

Economics Group

Special Commentary

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Is China a Financial Risk to the Global Economy?

Executive Summary

China's importance in the global economy has clearly risen significantly over the past few decades. As it has grown from an emerging economy of modest size to the world's second largest economy, China has become one of the most dominant players in global trade flows. Although the country's financial interactions with the rest of the world have also grown meaningfully, China does not have the same heft in the global financial system as it does in the global economic system. China is fairly open in terms of trade flows, but its use of capital controls has restrained its financial integration with the rest of the world.

Because foreigners have limited amounts of direct financial exposure to China, a financial meltdown, should one occur, would likely not be as consequential for the global economy as the financial crisis that emanated in the United States beginning in 2007. But the indirect effects would not be inconsequential. A financial meltdown in China would probably cause a painful economic downturn in that country, which would impart a significant shock to global growth via the exports that China takes in from the rest of the world.

How Much Financial Heft Does China Have in the Global Economy?

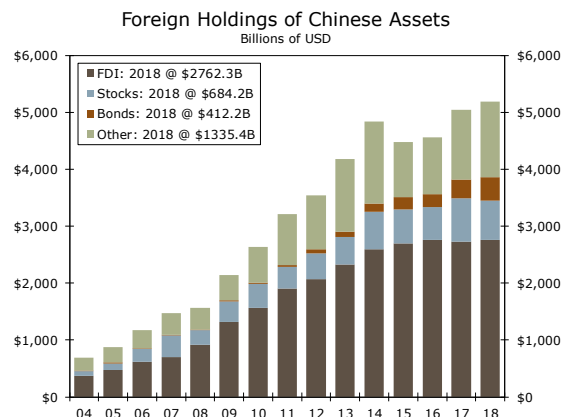
A few decades ago, when China was an emerging economy of only very modest size, it had very little economic and financial interaction with the rest of the world. In 1988, China took in less than 2% of the world's exports and only 2% of the world's imports were supplied by China (Figure 1). Thirty years later, China's absorption of the rest of the world's exports has grown to 10% and it supplies around 14% of the goods that the rest of the world imports. In other words, China has become a significant player in global trade flows in a relatively short period of time.

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Figure 1



Figure 2



Source: IHS Markit, CEIC and Wells Fargo Securities



Holdings of Chinese assets by foreigners account for only 3% of total cross-border financial exposure.

China also has become a more important player in the global financial system. Foreign holdings of Chinese assets have grown from less than \$700 billion in 2004 (earliest available data) to more than \$5 trillion in 2018 (Figure 2). Foreign direct investment (FDI) accounts for nearly \$2.8 trillion of the current total, but foreigners’ portfolio investment holdings include \$700 billion of Chinese equities and more than \$400 billion of Chinese bonds. On the other side of the ledger, China’s ownership of foreign assets has mushroomed as well. Chinese holdings of foreign assets shot up from less than \$1 trillion in 2004 to more than \$7 trillion last year.

The Chinese economy has decelerated markedly in recent years, however, and some observers fret that an economic “hard landing” in China, should one occur, could have a very damaging effect on the global economy. Slower economic growth in China has contributed to the marked downshift in global trade in recent years, and a downturn in the world’s second largest economy would cause growth in many other economies to slow even more. Furthermore, a Chinese recession could potentially impart an additional negative shock on the global economy *via* China’s financial linkages with the rest of the world. An economic downturn in China likely would cause prices of Chinese assets to plunge, which could lead to significant financial losses for foreign investors with meaningful amounts of financial exposure to the country. Additionally, Chinese investors may need to sell their foreign assets, which could lead to additional weakness in the prices of those assets, if an economic downturn in China were severe enough.

The amount of Chinese assets that foreigners own (more than \$5 trillion) is a large number, but it needs to be put into perspective. As shown in Figure 3, foreigners own \$35 trillion worth of American assets, and foreigners have more exposure to the assets of the United Kingdom, Luxembourg, the Netherlands, France, Germany, Ireland and Japan than they do to China.¹ According to IMF data, worldwide holdings of foreign assets total more than \$150 trillion, which means that holdings of Chinese assets by foreigners account for only 3% of total cross-border financial exposure.

Figure 3

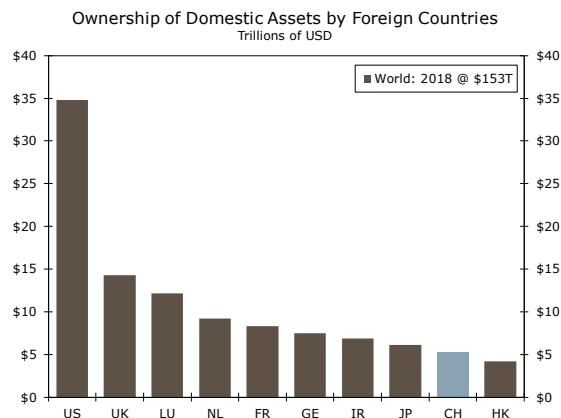
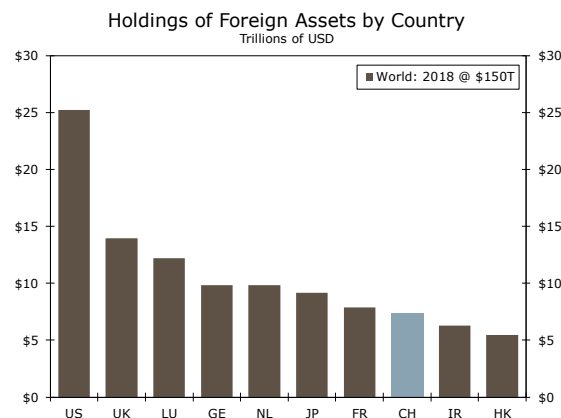


Figure 4



Source: International Monetary Fund and Wells Fargo Securities

China’s economic heft is significantly greater than its global financial heft.

Similarly, China is a relatively small player in terms of its ownership of foreign assets. As noted above, China holds roughly \$7 trillion worth of foreign assets. But Americans own more than \$25 trillion worth of foreign assets, and there are six other countries with more foreign financial exposure than China (Figure 4). In short, China’s economic heft, *via* its effect on global trade flows, is significantly greater than its global financial heft.

That said, China could still prove to be potentially problematic to the global financial system if its economy were to experience a “hard landing.” In the remainder of this report, we will take a closer

¹ As we noted in a recent [report](#), favorable tax treatment induces many institutions to domicile in Luxembourg, the Netherlands and Ireland, which inflates the size of the financial sectors of those otherwise relatively small economies.

look at different assets classes to ascertain potential vulnerabilities that foreigners may have due to their exposure to Chinese assets.

External Debt Appears to Be Manageable

As noted above, foreigners own about \$400 billion worth of Chinese bonds. But foreign exposure to Chinese debt includes more than this relatively small amount. That is, foreign banks also make loans to Chinese households, businesses and governments. Adding this loan exposure to the bond exposure shows that China’s external debt currently totals roughly \$2 trillion (Figure 5)². Three years ago, China’s external debt stood at \$1.3 trillion. The external debt of Chinese banks accounts for nearly one-half of the total, but the non-financial business sector (included in the “other” category in Figure 5) also has a meaningful amount of external debt. Would a Chinese default on some of this external debt have deleterious consequences for the global financial system?

In absolute terms, the total external debt of China is fairly sizeable, but again that figure needs to be put into perspective. First, China’s external debt of \$2 trillion pales in comparison to countries such as the United Kingdom (\$8 trillion), Germany and France (around \$6 trillion each), not to mention the United States (nearly \$20 trillion). Furthermore, China’s external debt-to-GDP ratio, which currently stands at 14%, is low relative to the comparable ratios of most other countries. Economies generally do not experience external debt difficulties until their external debt-to-GDP ratios are significantly higher. For example, Thailand and Indonesia each had ratios in excess of 50% when they experienced their financial crises in 1997.

China’s external debt pales in comparison to countries such as the U.K., Germany and France, not to mention the U.S.

Figure 5

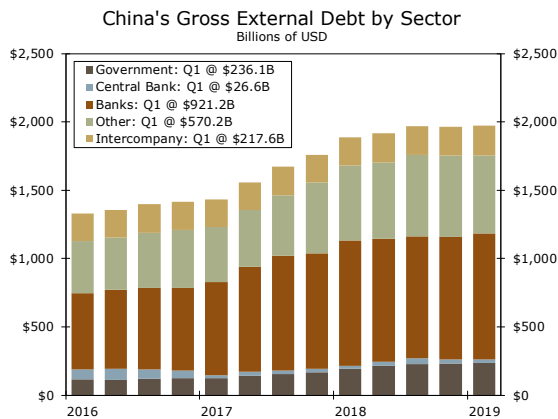
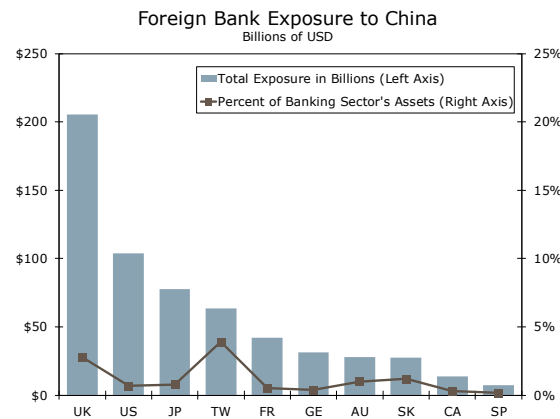


Figure 6



Source: CEIC, Bank for International Settlements, Bank of Japan and Wells Fargo Securities

Although readily available data do not allow us to determine which foreign countries have the most exposure to Chinese external debt, data from the Bank of International Settlements (BIS), which focus solely on exposure of foreign banks, are instructive.³ According to the BIS data, U.K. banks have the most absolute exposure to China, followed by banks in the United States, Japan, Taiwan and France (Figure 6). But these absolute amounts of exposure represent less than 3% of the financial assets of the U.K. banking system and less than 1% of financial assets of American banks. Among the banking systems shown in Figure 6, Taiwan has the highest amount of relative exposure to China but it still represents less than 4% of the financial assets of Taiwanese banks. In short, an

² External debt is defined as the debt that the household, business and government sectors owes to foreigners, regardless of currency denomination. In terms of Figure 2, external debt would include foreign holdings of Chinese bonds as well as part of the “other” category, where loans by foreign loans to Chinese households, businesses and the public sector would reside.

³ Foreign banks hold about 40% of China’s external debt. Other financial institutions such as insurance companies and pension funds would also hold significant amounts of Chinese debt, but data detailing a country-by-country breakdown of those institutions are not readily available.

Most foreign investors would not be materially affected by a significant drop in the Chinese stock market.

external debt crisis in China, should one occur, probably would not have systemic implications for the global financial system.

Limited Exposure of Foreign Investors to Chinese Stocks

As noted previously, foreigners owned roughly \$700 billion worth of Chinese equities last year. More up-to-date quarterly data reveal that this total had grown to \$825 billion at the end of Q1-2019. Could a slump in the Chinese stock market have significant implications for the net worth of foreign investors?

We do not have access to data on the equity holdings of investors on a comprehensive basis. However, selective data offer some clues. American households owned about \$150 billion worth of Chinese equity securities at the end of last year, but this amount represented less than 1% of the stocks and mutual funds that American households held in Q4-2018. U.K. investors own \$50 billion worth of Chinese equities, which is less than 4% of their total equity holdings. In Japan and Germany, Chinese equity investment constitutes less than 1% of both country's household equity holdings. To put these ratios into perspective, consider that U.S. stocks account for about 10% and more than 20% respectively of the equity holdings of German and Japanese investors. In short, it seems likely that most foreign investors would not be materially affected by a significant drop in the Chinese stock market, should one occur.

Manageable FDI Exposures of Western Economies

As noted above, FDI in China totals roughly \$2.8 trillion. Perhaps unsurprisingly, about 45% of this FDI originates from Hong Kong, making it easily the most exposed jurisdiction. In comparison, the value of American FDI in China totaled \$116 billion at the end of last year, a mere 2% of the \$5.95 trillion that American companies have invested abroad. This more limited FDI exposure is encouraging from a macro risk standpoint, since FDI is often more difficult to liquidate than portfolio investment, such as stocks and bonds. What about FDI exposure to China in other major economies outside of Asia? German FDI in China was \$88 billion at the end of 2017, about 5.5% of total outward FDI. In Italy and France, FDI into China as a share of total FDI is even smaller, at less than 2% each.

FDI exposure to China is unsurprisingly a bit bigger in other Asian countries, but here too the investment linkages appear weaker than the trade ties. The value of Japanese FDI in China was \$117 billion at the end of-2017, roughly in-line with the absolute level of U.S. investment. Since total Japanese FDI is only about \$1.5 trillion, however, the Chinese share is about 8%. South Korea is among the countries with the most relative FDI exposure to China, as 23% of outward FDI is in mainland China. Singapore is a bit below that, with about 17% of its FDI located in China.

FDI in China is only about 7% of the \$40 trillion of FDI in the world.

All told, the \$2.8 trillion of FDI in China is only about 7% of the roughly \$40 trillion of FDI in the world. Admittedly, FDI data can be a bit more opaque than portfolio investment data that track the flow of stocks and bonds across borders. For example, the United States reports an additional \$81 billion of FDI in Hong Kong, some of which may ultimately flow to mainland China via U.S. subsidiaries. Additionally, the United States reports \$331 billion of FDI in the Cayman Islands, and some of this money may ultimately end up elsewhere, such as China. That said, even though these numbers sound big, they must be kept within the context of the \$6 trillion in FDI the United States has abroad.

Conclusion

China has become a major force in global trade flows over the past few decades, and it also has become more important in the global financial system over that period. That said, foreign financial exposure to China appears to be generally manageable today. Although the external debt of China totals nearly \$2 trillion, that amount is widely distributed and most major foreign economies do not appear to have undue amounts of exposure to Chinese debt. Chinese stocks account for less than 1% of American equity holdings, and investors in other major economies also have limited exposure to Chinese equities. Although FDI in China totals nearly \$3 trillion, the absolute amount of exposure of any individual major foreign economy appears to be rather low. The limited exposure

of foreign economies to Chinese assets can be explained by the capital controls that have historically dominated the Chinese financial system.

In our view, a financial crisis in China, should one occur, would not be as significant for the global economy as the financial crisis that emanated in the United States beginning in 2007. That said, it probably would not be inconsequential either. Although the direct financial effects on other countries probably would be limited, there could be more meaningful indirect effects. That is, a financial meltdown in China would probably cause a painful economic downturn in that country, which would impart a significant shock to global growth via the exports that China takes in from the rest of the world.

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