QNB Economics
economics@qnb.com.qa
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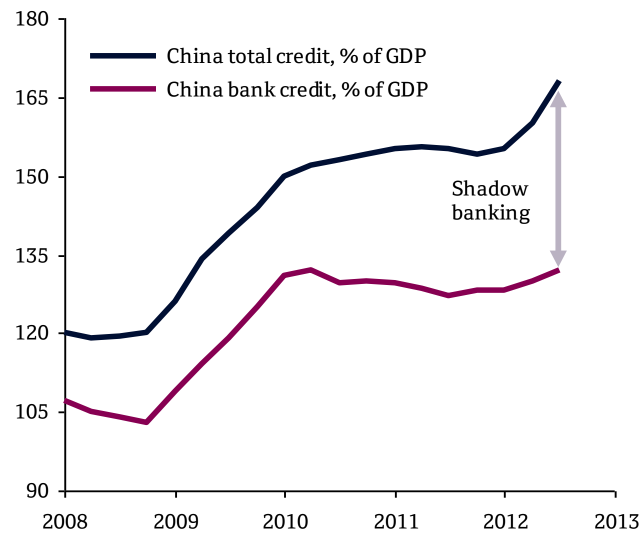
Credit Squeeze May Dampen Economic Growth in China, According to QNB Group

The Chinese authorities' policy to squeeze excessive credit expansion may dampen economic growth in the second half of 2013, according to QNB Group. China has experienced a very rapid increase in financial credit over the last decade driven both by commercial banks as well as other nonbank institutions. Earlier this year, the Chinese central bank (the People's Bank of China or PBC) determined that credit expansion has become excessive and is undermining China's financial stability. In response, it started squeezing liquidity and tightening credit regulations. While there is some merit to the PBC's concerns about excessive credit expansion, the consequence of the PBC policy has been a jump in overnight interest rates and a reduction in credit to corporate clients. According to QNB Group, this may result in a moderate slowdown in economic growth in the second half of 2013 to 6%-7%, which would undermine China's ability to attain its growth target of 7.5% for the year as whole.

China has experienced very strong credit growth in the last few years, which went to finance its extensive infrastructure and housing investment. Credit from the banking sector reached 132% of GDP at end-2012, from 103% at end-2008 (see chart). On top of this, nonbank institutions, like collective credit cooperatives, informal loans and wealth management products (generally called "shadow banking") have added another 33% of GDP to this large credit expansion (see table). This has contributed to China having the fastest average growth rate in the world during the last few years. However, it has also led to fraud, risky

China's Credit Boom, 2008-12
(Credit, % of GDP)



Source: Bank of International Settlements

China's Shadow Banking Instruments
(Amount Outstanding in 2012, % of GDP)

Entrusted Loans	11.2%
Informal Loans	6.6%
Bank WMPs, Packaged by Trusts	4.0%
Collective-Trust Products	3.6%
Bank WMPs, Off-Balance Sheet	3.4%
Bank WMPs, Packaged by Securities Companies	3.2%
Microcredit	1.1%
Total	**33.2%**

Notes: WMPs are wealth management products
Sources: PBC, China Trustee Association, China Banking Regulatory Commission, Bloomberg

lending practices and usury, particularly in shadow banking which remains unregulated by the authorities.

Given these conditions the PBC has since May started to tighten liquidity conditions and credit regulations, hoping to stem out bad lending practices particularly in shadow banking. Unfortunately, the impact has been rather different. The overnight Shanghai interbank borrowing rate (the Shibor), rose from 2.2% on May 15 to an all-time high at 13.4% on June 20. In addition, data through end-June 2013 suggest that the credit squeeze has led to a decline in funding to corporate clients through the traditional banking sector, while shadow banking continues to thrive. This has moderated real GDP growth to 7.5% in the second quarter of 2013, notwithstanding a large increase in private consumption.

Following this experience, both the PBC and the government have pledged to continue to provide liquidity injections to support the financial system. With that, overnight Shibor has moderated to 3.0% on 18 July. In particular, the PBC has refrained from selling bills to withdraw funds from the interbank market since June 20, providing relief for banks that have been having trouble finding funds to finance their short-term operations in the previous weeks.

Most economists expect credit growth to slow in the coming months, in large part owing to the liquidity squeeze and tougher credit regulations. One consequence of the squeeze will be slower economic growth. A series of recent economic indicators, from construction to bank lending and export growth, all point to lower economic activity, suggesting that China is at risk of slipping below its annual growth target (7.5%) for the first time since the Asian financial crisis 15 years ago.

Overall, despite much of the credit crunch being over, challenges remain for the Chinese financial system, according to QNB Group. China's government has vowed to ensure credit growth supports the real economy and to control the flow of new money into industries struggling with overcapacity. However, ensuring financial stability may prove challenging, given that latent nonperforming loans in the system need to be identified and absorbed. The corresponding reduction in credit to the economy will inevitably lead to slower economic growth in the second half of 2013. Over the medium term, however, QNB Group remains optimistic that Chinese economic growth will continue at a brisk pace.