IMF warns that China’s financial system is “vulnerable”

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22 November 2011

A report issued by the International Monetary Fund (IMF) last week warned that China “confronts a steady build-up of financial sector vulnerabilities.” The “Financial System Stability Assessment” underscored mounting international concerns that China’s slowing growth and a potential slump in the property market could spark a crisis in the country’s financial system.

Significantly, the study was conducted in the second half of 2010, when the global economy was in better shape, especially in the euro zone. The IMF undertook the risk assessment of the Chinese banking system as the Beijing regime’s 2008-09 stimulus package—once thought to have shielded the Chinese and even the world economy from slump—became a major source of economic instability.

From late 2008, Beijing unleashed a flood of credit, worth trillions of dollars, in response to the global financial tsunami that initially wiped out more than 20 million jobs in China, mainly in export industries. Much of the credit binge was channelled into speculative real estate markets by local governments and developers, as well as industrial companies unable to profit from exports.

Local governments alone incurred $US1.7 trillion debt by the end of 2010 through financing various infrastructure and property projects, many of which turned out to be unprofitable and unable to make repayments. If the debt of state enterprises and government liabilities such as pensions are added, public debt levels exceed over 30 trillion yuan ($US4.7 trillion), well above 75 percent of China’s gross domestic product (GDP).

Rampant property speculation produced a shadowy underground lending market, involving extremely high interest rates, that threatens to trigger a wave of bankruptcies among small and medium enterprises. No manufacturing enterprise can generate annual returns of 30, 50 or 100 percent—the rates of private lenders.

The resulting high home prices has also caused rising social discontent, forcing the Chinese Communist Party (CCP) regime to restrict speculative activities, leading to a sharp downturn in the real estate market.

The first risk the IMF identified was the massive credit expansion of 33 percent in 2009, creating a “moderate to severe” problem of non-performing loans (NPL) for banks. “A sizeable decrease of loan collateral values—which in China predominantly takes the form of real estate—would amplify potential bank losses,” the IMF warned.

Another major risk was the inflow of foreign capital, and its potential reversal, that could adversely affect financial stability via real estate and share markets. The report stated: “High real estate-related bank lending exposures (20 percent of GDP), and indirect exposures via property collateral, make banks vulnerable to real estate booms and bust related to more volatile capital flows.”

While China has formal capital controls, the study said rapid growth in financial holding companies and industrial conglomerate-related financial institutions meant that any financial failures created “potential contagious risk across different sectors and markets.”

The IMF further warned that China was vulnerable to price upswings in international commodities, especially copper and iron ore. “Borrowing firms without sufficient pricing power would suffer from lower profit margins,” it noted, “resulting in a potential upsurge of NPL accumulation.”

Another risk was a contraction in the global economy. Given China’s high dependence on trade and foreign investment, a global recession could lead to “rising unemployment, with an increase of corporate NPLs and an adverse impact on banks’ solvency.” Moreover, the scope for further stimulus measures was “likely more limited in view of the already sizeable government-led fiscal and monetary stimulus during the past crisis."

The final medium-term risk cited by the IMF was a substantial decline in real estate prices. Although the paper denied there was a "nationwide bubble," a significant market correction could occur, which "would impair asset quality due to banks' exposures to mortgage and developer loans."

The IMF carried out stress tests on China's 17 largest banks—in cooperation with the Chinese central bank and banking regulators. The conclusion was that China's banks could withstand "isolated shocks" such as falling housing prices, but the banking system could face a "severe" impact if there were "a confluence of events" such as major falls in property prices and a sharp economic downturn.

The study insisted that the likelihood of such a scenario was "low to medium" in the next three years. In reality, China's integration into the world capitalist economy as a cheap labour platform means that no shocks are "isolated."

There are mounting signs that "a confluence of events" is emerging. This week, the London-based *Financial Times* reported that property transaction volumes fell "dangerously" by 39 percent year-on-year during October in China's 15 biggest cities. The drop, an early warning sign of impending price falls, exceeded the 30 percent plunge postulated for a bank "stress test" ordered by the China Banking Regulatory Commission in April. The newspaper noted: "The fear is that the impact of a bursting of the Chinese property bubble could yield a crisis just as dramatic as the one now unfolding in Europe."

In addition, export figures showed a dramatic slowing in October, especially in the country's manufacturing hub, Guangdong province. Acting provincial governor Zhou Xiaodan admitted on November 14 that exports were slowing as precipitously as during the final months of 2008. Last month's exports from Guangdong rose only 7.8 percent year-on-year, a significant decline from the previous month, primarily due to the deepening European debt turmoil.

In late October, thousands of small business owners and their employees rioted in Huzhou in eastern Zhejiang province over the doubling of a "sewing machine tax" that deepened the crisis caused by Beijing's credit squeeze. Hundreds of riot police were sent to quell the unrest in China's child-wear centre, where businesses have been forced to turn to private lenders and pay interest rates of up to 150 percent.

China's infrastructure stimulus package, led by railway expansion, is also beginning to wane. Due to debts of $US300 billion accumulated by the rail ministry, China Railway Tunnel Group told the state media last month that a shortage of funds had halted the construction of more than 10,000 kilometres of track nationwide, threatening the jobs of six million workers. Unpaid wages have already led to protests by workers.

In a speech delivered in Sydney on November 17, *Financial Times* editor Lionel Barber warned that the present level of fixed asset investment, which stands at more than 50 percent of Chinese GDP, was unsustainable. The most pronounced example was the railway ministry, whose debt had jumped 227 percent in the past five years, while revenue rose by a mere 62 percent.

Barber declared: "The result is an insolvency so pronounced that even those stalwarts of Chinese state capitalism—the 'big four' state banks—are starting to refuse to lend to the state-owned railway construction companies… Rail is not the only sector in which huge debts are threatening long-term sustainability. Many road toll expressways, which were energetically built in 2009-2010 as local governments answered Beijing's call to stimulate growth, are also generating insufficient cash to service their interest on the loans used to construct them."

The IMF paper confirms that by early 2011 China was rapidly reaching the limits of its debt-stimulated growth over the previous two years. Far from providing a new growth engine for the world economy, China was facing explosive economic and social contradictions, even before its major Western markets again plunged into deep crisis.