China's Exploding Debt

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If the international media are to be believed the world, still struggling with recession, is faced with a potential new threat emanating from China. Underlying that threat is a rapid rise in credit provided by a "shadow banking" sector to developers in an increasingly fragile property market. Efforts to address the property bubble or reduce fragility in the financial system can slow China's growth substantially, aggravating global difficulties.

The difficulty here is that the evidence is patchy and not always reliable. According to one estimate, since the post-crisis stimulus of 2008, total public and private debt in China has risen to more than 200 per cent of GDP. Figures collated by the World Bank show that credit to the private sector rose from 104 per cent of GDP in 2008 to 130 per cent in 2010, before declining marginally in 2011. The evidence suggests that 2012 has seen a further sharp increase.

The problem is not merely the rapid rise in credit as a means to spur investment and growth. More significant is the rapid growth of lending by the 'shadow banking' system, at the forefront of which are off-balance sheet vehicles of banks to which deposits mobilised by offering relatively higher interest rates, through means such as wealth management products (WMPs), are diverted. Such loans are then provided to borrowers such as real estate developers to whom lending by the banks is being restricted. As of now WMPs are placed at around 10 per cent of total deposits in Chinese banks, but the rate of growth of this relatively new phenomenon is high. Further, banks are diverting these resources even to securities brokerages for management. Overall, central bank figures indicate that conventional bank loans have fallen from 95 per cent of total financing in 2002 to as low as 58 per cent in 2012.

Diversification away from bank lending as the main source of finance may be seen as a good thing. Further, 'shadow banking' institutions are not completely unregulated. The trusts that manage the WMPs are regulated. The problem is that such regulation is light and much less than applicable to the banks, especially with regard to the areas to and rate at which lending occurs. And the original sources of funds are the WMPs issued by the banks. This does lead to a significant degree of maturity mismatch, with the deposits being mobilised of much shorter duration than the investments made. The expectation clearly is that there would be adequate inflows of these 'deposits' to more than cover any withdrawals. That may be misplaced. Moreover, the investments to which these funds are being diverted are mostly opaque, though there are strong reasons to believe that the favoured destinations are the property or financial markets.

Recently, evidence has been emerging that customers investing in WMPs, enticed perhaps by their association with known institutions and promises of guaranteed returns have found themselves making losses. Examples quoted include products sold by leading banks and investment companies such as China Construction Bank, CITIC and Huaxia Bank. The net result is an effort on the part of the government to increase regulation of shadow banking by requiring greater disclosure. The fear is that this may reveal much and force a contraction in the activity of these institutions operating in the shadows.

But that only point to a larger issue that confronts the so-called "emerging markets" looking to sustain high rates of growth for long periods of time with the hope that they would experience the transition to developed country status as, for example, South Korea did. It is now increasingly clear that beyond a point debt-financed investment and consumption expenditure is crucial to delivering persistent high growth. Since that requires lax lending conditions to expand the universe of borrowers, it requires an environment of 'confidence'—among lenders to lend and borrowers to borrow.

That confidence, as in China's case, possibly comes from earlier rounds of robust real growth. The lending spree that it triggers only drives growth further and feeds that confidence leading to less caution in granting and accessing credit. This obviously requires intervention from outside in the form of strong regulation. China's central bank governor Zhou Xiaochuan says regulation is indeed adequate. But even the recent demand for greater transparency seems inadequate if the pace of credit expansion is an indicator. One reason for complacence is that the commitment to relatively high growth among China's policy makers discourages curbs on the credit growth that underlies GDP expansion. That ambivalence is felt in the context of a boom in China's property market triggered by the successful post-crisis stimulus fashioned by the government in which credit played a crucial role. With a significant share of that stimulus increasing demand for real estate, price increases have been so large, that the spiral is now being identified as a bubble. This does seem to call for a stronger dose of regulation, even if at the expense of some growth.

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