

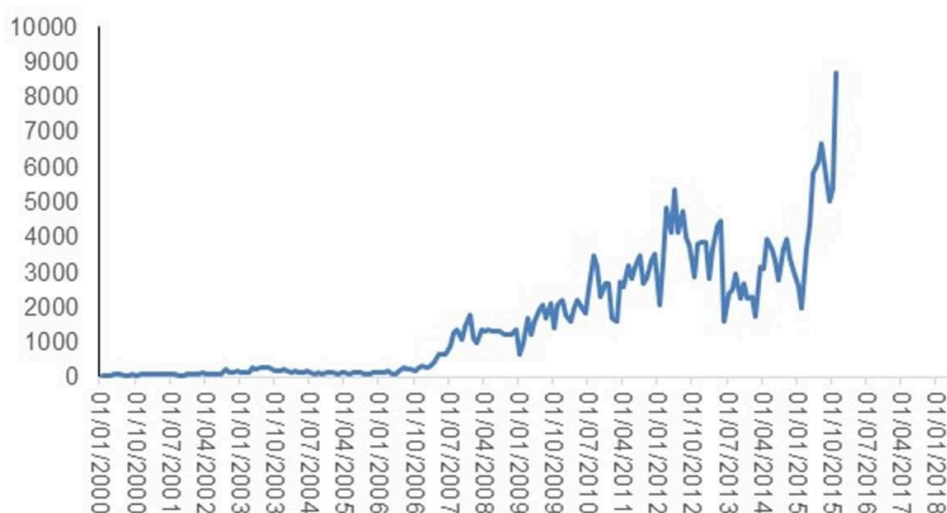
## Severe Stress

We have written at length, and in great detail, over the last nine months about the stresses in the Chinese banking system and the threat to both Chinese and global stability.

As if more proof were needed the following chart, showing the volume of interbank lending in China, illustrates the extent of the pressure on a banking system that is enormously over-extended in an economy that is overleveraged and with extreme overvaluation in equities, real estate, and increasingly, government bonds (10 year government bonds currently yielding less than one percentage point more than US 10 year government bonds).

Yes, in November 2015 (latest data) Chinese interbank lending hit Yuan 8769 billion (or Yuan 8.8 trillion, about \$1.4 trillion)

Chinese Inter-bank lending (Yuan bn)



In year on year terms the level of lending has exploded.

Year-on-Year CHANGE in Chinese Inter-bank lending (Yuan bn)



Now, interbank lending has typically been a way for Chinese banks to get around PBOC (People's Bank of China) restrictions on balance sheet growth and leverage (loans can be made via other banks and are off balance sheet and circumvent loan/deposit ratio limits and capital requirements). The PBOC has tried on several occasions to address this loophole in the structure of regulations to little or no effect.

The enormous increase in interbank lending can only mean the following: the banking system is creaking under the strain of capital flight and tightening domestic liquidity conditions and that bad loans must be piling up at an alarming rate.

How **should** banks respond to this sort of scenario? Well, look at US banks after the subprime crisis. US banks reduced their credit market debt outstanding by approximately \$3 trillion between the end of 2008 and the end of 2015. They reduced debt to add approximately \$1 trillion in equity. Eminently sensible – swap debt for equity and deleverage.

What have Chinese banks **actually** done? Well, step forward anyone who wants Chinese bank equity... I don't see a crowd. So, the Chinese response has been to **increase** bank leverage (when they are talking about deleveraging the system). Extremely worrying.

Consider that the balance sheet of Chinese depository corporations ("banks") is \$31 trillion, or three times Chinese GDP, and has quadrupled since the global credit crisis began in 2008. There you begin to see just how important Chinese banks are – they have a balance sheet equivalent to 30% of global GDP. Moreover, they are very inefficient lenders. In the last four quarters alone they expanded their balance sheets by \$4.3 trillion when Chinese GDP grew just \$0.5 trillion... which means just one thing, lots and lots of bad/non-performing loans in the pipeline.

And, for all those who think the Chinese can use their \$3.3 trillion in foreign reserves to bail out the banks, perhaps the following information might be helpful. Assuming just 20% of Chinese bank assets are non-performing at peak (and that number is very, very modest by historical Chinese standards) and with a 50% recovery rate, you write off \$3 trillion for the banks ( $0.2 * \$31 \text{ trillion} = \$6.2 \text{ trillion}$  and  $0.5 * \$6.2 \text{ trillion} = \$3.1 \text{ trillion}$ ). A relatively benign credit event cleans out PBOC reserves (assuming there is no further flight). If you think those FX reserves give the PBOC ample firepower to hold up their banking system then you are possibly guilty of wishful thinking and blind optimism.

Keeping to the USD peg, keeping real rates high enough to stem the capital outflow, deleveraging the financial system and keeping the economy motoring? These are impossibly incompatible objectives. Only or way out (as we highlighted many months back) – a significant decline in the Yuan (20% plus) that exports a of China's problems to Japan and the West in a deflationary tsunami.