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Commentary

China: Are its debts worrisome?

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The world had been fretting about the fast growth in formal banking debt and shadow banking in China since the global financial crisis. China's economic and property market slowdown in 2014 has heightened concerns of a debt crisis in the works. This commentary takes a closer look at China's debt level to assess if it is at a worrisome level and could trigger a financial crisis, as some commentators have suggested.

Debt level has surged

China's total bank debt including that of the financial sector has quadrupled from USD7.4 trillion in 2007 to USD28.2 trillion by mid-2014, according to a recent report by the McKinsey Global Institute[1]. The surge was the result of the government's stimulus program following the 2008 global financial crisis. The non-financial debt to GDP ratio has increased from 134% to 217% over the same period. If debt continues to grow at the same pace, it would reach 400% of GDP by 2018.

The more risky and less regulated shadow banking industry expanded quickly too, driven by private companies and local governments unable to get bank loans, and retail demand for higher-yielding saving/investment products in the face of low deposit savings rate. McKinsey estimated that shadow banking loans surged by 36% per annum between 2007 and 2Q2014 compared to 18% per annum for bank lending to reach USD6.5 trillion in the second quarter of 2014[1]. Moodys' estimated RMB45 trillion (USD7.3 trillion) as at end 2014. Fung Global Institute (FGI) estimated a lower RMB32.2 trillion[2] (USD5.2 trillion) at end 2014, which attempts to remove double counting.

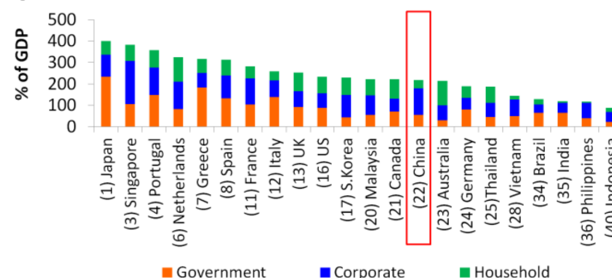
Much of the bank and shadow banking loans are in the real estate and related industries. McKinsey estimated that nearly half of the non-financial bank debt (about USD9 trillion) was directly or indirectly related to real estate including industries such as steel and cement, and debt raised by local governments for property development. The four main categories of borrowers are large state-owned enterprises (SOEs), private sector small- and medium-sized enterprises (SMEs), real estate companies and local government financing vehicles (LGFVs). Local governments, unable to issue municipal bonds and suffering from fiscal imbalances, often pledge proceeds from future land sales as collateral to fund projects and businesses to generate employment.

The non-performing loan (NPL) ratio of China's banks has been rising and reached a five-year high of 1.64% at end 2014. Due to the interconnectivity between shadow banking and traditional banking, a shock in the shadow banking system will have spillover impact to the banking sector.

But debt risk is manageable

While the credit growth had been steep since the global financial crisis, the total level is not high by global standards. China's non-financial debt to GDP ratio was ranked 22nd, behind the US, UK, Japan, Netherlands, Portugal, Italy, Greece and Spain[1] (Fig 1).

Figure 1: Comparison of debt-to-GDP ratios



Note:
1. Figures in parenthesis refer to ranking
2. 2Q14 data for advanced economies and China; 2013 data for other developing economies.
Source: McKinsey, AIP Research

Shadow banking debt is only a fraction of total debt (about 30% of non-financial debt[1]) and about half of the GDP size. In the US, shadow banking debt is similar in size to bank debt. China's shadow banking lacks complexity and credit is direct so contagion risk is small. The risk level is thus not comparable to that of the US shadow banking that drove the global financial crisis. It is the maturity mismatch that is the problem, as the loans are short-term backed by long-term investments.

[1] McKinsey Global Institute, Debt and not much deleveraging, Feb 2015
[2] FGI, Bringing shadow banking into the light, Mar 2015. FGI is a HK-based independent think tank.

China's government has more than sufficient assets to back its debt (including local government[3]). Local governments have net assets equivalent to 129% of GDP against liabilities of 61% of GDP[2]. The problem is more acute in some small-tier cities that have over-extended themselves but overall there is little risk from the government sector. McKinsey estimated that the total government debt would rise from 55% to only 79% of GDP to fund bailouts, even if half of property-related loans defaulted and lost 80% of their value[1].

Household debt is even lower at 38% of GDP. Coupled with high savings rate of about 50%, there is little mortgage default risk. Credit extended to developers is more at risk given their higher leverage.

The credit risk from the high corporate debt is overstated. Corporate debt comprises the bulk of borrowings (125% of GDP as at 2Q2014 according to McKinsey) but much of it is held by entities owned or backed by the state. In addition there is a high level of corporate deposits that may limit the exposure of banks. Corporate deposits amounted to RMB51 trillion in 2013 (89% of GDP), compared with 7% of GDP in the US[4]. This is due to corporate savings (about 20% of GDP) and a peculiar Chinese bank practice which credits loans immediately with an equivalent deposit amount. While it is possible that some corporate deposits may have been drawn down quickly, the exposure of the banks is nevertheless more limited to the extent that such collateral exists.

Domestic banks are healthy. China's NPL ratio is expected to continue to rise, but the risk is contained as banks have abundant capital to cover potential losses. Their average capital adequacy ratio was 13.2% as at December 2014[5], above Basel III's minimum requirement of 8%. According to a study by Oliver Wyman and FGI, bad shadow banking debts could incrementally increase banks' NPL ratio by 0.4% to 4.3% under various scenarios[6]. The worst-case scenario assumes 24% of NPL in shadow banking of which 44% are transferred to formal banking. The banks can thus absorb a significant amount of bad debts without serious repercussions apart from erosion in the quality of their loan portfolios.

There is no risk of foreign exchange crisis, or a global crisis, given China's high foreign exchange reserves, exchange controls and low external debt. At the end of 2014, China's foreign exchange reserves totalled USD3.8 trillion while its external debt position was USD0.9 trillion.

Nevertheless, we can expect more defaults in the short-term with potential social unrest due to expectations of guaranteed returns, tighter bank credit thus slowing economic growth, and erosion of confidence. However the government is taking active steps to ameliorate the situation such as:

1) relaxing housing purchase restrictions and reducing mortgage downpayments and mortgage rates to stabilise the housing market and ease developers' cashflow;
2) state-backed companies have been taking stakes in or giving credit to cash-strapped developers; and
3) enabling local governments to swap short-term debts to long-term bonds at lower rates to reduce default risk.

The central government is also implementing longer-term changes to ensure fiscal prudence among local governments and plug oversight gaps in shadow banking to bring it under closer supervision such as:

1) requiring banks to bring their off-balance sheet and trust-type lending back onto their balance sheets to improve transparency;
2) improving revenue sharing between central and local governments and broadening the tax base for local government;
3) disallowing LGFVs to raise funds after 2016. Future local government projects will be funded by bonds issued by provincial governments. Public projects with commercial viability will be financed via special-purpose bonds or public-private-partnerships; and
4) liberalising interest rates and carrying out capital market reforms that boost access to credit by more productive sectors.

[3] Includes local government financing vehicle (LGFV) borrowings
[4] FGI, Bringing shadow banking into the light, Mar 2015 pg 117
[5] Bloomberg
[6] Oliver Wyman & FGI, Bringing light upon the shadow, 2015

Conclusion

China has a debt problem, but it is not at the scale of a Lehman crisis. China has the resources and policy levers to address an essentially domestic problem. Although the debt level could potentially develop into a financial crisis if credit continues to grow unabated and into unsustainable investments, the government is already taking active steps to curb the excesses.

In the short-term, we can expect slow credit and investment growth, more credit default risks and higher risk premiums. However, these are positive for the long-term.

The key to success will be to manage the monetary easing and reforms so that the local subprime debts do not trigger excessive asset-price deflation, while moving credit to more productive sectors and regions and controlling the negative effects of shadow banking. In some cases the government may have to step in to restructure a few local government and SOE debts to provide stability despite its rhetoric on not providing bailouts. We think this can be managed well with President Xi Jinping at the helm providing strong leadership and strategic vision.

It will be a long process to reduce leverage though, as China has to slow down the pace of reforms and carry out monetary easing in the meantime to support growth. It will have to loosen financial controls slowly to prevent excessive flight of domestic capital, and support the housing market to prevent it dragging down the economy given that the property sector and related industries contribute to about a quarter of the economy. The regulators also have to grapple with new and less understood forms of shadow banking and internet financial platforms.

In the long-term, China's ongoing reforms could unleash major growth potential in many areas. GDP growth can be maintained at a higher level, and bad debt will be reduced, if money is invested more efficiently by private enterprises. As China deepens its financial reforms and introduce more financial products and options in the capital market, more investments will be funded by equity and other alternatives rather than debt which will also reduce credit reliance and retail demand for high-yielding products. There is currently an excessive dependence on bank credit in China due to the relative underdevelopment of its equity market.

The level of concern raised over the shadow banking and bank debt serves as an opportune reminder of the potential pitfalls as China pursues its reforms to liberalise the financial sector, e.g. the risk of contagion effect on foreign banks and investors will increase which we are beginning to see in the on-going Kaisa case. The fact that it is cautiously deregulating through the Shanghai Free Trade Zone and others should be viewed positively as a reflection of its measured approach to avoid opening the floodgates and untoward consequences, despite criticisms of its slow pace of progress.

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