China debt levels reach record high

Nick Beams
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Chinese debt levels have risen to a record 237 percent of gross domestic product, according to a report published in the *Financial Times* over the weekend, prompting warnings that the country could be heading for a Lehman-style financial crisis or a protracted period of low growth like that which has afflicted Japan over the past two decades.

The report said that total debt in China, including both foreign and domestic borrowing, had climbed to $25 trillion as a result of a rapid expansion of borrowing since the eruption of the global financial crisis in 2008–2009. In 2008, Chinese debt stood at 148 percent of GDP.

When the crisis erupted, leading to a contraction of world trade in the first months of 2009 at a faster rate than in the initial period of the 1930s Depression, the Chinese export model of economic growth collapsed, leading to the loss of 23 million jobs. The government responded with a stimulus package of half a trillion dollars and a massive expansion of credit to state-owned corporations and local government authorities. The credit expansion has been estimated to be the equivalent of the entire US financial system.

The expectation of the Chinese authorities was that the world economy would experience a recovery after the crisis and exports would resume their previous path. But nearly eight years after the financial crisis, the world economy continues to stagnate. Most significantly, world trade, which prior to the crisis grew at a faster rate than global GDP, is now running at a level below growth.

Since 2013, Chinese government and financial authorities, recognising that the expansion of infrastructure investment—especially in property—is inherently unsustainable, have been trying to effect a "rebalancing" of the economy away from capital intensive development and towards consumption and the expansion of services.

Growth rates have fallen from their previous levels of around 10 percent, lowering the government's official target for economic expansion to between 6.5 percent and 7.0 percent. But even this lower level is proving difficult to sustain.

Economic turbulence in the last half of 2015, flowing from the stock market crisis in August and slowing growth, prompted fears of a "hard landing," leading the government to reopen the credit spigots to sustain the economy. The first quarter 2016 estimate of growth was 6.7 percent, in line with government projections but nevertheless the lowest rate since the depths of the financial crisis. That result was achieved only through a major expansion of credit.

The *Financial Times* reported that according to central bank data and its own calculations, new borrowing increased by 6.2 trillion renminbi in the first quarter of this year, the biggest-ever increase over a three-month period, and more than 50 percent higher than the same period last year. The China chief economist at BNP Paribas, Chen Xingdong, said the first quarter GDP result was achieved only through the expansion of industrial production, fixed-asset investment, and what he called an "astonishing" increase in construction start-ups. At the same time, growth in the service sector, which is supposed to provide the basis for a "rebalanced" Chinese economy, slowed.

There is a divergence of opinion among economists and financial analysts as to how the Chinese debt problems will play out. Some warn that it will end in a "Lehman-style" crisis, with bank failures and a collapse in credit. According to Jonathan Anderson of the Emerging Advisors Group, whose remarks were cited in another *Financial Times* article over the weekend, the banks are relying on the sale of high-yielding products rather than deposits to finance credit—a formula that led to the 2008 collapse of the US

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banks Bear Stearns and, later in the year, Lehman Brothers.

"At the current rate of expansion" he wrote recently, "it is only a matter of time before some banks find themselves unable to fund all their assets safely. At that point, a financial crisis is likely."

Global hedge fund investor George Soros has compared the Chinese economy to the situation that prevailed in the US before the collapse of 2008. Others maintain that China's central bank will keep pumping money into the financial system in order to ward off a collapse, but this will lead only to Japanese-style stagnation.

Whatever the immediate outcome, the mounting debt crisis has far-reaching implications for the global economy as a whole, with a large number of economies, ranging from Australia and Brazil to the economies in Southeast Asia, Africa and Latin America, highly dependent on continued Chinese economic growth.

In a report issued earlier this year, Ha Jiming, an investment strategist with Goldman Sachs, noted: "Every major country with a rapid increase in debt has experienced either a financial crisis or a prolonged slowdown in GDP growth."

In its recent *Global Financial Stability Report*, the International Monetary Fund drew attention to the rising debt problems. It estimated that more than 15 percent of total commercial lending in China was "potentially at risk," meaning that banks faced a loss of 4.9 trillion renminbi, an amount equivalent to 7 percent of GDP. Others estimate that the stock of non-performing loans may be even higher.

The organisation's *World Economic Outlook* report, prepared for its spring round of meetings earlier this month, pointed to substantial and rising "spillover" effects on advanced economies from the Chinese financial system.

It is not clear what impact the growing concerns over Chinese debt levels will have in the short-term. But other short-term potential sources of instability are looming.

The Bank of Japan will meet on Thursday amid growing pressure for a further easing of its monetary policy, after it initiated negative interest rates at the end of January. While the central bank insisted that the lowering of the value of yen was not an official aim of the new regime—governments and central banks maintain an official fiction that they do not target the value of their own currency, lest they be accused of engaging in a currency war—the Bank of Japan and the government had hoped that the yen would fall.

Instead, in the three months since negative rates were introduced, the value of the yen has been rising, increasing the deflationary pressures on the Japanese economy and making it harder for Japanese companies to compete in global markets.

The official position of Bank of Japan Governor Haruhiko Kuroda is that the monetary policy is working. However, he put forward a similar position in the lead-up to the surprise introduction of negative interest rates at the end of January.

Much will depend on what the US Federal Reserve decides to do at its meeting on Wednesday. If it points to an interest rate rise in June, this will likely lead to a rise in the US dollar and a fall in the yen. However, if it pushes future interest rate rises further out, the dollar will tend to fall, putting more upward pressure on the yen—an outcome that could produce another surprise announcement from the Bank of Japan.

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