BACK TO BUSINESS

COMMENT

How liquidity evaporates from the mainland system

Beijing is unlikely to pump water to fill its tanks amid uncontrolled infrastructure spending

Richard Harris

Bill Phillips was a New Zealand engineer who in 1949 accidentally became an economist by being the first to model how cash flows around the economy using water, pumps, valves, tanks and connecting pipes.

Professor Phillips (better known for the Phillips Curve relating wages to unemployment) modelled liquidity in flows representing spending, taxes, investment and exports. If he got it wrong, he either got his feet wet or the tanks ran dry.

Computers have made liquidity statistics accurate but no easier to understand. The recent release of the mainland's credit figures is a perfect example of how not to look at the exact figures, but the trends. Not only did the creation of new credit fall 19 per cent, but M2 money supply growth has shrunk to the lowest levels since records began. Total social financing, the widest measure of financing, dropped 9 per cent over the year. Phillips' model would be drying out.

In the past few months, real estate, trust lending, fixed-asset investment, export growth, factory managers' optimism and consumption have all been weak, if not significantly so. Combined with falling liquidity, it is no surprise that the latest annual gross domestic growth figure was reported at a low 7.4 per cent.

The rapid 20-year growth in exports had provided great domestic liquidity, much of which went into the property market. In the past decade, massive leverage by local governments, who were largely responsible for uncontrolled infrastructure building, resulted in an economy awash with debt.

The mainland is largely a closed economy with minimal leakage so the Phillips pipes had to become larger and the tanks bigger to take on this liquidity boom.

The difficulty of accurately calculating the mainland's liquidity results from the unknown size of the shadow banking system in which non-banks borrow, lend and invest like a real bank but at market rates and outside the official regulated system. This market is calculated variously as 70 per cent of the mainland's GDP, or 20 per cent of all credit.

> **We can see it in empty tower blocks, empty train platforms and obsolete power stations**

But in reality, no one knows – except that it is significant. This black market has developed to allow market-based funding of smaller enterprises and individuals. It appears strange to have such a tightly regulated banking environment on the mainland when you can game the system so readily.

Yet it is now very difficult for the government to crack down on something so embedded, even if it might pose a risk to the system. Deleveraging provides an unhealthy braking force to an economy. Deleveraging into inefficient spending does not help.

The old joke is that half of the four trillion yuan (HK$4.54 trillion) spent on infrastructure after the global financial crisis was wasted. We don't know which half, though we can see it in empty tower blocks, empty train platforms and obsolete power stations.

Efficiency and accurate reporting are the new mantra on the mainland but that wasted debt still has to be paid off.

On the mainland, Phillips' tanks are now very big and the water supply must grow to fill them. In addition, the water pressure in the pipes, the velocity of money, how fast it moves around the economy, is likely to weaken in a slowdown. So near-term recovery is only likely if the government injects liquidity such as the Federal Reserve has done in the United States, which the leadership has said it is not prepared to do. It would be refreshing to see politicians take the pain now to build for a better future.

The news flow from the mainland is unlikely to be good as the leadership corrects the liquidity mistakes of the past. The government's world-record US$4 trillion of foreign reserves could back local government borrowing, but this is not cash with which to pay off irresponsible debt accumulation.

Why should Beijing bail out a corrupt local mayor or a profligate provincial government without making them sweat first? So far in recent months, it has allowed bondholders, small companies and banking products to go bust to teach the stupid or unwary new lessons. These bad news stories will continue to hit the wires in situations where systemic risk is unlikely. Like capitalist America, there is a lot of "too big to fail", though hopefully in China not "too big to jail".

It took a Cambridge engineer, Allan McRobie, to rebuild Phillips' liquidity model about 60 years later – after the economists had failed. "Economics," he said, "is run by people who didn't understand it."

The mainland's leadership has said it is not prepared to inject liquidity to boost the economy in the short term. Photo: Shutterstock

Richard Harris is chief executive of Port Shelter Investment Management in Hong Kong