Latin American Shadow Financial Regulatory Committee
Comité Latino Americano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financeiros

Statement No. 31

Enter the Dragon: Risks from China to Latin America

A continuing objective of the Committee is to monitor and assess risks to Latin America stemming from changes in the global economic scenario. In its previous statement, the Committee discussed the implications for the region of a tapering of bond purchases by the US Federal Reserve. In this statement, the Committee discusses the implications of a major slowdown in China's economic growth, a factor that may worsen the external environment for the region.

I. China's Changing Growth Prospects

Since the outbreak of the 2007/2008 global financial crisis, China's economic growth has evolved from primarily export-led to increasingly investment-driven. As a result, China's investment has risen to about 50 percent of GDP.

Notwithstanding its high investment rate, there are a number of compelling reasons why China may be facing a significant slowdown in growth. Firstly, the quality of investment has been uneven, as it led to overcapacity in the real estate sector and a surge in spending by local governments in ambitious, but low-productivity infrastructure projects. In turn, the declining quality of projects, coupled with significant indebtedness in the corporate sector and in local governments, is likely to lead to lower investment ratios and reduced growth prospects.

Secondly, the rapid increase in China's investment has been associated with an equally rapid increase in domestic credit. Total social financing increased from just above 120 percent of GDP in 2008 to over 200 percent of GDP in 2014.[1] While a significant portion of the expansion of credit has taken place through the regulated banking system, increasingly credit has been channeled through trusts and other non-regulated vehicles normally referred to as "shadow

[1] Total social financing (TSF) is defined by the People's Bank of China as an economic barometer that sums up total funding by Chinese non-state entities, including individuals and non-financial corporates, such as corporate bonds, bank and trust loans, and bank acceptance bills.

banking". Assets in the shadow banking system are currently estimated at 30 percent of the traditional banking system's assets. The combination of a rapid credit boom and low-productivity investment has raised the fragility of the financial sector in China.

On the liability side, the presence of ceilings on interest rates at banks has stimulated the expansion of unregulated financial institutions. In an attempt to foster competition in the financial sector and reduce the growth of shadow banking, Chinese authorities are considering removing such ceilings on deposit interest rates; lending rates were liberalized in 2013. However, an increase in financing costs may result in a further deterioration of the financial sector's balance sheet.

The Committee believes that current financial fragilities could result in a rapid contraction in new lending, contributing to the slowdown in China's GDP growth. The contraction in credit may be occurring at a time when Chinese authorities are tightening regulations in an attempt to contain the expansion of shadow banking. Furthermore, if the resolution of the financial fragilities extends over time, the above lower-growth scenario may also become persistent.

II. Channels of Transmission to Latin America

A scenario in which China's economic growth slows down significantly has important implications for Latin America. The Committee has identified the following main channels of transmission to the region, although the relative importance of these channels varies significantly across countries:

a) Commodity Prices

Historically South America has been a net exporter of primary commodities. In 2012, for instance, the sum of agricultural, fuel and mineral exports represented 97, 84, 78, 64, and 62 percent of total exports for Venezuela, Chile, Colombia, Argentina, and Brazil, respectively. With the exception of Brazil, the exports of the other countries are heavily concentrated in one or two commodities.

China's imports of primary commodities surged during the last decade exerting significant upward pressures on international commodity prices. For most countries this implied improved terms of trade. Since the 2000 lows to their 2012 peak, terms of trade increased, for example, by 82 percent in Chile, 63 percent in Peru and 51percent in Colombia.

The favorable international environment that commodity exporters enjoyed during this period was an important contributor to their rapid growth. **Since mid-2011 most**

commodity prices have softened and the Committee believes that a marked slowdown in China may exacerbate this trend.

The extent of the adverse shock derived from China's slowdown will differ among countries depending on a number of factors such as the degree of openness and dependence on external trade, the composition of exports, and sensitivity of commodity prices to changes in Chinese growth.

Whatever the specific result is in each case, the slowdown and rebalancing in China will entail fiscal challenges for Latin America, in some cases substantive. First, governments that are reliant on revenues from commodities may need to adjust in order to maintain fiscal sustainability. Second, authorities will have to contend with pressures to subsidize the affected commodity-producing sectors. Third, governments will need to reassess their contingent liabilities associated with the outstanding debt of commodity producers.

The high volume of capital inflows to the region and foreign direct investment until 2013 was a consequence of both the commodity boom and high global liquidity and, from 2008 onwards, low growth prospects in industrialized countries. A further weakening of terms of trade may, by itself, lead to a reduction or reversal of capital inflows and increased borrowing costs.

b) Reassessment of Risk in Emerging Markets

For emerging markets outside of Eastern Europe, the decade 2004-2013 was relatively crisis free. On the whole, notwithstanding the sharp interruption associated with the subprime crisis and its global spillovers during 2008-2009, emerging markets as an asset class were revalued for their comparatively strong fundamentals, notably vìs-a-vìs the debt-laden advanced economies. This period of comparative prosperity, rising sovereign credit ratings and substantial capital inflows was a contrast to the turbulence of the preceding decade, which saw the Mexican peso crisis of 1994-1995 and its spillovers, the widespread Asian crisis of 1997-1998, the Russian and Long Term Capital Management (LTCM) crises of the fall of 1998, and the Argentine default and contagion to Uruguay during 2001-2003.

External factors, notably low and declining interest rates in the United States and other advanced economies, high commodity prices, and robust growth in China had importantly favored emerging markets at a time during which credit ratings in the advanced economies (most markedly periphery Europe) were sliding, in some cases below investment grade.

By early 2013, following one of the most prolonged capital inflow bonanzas in history, signs of vulnerability had reemerged in a number of countries. The "Fragile Five" comprised of Brazil, India, Indonesia, South Africa and Turkey (among others) were manifesting an assortment of weakening fundamentals that included in varying degrees: the reappearance of current account deficits, domestic credit booms, currency overvaluation, and bubbly real estate prices. Growth had begun to slow and in some cases inflation had resurfaced as a concern. Complex domestic problems in Argentina and Venezuela made matters worse. In that environment, in May 2013 came the announcement of QE tapering that marked the first significant post-bonanza reassessment of risk for the emerging market class. The trend toward convergence in credit ratings between advanced and emerging markets has, at least for the time being, came to a halt.

Despite some abatement of concerns about an imminent tightening in US monetary policy, other shifts in external factors have emerged to pose risks for emerging markets in general, and commodity producers in particular. **The Committee believes that a slowdown in China and signs of stabilization in periphery Europe (which was buffeted by massive capital outflows and loss of capital market access through 2013) has begun to adversely tilt financial markets assessment of the risks in emerging markets.**

In the past, as in the period following the Asian crisis, this reduced appetite for emerging market assets was associated with a marked slowing in capital inflows, and in some cases a sudden stop, with its deleterious consequences for growth. **The Committee believes that these conditions place emerging markets in a vulnerable position which, as past episodes teach, could spawn contagion.** Hence, a crisis in one major emerging market could quickly spread to the whole asset class. Moreover, as the 1998 crisis shows, contagion could be exacerbated if developed capital market participants suffer a liquidity crunch following an EM crisis. Recent evidence shows that foreign investors have in recent years increased their exposure in China in a significant manner, a fact that could raise the risks of “fast and furious” contagion.

c) Foreign Direct Investment

In recent years, Chinese foreign direct investment has grown substantially and has provided an additional boost to growth in the region. Investment has been directed mainly at Argentina, Brazil, and Peru and, to a lesser extent, to Ecuador and Mexico. Investments have been concentrated mainly on agriculture, energy and mining and, to a lesser extent, on telecommunications, automotive, and railroads. More recently, Chinese investments have also started in the banking sector through the purchase by ICBC and CCBC of medium-sized banks in Argentina and Brazil.

In an environment of uncertain Chinese growth prospects it is less clear if foreign direct investment from China to Latin America will remain strong. A possible scenario is that a slowdown of domestic investment in China may lead to an increase in its current account. In that case, China's foreign direct investment to the region in strategic sectors may increase. This is especially so if further investment in agriculture, mining, and energy may become relatively more attractive in a context of lower commodity prices.

Alternatively, the decline in investment could be more generalized affecting both domestic and foreign investment. In this scenario, the international transmission of the slowdown of China is likely to add a recessionary pressure on the global economy.

d) Emerging Financial Links via Chinese Banks

As mentioned above, Chinese banks have recently begun entering financial markets in Latin America. So far, the size of the investments has been relatively small but it is expected that their presence in the region will expand in the future. The presence of Chinese banks is likely to be a positive development for the region in terms of their role in providing trade finance, thus supporting the growth of trade flows between Latin America and China.

In addition, the presence of Chinese banks in the region may reflect a strategy on the part of China to increase financing to the growing role of Chinese companies while hedging exchange and political risk.

However, Latin American regulators should be increasingly aware of the potential spillover of financial fragilities in China. In the recent crisis, some international banks have used their branches and subsidiaries in the region to channel funds to their headquarters in order to mitigate the effects of the credit crunch suffered in the advanced economies. A similar situation may arise in this context as well, although the current presence of Chinese banks is still very limited in size. The lack of convertibility of the renmimbi limits significantly the importance of this channel.

Financial links between China and Latin America have also increased recently at the official level. In September 2013, it has been agreed to set up a USD 100 billion BRICS Liquidity Fund by 2015. China's contribution to the fund is expected to be USD 41 billion, compared to Brazil's, India's, and Russia's contribution of USD 18 billion, and South Africa's contribution of USD 5 billion. Also, central banks of Argentina and Brazil have set up swap agreements in domestic currency with the People's Bank of China. The main aim of these agreements is to complement the role of other multilaterals in improving access to external funding in systemic episodes of turbulence in international capital markets, and to reduce the potential of disruptions in trade finance. Although still largely untested, these initiatives may eventually play a beneficial role in reducing the vulnerability of the region to external shocks.

III. Policy Recommendations

In order to help countries adopt precautionary policies and international financial institutions (IFIs) to be prepared to provide adequate support in case of need, **the Committee recommends following a two-step approach to quantify spillover risks identified above. Over the short term, countries should perform and release, in a credible and transparent way, a series of stress tests of financial, fiscal, and external vulnerabilities stemming from decline in commodity prices and financial disruptions, caused by different combinations of a potential China's significant slowdown and a global liquidity tightening.**

Over the medium term, **the Committee recommends these stress tests to be performed in a coordinated way, with a common framework, and with the support of global and regional IFI's, in particular the International Monetary Fund (IMF).** Results should be released following strict transparency standards.

The Committee believes that, in light of the risks discussed, the IMF should strengthen its efforts to be able to act as an international lender of last resort. The time to meet the call for recapitalizing the IMF is now, when the risks assessed in this and previous CLAAF statements have not yet fully materialized. This recapitalization is essential to make credible the automatic recourse to emergency financing facilities by eligible members, without compromising the IMF's capacity to fully utilize its other facilities.

As long as the IMF does not become a full international lender of last resort, **the Committee believes that it is critical for countries to build or maintain adequate external liquidity cushions, commensurate with these risks.** A regional institution such as the Fondo Latinoamericano de Reservas (FLAR) could play an important complementary role in strengthening the region's liquidity.

In order to have enough policy space to respond to a deterioration of external conditions and to facilitate the smooth absorption of potential shocks countries need to have strong fiscal and monetary policies, and to allow for exchange rate flexibility. It is reassuring that some of the countries in the region with higher exposure to a significant China slowdown are precisely those that are better prepared to handle it (such as Chile and Peru).

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