Concerns mount over Chinese growth and financial stability

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Is the Chinese financial system about to experience a "Lehman moment"—the equivalent of the US investment bank failure that set off the global financial crisis in 2008?

That is the question increasingly being raised in financial circles as concerns grow over the stability of China's financial system after warnings that it could experience a series of corporate defaults.

Premier Li Keqiang set the hares running in a media conference last week at the conclusion of the National People's Congress when he warned that future defaults on bonds and other financial products could not be averted.

"We are reluctant to see defaults of financial products, but some cases are hard to avoid," he told the press conference, where questions had been vetted in advance. "We must enhance oversight and solve problems in a timely way to ensure no systemic and regional risks."

That the premier even raised the prospect of "systemic risks"—a crisis of the whole financial structure resulting from a series of defaults—is indicative of the growing problems in the country's financial markets.

Li's remarks came in the wake of China's first bond default in modern history. Chaori Solar, a solar panelmaker, announced earlier this month that it could not pay interest on $US163 billion worth of corporate bonds. Unlike a previous occasion when the company experienced problems, government authorities did not intervene to prop it up.

Another company, Haixin Steel, is also reportedly in trouble and could be allowed to go under. The company failed to repay loans that fell due last week. Speculation about the company's stability is believed to have played a role in the rapid fall of more than 10 percent in iron ore spot prices, which last week saw billions of dollars slashed from the share values of the world's biggest iron ore mining companies.

According to the *Financial Times*, Li has decided that several small privately-owned companies should be allowed to default in order to address the problem of "moral hazard"—the belief of companies that no matter how risky their financial operations, government and financial authorities will always bail them out.

However, as the *Financial Times* noted: "Some analysts have warned that by doing so, Beijing could trigger investment panic and prompt a 'Lehman moment' in China's increasingly debt-dependent economy."

Haixin Steel's problems are symptomatic of a developing crisis in China's steel industry, which is experiencing significant over-capacity, a falling market and the increasing burden of large debts. Some estimates are that half of China's steelmaking companies are experiencing losses.

The steel industry situation reflects the state of the economy as a whole. Slowing growth means that the management of debt, which expanded rapidly over the past five years as Chinese authorities massively boosted the flow of credit to counter the effects of the global financial crisis, becomes increasingly difficult.

New lending by Chinese banks has been equivalent to about 30 percent of gross domestic product, with about 90 percent of this lending used to finance investment in building, plant and machinery and infrastructure. According to the World Bank, most of China's growth since 2008 has resulted from "government influenced expenditure."

Debt levels have risen sharply. Total government, corporate and household debt is now put at more than 200 percent of gross domestic product (GDP), up from

150 percent in 2008.

Comparing the growth in debt to the increase in GDP, it is estimated that China today needs as much as $5 of more debt for every $1 increase in GDP. This compares with a $1-$2 increase in debt for every $1 rise in GDP a decade ago. In other words, debt growth is much faster than economic growth which, in the final analysis, is needed to sustain it.

The growing sense that a financial crisis is looming is not only being fuelled by these long-term considerations. Immediate economic factors are having their impact as well.

The National Bureau of Statistics reported that factory production rose by 8.6 percent in January-February, the worst start to a year since 2009, when the Chinese economy suffered a major blow as a result of the global financial crisis.

Retail sales grew by 11.4 percent, the slowest increase for a decade, while the 17.9 percent increase in fixed asset investment was a 13-year low.

Yao Wei, China economist at Societe Generale SA in Hong Kong, an organisation that Bloomberg regards as the most accurate forecaster of China's GDP, described the results as "a very fast deceleration" beyond "the tolerance of the Chinese government."

Another financial analyst said the "dramatic slowdown" was unusual in the Chinese economic history of the past decade and said the figures were "shockingly weak."

Premier Li attempted to downplay the seriousness of the situation in his media conference. The official growth target for the year is "about 7.5 percent," prompting speculation that it could be some way below that figure. Li attempted to placate those anxieties, saying that "about" meant there was a degree of "flexibility" and that a bit higher or lower meant "we have a level of tolerance here."

Whatever the final figures, China is experiencing a significant slowdown. This will have consequences for the financial system under conditions where the government and financial authorities are attempting to rein in credit expansion.

As a result of government tightening, some corporations have been using purchases of stocks of iron ore and copper as collateral for raising loans. But as the price of these metals falls, as it has in the past period, it can call into question the viability of these financial operations.

Another factor contributing to instability is the fall in the value of the Chinese currency, the renminbi. It has dropped by 1.4 percent since the start of the year.

Funds, which flowed out of "emerging markets" last year and at the beginning of this year because of the US Federal Reserve's decision to "taper" its asset purchasing program, went to China in the belief that the renminbi could only continue to rise. If the currency continues to fall, that will have major consequences for financial markets.

The combination of all these factors—lower growth, corporate defaults and abrupt shifts in global financial flows—could produce a major crisis for the Chinese economy, with far-reaching worldwide consequences.