# China: bracing itself for financial turbulence

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According to a popular Chinese proverb, 'You should cross the river by feeling the stones', which means that one should avoid making radical moves that might lead to danger. The Chinese government has applied this to its economic reforms over the past 30 years and is doing so now in its goal to liberalise its financial system.

In any attempt to cross a river there are always a few stones that subside when stepped on. And just as the traveller might have to jump onto the next –firmer– stone, the Chinese financial markets might have to see a few market players stumble and fall in order for the reform process to continue its course on a sustainable path.

What is interesting about the current moment of the reform process is that increasingly more financial actors, both in Shanghai and Beijing, are bracing themselves for some market turbulence. Investment bankers in Shanghai predict that this year there will be a few bankruptcies in the financial sector; senior executives at the headquarters of the commercial banks in Beijing are singing from the same song sheet.

Even more remarkable is that senior officials at the People's Bank of China (PBoC) also recognise that a few mid-range financial institutions might have to go under, while explaining that this might be a good thing because it would cleanse the system. Incidentally, on Friday 7 March 2014, China could witness its first corporate-bond default, barring a last-minute bailout for the solar-panel company Shanghai Chaori.

This overall market perception of a high state of alert is striking. Normally, bankers in Shanghai are bullish about the Chinese economy, while policymakers in Beijing are keen to convince their interlocutors (especially if they are from the West) of the Chinese financial system's resilience. How can the change of attitude be explained?

To answer this question it is important to understand where China is on the journey to liberalise its financial sector and thus let market forces play a greater role in the allocation of capital. Analysts tend to focus on the liberalisation of interest rates as a first step towards this goal. Interestingly, however, while not having eliminated the official ceiling on the deposit rates offered by the state-owned commercial banks, the Chinese government has, to a large extent, already liberalised this field.

Liberalisation has been achieved by allowing the so-called 'shadow banking system' flourish. Since 2010 the proliferation of credit channels outside the state-owned commercial banks has increased exponentially, totalling RMB46 trillion, equal to 30% of the assets of traditional banks. At first, this sector attracted the attention of both the lower and upper ends of the credit-worthiness scale.

It appealed to micro-credit providers adventurous enough to lend money to those the official sector considered non credit-worthy, and it was a natural ground for expansion for the wealth-management products offered off-balance-sheet by the commercial banks, linking sophisticated investors seeking higher returns with speculative developers and local government officials eager to secure new sources of financing.

The widespread use of new media, however, has expanded the shadow banking system to more regular Chinese savers. The message is clear: why park your money at the state-owned commercial banks in deposits that offer a 3% return (which is below the inflation rate) when you can put your savings in money-market funds that offer a 7% yield? This is the message with which Alibaba, the Chinese e-commerce giant, has attracted 80 million clients to its newly-established web bank in less than a year.

The fact is that by now close to 50% of all credit provision in China is realised through the shadow banking system, which means that half of China's interest-rate settlements are determined by market forces. The Chinese government is not trying to curtail such a change and, on the contrary, it has actively encouraged its development. Hence, it appears that Beijing is keen to apply the 'dual-pricing' system (one official and another market-based) successfully used in the early years of economic reforms in the financial sector.

The problem, however, is that the increased market-based assessment of credit, and therefore of risk, is distorted. Over the past 30 years the Chinese government has never allowed the bankruptcy of any significant financial institution.

Hence, investors know that, legally, the commercial banks are not liable for their off-balance-sheet activities. They just act as intermediaries between creditors and borrowers. But they also know that the reputational risk would be significant if the commercial banks saw some of their flagship wealth-management products go bust.

This is precisely what happened in January to the Credit Equals Gold No1 fund of the Industrial and Commercial Bank of China (ICBC), which was rescued by an unnamed third party.

Furthermore, investors are also convinced that in the event of the state-owned commercial banks deciding to let one of their off-balance-sheet trust funds collapse, the Chinese government would step in to avoid a market panic.

But this is exactly the type of moral hazard the Chinese authorities are trying to avoid and, to prove it, they are willing to let some of these highly speculative funds go under. The rationale is clear: if you want to let the market gradually decide credit risk, then you need to let certain investors lose their money so that the risks of capital allocation can effectively be reassessed and a damper put on the housing bubble fuelled by shadow-banking activity.

The question of course is whether the Chinese authorities will be able to engineer a couple of bankruptcies (this should be easy since many non-performing loans are continuously refinanced and are thus de facto in default) in order to put some fear into market operators and convince them to engage in more prudent lending without generating a market panic.

Liberal-minded and reform-enthusiast officials at the PBoC think it is possible. They claim that the Chinese financial system is not like the West's. If there is a market panic, the Chinese government can activate all its state and party levers (both financial and disciplinary) to stop the possible herd effect. That is the Chinese system's strength, or so they claim.

Of course, by stating this, they are entering into what appears to be a contradiction. On the one hand, they want market forces to play a greater role in finance. On the other, they are keen to praise the stability offered by a state-controlled financial system. That is the reason why crossing the river of financial reform will be a long march for China.