Chi on China

WHAT WE DON'T SEE IN CHINA'S DEBT RISK?

A bend in the road is not the end of the road…unless you fail to make the turn.

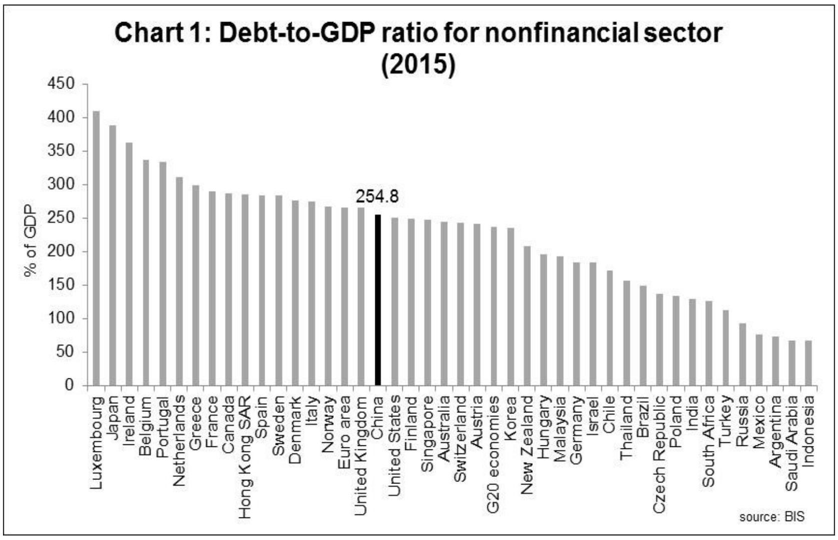
Unknown

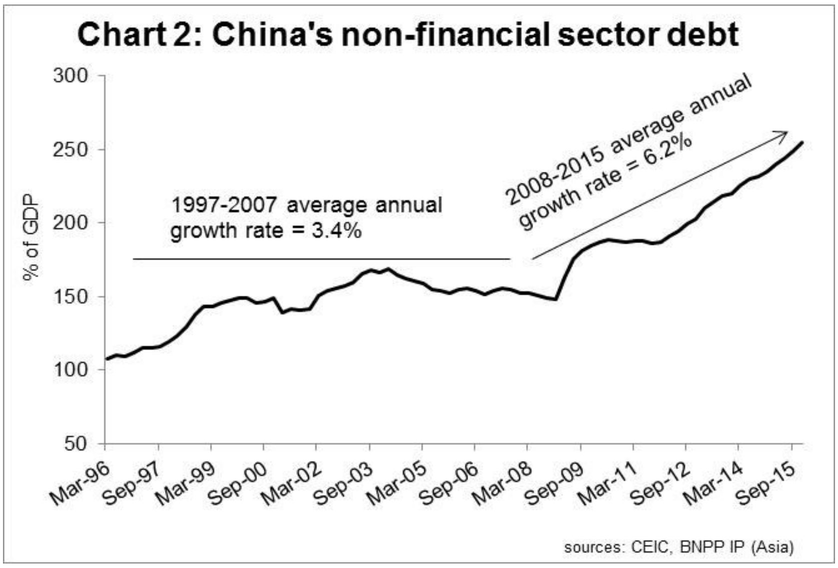
Summary

- China has started tackling its debt problem through practical means. However, a policy to cut the country's debt-to-GDP ratio swiftly, as some have urged, could crush the economy before the benefits of debt reduction could even emerge.
- China's debt risk lies in its rapid rate of accumulation. The debate on the problem has predominately focused on the liability side of the economic balance sheet. But it misses the asset side of the balance sheet that has growth implications from the debt accumulation.
- The coexistence of excess-capacity and under-investment in China is clouding the analysis of its debt as there is a lack of understanding of this conundrum. Headline data gives an incomplete picture of China's debt risk and, hence, may distort its strategic outlook.

The amount of China's debt (which is predominately bank loans) is not as excessive as the news headlines have painted (Chart 1). Contrary to conventional wisdom, China's debt is also structurally stable as it is funded by domestic savings and managed under an implicit guarantee policy (from which Beijing is retreating only slowly) and a relatively closed capital account[1]. The risk stems from its rapid rate of accumulation in recent years (Chart 2), which raises the alarm of capital misallocation leading to a financial crisis eventually.

[1] See "*Chi on China: China's Debt Problem May Be Different From What You Think*", 11 May 2016.





Deleveraging can't go fast

Beijing is not in denial of this risk, though it has been criticised for moving too slowly to cut debt. To be fair, a policy to cut China's debt-to GDP ratio swiftly, as many players have urged, would be implausible. This is because aggregate financing growth has outpaced nominal GDP growth by an average of six percentage points since 2012 (Chart 3). To cut debt abruptly would mean slowing credit growth by more than six percentage points below the nominal GDP growth rate. This could crush the economy before the benefits of deleveraging could even emerge.

The government has taken a practical approach to deleverage. It started a debt-swap programme in 2015 to pare the debt burden of the local government financing vehicles[2], implemented a debt-equity scheme to deal with non-performing bank loans[3] and set up provincial asset management companies to absorb regional

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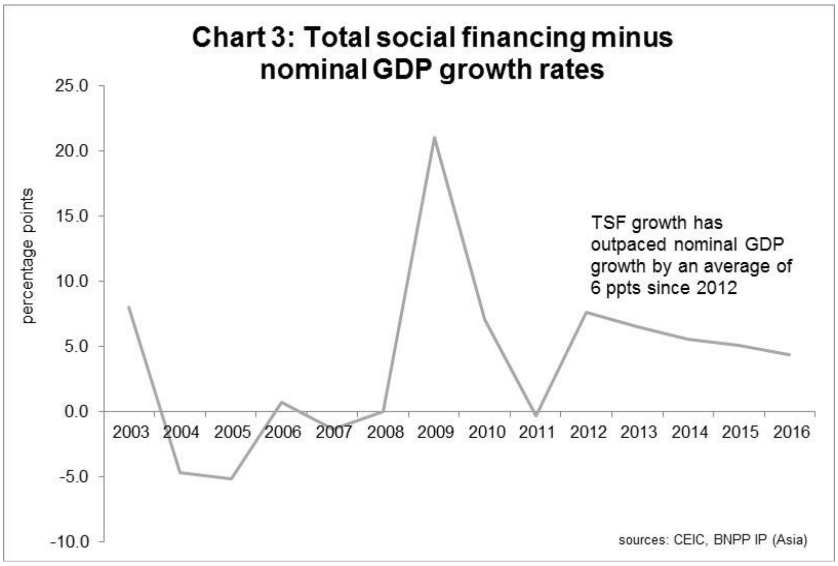
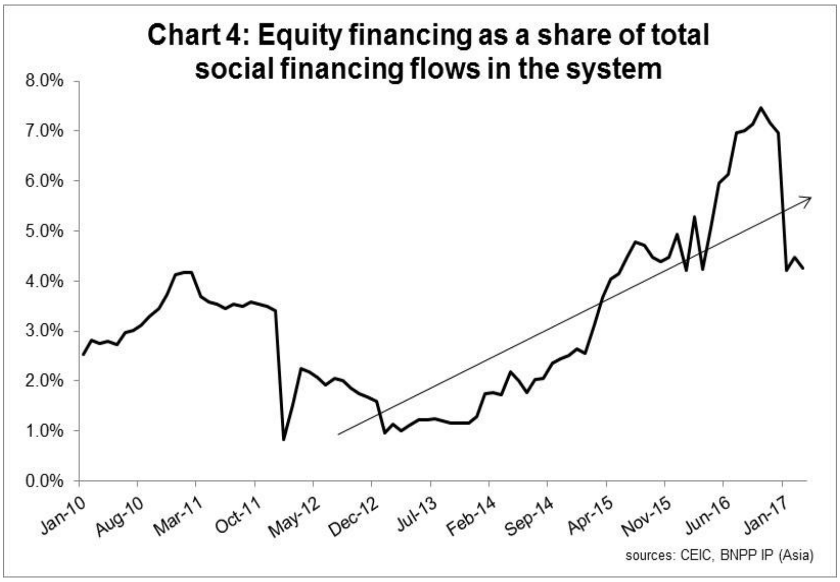
[2] The local government financing vehicle debt is counted as corporate debt by the market. See "*Chi Time: China Deleveraging (Part 1 of 2): Re-pricing Risk Premium*", 15 April 2015.

[3] China's debt-equity swap scheme only serves as a stop-gap measure to deleverage under the constraint of protecting GDP growth and it does not address the incentive problems in the system. See "*Chi Time: China's Debt-Equity Swap and Incentive Problems*", 14 December 2016.

bank loan losses. Despite the stock market's volatility, it has also encouraged equity financing (Chart 4) to channel domestic savings into the economy to reduce its reliance on debt for growth.





With growth concerns now easing, deleveraging has moved up the policy priority list. This can be seen from the PBoC's continued effort to use economic stabilisation as a cushion to force deleveraging through small "surgical" tightening[4]. Furthermore, the PBoC started to implement its Macro Prudential Assessment (MPA) framework in 1Q 2017, which has resulted in some initial debt reduction.

The MPA is a framework introduced in early 2016 that sets parameters such as capital adequacy ratios and lending standards for assessing banks' total credit growth, including their off-balance-sheet activities such as wealth management products (WMPs) and lending to non-bank financial institutions (NBFIs) and shadow

[4] See *"Chi on China: What's Next After Growth Recovery?"* 26 April 2017.

banks. Banks that fail the quarterly MPA test will be disqualified from using the PBoC's lending facilities or be hit with significantly higher interest rates from such facilities.

Hence, many banks have scaled back lending to the NFBIs in order to comply, leading to a liquidity squeeze in the wholesale funding market and a reduction in overall credit growth. Nevertheless, the PBoC is unlikely to continue squeezing interbank liquidity and risk creating credit events that could destabilise the system. It will likely take a stop-go approach to balance its dual policy objectives of supporting GDP growth and managing systemic risk via deleveraging.

The partial debt debate

The ongoing debate on China's debt risk has focused predominately on the liability side of the economic balance sheet. But it misses the asset side that has growth implications from the debt accumulation. Equity financing aside, debt arises when an economy transforms savings into investment. By design, China is a debt-financed system (mainly through bank loans), which accounts for 95% of its total financing[5]. The rapid increase in debt reflects the sharp rise in China's capital spending that makes the economy more capital intensive. Capital broadening[6] and capital deepening[7] are the ultimate ways for a country to improve productivity and living standard.

China has directed massive financial resources to infrastructure investment largely by state-owned enterprises after the 2007/08 Global Financial Crisis (GFC) to boost growth. Arguably, this debt-financed investment is equivalent to the massive increase in fiscal deficits in other countries to finance social welfare spending to support demand after the GFC. The difference is that China's state-led infrastructure spending boosts demand through capital accumulation, which will raise future output; while the developed world's fiscal spending boosts demand via consumption, which does not increase future income. Can one really argue that China's rapid rate of debt accumulation is more dangerous than the developed countries' burgeoning fiscal deficit?

One may argue that China's excess capacity is making its debt risk worse. But things are not that simple. The truth is that China suffers from excess capacity and under-investment simultaneously[8]. The coexistence of these two conflicting forces lays bare a more serious structural flaw in the Chinese system – capital misallocation – than its debt accumulation.

The culprit of China's excess capacity is not too much investment but the state sector's soft budget constraint under the old development model that focuses on misallocating capital to a few giant inefficient state-dominated industries. The state-sector's excess capacity dominates the system and stymies "animal spirits" as the private sector remains under-capitalised. Now the old growth model is broken. Genuine supply-side reform, not the ones that are currently implemented[9], is the only way out of this conundrum.

Under such circumstances, forcing debt reduction will not solve the problem of capital misallocation in China. It could even hurt future growth since China's debt supports investment, not consumption. Beijing will have to resolve this conundrum by a combination of deleveraging in the excess-capacity sectors and supply-side

[5] See reference in note 1.

[6] Capital broadening refers to increasing the capital stock at the same rate as the labour force so that labour productivity is kept constant by using existing technology.

[7] Capital deepening refers to increasing output through better/new technology so that labour, and even capital, productivity increases.

[8] See "*Chi on China: The Conundrum of China's Excess Capacity*", 14 September 2016.

[9] See "*Chi on China: China's Supply-side Reform is Not What You Think*", 25 May 2016.

reforms to improve capital allocation to the under-capitalised new economy. In its current form, the Chinese-style supply-side reform aims at improving operational efficiency of the state sector with minimal impact on employment and bankruptcy. This can only contain the flow of the structural problem under the weight of capital misallocation. It cannot solve the stock of the problem.

Beijing is facing significant headwinds in implementing structural reforms and debt reduction, but eventually it still needs to allow liquidation, reform the state sector, encourage bad debt write-offs by the banks and truly liberalise interest rates[10] in conjunction with other structural reform measures. It also needs to honour its pledge to give the market a bigger role in the economy to solve the capital misallocation problem. If it allows more equity financing and diverts borrowing to the under-invested areas, China's debt risk will be a much less concern than it is perceived today.

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[10] See "*Chi Time: China's Financial Reforms: Big Bang or Caution?"* 21 May 2014.

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