

# Deepening problems for the Chinese financial system

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The Chinese financial system is running into major problems with analysts saying that a “vicious cycle” could be set off. The warning has been triggered by a significant downturn in the property market, the renewed threat of debt defaults and the failure of a large investment trust to make payments on two of its products.

The property market has been of concern for at least five years as exemplified by the parlous position of the major developer Evergrande since 2021. Its access to cheap money, the basis of its business model, dried up because of tighter government regulations aimed at trying to control of the growth of debt.

At the start of this year, with the scrapping of all measures to contain COVID, the property market appeared to be picking up as part of a general upturn in the Chinese economy. That proved to be very short lived with all the major economic indicators turning down amid the onset of a deflationary environment.

Now property market woes have returned with a vengeance, exemplified by the fact that they have hit Country Garden, a 31-year-old firm and the largest survivor in the market. It had been held up by Chinese financial authorities as a model for others.

Its troubles surfaced at the beginning of the month when it failed to make interest payments of \$22.5 million on two securities with a total face value of \$1 billion.

The fact that the company was struggling just to make an interest payment, rather than the full repayment of a bond, was seen by analysts as indicating “a very tight liquidity” situation.

With a 30-day grace period, the company has until September 6 to make the payments before bond holders can send it a notice of default.

It may well find the cash in the short-term but longer-

term problems continue to grow, not least how it will deal with its \$300 billion debt load in conditions of a rapidly falling market.

The company has said it expects to record its biggest loss since going public 16 years ago. The loss could be around \$7.6 billion for the first half of year, under conditions where its contracted sales fell 60 percent in July from a year earlier.

One of the Country Garden bonds in question matures next month. Earlier this week the bond was reported to be trading at 27 cents on the dollar, compared to being close to par at the start of the year and 50 cents a few weeks ago.

The worsening situation in the property market has been compounded by the news that a company linked to the financial conglomerate Zhongzhi had missed payments on investment products.

The investment products were managed by Zhongrong International Trust in which Zhongzhi has a “strategic stake.” KBC Corporation, part of a semiconductor supply chain, and Nacity Property Service Group said they had not received payments of 60 million yuan (\$US8.4 million) and 30 million yuan respectively.

Bloomberg reported yesterday that there was a protest of about two dozen people outside Zhongrong’s offices demanding payment on the high-yield investments they had made.

Zhongrong is one of the biggest operators in China’s \$2.9 trillion trust industry. It pools savings from corporations and wealthy individuals and uses them to make loans and invest in commodities, stocks, bonds and real estate.

According to Bloomberg Economics, the trust sector has about 10 percent of its assets in real estate.

“The big danger is that a negative feedback loop

kicks in, with property stress causing strains in the financial system, undermining credit expansion and depressing growth, which, in turn exacerbates the slump in the property sector,” it said.

JP Morgan analysts have warned that as much as 13 percent of total assets across the investment trust sector, in which Zongzhi is involved, could be at risk.

According to analyst Katherine Le: “The trust defaults may set off a vicious cycle on [privately owned property] developers’ onshore debt.” The rising concern of developer defaults weakened “investment sentiment and, as a result, trust companies may not be able or willing to roll over existing real estate-related products.”

Such assessments are becoming more widespread. Brock Silvers, chief investment officer at a Hong Kong private equity firm told the *Wall Street Journal* (WSJ): “The market is now substantially uninvestable. The systemic risks are dramatically larger than previously estimated.”

Zhaopeng Xing told the WSJ: “The drag on the economy from the real-estate sector is expected to persist, and, at present, there’s no sign of the free fall on the developers’ end slowing down.”

The latest data show that new construction starts were down by 25 percent in the year to July with property investment falling 8.5 percent for year, compared to 7.9 percent for the first half.

Dickie Wong, head of research at Kingston Research in Hong Kong, told the *Financial Times* the next 30 days would be “really critical” for Country Garden. He could have added the same holds for the property sector as a whole if it fails to come up with the payments it is owing.

“Two weeks ago, the government insisted it was going to support the property market and that simply isn’t happening,” he said.

The People’s Bank of China has announced a 15-basis point cut in its interest rate to 2.5 percent, the biggest drop since the start of the pandemic. The cut was made in the wake of official data on Tuesday which shows retail sales rose by only 2.5 percent for July year-on-year while industrial production expanded by 3.7 percent, both figures below those for June.

The new measures have generally been regarded as having little nor no effect. In fact, the main response of the authorities has been to clamp down on what are

seen as “negative” comments on the state of the economy.

The bureaucratic suppression was underscored by the decision of the National Bureau of Statistics not to publish figures on urban youth unemployment, covering those aged between 16 and 24, which showed a rise to a record high of 21.3 percent for June, and a doubling of the rate from 2019.

A spokesperson for the bureau said labour statistics need to be “advanced and optimised.” But the growing problems confronting the ruling regime are not going to be resolved either by suppression of analysis or by changing definitions. They are rooted in objective conditions—above all the exhaustion of a growth model based on property and infrastructure financed by stimulus measures and the expansion of credit.

As the property sector confronts deepening financial problems so too do local government authorities whose spending on infrastructure projects has formed a vital component of Chinese economic growth over the past decade and more.

The International Monetary Fund has estimated that 66 trillion yuan (\$9.1 trillion) is held by Local Government Funding Vehicles which raised the money to finance their operations through land sales. But with revenues from this area declining, they are being characterised by some analysts as the “black holes” of the financial system.

The suppression of adverse economic commentary and analysis, followed by the decision not to publish youth unemployment data, points to the underlying fears of the regime. Sooner rather than later the mounting economic and financial problems are going to lead to social and class struggle by youth and the working class more broadly.



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