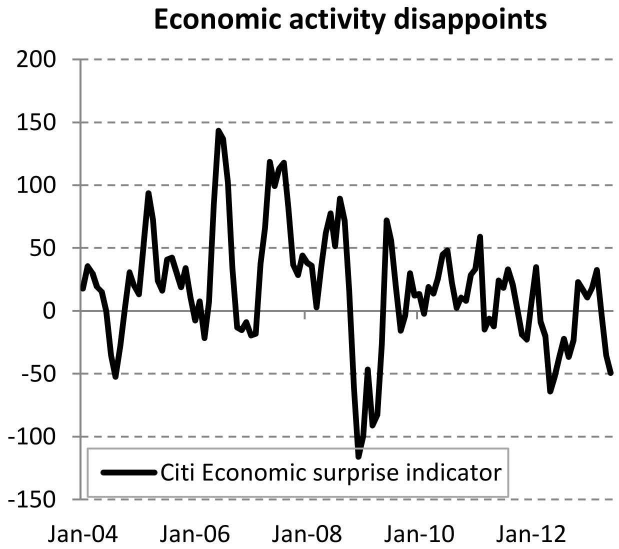
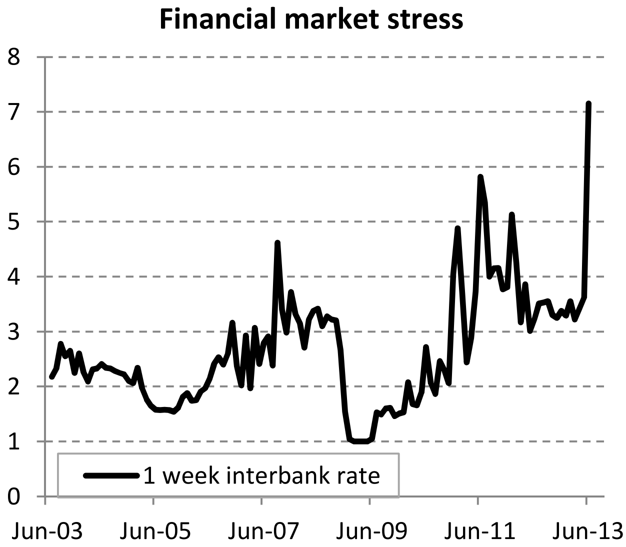
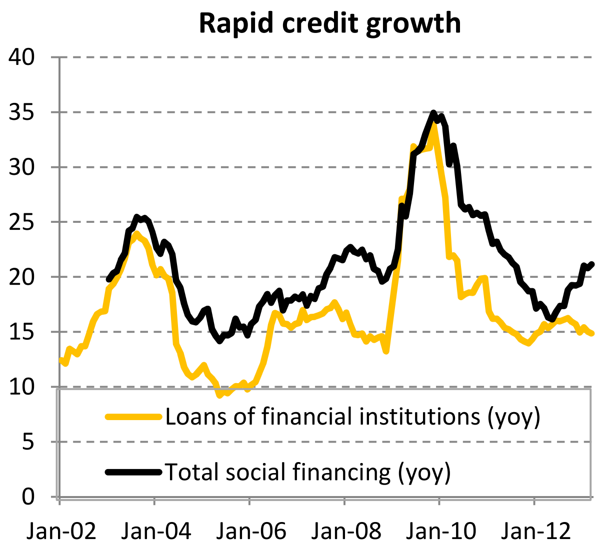
Fears of a full-blown financial crisis in China seem exaggerated

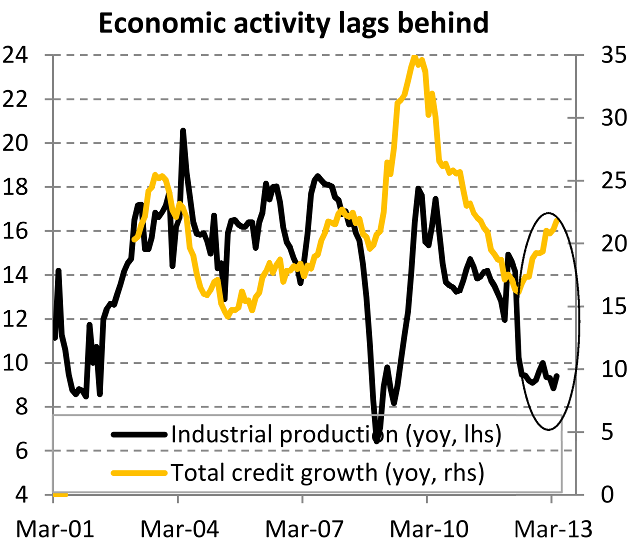
- **In recent days interbank rates in China soared on the back of increased financial market stress. Economic activity, meanwhile, continues to fall short of expectations. While this has prompted warnings of an imminent full-blown financial crisis, the situation is likely to turn out much less dramatically. That said, risks to GDP growth are clearly on the downside and consensus growth forecasts for coming years are probably still too high.**





- By not intervening as interbank rates spiked to unprecedented levels, Chinese authorities made it very clear that they will no longer tolerate the unrestrained credit growth seen over the past years which has resulted in misallocation of capital and speculation. Current policy (in)action fits into the new government's plans of rebalancing the economy away from investment towards consumption. Apart from earlier smaller steps of reform, this is probably the most convincing sign so far that policymakers are willing to move in the right direction. While both the initial lack of communication and the vague comments on Sunday do not meet general central bank standards, it is positive that authorities will act to rein in unsustainable credit growth.

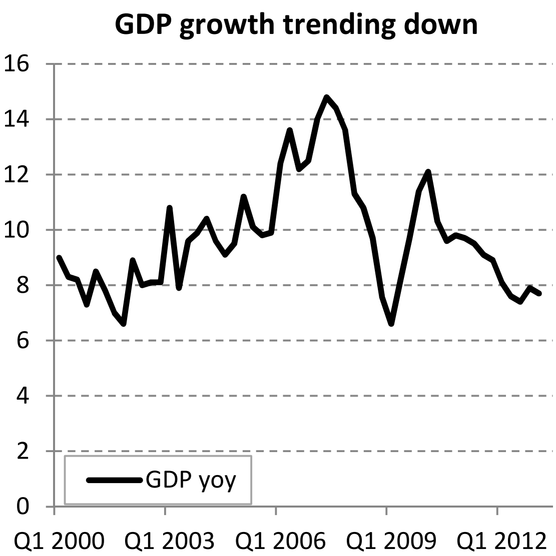


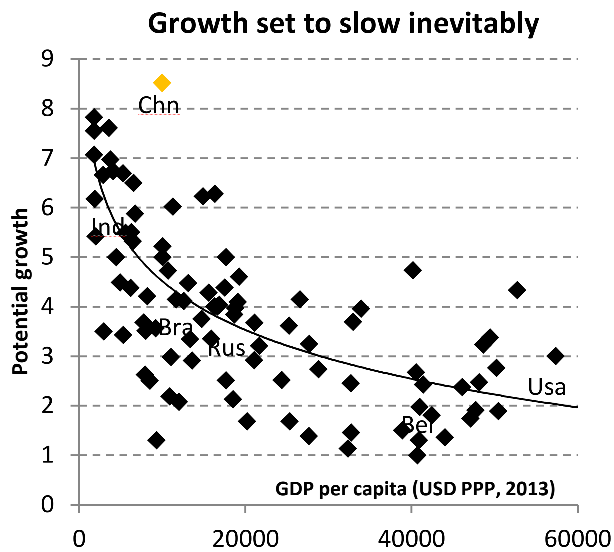


- Interbank rates have now fallen back to levels at around 7%, down from 12% last week, but remain significantly higher than was the case in the past. Given the latest policy response, a rapid return to former levels should not be expected. That is likely to result in less interbank lending, slower (credit) growth and possibly also in bankruptcies of some minor players.

- That said, fears of a full-blown financial crisis seem exaggerated. While Chinese authorities refrained from a broad-based intervention, they did in fact react by targeting their financial efforts. It can be expected that they will continue to do so if the turmoil in the Chinese financial system would persist. Authorities are likely to make sure the most important players in China's shadow banking system can continue to fund themselves. A Chinese 'Lehman-moment' therefore seems unlikely.

- Another reason why a financial system crash is rather unlikely is because the classical triggers of a financial crisis are not present. First, China has very limited external debt, a current account surplus and a fairly closed capital account. Second, banks continue to fund themselves from a broad deposit base. For depositors and investors to flee out of China is just not possible. Also worth noting is that the central government has enough means to recapitalize the financial sector in case the state-owned banks are left with significant losses.





- The fact that Chinese leaders take concrete steps and try to preserve the sustainability of medium-term growth should be welcomed. Most probably, a reconfirmation of earlier hints of reform can be expected at the annual Party Plenum in October.

- At the same time, this also implies that economic growth will continue to slow as reforms are implemented and that the era of '+8%-growth' is almost certainly a thing of the past. Annual GDP growth of around 7% and gradually slowing from there seems a more realistic scenario. Chinese leaders, meanwhile, will face challenging times in smoothly managing the transition to a more consumption-led economy.