Credit crunch hits China

John Chan
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After the US Federal Reserve on Thursday indicated a possible end to quantitative easing, there was a major outflow of speculative "hot money" from Asia and other emerging economies. In China, a credit squeeze by the country's central bank turned into a credit crunch.

Since the beginning of June, Chinese banks and financial institutions have been wary of lending to each other, leading to sharp rises in inter-bank borrowing rates (Shibor). On Thursday, however, inter-bank lending virtually froze. Against market expectations, the Chinese People's Bank did not inject cash into the money market to ease an acute credit shortage.

The result was panic that pushed the seven-day rate up by 3.8 percentage points, to a record high of 12.06 percent, and the overnight rate more than doubled, from 5.98 percentage points to 13.85 percent. The benchmark seven-day rate was only 2.78 percent in May and in the range of 6 percent in early June.

The *New York Times* warned on Thursday that the situation in China resembled the credit crunch that followed the collapse of Lehmann Brothers in 2008. "In a worst-case scenario, absent intervention by policy makers, defaults at lenders with the most exposure and shakiest balance sheets could lead those institutions to fail," it stated. "The damage could spread to other banks, setting off runs on deposits by ordinary Chinese."

The Chinese central bank stepped in on Friday to inject $8.2 billion, which led to sharp falls of the inter-bank lending rates. The 7-day rate fell by 3.57 percentage points. However, as the *Financial Times* pointed out yesterday, while inter-bank lending resumed, "short-term lending rates remained roughly double their normal level—high enough to cause serious pain for over-leveraged financial institutions."

Beijing appears to be trying to curb the huge "shadow" banking system that has emerged in China in recent years. This unregulated sector emerged after the government initiated a huge stimulus program following the 2008–09 global financial crisis, which included a flood of cheap credit from state banks to prop up the economy.

When highly leveraged companies and property developers were unable to secure loans from major banks, they turned to the developing "shadow" banking system. Smaller banks and trust companies borrowed at low rates from state-owned commercial banks, then re-lent, at much higher interest rates, short-term loans to businesses in need.

Fitch Ratings warned this week that China's "shadow" banking system was rapidly getting out of control as borrowers were struggling to repay debts. Fitch's senior director in Beijing, Charlene Chu, warned that particularly worrisome was the $2 trillion in off-the-balance-sheet lending in the form of "wealth products", such as trusts and managed funds. These financial vehicles were created to evade regulation aimed at curbing property speculation.

Property speculation has mushroomed since the 2008 crisis, due to the lack of profit to be made from investing in productive activity. Much of the "shadow" lending has gone into vast "ghost towns"—empty apartment blocks and shopping malls across China—which most of the population cannot afford to buy or rent. The property is simply owned and hoarded by a small wealthy elite.

Chinese banks have deposited $3 trillion in the central bank, to be drawn on in a crisis. But, as Fitch noted, this sum is only a drop in the bucket, compared to lending in the past five years. China's overall credit has jumped from $9 trillion in 2008 to $23 trillion today, which, in Chu's words, has "replicated the entire US commercial banking system in five years."

China's credit to GDP ratio has skyrocketed from 75 percent to 200 percent—compared to about 40 percent in the US before the subprime crisis and in Japan before the collapse of the property and share market bubbles in 1990.

"This is beyond anything we have even seen before in a large economy," Chu warned. "We don't know how this will play out. The next six months will be crucial."

The extent of bad debt is not known. Local governments, which rushed to support the 2008 stimulus measures, had accumulated debts estimated at 12.08 trillion yuan ($1.97 trillion) in 2012. But in the past few years, none of the principal of the loans has been paid off. Moreover, there are reports that some local governments have borrowed tens of billions of dollars more since 2010 to repay the older debts.

According to Société Générale economist Wei Yao, the ratio of corporate debt servicing to GDP in China has reached 30 percent—a typical threshold for a financial crisis, as many corporations will be unable to repay interest or principal. "The debt snowball is getting bigger and bigger, without contributing to real activity," she said. It is estimated that Chinese companies will have to repay $1 trillion in interest alone this year, a far higher amount than in any other country.

China's credit crisis is rooted in the fact that it is a cheap labour platform heavily dependent on exports which have been hard hit by the economic slump in major markets in North America, Europe and Japan.

On Thursday, the latest data showed that factory activity has dipped to a nine-month low in June. The British HSBC's preliminary purchasing managers' index (PMI) fell to 48.3 for the month, worse than the final reading of 49.2 for May. A figure below 50 indicates a contraction.

Exports have fallen sharply. According to Chinese customs, exports grew by just 1 percent in June—down from an increase of 13.5 percent in the first five months of the year. A commerce ministry survey of more than 1,000 enterprises revealed that their average profit margins on exports were less than 3 percent, with 26.8 percent recording losses on exports.

To boost profits, international finance capital is demanding that Beijing carry out a major restructuring of industry, involving speedups, layoffs, the shut down of plants and the consolidation of industrial sectors. To that end, the central bank has been tightening money supply since February.

The new Chinese leadership appears to have made finance sector "reform" a priority in its drive to accelerate pro-market restructuring and open up the remaining sectors of the economy to private investors.

Premier Li Keqiang was reported on Wednesday as saying: "While the economy faces many difficulties and challenges, we must promote financial reform in an orderly way to better serve economic restructuring." The following day, the central bank took no action to avert the credit crunch that hit the country's finance sector.

The financial instability and economic slowdown in China is another indication that the global economic breakdown beginning in 2008, far from being over, is accelerating. Many countries, especially in the Asia Pacific region, that have been highly dependent on exports to China were heavily impacted both by the Fed announcement and the credit crunch in China. Far from being the engine that pulls the world economy out of slump, China could well be the next trigger for renewed global economic chaos.