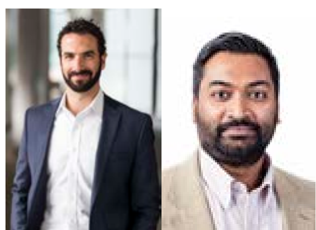
Country Risk Quarterly



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"Ask an economist a question, and prepare for three different answers," or so the common preconception goes. There are few current debates which elicit such prejudice than that over the sustainability of China's debt dynamics. But before we get to the disagreements, let's first agree on where we can all agree – history.

China's Big Bazooka

In the decade leading up to the global financial crisis, growth in China averaged almost 10 per cent per year. Then crisis hit, giving way to a collapse in international trade unlike anything any of us had experienced in our lifetimes. China, too, watched cross-border commerce crumble. By 2009, exports accounted for less than half of the Chinese economy, down from almost three-quarters only three years earlier. With trade no longer driving growth, the government stepped in to fill the void. And fill the void it did, with a stimulus package amounting to 13 per cent of GDP. Add to that the impact of monetary stimulus, and China's combined policy response pushed closer to 25 per cent of GDP within the first two years, equivalent to dropping all of Mexico into the Chinese economy over that time.

Unfortunately, this is where the agreement ends. Because while history – especially recent history – is replete with examples of this big bazooka approach, credit-led growth strategies attract as many champions as detractors. In this case, the alternative was never an option for a Chinese leadership preoccupied with the imperative of political stability. The massive debt-fuelled stimulus was channeled into the economy through an unprecedented build-up in real estate and heavy industry, mostly by local governments and SOEs.

However, stimulus in and of itself is but a short-term reprieve, absent a business-friendly environment that allows for private activity to be kick-started by this policy boost. Deprived of this critical incubator, future growth then demands not only ongoing stimulus, but ever-greater amounts of government largess. And when acceptable levels of growth equivalent to the size of some smaller G-20 economies are reinforced by entrenched political incentive structures, unparalleled excesses are an inevitable outcome.

A Mountain of Debt, No Matter How You Slice It

How big is the mountain of debt that's been left behind by this strategy? Well here again, it's hard to find consensus. According to the IMF, total social financing (TSF), a broad measure of credit, rose from 130 per cent of GDP in 2008 to 207 per cent of GDP in early 2014 (latest available data). Others claim that China's debt is more in the 250 per cent range, though there are questions around the double counting of, among other things, local government off-balance sheet liabilities in those estimates. The upper end of the spectrum is claimed by those who include financial sector corporates, and the role played by China's murky shadow banking sector, clocking in at more than 280 per cent of GDP.

The complex web of arrangements and partnerships between borrowers, banks and non-bank financial institutions such as trust companies, securities brokerages and wealth management firms, highlights the challenges of getting a firm handle on real liabilities inside the system. As shadow lending continues to expand at an alarming pace, some estimates measure this segment of the financial sector at between 40 and 70 per cent of GDP. The size of this under-reported and under-regulated sector also underscores the increased systemic risks attached to these sometimes more precarious schemes.

But whatever the true number, the one thing that we can all agree on is that it is BIG. Even more concerning is that, by our estimates, China's debt appears to be on track to hit 300 per cent of GDP by around 2020. Moreover, the bulk of this debt overhang rests with the country's bloated state-owned enterprise sector. Almost half of total liabilities can be found among China's nearly 150,000 SOEs, even before including all off-balance sheet shadow bank lending by state-banks. The balance is split roughly equally between the government and the private sector.

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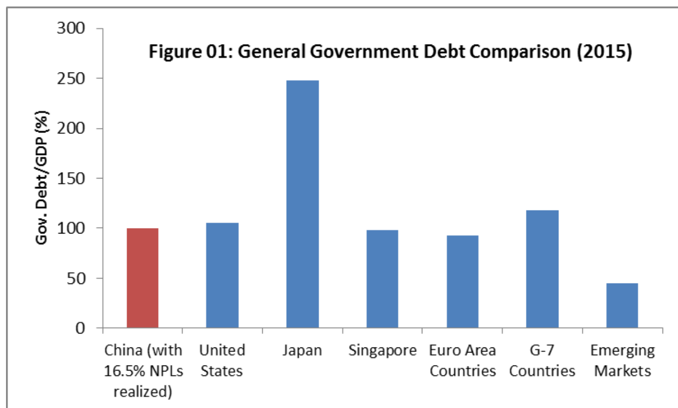
So it's big. And there is no question that China cannot continue to perform beneath such a weighty debt burden indefinitely. But can the country avoid a dreaded financial collapse, and even begin to repair its debt dynamics going forward?

Not Without a Net

One important characteristic of China's debt profile is that 90 per cent of total debt is domestically held and in local currency. This means that Chinese companies are more insulated from the whims of foreign investors than many of their emerging market peers. In addition, financial intermediation in China predominantly happens through the banking system. Equity and debt financing is still largely under-developed in the country, relative to what we are used to in the OECD. This means that the Chinese consumer's excessively high propensity to save, while a constraint on consumption, provides for a stable source of funding. And with much of this financing occurring between state banks and SOEs, the government is firmly in control of refinancing dynamics.

Given the central role of the State, there are concerns around mounting contingent liabilities on the government. In fact, while the official NPL ratio is 1.7 per cent, so-called special mention loans (ones that are currently serviced, but facing difficulties) are closer to 5.5 per cent. However, even if we consider NPL realization at triple that number, for good measure, and assume an ultra-conservative zero per cent recovery rate, a complete recapitalization of the banking sector would bring official public debt-to-GDP to approximately 100 per cent. This still compares favourably to the U.S. and most other OECD governments (see figure 1). In addition, the Chinese government possesses assets valued at one-and-a-half times that amount, some of which can also be liquidated to help with recapitalization efforts.



Sources: IFS, Haver, EDC Economics

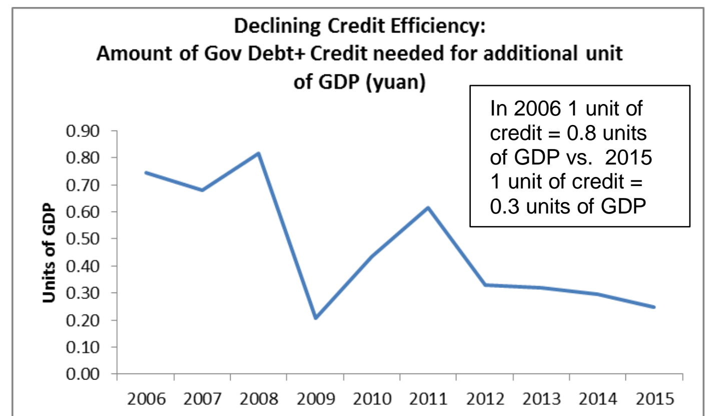
Does this mean that China is in the clear? Not really. As an important source of financing, consumer savings may have reached its limit, with bank loans already accounting for nearly 100 per cent of deposits. Further, as consumer spending picks up, expect to see some reversal in savings. On the public sector front, higher levels of debt become increasingly difficult to channel into productive investments. Eventually, the laws of diminishing marginal return kick in, and more loans are at risk of going sour.

Lost Decade?

One predominant concern among China watchers is that, even if the country can avoid a catastrophic Greek-style mass default, with all the attendant effects on the public, private and banking sectors, continuing to pump liquidity into the banking system could lead to a Japanese-style 'lost decade' of declining productivity and anemic growth. This is the so-called balance sheet recession – coined by Nomura Chief Economist Richard Koo – which sees NPLs rise and companies struggle beneath the weight of high debt levels.

As both the cost of capital and absolute liabilities climb, increasingly higher carrying costs mean that more money goes toward servicing debt, and less is spent on productivity-enhancing investment. Declining investment leads to deteriorating product quality, or even just perceptions thereof, resulting in falling corporate revenues. In such a scenario, monetary policy would be unable to revive growth, even at the most enticing borrowing rates, as companies increasingly focus on rebuilding their balance sheets.

The Bank for International Settlements (BIS) estimates that China's non-financial corporate sector spent 20 per cent of total revenue on debt servicing costs last year, up from 13 per cent in 2008. In GDP terms – even assuming debt-to-GDP at a conservative 250 per cent, and an average interest rate of five per cent – the country likely spends about 13 per cent of GDP on interest payments alone on an annual basis. Credit efficiency is also declining. According to some sources, China now needs four yuan of credit to generate one yuan of additional GDP, up from a ratio of 1:1 before the global financial crisis.



Sources: National Statistical Agencies, Haver, EDC Economics

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Tick-Tock

So is China destined for a prolonged period of weak and uninspired growth? We believe that government officials still have the time and resolve to set the country's debt dynamics on a positive trajectory. The Chinese Communist Party (CCP) is acutely aware of the risks of having to clean up a much bigger mess down the road, with less at its disposal. As such, a number of reform efforts currently underway show significant promise.

Local government debt swap pilot programs are actively reducing interest costs. SOE reforms have also begun. And while challenges remain with respect to communication around the latter, authorities have shown the ability to make difficult decisions in the past. In the 1990s, under the leadership of then-Premier Zhu Rongji, nearly 40 million SOE jobs were eliminated. By comparison, most estimates place today's required redundancies at around five million. Authorities are also reining in shadow banking activities, and allowing for selective defaults, while managing systemic liquidity risks via the PBoC and the securities regulator.

That said, officials still keep a wary eye on political sentiment and the standing of the CCP. While the government continues to encourage the transformation toward a more consumption-oriented economy, authorities will fall back on credit when required. Some estimates suggest that new borrowing in the first quarter of the year surged by more than 50 per cent from a year ago, adding to skepticism around the government's resolve.

Bottom line

The empirical evidence teaches us that every major economy which has relied on a rapid accumulation of debt in order to feed credit-led growth strategies has, at some point, experienced either a financial crisis or a prolonged slowdown in GDP growth. Furthermore, when we're talking about the world's second-largest economy (bigger than the next three countries combined), which houses the largest banking sector, second-largest equity market, third-largest bond market, and is one of the chief buyers of global industrial commodities, the world should take heed.

Yet despite all the handwringing, the Chinese leadership has stared down numerous similar challenges before. Notwithstanding repeated repudiation of command-style markets, the Chinese economy is more than 63 times its 1980 size, on a PPP basis. A dynamic private sector has emerged, wages have skyrocketed and poverty has been reduced.

Make no mistake, Chinese policymakers have made many missteps in managing their economic development, and will likely continue to err in the future. But we believe that authorities will find a way forward, if for no other reason than out of sheer political survival.

Our base case scenario does not include a massive debt-triggered implosion of the Chinese economy. Furthermore, we believe that China can avoid slipping into its own 'lost decade' if SOE reforms continue to move forward as planned, and the transformation of the Chinese economy is aptly managed. This doesn't mean that we expect to see a linear approach to change, carrying the Chinese economy toward some free-market panacea. Market reforms will bear a distinct Chinese characteristic, emphasizing socio-political stability and the primacy of the CCP. From time to time, new debt will chase after old debt, and give the appearance of a one-step-forward-two-steps-backward approach.

Observers who expect strict adherence to market reforms and a speedy recovery will be disappointed by the CCP's own timelines, especially given the upcoming 19th Congress leadership changes in 2017. Of the seven-member standing politburo, the highest leadership team in the CCP, five standing members are set to retire – notable exceptions being President Xi and Premier Li. Perhaps the more difficult reforms will be put off until the leadership change is complete. But as long as there is a plan, and it is implemented, China will likely muddle through. Because in this case, the desire for political survival may be as strong a force as the invisible hand.

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