THE BIG QUESTION: IS CHINA FACING A FINANCIAL CRISIS, OR NOT?

Prerna Gandhi
Research Associate, CAPS

In a first for Chinese Banks, four of them made history recently. The ***Industrial and Commercial Bank of China (ICBC)*** unseated Exxon Mobil last year to take the top spot on the Forbes Global 2000[i] as the world's largest company. ***China Construction Bank*** moved up 11 spots to number 2 on the list. ***Agricultural Bank of China*** stood at number 8 and ***Bank of China*** with its double digit growth in sales and profits, improved its ranking by 10 places to number 11[ii]. However what is more interesting is that *ICBC, world's largest and most profitable bank was* itself on the verge of defaulting until it was bailed out in January this year. A 3 billion Yuan (around US$500 million) product issued by China Credit Trust Co., a shadow bank and marketed through ICBC was underpinned by a loan to a mining operation of Shanxi Zhenfu Energy Group that later collapsed as the price of coal fell. Investors who had been promised a hefty 10% annual return over three years were told in January not to expect payment. Upset investors, some of whom had reportedly put as much as $500,000 each into the fund, sought reimbursement from the ICBC, who in turn, argued that it had never guaranteed the product, and had no legal responsibility to pay investors. However, the situation was retrieved by a bailout by an unnamed third party that ensured investors that they would recover their initial investment, though interest will not be paid[iii].

Shadow Banking in China comprises a web of non-banking financial institutions such as hedge funds, wealth management products, trust companies, along with pawn shops, underground banks, and unregulated activities by regulated institutions – which unlike banks don't take deposits to insure against risky lending activities and operate completely beyond the watch of regulatory authorities.These firms offer loans to companies or individuals that may have trouble securing traditional bank financing. Often, the loans are then packaged and sold to investors looking for higher returns. In China, the sector's exact reach is unknown, but some estimates put its size at roughly 60% of China's GDP[iv]. The China Banking Regulating Commission (CBRC) does not allow banks to offer loans valued at more than 75% of the relative value of deposits. Because of this cap, banks prefer to issue such loans without reflecting them on their balance sheet. While the latest estimates for lending from China's biggest banks put February 14's new loans at 800 billion Yuan, the highest figure in February 2014 since the 4 trillion Yuan stimulus in 2009, reports are emerging that the increase in new loans is not driven by real demand, but by banks moving off-balance sheet loans on to the balance sheet due to the government's crackdown on shadow banking[v]. It is one of the many indicators that signify a slowdown of Chinese economy.

The scale of trust assets however still pales in comparison to total banking sector assets of more than 100 Trillion Yuan as of the end of June. But without trusts, the banking system's non-performing loans (NPL) ratio might be much higher, although accurate estimates are not possible[vi]. Chinese non-financial companies held total outstanding bank borrowing and bond debt of about $12 trillion at the end of last year - equal to over 120 percent of GDP - according to Standard & Poor's estimates[vii]. By law, China's local governments are not allowed to borrow. After the 2008 global financial crisis, Beijing did relax this a bit and local governments created LGFV (Local Government Financing Vehicles), also known as UDICs (Urban Development and Investment Companies), which though separate from but owned or controlled by the local government, were permitted to borrow. The LGFV generally borrowed funds predominantly from banks (as much as 80% or more), with the remainder raised by issuing bonds or equity-like instruments to insurance companies, institutional investors and individuals. Recently, with pressure on banks to curtail loans, these financing vehicles have borrowed from China's shadow banking system.

According to statistics from the National Audit Office, as of June 2013 government debt at all levels totaled about 20.7 Trillion Yuan (US$3.4 trillion), of which domestic government debt accounted for around 10.9 Trillion Yuan (US$1.8 trillion). Of this amount, 2.39 Trillion Yuan (US$390 billion), or 22%, is due in spring this year[viii]. We can add that including the local government debt that matures this year, there is an estimated 5 trillion Yuan of trust products that are maturing, including as much as 1 trillion Yuan in May[ix]. China cannot allow corporate failures, particularly of the big state-owned companies, partly out of fear that widespread layoffs could lead to social unrest. Beijing knows that a default could prompt investors to pull their money from other trust products. This would arrest the flow of deposits needed to supply credit and fuel economic growth. Some analysts, however, argue that a default is needed to demonstrate Beijing's commitment to allow market forces to play a larger role in the economy, and to send a message to investors that high-yield investments carry significant risk.

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All this makes things tough for the People's Bank of China, especially when interbank rates are at an all time high, to control the local debt. The underlying economic assumption that if interest rates are higher, they will attract more foreign capital, and increase demands for the local currency, thereby driving up its value has been true in the Chinese case. Indeed, the Chinese Yuan has gained around 33% since 2005 against the U.S. currency[x]. Hence this has created a cycle wherein when the PBOC moves in with bailouts, it ends up encouraging risky lending, but when it has declined to add cash to the system—notably in

June and December of 2013—credit crunch has arisen leading to another set of crises[xi]. However China's low inflation rate and its huge population work in its favor as the high savings rate and potential for new consumption leave much scope for further economic growth, delaying a probable bubble burst. Also the communist regime is touted to be capable enough to fend off a credit crunch with its large foreign reserves.

But as solar-cell maker Shanghai Chaori Solar Energy Science & Technology Co. became the first defaulter in February this year as it missed its bond payment; structural reforms have become critical to growth and stability of China in the long-run. Capital markets are also yet to get a strong foothold in China's investment culture to provide a viable alternative to real estate or trust funds. Finance experts and China watchers argue that a vast majority of the trust loans cannot be repaid, which will eventually require substantial bailouts, leading to a collapse of the banking system and a larger economic crisis. Even if this is another round of literature that has been periodically predicting the bursting of China's bubble, one cannot doubt that huge liquidity risks exist given the known mismatch between the duration of trust loans and their underlying investments. The jury is still out on China's long term financial viability.

Endnotes:

(Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the position of the Centre for Air Power Studies CAPS)

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[i] The Forbes Global 2000 are public companies with the top composite scores based on their rankings for sales, profits, assets and market value.

[ii] Forbes: The World's Biggest Companies at http://www.forbes.com/sites/scottdecarlo/2013/04/17/the-worlds-biggest-companies-2/

[iii] Charles Riley, "China's $500 million shadow bank rescue", January 28, 2014 at http://money.cnn.com/2014/01/28/investing/china-icbc-default/

[iv] ibid

[v] Oliver Barron, "Latest Developments for China's Shadow Banking and its Implications for RMB", February 26, 2014 at http://www.forbes.com/sites/oliverbarron/2014/02/26/latest-developments-for-chinas-shadow-banking-and-its-implications-for-rmb/

[vi] Gabriel Wildau and Lu Jianxin, "Growth in China trust assets slows as shadow banking crackdown bites", August 6, 2013 at http://in.reuters.com/article/2013/08/06/us-china-economy-trust-idUSBRE97504Q20130806

[vii] Matthew Miller and Umesh Desai, "China's $12 trillion corporate debt pushes up refunding costs, drives mergers", February 25, 2014 at http://www.reuters.com/article/2014/02/26/us-china-debt-companies-idUSBREA1P06420140226

[viii] "RMB350bn in local government debt up for repayment", February 27, 2014 at http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20140227000050&cid=1202

[ix] Oliver Barron, "China Trust Default Avoided… What Comes Next?", January 27, 2014 at http://www.forbes.com/sites/oliverbarron/2014/01/27/china-trust-default-avoided-what-comes-next/

[x] Enda Curran and Prudence Ho, "Concern Over Hong Kong Banks' Growing Lending into China", February 27, 2014 at http://www.marketwatch.com/story/concern-over-hong-kong-lending-to-china-2014-02-27-124492221

[xi] Gwynn Guilford, "China's $122 billion boom in shadow banking is happening on phones", February 10, 2014 at http://qz.com/175421/chinas-122-billion-boom-in-shadow-banking-is-happening-on-phones/