Euler Hermes Economic Research

Economic Insight

China: Mini credit crunch for a mega economy?

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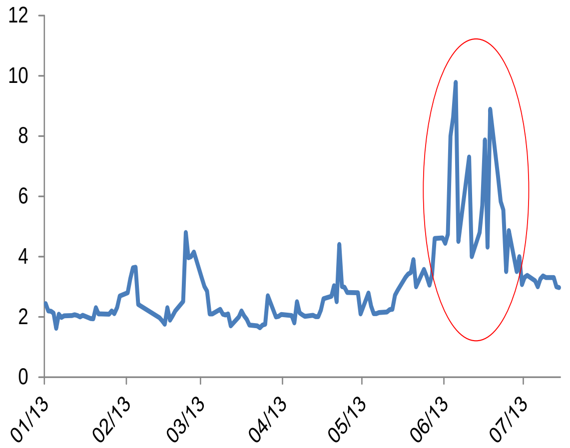
In summary

- A liquidity squeeze appeared in June 2013, giving rise to fears of a possible financial crisis. The latest credit data show a slight slowdown but no credit crunch.
- The causes of this slowdown are, in addition to regulatory factors, weakened markets, the change of growth model leading to more measured lending and tougher action by the government to rein in non-standard financing or shadow banking.
- The risk of financial crisis remains contained for the time being thanks to the financial solidity of the Chinese economy.
- By contrast, the risk of a liquidity crisis is real but confined to fragile economic agents (SMEs) and sectors with overcapacities (solar, steel and real estate).

Bank liquidity squeezes in June 2013

In late June 2013, the People's Bank of China (PBoC) tightened its monetary policy by sharply reducing liquidity injections. This led the overnight repo rate to soar (see Chart 1). In the PBoC's view there was abundant liquidity to ensure financial stability and credit supply, but it was being poorly used due to a lack of caution in lending, taking advantage of an accommodating monetary policy to favor unconventional loans (shadow banking). This warning came at a time when Prime Minister Li Keqiang was issuing increasing calls for "make active use of existing funds". Although the PBoC subsequently reassured the markets by guaranteeing sufficient liquidity to ensure financial stability and a sustainable pace of credit growth, this episode has given rise to fears of a possible financial crisis in China. While it is true that credit has slowed, this does not mean that such concerns are justified.

Chart 1: Overnight REPO rate evolution



Sources: IHS Global Insight, Euler Hermes

The data show a slight slowdown in credit, not a drying up...

In early 2013, total loans outstanding were at 120% of GDP, compared with only 98% in 2006. In 2009-2010, the public authorities conducted an expansionary monetary policy (sharp increase in M2) in order to ease up access to credit and stimulate the economy. After accelerating sharply during the recovery in 2009, credit growth returned to its long-term average (+16% y/y) in early 2012, and began a slowdown phase in Q4-2012 (+14% y/y in May 2013 – see Chart 2). While it is also true that credit is slowing as a trend, it remains relatively abundant. New loans increased by RMB 860 billion in June 2013 compared with May (RMB 660 billion), which exceeded expectations (RMB 800 billion).

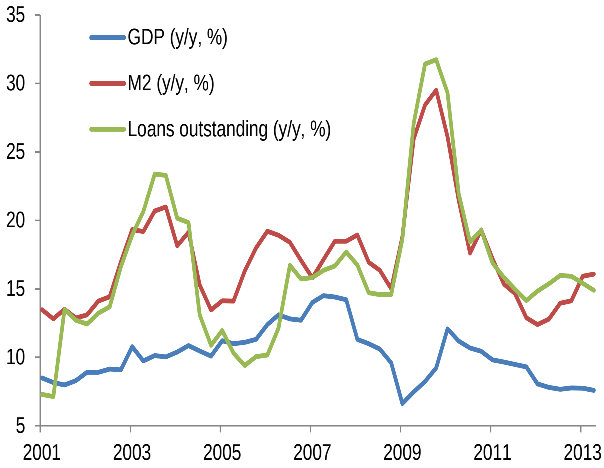
...The main causes: weak markets, change of model and rise in shadow banking

In addition to regulatory factors (reserve requirement payments, bank ratio assessments), this slowdown can be explained by three reasons.

(i) First of all, downward pressure on credit demand linked to weak markets. During the past decade, Chinese growth was driven by rising exports and investment. A favourable credit policy paved the way for an acceleration in investment in exporting activities, more competitive and more profitable thanks to the weakness of the RMB. One of the main causes of the slowdown in credit also stems from the decline in market prospects both at home and abroad. On the external front, declining demand in the eurozone (-0.6% in 2013), lower growth than in the past in the United States (+1.8% compared with +2.2% on average over a long period) and political tensions with its main regional competitor (Japan) have limited investment needs. On the domestic front, the ongoing deterioration in households' confidence as well as the rise in their savings (see Chart 3) point to a weakening of private consumption. These negative prospects, reinforced by the deterioration in order books since 2010 (see Chart 4), are exerting downward pressure on credit demand.

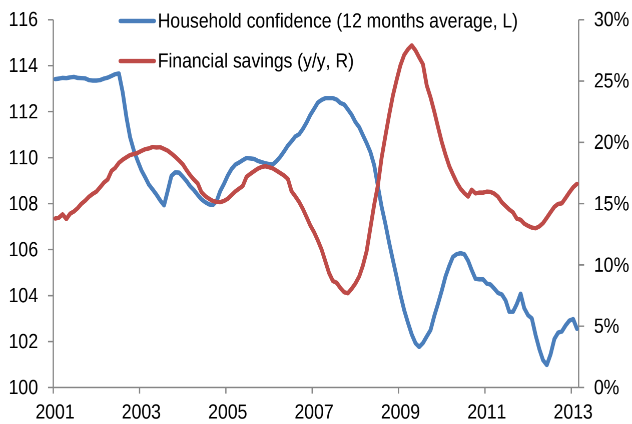
(ii) The determination for a change of growth model means more moderate credit supply. As part of its 12th five-year plan, the Chinese government has committed to working towards a rebalancing of growth in favour of household consumption, the share in GDP of which has been declining for more than a decade, in order to lay the foundations for more sustainable growth, lower (7%) than during the previous decade (+10%) but less dependent on external demand. The objective is to rein in investment, currently considered as being at a relatively "excessive" level (45% of GDP, see Chart 5), by limiting its speculative aspect particularly in real estate and redirecting it towards more profitable domestic activities (development of technology hubs, renewable energies) that generate more sustainable growth. To this end, the authorities have indicated there will be a more restrictive control of credit (tightening of conditions and regulations).

Chart 2 : GDP, money supply and credit outstanding



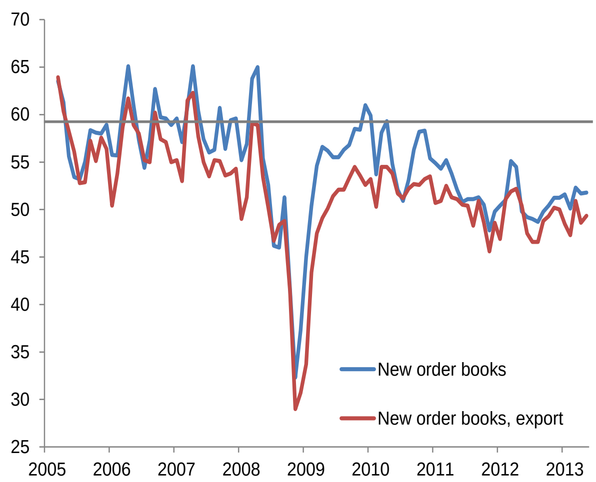
Sources: IHS Global Insight, Euler Hermes

Chart 3: Household confidence (12 months average) and financial savings (y/y)



Sources: IHS Global Insight, Euler Hermes

Chart 4 : Order books evolution (PMI index)



Sources: IHS Global Insight, Euler Hermes

(iii) Last, the third reason can be found in the rise of shadow banking. Shadow banking comprises all sources of intermediate financing other than bank credit. A portion of it can be measured by the PBoC, including discounted bills, trust and entrusted loans in particular, but also other less visible forms of loans such as pawnbroking and other private loans in the black market economy. Also, estimates of its size vary greatly. According to data from the PBoC, this form of financing has soared at the expense of bank credit since 2010 (see Chart 6). Financing flows from the shadow banking sector accounted for 7.6% of GDP in 2012, and 34% of total financing in 2013 (see Chart 7). In the month of May 2013, they increased by +136% 12m/12m. On the demand side, this substitution can be explained in particular by the difficulties facing some economic agents in accessing traditional credit. This is the case notably with SMEs (which lack sufficient security and are not guaranteed by the government) and state-controlled sectors (steel industry, solar energy and real estate) where access to credit is being restricted to limit their growth. On the supply side, shadow banking allows banks to circumvent the (many) regulations specific to their activity and to obtain higher returns. As this sector is a source of instability, because of a lack of diversification of (very risky) client portfolios and its lack of oversight, the public authorities have decided to react by tightening lending conditions. Accordingly, for over two years they have conducted an active policy to regulate shadow banking, the most recent policy of which aims at regulating the use of wealth management products (more profitable but more risky savings products), which trust companies use to attract public savings. Tighter regulation of banking activity is therefore another cause for the decrease in credit supply.

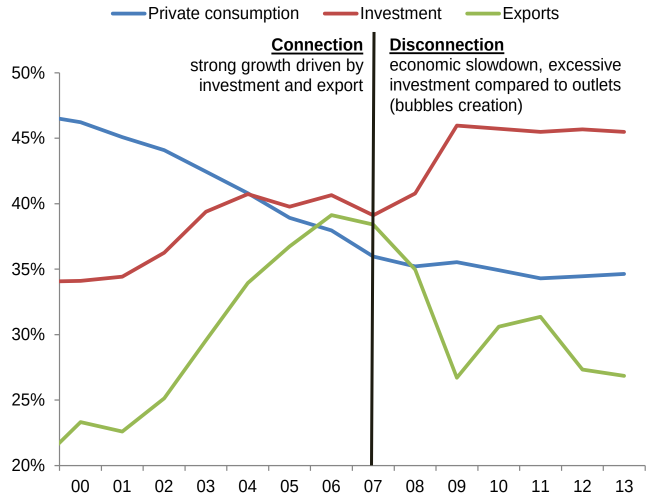
For the time being, the risk of a credit crunch remains contained: it is low and confined

Two factors could cause a credit crunch: a solvency crisis and/or a confidence crisis.

(i) A liquidity crisis is unlikely, as China's financial situation is solid. The government's finances are healthy (see Chart 8), China has the biggest foreign exchange reserves in the world (USD 3,442 billion) and the country continues to attract foreign investments (see Chart 9). Because of the central bank's ties (non-independent) with the government, the public authorities can easily and rapidly intervene upon the first signs of liquidity drying up. Thus, the persistence of the squeeze in June resulted from the government's intention to prompt banks into showing more discipline.

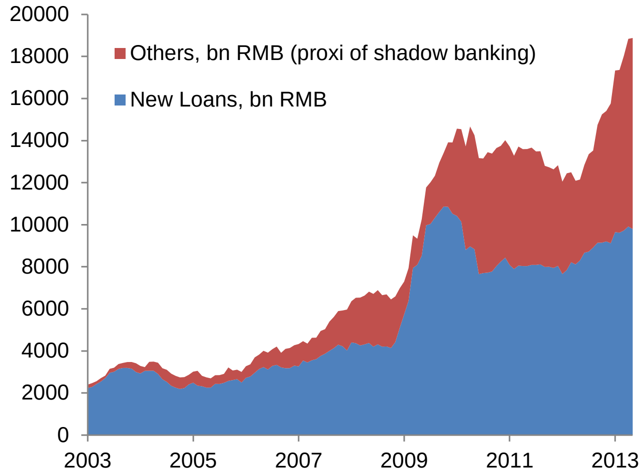
(ii) The risk of a confidence crisis appears small, as the Chinese authorities have gained a lot of credibility as a result of their responsiveness during the crisis and with respect to the imbalances linked to the shadow banking system, but also because of improved transparency (greater communication on the change of growth model and, for example, its role as a financial stabilizer).

Chart 5 : Relation between investment and exports



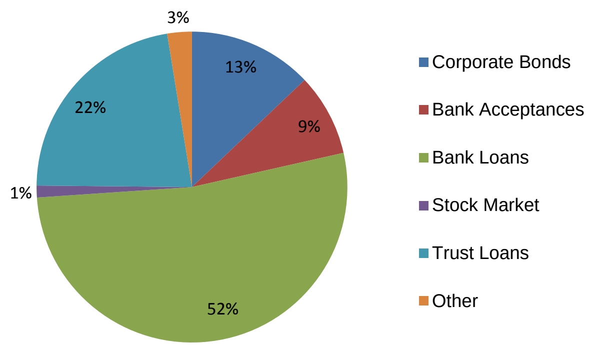
Sources: IHS Global Insight, Euler Hermes

Chart 6 : Financing sources (sum 12m, billion yuan)



Sources: IHS Global Insight, Euler Hermes

Chart 7: Financing breakdown (flows from January to May 2013)

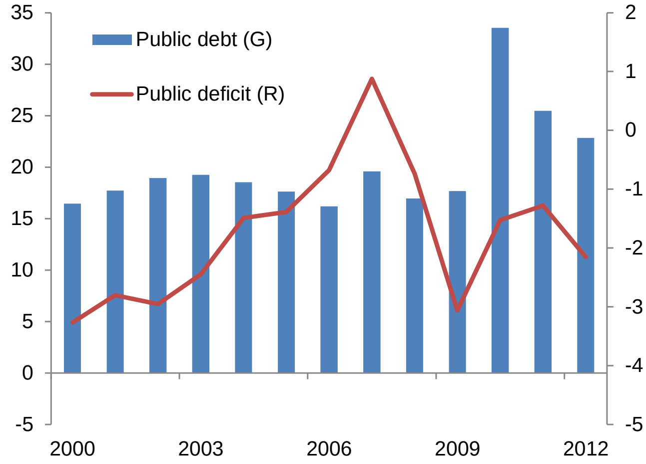


Sources: IHS Global Insight, Euler Hermes

The risk of a shortfall in liquidity exists but is confined to SMEs and to specific sectors. The sectors particularly exposed to a drying up of credit are those that are already struggling to access credit. These are non-state enterprises (notably SMEs) that do not have sufficient security and some highly regulated sectors (steel industry, solar energy and real estate).

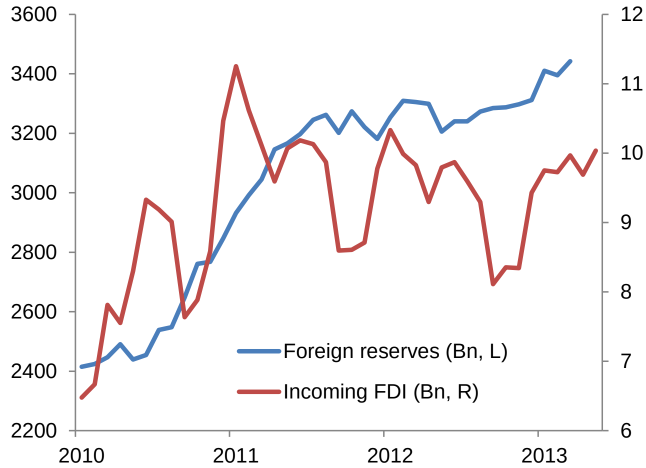
In the medium term, this risk could become more pronounced. For China it is a matter of finding the right balance for public policy. A tightening without monetary policy concessions would not take place smoothly: upward pressure on the exchange rate in this case, which would be detrimental to exports. Besides, without signs of acceleration in consumption, as a substitute for foreign trade, the Chinese economy is running the risk of a sharper fall in growth under the effect of a decline in exports and in the absence of a sustainable domestic driver.

Chart 8 : Public debt and deficit, % GDP



Sources: IHS Global Insight, Euler Hermes

Chart 9: Foreign exchange reserves and FDI



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