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# China's Communist Party goes way of Qing Dynasty as debt hits limit

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Nobody rings a bell at the top of the credit supercycle, to misuse an old adage. Except that this time somebody very powerful in China has done exactly that.

China watchers are still struggling to identify the author of an electrifying article in the People's Daily that declares war on debt and the "fantasy" of perpetual stimulus.

Written in a imperial tone, it commands China to break its addiction to credit and take its punishment before matters spiral out of control. If that means bankruptcies must run their course, so be it.

Fifteen years ago such a mystery article would have been an arcane matter, of interest only to Sinologists. Today it is neuralgic for the entire global - and over-globalized - financial system.

China's debt is approaching $30 trillion. The fresh credit alone created since 2007 is greater than the outstanding liabilities of the US, Japanese, German, and Indian commercial banking systems combined.

Moody's warned this month that China's state-owned entities (SOEs) have alone racked up debts of 115pc of GDP, and a fifth may require restructuring. The defaults are already spreading up the ladder from local SOE's to the bigger state behemoths, once thought - wrongly - to have a sovereign guarantee.

To put matters in context, leverage rose by roughly 50 percentage points of GDP in Japan before the Nikkei bubble burst in 1990, or in Korea before the East Asia crisis in 1998, or in the US before the subprime debacle. This gauge is an almost mechanical indicator of a future credit crisis.

As we all know, China is in a class of its own. Debt has risen by 120 to 140 percentage points. The scale of excess industrial capacity - and China's power and life and death over commodity markets - mean that any serious policy pivot by the Communist Party would set off an international earthquake.

China's debt bubble is twice as extreme as Japan's Nikkei bubble in 1990, and much greater in global scale Credit: IMF

Hence the fevered speculation about this strange article published on May 9 in the house journal of the Politburo. It was no ordinary screed.

The 11,000 character text - citing an "authoritative person" - was given star-billing on the front page. It described leverage as the "original sin" from which all other risks emanate, with debt “growing like a tree in the air”.

It warned of a "systemic financial crisis" and demanded a halt to the "old methods" of reflexive stimulus every time growth falters. "It is neither possible nor necessary to force economic growing by levering up," it said.

It called for root-and-branch reform of the SOE's - the redoubts of vested interests and the patronage machines of party bosses - with an assault on "zombie companies". Local governments were ordered to abandon their illusions and accept the inevitable slide in tax revenues, and the equally inevitable rise in unemployment.

If China does not bite the bullet now, the costs will be "much higher" in the future. "China's economic performance will not be U-shaped and definitely not V-shaped. It will be L-shaped," said the text. We have been warned.

Jonathan Fenby, a China veteran at Trusted Sources, says you can interpret the piece in two very different ways: either as a "call to arms" after three years of foot-dragging on the Third Plenum reforms, or the "last gasp for reformers who see their agenda slipping away."

"We see the current state of affairs as very much resembling the old imperial court, where various factions fight for attention of the undisputed leader – namely, Xi," he said.

Mr Fenby compares it to the Qing Dynasty in the late 19th century, when reformers battling to modernize the economy were ultimately defeated by the old guard. The same pattern recurred under Chiang Kai-Shek's Kuomintang in the 1920s and 1930s. Each time it ended in stagnation. The difference today is that China is vastly more important to the world economy.

Most think the author was either President Xi Jinping himself, or his right-hand man Liu He - who handles daily operations for the 'Leading Group', China's version of the White House National Economic Council.

A day later the People's Daily published a hitherto closed-door speech by Mr Xi lashing out at "careerists and conspirators existing in our Party and undermining the Party's governance".

He denounced the latest property bubble and excesses in the banking system, but confusingly he also laced his talk with quotes from Confucious, Mao, and Marx - the latter increasingly part of his discourse as he invokes dialectical materialism and other such forgotten gems.

It was the usual incoherence we expect from the new Helmsman. He may not be the clear-thinking mystery man after all, yet it would courting fate to ignore the warnings from the People's Daily altogether.

The latest stop-go credit cycle began in mid-2015 and has since accelerated to an epic blow-off, with the M1 money supply now growing at 22.9pc, by the fastest pace since the post-Lehman blitz.

Wei Yao from Societe Generale estimates that total loans rose by $1.15 trillion in the first quarter, equivalent to 46pc of quarterly GDP. "This looks like an old-styled credit-backed investment-driven recovery, which bears an uncanny resemblance to the beginning of the 'four trillion stimulus' package in 2009. The consequence of that stimulus was inflation, asset bubbles and excess capacity," she said.

House sales rose 60pc in April, despite curbs to cool the bubble. New starts were up 26pc. Prices jumped 63pc in Shenzhen, 34pc in Shanghai, 20pc in Beijing, and 18pc in Hefei. Panic buying is spreading to the smaller Tier 3 and 4 cities with the greatest glut.

China's housing market is on fire, yet again Credit: SocGen

It all has echoes of the stock market boom and bust last year. "Investors are convinced that the government will guarantee that housing prices won't fall," said Professor Zhu Ning from the Shanghai Advanced Institute of Finance, speaking to the South China Morning Post. It also sounds like Britain.

There was a slight cooling in April but less than headlines suggested. The old measure of total social financing (TSF) slipped but this was more than offset by record bond issuance of $180bn. Together they reached a 26-month high.

Capital Economics says budgeted funds must be disbursed by the end of this quarter under new finance ministry rules, implying another $310bn of bonds by late June.

The fiscal boost will be 'front-loaded'. The money will pile up in accounts and flood the economy over the late summer.  If the usual time-lags hold, the mini-boom will last for a few more months. Then the trouble will start. Needless to say, markets may roll over long before the economy itself.

China's M1 money supply is growing at an explosive pace Credit: SocGen

A number of western fund managers jumped the gun last year - including Britain's Crispin Odey -betting that the long-awaited China crisis was about to unfold. Some over-estimated the importance of the Shanghai equity fiasco; others mistook China's new currency regime for a devaluation (there was none), and many misread the credit, transport, and industrial data.

Bloomberg reports that Roslyn Zhang from China's sovereign wealth fund (CIC) mocked them for their "herd mentality" at last week's Skybridge Alternatives conference in Las Vegas.

“They really don’t know much about China but they just spend two seconds and put on the trade. Should we pay two and 20 for treatment like this?” she said, meaning the industry fee of 2pc in tithes and 20pc of profits. She vowed to cull amateurs mercilessly from CIC patronage.

Yet this year the China bears may get their revenge, if they have any money left to play with. The rot in the country's $7.7 trillion bond markets is metastasizing. Bo Zhuang from Trusted Sources said more than 100 firms cancelled or delayed bond issues in April due to widening credit spreads.

China's bond market $7.7 trillion bond market is now the epicentre of risk Credit: Trusted Sources

Ten companies have defaulted this year, with the shipbuilder Evergreen, Nanjing Yurun Foods, and the solar group Yingli Green Energy all in trouble this month.  But what has really spooked markets is the suspension of nine bonds issued by the AA+ rated China Railways Materials, the first of the big central SOE's to signal default. "This has greatly weakened investors’ long-standing expectation of implicit government support," he said.

Bo Zhuang said investors have poured money into bonds in the latest frenzy. The stock of corporate bonds has jumped by 78pc to $2.3 trillion over the last year. It is the epicentre of leverage through short-term 'repo' transactions, and it is now coming unstuck.

"The experience with the stock market shows how difficult it can be to contain a reversal in leveraged bets. In our view, a bond market crisis would be much more destructive," he said.

With luck, the rest of us outside China will have three or four more months to order our own affairs before the storm gathers. Whether it is bumpy landing, a hard landing, or a crash landing, depends on who the "authoritative person" in Beijing turn out to be.