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Is China Living a Minsky Moment? Between the "Lender of Last Resort" and the Chinese Shadow Financial System

Alicia Girón

Abstract: After Lehman Brothers bankruptcy in 2008, the Central Bank of China (PBOC) created a big 1.8 trillion dollars package to boost the Chinese economy. It was a necessary key measure not only to prop up the economy, but also to try to preserve the two-digit growth of the GDP that existed before the Great Recession. The financial instability of international financial circuits made necessary the involvement of the central bank. Ten years later, China's debt explosion went up during the financial crisis, from six to twenty-eight trillion dollars between 2007 and 2016. In other words, it went up from 148 to 260 percent of GDP during the same period. The goal of this article is to analyze whether China is living a "Minsky moment" or not, and what its implications are for international financial markets.

Keywords: big government, China, Chinese banks, financiarization, Minsky moment

JEL Classification Codes: E58, F34, F6, G01, G15, G21, G33, N25, O17

Zhou Xiaochuan, governor of the People's Bank of China, said during the Nineteenth Communist Party gathering in Beijing:[1] "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. During the financial crisis and after Lehman Brothers bankruptcy, China's debt exploded from six trillion dollars in 2007 to twenty-eight

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[1] The Nineteenth National Congress of the Communist Party of China (commonly referred to as Shíjiǔ Dà, or, in Chinese, 十九大）was held at the Great Hall of the People in Beijing on October 18-24, 2017.

trillion dollars at the end of 2016, or from 148 to 260 percent of the GDP during the same period (Wildau and Weinland 2016).

Since 2009, rating agencies like Fitch Ratings (2011) have been considering the importance of non-performing loans (NPLs), the leverage in the Chinese financial system (CFS), and the risks in the Chinese shadow banking system (CSBS). By implementing "lender of last resort" policies and with the participation of big state banks, regional banks, and new institutional financial investors, credit has continued to expand in China in order to keep the economy within its two-digit pre-crisis GDP. During the Great Recession, the PBOC was trying to induce economic growth, but the international environment was not the optimal path for the Chinese economy.

What resulted from these PBOC activities was a strong and fast debt accumulation that characterized the CFS. Today, the CFS is fraught with the growing debt of corporations, overdue portfolios, and nonperforming loans of banks and institutional investors. At the same time, international financial organizations and rating agencies have grown concerned with the financial fragility of the Chinese economy, largely caused by the indebtedness and instability of CSBS. During the Eighteenth Communist Party gathering, the Chinese president Xi Jinping announced economic and financial reforms — including the "One Belt, one Road" (OBOR) policy — designed to usher in a new pattern of economic development for inducing and satisfying internal markets as well as adjusting to globalization to the benefit of Chinese private and public corporative groups.

Big Government in a Monetary Economic Production

According to Hyman Minsky (1964, 315), "big government" means "a blessing when it prevents debt deflations and deep depressions." In a capitalist economy, demand must be guaranteed by consumption spending generated through employment creation. A capitalist economy is a market economy and "[it] is a financial system" (Minsky 1992, 16). In the post-crisis period, the Chinese financial system, assisted by PBOC, has been transforming into a capitalist economy through financial circuits. Therefore, Minsky's analysis is relevant. The deregulation and liberalization of the financial process induced the transformation of the Chinese financial system form "hedge" to "speculative."

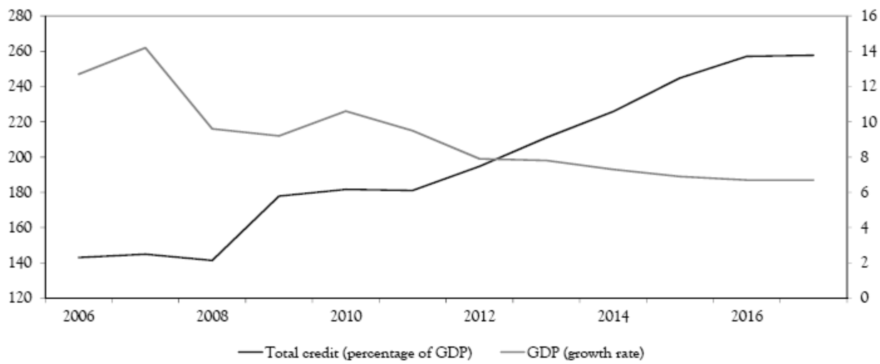
Statistics from the Bank for International Settlements (BIS 2017) show that, in 2007, the total amount of granted credit to the non-financial[2] system went from 143 to 258 percent of GDP, growing at an annual rate of 5.7 percent until it reached 5,207 billion dollars. Measuring the magnitude of the problem, it means that the debt which non-financial corporations, households and non-profit institutions, and the government would have to pay is two and a half times larger than the size of the second major economy of the world — the Chinese economy. Despite the boost provided by the central bank, economic growth is far from the two-digit numbers that

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

it had reached at the beginning of the twenty-first century, and during the last six years China's average annual growth rate has been 7.6 percent and the IMF so far correctly predicted a 6.8-percent growth for 2018 (IMF 2017). With the objective of maintaining high economic growth rates, the PBOC has increased liquidity of the economy since 2009 through a credit expansion policy channeled via the traditional banking system and feeding the development of shadow banking.[3]

The emergence of financial fragility and instability corresponds to a moment in the economic cycle (Girón and Chapoy 2009) when, even though credit granted has increased, it is not affecting the economy equally (Figure 1). It may be said that an agent's indebtedness is not being supported by an equally increasing growth, which hurts the profitability of investments and hinders the repayment of loans.

Figure 1. Relationship Between Total Credit and GDP



Source: Author's calculations based on BIS (2017).

The Mckinsey Global Institute[4] is of the opinion that there are three areas of risk. The first is the debt of households, non-financial corporations, and government. The second is the growth of lending in local government financing vehicles (LGFVs). The third is that around one-third of outstanding debt is due to the shadow banking system. Based on a careful "Minsky" reading of a McKinsey Institute report, one may think that the Chinese financial system is in a Ponzi situation, but how can this hypothesis be demonstrated? In order to explain the development of credit expansion and the risk such a situation poses, I will distribute the total credit in four areas: (i)

[3] In fifteen years, traditional banking went from being the only channel of financing to accounting for only three-fifths of the new credit (*The Economist* 2016).

[4] "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).

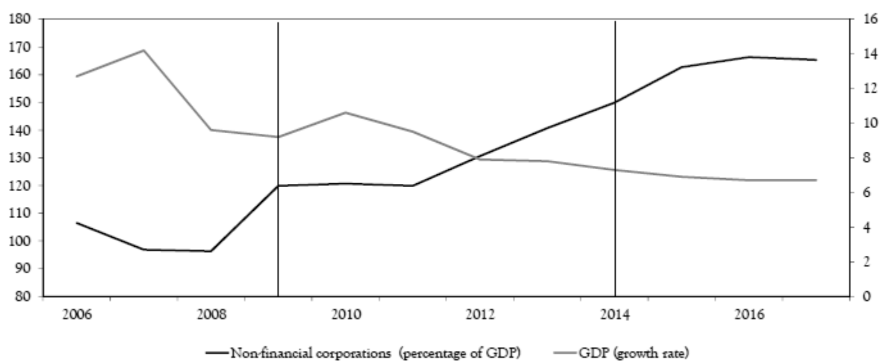
credit to non-financial corporations; (ii) credit to households; (iii) credit to the general government; and (iv) credit of banking institutions.

Credit to Non-Financial Corporations

About 64 percent of the credit provided to the non-financial sector is used by corporations. The excessive growth of such credit made it necessary for Zhou Xiaochuan, governor of the central bank of China, to point it out. He also mentioned that China is still on course to decrease its corporative debt to manageable levels, but the means to contain it will be through restructuring disabled enterprises so that they are able to meet their commitments (Waldmeir 2016). Thus, the banking system stability in China will greatly depend on corporations' ability to pay back their debts. Between 2007 and 2017, the credit granted to corporations went from 106 to 165 percent of GDP, growing at an annual average rate of 18.3 percent and adding up to 18.331 billion dollars to the national debt as of March 2017 (Figure 2).

A large credit expansion took place between 2009 and 2013, when credit increased by 25.2 percent. This expansion happened as a result of the anti-cyclical policies applied by the central bank of China. An example of such a policy was the effort to boost the economy by applying a 1.8-billion-dollar credit injection or a program specifically targeting infrastructure investment in October of 2008 (Girón 2009). One development worthy of mention is the deceleration of the growth variable in 2015 (accompanied by a decrease in economic growth), when it only increased by 3 percent of GDP (or by 1,062 billion dollars). This behavior of the economy may have been a consequence of the central bank's concern for the healthcare sector in China.

Figure 2. Credit to Non-Financial Corporations



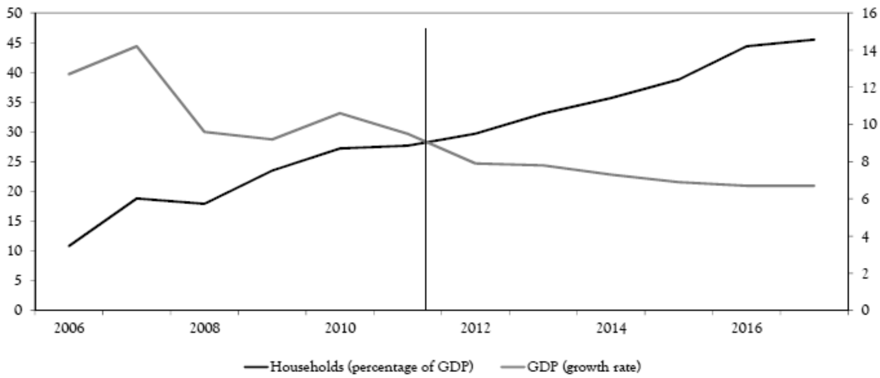
Source: Author's calculations based on BIS (2017).

Credit to Households

Despite the fact that credit given to households constitutes only 18 percent of total credit granted, household credit is the variable with the most growth. Between 2007 and 2017, the credit granted to households increased four and a half times. It rose from 10 to 45 percent of GDP, while the average annual growth rate of the same period became 32 percent, reaching 5,050 billion dollars during the first trimester of 2017 (Figure 3). The period with the greatest expansion of credit took place between 2006 and 2010, as the household credit variable increased at an annual average rate of 58 percent, jumping from 10 to 27 percent of GDP. This increase in credit granted to households has been accompanied by a major economic expansion in China in the last sixteen years , with an average growth rate of 11.2 percent.

A problem regarding the financing for households is linked to the increase in mortgage loans, which represent around 60 percent of the debt of urban households (Tang 2017). IMF estimates that more than one third of that debt stems from seriously indebted households, which is evident in the greater deterioration of balance sheets (IMF 2017). Faced with this fact, the government took preventive measures like restricting estate purchases and limiting the number of apartments that a household can own (Cheng 2017).

Figure 3. Credit to Households



Source: Author's calculations based on BIS (2017).

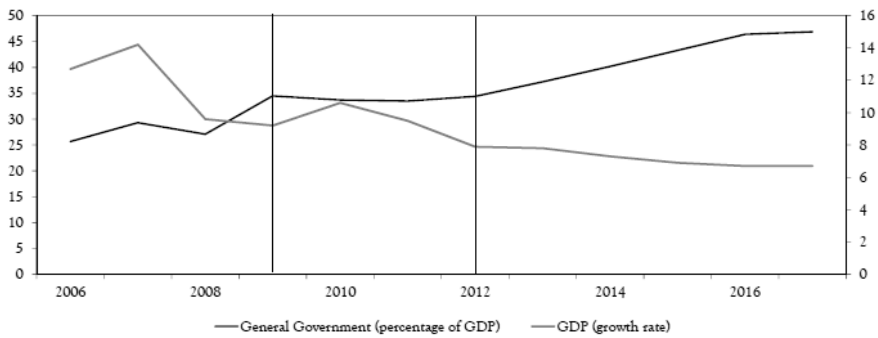
Credit to the General Government

In the period between 2007 and 2017, the debt of the government increased at an annual average rate of 20 percent. In other words, it increased from 25.7 to 46.9 percent of GDP, reaching 5,207 billion dollars in the first trimester of 2017. Notwithstanding the extent of credit granted to households, the impact has been the opposite of the intended, which is visible in a constant drop in economic growth — an issue that has received the least amount of attention on an international level (Figure 4).

Banking Institutions

Statistics from China's Banking Regulatory Commission (CBRC 2015) shows that, at the end of 2015, the total amount of bank assets was 32.15 trillion dollars, which represents an increase of about 27 trillion, or 15.7 percent as compared to 2014. The average growth rate between 2013 and 2015 was 18 percent, but the greater expansion took place in 2009, when the total amount of assets increased by 25.9 percent — this is 7 percent greater than the average for the period I study. On the other hand, the total of liabilities was 29.7 trillion dollars, which is a 15.1-percent increase as compared to 2014. The average annual growth rate for the period between 2003 and 2015 was 17.5 percent. It is worth mentioning that passives in 2013 decreased from a 17.5 to a 13.8 percent on average (Table 1). In 2015, the loans from banking institutions reached sixteen trillion dollars (or 99.3 yuan), which represented an increase of 14.5 percent as compared to 2014. Between 2003 and 2015, bank credit had an average growth rate of 16 percent, with its greater expansion occurring in 2009, when it increased by 32 percent increase (this is double as compared to the period under study).

Figure 4. Credit to the General Government



Source: Author's calculations based on BIS (2017).

Bank deposits represent the money delivered by saver agents to a bank with the objective of generating 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 percent and reached 22.54 trillion dollars. It is worth mentioning that the growth rate has shown little fluctuation when compared to its average value, which indicates trust in the banking system, despite the financial crisis and economic deceleration. The period of greater growth of bank deposits happened in 2007 and 2008, with an increase of 32.6 percent. Also, between 2008 and 2015, the benefits after taxes grew at an average rate of 24.5 percent, with the amount of the variable being barely 0.318 trillion dollars. The Chinese banking system is controlled by state banks and a great amount of credit is still directed toward specific projects. Because banks are state entities, their goal is not to look for profit, but to increase social welfare. This could be shown by examining the year 2009, when the growth of benefits after taxes dropped to 14.7 percent. In other words, there have been fewer benefits in moments of economic difficulties.

Table 1. Banking Institutions (Trillion USD)

Institutions/ Year	Total assets	Total deposits	Total loans	Profit after tax	Liabilities
2003	3.3	2.7	2.1	nd	3.2
2004	3.8	3.1	2.3	nd	3.7
2005	4.6	3.7	2.6	nd	4.4
2006	5.6	4.4	3.0	nd	5.3
2007	7.0	5.3	3.7	0.1	6.6
2008	9.2	7.0	4.7	0.1	8.7
2009	11.6	9.0	6.2	0.1	11.0
2010	14.1	10.8	7.5	0.1	13.2
2011	17.7	12.9	9.1	0.2	16.6
2012	21.2	14.9	10.7	0.2	19.8
2013	24.6	17.4	12.5	0.3	23.0
2014	28.1	19.1	14.1	0.3	26.1
2015	32.2	22.5	16.0	0.3	29.7

Source: Author's calculations based on CBRC (2015).

Channeling and Financialization, a PBOC Concern

The need for financing in a monetary economy of production corresponds 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 increase due to the accumulation of debts, which is the result of new combinations and "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, while the conditions for fragility in the future are created by prosperity. On one hand, the process of "creative destruction," referred to by Joseph 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 repay their liabilities.

On the other hand, as Minsky points out, 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 finances that will lead financial units to a deflation of financial assets until reaching the economic cycle of panic, recession, and depression. From a heterodox perspective, one can observe a trend in the Chinese economy on the financing process endorsed and sustained by PBOC. Deng Xiaoping's economic reforms, the strengthening of PBOC, the formation of a financial system to maintain economic development, and the insertion of China in the world market, all provided the country with a formidable place in the world. These factors functioned as its locomotive that kept the process of growth before the collapse of the international financial system in 2008.

The PBOC performance following the injection of $1.8 billion dollars in 2009, and the constantly growing public and private indebtedness represents 281 percent of China's GDP, with 55 percent public debt and 51 percent government debt (Liang 2016). It is not the main commercial banks that have been favored by the position of PBOC, as stated 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, whose value is estimated between 2.3 and 4.8 billion dollars, has surprisingly grown and is now facing a Ponzi situation. PBOC's intervention, therefore, was not coincidental when assets fell by 29 percent in only two months and fragility in financial circuits increased (Stewart 2015).

Unlike investment in the United States, the shadow financial system in China consists of trust companies, which are non-financial institutions that lend money and take direct shareholdings as shareholders. Most financing for the China's HNA Group,[5] Dalian Wanda, Fosun, Anbang, and Zhejiang Rossoneri comes 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 on companies like 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, and China Railway Material (Table 1).

Reflections

Recent interviews with members of the Chinese Academy of Social Sciences[6] on the situation of the Chinese financial system seem to agree on the impossibility of a financial crisis because of the strength of the state. The increased amount of expired portfolios in Chinese banks, the weakness of the financial system, as well as the instability of currency and the exit of capitals have all been perceived as alarm signs since 2015. However, China will likely not have a financial crisis as the one experienced by the United States between 2006 and 2008, and a bankruptcy of the magnitude of Lehman Brothers is even less likely. On the contrary, China is a country with a strong economic state and there is a "big government," as defined by Minsky, which is able to endure a decrease in production and an increase in bad financial

[5] In December, HNA said it received pledges of support for 2018 from eight big domestic policy and commercial banks, including China Development Bank, the Export and Import Bank of China, and the Industrial and Commercial Bank of China (Miller 2017).

[6] Interviews were made during an academic exchange program between UNAM and CASS for Chinese academics from the Chinese Academy of Social Sciences, who specialize in financial matters of diverse institutes, in November 2016.

assets of its financial investors. The role played by PBOC has allowed stability in China in the context of a globally unstable environment of financial circuits.

Despite initiating a gradual deregulation and financial liberalization process, operations outside the balance sheet of many banking institutions have increased the shadow financial system (SFS) in China. SFS has been financing projects at a global level within the framework of OBOR. As Yan Liang (2016, 462) states, 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 weighted average yield of 5.5%, compared to the 3.0% one-year deposit rate."

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Appendix

Table 1A. Terminology

Terms	Coverage of institutions
Banking institutions	Policy banks, large commercial banks, joint-stock 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 institutions, and other types of financial institutions under the CBRC's jurisdictions
Policy banks	China Development Bank, Export-Import Bank of China, Agricultural Development Bank of China
Commercial banks	Large commercial banks, joint-stock commercial banks, city commercial banks, 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-size 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., China Great Wall Asset Management Corporation, China Orient Asset Management corporation, and China Cinda Asset Management Co.
Non-bank financial institutions	Trust companies, finance companies of corporate groups, financial leasing companies, money brokerage firms, auto financing companies, and consumer finance companies
Small- and medium-size rural financial institutions	Rural cooperative financial institutions and new type rural financial institutions
Rural cooperative financial institutions	Rural credit cooperatives, rural cooperative banks, and rural commercial banks
New type rural financial institutions	Village or township banks, lending companies, and rural mutual cooperatives

Source: CBRC (2015).