

IS CREDIT GROWTH PICKING UP IN CHINA?

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One of the key takeaways from the [Federal Reserve's \(Fed\)](#) decision not to raise [interest rates](#) in September was its newfound concern for “global economic and financial developments.”¹ The Fed indicated that in addition to monitoring U.S. employment and U.S. [inflation](#), it would also monitor the economic and financial climate overseas, which I translate as “tribulations emanating from China that can ripple through emerging markets.” Chairman Janet Yellen’s September press conference raises the question, “Will the Fed have any more visibility into what is happening in China by the October or December meetings?” The Chinese stock market is easy enough to monitor. With [margin lending](#) contracting, the Shanghai stock exchange stabilized in recent weeks, trading water around the 3,000 level after declining 40% from its June highs. But getting a precise pulse on what’s happening inside China’s economy is harder. The government reports that Chinese [gross domestic product \(GDP\)](#) growth has fallen to 7%, after averaging 10% per year for the past 20 years. Other market indicators are more troubling. China’s [Caixin Manufacturing Purchasing Managers' Index \(PMI\)](#) stayed below a reading of 50 for the seventh consecutive month in September, falling to 47.2, a reminder that China’s immense manufacturing sector is contracting. Imports into and exports out of China are both down compared to a year ago. The approximate 25% decline in the price of copper in the last year is one indication that Chinese industrial and construction demand is waning, as China accounts for about 40% of global copper demand. Chinese demand for certain imported agricultural commodities is also down. For example, the world’s most populous nation imported 25% less sugar in August than it did a year ago, pushing down the price of sugar to levels not seen since the financial crisis in 2008. All of this is impacting companies and countries that depend on China for their exports, particularly those in emerging markets. The steady slide in the currencies of many commodity-exporting nations has added a new measure of potential instability into the global financial system. The most recent [International Monetary Fund \(IMF\)](#) (IMF) update on emerging market borrowing reminds us that outstanding [corporate debt](#), denominated in dollars, has risen in the developing world from \$4 trillion in 2004 to more than \$18 trillion today.² This is, in my view, one of the reasons the IMF—the world’s lender of last resort—has cautioned the Fed not to raise interest rates in the past few months. Emerging market debt in dollars— and with it, the potential for further dollar appreciation against foreign currencies—is yet another risk the Fed may need to be mindful of as it considers raising interest rates. So a key question for U.S. investors is how well the Chinese navigate their current transition from an investment-led economy to one in which consumer spending plays a greater role in future growth. One window into that transition is [credit](#) growth, specifically lending activity that fuels household consumption. A look inside China’s latest [total social financing \(TSF\)](#) data presents a useful summary of credit formation in the world’s second largest economy. From the detailed breakdown presented below, I make the following observations. **China Total Social Financing Summary (Flow Data, [Renminbi](#)**

Month	Total	Loans in Local Currency	Loans in Foreign Currency	Corporate Bonds	Non-FI Equity Raising	Entrusted Loan	Trust Loan	Bank Acceptance Bill	Other	Shadow Banking
Aug-14	958	703	-20	193	22	175	-52	-112	48	12
Sep-14	1136	857	-51	234	61	161	-33	-141	46	-13
Oct-14	681	548	-72	259	28	138	-22	-241	42	-125
Nov-14	1146	853	-3	181	38	127	-31	-67	48	29
Dec-14	1695	697	54	76	66	455	210	60	76	725
Jan-15	2047	1471	21	182	53	83	5	195	37	283
Feb-15	1356	1144	-15	67	54	130	4	-59	32	75
Mar-15	1241	992	0	132	64	111	-8	-91	41	12
Apr-15	1056	805	-27	159	60	34	-5	-7	36	22
May-15	1236	851	8	168	58	32	-20	96	42	109
Jun-15	1833	1324	56	208	105	141	54	-103	48	92
Jul-15	742	589	-13	248	62	114	10	-331	65	-208
Aug-15	1082	776	-62	288	48	120	32	-158	40	-6
Average (LTM)	1271	909	-9	183	58	137	16	-71	46	83
Year-over-Year	13%	10%	-208%	49%	121%	-32%	162%	-41%	-18%	-152%
Month-over-Month	46%	32%	-366%	16%	-22%	5%	220%	52%	-39%	97%

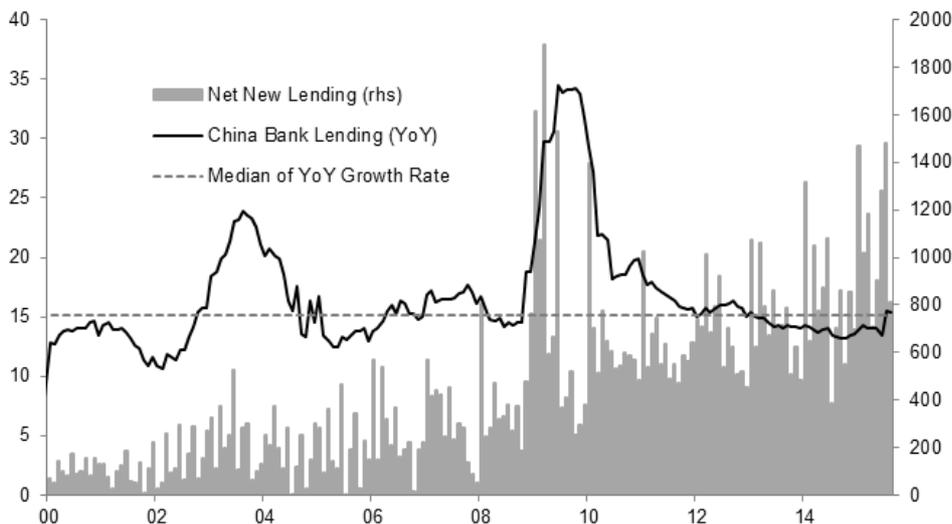
Shadow banking includes entrusted loans, trusts loans and bank acceptance bills.

(RMB), Billions) Sources: PBOC, Bloomberg, WisdomTree, as of 8/31/15.

For

definitions of terms in the chart, please visit our [glossary](#). Total credit formation in August 2015 was 1.08 trillion RMB, which was up 13% on a year-over-year basis, and 50% higher than the month earlier. Although still lower than its average over the last 12 months (LTM), the overall growth trend seemed to be picking up. Bank lending to the real economy contributed the most to the credit growth, reaching 776 billion RMB. The 10% annual growth in these “loans in local currency” (including the loans to nonbank financial institutions) signals that new bank lending inside the country has been holding up relatively well, despite the broader slowdown elsewhere in the Chinese economy. Credit growth has been contracting in the [shadow banking](#) channel, which includes [entrusted loan](#), [trust loans](#) and [Bank acceptance bill](#). As a whole, lending in this segment decreased 6 billion RMB in August after a more pronounced decrease of 208 billion RMB in July. In other words, while the growth in overall credit formation has slowed in the last 12 months, traditional bank lending remains healthy in the face of a contraction in new credit within the shadow banking system. Net-net, this is likely a positive for the transparency and regulation of the Chinese banking system. [Corporate bond](#) issuance posted another strong reading of 288 billion RMB in August. That represented 49% growth versus the same time last year. The issuance of corporate bonds by Chinese companies is also an encouraging signal. It suggests a better mix of credit formation may be developing in China, which may help to reduce the concentration risk of the overall credit system.

China Bank Lending (Billions, RMB) and Growth Rate (YoY, %) Monthly, Jan-2000 to Aug-2015



Sources: PBOC, WisdomTree, 1/1/00-8/31/15.

Conclusion

At a time when capital has been flowing out of China in search of havens outside the country, it is important that private sector credit growth continues to expand inside China, and that it continues to flow to consumers and businesses. The most recent figures signal that net new Chinese bank lending has been inching up in recent months. Continued credit expansion to households will be an important metric to monitor, as will overall consumer spending as a percentage of Chinese GDP. This transition is likely to take several years. But in the short term, a bottoming process to the Chinese stock market and renewed credit growth in China are two important data inputs for monitoring the stabilization of “global financial conditions.” *All sources are Bloomberg as of 10/5/15 unless otherwise stated.* ¹FOMC statement, 9/17/15.

²"Market Liquidity—Resilient or Fleeting?" International Monetary Fund, 10/15.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Inflation : Characterized by rising price levels.

Margin lending : Allows individuals to borrow funds meant for investing by using their current assets held as collateral.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Caixin Manufacturing PMI : Chinese manufacturing composite indicator designed to provide an assessment of manufacturing activity. A number below 50.0 indicates that the manufacturing economy is declining, and a value above 50.0 indicates an expansion of the manufacturing economy.

International Monetary Fund : international organization for global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth around the world.

Corporate debt : Bonds a company issues in order to raise money.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Total social financing (TSF) : A broad measurement of credit in the Chinese economy.

Renminbi (RMB) : is the official currency of the People's Republic of China.

Shadow banking system : A collection of non-bank financial intermediaries that provide services similar to traditional commercial banks.

Entrusted loan : A loan between borrowers and lenders that is organized by an agent bank.

Trust loans : Loans of trust companies.

Bank acceptance bill : A bank endorses the drafts or bills issued by a company.

Corporate Bonds : a debt security issued by a corporation.