Is China living a Minsky Moment? Between the 'Lender of Last Resort' and the Chinese Shadow Financial System[1]

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Abstract

The Central Bank of China (PBOC) after Lehman Brothers bankruptcy (2008) created a big 1.8 trillion dollars package to reactivate the Chinese economy. It was a necessary key measure to reactivate the economy and to try to keep the two-digit growth of the GDP before the Great Crisis. The financial instability of the international financial circuits made necessary the involvement of the central bank. Ten years later, China's debt explosion went, during the financial crisis, from 6 trillion dollars to 28 trillion dollars between 2007 and 2016; and from 148 to 260 percent of GDP during the same period. The objective of this research is to show whether China is living a Minsky Moment or not and its implications in the international financial markets.

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Is China Living a Minsky Moment?

Zhou Xiaochuan, governor of the People's Bank of China, said at the 19th Communist party gathering in Beijing[3] "If we are too optimistic when things go smoothly, tensions build up, which could lead to a sharp correction, what we call a 'Minsky Moment'. That's what we should particularly defend against" (Wildau, 2017). This statement is true. China's debt explosion went, during the financial crisis and after Lehman Brothers bankruptcy, from 6 trillion dollars during 2007 to 28 trillion dollars at the end of 2016; and from 148% to 260% of the GDP during the same period (Wildau and Weinland,2016).

Since 2009, Rating Agencies such as Fitch Ratings (2011) have been wondering the importance of NPLs, leverage in the Chinese Financial System (CFS) and the risks in the Chinese Shadow Banking System (CSBS). The credit, through the 'lender of last resort' with the participation of State Big Banks, regional banks, and the new institutional financial investors, has continued to expand to reactivate the economy trying to return to the two-digit GDP before the Great Crisis. During the Great Recession, the PBOC has been trying to induce economic growth but the international environment has not been the optimal path for Chinese economy.

What happened years later, after these measures were taken by the PBOC, was a strong and fast debt development characterized by the CFS. Today the CFS is characterized by growing debt of corporations, overdue portfolios and nonperforming loans of banks and institutional investors. At the same time, financial fragility has concerned international

[3] The 19th National Congress of the Communist Party of China (commonly referred to as Shíjiǔ Dà; Chinese: 十九大) was held at the Great Hall of the People, Beijing, between October 18th and 24th, 2017.

financial organizations and rating agencies by the indebtedness and instability of China Shadow Banking System (CSBS). Until the 18th Communist Party, Economic and Financial Reforms and 'One Belt, one Road' (OBOR) were announced by the president Xi Jinping to follow a new pattern of economic development to induce and satisfy internal market and apply to globalization favoring Chinese private and public Corporative Groups.

Big Government in a Monetary Economic Production

'Big Government' means "a blessing when it prevents debt deflations and deep depressions" (Minsky, 1964:315). In a capitalist economy, demand must be guaranteed by consumption spending, of course through employment creation. A capitalist economy is a market economy, "is a financial system" (Minsky, 1992:16). What we have seen in the Chinese financial system after the post-crisis period is the way in which the PBOC has been transforming Chinese economy into a capitalist economy through the financial circuits. Therefore, Minsky's analysis is relevant. The deregulation and the liberalization of the financial process induced the transformation of the financial system form 'hedge' to 'speculative'.

Numbers from the Bank for International Settlements (2017) show that during 2007 the total amount of granted credit to the non-financial[4] system went from 143% to 258% of the GDP, growing at an annual rate of 5.7 % until it reached 5,207 billion dollars, to measure the magnitude of the problem, it means that the debt that corporations, families and government will have to pay is 2.5 times larger than the size of the second major

[4]The total credit is broken down into (i) credit to non-financial corporations and (ii) credit to households and non-profit institutions serving households, (iii) credit to general government (Bank for International Settlements, 2017).

economy of the world. Despite the impulse provided by the central bank, economic growth is far from the two-digit numbers that it reached at the beginning of the century; during the last six years the average annual growth rate was 7.6% and the IMF predicted 6.7% for 2017 (IMF, 2017). With the objective of maintaining the high economic growth rates, from 2009 the PBOC increased liquidity for economy through a credit expansion policy channeled via the traditional banking system, feeding secondarily the development of shadow banking[5].

The emergence of financial fragility and instability responds to a moment in the economic cycle (Girón and Chapoy, 2008), even though granted financing has had a growing tendency, it is not affecting equally the economic activity (See figure 1). It may be said that agent's indebtedness is not being supported with increasing growth, which deteriorate the profitability of investments and hinder the payment of loans.

Insert figure 1

The Mckinsey Global Institute's[6] opinion is that there are three risk areas; reading carefully the McKinsey report, through Minsky's eyes, one may think that CFS is in a Ponzi situation, but how can this hypothesis be demonstrated? Trying to explain the expansion of the development of the credit and the risk of the situation, we will divide the total credit in

[5]For 15 years, traditional banking went from being the only cannel for financing to explain only three fifths of the new credit (The Economist, 2016).

[6]"First, roughly half of the debt of households, non-financial corporations, and government is associated with real estate, either directly or indirectly. The second risk is rapid growth in lending to local government financing vehicles (LGFVs), many of which may struggle to repay. A 2014 audit of local governments found that more than 20 percent of recent loans were used to pay older debts and that almost 40 percent of debt servicing and repayments were funded by land sales. The third risk stems from the fact that around one-third of outstanding debt in China is provided by its rapidly growing, opaque shadow banking system" (McKinsey Global Institute, 2015:73).

four charts: 1) credit to non-financial corporations; 2) credit to households; 3) credit to general government; and 4) banking institutions.

1) Credit to Non-Financial Corporations

64% of the granted credit to the non-financial sector is in corporations, its excessive growth made it necessary for Zhou Xiaochuan, governor of the central bank, to pronounce. He mentioned that China is still on time to decrease its corporative debt to manageable levels, the means to contain it will be through restructuring disabled enterprises so that they are able to face their attained commitments (Waldmeir, 2016).

The banking system stability will depend, greatly, on corporations to be able to pay their debts. Between 2007 and 2017, the credit granted to corporations went from 106% to 165% GDP, growing at an annual average rate of 18.3%, adding up to 18.331 billion dollars during March 2017 (See figure 2).

The period with the greater expansion is the one between 2009 and 2013, in which credit increased 25.2% , which happened because of the anti-cyclical policies applied by the central bank; and example of the latter is the program for boosting economy by applying, during October 2008, a 1.8-billion-dollar injection or the program for boosting infrastructure investment (Girón, 2009).

A characteristic that is important to notice is the deceleration of the growth variable during 2015 (accompanied by a decrease in the growth of economy), when it only increased in 3% of the GDP or 1,062 billion dollars; this behavior may be a consequence of the central bank's concern for the health sector.

Insert figure 2

2) Credit to Households

Despite that the credit granted to households represents only the 18% of total; it is the variable with the most growth. Between 2007 and 2017, the credit to households multiplied 4.5 times, it went from 10% to 45% of the GDP, and the average annual growth rate of the period was of 32%, reaching 5,050 billion dollars during the first trimester of 2017 (See figure 3).

The period with the greater expansion locates between 2006 and 2010, since the variable increased at an annual average rate of 58%, going from 10% to 27% of the GDP; this increase in credit granted to households was accompanied by the major economic expansion of the last sixteen years and it had an average growth rate of 11.2%.

A problem related to financing for households is the increase in mortgage loans, which represent around the 60% of the debt of urban households (Tang, 2017), the IMF estimates that more than a third is from seriously indebted households, and this is shown in a greater deterioration of balances (IMF, 2017). Facing this fact, the government started applying preventing measures such as restricting the estate purchases and limiting the number of apartments that one may own (Cheng, 2017).

Insert figure 3

3) Credit to General Government

During the period between 2007 and 2017, the debt of the government increased at an annual average rate of 20%, from 25.7% of the GDP to the 46.9%, reaching 5,207 billion dollars for the first trimester of 2017. Notwithstanding that the dimension of the variable is like the amount granted to households, its behavior has been the opposite, which is visible in a constant decrease in its rhythm of growth and it is the item that has the least attention at an international level (See figure 4).

Insert figure 4

4) Banking institutions

The data from the China Banking Regulatory Commission (2015), show that at the end of 2015 the total amount of bank assets located at 32.15 billion dollars, which represented an increase of 27 billon or 15.7% when compared to 2014; the average growth rate between 2013 and 2015 was of 18%, the greater expansion happened during 2009, when the total amount of assets increased 25.9%, which 7% greater than the average for the period that is being studied. On the other side, the total passive was 29.7 billion dollars, increasing in 15.1% when compared to 2014; with an average annual growth rate of 17.5% for the period between 2003 and 2015. It is worth mentioning the decrease of passives during 2013, since its average growth rate decreased from a 17.5% to a 13.8% (See table 1).

During 2015, the loans from banking institutions reached 16 billion dollars (99.3 Yuan), which represented an increase in 14.5% when compared to 2014. Between 2003 and 2015, bank credit had an average growth rate of 16%, having its greater expansion during 2009, when there was a 32% increase (the double when compared to the period that is being studied).

Bank deposits represent the money delivered by surplus agents to a bank with the objective of receiving a future interest, that is, it symbolizes the sacrifice of current consumption for future consumption. Between 2013 and 2015, bank deposits grew at an average rate of 19% and reached 22.54 billion dollars; it is worth mentioning that the growth rate has shown little fluctuation when compared to its average value, which shows trust in the banking system despite the world crisis and the economy deceleration. The period with greater growth happened during 2007 and 2008, since it increased 32.6%

Between 2008 and 2015, the benefits after taxes grew at an average rate of 24.5%, the amount of the variable is barely 0.318 billion dollars. The banking system is controlled by state banks and a great amount of credit is still directed towards specific projects; since they are state entities their goal will not be to look for profit but social welfare. This may be shown by examining 2009, when the variable's growth decreased to 14.7%, which is 9.8% less that the growth of the period. In other words, there has been less benefit in moments of greater economic shortening.

Channeling and Financialization, a PBOC Concern

The need for financing in a monetary economy of production responds to the interactions between investment and consumption throughout the economic cycle. To satisfy the demand for investment and consumption from economic agents, indebtedness is necessary as the essential financing mechanism. Financial fragility, panic and asset deflation increases from accumulation of debts, the result of new combinations and a 'creative destruction'. Financial instability is constant in a monetary economy of production. The demand for capital flows in the phase of the expansionary cycle allows new combinations; the conditions for fragility in the future are created by prosperity. On the one hand, the process of ‘creative destruction’, referred to by Schumpeter (1968) in the face of technological change and new products in the market, creates the conditions of fragility for companies that leave the market when they are unable to face the payment of their liabilities.

Minsky points out, on the other hand, that debts accumulation in prosperity “does not allow units to fulfill their payment commitments” (Minsky, 1964:178); by conceiving money as a flow of capital and not as a stock of money, its flow plays a very important role in financing the financial units. Thus, there will be hedged, speculative and Ponzi that will lead financial units to a deflation of financial assets until reaching the economic cycle facing panic, recession, and depression. From a heterodox perspective, one can observe a trend in Chinese economy on the financing process endorsed and sustained by the PBOC. Deng Xiaoping's economic reforms, the strengthening of the PBOC, the formation of a financial system to maintain economic development, and the insertion of China in the world market, provided the country with a predominant place in the world; it functioned as its locomotive, the factor that kept the process of growth before the bankruptcy of the international financial system during 2008.

The performance of the PBOC from the injection of $ 1.8 billion dollars in 2009 and the constant and growing public and private indebtedness represents 281% of China's GNP: 55% corresponds to public debt and 51% corresponds to governments (Liang, 2016). It is not the main commercial banks that have been favored by the position of the PBOC, as estimated by academics of the Chinese Academy of Social Sciences (CASS), but the shadow

Chinese financial system. It is calculated that the problem of the shadow financial system, which value is calculated between 2.3 and 4.8 billion dollars, is the one that has surprisingly grown and is facing a Ponzi situation. The PBOC's intervention was not a coincidence when assets fell 29% in only two months and fragility in financial circuits recalled the crack of 29 (Stewart, 2015).

Unlike the investment baking of the United States, the shadow financial system in China consists of trust companies, non-financial institutions that lend money and take direct shareholdings as shareholders. Trusts charge higher rates than bank loans and offer a higher rate of return for investors whose minimum investment is expected to reach one million Yuan (The Economist, 2016). On the other hand, the Chinese companies that have had an overwhelming growth since the Great Crisis own the attention of the shareholders and the Regulatory Commission. Most financing for the HNA, Dalian Wanda, Fosun, Anbang and Zhejiang Rossoneri come from Chinese domestic investors and growth operations have been significant overseas. The government is concerned about large companies whose investments are outside mainland China (The Economist, 2017) as well as about the recent moratorium that have presented companies such as Chaori Co., China Shanshui Cement Group, Boarden Tianwei Group, Cloud Live, ZhuhaiZhongfu, China National Erzhong Group, China National Machinery Industry Corp. (Sinomach), Sinosteel Co., Dongbei Special Steel Group, Shanxi Huayu Energy, China Railway Material (Table 1).

Reflections

Recent interviews to members of the Chinese Academy of Social Sciences[7], in what refers to the situation of the Chinese financial system, show and agreement on the impossibility of financial crisis because of the strength of the State. From occidental perspective, the increase of expired portfolios in Chinese banks and the weakness of its financial states as well as the instability of currency and the exit of capitals, they are perceived as an alarm sign since 2015. However, China will not have a financial crisis as shown by the United States between 2006 and 2008 and bankruptcy, as happened with Lehman Brothers during 2008, is even less possible. On the contrary, China is a country with a strong economic State and there is a "Big Government", as defined by Minsky, who is able of facing a decrease in production and an increase in bad financial states of its financial investors. The role played by the PBOC has allowed stability in a global unstable environment for the financial circuits.

Despite of initiating the gradual deregulation and financial liberalization process, accompanied by an increase of operations outside the balance that have increased the SFS, financing towards projects with a great reach at a global level, such as the projects contemplated by the OBOR, they will prevent and economic and financial crisis that might impact at a global level in China. It is important to emphasize that "the rapid growth of shadow banks in China is driven both by structural and transitory forces. Structurally, China's state-dominated banking sector lends mainly to state-owned enterprises and leaves many of the small and medium size enterprises underfinanced. Moreover, given the ceiling on deposit rates, many savers seek alternative venues for their savings. WMPs provide a

[7] Interviews made during the academic exchange program UNAM – CASS, to specialized Chinese academics in financial matters of diverse institutes at the Chinese Academy of Social Sciences. November 2016.

weighted average yield of 5.5%, compared to the 3.0% one-year deposit rate" (Liang, 2016:462).

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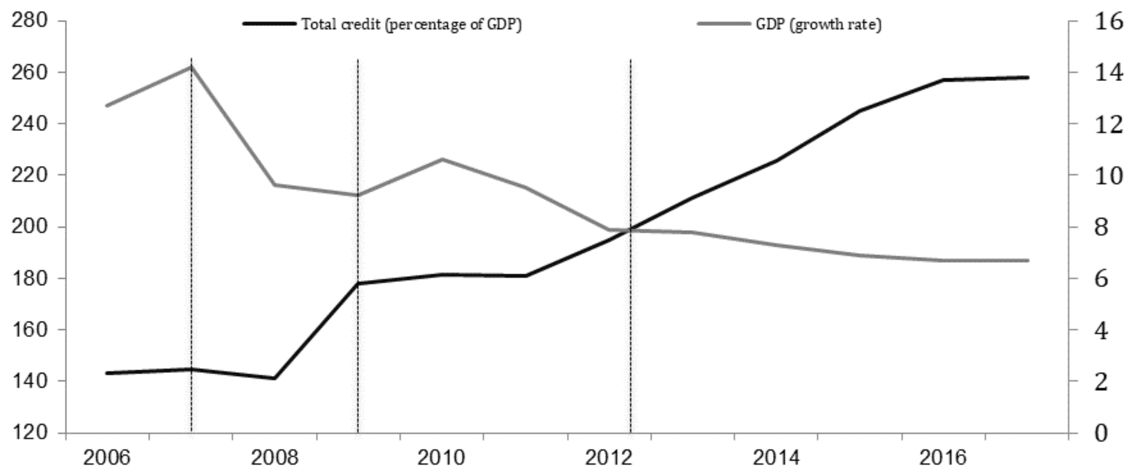
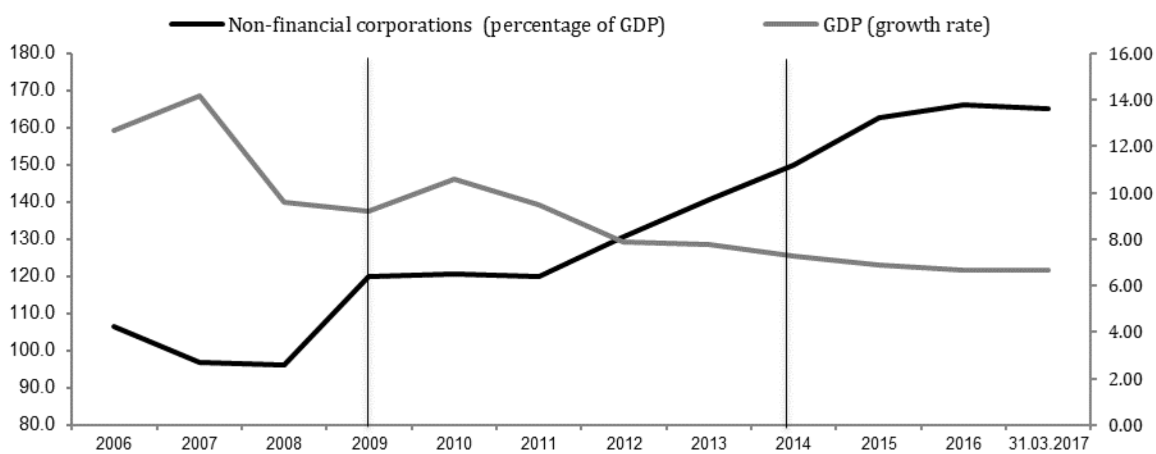
Figures

FIGURE 1: RELATIONSHIP BETWEEN TOTAL CREDIT AND GDP



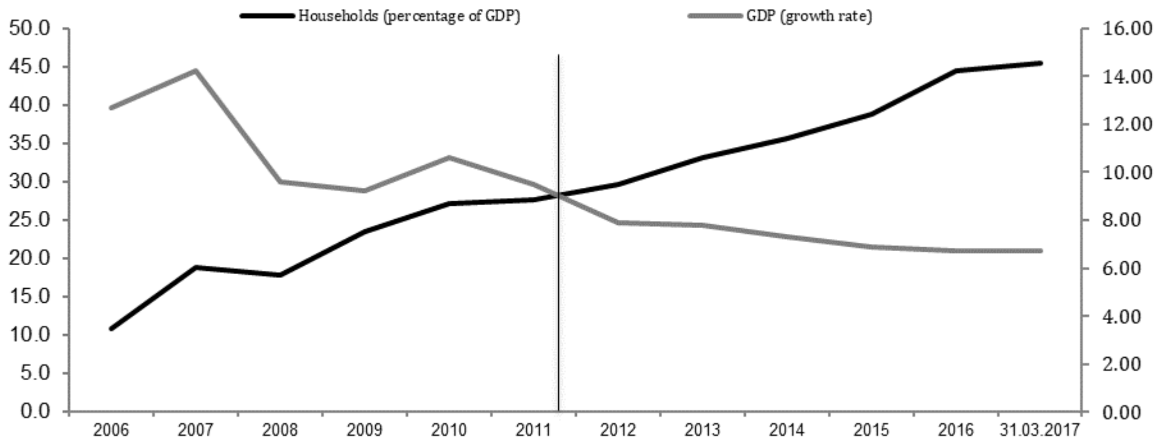
Source: Own construction based on Bank for International Settlements (2017), Long series on total credit and domestic bank credit to the private nonfinancial sector, September. Available at: <http://bit.ly/2oEuE3w>; IMF (2017), "World Economic Outlook Database", November 2017. Available at: <http://bit.ly/1nh4DRU>"

FIGURE 2: CREDIT TO NON-FINANCIAL CORPORATION



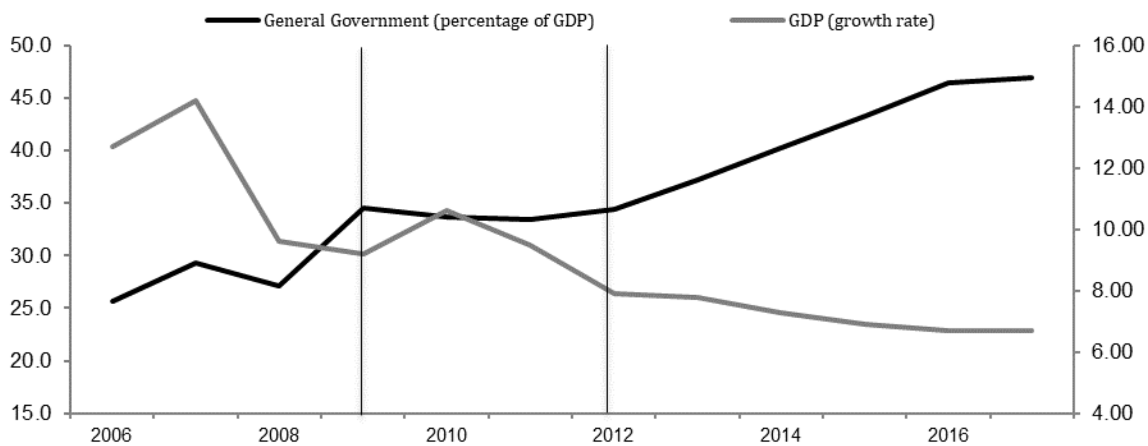
Source: Own construction based on Bank for International Settlements (2017), Long series on total credit and domestic bank credit to the private nonfinancial sector, September. Available at: <http://bit.ly/2oEuE3w>

FIGURE 3: CREDIT TO HOUSEHOLDS



Source: Own construction based on Bank for International Settlements (2017), Long series on total credit and domestic bank credit to the private nonfinancial sector, September. Available at: <http://bit.ly/2oEuE3w>

FIGURE 4: CREDIT TO GENERAL GOVERNMENT



Source: Own construction based on Bank for International Settlements (2017), Long series on total credit and domestic bank credit to the private nonfinancial sector, September. Available at: <http://bit.ly/2oEuE3w>

TABLE 1: BANKING INSTITUTIONS

(Trillion USD)

Year	Total assets	Total deposits	Total loans	Profit after tax	Total liabilities
2003	3.34	2.66	2.05	n.d.	3.21
2004	3.82	3.07	2.29	n.d.	3.66
2005	4.64	3.72	2.56	n.d.	4.44
2006	5.56	4.41	3.02	n.d.	5.28
2007	6.99	5.28	3.65	0.059	6.59
2008	9.24	7.00	4.68	0.085	8.69
2009	11.65	8.96	6.23	0.098	10.99
2010	14.08	10.83	7.52	0.133	13.22
2011	17.70	12.92	9.09	0.196	16.57
2012	21.18	14.95	10.66	0.240	19.80
2013	24.62	17.41	12.47	0.284	22.96
2014	28.07	19.12	14.13	0.314	26.06
2015	32.15	22.54	16.02	0.318	29.70

Source: Own construction based on China Banking Regulatory Commission (2015), Annual Report. Available at: <http://bit.ly/2l7RVgA>

TERMINOLOGY

Terms	Coverage of institutions
Banking Institutions	Policy banks, large commercial banks, jointstock commercial banks, city commercial banks, rural cooperative financial institutions, postal savings bank, banking asset management companies, foreign banks, Sino-German Bausparkasse, non-bank financial institutions, new-type rural financial instituions, and other types financial institutions under the CBRC's jurisdictions
Policy banks	China Development Bank, the Export-Import Bank of China, Agricultural Development Bank of China
Commercial banks	Large commercial banks, joint-stock commercial banks, city commercial bank, rural commercial banks and foreign banks
Major commercial banks	Large commercial banks and joint-stock commercial banks
Large commercial banks	Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank, and Bank of Communications
Small-and medium-sized commercial banks	Joint-stock commercial banks and city commercial banks
Joint-stock commercial banks	China Citic Bank, China Everbright Bank, Huaxia Bank, China Guangfa Bank, Ping An Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Corporation, Evergrowing Bank, China Zheshang Bank and Bohai bank
Banking Asset management companies	China Huarong Asset Management Co., Ltd., China Great Wall Asset Management Corporation, China Orient Asset Management corporation, and China Cinda Asset Management Co., Ltd.
Non-bank Financial Institutions	**Turst companeis, finance companies of corporate groups, financial leasing companies, money brokerage firms, auto financing companies and consumer finance companies**
Small- and Medium-sized Rural Financial Institutions	Rural cooperative financial institutions and newtype rural financial institutions
Rural Cooperative Financial Insitutitons	Rural credit cooperatives, rural cooperative banks, rural commercial banks
New-type Rural Financial Insitutions	Village or township banks, lending companies, rural mutual cooperatives

Source: China Banking Regulatory Commission (2015), *Annual Report* . Available at: <http://bit.ly/2l7RVgA>