China's Growing Economic Miracle… Cracks and Bubbles?! Realties of China's Banking and Finance

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In emulating the American economic raison d'etre, China has attempted to develop its unique capitalist model while ignoring that it too will soon suffer the same fate for the same reason: Unsustainable debt. When examining the recent realities of Chinese banking and finance over the past year it seems the steam that president Xi Jinping touts as powering the engine of his purported economic miracle of a master-planned economy is only a mirage, now almost completely evaporated before his eyes.

Like the many other similarly foolish western nations, China seeks only one path out of this fiscal death spiral, one that will likely spell doom and/or revolution in many countries soon: *More debt.*

China is becoming increasingly unable to continue to pay into the base of the world's largest pyramid scheme of an economy and the cracks in the bubble are showing. This past year, saw three of the 4,279 Chinese lenders almost fail, if not for the massive intervention by the People's Bank of China (PBoC) of immediate liquidity via more debt. The Chinese economic miracle is built on unsustainable debt-based infrastructure projects over the past two decades that have provided China with a face of prosperity to show the world, but this is only a mask to hide the limited countrywide success of the Chinese miracle into the rural areas. The injection of $Trillions in capital has seen China distribute these sums across the base of its economy creating a GDP that hit a high of 14.2 % in 2007 then averaged nearly 9% for the next decade before dropping yearly to 6.1% in 2018. All this growth had produced a personal affluence to a sub-set of Chinese society that has stoked this appearance of a flourishing economy.

This Chinese economic Keynesian trick of interjection of liquidity into national infrastructure is somewhat similar to the TVA and national works projects funded under Roosevelt's depression-era New Deal. In this approach employment and therefore a growing tax base accelerated year after year as workers and corporations received the short-lived benefits of this massive windfall of available liquidity.

China's method of stimulus is of course distinguished from today's American model that merely shovels the injection of its own manufactured $Trillions by using multiple fiscal tricks to by-pass the citizenry and instead shovel the cash straight into the wallets of the already super-wealthy. Meanwhile, the US peasant once again pines in the *"Hope"*of yet another election.

The Metrics of a Failing Economy

Many analysts have for nearly a decade opined that China's belief in national fixed-asset investment, the biggest engine of China's economy, has long been the fundamental contributor to Chinese GDP growth, which was directly proportional to an ongoing increase in public and private debt. *"China has relied on export and debt-financed fixed asset investment for growth for over two decades,"* said Ho-Fung Hung, Professor in political economy at the Johns Hopkins University.

But as the world economy slows while the metrics show a recession looming China's economy is already cooling rapidly. *"And as the central government and banking system keeps producing new loans to absorb the debt, it leads to the continuous debt buildup,"* Maximilian Kärnfelt, an analyst with the Berlin-based Mercator Institute for China Studies, told news service DW, adding that infrastructure investment still largely drives China's economic growth since fixed investment contributed to 45 per cent of China's GDP in 2016.

In a sign of the disaster to come, the first Bank to almost fail was Baoshang Bank Co. in May 2019. In this instance, for the first time in twenty years, the government took over control and seized the bank. This progression next took form when Chinese regulators took a different approach by ordering three state-owned financial institutions to buy significant stakes in Bank of Jinzhou Co. When, Shandong-based Heng Feng Bank, which had failed to disclose its financial statements for two straight years, required a bail-out, the bank sold new shares for about $14 billion to a group of investors including a unit of China's public sovereign wealth fund and a local government-backed asset management firm.

Although these were some of the smaller rural banks, as shown this past month in Chinese reports, their economy is following the world in a quantified slowdown that has seen GDP slip yearly since 2012. Making the matter worse a similar world slow-down in purchasing is already affecting China's manufacturing-based economy. The three bank failures were only the tip of a huge iceberg.

China's $40 Trillion banking system dwarfs the American system at double the size, with over 4,000 small, medium and massive, state-owned banks. The world's four largest banks, including behemoth ICBC ($4TN), are all Chinese.

The failure of just three banks was important enough that Chinese regulators submitted Chinese banks to a stress test and the results were shocking. China's central bank admitted that China's banking sector is *"showing signs of strain."* The stress tests had revealed that over 13% of China's 4,379 lenders were designated "high risk" by the central bank's report. With this amounting to over 570 banks, and thus multiplied by the three existing examples of bank bail-out funding, with the Chinese economy following the world into recession, the financial numbers and likelihood of any future series of bail-outs are truly biblical. If not, *fiscally impossible.*

Separately, the PBOC also stress-tested 30 medium- and large-sized banks in the first half of 2019. In the base-case scenario, assuming GDP growth dropped to 5.3% – or well above where China's real GDP is now – nine out of 30 major banks failed and saw their capital adequacy ratio drop to 13.47% from 14.43%. In the worst-case scenario, assuming GDP growth of 4.15%, or just 2% below the latest official Chinese GDP report, seventeen out of the thirty of these major banks failed the test. Separately, a liquidity stress test at 1,171 banks, representing nearly three-quarters of China's banking sector by total assets, showed that ninety failed in the base-case and 159 in the worst-case scenario. The metrics of any collective bail-out indicates that China has upwards of an insurmountable $20 trillion problem rapidly approaching.

In reaction to these first three bank failures, the stress tests and poorer economic news China did what centrally planned economies do: Chinesepolicymakers focused on strengthening oversight and regulation by the PBoC and gave it authority to write new rules for much of the financial sector. The China Banking Regulatory Commission and the China Insurance Regulatory Commission will now be merged as part of an overhaul aimed at resolving existing problems such as unclear responsibilities and cross-regulation as well as closing regulatory loopholes and curbing risk in the $40-43 trillion (€34.78 trillion) banking and insurance industries.

With the metrics of China's banking system already pause for considerable concern to the tune of $20 Trillion, this huge obligation is as much a mirage as the economy since it fails to add to the account the very large and un-tabulated Shadow Banking loans which would add $Trillions in debt to China's already highly leveraged systemic banking risk. The International Monetary Fund (IMF), which provides- despite its predatory legacy- some excellent yearly analysis of worldwide economic developments has warned China's problems could lead to *"financial distress"* in the world's second-biggest economy. China is seen as one of the economies most vulnerable to a banking crisis, although Beijing has repeatedly assured that the risks are under control. In response to the PBoC reports, Chinese Finance Minister Xiao Jie echoed that the situation *"was under control."*

China's Economic Tricks of Sustainability

As the world economic body politic runs out of any remaining gas to keep a pilot light under the rapidly cooling metrics that show their long forestalled recession is near and certain, China is also contracting.

The national debt of China, which is the total amount of money owed by the Chinese government and all organizations and branches stands at nearly CNY 38 Trillion ($5.4 TN) and 54.44% of GDP.

Chinese debt has been accumulating ever more rapidly. The Institute for International Finance (IIF) reported that year-on-year, in Q1 of 2019 China's corporate, household and government debt increased 6% more from 297% of GDP to an incredible 303%. However, this is also more than a 100% increase since 2008 and amounts to 15% of all global debt.

These figures do not include the off-the-books "Shadow Banking loans that some estimates predict would triple that debt percentage to much closer to $16 Trillion. The problems are most serious in China's rural banking sector where an ever nervous public has reacted with two late-2019 bank runsat China's Henan Yichuan Rural Commercial Bank and then at Yingkou Coastal Bank.

At the end of 2018, the budget deficit of the Chinese government was close to five per cent. However, if the off-balance-sheet ("shadow") financing of local governments is taken into consideration, the budget deficit rises to over 11 per cent. However, at the end of 2014, the official government deficit stood at less than one per cent, but an accounting which includes local "shadow" funding was around five per cent.

China's shadow banking system is so-called since this myriad of endemic lending trickery is believed to be massive in total and kept off the books. These risky, undisclosed loans entered China's financial system in 2009 throwing open the doors to debt for a Chinese population hungry for investment in order to pay for all those Chinese and internationally made western goods.

The main kind of shadow deposit is generally offered as a wealth management product (WMPs). Chinese banks offer these via aggressive marketing of high-interest-rate accounts as their alternative to savings accounts which are regulated to a maximum return of 3 %. Since these sanctioned shadow loans advertise a return of as much as 8% or more, normal banking customers have been throwing their miraculously large paychecks into these funds by the billions.

One reason WMPs offer higher rates is that they are based on much riskier bank loans, much like the precursor to the late '80s, early '90's American savings and loan meltdown. Incredibly, banks don't hold these loans on their balance sheets or set aside capital against their potential defaults. Instead, they typically extend this debt via intermediaries called trust companies—firms that are not allowed to accept deposits or formally loan out money but are allowed to manage it. The trust companies create investment products like WMPs, which banks market for them in return for a commission.

With some smaller Chinese banks having already found themselves either getting bailed out or the subject of a bank run, one reason is that, like America, China's interbank/repo rates have surged amid growing counterparty concerns of the many banks seeking depleting available liquidity. This has forced many banks to rely almost entirely on new deposits to fund themselves, forcing them to hike their deposit rates to keep their funding levels stable. Like any Ponzi trick in banking, new cash is required to sustain these thousands of lending pyramids. With the economy in decline, this need has lead to some desperate regional banks offering incentives for depositor's cash that would make the long-ago American *"free toaster"*seem ordinary.

China has a massive pork famine that has seen disease wipe out 40% per cent of its pig population in 2019. With China being the world leader in pork consumption these bank's desperations have created some interesting incentives to attract depositors. The SCMP reports that new clients who deposited 10,000 yuan (US$1,430) or more in a three-month time deposit at the Linhai Rural Commercial Bank in Duqiao in Zhejiang province were then eligible to enter a lottery to win a portion of pork ranging from 500 grams (18 ounces) to several kilograms.Other rural commercial banks in northern China's Hebei province and western China's Guizhou province have also launched similar pork rewards programs. Dushan Rural Commercial Bank, located in the remote mountainous county in Guizhou, offered a coupon for 10 yuan (US$1.4) worth of pork for every 10,000 yuan of new deposits.

This solution has been touted as uniquely beneficial to these banks since,instead of offering higher rates which only accelerate the bank's insolvency due to requiring higher payouts on deposits, the bank is instead making a one-time payment, and the unusual incentive is enough to garner substantial new deposits.

PBoC cuts in its key lending rates in August '19 designed to stimulate a slowing economy have only exacerbated net interest margin pressures on these banks. With less income from returns on their loans and without the many funding options available to China's much larger banks, these increasingly high-interest rates that China's smaller banks have to offer in order to attract new cash deposits could further lead to their insolvency.

It’s been over four years since the last official Chinese benchmark rate cut. With America leading the way across the globe with rate cuts aplenty and China still having a base rate of far higher than the US rate of < 1.5%, it was only a matter of time for China to also drop rates.

With the new authority given to the PBoC, this key Loan Prime Rate (LPR) has become the new Benchmark Reference Rate to be used by banks for lending. This, like most recent decisions are designed to interject further liquidity in the form of debt once again into a still failing economy by lowering borrowing costs for small businesses. This rate will be now set monthly (20th of every month) and will be linked to the Medium-term Lending Facility rate. The current 1 year LPR stands at 4.15% after its latest cut on Nov 30 versus the Benchmark Rate of 4.35%. This number is sure to continue to shrink and can be considered a key indicator of Chinese frustration at retaining needed annual GDP growth since the result of this one move lowered the costs of the roughly 152 trillion yuan ($21.7 trillion) in yuan-denominated outstanding loans held by financial institutions (that are actually on the books) in a further hopeful attempt to again boost economic growth.

Just mere days after the 20 bps cut the PBoC further highlighted its desperate need for capital, announcing that it will be lowering the required reserve ratio (RRR) – or the amount of money banks are required to have on hand – by 50bps for commercial lenders. Currently, the required reserve ratio is 13% for large banks and 11% for small banks. The cut, which is the first since September, will bring the blended reserve ratio for Chinese banks to the lowest level since October 2007. In doing so PBoC effectively released about 800 billion yuan ($115 billion) in instant liquidity from out of the already cash-strapped financial system.

All these adjustments by China and the PBoC do little to control or pay-off increasing debt and are designed to maintain the Chinese miracle of TVA style infrastructural improvements that has been the employment engine of its economic growth. China’s new development of the Belt and Road Initiative (BRI), although a masterstroke in Eurasian commerce, also serves to continue the illusion.

As traditional monetary policy becomes ineffective to boost the economy, Chinese President Xi has installed twelve former executives at the state-run financial institutions across the country who will support the communist government’s ability to combat banking and debt difficulties, reported Taipei Times.

These appointments are in response to growth collapsing to a three-decade low in 2019. New manufacturing orders did increase but this was in large- and medium-sized enterprises. Small enterprises continued deeper into contraction and new non-manufacturing orders slowed, pushing employment further into quantified contraction.

An easier to understand recessionary metric, passenger car vehicle sales, fell yet again in December, plunging 3.6% to 2.17 million units, according to the China Passenger Car Association. This marks the 18th drop in the past 19 months for the country.Sales fell 7.5% in 2019 and 6% in 2018. GM said that its sales were down 15% in China and said that pressure into 2020 would likely continue.

Meanwhile, local Chinese manufacturers’ numbers are also down. BYD Co. posted an 11% drop in 2019 sales and SAIC Motor reported a “similar decline”.

Worse, exports to the United States were down 23% from the prior year.

Running from the Piper's Call

But, it seems that China has no choice but to carry on with the façade of financed infrastructure projects as the only path to survival. Said Victor Shih, an associate professor of political economy at the University of California in San Diego:

> "Because it [infrastructure investment] already is a large contributor to growth, the slowing investment will substantially reduce growth rates. This is not what the leadership wants."

Shih's assertion seemed confirmed when last year, President Xi said Chinese banks would lend 380 billion yuan ($55.09 billion) to support [Belt and Road cooperation](), and Beijing would also inject 100 billion yuan into a Silk Road Fund. Some observers view the project as an instrument designed to help the Chinese economy, with state-owned companies in specific sectors expected to profit massively from its implementation.

But they still need funding and Chinese banks on their own volition may be reluctant to get involved when already having troubles of their own. Andrew Collier, managing director at Orient Capital Research, says

> "The banks [may] remain leery of these projects because they doubt they will be profitable and they will be stuck with bad loan. In the end, we are going to see increasing defaults among smaller institutions, the collapse of private loans via wealth management products, and growing layoffs in areas of the country with less political power."

Making matter worse, a study conducted by the Center for Global Development estimates that the initiative could increase debt sustainability-related banking problems in eight countries also involved in the BRI.

> "I still think that if growth falls below a certain level, the top leadership will order a stimulus, which involves acceleration in debt growth," said Victor Shih. "That is the only viable tool in China's arsenal if the economy slows too much."

As noted in a recent article by University of Helsinki economics professor Tuomas Malinen, China has stimulated its economy aggressively in Q1 and Q3 2019 but interestingly has not continued its past emphasis on infrastructure investments as in 2015/2016. Q3 of 2019 saw record-breaking stimulus programs, however, China concentrated instead on providing loose credit to enterprises through both conventional and "shadow" banks.

As Malinen forewarns:

> "What is notable is that even with this record stimulus, China has kept its economy growing barely above the 'official rate'. This tells us that the Chinese economy has reached or is very close to reaching the point of debt saturation, where households and corporations simply cannot absorb any more debt, and any new debt-issuance fails to stimulate the economy."

Though a massive infrastructure-spending program could revive growth, the ability of China to issue fiscal stimulus is starting to be seriously limited. This effectively means that China is fiscally unable to underwrite massive infrastructure projects and so any new world-economy-saving stimulus from China, as in 2015/2016, will be practically impossible. New infrastructure initiatives- if recessionary metrics continue to deteriorate- could only be realized if those costs are directly monetized by the PBoC. This would be the weapon of last resort for China but , when considering a declining economy, may soon be inevitable.

As Goes China…?

China is just one more working example of the failure of the many globalist economies worldwide that are already similarly suffering in the grip of massive unsustainable- if not orchestrated- debt. Which country becomes the first to trigger the almost certainly pending domino effect of global economic collapse, is merely a rhetorical question at this point. As goes China…?

This week in an interview, former Reagan OMB director David Stockman highlighted the global economic link to China, saying,

> "The world economy would be not nearly as good as it looks had the Chinese not been borrowing like there's no tomorrow and building regardless of whether its efficient or profitable."

Stockman added, in summation,

> "The whole global economy is really dependent on China piling even more debt onto the $40 trillion pile they already have."

China economically continues to play the financial role of Kenneth Lay to its American mentor's Bernie Madoff. But in the last few months China has shown, like so many other so-called first world economies, that it too is now all-in at the casino and using only borrowed money in a desperate effort to stay at the table…*or starve.*

Worldwide, many countries already burn in political turmoil of their own debt-ridden making as their own primal forces of nature squeeze their populations with the resultant new mantra of ever increasing austerity while the IMF and World Bank waits in the wings, salivating to gobble-up the carcass.

Alas, when it comes to unsustainable national endemic debt one primal truth is now being heard clearly in China, as in other Central bank boardrooms across the globe, and the empty dinner plates of their public…

When the time comes to pay the piper, that debt *will*be paid, no matter…but the Piper will take, in lieu of payment, pork, flesh, blood, or… *dreams!*

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