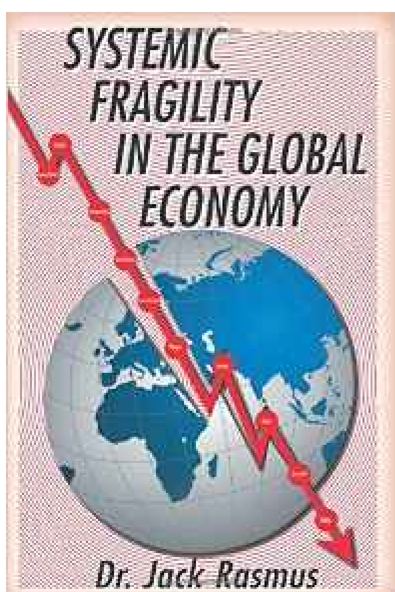
China's Financial Crisis Erupts Again–What's Next?

By [Dr. Jack Rasmus](#)
Global Research, January 11, 2016
[jackrasmus.com](#) 10 January 2016

Region: [Asia](#)
Theme: [Global Economy](#)

The primary indicator of excess liquidity and financial asset investment and speculation is debt. Debt—i.e. credit extended by lenders—is the mediating element between liquidity and financial asset investing. Excess liquidity is necessary for the availability of excess credit to be loaned out as debt. Debt and its leveraging is the stuff of financial asset over-investment and financial speculation that eventually leads to financial asset bubbles, instability events, and periodic asset bubble crashes. And when those crashes are of sufficient scope and magnitude, an economy-wide—or even global-wide—financial crisis results.

In parallel with China's exploding liquidity, its total debt has also nearly quadrupled from 2007 to mid-2015. According to a recent 2015 study by McKinsey &Company, the global business research and consulting firm, China's total debt rose from $7.4 trillion in 2007 to $28.4 trillion through mid-2014. That total represents 282% of China's GDP at mid-year 2014, among he highest in the world



The problem with China's debt, however, is not just its magnitude; nor even its rate of increase. Both are impressive enough. The even greater problem is its composition, by which is meant the proportion of the debt that is private business associated debt. China national government debt is not particularly severe as countries go. But private businesses are, and especially older basic industrial companies including the many that are government enterprises.

Click image right to order [Dr. Jack Rasmus' Book](#)

By far the largest part of the $28.2 trillion in outstanding debt in China, as of mid-2014, was debt held by non-financial businesses. At 125% of China's $9.4 trillion 2014 GDP, that's about $11.9 trillion. Add another $6.2 trillion for financial institutions' debt. That's more than

$18 of the $28 trillion, roughly two-thirds of its total debt as business-financial. Corporate debt is roughly $16 trillion in 2015 of that.

Local government debt is another problem of major dimensions in China, and should be viewed in part as wrapped up with private sector business debt. Over 10,000 local government entities in China set up ‘off balance sheet’ property investment vehicles called LGFVs, local government financing vehicles. Borrowing heavily from shadow banks, they then over-invested in local property markets. LGFV debt was approximately 18% of China GDP in 2008, or $634 billion. According to a China government survey done at the end of 2013, it rose to about $3 trillion for that year. Projections are it will rise further, to 45% of China GDP in 2015, or $4.6 trillion.

Another approximate $3.8 trillion represents household debt in China as of 2014, according to the McKinsey study, about half of which is household mortgage debt. That $3.8 trillion rose from $1.9 trillion in 2010. But the amount today may be actually higher, since the $3.8 trillion McKinsey estimate predates the bubble in China stock markets that began growing rapidly after the 2014 data by the McKinsey study. As the stock bubble grew, ‘margin debt’ lending by brokers to retail stock market investors, i.e. households who constitute 85% of China’s stock buyers, rose by as much as another $.85 trillion in just one year, from July 2014 to June 2015, according to some estimates.

Extrapolating from the mid-2014 figures, China’s total debt therefore likely will exceed $30 trillion in 2015—just about three times China’s nominal annual GDP. About $26.5 trillion is private sector debt or various kinds and related off balance sheet local government, LGFV, real estate debt. The rest is general government debt of about $4 trillion. That private sector + LGFV debt represents a $20 trillion increase in private sector debt alone since the 2008 crash—an unprecedented, historic rise in debt in only five years or so.

That debt would not have been possible without the massive liquidity injection by banks, foreign money capital in-flows, shadow bank source funding, and forms of ‘inside credit’ like margin debt, most of the latter of which is reportedly provided by shadow banks as well. And debt has consequences, especially when of that magnitude and composition. It becomes particularly important when the real economy is slowing or declining and when deflation is a factor, both in financial securities prices as well as in real goods and services prices.

China’s Triple Bubble Machine

Thus far China has faced three financial bubbles since 2013 which are in various stages of collapse and therefore financial asset deflation. The first is the local government property and infrastructure bubble. The second, the corporate junk bond and refinancing bubble involving older industrial companies and SOEs. In both cases, China’s central government has been intervening to prevent a rapid collapse of the bubbles and financial assets, trying to slow them down, prevent contagion, and extend the period of unwinding. The third bubble, in its two major stock markets, Shanghai and Schenzhen, began to form late summer 2014. In a year’s time, the stock markets surged 120%, clearly a bubble, and then began collapsing in June 2015. Since June 2015 the central government has been desperately intervening on an unprecedented scale to prevent the stock collapse from gaining momentum, just as it has been since 2013 to contain the deflating of the previous housing-local infrastructure bubbles that continue to be a problem.

The first bubble, in local real estate property, was driven by local governments, their off balance sheet financing vehicles, the 10,000 or so LGFV funds, and shadow bank financing (domestic and foreign) providing the liquidity and debt that fueled financial speculation in real estate from 2011 to 2014. Real estate prices rose to record levels in 2013. That bubble finally began to deflate in 2013-14. The collapse of the over-investing in housing and local infrastructure meant that a major stimulus to China's real economy was thus removed after 2013, or at least significantly reduced. It has been estimated that housing constitutes 10% of China's GDP. So it's collapse and retreat has taken away a major underpinning to China's real economy. In other words, the collapse of financial asset prices, and their subsequent deflation, has direct effects on a real economy GDP.

The effect of the housing bubble as it expanded also impacted the real economy. China's central government intervened several times to slow the housing bubble before 2014 but without much effect. Each time it intervened by raising interest rates it simultaneously slowed the real economy as well as the real estate sector. As this happened, China then lowered rates again and introduced fiscal mini-stimulus packages to get the real economy back on track. This in turn restarted the real estate bubble. This see-saw policy to try to tame the shadow banks and keep the economy growing at the same time happened several times before 2014. Thereafter, China adopted a more targeted approach to attacking its shadow banks, speculators, and their local government official allies feeding the bubble in local real estate and infrastructure. By 2014 real estate prices began to moderate. However, the speculators and the profits they made from the real estate bubble then moved on—to investing and speculating in the new financial asset opportunity associated with the WMPs, the 'asset management fund' securities.

The WMPs fueled the continuing bubble in what other economists in the past have called 'ponzi' finance, providing high interest loans from 'trust accounts' managed by Trusts and other shadow banks to enterprises becoming increasingly fragile. A parallel development in the boom in 'high yield' (junk) bonds was occurring simultaneously in the US and AEs. But as China's real economy has continued to slow, fragile enterprises are increasingly unable to repay even these high cost WMP (junk) loans. On several occasions since 2014, the China central government has had to bail them out and absorb the losses. As China's real economy slows more rapidly in 2015-16, it is questionable whether the central government can continue to bail out ever-wider potential debt payment defaults by these enterprises. Should it not do so, the market value of the WMPs will also deflate rapidly, just as housing has.

China's third clear financial bubble has been the acceleration in its stock markets. China's stock bubble of 2014-15 and its current collapse has several roots. First, it is the outcome of a conscious shift in policy by China made in 2014, to redirect the massive liquidity and deb that had been destabilizing its internal financial system—i.e. in housing, local government investment, real estate, and desperation financing of failing enterprises—into the stock markets. In 2013 a major policy 'turn' was decided by China leadership, of which the encouragement by the central government of the stock bubble was one element.

That major policy turn was to move toward encouraging more private investment and private consumption as major drivers of the economy, and to therefore shift away from the prior heavy reliance on direct central government investment and export sales, as was the previous case. That direct investment plus exports growth strategy began to lose momentum by 2013. Future growth based on exports was about to become more difficult, as both Japan and Europe had entered double dip recessions and US growth showed no

signs of accelerating. Japan introduced its QE program, designed to drive down its currency exchange rate and make it more competitive in export markets. Europe introduced its own liquidity version, a kind of 'pre-QE' called Long Term Refinancing Option (LTRO), with the same objective in mind. The US signaled it would raise interest rates which meant emerging markets would be severely economically impacted at some point and thus reduce their demand for China exports as well. Global trade showed signs of initially slowing. An export-driven strategy was therefore less reliable, China apparently decided. At the same time, it was also growing clear there were limits to China's government direct investment stimulus to growth. China apparently therefore decided at an important Communist Party conference in 2013 to 'restructure' by shifting to more private sector driven growth. That is, to encouraging more private business investment and private consumption. Boosting the stock market was viewed therefore as the solution to enable the transition to more private investment and consumption.

Stimulating the rise of stock prices was also considered to have a double beneficial effect. It would divert money capital out of the over-heated local housing and real estate-infrastructure market, which it did. Higher stock prices would in theory also provide an important funding source for SOEs and other non-financial enterprises in trouble. If their stock price rose, it would reduce their need to borrow more debt at higher rates with more stringent terms of repayment. Debt would be exchanged for equity, reducing their financial fragility. Higher stock prices also meant, in theory at least, that enterprises in general would realize higher capital gain income, from which they could and would invest in expansion. Real asset investment would result, providing jobs and income for more workers and thus more private consumption. Rising stock prices would also have a positive 'wealth effect' on high end retail investors in the market, and also promote more private consumption. Higher stock prices would assist in the strategic shift to more private sector investment and consumption as the key drivers of economic growth.

It appeared a stock market boom was therefore the answer to several strategic challenges: first, the stock boom enabled plans to restructure toward more private investment and consumption; second, it addressed the need to tame the shadow banks and the bubbles they were creating by redirecting money flows into stocks; third, the new investment and consumption would get the China economy back on a faster GDP growth path—a path that was clearly slowing as the slowdown in global trade promised to negate an export driven growth strategy.

So China's government undertook a series of measures in 2014 to rapidly expand stock values. However, the timing was inopportune. Emerging markets were already under growing pressure and slowing. Their income from commodities exports was declining. The domestic real economies of Japan and Europe economies were not recovering as planned and their demand for China exports was not rising sufficiently. Then, in June 2014, the collapse of global oil prices commenced. To boost the markets, China's central bank, the Peoples Bank of China (PBOC) began lowering interest rates in late 2014, the first of what would be five consecutive cuts. It further injected liquidity into the markets by lowering reserve requirements of banks to get them to lend even more. In mid-November 2014 it introduce several changes to open the economy and markets further to foreign money capital. And, as a clear signal as to where the additional liquidity should flow, it introduced measures to encourage even more aggressive buying of stocks on margin. A flood of 'retail' investors came into the market in early 2015 as a result. The margin buying by retail investors was especially getting out of hand. Measures were introduced to slow the trend, to

no avail.

After rising 120% in a year, the damn broke in China's two major equity markets in June 2015. Stock prices crashed by 32% in just two weeks on the Shanghai exchange and by 40% on the Schenzen. Just as it had intervened to help create the stock boom, China policy makers quickly intervened again, this time to try to quell the collapse. Various measures were introduced to prevent selling of stocks, including suspension of trading at one point of nearly three-fourths of all the listed companies on the exchanges. Short selling of stocks was banned. Major shareholders (more than 5% of total shares) were banned from selling. Other measures were initiated to get buyers back into the market to buy stocks. SOEs were required to buy their stock, even if it meant raising more debt. State investment funds were ordered to buy. The PBOC provided more liquidity to brokerages to buy stock. And in another 180 degree turnaround, margin buying terms were again loosened and encouraged. In other words, a return to massive liquidity injections to try to resolve the problem that excess liquidity had helped create in the first place. That additional liquidity would translate into yet more financial debt earmarked for financial asset investment and speculation. The long run problem—too much liquidity and therefore too much leveraged debt feeding financial markets—became the short run solution. But the solution would again add to the long run problem.

China's strategic policy shift in 2013—away from direct government investment, manufacturing and export driven growth, and monetary policy in service to that real investment and exports approach—amounts in retrospect to a strategy for recovery not unlike that failed approach adopted by the advanced economies from the beginning of the crash of 2008-09. That AE strategy relied primarily on monetary measures that accelerated liquidity in the system. Fiscal policy was token at best (or negative in Europe and Japan), assuming forms of austerity. AE central banks believed that massive money injections would flow into real asset investment as banks resumed lending to non-financial enterprises. Real investment would bring back jobs, and therefore income and consumption. Wealth effects from rising financial asset values would add to consumption. More consumption would stimulate more real investment in turn. But nothing like that happened. The liquidity flowed into financial asset investing and financial markets, boosting stocks and bonds but little else.

China differed from the AEs in the initial period of 2008-10. Fiscal policy came first, and monetary policy and liquidity was primarily accommodative. But that began to reverse as a result of a series of measures, first in 2010 and then in 2013. The liquidity and debt explosions in China thus came later, well after the AEs, and in different forms. The eventual financial asset bubbles occurred in different markets as well. But China's experience, especially after 2013, shows the same problems with AE recovery strategies that focus on liquidity injection that ultimately lead to excessive debt leveraging that tends to flow into financial asset markets. They lead to financial asset bubbles, to the need for still more liquidity to prop up the financial asset deflation that inevitably occurs when bubbles unwind and prior debt cannot be repaid. Excess liquidity leads to debt leads to more liquidity and yet more debt. It is a vicious circle leading to financial fragility and instability.

Author's Note: With all the news about China this past week, likely to continue this week and next, how did the growing crisis in China originate? The above text is an excerpt from chapter 6 of my just published book, 'Systemic Fragility in the Global Econonomy". That chapter, dedicated to China, is entitled: "Bubbles, Bubbles, Debt and Troubles". The following are two excerpts from Chapter 6 on China in the book. Order a copy of Rasmus'

book here or on amazon.

The original source of this article is jackrasmus.com
Copyright © Dr. Jack Rasmus, jackrasmus.com, 2016

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Dr. Jack Rasmus

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca