Chinese bond market surge points to economic and financial problems

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The ongoing slowdown in the Chinese economy, the outcome of the ending of its previous growth model based on property and construction, is throwing up a set of problems in the financial system centred on the bond market.

The slowing of the economy suggests that government and financial authorities would like to see a lowering of interest rates to provide some economic stimulus. But instead, the People's Bank of China (PBoC) is moving in the opposite direction, at least as far as the bond market is concerned. (The price of bonds and their yield move in the opposite direction.)

But rather than welcoming the lowering of interest rates this produces, the central bank has been moving in the opposite direction for the past several months including selling bonds in order to lower their price and push up their yields.

Earlier this month, it even went so far as to "name and shame" a group of four rural banks for buying government bonds which the *Financial Times* (FT) characterised as a "most unusual sin" and likened it to "punishing a child for tidying up their bedroom."

However, this seemingly irrational behaviour does have an objective foundation. The PBoC is fearful that if banks load up on bonds, then they will suffer major losses if interest rates start to rise, and the value of their holdings falls.

This could then lead to the same kind of crisis which hit the US Silicon Valley Bank in March 2023 when, as a result of interest rate rises by the US Federal Reserve, the value of its bond holdings fell, leading to a run on the bank and forcing it under.

The crisis, which threatened to spread, was only halted through intervention by government authorities—the Treasury, the Fed and the Federal Deposit Insurance Corporation—in which they gave an implicit guarantee that uninsured depositors throughout the banking system would not lose their money. (Uninsured deposits are those greater than $US250,000.)

At the same time there is an objective reason for the rush into bonds. As the FT noted in a recent article, prices in China are falling and that increases the return to be made by holding bonds after this is taken into account.

It pointed out that while the consumer price index (CPI) has been slightly positive, the deflator for the measurement of GDP has been negative for five consecutive quarters, and given that investment is a huge share of China's economy, the deflator is likely a more accurate measure of overall prices than the CPI.

The article said that with a gloomy economic outlook—no end in sight for the housing market downturn, domestic companies hit by weak consumption and the problems resulting from the government crackdown on high-tech companies such as Alibaba and Tencent—"it seems wholly rational for Chinese investors to flock into bonds and gold."

The extent of this movement was outlined in a *Wall Street Journal* article this week. It said that according to their half-year reports, "investment gains from government bonds now make up a large chunk of profits for some smaller city-level commercial banks."

As an example, it cited the case of the Jiangsu Kunshan Rural Commercial Bank. Its holdings of government-bond investments jumped from $2.9 billion at the end of 2022 to $5.3 billion at the end of last year.

For the average Chinese investor bonds were attractive because the property market is in a "downward spiral," the stock market is "on track for a fourth straight yearly decline" and capital controls

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mean it is difficult to invest much overseas.

The government has tried to take some measures to boost the property market, but they have had little effect and are generally regarded as being insufficient, either to increase housing demand or bolster the financial position of developers.

Goldman Sachs has estimated that the stock of unsold new housing could be up to 30 times the level of average monthly sales.

There have been repeated calls from many sources for the government to undertake stimulus measures to boost the economy. But no major stimulus program is going to be undertaken because authorities fear this this will only lead to greater debt and cause problems for the financial system.

Central government debt is relatively low, coming in around 24 percent of GDP. But the debts of local government authorities, which are responsible for much of government spending, amount to at least 93 percent of GDP, and are rising.

The central government policy is the development of "high quality productive forces" and the expansion of high-tech exports to the world market.

This export drive, however, does little or nothing to boost the domestic economy. It is also running into problems because of the US imposed of tariffs against cheaper Chinese goods—electric vehicles being one of the major items. Overall while the volume of exports may be rising, the revenue is not because of the general slowdown in the world economy.

The interconnected economic and financial problems have social and political implications. The Xi Jinping regime, which represents the oligarchy that had developed with the restoration of capitalism, rests on a base of better-off sections of the middle class with which it has a kind of social contract—the repressive character of the regime is tolerated insofar as it can deliver a growing economy, with prospects for their social advancement and their children.

But with the growth of economic problems, that is coming apart and the fear of the ruling oligarchy is that through the cracks opposition from the 400 million strong working class may emerge.

These political considerations are also at work in the attempt to halt bond-buying because the fall in their yield implies a degree of economic weakness, sending out a dangerous message regarding political stability.

This week the China Dissent Monitor published by the US Freedom House organisation reported an 18 percent increase in cases of dissent for the second quarter of the year compared to 2023.

Such data, coming from a right-wing organisation, should be taken with a grain of salt. But they are in line with the trend of economic developments. According to the report, some 44 percent of dissent incidents related to labour and 21 percent involved aggrieved homeowners. This dissent has yet to threaten the regime, but it could well develop further.

As the head of the Dissent Monitor, Kevin Slaten, noted there was a certain acceptance of the authoritarian nature of the regime as a "trade-off for economic prosperity" but this could be undermined as slowing economic growth impacted more people.

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