

Growing warnings over Chinese debt

Nick Beams
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While the turbulence that hit global financial markets in the early part of this year has subsided somewhat, at least temporarily, the underlying recessionary trends continue to intensify. These trends are clearly seen in the world's two major economies, the United States and China.

Earlier this week, the *Financial Times* pointed to the flattening of the yield curve, which measures the difference between the interest rates on higher yielding long-term 10-year treasury bonds and two-year debt, noting that it was down to its lowest level since December. A flattening of the curve, when long- and short-term rates start to converge, signals lack of investor confidence about the long-term outlook for the economy. The yield curve has not inverted—a situation which is regarded as indicating a recession—but there are other indications of slowing growth.

American corporations are in an earnings recession, with profits down for the fourth straight quarter in a row. This is the longest period of lower profit growth since the financial crisis of 2008–2009, with US firms described as struggling under the weight of a strong dollar and “sputtering growth in other developed and emerging markets.”

In the wake of the global financial crisis, the spending and credit stimulus initiated by the Chinese government provided support for the global economy, particularly for emerging markets. But the Chinese economy is now experiencing much lower rates of growth—down from levels of 10 percent a few years ago to below 7 percent—and the expansion of credit has brought fears of a financial crisis.

Earlier this month, CLSA, a leading Hong Kong based brokerage and investment firm, warned that Chinese bad debts were reaching a “crisis level.” The company has released research showing that China's non-performing loans are as high as 19 percent of bank assets, compared to the official figure of 1.6 percent,

with most of the bad debts on the books of loss-making companies. The difference is accounted for by the fact that CLSA used international standards when calculating non-performing loans, rather than looser Chinese benchmarks.

The International Monetary Fund has said that \$1.3 trillion of corporate debt in China, around one sixth of business loans made by banks, has been incurred by companies that are bringing in less revenue than they owe in interest payments.

In the first three months of the year, the government and financial authorities undertook a further expansion of credit in order to try to boost the economy in the wake of the stock market crisis of last year and fears that growth could fall sharply.

But these measures appear to have set off a conflict within the ruling Communist Party regime. Earlier this month the official *People's Daily* featured a front-page interview with an “authoritative figure” who said that soaring debt levels could lead to a crisis.

“A tree cannot reach for the sky,” the “figure” was quoted as saying. “Any mishandling will lead to systemic financial risk, negative economic growth and evaporate people's savings. That's deadly.”

The official also warned that China's growth rate, which has fallen from 12 percent in 2010 before dropping to 8 percent in 2013 and is now down to below 7 percent, will not return to the previous levels.

The interview is being interpreted in some quarters as part of a conflict between Chinese President Xi Jinping and Chinese Premier Li Keqiang, who is regarded as the leading proponent of increased credit.

In any case, it is clear that credit expansion is not bringing the boost to the Chinese economy it once did. In the year to November 2009, total credit was expanded by an amount equivalent to 34 percent of gross domestic product. This lifted the growth rate from 6.1 percent in the first quarter of the year to a full-year

level of 9.2 percent. In the year to February, credit was increased by 40 percent of GDP, but the growth rate has only barely been maintained at the official level of between 6.5 and 7 percent.

Further evidence of the ongoing slowdown in China was provided in the trade figures for April that showed a decline in both imports and exports. Exports fell by 1.8 percent year on year, following an 11.5 percent surge in March. Imports were down by 10.9 percent compared to the same month a year ago, following a 7.6 percent decline the previous month.

The contraction in global markets resulting from the China slowdown is fuelling tensions over currency values. Japan is at the centre of this growing global conflict. Despite the move by the Bank of Japan to introduce negative interest rates at the end of January in the expectation that this would start to bring down the value of the yen, the Japanese currency has risen by around 13 percent so far this year.

This prompted a warning last week from the Japanese finance minister, Taro Aso, that a persistent “one-sided” yen could lead to intervention. “We are determined to stop it,” he said, without proving any specific details as to how that might be achieved.

In an interview with the *Financial Times* on Monday the vice-minister for finance and international affairs, Masatsugu Asakawa, said the government regarded selling yen in international markets as a legitimate part of its policies. This was despite the commitment at the G20 meeting earlier this year that countries would not resort to devaluing their currencies in response to the downturn in global markets—a move regarded as a return to the kind of beggar-thy-neighbour policies that characterised the 1930s. The US has now put Japan on a watch list of countries that may be seeking to push down their currencies.

This move, however, was dismissed by Asakawa who told the *Financial Times* that Japan had not been singled out and so “we do not see this as having an immediate impact on Japan’s currency policy.”

Major Japanese manufacturers, including Toyota, which are adversely impacted by a rising yen, have issued warnings that profit levels are falling at the fastest rate since Prime Minister Abe came to power in late 2012 with promises to boost the economy through so-called Abenomics, based on central bank purchases of financial assets and an implicit commitment to

ensure Japan remained competitive.

Monetary policy is also the subject of conflict in Europe, where German financial authorities are continuing their opposition to the quantitative easing and negative interest rate policies of the European Central Bank (ECB) under president Mario Draghi. Earlier this year, German Finance Minister Wolfgang Schäuble said Draghi was at least 50 percent responsible for the rise of the right-wing German populist party, the AfD.

The chief economist at Deutsche Bank, David Folkerts-Landau has written a comment for the *Financial Times* comparing the ECB measures to the German Reichsbank, which printed money to finance government spending in the 1920s, leading to hyperinflation.

“Today the behaviour of the European Central Bank suggests that it too has gone awry,” he wrote. When reducing interest rates to historically low levels did not stimulate growth, the ECB began purchasing sovereign debt and when that did not work, the ECB went to the next extreme and introduced negative interest rates with the result that almost half European sovereign debt is trading at negative yields.

Six years after the financial crisis, European debt keeps rising, the eurozone is as fragile as ever, insurance companies, pension funds and savings banks barely have a positive spread, growth is anaemic and debt levels in some countries, such as Italy, is not sustainable. “Monetary policy has become the number one threat to the eurozone,” he concluded.

The worsening global economic outlook will be one of the key issues at the meeting of the G7 major economies later this month, at least in closed-door discussions. While there will no doubt be efforts made to prevent divisions from erupting into the open, they will be very much present.



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