# Chinese storm clouds

Shadow banking defaults could precipitate chaos

by Marcello Minenna and Edoardo Reviglio in Rome

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There are no signs that the storm clouds over Beijing and Shanghai are abating. Chinese stock markets, down a further 3.3% today, have fallen 20% this year, with few signals of stabilisation. The so-called circuit breakers have failed. Risks have grown through massive stock market support from government funds (the 'China plunge protection team') and Chinese banks' loans of over $200bn to institutional investors, all under the benign eye of the People's Bank of China.

The PBOC faces serious difficulties in managing the renminbi, under pressure from the US interest rate hike. The central bank has run down its foreign exchange reserves from $4tn in mid-2014 to $3.3tn in December in a bid to stem the currency's decline.

On offshore markets the Chinese currency is trading much lower than on the official one, stoking speculation that the PBOC is managing the official exchange rate down towards the offshore value. This detachment could be dangerous because it encourages a 'dollar black market' by operators defending themselves against devaluation risks.

Offshore renminbi markets are still in their infancy (only 3% of the official market) but are gaining weight rapidly after the November 2015 decision to bring the currency into the International Monetary Fund's special drawing right. In a foretaste of possible Argentina-like troubles, in recent weeks Shanghai's foreign exchange booths have attracted sizeable queues of dollar-seeking Chinese citizens.

To mitigate renminbi short-selling, the PBOC has raised the overnight bank lending rate by up to 80%. In the short term, the PBOC can win these battles. But falling foreign exchange reserves cast doubt on its ability to surmount a full-scale currency war.

The biggest risks lie within the Chinese banking system. In the last decade, credit to China's real economy has grown 10% a year, with corporate debt now surpassing 147% of GDP. Last year's economic growth decline to a 'meagre' 6.9% has raised registered bad debts to $700bn. This is 2.3% of total banking assets, tiny compared with 40% in Greece and 16% in Italy, causing some independent analysts to doubt whether this adequately reflects Chinese banks' hidden risks – especially since the dollar's rise is exacerbating the problem of hard currency loan repayments, as we highlighted earlier this month .

A dangerous accounting malpractice – transforming standard loans into 'investments' supporting non-financial intermediaries (the shadow banks) – appears to be spreading. This reclassification allows banks to boost profits by circumventing regulatory standards imposing reserves against bad loans. Lack of adequate reserves could trigger uncontrolled defaults of some of these shadow loans, precipitating chaos faster than anyone can imagine. The New Year has started badly in China. We may not yet have seen the worst.

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