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WSJ Blog:Credit Crunch Looms For China

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By Alen Mattich

China's credit boom could well be unprecedented, even in an era of massive debt binges. And day by day, it's looking ever more vulnerable.

China re-ignited growth in the wake of the financial crisis by pumping vast amounts of credit into the economy through its banking system. This worked to get China growing again as the rest of the world ground to a halt. But it also set up some longer-term problems.

Much of the credit went into expanding industrial capacity or into speculative real-estate projects. The result now is that Chinese property prices are over-inflated and can only be maintained by ever larger infusions of cheap credit, while Chinese industry is only being kept afloat through massive subsidies.

The country has huge over capacity problems across Chinese industry. One academic analysis estimates that subsidies account for 30% of Chinese industrial output. "Most of the companies we looked at would probably be bankrupt without subsidies," said **Usha Haley**, one of the paper's authors, quoted in a recent Financial Times article.

Banks have been happily rolling over debts that in all likelihood won't ever be repaid.

And the economy is rapidly reaching the limits to which ever more credit expansion can keep this system going. For one thing, the subsidized credit isn't free. It comes at a cost to Chinese households, which are forced to bear losses in real terms on savings that generate below-inflation yields. It would take a dramatic shift to rebalance the economy away from investment--which makes up an unparalleled 50% of GDP growth--towards domestic demand. Chinese household demand made up 34% of the economy in 2011 (it's risen only slightly since) against 53% for South Korea, 63% for Vietnam and 56% for Thailand.

Household consumption tends to make up between 60% and 70% of developed economy outputs--Japan's at the low end, the U.S. at the high.

China has certainly made efforts to shift towards a more balanced type of growth, not least through the central bank's efforts at limiting credit growth. Unfortunately, that's been accompanied by a wider slowdown in the economy.

The more the economy slows, the more uneconomic firms will suffer and fail. There have been waves of rumors about problems in the Chinese banking sector. The government will, no doubt, be tempted to step on the gas again if the shift from credit-driven growth to household consumption causes growth to slow too much.

But one wonders how much that will help, when, in May, a 2.3% increase in total social financing (which is how the Chinese government measures credit expansion) only generated 0.6% of GDP growth, according to Michael Pettis, a finance professor at Peking University, writing in his latest monthly research note.

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What's more, a lot of credit expansion--around 36% by one estimate--has stemmed from the shadow banking industry, over which regulators have little control and about which they have less information.

The senior director covering China for Fitch, the rating agency, warned that China's credit-driven growth model falling apart is a particular worry given that China's credit boom is bigger than anything ever seen in a major economy, according to quotes in a Daily Telegraph article.

The turn in China's credit cycle isn't just a function of domestic policies, which can be reversed, but also of developments elsewhere, particularly in the U.S. As the Federal Reserve shifts to a less accommodative policy stance, hot money that had been flooding China in search of a return will increasingly flow out. This will cause a credit squeeze beyond the modest one the Chinese authorities are trying to engineer and could well be a force they find it hard to offset.

Well informed China watchers like the economist Andy Xie, Mr. Pettis and Patrick Chovanec, an asset manager and former professor at Tsinghua University in Beijing, have long warned about the dangers of China's unfettered credit growth.

No doubt, we'll now see what happens when it goes pop.

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