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HD **Spike in defaults raises fear of China collapse**

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Big picture

Investors in Australian resources stocks were given more to worry about this week as the collapse of a Chinese property developer fanned fears the country could be on the verge of its own "Minsky moment".

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This week Chinese government officials from the eastern town of Fenghua held meetings in an attempt to hammer out a plan for dealing with Zhejiang Xingrun Real Estate Company, which collapsed under the weight of a 3.5 billion yuan ($620 million) debt burden, of which 2.4 billion yuan was borrowed from banks, and the remaining 1.1 billion yuan came from other creditors.

Markets fretted that Zhejiang Xingrun's collapse highlights the growing cracks in China's real estate sector as Beijing cracks down on runaway credit growth. Many developers borrowed heavily to buy land, and then turned around and used the land as collateral for further borrowings to fund development.

Investors, of course, had already become concerned about the possible side effects of Beijing's efforts to dampen credit growth after solar panel maker Chaori Solar this month became the first Chinese company to default on a publicly traded corporate bond in China. They found little reassurance in Chinese prime ministerLi Keqiang's comments that further defaults on bonds and other financial products were "unavoidable".

Fears of a Chinese liquidity crunch have been heightened by Beijing's recent move to guide the yuan lower to choke off "hot money" flowing into the country. This year the PBOC, which keeps a tight grip on the currency, has pushed the yuan down by more than 2 per cent against the US dollar, reversing much of the 2.9 per cent rise it saw in 2013.Foreign funding access

The PBOC's move has made it much more expensive for riskier Chinese borrowers to access low-interest rate foreign funding. Typically, Chinese firms were able to able to use commodities – primarily gold, copper and iron ore, but also soybeans, palm oil, natural rubber, nickel, zinc and alumnium – as collateral for highly leveraged, low-interest-rate foreign currency loans.

But by pushing the yuan lower, the PBOC has clamped down on Chinese commodity financing deals. The lower currency makes these deals much less profitable, and chokes off some of the foreign funds flowing into China's shadow banking system.

Already the PBOC campaign appears to be having some success, with foreign money entering China falling to a five-month low of $US21.1 billion in February, and well down from the $US72.3 billion inflow in January. But some analysts fear that the rising number of defaults are a sign China is fast approaching its "Minsky moment" when its credit boom starts to unwind.

This refers to a theory developed by the US economist Hyman Minsky who argued that after long periods of financial stability, borrowers tend to take more and more risk. As a result, the credit system transitions from its initial point – where borrowers have large enough cash flows to cover their interest and principal repayment – to a second phase of speculative finance, where borrowers can meet their interest payments but can't repay their principal, so they are forced to roll over their borrowings. The final phase, of Ponzi finance, occurs when borrowers don't have large enough cash flows to meet their interest payments, and so need to borrow more money or else sell assets.Unstable state

In a research paper released this week, Morgan Stanley analysts argued "Our analysis indicates that **China**'s economy has arrived at that unstable state where speculative and Ponzi finance appear to dominate.

"Very few economies have created as much debt as **China** in the past five years. **China**'s private sector debt has increased from 115 per cent of GDP [gross domestic product] in 2007 to 193 per cent [by December] 2013."

They point out "that 80 per cent increase over five years compares to the US's 26 per cent in 2000-2005". "In recent years, only Spain and Ireland have achieved debt growth greater than **China**'s. Every year **China** is now adding $US2.5 trillion of private sector debt to a $US9.7 trillion GDP."

Even worse, they note, "there is evidence this debt growth has become excessive and non-productive".

Minsky argued there is a tipping point – usually when central banks tighten policy to fight inflation – when the credit boom unwinds.

As the Morgan Stanley analysts note, the **Chinese** central bank has been tightening credit for nine months, and in its latest monetary report it signalled it will continue to tighten liquidity to control rapid growth of shadow banking credit.Investors unnerved

At the same time, the spike in defaults has unnerved investors and caused them to worry they won't get all their money repaid. So interest rates on trust products, wealth management products, corporate **bonds** and bank loans have risen by roughly 200 basis points in the last year. Adding to the pressure is the almost $US600 **million** in trust loans from the shadow banking sector that come due for repayment this year.

"So [while] large amounts of debt come due and borrowers are stretched, growth is slowing, monetary policy is being tightened, and market rates are beginning to rise, making new borrowings even more expensive and difficult. The combination indicates to us that **China**'s Minsky moment is approaching," says Morgan Stanley.

Its analysts say the unwinding of **China**'s credit boom will cause its economy to grow much more slowly.

"Our baseline case is **China** may slow from 7.7 per cent GDP growth to 5 per cent over the next two years. But a disorderly unwind could take growth down to 4 per cent in a shorter time with potentially disastrous consequences for levered **Chinese** assets (banks, property) and the commodity supply chain (commodity stocks, equipment stocks, commodity-sensitive countries and their currencies)."

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