Chi on China

FOR PROFESSIONAL INVESTORS – 22 November 2017

CHINA'S DELEVERAGING STRATEGY AND EVIDENCE

Debt is one person's liability, but another person's asset.

Paul Krugman

SUMMARY

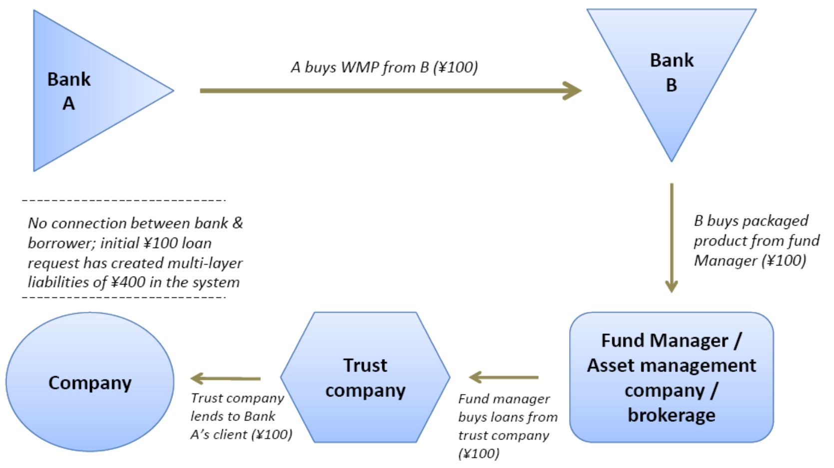
- China's debt-to-GDP ratio has been boosted by financial innovation through the shadow banking market creating multiple lending layers between the end-fund users and various non-deposit-taking financial institutions in the system.
- Beijing has started to correct this distortion through "surgical tightening" measures to force the shadow banks to reduce leverage. Evidence is emerging for some initial success, with even the state-owned enterprises (SOEs) starting to pare debt.
- The immediate objective of the debt-reduction policies at this stage is to reduce risk, not to cut the debt ratio to any specific level. In stage two, the effort will shift from cutting local-government and shadow bank debts to SOE debt, which should then reduce the debt-to-GDP ratio.

Regulatory arbitrage activities by the banks and non-deposit-taking financial institutions (NDFIs), including shadow banks, have created multi-layer lending in the system. This rent-seeking behaviour has inflated the credit-to-GDP ratio, thus aggravating China's debt risk.

In a stylised example (Chart 1), a company approaches Bank A for a RMB100 loan. But Bank A's lending ability is restricted by some regulatory constraints. So it approaches Bank B and buys from it a wealth management product (WMP) for RMB100. Bank B uses the proceeds to buy some packaged assets from an asset manager. The asset manager then uses the RMB100 funds to buy loans from a trust company, which then uses the proceeds to lend to Bank A's client.

In the end, the company gets the RMB100 loan via this complicated credit creation process without having to deal with Bank A who is the *de facto* lender by eschewing the regulatory lending constraints. Meanwhile, this multi-layer lending process has created RMB400 liabilities out of a RMB100 loan demand. Except Bank A, all the other players are, arguably, rent-seekers in facilitating this regulatory arbitrage process[1].

Chart 1: Stylized example of regulatory arbitrage for banks & NDFIs to create multiple lending layers



Source: BNPP AM (Asia)

EVIDENCE OF DELEVERAGING

Seeing this distortion in China's financial system, Beijing has started to correct this distortion since late 2016 by implementing "surgical tightening" measures that focus on hitting the regulatory arbitrage activities between the banks and NDFIs[2]:

- The PBoC has expanded its macro-prudential assessment (MPA) framework to restrict banks' off-balance-sheet activity via the usage of WMPs and negotiable certificate of deposits.
- The CBRC has tightened rules and supervision on banks' liquidity and credit risk management, WMP business and lending to NDFIs.
- The CSRC has tightened rules on asset management business by securities companies and subsidiaries of fund management companies and raised the standards for corporate bond issuance.
- The authorities have also announced tighter rules on limiting local government borrowing and pushed the usage of debt-equity swaps.

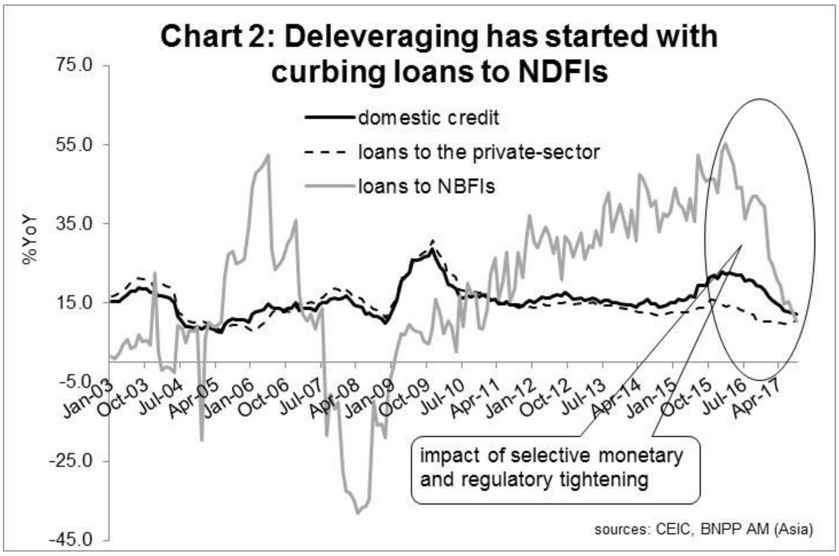
The list will grow as regulations catch up with financial deepening and innovation in the system. Evidence has emerged since early this year showing some initial success on Beijing's deleveraging efforts:

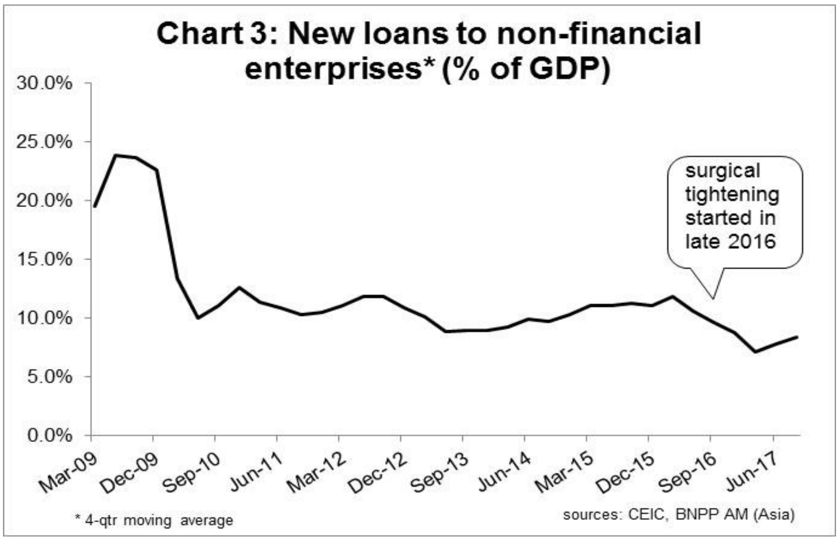
- Bank lending to the NDFIs has slowed sharply, with the dragging effect spilling over to total credit growth as multi-layer lending has been dismantled (Chart 2).
- New credit flowing into non-financial enterprises has also slowed (Chart 3).

[1] To understand why the NDFIs and banks cheat, see *"Chi on China: Where Does China's Financial Risk Lie?"* 23 November 2016.
[2] See *"Chi Time: Uncertainty, Risk and Dilemma of Deleveraging China"*, 26 May 2017.

- The surgical tightening has hit NDFIs' arbitrage and rent-seeking activities and led to a fall in the AUM of the asset management products by different NDFIs, including WMPs (Chart 4 and 5).
- Even the SOEs are starting to follow the footstep of the private sector by cutting debt (Chart 6).

Under the old model of high-growth at all cost, many SOEs armed with soft budgets and government-subsidised land expanded recklessly. During economic downturns, such as the 2007-08 Global Financial Crisis (GFC), when mounting losses forced private firms to cut production and debt, SOEs continued to produce by gearing up. But when China started to trim excess capacity in 2014, the SOEs started to deleverage also, and the surgical tightening measures in late 2016 gave the debt-reduction effort another push (Chart 6).





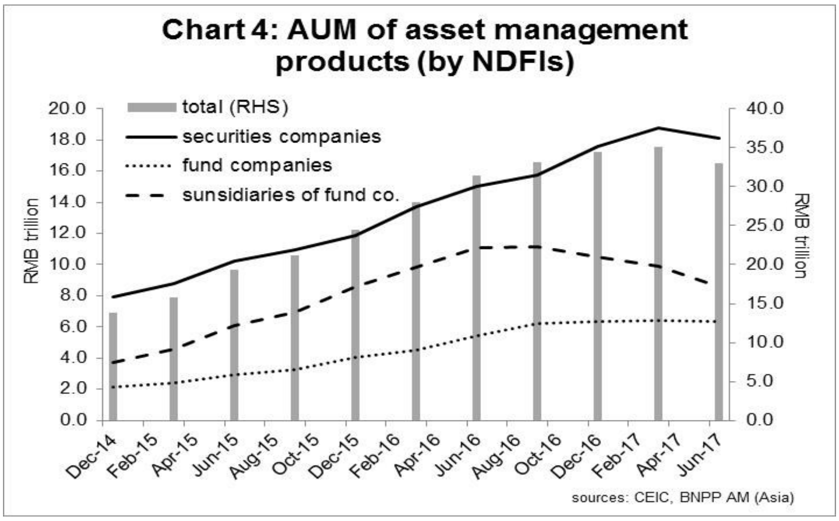


Chart 4: AUM of asset management products (by NDFIs)
total (RHS)
securities companies
fund companies
sunsidiaries of fund co.
RMB trillion
RMB trillion
Dec-14
Feb-15
Apr-15
Jun-15
Aug-15
Oct-15
Dec-15
Feb-16
Apr-16
Jun-16
Aug-16
Oct-16
Dec-16
Feb-17
Apr-17
Jun-17
sources: CEIC, BNPP AM (Asia)

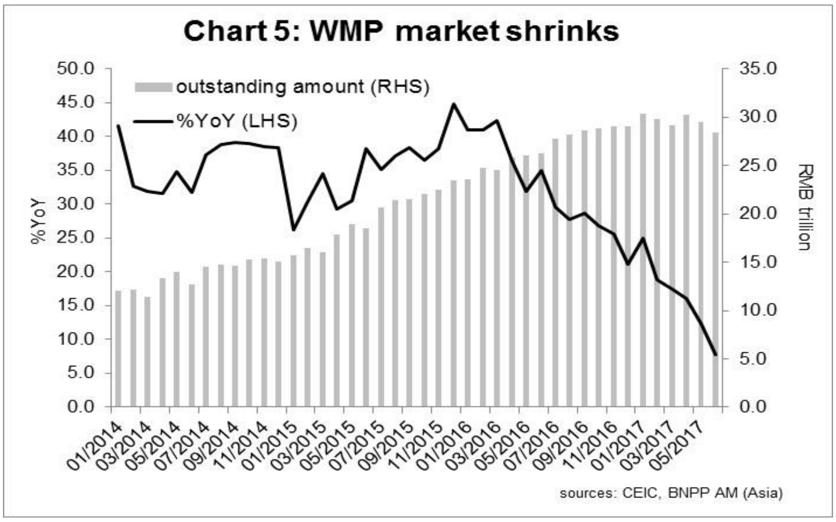


Chart 5: WMP market shrinks
outstanding amount (RHS)
%YoY (LHS)
%YoY
RMB trillion
sources: CEIC, BNPP AM (Asia)

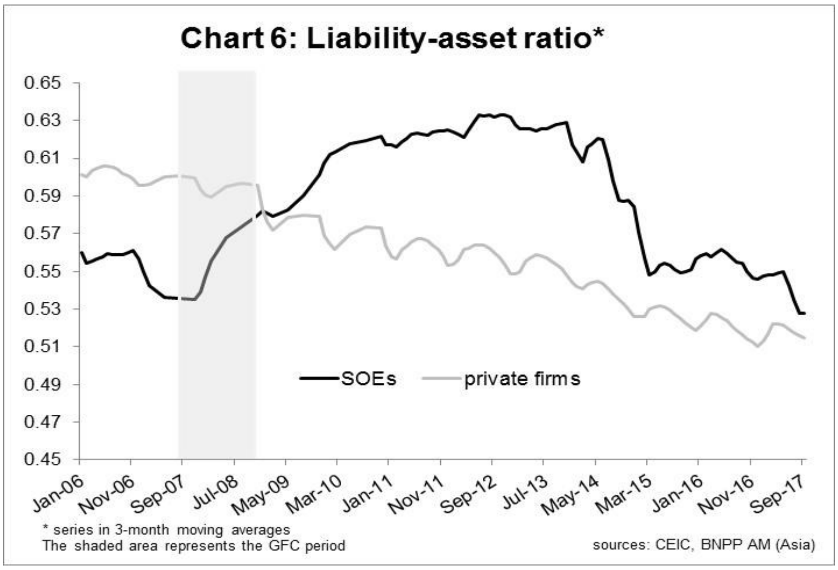


Chart 6: Liability-asset ratio*
SOEs
private firms
Jan-06
Nov-06
Sep-07
Jul-08
May-09
Mar-10
Jan-11
Nov-11
Sep-12
Jul-13
May-14
Mar-15
Jan-16
Nov-16
Sep-17
* series in 3-month moving averages
The shaded area represents the GFC period
sources: CEIC, BNPP AM (Asia)

GOING FORWARD

The objective of the deleveraging policy at this stage is not to cut the debt-to-GDP ratio to any specific level, in my view, but to reduce risk given the debt stock. Deleveraging efforts and structural reforms will continue under a more reform-minded Standing Committee of the Politburo in which there are now six reformers out of the total seven members[3]. A key part of the economic rebalancing effort is to deleverage the SOEs and the heavy industries that they dominate and reallocate capital to the new economy, which includes the service sector, high-tech manufacturing and household consumption.

In the second stage, the focus of deleveraging will shift from local-government debt and shadow banking to SOE debt, which should then start reducing the debt-to-GDP ratio. Debt-equity swap will play an increasing role in lowering SOE debts in the process. A key solution to resolving China's debt problem should be privatisation of SOE assets. But this approach will take much longer time to deliver as it touches the nerves of China's political system.

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[3] See "*Chi Time: Party Congress Opens a New Era for China*", 30 October 2017.

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