IMF warns of growing risks to China's financial system

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The International Monetary Fund's (IMF) annual report on China, published last week, warns that the world's second largest economy faces serious financial risks.

The IMF pointed to the widely-cited fears over China's total loan issuance, which has jumped from 129 percent of its gross domestic product (GDP) to 195 percent since 2008. This was a result of Beijing's desperate response to the initial shock from the Wall Street crash that year. After 23 million Chinese workers lost their jobs, threatening an explosion of social protests, Beijing passed a massive stimulus package of 4 trillion yuan ($US650 billion today).

The stimulus package soon turned into rampant lending from the state-owned banking system. However, the majority of credit was not channelled into production, because China's major export markets in the US and Europe were mired in slump; instead, it went into speculative real estate development. In 2010, the estimated total real estate values of Beijing surpassed the GDP of America—reminiscent of the kind of property bubbles leading to Japan's crash in early 1990s, which was followed by two decades of stagnation.

In that context, the IMF warned, "As of now, the authorities still have sufficient tools and fiscal space to address potential shocks. However, failure to change course and accelerate reform would increase the risk of an accident or shock that could trigger an adverse feedback loop."

The "adverse feedback loop" refers to a prospect in which the financial system and the productive economy take each other down in a mutually reinforcing spiral.

The IMF pointed particularly to the dubious $2 trillion "wealth products" that have mushroomed in recent years, which offer high returns but do not disclose their income sources. In fact, most of these products are speculative schemes in the property markets. They are now effectively a disguised second balance sheet of the banks, which "could over time evolve into a systemic threat to financial stability". The IMF warns that a sudden loss of confidence could "trigger a run" and lead to "severe credit crunch".

Taking into account the liabilities of local government financing vehicles and other debts, actual government debt reached 45 percent of the GDP last year. Although the levels are still relatively low compared to various debt-stricken European countries, slowing economic growth in China means less tax revenues for the government than a few years ago. The IMF predicts the Chinese economy to grow just 7.75 percent this year, to be followed by 7.7 percent in 2014— well below the traditional benchmark of 8 percent that has been regarded by the Chinese regime as necessary to keep unemployment under control.

The real danger, the IMF writes, is a major crisis due to China's structural dependency on exports and investment: "Progress with rebalancing has been limited and is becoming increasingly urgent. A decisive shift toward a more consumer-based economy has yet to occur."

With investment still accounting for 48 percent of GDP (the highest in the world) and consumption only 35 percent (among the lowest), China remains a giant cheap labour platform dependent on exporting to Western markets via transnational corporations' supply chains. On the other hand, the previous driving force of expansion—the relocation of rural labourers into urban areas—is coming to end. The current "reserve army of labour" of 160 million will cease to exist by the end of this decade.

IMF and Chinese officials often talk about the need to “rebalance” China’s economy toward a “consumption-based” profile. The Chinese Communist Party (CCP) bureaucracy promised at its latest national congress last November that a new round of pro-market reform will result in doubling the per capita income in 2020 from 2010.

The idea of creating a flourishing consumption-based economy in China under capitalism is a pipe dream. Chinese workers receive poverty wages, which are themselves under pressure from competition from other cheap-labour platforms, such as Vietnam and India.

To the extent that consumption in China has grown, it was only in a small layer of the upper middle classes, corrupt officials and business people, propelling the country to become one of the largest luxury goods markets in recent years. Their growing wealth, derived while the vast majority of urban workers and rural poor remain mired in poverty, has not sufficed to create a domestic consumer market to absorb China’s industrial output.

The real agenda of the IMF and the CCP is not to lift the Chinese masses’ living standards, but to boost productivity and open up the rest of the state-dominated sectors to private capital. This can only cause massive job cuts, speedups, and cutting of already rock-bottom wages.

Since coming to power last November, the CCP leadership under President Xi Jinping and Premier Li Keqiang has moved steadily to carry out this agenda, initially outlined in a joint report with the World Bank, “China 2030” last year. However, moves to fully integrate China’s financial system to the global financial centres, take place in a highly risky international environment, which could rapidly produce unpredictable shocks.

In June, amid capital outflow from Asia following the comments by the US Federal Reserve Board that it is ending the policy of “quantitative easing”, the news triggered a credit crunch in China, sending inter-bank lending rates up to a record high. The Chinese central bank, which initially sought to scale back its intervention to reduce the lending frenzy, had to inject billions of dollars again to ease the crisis.

According to IMF calculations reported on Monday, rapid lifting of capital controls could produce net capital outflows from China on the order of $1.35 trillion, or 15 percent of GDP. This could amount to a major meltdown similar to the Asian financial crisis in 1997-98. The outflow of capital could occur very rapidly either as a panicking response to unrest of Chinese workers or a military confrontation between China and the US or its allies.

Last Friday, in another move towards financial reforms, the People’s Bank of China declared it would scrap a floor on Chinese commercial interest rates. The move was supposedly designed to enhance market competition, making cheap loans more accessible to small and medium-sized private enterprises. However, the central bank did not remove a widely expected cap on interest rates on deposits, due to fears of causing financial instability. Interest rates liberalisation has long been regarded as essential to make Chinese yuan internationally convertible.

A study released on Monday by Shanghai-based research firm ChinaScope Financial, which is partly owned by international credit rating agency, Moody’s Corp, warned that the end of lending rate floor could lead to decline in net interest rate income, forcing Chinese banks to raise up to $100 billion in the next two years to maintain their current capital base. However, according to the *Wall Street Journal*, “in a sign of investors’ belief that more stress is ahead for Chinese banks, many hedge funds and other alternative funds are sticking to heavy bets against Chinese banks listed in Hong Kong.”

Investors are reportedly concerned over China’s weakening economic growth, huge industrial overcapacity and the banks’ general exposures to risky borrowers like real estate developers.