Financial Strains in the "New" China

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Early in March, the largest private steel producer in China, Shanxi Haixin Iron and Steel Group, defaulted on loans from Minsheng Bank estimated at 20 billion yuan ($3.57 billion) that had fallen due. This set off one more spurt of speculation on whether we are seeing the beginning of the end of the Chinese 'growth miracle', precipitated by an internal meltdown of the financial sector. The international financial media is replete with stories on the fragile foundations of China's rapidly built edifice of bond-based debt and the possibilities of a crisis.

There are a number of reasons why an event relating to a firm that is a relatively small steel producer compared to its state-owned rivals is seen as heralding the collapse of an emerging giant. To start with, a few days earlier, another relatively small company, Shanghai Chaori Solar Energy Science & Technology failed to meet its commitment to pay up 89 million yuan ($14.5 million) in interest due on bonds worth 1 billion yuan ($163 million) it had issued two years back. With these defaults coming in quick succession, the two events could be seen as indicators of an emerging trend that could spiral into a debt crisis.

Such speculation seems plausible also because there are many economic sectors in China that have experienced the creation of large excess capacities financed with easily accessed credit, which are now in trouble. A typical example is the steel sector to which Haixin belongs. According to reports, other steel mills burdened with excess capacities and large debts are running losses because of the slowdown that China and the world economy are experiencing. But steel is not the only industry thus affected. There are many more in areas as diverse as solar power and real estate.

Finally, while debt defaults may be common in other contexts, these are special events in China. The Chaori Solar instance was the first corporate default in the country in 17 years. Like many other so-called "emerging markets", and on a much larger scale, China has seen a huge credit boom over the years, with that boom having been augmented by the stimulus measures adopted in response to the 2008 global crisis. But this did not seem to matter, since in the past the government always intervened to bail out potential defaulters and foreclose any possibility of instability in financial markets that are important instruments for sustaining China's investment-led growth. This encouraged the belief that all debt from the financial system was implicitly guaranteed by the state. The confidence that came with that belief is now being challenged. Not just by the Chaori and Haixin defaults, but also by evidence that there is a subtle change occurring in the stance of the government. In the period between the two defaults under discussion, China's premier, Li Keqiang, suspected by many to be a neoliberal reformer, announced at a press conference that defaults on bonds and other financial products were "unavoidable". This seemed to be a signal that there are sections at the top in government which want to withdraw the hand of support the state had provided borrowers and lenders in the past in order to prevent default so as to deal with the problem of growing "moral hazard". The implicit promise of a bailout when needed reduces the pressure to exercise due diligence when making lending decisions.

The government's decision to stand back in the two recent cases of default is surprising because a little more than a month earlier, it had intervened to bailout investors in an unusual trust product or security issued by The China Credit Trust, one of China's many "shadow banking" companies. Named "Credit Equals Gold No. 1" to attract investments to the tune of 3 billion yuan, the product proved a dud because it was backed by loans to a coal mining company that went bust. Yet the investors were bailed out by intervention to make good the loan with only interest for the third year reportedly shaved off. According to the Financial Times, Moody's as expected declared that: "Although the current proposed settlement does entail losses to investors in terms of foregone interest, by fully repaying their principal, it reinforces the perception that investors will be bailed out one way or another when the products go sour, which is contrary to the establishment of sound market discipline and a healthy credit market." Given this history, it must be the case that either sections in the government that are in agreement with financial markets have gained the upper hand, leading to the Chaori and Haixin defaults, or the government now finds itself faced with a wave of defaults that it cannot simultaneously address without some difficulty, making some of them "unavoidable" as Premier Li put it.

If more defaults are inevitable, they could trouble China, where corporate debt, for example, has soared in recent years. According to reports, Standard and Poor's has estimated the size of corporate debt in China to be around $12 trillion or 120 per cent of GDP at the end of 2013. At the margin, a large chunk of these loans has been financed with investments in trust products issued by the shadow banking sector, such as "Credit Equals Gold". According to figures released recently by the People's Bank of China (PBC), China's central bank, loans provided by trust companies that populate the shadow banking sector rose by an annual 23 per cent to touch RMB17.3 trillion ($2.9 trillion) or 30 per cent of credit advanced in 2013. Around $650 billion of trust loans are expected to fall due in 2014, raising the possibility of further defaults in different parts of the economy. Under observation are firms like Zhejiang Xingrun Real Estate, a provincial real estate developer that would have to repay RMB3.5 billion ($569 million) of debt soon.

The other borrowers receiving large loans were local governments, which after a central borrowing ban in 1994, had set up off-budget local government financing vehicles to receive the loans and finance infrastructural and other prestige projects. They received loans not just from official agencies like the China Development Bank, but also from the trusts. According to China's National Audit Office local government debt had risen by as much as 70 per cent from the end of 2010 to touch $3 trillion in June 2013.

To this must be added the large volume of credit that has poured into China's real estate sector, giving rise to its own version of a housing and commercial real estate bubble. According to a 2013 survey by economist Gan Li (quoted by William Pesek of BloombergView), about 65 per cent of China's wealth is invested in real estate. A lot of this investment could be speculative with 42 per cent of housing demand in the first half of 2012 coming from those who already own at least one home. In many areas, these new properties remain unoccupied, indicating that some of the construction is in areas where demand is low. This has led to price declines that can be damaging since investment has been financed by credit that needs to be repaid. Overall, credit in China is estimated to have risen from 130 to 210 per cent of GDP over the last five years.

The need to restructure this overhang of debt, by imposing losses in areas where the risks are not seen as systemic, may be driving the decision of the reformist elite to allow defaults to occur. But the problem is to identify which of the problem loans carry systemic risks with them. Consider Shanxi Haixin, for example. It may not just be a borrower unable to meet payments that fall due, but rather an entity that is carrying risks residing in other parts of the economy. Some argue that Haixin is entangled in a web of debt involving other companies. It was, reportedly, the lead investor, along with other partners, in a credit guarantee company that guaranteed the debts of others for a fee (Financial Times, March 14). Exploiting financial liberalisation, companies such as these have given themselves a foothold in finance to beef up profits. As in the case of Enron and other such companies engulfed by the lure of profits from finance rather than from production, it seems unclear to what extent Haixin is a brick-and-mortar steel company and to what extent a financial intermediary. If its latter role is important, the systemic implications of its failure can be much larger than its size as a steel producer indicates.

Moreover, many companies such as these use raw materials. Their failure could affect demand and depress the prices of raw materials. That would affect the value of the stocks of these raw materials used as collateral for loans. Recent bond defaults are reportedly adversely affecting copper prices, already under pressure because of rising inventories. If debt guaranteed with metals such as copper, zinc and iron ore face default, investors would bring more metal to market depressing prices further.

What all this suggests is that what were being considered unrelated problems in separate compartments of the Chinese economy are in fact part of web that finance has woven. That has happened because China chose to liberalise its financial sector and continues to do so despite the warning signals it receives. At a recent press conference Li Keqiang placed his emphasis on “energizing the market and stimulating social creativity” rather than on reining in speculative capital. In his words: "How can an arrow shot be turned back? We're most determined to see the reform through."

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