China growth on target but debt concerns mount

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Earlier this month the Chinese government announced that the economy had advanced at an annual rate of 6.7 percent in the third quarter, putting it well on track to meet the official target of above 6.5 percent. But concerns are being expressed, even from official sources, about how long this will continue.

Releasing the data, the National Bureau of Statistics said: "We must be aware that economic development is still in a critical period of transformation, with old growth drivers to be replaced by new ones. With unstable and uncertain domestic and external factors, the foundation for continued economic growth is not solid enough."

The official scenario is that the "transformation" will see a shift from debt-fuelled investment spending to increased consumption, supposedly providing a more stable base for economic expansion. But that is not taking place.

Real estate continues to be a key economic driver with property prices increasing by as much as 25 percent in Beijing and Shanghai over the past year. It is estimated that when the flow on effects are considered, such as demand for concrete, steel and household goods, real estate accounts for at least half of all investment. Overall real estate investment expanded by 7.1 percent in the year to September and the services sector by 7.6 percent. Both of these sectors, however, were outstripped by infrastructure investment which rose by 19.4 percent.

The continued reliance on debt-financed infrastructure and real estate is giving rise to concerns that a financial crisis is in the making. The fear is that Chinese authorities will not be able to balance the push for continued growth and bring down debt growth at the same time.

In order to head off one of the potential sources of a financial crisis, the Chinese government earlier this month approved a plan to allow companies struggling to repay debt to swap it for equity. Chinese firms are estimated to have about $18 trillion worth of debt, equivalent to 170 percent of the country's gross domestic product.

The measure was controversial because critics said banks could simply swap bad loans in return for shares and lead to the creation of "zombie" companies. The government has insisted that the debt-for-equity swaps will be "market-oriented" and there will be no "free lunch." A spokesman said the government "takes no responsibility for bailing out losses."

Global financial authorities see two interconnected problems associated with Chinese debt: it is rising very rapidly and the increase is producing less economic growth than it did in the past. Last month, the Bank for International Settlements said while it was not yet concerned with the absolute size of the debt, the speed of the increase could create conditions for a financial crisis.

At the end of 2008, Chinese debt was equivalent to 147 percent of GDP. That figure has risen to more than 255 percent of GDP. No other country that has experienced such a rapid rise has managed to escape a financial crisis.

Moreover, the increased borrowing is losing the impact it once had. Eight years ago a 1.5 percent increase in credit generated 1 percentage point of additional growth. Today more than a 3 percent increase is needed to achieve the same result, according to the IMF.

Given the increased dependence of the Australian economy on China—the proportion of its merchandise exports going to China has risen from 10 percent a decade ago to more than 30 percent today—the Reserve

Bank of Australia (RBA) drew attention to China in its latest semi-annual financial stability report. Issued earlier this month, the report warned of the possibility of a “disruptive adjustment.”

Australia is not only reliant on China for merchandise exports, such as iron ore, coal and natural gas, but increasingly for other exports. China is currently Australia’s largest market for services and accounts for 15 percent of the country’s exports in that sector, up from 3 percent in the past 15 years.

The RBA report pointed to the problems confronting the Chinese government as it tried to support economic growth and “maintain financial stability in the near term.”

It said the “continued reliance on debt-financed growth and bank forbearance, along with official actions that reinforce perceptions of implicit government guarantees, add to existing vulnerabilities.”

While Chinese authorities recognised these risks and had often expressed concern about them, implementing the necessary wide sweep of financial reforms “within an increasingly large and complex financial system, will remain a key policy challenge.”

To underscore these risks the RBA published a graph showing the rapid escalation of Chinese debt since the global financial crisis of 2008, an increase far outstripping that of other emerging markets.

“Recent policy stimulus,” the RBA said, “has helped stabilise parts of the economy, but has also helped to further fuel the rapid pace of credit growth.

“The interaction between high and rising debt, slower growth and excess capacity in some areas is raising the chance of widespread loan defaults and economic disruption.”

Authorities were taking steps to address the growth of the shadow banking sector but the financial system was becoming “increasingly large, opaque and interconnected.” This raised concerns about “asset quality and the funding positions of some of the fast-growing parts of the system, and increased the risk of financial contagion.”

The RBA warned that the risk of contagion was a major concern, not only for China but for the global financial system as a whole because China was the second largest economy after the US.

“The main connections between China and other economies that would be relevant in a negative scenario are trade volumes and commodity prices, as well as sentiment in global financial markets.”

While some may take comfort that the Chinese financial system is still relatively closed and that a crisis could be contained, the RBA noted that there are close linkages to other financial centres in Asia and some banks in Hong Kong and Singapore that “have large exposures to China which could transmit financial stress.”