# Tighter Chinese credit policy threatens financial instability

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China's State Council announced a series of policies last Friday aimed at reducing the country's vast credit bubble created by the stimulus measures introduced in the midst of the 2008-09 global financial crisis. A credit crunch, however, threatens to trigger a wave of bankruptcies and destabilise the banking and financial system, which is burdened with high levels of bad debt.

Although the State Council statement insisted the state-owned banking system would keep the credit supply at a "reasonable level", it is widely understood in financial circles that the new policy will end the massive injections of credit seen in the past four years. The guidelines indicated support for advanced manufacturing and promising new industries, rather than traditional sectors such as steel and shipbuilding that have huge overcapacities. This will inevitably lead to widespread restructuring, factory closures and mass lay-offs.

The Chinese Communist Party (CCP) regime faces a monumental dilemma. Credit ballooned to 200 percent of gross domestic product (GDP) in 2012, or $23 trillion, up from 75 percent of GDP before the global financial crisis in 2008. Local governments, as well as the corporate sector, have stacked up massive debts, which, if uncontrolled, will lead to a financial meltdown.

However, the very measures undertaken by China's central bank to reduce credit last month produced a credit crunch that pushed short-term inter-bank lending rates to record highs (see: "Credit crunch hits China"). The central bank was forced to intervene in the market to prevent the banking system grinding to a halt.

Nevertheless, the new policy announced last Friday will significantly restrict credit. According to a survey of economists by US *Bloomberg News* this week, the cash supply this year will be reduced by $122 billion—a sum equivalent to the size of Vietnamese economy.

Some economists have expressed concerns about the impact on the already slowing Chinese economy. Louis Kuijs, chief China economist at Royal Bank of Scotland Group, told *Bloomberg* that "the liquidity crunch has increased downside risks". He warned that heavily indebted local governments and small enterprises "are going to be the hardest hit by a clampdown on financial activity".

Estimates of local government debt range from 15 to 36 percent of the GDP. Much of the credit was used to finance unprofitable infrastructure projects or to speculate in the property market, Vice Finance Minister Zhu Guangyao said last Friday that Beijing has not released new figures since a 2010 audit put local government debt at 10.7 trillion yuan ($1.74 trillion). However, he acknowledged: "I think this number will rise."

Beijing is particularly concerned about so-called "wealth products" issued by commercial banks, estimated at around $2 trillion, mainly in property speculation. Along with these risky financial assets, a vast "shadow banking" market has also developed. Smaller banks and financial institutions take out loans from major state banks and re-lend to companies and property developers unable to borrow through regular channels.

Last week's State Council statement called on banks to isolate "wealth products" from other types of assets, in the hope of preventing any crisis in this sector spreading to the entire banking system.

The explosion of speculation and risky investments in China over the past four years is connected to a sharp downturn in its export markets in the US and Europe. In 2008, Beijing announced a 4 trillion yuan stimulus package in the hope that the developed economies

would recover quickly. But that did not happen.

With the US and Europe going deeper into slump, net exports have not contributed to China's GDP growth since 2008. The latest export figures show a 3.1 percent decline in June from a year earlier, well below the expected rise of 4 percent. Exports to the US fell sharply, by 5.4 percent, and to the EU by 8.3 percent. China's overall foreign trade growth has plunged from 13.5 percent in the first quarter year on year, to 4.3 percent in the second quarter. In May, it was just 0.3 percent, followed by a 2 percent fall in June.

China's economic expansion has overwhelmingly depended on fixed capital investment, which rose from the already high figure of 42 percent of GDP in 2007 to 48 percent in 2010. With little profit to be made in production, increased capital spending did not go into manufacturing and related infrastructure, but mainly into real estate speculation.

The *Financial Times* reported last month on the huge overcapacities across Chinese industries, all of which heavily depend on government subsidies. The article cited a study by US academics Usha Haley and George Haley, who found that steel, glass, paper and auto parts are actually highly fragmented industries, the "vast majority of companies enjoyed no economies of scope or scale." They explained: "There is enormous overcapacity and no gauging of supply and demand and we found that subsidies account for about 30 percent of the industrial output. Most of the companies we looked at would probably be bankrupt without subsidies."

The State Council statement came just as China's largest private shipbuilding company, Rongsheng Heavy Industries Group, appealed to the government and large shareholders for a rescue package. Despite receiving state subsidies since 2010, Rongsheng has suffered from the global shipping downturn. New orders for Chinese shipbuilders halved in 2012. Rongsheng's orders were $US55.6 million—well short of its target of $1.8 billion—and it now has debts of $4.1 billion.

The *Wall Street Journal* reported that this flagship company cut 8,000 jobs recently. Last week, 2,000 workers at its Nantong shipyard in Jiangsu province protested over unpaid wages and clashed with police. This situation is a harbinger of the social and political upheavals that will be triggered by a wave of job losses, potentially in the millions.

The new CCP leadership under President Xi Jinping and Premier Li Keqiang is exploiting the credit crisis as the means for enforcing pro-market restructuring. State bank credit will be replaced, according to the State Council, by encouraging private capital to set up financial institutions, including banks, financing leasing companies and consumer financing companies. The aim of promoting market-driven credit is to boost "productivity"—that is, to intensify the exploitation of the working class through speedups, layoffs and consolidation.

Just two days before the State Council released its guidelines, it approved the establishment of a new free trade zone in Shanghai as a testing ground for new financial and monetary policies. This includes convertibility of the now highly regulated Chinese yuan with international currencies and liberalising tightly controlled capital accounts, with the aim of establishing Shanghai as a competitive global financial centre.