China's debt - latest assessment

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SUMMARY

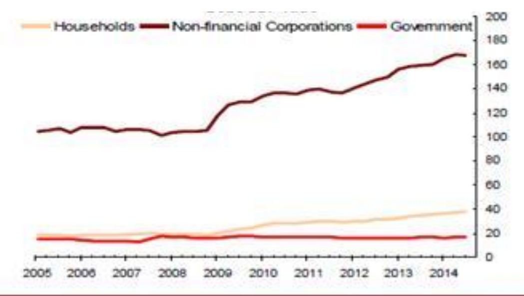
China's debt-to-GDP ratio continues to increase despite the slowing economy. A convincing case can be made that the situation is manageable: the rate of credit growth is falling steadily; fiscal and financial reform have strong momentum; and the authorities have the tools to respond if necessary. Balanced against this are moral hazard, extremely fast financial-sector evolution and plenty of global precedent of debt-induced crises. .

DETAIL

1. Despite a rapidly slowing economy (see figure 1), China's debt levels continue to rise. Standard Chartered estimated earlier this year that the debt-to-ratio reached more than 250 percent, up from less than 147 percent at the end of 2008. Corporate sector debt is particularly high at around 160 percent of GDP (see figure 2). By contrast, corporate debt in India, Brazil and Russia is less than 100 percent of GDP. The credit rating agency Standard and Poor's (S&P) estimate that China now has the world's largest stock of outstanding corporate debt: $14.2trn, compared with the US' $13.1trn. S&P forecast that China's corporate debt is likely to reach $20trn by 2018, which would represent approximately 25 percent of global GDP.

Figure 1: Actual vs. Targeted GDP growth, year-on-year

Figure 2: Chinese debt as percentage of GDP



2. Rapid credit growth combined with falling GDP growth implies the credit intensity of Chinese growth, i.e. the amount of additional credit needed to generate incremental GDP, is increasing. This occurs because a growing

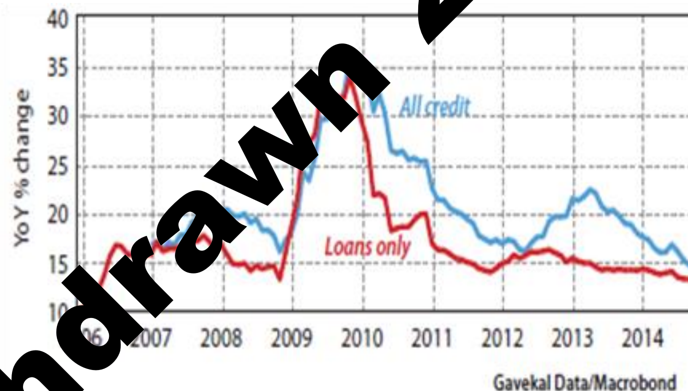
proportion of new credit is needed to service old debts, a proportion of which are non-performing, leaving a smaller residual to finance productive new investments. This is clearly a worrying trend.

3. Most observers believe that a dynamic financial crisis is extremely unlikely to occur in China. . All important financial institutions are state owned and the level of foreign debt in China remains very low. However, if the credit intensity of growth continues to increase then this could result in a sustained period of lower than currently anticipated growth..

ON BALANCE THE DEBT SITUATION LOOKS MANAGEABLE

4. **The rate of credit growth is steadily falling** – see figure 3. Controlling credit expansion is key to containing the overall debt situation. However, it is important that the rate of credit growth does not fall *too* quickly: this would result in a precipitous decline in investment. This would likely feed into income growth, hurting private consumption and thereby resulting in a sharp decline in overall GDP. Credit is currently growing at around 14 percent year-on-year, down from 22 percent in April 2013. Assuming current trends continue, credit growth will fall below nominal GDP growth within the next couple of years, at which point a (lengthy) deleveraging period can begin.

Figure 3: y-on-y growth in credit



5. **Fiscal and financial reform are both gathering pace**. Distortions within China's fiscal and financial system explain why China's levels of corporate debt have increased so rapidly. Inadequate fiscal leavers compelled Chinese policymakers to rely on the banking system to deliver their $4trn stimulus response to the global financial crisis and it has been difficult to stop the flow of credit once it was started. China's financial system is not good at allocating capital efficiently: interest rates aren't fully liberalized and China's monetary policy relies on quantity based controls like the required reserve ratio, rather than price based controls like interest rates..

6. Financial and fiscal reform have both been prioritized by the authorities in the past two years. Key achievements have included:

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a. The passing of the Budget Law in August this year, which ought to improve the transparency of local government finances; reduce informal ' methods of local government financing (such as local government financing vehicles) and allow for the issuance of local government bonds. Greater use of private capital through the expansion of public private partnerships is also being pushed strongly.

b. Greater regulatory scrutiny over the shadow banking system. The Chinese Banking Regulatory Commission has become more active in supervising financial intermediation, including trust and wealth management products. As a result, growth in non bank lending has slowed rapidly in recent months, and

c. Further liberalization of the financial system, including allowing greater flexibility in the interest rate and the exchange rate. The People's Bank of China has indicated that a deposit insurance scheme will finally be introduced early next year. This should replace the current implicit guarantee for all financial institutions with a more constrained explicit guarantee.. Deposit insurance should also allow for greater competition in the banking sector and full interest rate liberalization.

7. The pace of reform is expected to continue or even accelerate in the coming few years. The leadership has set 2016 as the deadline for 'basically completing' fiscal reform, 2020 for China achieving the goal of becoming 'a moderately prosperous society in all respects' and 2022 for implementing the measures set-out in 'The Decisions' document issued after the Third Plenum in November 2013.

8. **Finally, the authorities have the policy tools to deal with problems as they emerge. Policy tools potentially available to the Chinese authorities include**:

a. Monetary policy: a short term fix would be to lower interest rates or the require-reserve requirement, which would kick-start lending. This would in effect be delaying a more permanent solution but would be effective at maintaining the economy's momentum in the shorter-term. Although returns on investment are falling they are still positive: particularly in the central and western provinces China's investment needs remain huge;

b. Fiscal policy: Although the economy has huge liabilities, it also benefits from huge assets and relatively low levels of government debt (around 50 percent of GDP). For example domestic bank deposits of around $17 trillion of domestic bank deposits and nearly $4 trillion in foreign exchange reserves. The

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government also has huge physical assets in the form of land and the state-owned enterprises; and

c. Structural reform: The Chinese economy remains constrained by excessive regulation and/or monopoly control by SOEs. These problems are very well understood (more than 300 economic reforms were listed by President Xi in last year's Third Plenum decisions document, for example) and progress is being made in addressing them. However, the pace of reform could be accelerated, if it became clear that the economy had hit the wall. This wouldn't prevent a short-term slow-down as many of the necessary reforms would hurt short-term growth prospects. However, it ought to ensure any slowdown could be reversed relatively quickly.

9. Moreover, over the past 30 years the Chinese authorities have established a strong track-record for intervening decisively when economic stability is threatened, including through repeated recapitalisations of the banking system. The assumption ought therefore to be that they would respond forcibly and decisively again in the future. This ought to prevent a repeat of the drawn-out resolution to the debt situation that has plagued the Japanese economy over the past 20 years.

OTHER FACTORS

10. **Moral hazard is still common in the financial system and the authorities still show little tolerance for default.** There was hope earlier this year that China had experienced its first corporate bond default (by Chaori Solar). It was later reported in local media that principle creditors had been compensated. China's leaders at central and local government levels are obviously conscious of the social implications of allowing consumers to lose their shirts. Moral hazard results. China will never be able to price risk effectively or allocate capital efficiently until defaults are allowed.

11. **Official financial data** is not always reliable. China's financial system is extremely opaque. Communication from the regulators is usually elliptical, as shown in recent months by the absence of any explanation from the People's Bank as to what was happening in inter-bank markets. Hard data is no better: the published figures for non-performing loans (NPLs), showing the NPL ratio has barely budged in last 4 years, are obviously inaccurate. It's impossible to determine what the real level of bad debt is in China's financial system but S&P estimate that the corporate financial risk in China has increased significantly in recent years;

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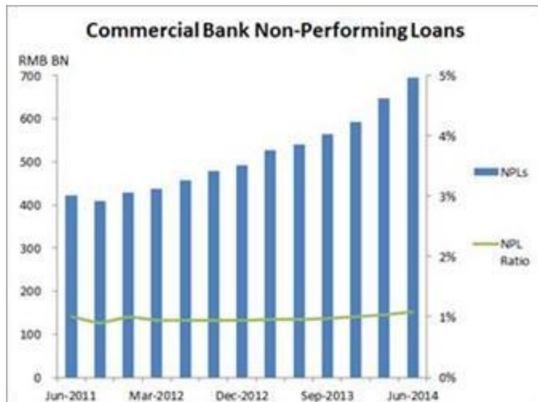
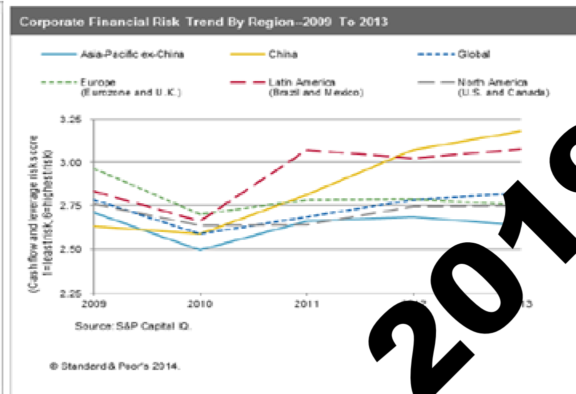
Figure 4: official figures for non- **Figure 5: S&P assessment of corporate**





Source: China Banking Regulatory Commission

12. **The speed and magnitude of change in China's financial system is extraordinary, which makes it extremely challenging for the regulators to keep pace**. China's savers are always looking for better returns. The repressed financial system, whereby deposit interest rates remain largely controlled, provides many opportunities for regulatory arbitrage. China's huge population, steady growth in incomes and stubbornly high savings rates mean the numbers involved are invariably large. For example, online money market funds only started in June 2013 but within a year already had 2 trillion RMB ($310bn) under management. Wealth management products started in 2008 and by March 2014 had 8.2 trillion RMB ($1.3trn) under management, according to the government, or 13 million yuan ($2.[illegible]) according to Fitch ratings agency. Under these circumstances it's hard for the financial regulators to maintain e complete control of the situation.

13. **Finally, economic and financial crisis do happen so why should China be so different?** Since the start of the reform and opening period, China has experienced 36 years of near-continuous 'super-fast growth' (above 6 percent per year) – only in 1981, 1989 and 1990 did growth fall below 6 percent. By comparison, the average length of a super-fast growth period is 9 years, with only Taiwan and Korea coming close to matching China (with 32 years and 20 years of >6 percent growth respectively). As shown in a recent Larry Summers paper ('Asiaphoria meets regression to the mean'), the vast majority of super-fast growth periods end in a rapid growth deceleration and this turning point is usually the result of a debt crisis in some form. Sound arguments can be made about China's exceptionalism, including the fact that the economy was so weak prior to 1978 (and hence an unusually large catch-up phase) and that economic reform has proceeded almost continuously since..

CONCLUSION

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14. We have reported repeatedly on China’s debt situation in recent years. Our core argument is that while debt-associated problems represent one of the most significant latent economic risks in China, our judgment is that the authorities have the tools to tackle them..

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