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To Problems With China’s Financial System, Add the Bond Market

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By KEITH BRADSHER DEC. 20, 2016

SHANGHAI — Chinese officials cheered on the country’s stock market when it reached heady new highs, offering hope that it could become a new source of money to fix China’s economic problems. Then, last year, the market crashed.

Now another fast-growing part of China’s vast and increasingly complicated financial market is showing signs of distress: its $9 trillion bond market.

Prices for government and corporate bonds have tumbled over the past week, a sell-off that continued on Tuesday. The situation has spooked investors, prompting the government to temporarily restrain some trading and to make emergency loans to struggling financial institutions.

The price drops have resulted in higher borrowing costs at a time when more Chinese companies need the money to cope with slowing economic growth. Yields reached new highs again on Tuesday.

In part, China is reacting to financial shifts across the globe. With the Federal Reserve raising short-term interest rates and many expecting the presidency of Donald J. Trump to lead to heavier government spending, investors worldwide are selling bonds.

But China is struggling with its own balancing act. The Chinese bond slump also stems from Beijing's efforts to wring excess money from its financial system and to stop potential bubbles that may lurk in shadowy, hard-to-track corners of its economy. Should it continue with those efforts, bonds could fall further.

"The adjustment has not yet finished," said Miao Zuoxing, a partner at the FXM Brothers Fund, a Shanghai-based investment fund that trades stocks, bonds and futures. "It will continue and normalize until money is put where the government can see it."

At least 40 companies have said they would postpone or cancel bond offerings rather than risk being forced to pay high interest rates to sell the bonds — or being unable to sell them at all. Among them was the Jiangsu Sumec Group Corporation, an industrial trading house that exports items as varied as gardening tools and auto parts; the company said on Thursday that it would not go through with the sale of $130 million in short-term bonds.

"Due to recent, relatively large market fluctuations, our company decided to cancel the issue of the current bond," Jiangsu Sumec Group said in a statement, "and will reissue it at a chosen time."

China has particular reason to worry. As the world's second-largest economy, after the United States, it relies on a rickety financial system that is mired in debt and susceptible to hidden stresses. Higher overseas interest rates could also prompt more Chinese investors to move their money out of the country, either to chase higher returns elsewhere or to avoid what some see as China's growing problems.

The outflows are "adding to domestic banking system stresses and weakening the already fragile foundations of the entire financial system," said Eswar S. Prasad, a professor of trade policy at Cornell University who was formerly chief of the China division at the International Monetary Fund.

A healthy bond market is crucial to China's restructuring plans. The country has been counting on its fast-growing bond market as one way to bring market discipline to its traditionally state-directed — and wasteful — economy.

In the mature financial system of the United States, businesses have plenty of ways to get money. They can borrow from a bank, raise money selling stocks or bonds, or seek funds directly from any number of investors.

But in China, state-run banks are by far the main source of funding. That helped power the country's economic rise, but it also led to loans going to politically connected borrowers rather than to where the economy needed it most. That is one reason the Chinese economy is now stuck with more steel, glass, cement and auto factories than it needs.

Particularly in the past two years, China has taken steps to encourage the development of robust stock and bond markets as well as private lenders, needing a way to ensure the flow of money was being directed by profit-minded investors rather than politicians and their allies at state-owned banks.

The stock market crashed last year, and private lending has been slow to take off. But until this past week, the bond market had performed well. The investment arms of local governments and other large borrowers rushed in recent months to issue bonds at low interest rates and to pay off bank loans issued at higher rates — just as the government intended. Bond issuance jumped 47 percent in the first 11 months of this year from the same period last year.

What the government did not foresee was an explosion of speculative bond trading by Chinese banks.

Banks have increasingly raised money by selling wealth management products, investments that have the look and feel of dependable bank deposits and are usually sold to average investors. Banks rarely disclose what is behind those wealth management products and generally keep them off their books.

Still, it is becoming increasingly clear that many of them are backed by bonds. The bond holdings of wealth management products more than doubled over the 18-month period that ended in June. Adding to the risks, banks are also making large, leveraged bets on the direction of bond prices.

Now the government is moving to rein it in. On Monday evening, The Financial News, a newspaper controlled by China's central bank, published questions and answers with a central bank official who was identified only as being in charge of the reviews of banks' financial soundness. The official told the newspaper that starting next year, the central bank would include wealth management products in these reviews.

A press officer at the central bank confirmed that the interview was an accurate reflection of the institution's views but declined to elaborate.

On Tuesday, the yield on one-year government bonds rose to 3.11 percent, compared with 2.35 percent two weeks ago, a considerable jump for bonds. Yields go up when bond prices go down, and a higher yield makes it more expensive to issue bonds.

Corporate bond yields are also rising fast, as investors have begun demanding a better return from entrusting their money to China's frequently opaque companies. That reverses a trend from this year, when investors were so enthusiastic for Chinese bonds that they bought corporate bonds as well, narrowing the natural spread between government and corporate bonds.

Mr. Miao, of FXM Brothers, predicted that corporate bonds would continue to sell off until the spread between government corporate yields was wider again.

"When the corporate bubble has burst," he said, "then we could say the adjustment is finished."

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