Growing danger of Chinese credit collapse

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At first, they took the form of quiet expressions of concern, but in recent weeks warnings about the state of China's finances and its implications for the global economy have become a rising drumbeat.

A complex of interacting factors is involved: the slowing Chinese economy, and the problems that poses for basic manufacturing industry, especially steel; the prospect of a collapse of the real estate and development boom; and the possibility that financial arrangements involving international banks and financial institutions may soon begin to unravel because of a fall in the value of the Chinese currency.

Following the 2008 financial crisis and its impact on the Chinese economy, when more than 23 million jobs were lost in just a few months, the government initiated a massive stimulus program, including a spending package of $US500 billion—the largest in the world.

The program's most significant feature was a directive to state-owned banks to open the credit spigots—to businesses, financial institutions and local government authorities—to finance investment in industrial capacity, real estate development and infrastructure projects.

China experienced an expansion of credit unprecedented in world economic history—by an estimated $15 trillion in the past five years. This is equivalent to the size of the entire US banking system.

Credit growth has been running at twice the rate of gross domestic product (GDP) growth. By the last quarter of 2013, credit, or "social financing" as Chinese authorities describe it, had reached 200 percent of GDP, up from 125 percent before the eruption of the global financial crisis.

Now the slowdown in the Chinese economy—this year's official growth target is "about 7.5 percent," compared to previous growth rates of 10 percent—is hitting all sections of manufacturing industry, particularly steel.

During the first two months of this year, members of China's Iron and Steel Association made a collective loss of $490 million. As a result, the first quarter is likely to be "the worst performing quarter in the new century," according to the organisation's deputy director, Liu Zhenjiang.

Last year, the steel industry as a whole barely managed to stay profitable, recording a profit margin on sales of just 0.48 percent. The industry has become increasingly dependent on credit, with the seven largest mills owing a total of $226 billion, an amount larger than the market capitalisation of the global mining giant BHP Billiton.

Macquarie Commodities Research has reported that, according to a survey of the industry taken in mid-March, medium and small mills were all suffering a contraction in orders compared to the corresponding period last year and profits had declined to historic lows.

The month of March usually sees a rise in orders following the Chinese New Year holidays but this year there has been increasing gloom.

Speaking to the *Financial Times*, Colin Hamilton, an analyst at Macquarie Capital (Europe), said debt defaults in the steel industry were a distinct likelihood, because the Chinese government indicated that it is prepared to see some companies go under, due to the overcapacity in the sector.

An even bigger concern is the growing danger of a collapse in the Chinese real estate bubble, following a ten-fold growth in the property market over the past decade.

While the property boom is still continuing in Beijing and Shanghai, it is a different story in the smaller cities, which accounted for two-thirds of all property under construction last year.

Large apartment blocks are now standing empty or are only partially constructed. According to the chief economist for the Japanese financial giant Nomura, the housing market is the Chinese economy's "top risk" for this year.

A real estate market collapse will have immediate international consequences because foreign investors have become an ever-more important source of credit. Since 2010, they have lent Chinese real estate developers at least $48 billion in US dollar bonds. According to Credit Suisse, offshore credit accounts for more than half the total debt outstanding for six major developers.

The problems for major developers caused by declining real estate prices are being compounded by the fall in the value of the yuan. Every time the currency falls, the debt-burden of dollar-denominated loans increases.

The third major source of financial instability is the

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activities of local governments. As part of the central government's stimulus measures following the 2008 crisis, they massively increased property and infrastructure development.

While local governments are responsible for 80 percent of total government spending, they only receive 40 percent of tax revenue. Other sources of finance have had to be found. Local governments are not legally allowed to borrow, so they set up local government financing vehicles (LGFVs), which are able to borrow.

There are estimated to be some 10,000 LGFVs. They have close ties to the major banks as well as to the "shadow banks," which raise money not by taking deposits but by issuing short-term bonds.

The Chinese central government has been trying for the past year to rein in the expansion of credit, which it regards as unsustainable in the long term. But the local authorities are under the control of regional Chinese Communist Party chiefs, who have pocketed considerable wealth from property and infrastructure development.

This has meant that the attempts of central authorities to curb credit expansion have had a perverse result. Faced with official restrictions, local CCP chiefs, eager to preserve and enhance their wealth, have resorted increasingly to the "shadow banking system," thereby increasing financial risk.

According to financial analyst Satyajit Das, writing in the *Independent* on Tuesday: "Many of the LGFVs do not have sufficient cash flow to service debt, being reliant on land sales and high property prices to meet obligations. Probably more than 50 percent of LGFVs have unsustainable debt levels."

Some commentators have discounted the prospect of a major crisis because of China's large currency reserves and the state controls on the economy. Several of the world's major banks, however, have pointed to the impact of any US Federal Reserve decision to lift interest rates.

Last year, when the Fed first signalled its intention to reduce or "taper" its asset purchasing program, emerging markets experienced a major capital outflow. Much of this "hot money" went to China in the belief that, unlike the emerging markets where currency values had fallen, the value of the yuan would continue to rise.

So far this year, however, the currency has fallen by more than 2.5 percent, partly as a result of attempts by Chinese financial authorities to rein in speculation, resulting in losses of around $5.5 billion for companies involved in the carry trade, in which dollars are borrowed to purchase Chinese assets. While this is a relatively small amount, it could be a sign of things to come.

Concerns are now being raised that a second phase of reaction to Fed "tapering" could impact on China. A recent Citigroup report noted: "There's a dangerous scenario in which the combination of rising US short-term rates and the more volatile RMB (yuan) could lead to a rather large capital outflow from China."

Nomura issued a note last week saying the carry trade was "reversing gear" in conditions where Chinese investors, commercial banks and exporters had all been involved in the game of dollar borrowing.

Nomura China analyst Wendy Liu said investors were putting too much hope on the prospect of a fresh stimulus and infrastructure program, and were ignoring currency dangers. The fall in the yuan could be an early warning sign that "China's credit bubble may implode imminently," she said.

According to Credit Suisse, the size of the speculative carry trade has reached $200 billion, involving complex manoeuvres through Hong Kong, and "various indicators" were pointing to "stress" in the system, increasing "the risk of a misstep."

The mounting Chinese debt crisis underscores the fact that none of the contradictions which led to the 2008 crisis has been resolved. They have simply assumed new forms.

The massive Chinese credit expansion over the past five years was the direct result of the financial crisis sparked by the near-meltdown of the US financial system. The economic stimulus that followed played a crucial role in sustaining the world economy.

It has been estimated that emerging markets were responsible for three quarters of global growth over the past five years, much of that emanating from China. But this Chinese growth was the outcome of a credit bubble which now threatens to burst, with potentially disastrous consequences for the global financial system as a whole.

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