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Focal Point

China's structural debt problem is still aggravating

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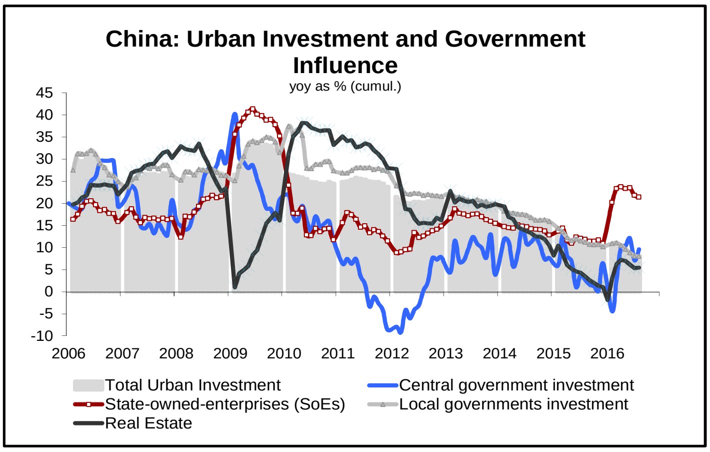
- At the end of 2015, China's credit-to-GDP ratio stood at around 225%, about 100 pp higher than in 2007 before the Great Financial Crisis (GFC).
- The strong rise in leverage reflects China's policy of stimulating investment demand in order to stabilize the business cycle. With a share of more than 46% in GDP, China seems overly dependent on capital expenditures.
- Market fears of an unsustainable debt accumulation initially concentrated on local governments, but spilled more recently over to corporate debt, especially of State-owned-Enterprises (SoEs). Their median return on assets has decreased from 4.5% to below 2%, posing a risk to China's medium-term financial stability.
- To contain these risks, China needs to rebalance its economy towards more private consumption, to continue with structural reforms, especially capacity reductions, and to strengthen the capital basis of banks. This all requires Beijing to eventually accept lower GDP growth rates.

At the end of 2015, China's credit-to-GDP ratio stood at around 225%, about 100 pp higher than before the GFC. The process of rapid debt accumulation started back in 2008, when China announced a large fiscal policy package worth RMB 4 tr; or 12.5% of GDP. This was the largest in the world in relative terms. Only RMB 1.2 tr of the package were scheduled to come from central government funds, while RMB 2.8 tr were expected from provincial and local authorities. However, as the graph to the right shows, the stimulus was not limited to direct government expenditures, but Beijing also used its influence on SoEs as well as on the real estate sector to push up investment. The policy was quite successful in business cycle terms. However, the package also had major adverse side effects, which laid the foundations for several still lasting structural problems.

Slow pace of China's growth rebalancing

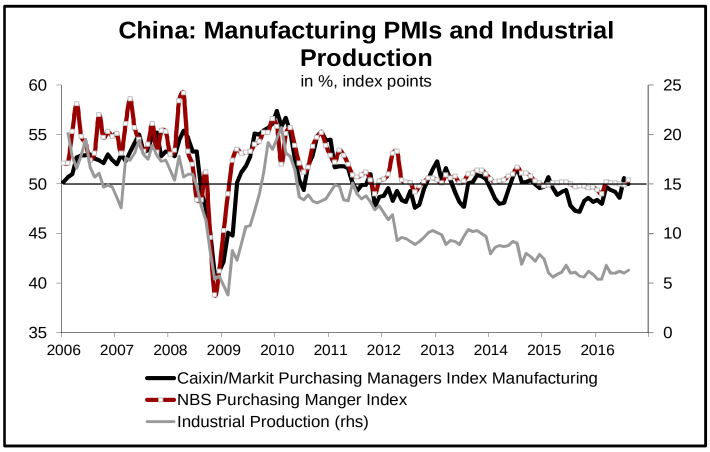
First, China's economy seems overly dependent on investment. In 2009, with the implementation of the fiscal package, investment contributed 85% to total GDP growth. Its share in nominal GDP rose from an already quite high pre-GFC level of 40% to 48%, and slowed since then only rather reluctantly. The main reason is that China resorted to a policy of stimulating investment outlays in a stop-and-go manner to prevent growth from decelerating too much. The cyclical structure of the Caixin manufacturing PMI gives a vivid account of this policy approach (see first graph next page). Nevertheless, a lasting effect on industrial production cannot be detected. China's rebalancing is a constant but so far rather soft process. At the same time,

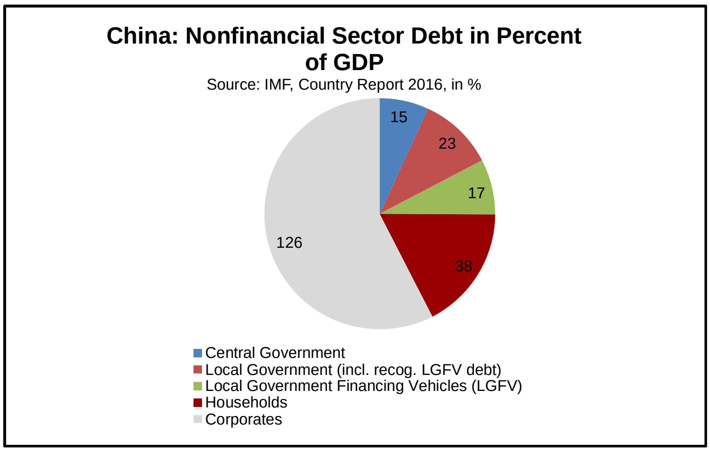


debt and overcapacities piled up in several sectors, eliciting already several bouts of high market mistrust.

Local Government Debt Crisis has become less likely

Market worries about China's accumulating local government debt started to rise already at the turn of the decade. Historically, local governments (LGs) were banned to raise debt in their own names. However, to finance the large 2008 fiscal program, LGs set up Local Government Financing Vehicles (LGFV), reaching a number of more than seven thousands in 2013. This complex structure rendered the actual amount of new LG debt rather opaque. The State Council responded with several rounds of audits – in 2010, 2013, and 2014 – and the very first already put the figure of LG debt at RMB 10.7 tr, i.e. 3.8 times the initial plan. On top, LGFV's borrowing was mostly short-term bank lending. This was not only inadequate for long-term





infrastructure projects but also raised fears regarding the stability of the banking system.

Subsequently, the central government tried to bring more transparency into the debt structure. The audits sought to classify outstanding LG debt according to its legal status (repayment obligations vs guarantees or bailout responsibilities). Moreover, authorities tried to halt leveraging and by October 2014, LGFV were prohibited from accruing further liabilities. However, the stance was softened again amid China's slowing growth. In its 2016 Country Report, the IMF published its estimate of the level and structure of existing LG/LGFV debt. This amounts to 40% of GDP.

Nevertheless, China sought not only to increase transparency, but also to put LG debt on a more sustainable basis. Thus, it introduced a debt swap program to shift certain maturing LGFV debt into a new municipal bond market. The program began in early 2015 with a RMB 1 tr swap program, which was expanded to RMB 3.2 tr by August 2015. At the end of 2015, the Ministry of Finance (MOF) announced to use the swap program also for the remaining RMB 11.1 tr (officially recognized debt) until the end of 2017. The debt swap entails much lower interest rates amid longer maturities, and thus provides a positive contribution to the viability of the underlying infrastructure projects. Moreover, China revised its budget law, allowing direct borrowing by upper-level local governments on a trial basis. For 2016, the MOF set a total ceiling for LG debt at RMB 17.2 tr. (some overshooting possible). In sum, government reforms have contributed to more transparency and sustainability of LG debt and thus reduced the risk of debt spilling out of control.

Market mistrust shifted to corporate debt

More recently, structural debt worries have broadened to corporate, predominately SoE debt. The IMF puts the domestic corporate debt quota (excluding LGFV) at 120%[1] of GDP by the end of 2015. During the GFC, SoEs' investment growth jumped up to a peak of 40.2% yoy year-to-date in mid-2009. In 2016, it rose again to more than 20% yoy ytd. The government clearly used its influence on SoEs again to stabilize growth, but thereby also intensified debt sustainability worries. However, it is not the debt level itself that is decisive, but the capacity of servicing it. Years of easy (preferred SoE) credit contributed to overcapacities especially, but not only, in the "old economy sectors". Against the background of the slowing Chinese economy, low global demand and the correction of property markets, overcapacities amid downward pressures on production volumes led to receding producer prices. This in turn eroded margins amid rising debt, putting Chinese corporate profitability more and more into doubt. The IMF (Global Stability report, April 2016, pp 13-21) sees the return on assets in the median below 2%, after still 4.5% at the turn of the decade. Moody's puts the average SoE figure at 2.9%, down from a pre-crisis high of 5.9%. It also increased the share of issuers with a negative rating outlook to a record high of 69% this year, after lowering its outlook on the sovereign rating in March.

In sum, the ability of many firms to service their debt has come under pressure. As comprehensive data are not available, the IMF used several samples to estimate the size of the problem. Debt relative to earnings (EBITDA) has risen to a multiple of about four, doubling since 2010. Risks are concentrated in five sectors, including real estate, manufacturing, industrial trading (part of retail and wholesale), mining, and steel. The overall share of firms where interest payments exceed earnings (debt at risk) increased to 14%, from 4% over the period 2010-15. It is highest with 39% in the steel sector, followed by 35% in mining and retail & wholesale. However, in terms of absolute borrowing, the real estate sector – despite its share of only 11% – is also a heavy contributor. For the end of 2015, the BIS calculated a credit overhang of 25% of GDP.[2]

How vulnerable is the banking sector?

This could have large negative implications for the banking sector. Therefore, the IMF applies the debt-at-risk ratios at the industry level to the loan structure of the entire banking sector, implying 15.5% of loans to the corporate sector to be potentially jeopardized. Assuming a loss ratio of 60%, this would result in potential bank losses of about 7% of GDP. The IMF judges that "loans potentially at risk are substantial, but still manageable". Estimated losses are equivalent to around 1.9 years of banking pretax profits. Bank Tier 1 capital amounts to 11.3% of risk-weighted assets and including bank reserves to around 21% of GDP. Using a different estimate method, e.g. SocGen reaches a similar conclusion of 7.6% of GDP of loans at risk.

However, the picture has to be broadened to corporate bonds, of which banks also hold a large share. Corporate bond issuance has increased by about 3 pp to 20.5% of GDP in 2015. "Debt issuance has been substantial in exactly the sectors that are suffering from price pressures, overcapacities and rising balance sheet weakness, namely in the real estate, mining and manufacturing sectors."

(IMF, p 17). Moreover, given the high uncertainty in overall debt figures, the problem could be even larger.

The importance of structural reforms

Market views on the debt problem differ widely. Some authors see a debt/banking crisis as unavoidable while e.g. HSBC considers these fears as overblown. In fact, there are several mitigating factors that should be able to calm nerves. Basically, the government, with a debt quota seen between 55% - 65% of GDP, would still be able to absorb substantially more than the estimated debt-at-risk. Secondly, with the capital account still largely under government control, China's debt is to a large extent domestically held, which largely prevents external pressures. Thirdly, current business cycle developments are likely to soften margin pressures: Property investment, which has a large impact on upstream sectors, has stabilized. In addition, PPI deflation has turned positive to 0.1% yoy as of late, after about -6% at the end of 2015. On top, industrial profit growth has improved in 2016. Thus, we consider the debt problem less likely to cause a hard landing near term.

Nevertheless, fundamentally, China needs to put especially SoEs on a more sustainable footing and has to make more progress in rebalancing its economy towards private consumption and less investment. In September 2015, China has announced a kind of "roadmap", calling for regrouping state firms by function (in a public class, serving public welfare and a commercial class), further consolidating assets (by mergers, a key strategy of the supervisory body) while developing mixed ownership and loosening state authority over the management in non-strategic sectors. An important step was made in early 2016, when the State Council announced to cut overcapacities in steel and coal industries over the coming years (steel sector to be reduced by 10-15%, coal sector by about 20%). The needed lay-off of workers will be buffered by a fund of RMB 100 bn. Furthermore, a trial project for a debt-for-equity swap with the size of RMB 1 tr – in order to stabilize SoEs capital base – was discussed. On October 10, China detailed plans for the debt-equity swaps, which will be available for companies with "temporary difficulties" but not for "zombie enterprises". However, press reports also highlighted that most recently party cells were given more say within every SoE, contradicting the basic target of giving market forces more influence.

All in, it seems fair to say that a comprehensive SoE strategy has still to take more shape. Key sign posts will be progress in rebalancing the economy towards more private consumption, structural reforms (capacity reduction, SoE consolidation, debt-equity-swaps) and to strengthen banks' capital base. Eventually, China needs to tune down its debt-financed growth strategy, i.e. to scale down the high growth targets to more realistic levels. Moreover, Beijing has to tackle the problem rather sooner than later, in order to prevent the issue to spill out of control which could result in a hard landing over the medium term. Moreover, a more clearly defined strategy would calm markets and reduce the likelihood of bouts of market mistrust.

[1] There are large differences on Corporate Debt estimates be-tween different sources. SocGen (Restructuring China, 23.5.2016) e.g. puts the figure at 167% of GDP (SoE debt 99%). Others see even higher figures. The BIS recently published a figure of 255% of GDP for total credit to the nonfinancial sector.

[2] Credit overhang is defined by the credit gap, given as the deviation of the credit-to-GDP ratio from trend (using a HP filter).

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