

China's Credit Boom: How Long Will It Last?

Stefano Grancini (38691), Federico Barbaro (42500), Johannes Karge (33099)

China faces a possible credit crisis as indebtedness of households and firms reaches all-time highs. Growth slowed down notably in the beginning of the year and is expected to weaken further. This report analyses the debt situation in China while focusing on the looming private sector indebtedness and its implications for investors.

HIGHLIGHTS

- Non-financial sector debt levels at all-time high
- China's household sector debt is about to double in 2024 since 2014
- The corporate sector built up large over-capacities creating a substantial drag to future growth
- Investors should stay away from metallurgy, zombie firms and SOEs and consider Chinese government bonds as they are the upcoming safe-haven asset

I. INTRODUCTION

China's total firm, government and household debt rose to 303 per cent of GDP in the first quarter of 2019, accounting for a total of 15 per cent of global debt. With 6.2 per cent in the second quarter 2019, economic growth slowed to the lowest level seen in 27 years, as demand at home and abroad weakened in the face of the country's trade conflict with the US.¹ Latest IMF projections expect a further decline in the coming years, with about 5.5 per cent in 2024. Within this situation, the non-financial sector faces the highest and most fragile debt burden so far, representing a major concern for the country's economic prospects.

In addition, the usually low level of household debt have increased steadily over time. It reached an all-time high of 56.2 per cent of GDP this year and is expected to amount to 67.9 per cent in 2024. Given that disposable household income is steady, this should be a major concern. Consequently, household savings, which used to be as high as 38 per cent of disposable

¹<https://www.reuters.com/article/us-china-economy-debt/chinas-debt-tops-300-of-gdp-now-15-of-global-total-iif-idUSKCN1UD0KD>

income, decreased by eight percentage points today and will decrease even further to 25 per cent over the next five years. Corporate debt peaked in 2016 at 140 per cent of GDP, and will stabilize at lower, yet high, levels in the coming years. China's government debt is low, around 40 per cent of GDP this year, and might reach levels of 50 per cent in the next five years. The surplus of the Chinese trade balance, once heavily criticized, is expected to stabilize at levels below three per cent of GDP.

II. CHINA'S ECONOMY TODAY

The Chinese economy grew by 6.5 per cent last year, the lowest rate since 1990. However, also internally there are growing signs of fragility, mainly circled around the increasing debt levels of households and firms and massive over-capacities. In December, the industrial sector contracted for the first time in two and a half years, according to government data published last week.² The Purchasing Manager Index (PMI) has fallen far below forecasts - to 49, 4 - indicating that manufacturing performed worse than in the previous month. In contrast, the service sector gained 7.7 per cent compared to last year. However, it is yet unclear how a sector which is mostly composed of software and business service companies, can keep up such high growth rates while the industry is in downturn. The current trade war also showed negative impacts: in 2018 exports increased only by 7.1 and imports by 12.9 per cent, compared to 7.9 and 15.9 percent in 2017.³

However, the most worrying signs come from consumption data. Although retail and online still keep flourishing, car purchases, traditionally an indicator of demand dynamics, are in sharp decline. According to data from Oica (International Organization of Motor Vehicle Manufacturers) and Caam (the Association of Automotive Manufacturers in China), the number of car registrations amounted to 28.1 million in 2018, 2.8

²<https://www.ispionline.it/en/pubblicazione/cina-quanto-e-stretto-il-nodo-del-debito-23274>

³<https://www.bloomberg.com/graphics/2019-us-china-trade-war-economic-fallout/>

percent less than in the previous year. This is the first decline since 1990 in the world's largest auto market.⁴

III. DEBT ACCUMULATION, OVER-CAPACITIES AND THE SITUATION IN THE NON-FINANCIAL SECTOR

The non-financial sector domestic credit-to-GDP ratio was stable at around 135 percent before the Great Financial Crisis but increased steeply over the last decade to about 235 percent in 2016. Consequently, the credit gap - the deviation of the credit-to-GDP ratio from its historical trend - amounts to about 25 per cent of GDP, which is well above the 10 percent threshold for the maximum counter-cyclical buffer as suggested by the Bank for International Settlements. Overall, the debt of the non-financial sector grew by 3.5 percentage points of GDP in 2017 and 2018. This is relatively slow compared to the previous decade as debt accumulation by the government and households was partially offset by deleveraging in the corporate sector. In contrast, the first quarter of 2019 saw a steep pick-up in debt accumulation driven by monetary policy easing measures. Household debt grew by one and corporate debt by three percentage points during that time.

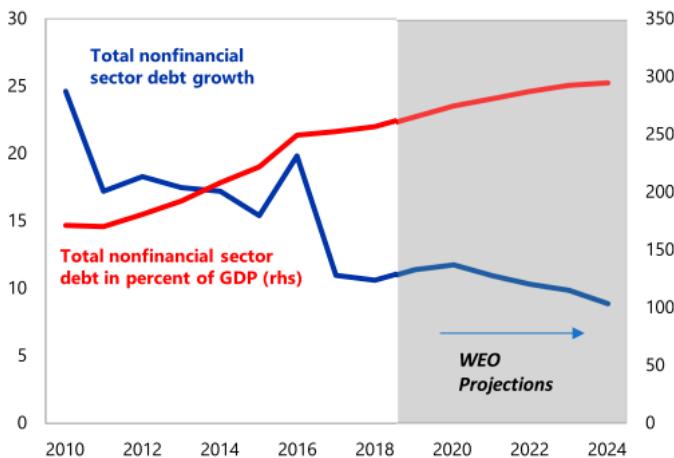


Fig. 1: Non-financial sector debt to continue increasing in 2019 (percent of GDP)

Source: IMF (2019)

In addition, the efficiency of the credit created deteriorated since 2013, which comes along with negative effects on resource allocation and future growth by pushing debt levels higher and causing the built-up of industrial over-capacities - mostly in the sectors

⁴See footnote 2.

of steel, aluminium, coal, plated glass and cement.⁵ Around RMB 6.5 trillion of new credit were needed to raise nominal GDP by about RMB 5 trillion per year in 2007-08. In contrast to that, it took more than RMB 20 trillion of new credit in 2015-16 for the same nominal GDP growth. Last year, China's economy was left with extensive over-capacities, as eleven per cent of factories produced on average 20 percent more goods than markets demanded.⁶ Corporate debt reached a peak of 136 per cent of GDP in 2016, declined thereafter and will stabilize around 124 per cent in the coming years. SOEs accounted for over half of all China's corporate debt, but only contributed to 22 percent of China's total GDP in 2016.⁷ Specifically, if credit is issued to unprofitable firms, this contributes to bubbles (e.g. in real estate), and hampers productivity growth by preferential credit provisions to SOEs and other government-supported entities. 25 per cent of Chinese corporate debt was at higher risk in 2018, since it has been issued to overcapacity sectors or zombie firms. If the trade war with the United States intensifies further, this could lead to further monetary expansion as well as an increase in useless and inefficient public investments as a short-term solution to stimulate economic growth, given the country's industrial over-capacity problem.

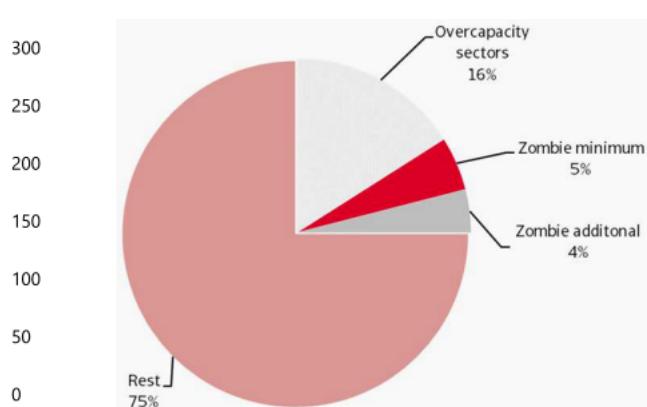


Fig. 2: Composition of corporate debt in percent of total 2018

Source: Frankena et al. (2019)

There is a massive re-nationalization by local governments of previously privatized companies, a phenomenon already present between 1999 and 2007, but increasing since 2014, with negative consequences on profitability and productivity. All these problems

⁵<https://fas.org/sgp/crs/row/RL33534.pdf>

⁶<https://chinapower.csis.org/china-face-looming-debt-crisis/>

⁷See footnote 6.

contribute to a weakening of China's corporate sector which carries a massive burden of debt. As the corporate sector started deleveraging since 2016, private firms were hit especially hard - mainly because their funding relies heavily on the country's extensive shadow banking sector. Shadow banks - an alliance of fund managers, trust companies and loosely regulated finance firms - lowered their activity and decreased from 87 per cent of GDP at the end of 2016 to 70 per cent in September 2018. Since private companies are the driving force of Chinese growth and job creation, deleveraging has worsened the economic slowdown.

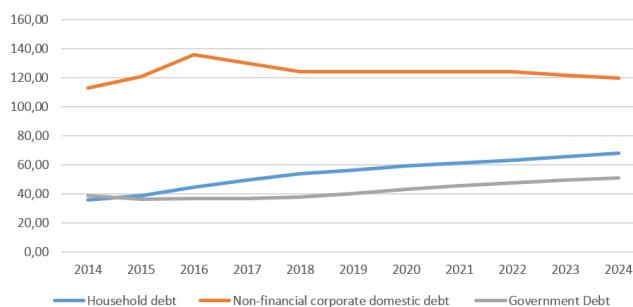


Fig. 3: Chinese household, corporate and government debt with projections (per cent of GDP)

Source: IMF (2019)

Regarding Chinese household debt, the picture is similarly dramatic. As 80 per cent of household debt is financed at flexible interest rates, Chinese households are more vulnerable to interest rate changes and business cycle movements. This applies particularly to young people living in cities. Moreover, it might exacerbate an economic slowdown, as a sluggish economy worsens disposable income. Hence, a higher income share is required to service the debt, which reduces household consumption. Within this context, levels of household debt have increased steadily since 2014 from 35.8 to 56.2 per cent of GDP this year. Even though, this is below the global average of 62 per cent, its pace of growth should be of concern. The IMF noted that the country's household debt levels are now at the high end for emerging markets.⁸ Moreover, Moody's reported that "China's household leverage often flies under the radar, but it should not."⁹ In 2024 household debt is expected to amount to 67.9 per cent of GDP.

⁸<https://www.bloomberg.com/opinion/articles/2019-01-22/china-s-rising-consumer-debt-is-weighing-on-spending>

⁹<https://www.moodysanalytics.com/-/media/article/2018/global-debt.pdf>

At the same time, disposable income of households did not grow over the last years, remaining stable at around 60 per cent of GDP.

China's government debt is low, around 40 per cent this year, and might reach levels of 50 per cent in the next five years - very low numbers compared to Western standards. The Chinese trade balance, once heavily criticized due to a massive surplus, is expected to stabilize at levels below three per cent in the future.

As the corporate sector faces massive structural problems and households are taking on more and more debt, the quality of credits has deteriorated over the last years. Together with one quarter of corporate debt at risk, the Chinese non-performing loans ratio has been rising over the last years with another jump in the last year. Even though the other two macroeconomic sectors, government and trade, look less worrisome, the financial development of households and firms represents a major risk for the country's macroeconomic stability.

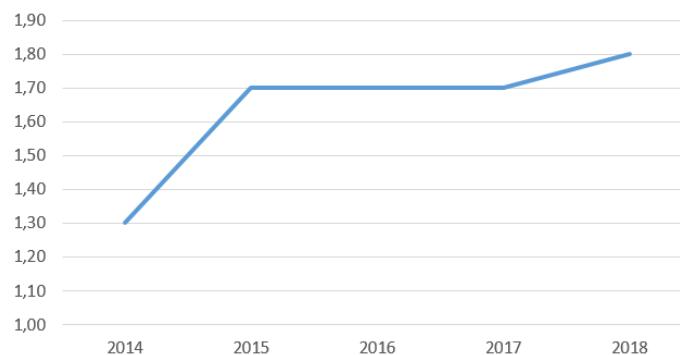


Fig. 4: Non-performing loans ratio (in percent)

Source: IMF (2019)

IV. CHINA'S FINANCIAL SECTOR

Together with household and corporate indebtedness, the constitution of the financial system is a major concern for the Chinese economy. Official banks, shadow banks and the four major asset management companies in China hold approximately \$ 1.4 trillion of bad debts; a figure destined to grow in the coming years, with the slowdown in economic growth and the decrease in corporate profits. Chinese asset managers, as in many other countries, have purchased a large number of distressed debt portfolios. If they fail to sell them quickly and recover the money, they could face liquidity risks when their short-term loans expire.

In 2017 the government reduced banks' capital ratios to ease financial access. However, this policy did not work and credit access did not improve. In fact, in January 2019 Chinese state-owned banks increased the interest rate for credits. At the expense of loans to private companies, however, the share of new bank loans of government-owned companies rose from 30 per cent to 70 per cent.¹⁰ A situation that has led many private companies to increasingly turn to shadow banks. In addition, funding for public investments is often engulfed by wasteful projects and inefficient state-owned companies that tend to slow down productivity growth. However, for a private investor the access to the credit is still accessible, and the risk is not likely to rise too much, even if the control of the government will remain strong.

V. CONCLUSION

The Chinese economy faces many headwinds in 2019, ranging from trade conflicts to domestic debt problems and structural issues. As shown above, firms are vastly indebted and the household sector has doubled its indebtedness in only a few years, with a stagnating income and a decreasing share of savings. Companies built up massive over-capacities and this contributes to resource misallocations as well as it fuels a growing mountain of risky assets in the banking sector, as these investments rely on credit finance. This alone could cause the next turmoil in the Asian economy, but a vast shadow banking system makes the country even worse off to combat slowdown.

For engagements in the industrial sector, investors should stay away from metallurgy-related business, given the previously mentioned over-capacity problem and the fact that their debt-to-asset-ratio rose at an alarming in the last years, amounting to 75 per cent today.¹¹ In addition, investing in China means carefully selecting not just the sector but also the very company. SOEs and zombie firms are to be avoided due to their unclear debt ratios and uncertain ties to the shadow banking system. Moreover, caution should also be applied to consumption goods producing firms, as they possibly will face headwinds soon due to the US-China trade war affecting consumer's confidence and the fact

¹⁰<https://www.ispionline.it/it/pubblicazione/cina-quanto-e-stretto-il-nodo-del-debito-23274>

¹¹Molnar, Margit and Jiangyuan Lu (2019): *State-owned firms behind China's corporate debt*, OECD Economics Department Working Papers, No. 1536, February.

that overall households are highly indebted and might step up attempts towards deleveraging soon.

We see Chinese government bonds as a safe, yet profit-strong option to stay invested in the Asian economy as they currently provide a yield of 3.16 per cent.¹² Even more, Chinese government bonds are likely to become a new safe-haven asset. With future disruptions and a possible recession in the US in foresight, diversifying also in terms of sovereign bonds becomes increasingly important.¹³ As authorities are more and more opening up the government bonds market to non-Chinese investors and demand for this asset class is considered to keep on growing, this option appears attractive - also given it provides an insurance against strong volatility in other markets of the world.¹⁴

Alternatively, investors who are seeking higher yield assets could buy into the non-floating interest rate coupon bonds of two major state-owned policy banks: Agricultural Development Bank of China and China Development Bank. Bonds issued by the ADBC are considered as secure as PBOC bonds, since they are fully backed by this institution and debt issued by the CDB is guaranteed in full by the central government of China.¹⁵ The first offers a current coupon rate of 4.16 per cent and the latter 4.20 per cent, both with semi-annually coupon frequencies.¹⁶ Furthermore, the policy move that bonds issued by these banks were brought under regulators' administration on interbank investment adds confidence to buy into these assets.¹⁷

REFERENCES

- [1] Chen, Sally and Joong Kang (2018): *Credit Booms - Is China Different?*, IMF Working Paper, No. 18/2, January.
- [2] IMF (2019): IMF Country Report No. 19/266, August.
- [3] Tang, MK, Yu Song, Zhennan Li, Maggie Wei and Andrew Tilton (2019): China 2019 outlook: Testing resilience, *Goldman Sachs Economic Research*, November 2019.
- [4] Frankena, Greetje, Dana Bodnar and Bert Burger (2019): Private debt in US and China could amplify costs of the trade war, *Atradius Economic Research*, July 2019.

¹²<https://tradingeconomics.com/china/government-bond-yield>

¹³<https://www.home.saxo/insights/content-hub/articles/2019/03/04/why-chinese-government-bonds-are-crucial>

¹⁴<https://www.cnbc.com/2018/09/04/chinese-bonds-a-safe-option-amid-trade-war-investors-say.html>

¹⁵<http://cbonds.com/organisations/emitent/19527>,
<http://cbonds.com/organisations/emitent/30757>

¹⁶<http://cbonds.com/emissions/issue/463439>,
<http://cbonds.com/emissions/issue/25081>

¹⁷<https://www.reuters.com/article/china-interbank-bonds/update-1-china-government-bonds-rally-after-regulator-moves-to-restrict-some-bond-investments-idUSL3N25P22V>