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Fitch reveals the $2trillion black hole in China's economy that heralds a lost decade

China's debts have caught the worried eye of Fitch CREDIT: TELEGRAPH

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Bad debts in the Chinese banking system are ten times higher than officially admitted, and rescue costs could reach a third of GDP within two years if the authorities let the crisis fester, Fitch Ratings has warned.

The agency said the rate of non-performing loans (NPLs) has reached between 15pc and 21pc and is rising fast as the country delays serious reform, relying instead on a fresh burst of credit to put off the day of reckoning.

It would cost up to $2.1 trillion to clean up this toxic legacy even if the state acted today, and much of this would inevitably land in the lap of the government.

“There are already signs of stress that point to NPLs being much higher than official estimates (1.8pc), most obviously the increased frequency with which the banks are writing off or offloading loans,” it said.

The banks have been shuffling losses off their balance sheets through wealth management vehicles or by classifying them as interbank credit, seemingly with the collusion of the regulators. Loans are past 90 days overdue are not always deemed bad debts.

“The longer debt grows, the greater the risk of asset quality and liquidity shocks to the banking system,” said Fitch. Capital shortfalls are currently 11pc to 20pc of GDP, but this threatens to hit 33pc in a worst case scenario by the end of 2018.

“Defaults in China could lead to mutual credit guarantees in the background pulling other firms into distress. A large increase in real defaults risks triggering a chain of bankruptcies that magnifies the potential for financial instability,” it said.

“Mid-tier banks have the weakest buffers, and are the most vulnerable to funding stress,” said the report, by Jonathan Cornish and Grace Wu.

The damage eclipses losses during the global financial crisis in Britain and the US, where the direct costs of bank rescues were roughly 8pc of GDP. It would be closer to the trauma suffered by Ireland, Greece, and Cyprus when their banking systems collapsed, but on a vastly greater scale.

The Chinese state has deep pockets but strains are mounting. Public debt has reached 55pc of GDP following the bail-out of local governments. This is now higher than among ‘A’ rated peers, mostly in the developing world. “Pressure on China’s sovereign rating could emerge if general government indebtedness were to rise significantly,” said the Fitch report.

China let rip with a fresh burst of credit growth from the middle of last year after a series of policy errors triggered a recession – with ‘Chinese characteristics’ - in early 2015. It ditched any serious effort to reform the economy and opted for stimulus as usual, cutting interest rates and the reserve requirement ratio.

Credit reached 243pc of GDP by the end on last year, double the level in 2008. Banking system assets have grown by $21 trillion over that time, 1.3 times greater than the entire US commercial banking nexus.

Fitch estimates that the ratio will jump to 253pc this year, and 261pc next year. Curbs on property lending have been relaxed and much of the fresh credit is going to housing speculation, driving up prices over the last year by 40pc in Hefei, 37pc in Shenzhen, 37pc in Nanjing, and 31pc in Shanghai.

Loans increased by $1.2 trillion in the first five months of this year alone. The authorities have since begun to tap on the brakes, implying a fresh economic slowdown in early to mid 2017. Pessimists fear this could prove to be an inflection point for China and the world.

The credit addiction is becoming increasingly dangerous for two reasons. The efficiency of credit has collapsed. Fitch estimates that each new yuan of credit generates just 0.3 yuan of economic growth, down from 0.8 before the Lehman crisis.

At the same time, the growth rate of nominal GDP has halved from around 15pc to nearer 7pc, making it much harder for the country to work off the debt load – the so-called denominator effect. A pattern has become entrenched where credit is rising much faster than the underlying nominal base of the economy, and is achieving ever less in the process.

“We think the Chinese authorities can still clear this debt,” said Mark Williams from Capital Economics. “In an extreme scenario - with non-recoverable loans of 25pc – we calculate that the government would have to spend a full 35pc of GDP bailing out the banks. That would lift debt to 90pc. That is high but in principle it is possible.”

Mr Williams said it will be very hard for Beijing to repeat the tricks used to overcome the last banking crisis in the late 1990s. A roaring global boom – and surging nominal GDP – whittled down the burden of state’s bail-out bonds, and the use of “financial repression” to hold down deposit rates for effectively imposed the cost on savers.

Neither are now possible. Deposit rates have been liberalized. The global context is entirely different and China is starting to face demographic strains from a shrinking work force. Mr Williams said the biggest worry that the Communist Party fails to deliver on reforms, leading to economic stagnation and a darkening calculus for the debt trajectory. “We’re afraid that growth could drop to 2pc,” he said.

Fitch doubts that there will be a Lehman-style meltdown or a great drama akin to western banking crises, since the four big lenders are instruments of the Communist Party. “The dominance of the state-owned banks and the fact that they are funded overwhelmingly by deposits mitigate against a financial crisis,” it said.

The denouement is more likely to be a murky compromise, a Japanese picture of slow deflation and muddling through. A lost decade may lie in store.