The Chinese economy, dangers ahead?

By Craig Stephen, Market Watch, 4 February 2015

HONG KONG (MarketWatch) — Despite an interest-rate cut late last year, China's economy has got off to a slow start, with weak factory and service-sector readings. The typical response to such data is to expect more monetary stimulus. But have we reached the point where rate cuts are no longer able to lift China's debt-heavy economy?

Third year of slowing growth

As China enters its third year of slowing growth, there is growing concern the debt reckoning cannot be kicked down the road any longer. Credit has been growing faster than the economy for six years, and there has always been a recognition this cannot continue indefinitely.

Experience elsewhere would suggest countries coming off a multi-year, debt-fueled expansion could expect an inevitable hangover. This would include everything from bad debts, bankruptcies and asset write-downs, together with currency weakness and perhaps a dose of austerity to restore order to finances.

A different economy

For China, however, we are led to expect a different economy — one where, even in a down cycle, you don't get recessions but growth that only changes gear from double-digit to "just" 7%.

While naysayers warn China's debt binge is an accident waiting to happen, it never quite does: The bond market and shadow-banking sector have not experienced any meaningful defaults, nor has the banking system seen anything more than a limited increase in non-performing loans.

Looks a lot like other bubbles

China's property market might look a lot like bubbles in the U.S., Spain or Japan at different times in history, yet here the ending is again benign, with a gentle plateauing of prices.

But elsewhere, it is possible to find evidence that an abrupt China slowdown is underway. In various global hard-commodity markets — where Chinese demand was widely acknowledged to have lifted prices in everything from iron ore to copper in the boom years — a major reversal is underway. A collection of industrial commodities has now reached multi-year lows. This suggests a lot of folk in China are already facing a hard landing.

A moment of reckoning

Signs are accumulating that the financial economy is now getting to a moment of reckoning.

At home, slower growth puts added pressure on servicing corporate debt as profitability weakens. Overseas, tighter credit as the Federal Reserve retreats from quantitative easing means hot-money flows are no longer providing a boost to liquidity and are instead reversing.

The political will now appears ready to call time on the debt party, with Beijing targeting reform of local governments' debt and freewheeling government-financing vehicles. But this is fraught with dangers.

In a new report entitled "China's Credit Dominos," Société Générale warns of the fallout if an implicit state guarantee on debt is removed.

The puzzle has been that China's financial system has remained impervious in the face of an economic slowdown. The explanation, they argue, lies in the pervasive implicit guarantee of the state.

The secret to China's exceptional financial stability is that the majority of both borrowers and lenders are in some way part of the state. Local-government financing vehicles and state-owned enterprises account for the lion's share of debt in the system, while state-owned banks dominate lending. Even in shadow banking, such as trust finance, government entities still dominate.

The way China has developed its unique brand of state-capitalism means that much of the economy has avoided the judgment of the market by creating a situation where the market dynamics of risk discovery usually get suppressed. We see this in action when loans get rolled over or when there is some last minute bond rescue, often put together by the state.

But this system is now looking wobbly as Beijing acts to rein in local-government debt. On Jan. 5, local governments had to submit their final debt figures to Beijing, and the market is now braced for some scary numbers.

The situation of local governments has been made all the more precarious because they are so reliant on land sales for revenue, and the property market is slowing. More worryingly, SocGen notes that 40% of local-government debt relates to pledges on future land sales, making it all the more vulnerable to any fall in prices.

The big danger in all this is contagion or credit-risk unwinding in unexpected areas.

What is now different with China's financial system compared during to the financial crisis of 2008 is that it's no longer sealed from the outside world. The yuan USDCNY, -0.28% is increasingly circulating overseas, and Chinese corporations have sizeable dollar-denominated borrowings.

The day looks to be approaching when China will need to get used to growth without a pervasive "Beijing put." Global markets should brace for this new normal.