The Telegraph

China capital flight flashes warning as authorities forced to prick property bubble

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China's property market went mad after the authorities poured fuel on the flames. Beijing is now slamming on the brakes

Capital outflows from China are accelerating. The hemorrhage has reached the fastest pace since the currency panic at the start of the year.

The latest cycle of credit-driven expansion has already peaked after 18 months. Beijing has had to slam on the brakes, scrambling to control property speculation that the Communist authorities themselves deliberately fomented.

How this episode could have happened is astonishing, given that premier Li Keqiang has warned repeatedly that excess credit is becoming dangerous and will ultimately doom China to the middle income trap.

It will be clear by early to mid 2017 that the economy is rolling over and that the underlying 'quality of growth' has deteriorated yet further. "We think the recovery will run out of steam early next year," said Chang Liu from Capital Economics.

This stop-go rotation - an all-too familiar pattern - coincides with an incipient liquidity squeeze in global finance as dollar LIBOR and Eurodollar rates ratchet upwards. A rate rise by the US Federal Reserve will clinch it.

Since the commodity rebound is in great part driven by demand for Chinese industry and construction - and by a touching belief that China's economy will sail majestically through 2017 - this looming slowdown spells trouble.

Stress is already visible in the capital account. Morgan Stanley estimates that net outflows reached $44bn in September. Capital Economics thinks the figure was closer to $55bn, led by a surge in purchases of off-shore securities through the Shanghai-Hong Kong Stock Connect Scheme.

This does not yet match the capital flight seen late last year when a mismanaged shift in exchange rate policy set off outflows averaging $70bn a month, and triggered the global equity rout of January and February. But it is nearing a neuralgic threshold for currency traders.

Beijing is clearly alarmed. Nikkei's Yusho Cho reports that the authorities have ordered banks in Shanghai and Guangzhou to restrict access to foreign currency, and have imposed a "gag order" to keep it quiet.

Institutions must now justify why they need foreign exchange. The worry is a "negative feedback loop between a weakening yuan and capital flight".

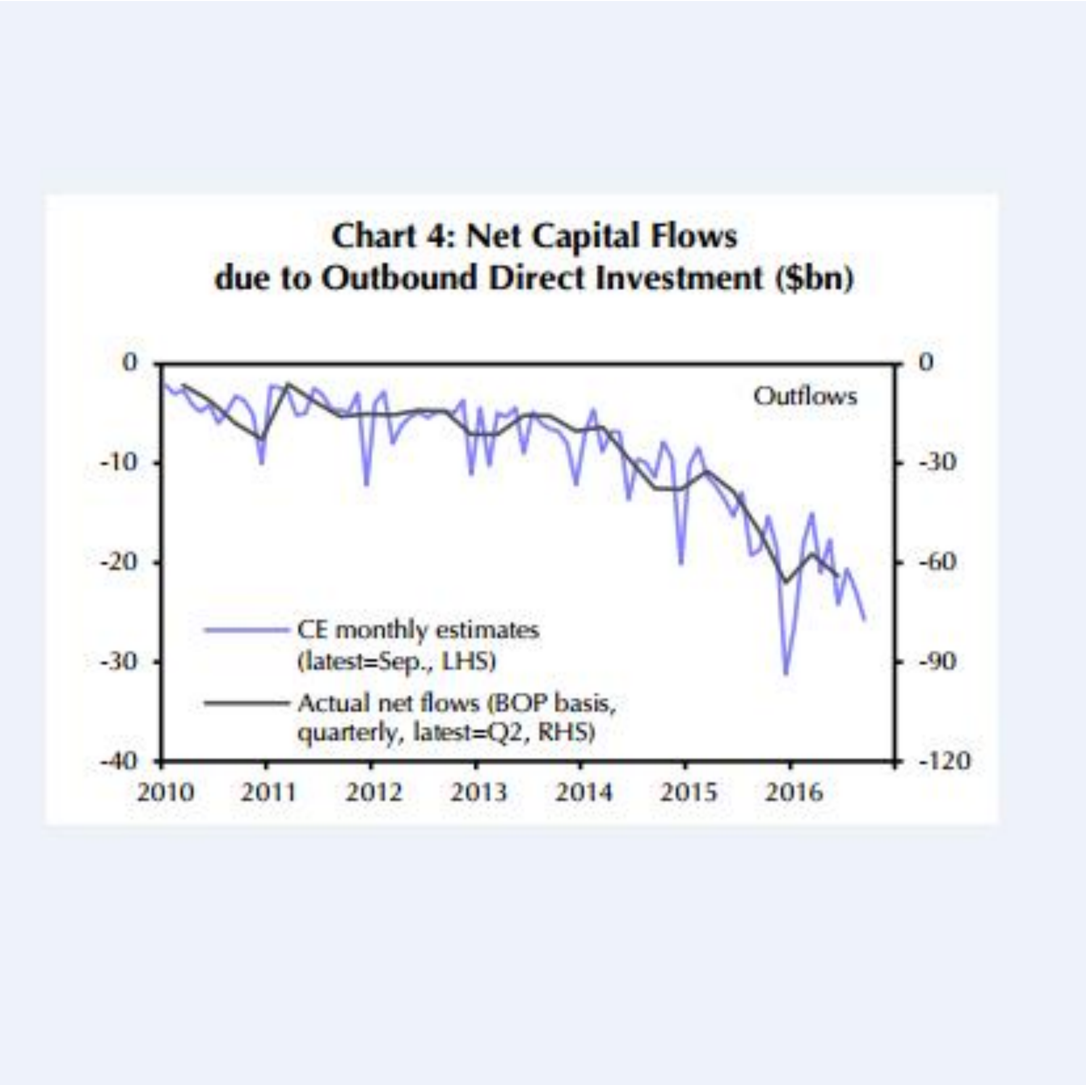
US dollar funding cost are ratcheting up, tightening global conditions CREDIT: IMF

The central bank (PBOC) spent roughly $50bn defending the yuan last month, but this has not stopped the exchange rate sliding to 6.77 against the dollar - the weakest in six years.

The PBOC has burned through $800bn of foreign reserves since mid-2014, when they peaked at $4 trillion. It still has ample fire-power but bond sales automatically tighten China's internal monetary policy since it is hard to sterilize the effect, and tightening may the last thing they want if the economy is slowing hard next year.

"Our view is that the RMB (yuan) will depreciate 20pc against the US dollar to 8.1 by the end of 2018 as deflation of the property bubble leads to more capital outflows," Zhiwei Zhang from Deutsche Bank. "This is deflationary for global trade."

That is an understatement. A Chinese devaluation on this scale would be an earthquake for the world's economic and financial system, unleashing a tsunami of cheap manufacturing exports into Europe and the US. It would silence all talk of global reflation. Bond yields would fall even further.



Ouflows from China in the form of direct investment is increasing fast, and may disguise capital flight CREDIT: CAPITAL ECONOMICS

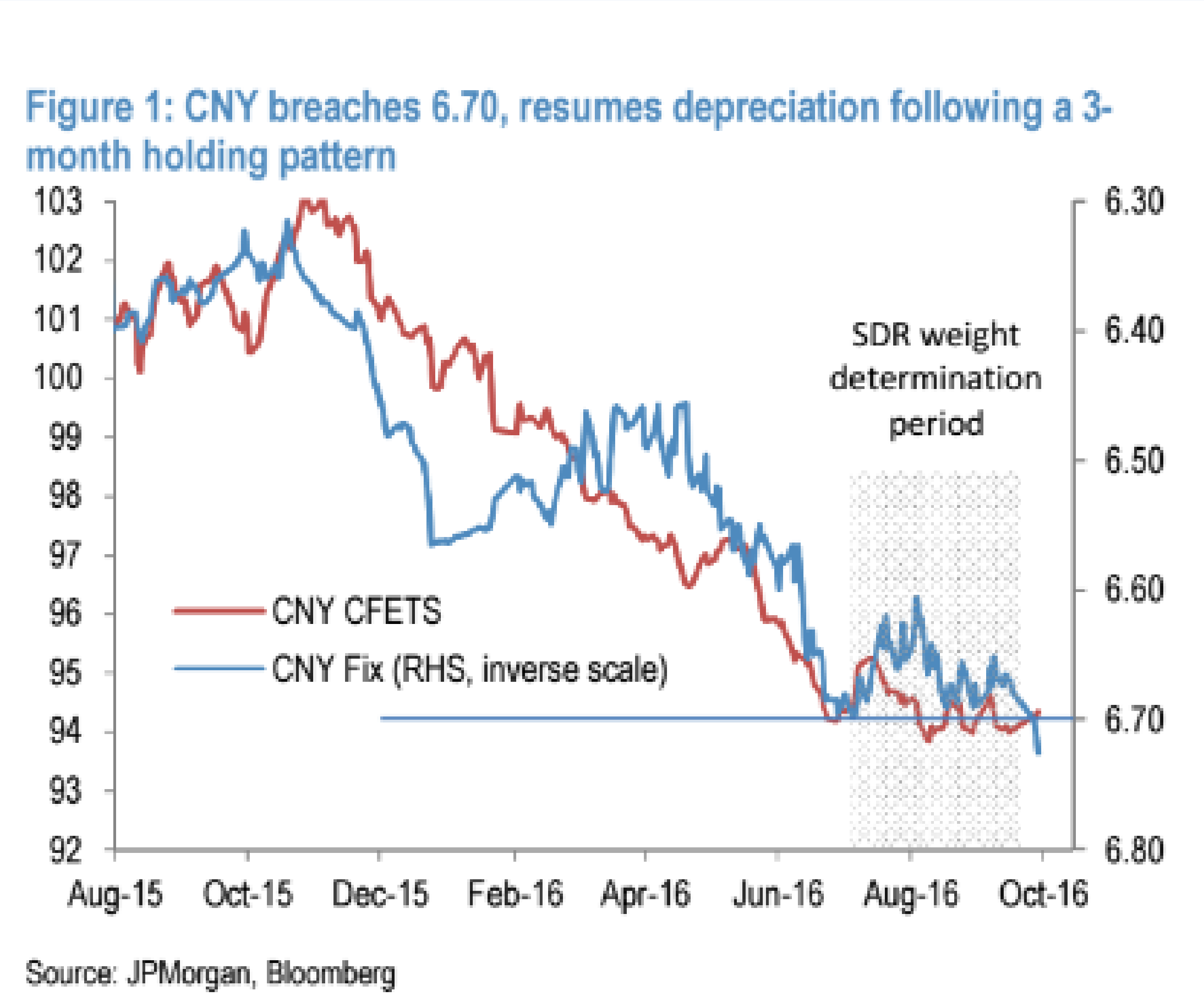
Beijing is trying to curb excess capacity across a swathe of sectors from steel to shipbuilding, chemicals and solar panels, but regional party bosses and vested interests largely do as they please.

Caixin reports that steel plants are "conjuring up" figures, listing long-closed production lines and "dead factories" as fresh cuts. Much of the 36m tonnes of reduction in steel capacity claimed this year is fiction. It is probably the same story in other industries.

The fact remains that fixed capital investment in China is running near $5 trillion a year, as much as in Europe and North America combined. The world cannot absorb the consequences of so much excess plant.

Premier Li Keqiang and PBOC vowed in January to keep the exchange rate "basically stable" in trade-weighted terms. “China has no intention of stimulating exports through competitive currency devaluation,” said Mr Li.

Chinese officials repeated the same message vehemently in my presence in Davos. For whatever reason - necessity or opportunism - the solemn pledges have been breached. The yuan has fallen 8pc over the last year. Economists in China talk openly about a "strategic devaluation" as if it were the established policy.



China's yuan has been depreciating steadily, despite pledges by Beijing to hold it stable CREDIT: JP MORGAN

For now, the economy is firing on all cylinders. Capital Economic's proxy gauge suggests that growth has surged to 5.6pc from 4.4pc in the middle of the year. Nomura's heat-map has 74pc of its indicators "flashing hot", up from 55pc in July, 39pc in May, and 19pc in April.

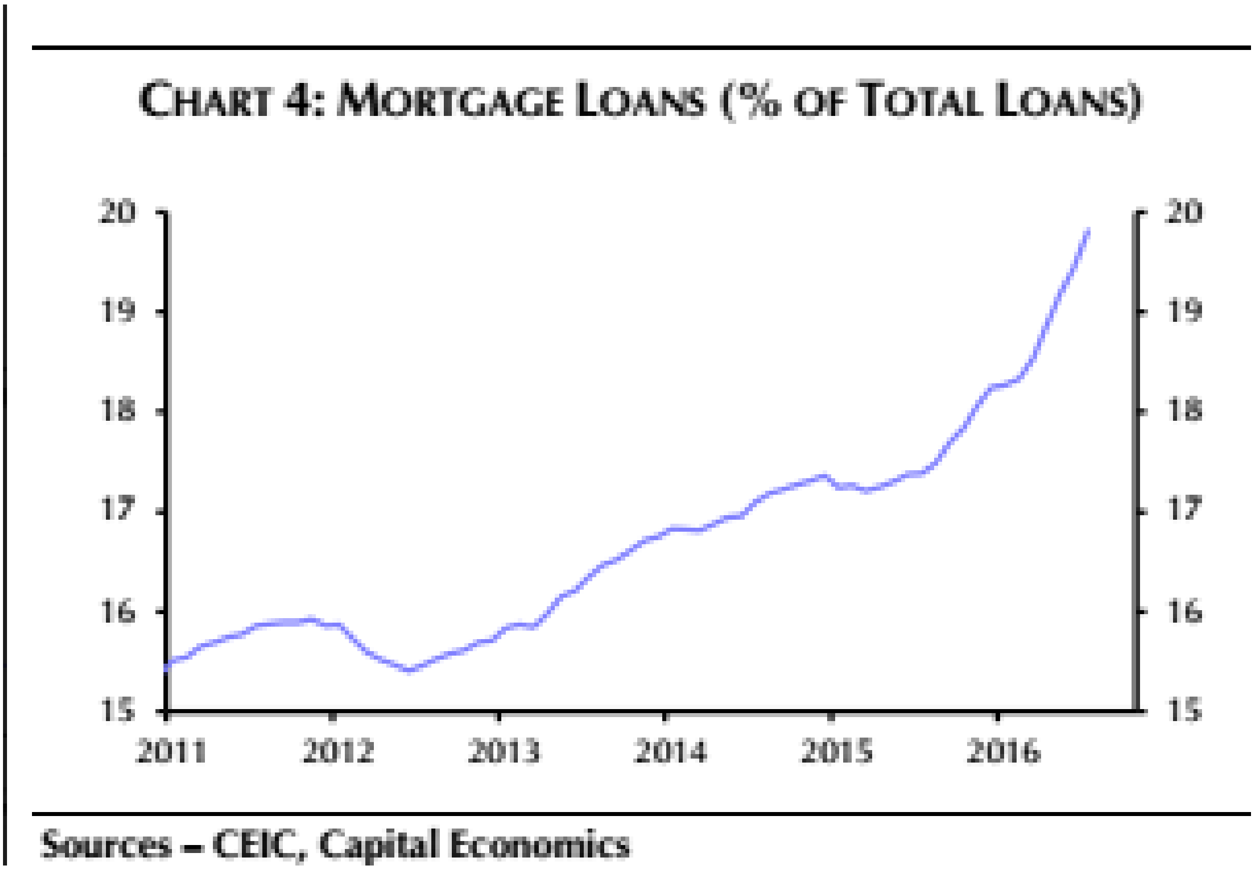
Yet it is deformed growth. Investment by private companies has stalled. Credit efficiency has collapsed. Loan are propping up derelict structures, perpetuating the imbalances. The stimulus has been cornered the state-owned industrial dinosaurs, or gone into the housing market.

Zhiwei Zhang says Beijing has repeated the error it made by talking up the stock market in early 2015, when it caused a stampede into equities (thinking this a clever way to switch from debt to equity funding). It ended in debacle.

In June of this year, the State Council stated that households could "leverage up" on property, supposedly to "help the corporate sector lower their leverage". Whatever they were thinking, the net effect was to draw yet more people into the quagmire.

This State Council endorsement was the green light for a final the blow-off in a country where people are highly attuned to signals from the Communist Party. Down payments for mortgages were cut to 20pc, and to 30pc for second homes. Both buyers and developers seized on the latest Beijing 'Put' with alacrity.

Mortgages made up 71pc of all loans in July and August, up from 26pc last year. Land prices have risen 140pc this year, and in some places are even higher than the equivalent sales prices of finished apartments nearby, a pattern aptly described in China as "flour being more expensive than bread".



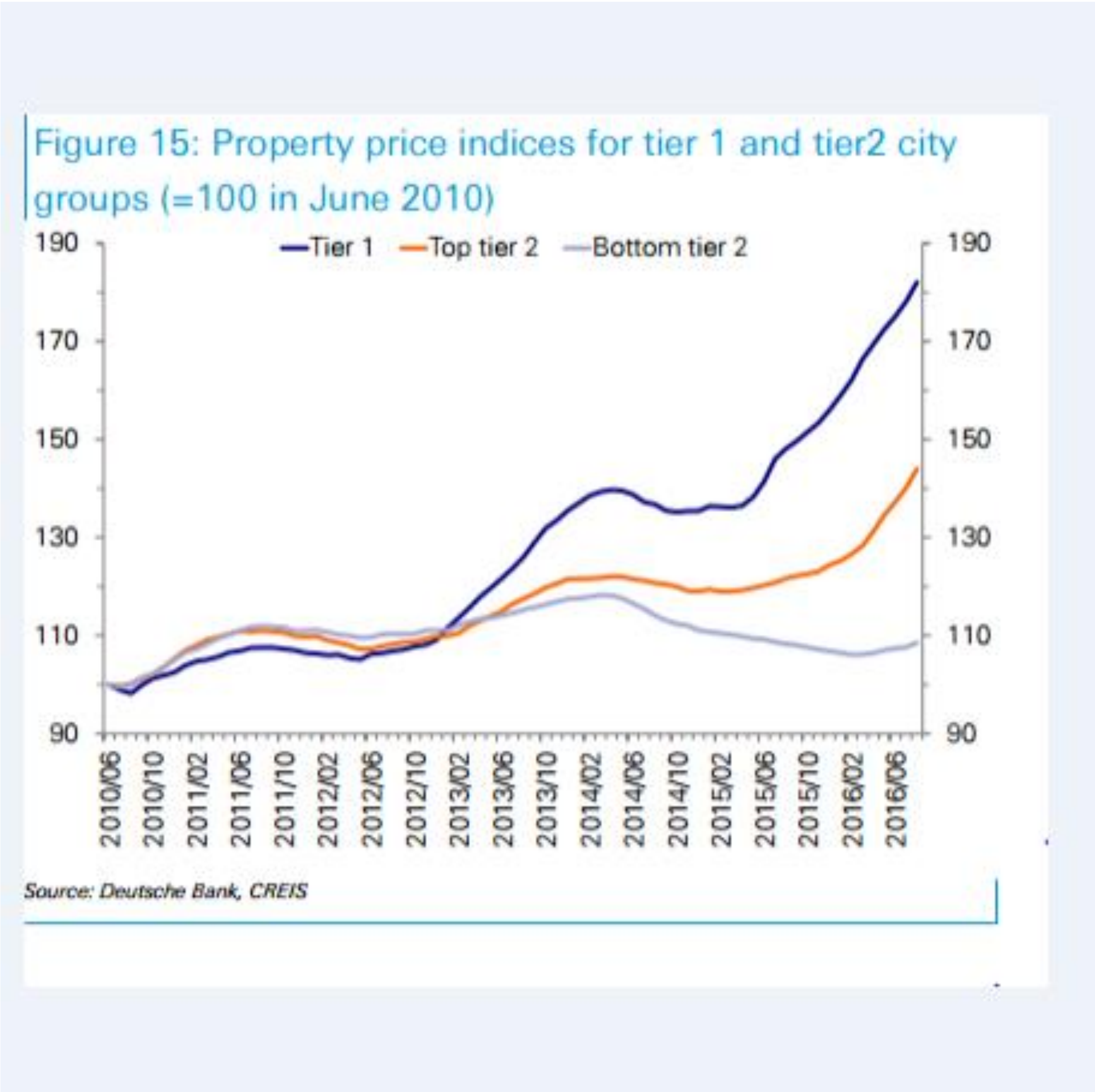
Chinese mortgage loans have exploded over the last four months CREDIT: CAPITAL ECONOMICS

The bubble went mad in September. Home prices in Shanghai rose 5pc in one month. Over the last year they have risen 28pc in Bejiing, 33pc in Shanghai, 37pc in Xiamen, and 47pc in Hefei.

The authorities are belatedly scrambling to restore sanity. Developers face curbs on borrowing from banks, trust funds, or capital markets to buy land. They can no longer issue bonds, or raise money in Hong Kong.

Minimum down payments for buyers have been lifted to 50pc, and 70pc for second properties. Curbs have been imposed in the big 'tier I' and tier 2 cities, and measures are spreading to other parts of the country.

As real estate lurches from boom to probable bust, developers will be left sitting on $1.1 trillion of debt, similar to the US subprime bubble in 2007. How this will end is anybody's guess. Vacancy rates are as high as 40pc the North Eastern cities if the builders' inventories are included.



Property prices have soared this year after the government deliberately fomented a boom CREDIT: DEUTSCHE BANK

The risks of China's debt addiction are spelled out in the International Monetary Fund's Global Financial Stability Report. It warned that the country has a 'credit overhang' of 22pc to 27pc of GDP, over five times the level that usually precedes a financial crisis. Bank exposure to "shadow" credit products - China's equivalent of junk instruments - jumped by 50pc last year to $6 trillion.

But what really worries the IMF is that reliance on "wholesale funding" has jumped to 30pc, mostly in the overnight and one-week repo markets. "Borrowers must roll over their liabilities on average almost daily, whereas funded credit products have mostly longer maturities. This maturity mismatch makes borrowers highly vulnerable to a sudden liquidity crunch," it said.

"This is the Achilles Heel of the Chinese financial system. It isn't just the level of debt, it is the source of funding," said George Magnus from UBS. It was dependence on wholesale funding that doomed Northern Rock and Lehman Brothers. Such financing is inherently prone to sudden seizures.

We will find out soon enough whether China can deliver yet another calibrated soft-landing, this time with a record debt load of 255pc of GDP. The leakage of capital is already telling us that Chinese investors have their doubts.