



Sinology

by Andy Rothman

September 12, 2016

- * China's debt problem is serious, but the risk of a hard landing or banking crisis is low.
- * China's 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.
- * The majority of potential bad debts are to state-owned firms, while privately owned companies that employ the majority of China's workforce have been deleveraging.
- * 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/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

CLEANING UP CHINA'S DEBT: Q&A

A leading cause for concern over the health of China's economic prospects is its debt burden. Since writing about this topic last year, I've received many questions from investors, so in this issue of Sinology, I share my responses to those questions.

The debt problem is serious, but the risk of a hard landing or banking crisis is, in my view, low. The key reason for that 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 to state-owned firms, while the privately owned companies that employ the majority of the workforce and account for the majority of economic growth have been deleveraging. 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 this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

Now, to your questions:

Q: Everyone agrees China faces a serious debt problem. How did this problem develop?

The origin of China's debt problem was the 2007 to 2008 Global Financial Crisis (GFC). Prior to that point, China's debt/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 collapsed, 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.

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

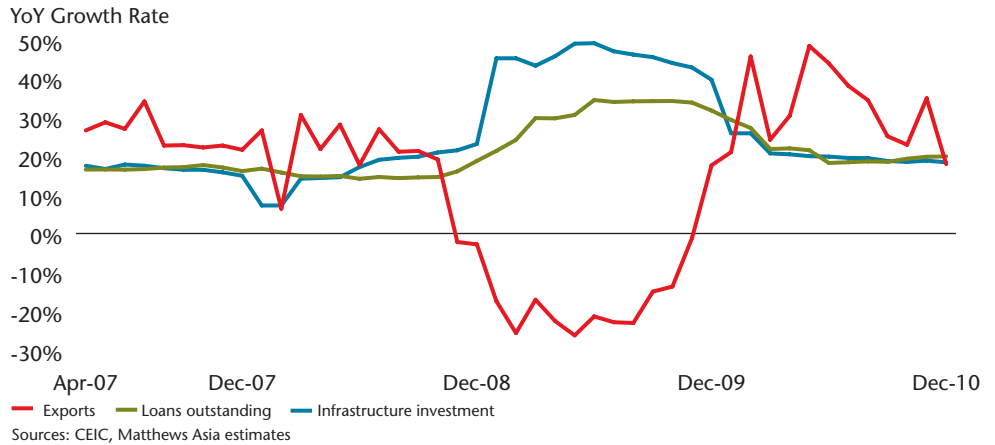
Instead, Beijing undertook the world's largest Keynesian stimulus: spending government money to accelerate the construction of public works projects—everything from bridges and roads to wastewater treatment plants—that had been scheduled to be built in the future. The objective was to quickly create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

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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.



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



Q: How did China pay for this stimulus?

In most countries, a huge stimulus like this would have been funded directly by the government via fiscal spending. China, however, chose to fund its infrastructure construction stimulus via 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) who 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.

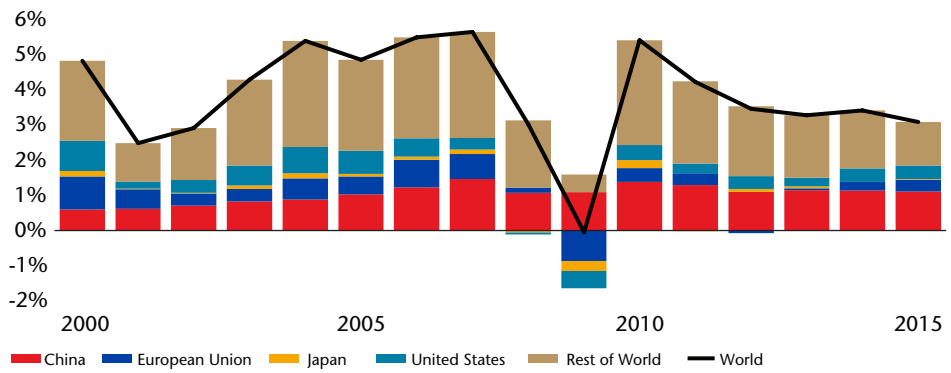
Q: Was the stimulus a success?

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.

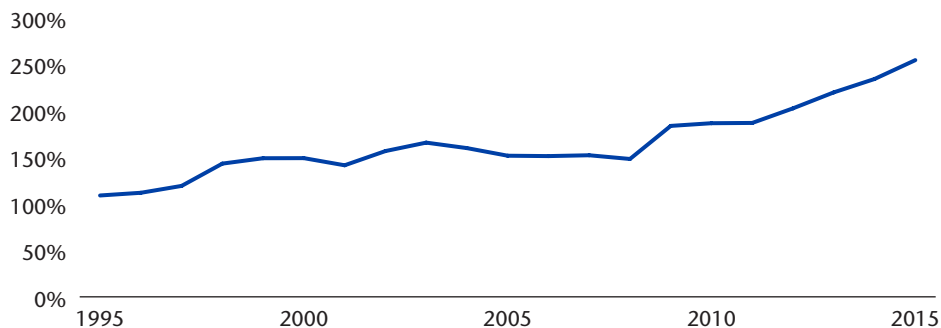
From an international perspective, the stimulus was also successful in that it put a floor under global economic growth: in 2009, China off-set most of the decline in global growth from the U.S., E.U. and Japan. In 2015, China accounted for about 35% of global growth.

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



But the jump in lending to finance the GFC stimulus was also the root cause of China's current debt problem. As the next chart illustrates, in the years immediately prior to the GFC, China's debt/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 reaching about 255% of GDP last year.

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

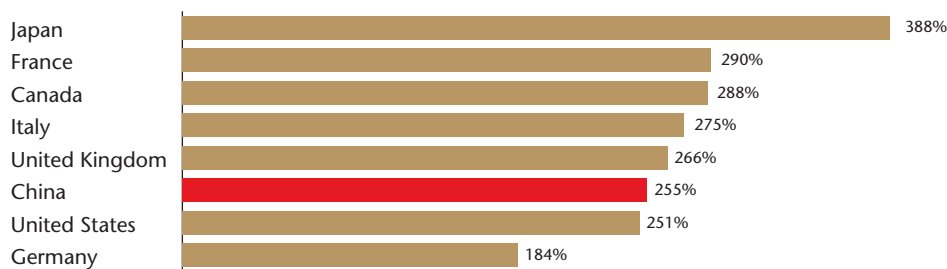


Source: Bank for International Settlements

Q: It sounds like China's debt/GDP has reached a scary level?

China's overall debt/GDP ratio rose rapidly after the GFC and is very high, but not so scary in context: it is lower than the debt/GDP ratio of five of the G-7 advanced economies.

Figure 4. DEBT-TO-GDP RATIOS FOR G-7 AND CHINA, 2015



Source: Bank for International Settlements

Q: Do Chinese consumers have a debt problem?

Understanding the composition of China's debt is important to understanding the seriousness of the problem. A key factor is that the Chinese household debt/GDP ratio is fairly low, about 40%, compared to 80% in the U.S., 90% in the U.K. and 60% in the Euro zone.

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—far from 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 sub-prime mortgages and there are very few mortgage-backed securities. There is no secondary securitization so no collateralized debt or loan obligations (CDOs and CLOs).

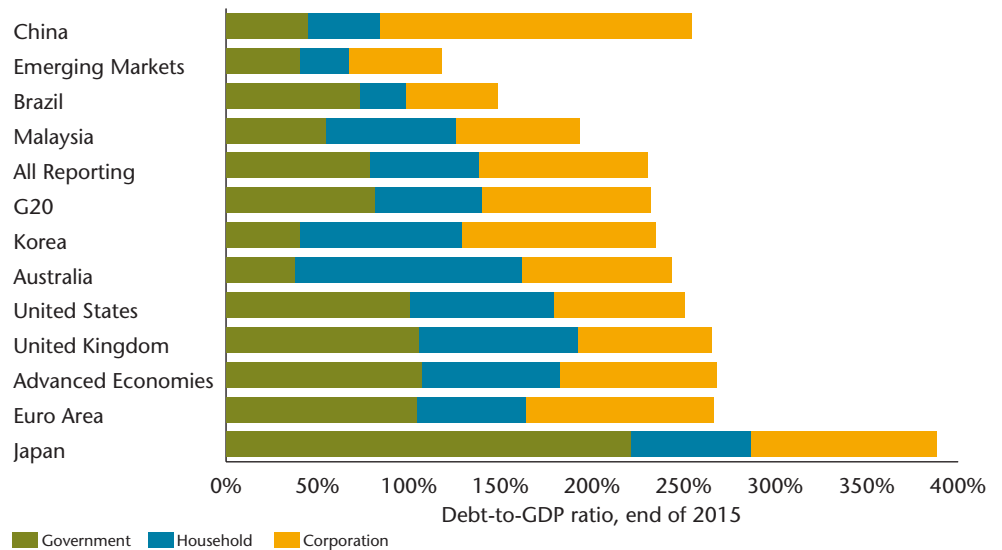


This is an important distinction from the pre-GFC period in the U.S., where there was a steep increase in consumer debt, especially in sub-prime mortgages, and the “enormous rise in residential mortgage foreclosures soon developed into a full-blown financial crisis and led to one of the sharpest market 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/GDP ratio of 40%, 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/GDP ratio is 80%, while household (and non-profit organization) savings deposits are equal to 46% of GDP.

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



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

Q: How bad is China’s corporate debt problem?

China’s real problem is corporate debt. The ratio of non-financial corporate debt/GDP jumped to 127% from 97% in the three years after the stimulus began, and then continued to increase. Now at about 170%, China’s corporate debt/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 SOEs to state-controlled banks.

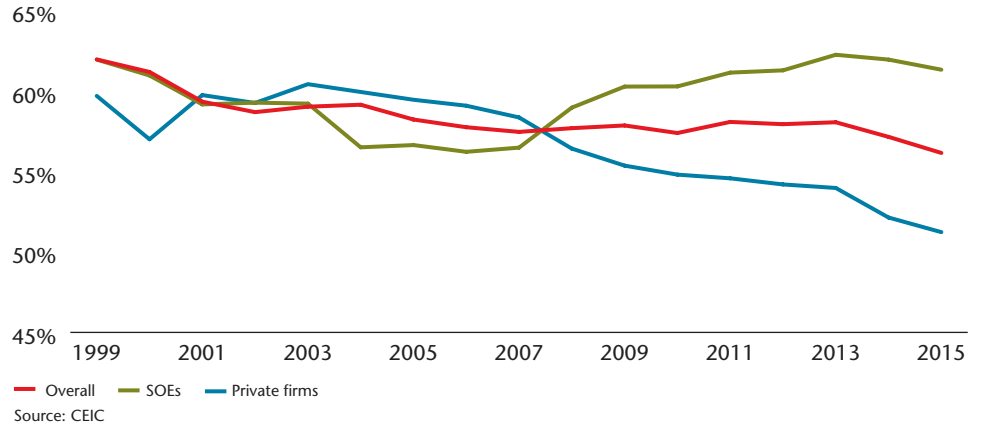
During the GFC, the state directed state-controlled banks to lend to state-owned firms (SOEs) in order to finance construction of the public infrastructure projects that constituted the stimulus program, as well as to expand capacity in sectors related to those infrastructure projects, such as steel, aluminum and coal.

However, while SOEs have been leveraging up, privately owned firms have been deleveraging. “On average, private firms have steadily deleveraged over time while SOEs have increased their leverage,” according to the International



Monetary Fund. Economists at the Hong Kong Monetary Authority agree: “By ownership, it is mainly SOEs that have increased leverage, while private enterprises have deleveraged in recent years.”

Figure 6. LIABILITIES-TO-ASSETS RATIO OF INDUSTRIAL FIRMS BY OWNERSHIP



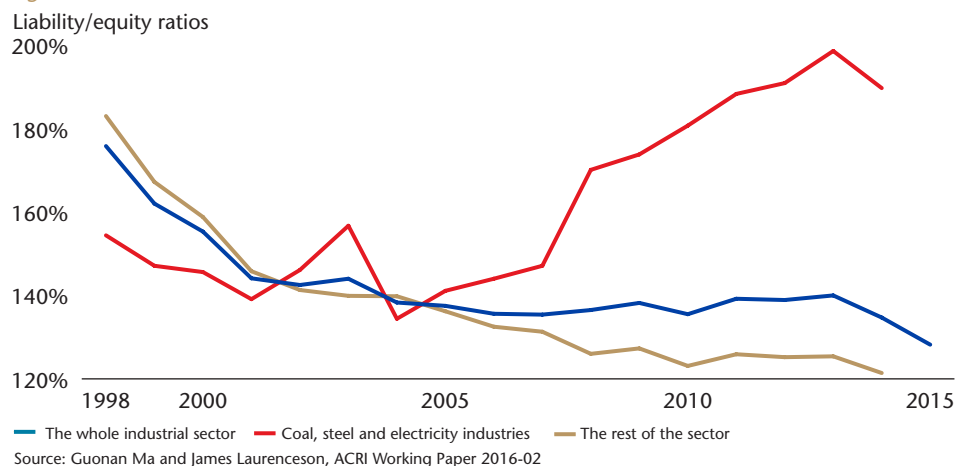
This is really important for several reasons—first, because privately owned small- and medium-sized enterprises (SMEs) are the engine of China’s economic growth, accounting for more than 80% of employment and almost all new job creation, as well as most investment. With the liabilities-to-assets ratio of privately owned industrial firms falling to 51% in 2015 from 59% in 2006, China’s most important companies are less afflicted by debt disease.

Second, this is important because the banking system is increasingly directing credit away from SOEs and toward entrepreneurs. In 2014, the latest data available, only 30% of loans outstanding were to SOEs, down from 41% in 2006, while the share of loans outstanding to private firms rose to 43% from 36%.

Third, the medicine for this problem will be another round of serious SOE reform—including closing the least efficient, dirtiest and most indebted state firms in sectors such as steel and cement—rather than broad deleveraging, leaving healthier, private SMEs with room to grow. In contrast to the experience in the West after the Global Financial Crisis, cleaning up China’s debt problem should actually improve access to capital for the SMEs that drive growth in jobs and wealth.

Additionally, IMF economists found that among SOEs, “leverage has increased significantly at the tail end of the distribution at the 75th and 90th percentiles,” meaning that SOE reform can focus initially on a relatively small number of firms.

Figure 7. DEBT INCREASE CONCENTRATED IN SECTORS RELATED TO INFRASTRUCTURE STIMULUS





Q: What if China’s economy slows and firms are unable to repay their loans? Won’t this trigger a banking crisis?

The most important difference between China’s debt problem and past debt problems in Western countries is that in China, there are no private-sector participants in the majority of the problem debts.

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 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.

Q: What steps are Chinese officials taking to deal with the country’s debt problem?

China has a long way to go to clean up its bad debt problem, but some progress is underway.

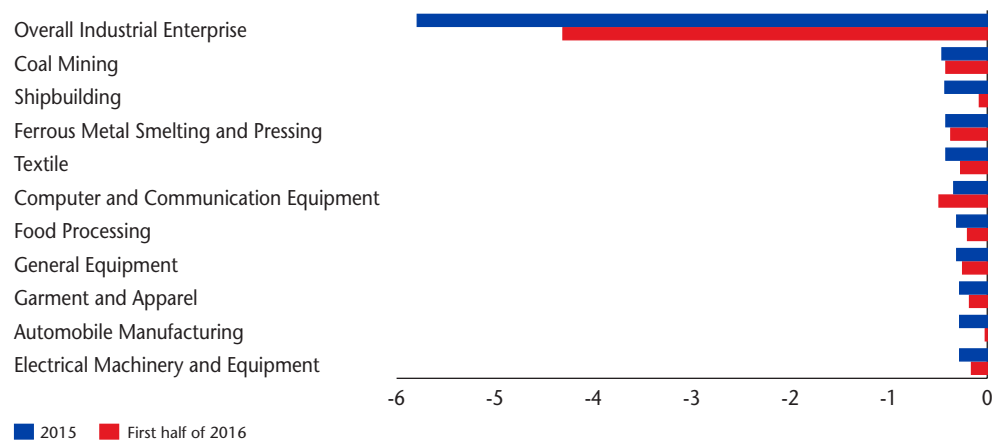
A good first step has been to slow the growth rate of credit. Growth in total social finance, or aggregate credit, peaked at 35% year-on-year in 2009 and was down to 12% in July 2016. And, as noted earlier, a larger share of bank loans are now going to privately owned firms, which in general are more profitable than state-owned companies.

Private companies, which account for more than 80% of employment, have been deleveraging.

In the state sector, there are also some initial steps in the right direction. Employment by SOEs fell by 1 million jobs in just one year, in 2015.

More broadly, there were significant job cuts in the industrial sectors with serious overcapacity problems last year, and that process continued during the first half of 2016. For example, coal mining cut 460,000 jobs last year and then another 420,000 in 1H16. The steel industry lost 420,000 jobs in 2015 and another 370,000 in 1H16.

Figure 8. JOB REDUCTION BY INDUSTRY, IN MILLIONS



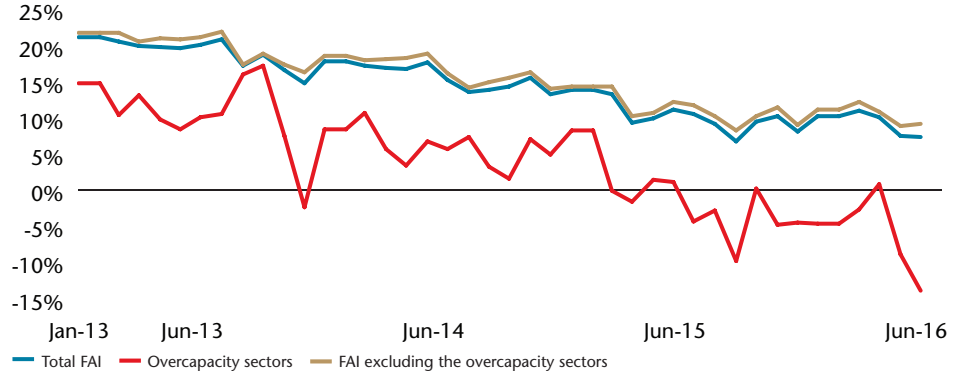
Source: CEIC

New investment in sectors with serious overcapacity has also dropped sharply. Fixed-asset investment in those sectors fell 14% year-over-year in June 2016, compared to a 1% rise in June 2015 and an increase of 7% in June 2014.



Figure 9. INVESTMENT FALLING IN OVERCAPACITY SECTORS

Fixed Asset Investment Growth, Year-on-Year



Overcapacity Sectors: Coal Mining & Dressing; Ferrous Metal Mining & Dressing; Non Ferrous Metal Mining & Dressing; Non Metal Mineral Mining & Dressing; Non Metallic Mineral Products; Ferrous Metal Smelting & Pressing; Non Ferrous Metal Smelting & Pressing; Rail, Ship, Aircraft, Spacecraft & Other Transport Equipment.
 Source: CEIC

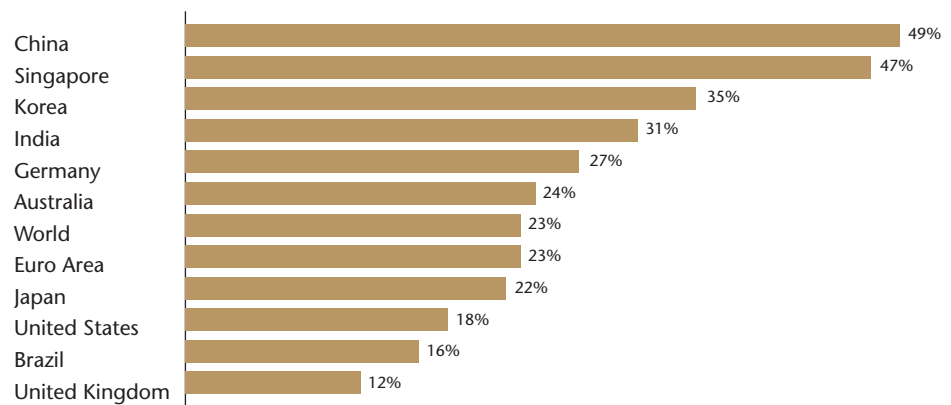
Over the last 18 months, there has also been a material acceleration in formation of nonperforming loans (NPLs) at China’s banks, as well as a comparable acceleration in write-offs of bad loans.

Q: Won’t the rise in bad loan recognition lead to a banking crisis?

While accelerated NPL formation has contributed to weaker bank profitability, the process leads to reducing corporate debt and transferring much of the losses to the balance sheet of the state, which controls most of the asset management companies that purchase distressed loans from the state banks. This will result in a gradual increase in the fiscal deficit/GDP ratio, which was 2.4% last year, meaning that over time, the government’s ability to continue increasing spending on health care, education and the environment at double-digit growth rates will be constrained. This is, however, far from the banking crisis scenario some are predicting.

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.

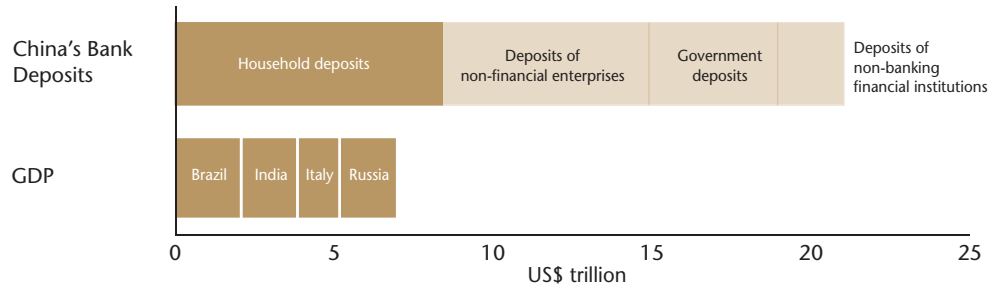
Figure 10. GROSS SAVINGS AS A PERCENT OF GDP



Source: World Bank, 2014

Figure 11. A VERY LIQUID BANKING SYSTEM

Household savings more than combined GDP of Brazil, India, Italy and Russia, end of 2015



Sources: CEIC, World Bank

Some banks will need to be recapitalized, but the scale should be manageable. In one past instance, China drew, to a limited extent, on its FX reserves to recapitalize its banks. But this is not the only option available. The government could, for example, issue domestic bonds, keeping in mind that over 95% of loans outstanding are local currency loans. The government could also choose to issue additional equity in some banks. Moreover, required reserves held by the central bank are equal to about 35% of China's GDP, and the very high required reserve ratio could be cut, returning some of those funds to banks. There is no reason to believe the government would have to use a large share of its US\$3.2 trillion in FX reserves for this purpose.

Q: What about China's external debt?

China's foreign debt exposure is low, about 13% of GDP. 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.

Q: So, what's the risk that China's debt problem creates an economic hard landing?

In my view, the risk of a hard landing or banking crisis is low, for the following reasons.

First, 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.

Second, the majority of potential bad debts are to state-owned companies in a handful of construction-related sectors, while the privately owned companies that account for most jobs and all new job creation have been deleveraging. This means that a debt-cleanup program can be concentrated on a relatively small number of SOEs, avoiding a broad austerity program that would hurt most companies.

Third, the banking system is very 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.

Fourth, the process of dealing with the debt problem is underway, although much more needs to be done. Credit growth is slowing; formation of NPLs and NPL write-offs have accelerated; and jobs are being cut in the sectors with the most serious overcapacity problems.



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/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

Q: What would lead you to change your mind, and conclude that the debt problem is likely to cause a hard landing?

I've described a corporate debt problem that revolves around the Chinese government, based on loans from state-controlled banks to SOEs. So the key risk 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.

Andy Rothman
Investment Strategist
Matthews Asia

Readers who would like to explore this issue in more depth can find an excellent academic paper here:
http://www.australiachinarelations.org/sites/default/files/ACRWORKINGPAPER2016-02_Ma%20and%20Laurenceson%2020160728.pdf

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