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Chinese Debt Soars Into Space

Astronomical credit binge exceeds 2009 stimulus; 'financial Star Trek'

China's debt levels and economic fragility may limit the rise of the yuan on the global stage, economists warn. *PHOTO: REUTERS*

By

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SHANGHAI—Since China was the first country to use paper money it shouldn't be a surprise that it was also guilty, earlier than most, of monetary recklessness.

When Marco Polo visited China in the 13th century, notes the Cornell economist Eswar Prasad in his coming book "Gaining Currency: the Rise of the Renminbi," the Venetian adventurer was so impressed by the use of notes, rather than hard cash, he wrote that the Mongol emperor "has a more extensive command of treasure than any other sovereign in the universe."

Alas, this control was fleeting: The Mongol dynasty printed too much money, succumbing eventually to a lack of financial discipline as well as internal rebellion.

Latter-day Marco Polos regard Chinese financial practices with a deeper skepticism but a similar sense of head-shaking wonder. Today's monetary boom in all its forms has few parallels. Over the past 12 months, China added more domestic credit than in 2009, when authorities engineered one of the greatest bouts of stimulus spending in history to rescue the economy as exports wilted during the global financial crisis.

The multiyear boom surpasses even America's excesses in the run-up to that crisis, and the biggest question hanging over the economy is how it will end. Because end it must.

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"I sometimes joke that we're in financial Star Trek," says Rodney Jones, the Beijing-based principal of Wigram Capital Advisors. "We've left the solar system behind."

This voyage into the unknown, says Mr. Jones, could reach further and last longer than many expect. He points out that Beijing has lately fired up a new thruster: bonds.

Beijing has encouraged local governments—which do the bulk of China's investing—to issue huge quantities of bonds, ostensibly to repay more expensive bank debt but in reality to accumulate new funds for roads, subways and other infrastructure for which the returns are far from clear.

On top of that, the central bank is selling large volumes of bonds to commercial banks to shore up their balance sheets so they can keep pumping out loans. Bank credit is increasing at twice the pace of the overall economy.

This financial jolt—monetary expansion has been larger than quantitative easing in the U.S., eurozone, U.K. and Japan combined—has considerably brightened the economic gloom.

The Mongol emperor Kublai Khan impressed Marco Polo with the use of paper money but his dynasty, the Yuan, eventually succumbed to financial indiscipline and internal rebellion. *PHOTO: AGENCE FRANCE-PRESSE/GETTY IMAGES*

A year ago, global investors were bracing for a Chinese collapse. The Shanghai stock market had crashed and capital was flooding out. The property market looked shaky and sinking factory prices and corporate profits threatened to squeeze wages and consumption. Currency speculators bet on a sharp depreciation of the yuan.

Instead, property transactions are on track for an annual record this year. In August, car sales grew at a double-digit rate for the fourth consecutive month. Meanwhile, capital outflows have shrunk and factory prices are recovering. The yuan has fallen only moderately.

Economists warn that there's an inevitable price to pay. China's debt-to-GDP ratio has ballooned from 150% to more than 260% in a decade, the kind of run-up that usually ends in a bust, or a sharp slowdown.

But Chinese leaders don't seem particularly concerned. Perhaps they believe they can keep churning out bank loans and bonds and postpone a crisis indefinitely, just as Japan does.

In any event, turning back may now be politically impossible; the required adjustments needed to get debt under control—slower growth, worker layoffs—would create severe social risks. President Xi Jinping needs buoyant growth ahead of a key Communist Party congress next year, when he intends to crown his power by packing the party's top echelons with his own people.

Thus the Chinese dynastic cycle plays out. The Mongol Yuan dynasty was followed by the Ming (1368-1644), which again printed paper money indiscriminately, finally having to abolish it. Paper money didn't make a comeback until 1853 when the last imperial dynasty, the Qing, printed notes to raise money to suppress the Taiping Rebellion. The

Communists took power from the Nationalists, who ran the printing presses so hot to finance war against Japan that prices increased 35 million times, by one estimate.

The Communist leadership appears secure for now: Mr. Xi is immensely powerful and popular.

And Mr. Prasad, the Cornell economist, thinks fears of a financial meltdown are overblown. Most borrowers and lenders, he points out, are owned by the government, so banks are unlikely to pull their loans and precipitate a cascading crisis. Still, economic and financial fragility, he argues, will limit the rise of the Chinese yuan as a global "safe haven" currency.

China's very first notes were called "flying money" because, unlike coins, they could flutter away in a breeze. That's an appropriate metaphor for Chinese financial policy, now wafting in an orbit of its own. One way or another, it will have to come back down to earth.

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