



Sinology

by Andy Rothman

March 19, 2019

- * Cleaning up China's debt problem will be expensive, but is unlikely to result in a hard landing or banking crisis.
- * Potential bad debts are corporate, not household, debts and were made at the direction of the state by state-controlled banks to state-owned enterprises (SOEs). This provides the state with the ability to manage the timing and pace of recognition of nonperforming loans.
- * Because a debt-cleanup program can be concentrated on a relatively small number of SOEs, there is no need for a broader austerity program that would hurt the private sector, which drives China's economic growth.
- * The process of dealing with the debt problem is underway, although much more needs to be done. Credit growth is slowing; formation of nonperforming loans (NPLs) and NPL write-offs have accelerated; and jobs are being cut in the sectors with the most serious overcapacity problems.

CHINA'S DEBT PROBLEM

China's debt problem is serious, but the risk of a hard landing or banking crisis is, in my view, low. The reason is that the potential bad debts are corporate, not household, debts and were made at the direction of the state—by state-controlled banks to state-owned enterprises. This provides the state with the ability to manage the timing and pace of recognition of nonperforming loans. It is also important to note that the majority of potential bad debts are held by state-owned firms, while the leverage of the privately owned companies that employ the majority of the workforce and account for the majority of economic growth isn't high. Additional positive factors are that China's banking system is very liquid, and that the process of dealing with bad debts has begun.

Cleaning up China's debt problem will be expensive, but will not likely lead to the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

This is the first of a three-part *Sinology* looking at what could go wrong in China. Part II will discuss the risk of a property bubble, and Part III will explain why the absence of the rule of law is a serious long-term risk.

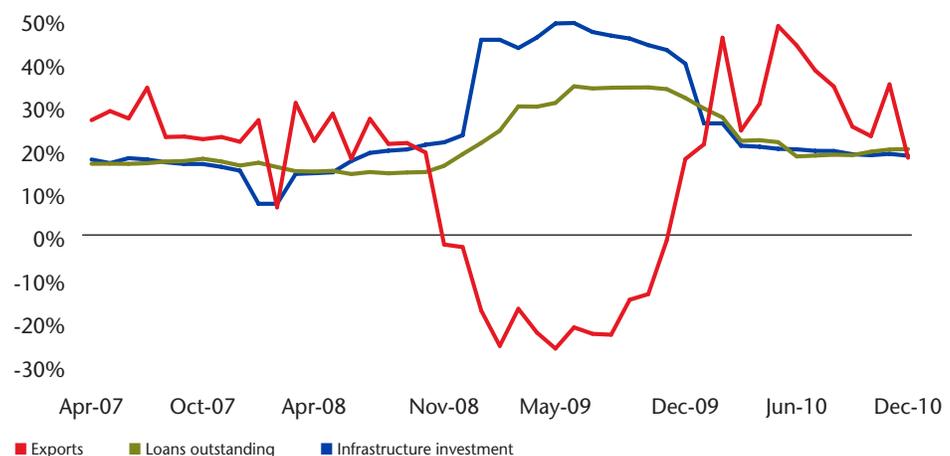
In the beginning: A response to the GFC

The origin of China's debt problem was the 2007 to 2008 Global Financial Crisis (GFC). Prior to that point, China's debt-to-GDP ratio was relatively low and stable.

The GFC led to a collapse in global demand for goods, including exports from China. As Chinese exports plummeted, many factories closed and an estimated 20 million workers lost their jobs. The government was concerned that this spike in unemployment—primarily of young workers who left rural homes for urban manufacturing jobs—might lead to social unrest.

The government rejected the idea of a large currency devaluation to boost exports because the problem was lack of demand in markets such as the U.S. and Europe, not weak competitiveness of Chinese goods.

Figure 1. CHINA'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS (GFC)



Source: CEIC, Matthews Asia estimates

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.



Instead, Beijing undertook the world's largest Keynesian stimulus: spending government money to accelerate the construction of public works projects—everything from bridges and roads to wastewater treatment plants—that had been scheduled for future development. The objective was to quickly create millions of jobs, ranging from construction and truck driving to accounting, in an effort to reduce unemployment and the risk of social instability.

In the beginning: paying for stimulus with bank loans

In most countries, a huge stimulus would have been funded directly by the government via fiscal spending. China, however, chose to fund its infrastructure construction stimulus with bank loans.

Back then, officials told me they preferred to use bank loans because every bank in China was (and still is) controlled by the government, and most of the loans went to state-owned enterprises (SOEs), which were responsible for managing the construction projects (although much of the work was carried out by privately owned contractors). Officials said they hoped a network of bank branch managers could be held responsible for ensuring that construction proceeded rapidly with a minimal level of waste, fraud and mismanagement.

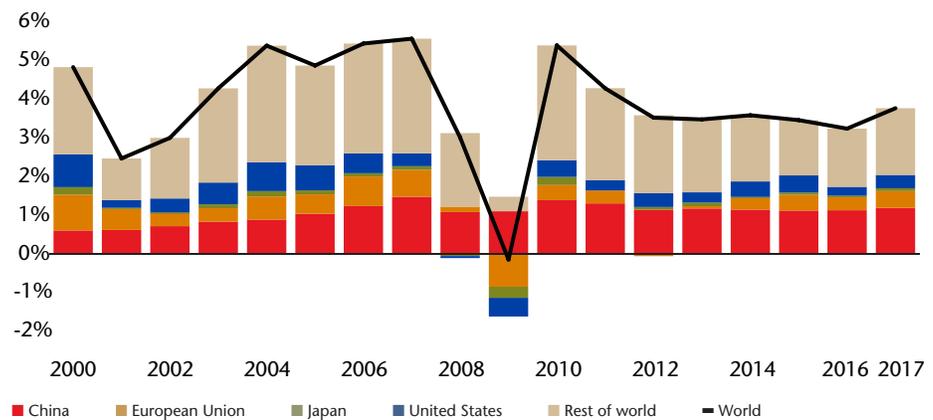
The stimulus worked, but at a cost

By some metrics, the stimulus was very successful. Most importantly, from the Chinese government's perspective, the stimulus created enough jobs to help the country weather the GFC without significant social unrest.

Also, China's debt was the result of spending on public infrastructure, which is a sound, long-term investment, helping reduce poverty and raise productivity. China has more than 150 cities with populations over 1 million, and before the stimulus many of them lacked the infrastructure necessary to support good manufacturing and services jobs.

From an international perspective, the stimulus was also successful in that it put a floor under global economic growth: in 2009, China offset most of the sharp decline in global growth from the U.S., E.U. and Japan. (In the years since then, China has, on average, accounted for about one-third of global growth each year, a larger share of global growth than from the U.S., Europe and Japan combined.)

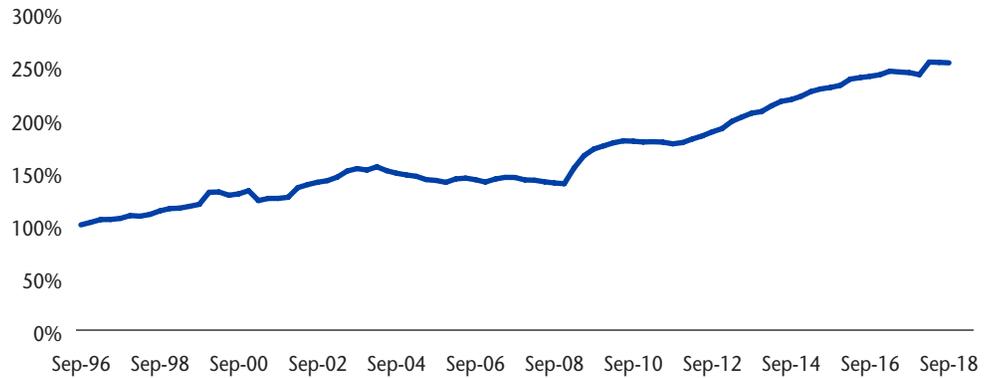
Figure 2. CONTRIBUTION TO GLOBAL GDP GROWTH (PERCENTAGE POINTS)



But the steep jump in lending to finance the GFC stimulus was also the root cause of China's current debt problem. As Figure 3 illustrates, in the years immediately prior to the GFC, China's non-financial debt-to-GDP ratio was relatively stable at about 150% of GDP. That ratio jumped dramatically in 2009, as the stimulus was deployed, and continued to climb until it reached about 253% of GDP in September 2018.



Figure 3. CHINA'S TOTAL NON-FINANCIAL DEBT-TO-GDP RATIO

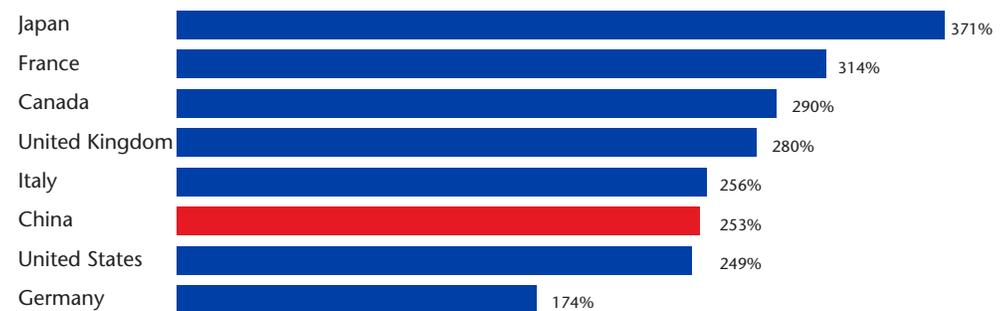


Source: BIS

The current scale of China's debt problem

China's overall debt-to-GDP ratio rose rapidly after the GFC and is very high, but in context appears less frightening: it is lower than the debt-to-GDP ratio of five of the G-7 advanced economies.

Figure 4. DEBT-TO-GDP RATIOS FOR G-7 AND CHINA, AS OF JUNE 30, 2018



Source: BIS

Composition of China's debt: the consumer

Understanding the composition of China's debt is important to evaluating the seriousness of the problem. A key factor is that the Chinese household debt-to-GDP ratio is relatively low, about 50%, compared to 77% in the U.S., 86% in the U.K. and 58% in the eurozone as of June 2018.

Moreover, the largest share of Chinese household debt is home mortgages, and these are far safer than the mortgages that created significant problems in the past decade for households in the U.S. and U.K. For example, about 90% of new homes in China are bought by owner-occupiers (not speculators) who are required to pay a minimum of 20% cash to receive a mortgage, and most put down 30% cash or more—far above the U.S. median cash down payment of 2% of the purchase price in 2006.

The products that broke Lehman Brothers—and caused havoc throughout the U.S. financial system—do not exist in China. There are no subprime mortgages and very few mortgage-backed securities. There is no secondary securitization so no collateralized debt or loan obligations (CDOs and CLOs). Most mortgages are held to maturity by the issuing bank, raising the incentive for careful due diligence on borrowers.



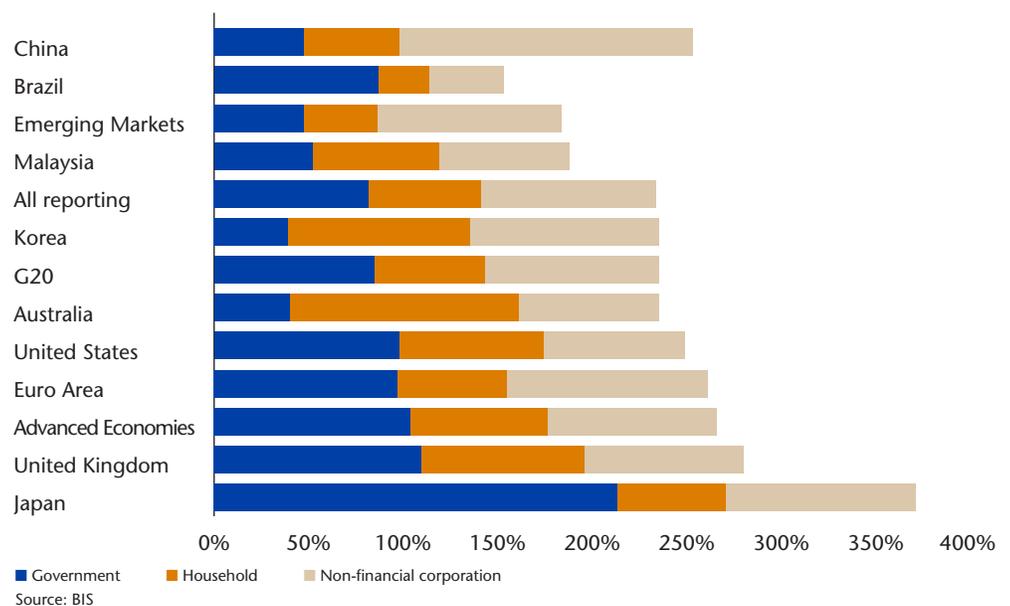
This is an important distinction from the pre-GFC period in the U.S., when there was a steep increase in consumer debt, especially in subprime mortgages, and the “enormous rise in residential mortgage foreclosures soon developed into a full-blown financial crisis and led to one of the sharpest market contractions in U.S. history. While many trends in the financial system played a role in these developments, household behavior was clearly a fundamental contributor,” according to a study by the Federal Reserve Bank of New York.

It is also worth noting that in addition to a relatively low household debt-to-GDP ratio of 50%, Chinese families have a very high savings rate, with household bank deposits equal to about 80% of GDP. In the U.S., the household debt-to-GDP ratio is 77%, while household (and nonprofit organization) savings deposits are equal to 47% of GDP. And while the level of household debt in China has risen rapidly in recent years, that growth has been in line with the growth rate of new home sales, the majority of which are financed with the type of mortgages described earlier.

The absence of a large consumer debt burden should make China’s overall debt problem much easier to manage and make the debt reduction process much less painful.

Figure 5. CHINA’S DEBT PROBLEM IN CONTEXT

Debt-to-GDP ratios, as of June 2018



Composition of China’s debt: corporate

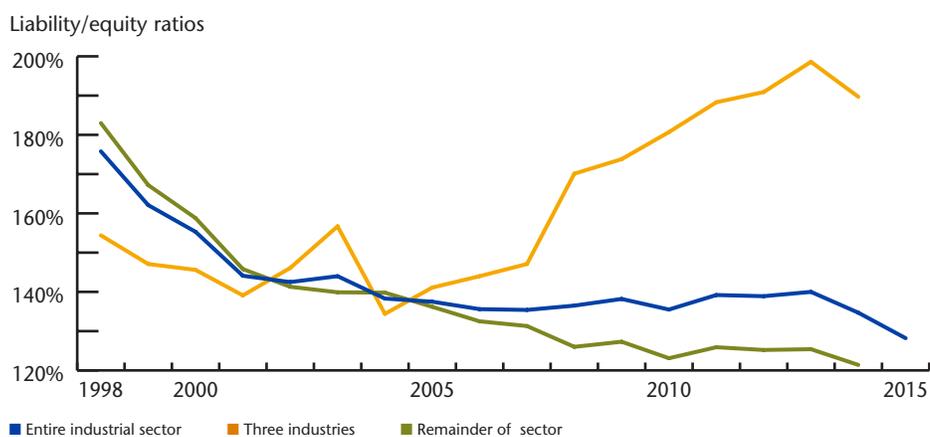
China’s real problem is corporate debt. The ratio of nonfinancial corporate debt-to-GDP jumped to 116% from 93% in the three years after the stimulus began, and then continued to increase. Now at about 153%, China’s corporate debt-to-GDP ratio is one of the highest in the world. Dealing with this will be a serious challenge.

But it is important to understand that about two-thirds of corporate debt is owed by state-owned enterprises (SOEs) to state-controlled banks.

As we noted earlier, during the GFC, the state directed state-controlled banks to lend to state-owned firms in order to finance construction of state-selected public infrastructure projects that constituted the stimulus program, as well as to expand capacity in sectors related to those infrastructure projects, such as steel, aluminum and coal.



Figure 6. DEBT INCREASE CONCENTRATED IN SECTORS RELATED TO INFRASTRUCTURE STIMULUS



Source: Guonan Ma and James Laureceson, ACRI Working Paper 2016-02

It is also significant that this debt burden is concentrated among a relatively small number of state-owned firms, making the cleanup a bit easier. IMF economists found that among SOEs, “leverage has increased significantly at the tail end of the distribution at the 75th and 90th percentiles.”

Moreover, according to an economist at a Chinese government think tank, about two-thirds of China’s corporate debts are debts of SOEs, while roughly half of SOE debt is related to local government finance vehicles (LGFVs). And in China, local governments are all effectively branch offices of the central government, in contrast to the U.S., where there is a clear separation between the financial obligations of local, state and national authorities. This is consistent with my view that the vast majority of China’s debt is owed to state-controlled banks by state-controlled entities, including SOEs and LGFVs. As a result, while the debt burden is significant, the risk of default or systemic crisis is not.

Recent progress on SOE debt

In recent years, modest progress has been made in dealing with the SOE debt problem.

Investment by SOEs in the industrial sectors responsible for the majority of the debt burden has been declining over several years, alleviating some of the pressure. For example, due to supply-side reforms, we estimate that in 2017, fixed asset investment in the coal industry was 50% lower than in 2013, while investment in the steel industry was 25% below the 2013 level.

The state sector has also been reducing employment, which enables some SOEs to shut inefficient or unused capacity, some of which had been kept operating simply to protect jobs. During Xi Jinping’s first five-year term as head of the Communist Party, 3 million jobs at industrial SOEs were eliminated, a decline of 16%.

There were significant job cuts in the industrial sectors with serious overcapacity problems, regardless of ownership, over the past four years. For example, 1.7 million jobs were eliminated in coal mining (a 34% reduction), and 1.8 million in steel (down 44%).

These changes, along with healthier profit growth for SOEs during 2017 and 2018, helped generate a modest reduction in the liabilities-to-assets ratio for state-owned firms, to 59% at the end of 2018 from 62% at the end of 2014.

Figure 7. EMPLOYMENT BY COAL AND STEEL INDUSTRY

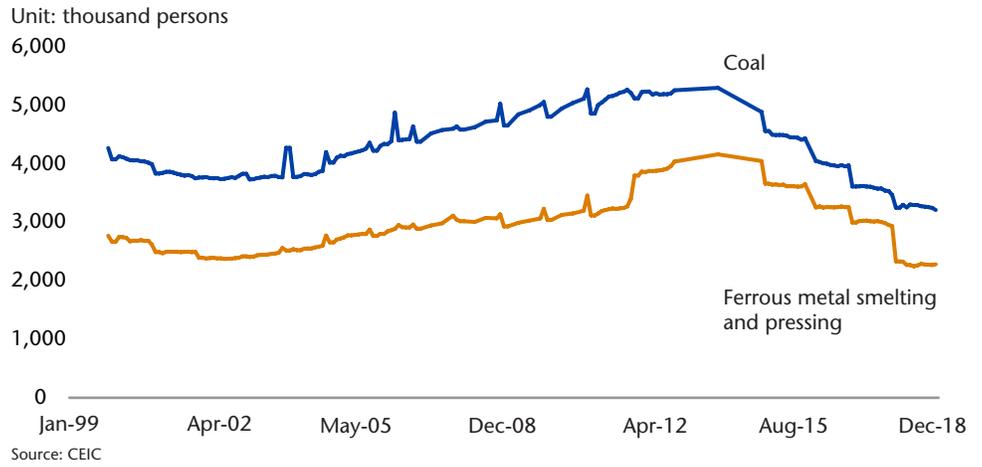
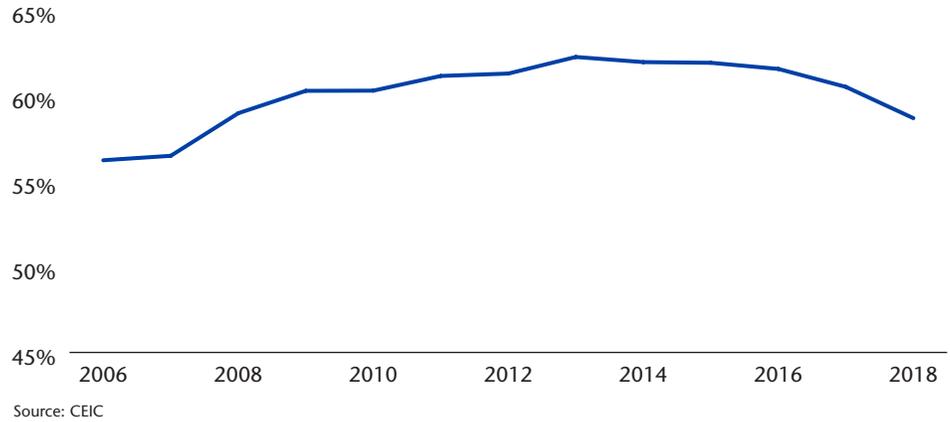


Figure 8. LIABILITIES-TO-ASSETS RATIO OF INDUSTRIAL SOES



Another factor contributing to the modest improvement in China's debt problem has been the slowdown in the growth rate of credit outstanding in the economy, a large share of which flows to SOEs. The growth rate of augmented total social finance (TSF) outstanding cooled from 16.1% at the end of 2016 to 10.3% by the end of 2018. This rebounded a bit to 10.8% through February, but I expect only a modest credit stimulus this year, and the growth rate of augmented TSF is likely to remain well below the pace set in 2016.

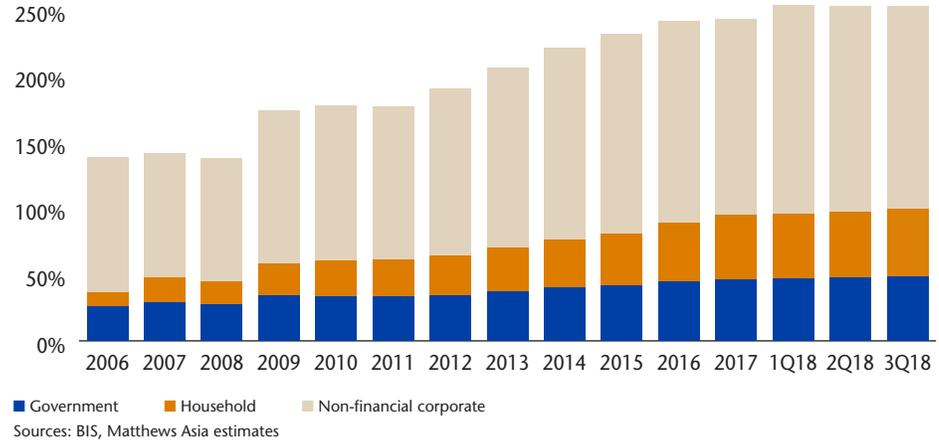
Figure 9. EARLY STAGES OF MODEST EASING





As a result of these changes, China's overall debt-to-GDP ratio stabilized during the first three quarters of 2018. Corporate debt-to-GDP, which rose sharply from 93% in 2008 to 151% in 2015, was 153% at the end of 3Q18, according to data from the Bank for International Settlements (BIS). Similarly, overall debt-to-GDP, which rose from 138% in 2008 to 232% in 2015, rose less rapidly in recent years, from 243% at the end of 2017 to 253% at the end of 3Q18.

Figure 10. CHINA'S NON-FINANCIAL DEBT-TO-GDP RATIO BY SECTOR

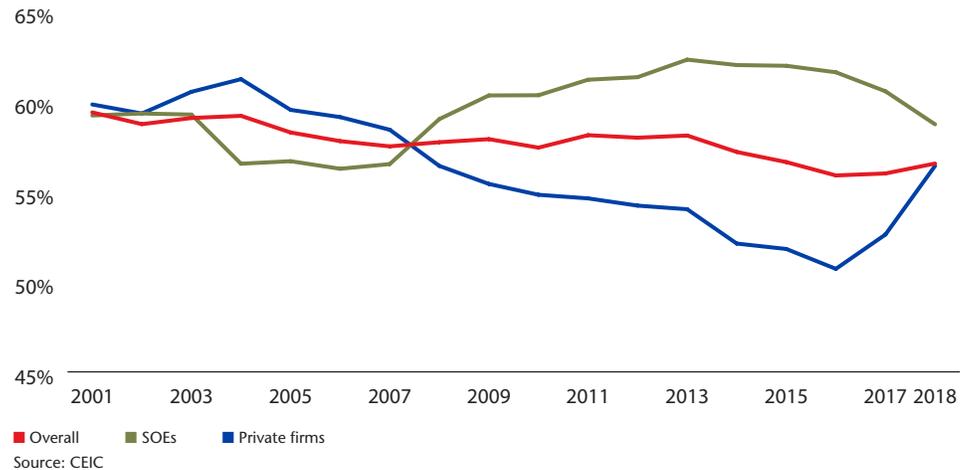


Rising debt levels at private industrial firms unlikely to be dangerous

Privately owned small- and medium-sized enterprises (SMEs) are the engine of China's economic growth, accounting for more than 85% of employment and almost all new job creation, as well as most investment. These firms account for a minority of the corporate debt burden and, for several years, their debt levels were declining.

The liabilities-to-assets ratio for privately owned industrial firms fell every year from 2006 (59%) through 2016 (51%). But this ratio rose to 53% in 2017 and then to 56% in 2018, resulting in a rise of the overall industrial liabilities-to-assets ratio.

Figure 11. LIABILITIES-TO-ASSETS RATIO OF INDUSTRIAL FIRMS BY OWNERSHIP



The problem was that while the growth rate in liabilities for private industrial firms accelerated just a bit in 2016 and 2017, the growth rate of its assets slowed. This reflects that private firms had a couple of difficult years, and it resulted in a higher liabilities-to-assets ratio. (For SOEs, the growth rate of assets was faster than that of liabilities over the same period.)



The problem for private firms was not a sharp rise in leverage. In fact, I think the key factor behind the rising liabilities-to-assets ratio was a lack of access to credit—the unintended consequence of the government’s financial sector de-risking campaign—which in turn led to slower asset growth.

This problem is likely to be less severe in 2019, as the toughest part of the de-risking program has passed, and the government has announced a series of measures to support the private sector. The measures include lowering taxes and fees; cutting corporate social security contributions; and expanding credit access for private firms and reducing the funding cost. These steps are likely to result in improved profitability and faster asset growth for privately owned firms.

Could an economic slowdown turn a debt problem into a banking crisis?

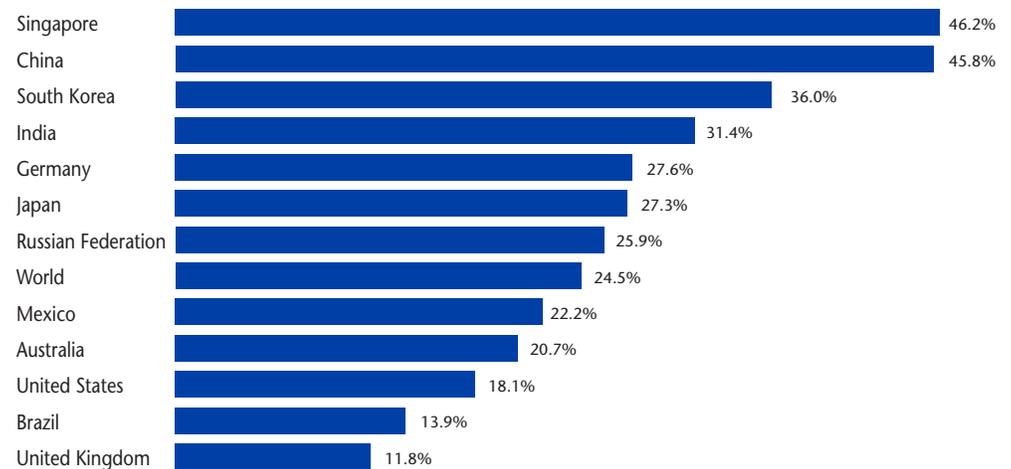
The most important difference between China’s debt problem and past debt problems in Western countries is that in China, there is little private-sector participation in debt creation.

As noted earlier, the origin of China’s debt problem came in response to the GFC, when the state directed state-controlled banks to lend money to state-owned enterprises, to carry out the public infrastructure stimulus program. There are no privately owned banks involved, so there is no mark-to-market pressure. As a result, and in contrast to the recent experience in the West, the Chinese government has the luxury of being able to control the timing of when bad loans are recognized and dealt with.

And there has been some progress in dealing with bad loans. Over the past 18 months, there has been a material acceleration in the formation of nonperforming loans (NPLs) at China’s banks, as well as a comparable acceleration in write-offs of bad loans.

It is also worth noting that China has one of the world’s highest savings rates. This probably influenced the rapid growth in bank lending, and it also means that the banking system is unlikely to experience a liquidity squeeze.

Figure 12. GROSS SAVINGS AS % OF GDP, 2016



Source: World Bank

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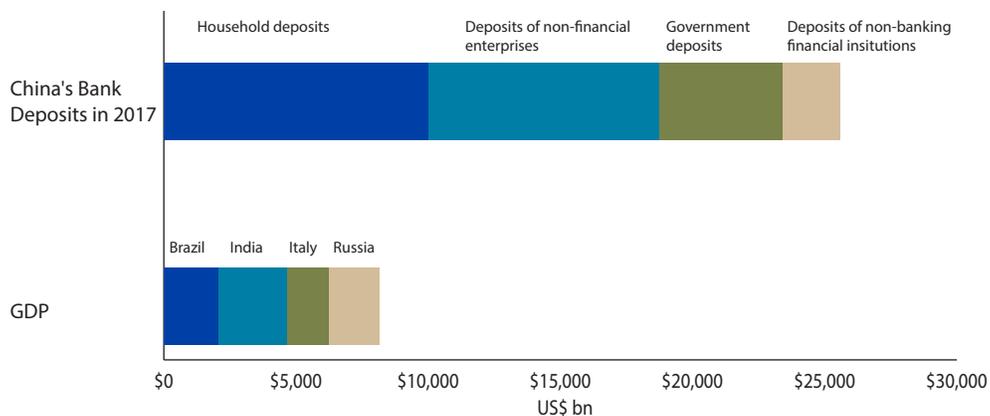
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Figure 13. HOUSEHOLD SAVINGS MORE THAN COMBINED GDP OF BRAZIL, INDIA, RUSSIA AND ITALY



Sources: CEIC and World Bank

China's external debt is not a problem

China's foreign debt exposure is low, about 14% of GDP in 2017. This is a sharp contrast to Thailand's 62% ratio in 1996, ahead of the Asian Financial Crisis. By funding its infrastructure buildout domestically, rather than through foreign lenders, China has avoided one of the key problems that contributed to past emerging market debt crises.

Potential for other risks

As I stated earlier, China's banking system is quite liquid and the government faces no political, legal or financial constraints to recapitalizing banks that may require it, without drawing down China's foreign exchange reserves.

The key risk, then, is government policy. Over an extended period of time, if the government were to fail to reduce the growth rate of new credit to SOEs in overcapacity sectors, the scope of the debt problem would expand and the cost of cleaning it up would jump. If the government were to reverse the initial steps underway toward managing the problem—recognizing and writing-off NPLs; reducing capacity and jobs—that would lead me to reconsider the impact of the debt problem on China's economic prospects.

Another policy mistake that would lead me to reconsider my views on this issue would be if the central government were to fail to control the future growth of debt by local government finance vehicles (LGFVs). Given the implicit guarantees extended by the central government to these vehicles, runaway spending by them would create a much larger problem.

Cleaning up China's debt problem will be expensive, but this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit-to-GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

Regards,

Andy Rothman
Investment Strategist
Matthews Asia

Sources: Matthews Asia, CEIC, National Bureau of Statistics (NBS) and CLSA.

All the "debt-to-GDP" data mentioned in the report refer to the non-financial debts only.