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A LOOK AT THAT WHICH AILS THE ECONOMY OF THE PEOPLE'S REPUBLIC OF CHINA

Where Will PRC Banks Go For Honey ?

It appears to some people that the many problems, facing the second-largest economy of the world, are grossly exaggerated.

Just about every week, now, one is told that the economy of the People's Republic of China (PRC) is contracting and that the worst is yet to come.

For the most part, this intelligence has some merit, without question, but what appears to have been overlooked, to a very great extent, are the multifaceted problems, facing the PRC's banking industry.

It would be bromidic to repeat how the economy of the PRC was viewed, only a short time ago, but it bears repeating, nevertheless: It was the '*darling*' of the struggling economies of the world.

In today's world, however, the economy of the PRC has fallen from grace.

Those halcyon days of yore, sadly for the leaders of the PRC, today, may only be found in the pages of history.

That the PRC economy will rise again and, probably, it will outpace its successes of yesteryear, is a foregone conclusion.

But the question is: How long will it take?

How PRC Banks Are Suffering

It is very clear, today, that most PRC banks are suffering and, ironically, their collective plight is due, in large part, to the numerous, well-intentioned determinations, made by The People's Bank of China (), the PRC's Central Bank.

In order to try to stimulate economic activity within the country, The People's Bank of China has employed its concept of '*monetary easing*' (this term, having been made popular only a few short years ago by The Federal Reserve [The **FED**] when it was found imperative that something had to be done to help the ailing US economy).

The People's Bank of China has cut interest rates five times, so far this year. It has, also, adjusted banks' reserve requirements (on September 7, 2015) – downwards by 50 basis points.

On August 11, 2015, it devalued the renminbi by 1.90 percent, vis-à-vis the US dollar.

Since August 11, 2015, however, the translation value of the renminbi against the US dollar has continued to fall by more than 2.70 percent.

As a result of these (and other) moves, that which the PRC banks are experiencing, today, is a decided squeeze on interest margins.

For most – if not all – PRC banks, there is no way out of its problems of diminishing profits.

As the economic slowdown gathers momentum in this country, that houses some 1.30 billion people, more bad debts are being created.

And the domino effect has, already, kicked in.

For PRC banks, the first half of this year has been a horror, six-month period, with banks' Management, being forced to report little to no growth in their Bottom Lines, compared with the like period in 2014.

For the second half of this year, it may well eclipse the deteriorating situation that has persisted in the first half.

Since time immemorial, this has never happened before.

This situation will, no doubt, take its toll on the real **G**ross **D**omestic **P**roduct (**GDP**) – the broadest, quantitative measure of a nation's total economic activity, measuring the monetary value of all goods and services, produced within a country's geographic borders over a specified period of time.

It has been suggested that, for the entire 2015 Fiscal Year, the growth of the PRC in terms of its GDP could well be below 6.80 percent – which, if achieved, would be the slowest growth in the GDP of the past two decades.

Only last week (on October 9, 2015), the **I**nternational **M**onetary **F**und (**IMF**) went on record, stating that it expects the PRC's growth in terms of its GDP to be about 6.80 percent, down from 7.40 percent, last year.

That is an 8.11-percent drop, Year-On-Year.

For the 2016 Fiscal Year, it is estimated that, all things being equal, there will be another fall in the growth of the PRC's GDP, closer to 6.20 percent.

If this estimate comes to pass, the country's GDP will have fallen by another 8.82 percent, Year-On-Year, and an aggregate fall from the 2014-Year's figure of a growth of 7.40 percent, by about 16.22 percent.

And, should this prognostication come to pass, it could well cause investors, locked into stocks and shares, listed on the PRC's two equity markets, to dump a goodly portion of their holdings, having been forced to bite the proverbial bullet.

As a direct consequence, in turn, it could cause the key indices of The Shanghai Stock Exchange and The Shenzhen Stock Exchange to fall, dramatically.

Such a scenario may well be felt far and wide.

Not surprisingly, many foreign investors, especially those from Western Europe and The United States of America, have determined to pull out a great deal of money from their PRC investments.

To quote an English nursery rhyme:

'*And all the king's horses and all the king's men*
couldn't put Humpty together again'.

<u>The Fed Takes Note</u>

It was hardly any wonder, therefore, that The Fed, on Wednesday, September 16, 2015, made the decision not to raise interest rates in the US.

The current state of play suggests that The Fed is unlikely to raise interest rates, this year, but will delay such determinations until 2016 … or beyond.

A '*considerate*' monetary policy in respect of the largest, single economy of the world appears to be here to stay for some time, yet.

The use by **TARGET** () of the adjective, '*considerate*', refers, especially, to the situation in the PRC.

With regard to The Fed's statements of September 16, The Central Bank of the US said in its Minutes of The **F**ederal **O**pen **M**arket **C**ommittee Meeting (**FOMC**), inter alia:

> *'In their discussion of monetary policy for the period ahead, members judged that information received since the FOMC met in July indicated that economic activity was expanding at a moderate pace. Although net exports remained soft, economic growth was broadly based. Members noted that recent global and financial market developments might restrain economic activity somewhat as a result of the higher level of the dollar and possible effects of slower economic growth in China and in a number of emerging market and commodity producing economies. Nevertheless, they still viewed the risks to U.S. economic activity as nearly balanced, and they continued to expect that, with appropriate policy accommodation, economic activity would most likely continue to expand at a moderate pace …*
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> *'Most continued to see the risks to real activity and unemployment as nearly balanced, but many acknowledged that recent global economic and financial developments may have increased the downside risks to economic activity somewhat …'.*

The full, FOMC Minutes mention the PRC exactly four times.

It is very clear that The Fed, in making its determination not to raise US interest rates, took careful note with regard to that role, being played by the second-largest economy of the world on the rest of the world's economies, today, and the role that the PRC shall be playing, tomorrow.

One cannot say for certain, of course, but it is an odds-on bet that the current lamentable, economic situation in the PRC, along with its attendant, global effect on the prices of quite a number of commodities, leading to the associated knock-on effect in respect of the economies of countries, such as South Africa and Australia, was an important factor in The Fed's determination not to increase interest rates at this juncture.

That which would be of immediate concern to those quasi-Government officials of the US, those with a remit to monitor the pulse of the economy of the country, is, simply put: Should the economy of the PRC take another nosedive, no matter how shallow it might be deemed or perceived, it could, nevertheless, have a deleterious effect on the largest, single economy of the world – and that fungus could well spread to the trading partners of the US.

It has come to be realised, during the past few decades that material developments, internationally, have played an important part with regard to the economic health of the US.

Such international developments have the ability to affect, negatively, the largest single economy of the world.

Further, by itself, the US economy cannot sustain growth, internally, without the help of economies, such as that of the PRC.

There are growing – and fully justified – fears that the PRC's economic situation could, in the manner of an internal, unwanted growth, spread to many countries, round the world.

A poignant example of the above is the direct effect the economic slowdown of the PRC is having on the economies of Argentina, Brazil and Australia, not to mention how the South African rand has come under immense pressure, of late.

On August 24, 2015, about a fortnight after The People's Bank of China devalued the renminbi by 1.90 percent, vis-à-vis the US dollar, the South African rand fell to a record low of 14 rand: $US1.00.

The South African economy relies heavily on the sales of its commodities, with the PRC, being one of its most-important customers.

The PRC's economic slowdown, along with the devaluation of the renminbi, was a double blow to the Government of South Africa.

In Brazil, the '*real*' – the currency of the country – has fallen by about 30 percent against the US dollar since July.

Brazil's situation, however, was partly political and partly due to the PRC's economic slowdown.

Thus, Brazil's problems, as with similar problems, experienced in South Africa (albeit a horse of a different colour), could well be described, in the vernacular of the US, as a double whammy.

The Looming Banking Crisis

The PRC Government's numerous stimulus packages, from April 2014 until the end of that year, caused The Shanghai Composite Index to rise by about 60 percent.

Those stimulus packages included, inter alia, spending vast sums of money on much-needed, infrastructural projects as well as giving small-and-medium sized enterprises extended tax breaks.

Everybody was happy in that year and fortunes were made, simply by shutting one's eyes and buying and selling equities on the two equity markets of the Middle Kingdom.

Share prices continued to rise and investors seemed to be of the opinion that the gains would go on, and on, and on, and on.

But the gains in share prices came to an abrupt stop!

It was a shock to most investors in the country and, especially, to stockbrokerage companies that saw themselves as being, potentially, exposed to multiple margin accounts.

It proved to be the case.

The following year, it was a completely different story for PRC equity investors, compared with the situation that had existed for most of 2014.

There was considerable evidence to suggest that many investors had become gun-shy: nervous and apprehensive.

This was made only too apparent when it was noted that the economy of the PRC was continuing to retract.

The key indices of the country's equity markets fell swiftly, much to the consternation of the majority of PRC investors who had entered the equity markets, using borrowed money.

This realisation was due to intelligence that, on scanning the statistics, made available by official, PRC

Government Releases, it indicated, among other things, that the production and consumption of goods and services and the supply of money was not that which had been expected.

Investors, faced with margin calls from banks and/or stockbrokerage houses, were forced to sell some or all of their equity holdings.

This exacerbated the speed in the falls of key, stock-market indices.

By August 26, 2015, the key indices of The Shanghai Stock Exchange and The Shenzhen Stock Market had given up about 45 percent of their values from their peaks in June.

The PRC Government sought to allay the fears of investors by the introduction of various concessions.

But to no avail.

A cumulative effect that could hardly have been anticipated – at least, not to the extent that it, eventually, became manifest – was that PRC banks suddenly found themselves exposed to a plethora of bad debts, brought about by equity investors who could not find the wherewithal to cover their financial commitments when called upon so to do.

Banks' profits were hit, especially hard, so much so that it was an embarrassment too hard to swallow for many senior bank officials – and many a senior bank official was forced to resign his/her position as bank inspectors came calling.

For many PRC banks, in the previous, 10-year cycle, their profits had been steadily rising, but, as the 2014-Year drew to a close, these banks saw profits start to wilt, appreciably.

For the entire 2015 Year, it is well accepted that PRC banks' profits will continue to be hit … and hit hard.

Many a PRC bank will be forced to make material provisions for non-performing loans.

Estimates of the extent of provisions and write-offs of non-performing loans at PRC banks vary from 10 basis points up to 25 basis points.

If banks' bad debts continue to rise, the banks' management will be forced to go, cap in hand, for cash handouts in order to obtain more capital to meet commitments.

The People's Bank of China will, without question, come to their rescue because there would be no other option.

Add to all of the woes of PRC banks is the matter of a very likely continued devaluation of the renminbi vis-à-vis the US dollar on foreign-exchange markets.

Since the beginning of this year, the renminbi has given up about 2.70 percent of its former value against the US dollar.

It is expected that, if the economy of the PRC does not improve, smartly and materially, a further deterioration in the translation value of the renminbi vis-à-vis the US dollar is likely to be in the order of five percent – or more.

This may appear to be good for PRC exports, but, for managements of PRC banks, it is another thorn in their proverbial sides, the pains of which could be long-lasting.

Beijing knows of the importance of a healthy banking system and it cannot allow its banks to be compromised.

The refinancing of local governments by the PRC's massive, State banks must be on the cards and cheaper bond issues are quite likely to be the answer in the short term.

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