

China's Economy and the Subprime Crisis

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Q1: China has been a major creditor of the United States—what impact does the subprime crisis or a broader U.S. recession have on China?

A1: Chinese banks are significantly less transparent in reporting their holdings than many international counterparts. It came as a surprise to many when on January 21 the Bank of China announced holdings of some \$8 billion of subprime loans, of which it planned to write down 25 percent. Other Chinese banks are in the process of writing down their holdings, which may be less in aggregate but will still be significant. These are significant losses that the banks can almost certainly tolerate but which point out an overall lack of transparency and accountability in the Chinese financial system, which should worry both international investors and Chinese regulators.

More fundamentally, the dramatic drop in share prices in Chinese and other Asian markets in response to that in the U.S. markets suggests that the Chinese economy is not as “decoupled” from the U.S. economy as some economists have argued. In recent years, as Europe has passed the United States as China’s largest export market and Latin America has increased in importance as a market for China, a number of experts have suggested a softening of the U.S. economy will not have a dramatic impact on China. Judging at least by investor sentiment to date, the prevailing view in China is that China is heavily reliant on continued U.S. economic strength.

Even if China overcomes its exposure to U.S. subprime assets, it is unlikely to emerge unscathed from a U.S. recession. Politically, that could translate into broader demands for protectionism and economic nationalism in China, which could further challenge U.S.-China economic engagement.

Q2: Would a U.S. recession drive China to either diversify away from U.S. Treasury holdings or begin dumping those holdings?

A2: China has already begun to look for alternatives to U.S. dollar holdings, but other instruments are still not as attractive. China’s main interest is in bolstering the value of its U.S. holdings, rather than dumping them or otherwise sending further shocks through the global financial system. It continues to look for higher rates of return in the United States and elsewhere than those available through traditional foreign exchange reserve practices. That is one reason that China transferred some \$200 billion in reserves into a sovereign wealth fund late last year. Certainly, a U.S. recession creates a fair degree of alarm for those in China who are large creditors of the United States. On the other hand, it is clear that a slowed U.S. economy will also open up some new investment opportunities in the United States for assets that will begin to look like good values.

Q3: How has the subprime crisis affected China’s efforts to liberalize its financial services market, if at all?

A3: China’s plans to reform its financial services market—to allow more relaxed capital controls, offer greater market access to foreign financial services firms, and otherwise allow new financial products and services into its domestic economy—have proceeded with great caution. A primary consideration in any new economic reform is to ensure that the rewards far outweigh the risks. For a government that is primarily concerned with protecting against domestic instability, allowing for any new “opening” or “relaxation” of its domestic financial markets, which might destabilize its domestic economy, is a nonstarter.

The subprime crisis suggests to many in China that the United States, with all its transparency and sophisticated regulatory mechanisms, still can’t adequately account for and manage risks. As a result, calls from the U.S. Treasury for faster reform and opening-up are likely to fall on deaf ears for the time being. Absent evidence that the current risks in the Chinese financial system are greater *without* reform, Chinese policymakers are more likely to choose the apparently stable present state of affairs over the potentially unstable future.

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