5.1 Focus Topic: Vulnerabilities in China's Financial System

Authorities in China have been concerned about domestic macro-financial imbalances for many years, particularly those related to the real estate and shadow banking sectors. More recently, growth in the Chinese economy has slowed and there has been a sharp deterioration in property market conditions, increasing risks to China's financial system. While authorities have announced targeted policy support in response to weakening conditions in the real estate sector and the wider economy, they continue to balance the need to support growth against many longer term financial vulnerabilities, including high debt levels and perceptions of implicit guarantees.

This Focus Topic considers the vulnerabilities in China's financial system and the implications for Australia and the global financial system.

Continued weakness in demand has intensified stress in the Chinese property sector and exacerbated financial system vulnerabilities.

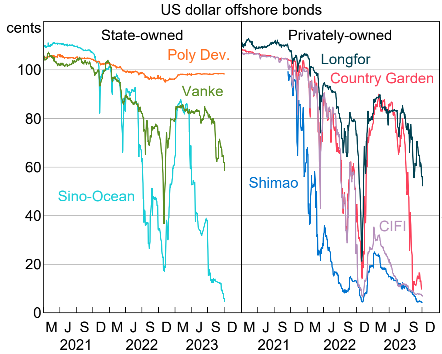
Weak consumer confidence, falling house prices and ongoing uncertainty regarding the completion of homes under construction have reduced the demand for new housing in China. This has exacerbated financial pressures on property developers (most notably Country Garden, one of China's largest property developers) and contributed to further defaults on offshore debt and delays in payments on onshore debt. While authorities have announced further support for the property sector, the effects of these measures are uncertain. The sector faces significant funding difficulties, with private developers largely unable to access capital markets and facing considerable upcoming debt maturities in the coming months. The bond prices of many large developers, particularly privately owned firms, indicate significant financial stress (Graph 5.1.1).

Stress in China's property sector has further exacerbated long-running vulnerabilities in local government balance sheets. Revenues from land sales are weak by historical standards, and local governments have continued to rely on local government financing vehicles (LGFVs) to replace developer demand in land auctions.[1] In addition, LGFVs are exposed to a downturn in property prices as land purchased from local governments is often used as collateral when borrowing. Given LGFVs comprise a large share of Chinese lending markets – 40 per cent of the non-financial corporate bond market and 14 per cent of total bank loans – a jump in LGFV defaults could trigger a disorderly repricing of risk in Chinese financial markets and a

Graph 5.1.1

Chinese Developer Bond Prices

US dollar offshore bonds



Source: Bloomberg.

deterioration in bank asset quality and profitability. Authorities will reportedly allow local governments to use proceeds from bond sales to bring LGFV debt onto their balance sheet via a CNY1 trillion (US$139 billion) debt-swap program. However, the size of this program is smaller than a similar scheme in 2015, and much smaller than the CNY57 trillion (US$8 trillion) in LGFV debt that the International Monetary Fund estimates is outstanding.

The number of defaults on shadow banking products, including trust loans and wealth management products, has increased further, likely reflecting stress in the property sector. Concerns over shadow banking have increased after a large entity, Zhongrong International Trust, missed payments on multiple trust loan products. While these missed payments did not lead to wider stress, the shadow banking sector remains a source of financial fragility in China as it is opaque, undercapitalised and has interlinkages with the wider financial system (especially banks).

Large Chinese banks have a strong capital position, despite a decrease in capital adequacy ratios over the June quarter of 2023 (Graph 5.1.2). Smaller banks have weaker capital adequacy positions, and are more vulnerable to real estate and LGFV risks. Reported non-performing loan ratios have been stable, though they are widely believed to be under-reported, and forbearance continues to mask true asset quality. Many banks have also recorded a decline in their profitability, partly reflecting a narrowing of net interest margins as lending rates have declined (alongside recent policy rate cuts) by more than deposit rates.

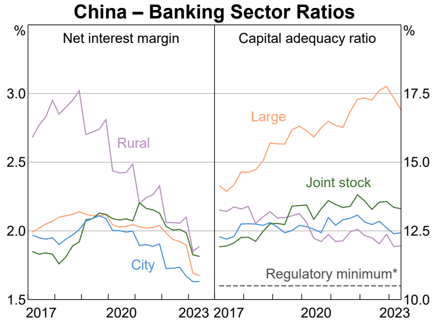
Stress in China's financial system could affect the global financial system, including Australia, via slower growth and an increase in risk aversion.

Direct links between mainland China's financial system and advanced economy banking systems are limited.[2] Widespread financial stress in China would therefore affect advanced economy financial systems mostly via its impact on Chinese trade and a general increase in risk aversion in global financial markets. However, China's financial system is a significant source of bank lending and direct investment for emerging market economies (EMEs). As a result, a disorderly repricing of risk in the Chinese financial system could lead to a significant tightening in financial conditions in some EMEs.

The direct links between Australia's financial system and China's financial system are small. The Australian banking system's exposure to mainland China is 0.2 per cent of assets (or 0.3 per cent when including Hong Kong). As a result, financial stress in China would have little direct effect on credit quality in the Australian banking system. Chinese banks also have a small presence in Australia and tend to confine their lending activities to particular segments, especially commercial real estate (CRE) and lending to Chinese enterprises with activities in Australia. Chinese banks account for 5 per cent of bank credit outstanding in the Australian CRE sector, much of which is thought to have funded the increase in purchases from Chinese investors around the mid-2010s. Since then, there has been little reported activity from Chinese investors in Australian CRE markets. Never-

Graph 5.1.2

China – Banking Sector Ratios



* Regulatory minimum is 10.5 per cent; 11.5 per cent for systemically important banks.

Sources: CEIC Data; RBA.

theless, there is a risk that Chinese investors sell their holdings of Australian assets in response to stress in their home economy, adding to downward pressure on CRE (or other) valuations in Australia, and increasing the tail risk of a disorderly price adjustment.[3]

The main effects of financial stress in China on Australia would likely be felt through slowing global economic activity, lower global commodity prices and reduced Chinese imports of Australian goods and services. This is a result of connections between Australia and China being far stronger through trade rather than financial linkages. A broad-based spike in risk aversion in global financial markets due to concerns over the outlook in China is the most likely channel through which a tightening in financial conditions could transmit to Australia.

Endnotes

[1] See RBA (2019), 'Box A: China's Local Government Bond Market', *Statement on Monetary Policy*, May.

[2] One exception is Hong Kong, though it is mostly the largest (and safest) mainland Chinese banks that have a presence in Hong Kong and many are subsidiaries regulated by the Hong Kong Monetary Authority.

[3] For further discussion of how stresses in overseas CRE markets could spill over to affect the Australian CRE market, see Chapter 2: Resilience of Australian Households and Businesses; see also Lim J, M McCormick, S Roche and E Smith (2023), 'Financial Stability Risks from Commercial Real Estate', RBA *Bulletin*, September.