Bond Selloff Shows Risks of China’s Efforts to Restrain Credit

Central bank’s tightening of short-term credit led to sharp market drops, forcing authorities to reverse course

Pedestrians walk past the headquarters of the People's Bank of China in Beijing. China’s central bank has guided short-term lending rates higher in order to squeeze out borrowers who are using the cheap money to make risky bets and loans. ENLARGE

Pedestrians walk past the headquarters of the People's Bank of China in Beijing. China’s central bank has guided short-term lending rates higher in order to squeeze out borrowers who are using the cheap money to make risky bets and loans. PHOTO: ZHANG HAIYAN - IMAGINECHINA

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15 COMMENTS

China’s newly troubled bond market is showing how difficult it will be for Beijing to restrain the easy credit that rapidly expanded the country’s indebtedness over the past decade.

A gradual tightening of short-term credit by China’s central bank—combined with rumors of liquidity squeezes at brokers—prompted a mini-rout in the country’s $8 trillion-plus bond market last week, forcing authorities to reverse course and inject some $86 billion in short- and medium-term funds.

China’s main stock indexes also tumbled following moves by regulators to crack down on some speculative investors.

Adding to market worries, China’s currency, the yuan, has fallen to its lowest level against the U.S. dollar since 2008 as more Chinese move their wealth out of the country despite strict capital controls.

The bond selloff is raising concerns about the stability of China’s opaque and deeply intertwined credit markets.

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“When you have an event like last week people take notice of it, you have to go back and review your China [investment] thesis,” said Jim Veneau, head of Asia fixed income at AXA Investment Managers in Hong Kong, with $2.2 billion under management.

“Everyone is nervous,” said Wang Ming, a partner at Shanghai Yaozhi Asset Management Co., which holds $2.9 billion in debt.

Like all bonds world-wide, Chinese bonds are under pressure from the U.S. Federal Reserve’s plans for faster interest-rate increases than some expected. China may guide its own rates higher to prevent the Chinese currency from weakening faster against the dollar, a scenario that would further squeeze Chinese borrowers in need of cheap finance.

China’s total debt surged to around $27 trillion this year, or 260% of gross domestic product, compared with 154% in 2008 at the start of a stimulus program to offset the financial crisis. It is continuing to grow at more than twice the pace of the economy.

Economists say growing amounts of money are flowing into less-productive channels, such as keeping struggling companies on life support, or feeding speculative investments in everything from property to bonds and steel.

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Last week, some bondholders, including asset managers and issuers of “wealth management products”—off-balance-sheet investment vehicles used by banks and other institutions to get around regulatory limits on lending—were likely squeezed too much. As a result, they began dumping government bonds—which are liquid and thus easy to sell—to raise cash, analysts say.

Some 40% of the assets in wealth management products—the biggest portion—was invested in bonds as of the first half of this year, up from 29% in 2015, according to Moody’s Investors Service.

The selloff sent China's benchmark 10-year government bond yield to 3.33%, its highest level since September 2015. The 10-year bond yield had hit a 14-year low of 2.66% as recently as October. Yields move in the opposite direction of prices.

Last week's sharp price drop has raised concerns that a larger bond rout may be in the offing. China's stock markets crashed in 2015, wiping out $5 trillion of value, a fresh memory for many investors.

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Many economists say China's debt scale up may result in a crash similar to the 2008 mortgage crisis in the U.S., or a long slowdown such as Japan's after its 1980s property bubble burst—or both.

The clearest sign that many Chinese are worried is the amount of money flowing out of China despite strict measures to stop it. China's foreign reserves have dropped by 21% to $3.05 trillion in the past two years.

Chinese authorities are aware of the risks. On Friday, a senior Chinese government economic working group said for the first time that controlling financial risk and reducing asset bubbles had become a priority, according to a statement reported by Chinese state media. The country's top decision-making body, the Politburo, issued a similar warning earlier this year.

As much as 15% of the value of bank loans to Chinese companies may go unpaid, researchers at the International Monetary Fund estimate. Even riskier are an estimated $8.5 trillion in off-balance sheet "shadow" finance issued by a matrix of banks and lightly regulated institutions.

A key question now is how much of China's bond market is owned outright, and how much was bought with money borrowed under murkier circumstances such as shadow finance, raising risks.

Analysts estimate leverage in the system overall is between 1.2- and 5-times assets, a relatively low figure, although in pockets of the market it can go much higher.

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But since much of the financial system is lightly regulated, the true amount of leverage in the system is unknown. Market experts say asset managers routinely use bonds as collateral to buy more bonds, repeating the process many times over.

Rumors of defaults have rattled the market. Shares of Guangxi-based brokerage Sealand Securities Co., which has $7.2 billion in assets, stopped trading on Dec. 15 and a Chinese newspaper reported over the weekend that its executives met Friday with a large group of counterparties over losses related to bonds swaps. Sealand has denied it is in distress.

Economists say China’s central bank has the firepower to keep its debt markets from plunging by injecting more money into the system if necessary. And since most of China’s debt is issued in its own currency, the debt markets aren’t vulnerable to other shocks like currency devaluations. A closed capital account—which limits the ability of companies, banks and individuals to move money in or out of the country—will slow outflows.

“The crisis is not over,” said Zeng Xianzhao, a fund manager at Chongqing Nuoding Asset Management, with $28.7 million in assets: “The central bank’s liquidity injection only assuaged the crisis but didn’t solve it at its root.”

—Yifan Xie contributed to this article.

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