

The Role of Debt and China's Shadow Banking System: Is Baoshang Bank China's Lehman Brothers?

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Modern fractional reserve banking is ultimately a confidence game. If lenders or depositors are confident their bank is solvent, it stands. If confidence is broken, that historically leads to bank panics, deposit runs and domino collapse of a financial system or worse. The surprise collapse in late May of a small Inner-Mongolia Chinese bank, Baoshang, has suddenly focused attention on the fragility of the world's largest and largely opaque banking system, that of the Peoples Republic of China. The timing is very bad, as China struggles with a sharp domestic economic slowdown, rising food inflation, combined with the uncertainties of the US trade war.

At the end of May, for the first time in three decades, the Chinese Peoples' Bank of China (PBOC) and the State banking regulators seized an insolvent bank. They did so publicly and in a way that apparently was aimed at sending a message to other banks to control lending risks. By doing so, they may have detonated a domino-collapse of one of the world's largest and most opaque and under-regulated banking systems—China's poorly-regulated regional and local banks sometimes called shadow banks. Total assets of China's small and medium banks are estimated to approximately equal that of the four regulated giant state banks, so a spreading crisis here could be nasty. That clearly is why Beijing stepped in so quickly to contain Baoshang.

The Baoshang Bank to all appearances looked healthy. Its last financial report issued in 2017 showed a profit of \$600 million for 2016, assets of near \$90 billion and bad loans of less than 2%. The insolvency shock has created a growing risk crisis in China's interbank lending markets not unlike the early stages of America's 2007 sub-prime mortgage interbank crisis. It has forced the PBOC, the national bank, to inject billions of yuan, so far \$125 billion equivalent, and to issue a guarantee of all bank deposits to contain fears of a larger systemic banking [crisis](#). Indications are the crisis is far from over.

The problem is that China has built one of the most impressive construction and modernization efforts in human history in an astonishingly brief three decades or more—entire cities, tens of thousands of miles of high-speed rail, mechanized container ports, like no other nation in history—all on debt. The servicing of that debt depends on an economy whose profits are continually growing. If contraction once begins, the consequences are incalculable.

Now as the economy is clearly slowing down, some say even in recession, risky investments across the country are suddenly facing insolvency. Lenders of all sorts are suddenly looking again at the risks of new lending. The auto sector is sharply down in recent months, but

other industries as well. To make matters worse, a severe epidemic of African Swine Fever is decimating China's huge pig population leading to almost 8% food inflation. In this climate the PBOC is valiantly trying to avoid turning on the printing presses that creates more inflation and weakens the Renminbi for fear of igniting a new financial bubble.

An added Achilles heel in all this is China's dependence on global dollar financial markets for trillions of dollars of that debt at a time when dollar export earnings are declining even before the US trade war tariffs. Were China insulated from the global economy as in the 1970's, the state could simply deal with the problems internally, wipe out the insolvent loans and reorganize banks.

China Debt Model

In critical respects the China credit model is unlike that of the West. The currency, Renminbi, is not yet freely convertible. Control of money is not in the hands of privately-owned independent central banks as in the USA or the ECB in the EU. Rather it is in the hands of the wholly-state-owned Peoples' Bank of China, itself answerable to the Politburo of the Communist Party. Its largest industrial conglomerates are not private but State-Owned Enterprises, including the four largest banks in the world, the world's largest rail construction company and giant oil companies. That gives a huge apparent advantage. When the government gives an order, things happen. Rails get built with little obstruction, or highways. However, when the order is flawed, under a command or central planning model, it can magnify errors.

Now for the past two years Beijing has been clearly concerned with how it can correct the uncontrolled explosion of "off-balance-sheet" or shadow bank lending across the economy. Since the 2008 Lehman crisis, China has financed a staggering volume of construction projects to modernize what was one of the world's poorest nations a mere four decades ago, and to prevent economic contraction and exploding unemployment and social unrest. Since 2013 it has added the ambitious Belt, Road Initiative to the spending list, partly to sustain the pace of China steel and infrastructure industrial growth, as the domestic economy neared saturation.

With the 2008 global Lehman crisis, Beijing expanded that debt balloon like no other country in history. Since 2009, the China money supply grew nearly 400% or by \$20 trillion (133 trillion Yuan) while China's annual GDP grew by only \$8.4 trillion. That is inherently not [sustainable](#). Suspicion is that within that huge monetary expansion lie more than one Baoshang Bank insolvency today. At this point, however, as the financial regulation is still in its relative infancy, no one knows the true risks of insolvency contagion, not even Beijing.

Interbank risks unclear

The problem with the lending that is implied in these numbers is that the credits issued by so-called shadow banks-loosely-regulated small to middle size banks not part of the big state bank system- are poorly controlled and now facing widespread loan defaults and bankruptcies from high-risk loans they have made. Baoshang Bank's collapse has suddenly turned all eyes to those risks.

Big banks are hesitant to continue to lend to the small banks via the interbank market, forcing borrowing rates up. Assurances by the PBOC that the Baoshang case is an "isolated" one are not likely to reassure. Bloomberg estimates that for the first 4 months of 2019,

Chinese companies have defaulted on some \$5.8 billion in domestic bonds, more than three times the rate a year ago.

Beijing authorities including the PBOC have made it clear for months that they want to reduce such risky lending by local shadow banks and others to get the situation under control. However, it will not be easy to restrain risky local bank lending without triggering a wave of bankruptcy failures in China's slowing economy.

As a result of the unexpected Baoshang collapse, China's interbank lending market is suddenly in crisis. It is not yet clear whether Beijing authorities are acting sufficiently to calm the crisis or whether a quiet drying up of lending from large banks via interbank lending to small regional or shadow banks is underway that will cause further economic woes, bankruptcies and unemployment. A sign all is not well, on June 24 the PBOC announced that it will allow select brokerages to borrow up to three times more 90-days short-term commercial paper to keep liquidity flowing as they try to sort the mess out, according to Caixin financial news. This is clearly a stop gap to buy time.

Another sign Beijing is concerned, in early June authorities gave the green light for municipalities to further increase their already enormous borrowing for infrastructure. Local government officials will be allowed to use proceeds of bond sales to count as equity in the new infrastructure projects including more railways and highways, adding to the [debt mountain](#).

China Finance Minister Liu Kun just issued a report on the regional and local and national fiscal situation for the five months to end May. The numbers were not encouraging for Beijing's stated policy of controlling inflation and asset bubbles. He noted that all government revenue grew by just 3.8% year on year. Tax revenue grew only 2.2% owing to a big tax cut. At the same time, government spending grew by 12.5% annually. In response he announced that the government would demand austerity of "more than 10%" to reduce the gap.

China is governed by highly intelligent and hard-working people. There is no question. However, to put the easy money genie back in the bottle without major mishaps will require extraordinary skill and quite a bit of luck.

China external debt at the beginning of 2019 stood officially at just under \$2 trillion, two thirds of that [short-term](#). Unofficially, reports are that the large State-Owned Enterprises have taken on far more than that in low-interest foreign borrowings from the dollar and Euro. Nobody knows precisely.

This current situation will be the test for Beijing to show that it has banking crises like Baoshang under firm control, and that it is serious about opening China financial markets to foreign firms as part of its globalization. China needs the good cooperation of Western banks to maintain its impressive economy.

Until now China has been the apparent winner of the post-1990s globalization model. How Beijing manages its banking problems in the coming months may determine if that incredible record will continue. The challenge is real.

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Seeds of Destruction: Hidden Agenda of Genetic Manipulation

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