China's *Faustian* Bargain

An extraordinary debt bomb?

BY CHI LO

Worries about China's debt blow-out, which would potentially send shockwaves across the global economy, have emerged again, with many financial market players and the Bank for International Settlements warning that China's private sector credit growth has accelerated to a potential crisis point.

Yet China's "credit bomb" has not gone off despite decades of similar expert warnings. Indeed, China is still many years away from a potential debt/banking crisis for several good reasons. The true concern is whether Beijing is entering into a Faustian bargain that trades the short-term gains of limited economic growth today for the long-term pains of diminishing investment returns tomorrow.

China's debt problem does not stem from its household and public sectors (their debt stood at 35 percent and 44 percent of GDP, respectively, in 2015); it stems from the corporate sector. Bank for International Settlements data show that China's non-financial sector debt grew at an annual rate of 18.1 percent between 2010 and 2015 to more than 160 percent of GDP, a level that was even higher than that of the United States. While state-owned enterprises were the major borrowers, many private-sector property developers were also among the most highly leveraged Chinese companies.

CHINA'S PRIVATE-SECTOR DEBT

Many analysts associate China's private credit with corporate debt and define China's total private credit as bank credit plus corporate bonds. Some have argued

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that China's private credit has grown larger than that of the European Union and that the situation had gone out of proportion since China has much lower per capita income than the European Union. However, this commonly used definition of China's private credit is wrong.

About 60 percent of Chinese corporate bank loans are extended to the state-owned enterprises and about the same share, if not more, of the so-called corporate bonds are issued by the local governments and their financing vehicles. True private-sector credit, as approximated by bank loans to the small- and medium-sized companies, has been stuck at around one-third of total bank lending, despite years of official rhetoric about expanding private-sector loans. The share of private credit is higher if one includes shadow bank lending, and this is where the true financial stress lies; but it is not yet fatal.

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The problem with analyzing China's corporate debt is the confusion between its private sector obligations and it public sector debt. The definitions are indeed iffy. In China, a large share of company borrowing that is often counted as private sector is actually lending to the state-owned enterprises and their affiliates that enjoy implicit guarantees. These are not really private debt. One may argue that debt is debt and it does not matter whether it sits on the private or public sector's balance sheet. However, the distinction is crucial when it comes to assessing the risk of systemic defaults. These are far less likely when the bulk of the debt is owed by the public sector with its strong balance sheet, as is the case in China. One should allow for the implicit guarantee distortion in most "private" debt when assessing China's credit problem.

MIND THE CREDIT GAP

The BIS data also shows that China's corporate debt has risen above its long-term trend by 30 percent of GDP in 2015, creating a large gap between actual and trend growth. Its research argues that a credit gap of more than 10 percent of GDP would sharply increase the odds of a country's financial crisis. However, even if one accepts the BIS estimate at face value, the credit gap is not a reliable crisis predictor.

There were countries that fell into a financial crisis with a credit gap of less than 10 percent of GDP, such as the United Kingdom (with a credit gap of less than 10 percent in the years before the 2007–2008 Great Financial Crisis) and South Korea (with a gap of only 5 percent of GDP in the run up to the 1997–1998 Asian financial crisis). On the other hand, some economies avoided a financial crisis with a credit gap of more than 10 percent of GDP, such as Australia in the years around 2006 and Hong Kong around 2011.

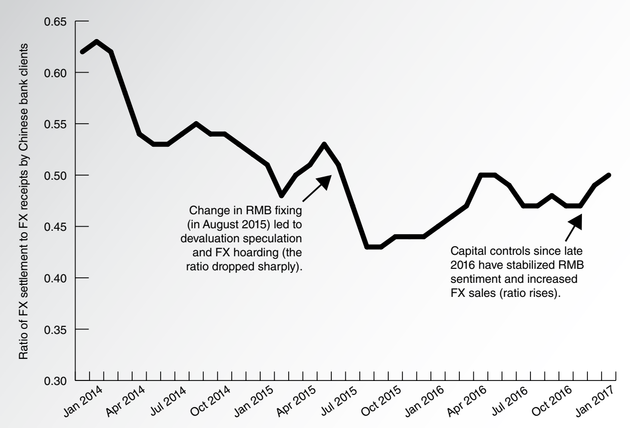
WHAT IS HOLDING CHINA TOGETHER?

All this is not to deny China's debt problem. Financial stress has risen as GDP and corporate profit growth slow, non-performing loans rise, corporate bond defaults emerge, and capital outflows increase. Still, a full- fledged debt-currency crisis remains a remote possibility in China at this stage. The key reason is a combination of capital controls (which allow Beijing to use monetary easing to reduce debt default pressure and prevent a systemic crisis without suffering massive capital flight) and a tiny foreign debt.

CAPITAL CONTROLS

Contrary to conventional wisdom, China's capital controls have been effective, as the major outflow drivers of Chinese banks' foreign lending and companies' overseas direct investment are easy targets for controls. Notably, foreign mergers and acquisitions of US$10 billion or more have been banned since later 2015, while all overseas direct investment applications have been subjected to increased scrutiny. Other control measures include curbing mainland Chinese buying insurance and property in Hong

Bank clients' FX settlement to FX receipt ratio



Sources: CEIC, BNPP IP, Asia

Kong, upping foreign exchange disclosure requirements, increasing scrutiny on onshore individual foreign exchange transactions, and asking Chinese banks to stop processing cross-border yuan payments until inflows and outflows are balanced. Crucially, there has been no evidence of capital flight, as there has been no loss of local renminbi deposits.

These measures have reduced capital-outflow incentives, as seen in the rise in the ratio of foreign exchange settlement to foreign exchange receipts by Chinese bank clients (see figure). This ratio reflects an increase in the percentage of foreign exchange actually sold in the market out of foreign exchange receipts, and thus indicates that domestic players intended to sell more foreign exchange and hold more renminbi. Balance of payments data also shows that net foreign direct investment inflows resumed in the last quarter of 2016 after net outflows in the previous quarters. These are all signs of effective capital controls.

FAVORABLE DEBT DYNAMICS

There are other factors that mitigate China's debt explosion risk. The government owns a substantial stake in the banking sector and some of the largest and shakiest state-owned enterprises and corporate affiliates. This makes it possible to push for large-scale debt restructuring without setting off a systemic shock. Moreover, the corporate sector is cash-rich, with an estimated aggregate holding of US$1 trillion in 2016. Even though companies' funding conditions differ significantly, these cash reserves would facilitate industry consolidation through mergers and acquisitions and, thus, reduce systemic default risk.

Crucially, China's debt is funded by domestic savings in local currency. This makes the debt much more stable than debt in countries that rely on foreign savings. Indeed, research shows that domestic debt in local currency offers a far wider range of policy options to contain the problem than does foreign currency-denominated external debt. The government can use financial repression to keep debt servicing costs low and push debt into public pension funds and insurance companies through regulation. It can also inflate the country out of debt. Indeed, a mix of financial repression and inflation can be a potent way of reducing domestic-currency debt.

I am not arguing that these would be the right policies to deal with China's debt problem. But they highlight the point that the array of policy options is much wider for local-currency debt funded by domestic savings than for debt financed by foreign savings. At the time of writing, China's total foreign debt is about US$1.4 trillion, or less than 15 percent of GDP. It has more than US$3 trillion in foreign exchange reserves, implying a foreign exchange-debt coverage of over 200 percent (compared to the 100 percent safety threshold deemed by the international community).

The BIS raised a similar warning about China's debt crisis in 2012, when it argued with international experience showing that a financial crisis would follow when there was a fast run-up in a country's private-sector debt service ratio to above 25 percent of GDP a year. And China's ratio was estimated at more than 35 percent in 2013. But four years since the last BIS warning, nothing to that extent has happened because of China's stable debt dynamics and its implicit guarantee policy, relatively closed capital account, and slow pace of financial liberalization.

WHAT TO DO WITH DELEVERAGING?

In the short term, swift large-scale deleveraging is not plausible if Beijing wants to keep stable GDP growth. This is because China's total credit growth has outpaced nominal GDP growth by an average of six percentage points since 2006. If Beijing were to bring down the debt-to-GDP ratio, credit growth would have to fall by more than six percentage points relative to nominal GDP growth. Given excess capacity, weak exports, and a structural reform drag on growth, this sharp fall in credit growth would crush the economy before the benefits of deleveraging could materialize.

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In the medium to long term, Beijing will have to use a mix of deleveraging strategies, including debt restructuring, genuine debt-equity swaps (not the ones that it is implementing) and write-offs through bankruptcy of zombie companies, and austerity measures by cutting local government borrowing and excess capacity to diffuse the danger of a debt-bomb explosion over time. The policy challenges are, first, to prevent deleveraging from creating excessive deflationary pressure on the economy, and second, to improve credit allocation to support structural reforms. Overcoming these challenges will allow the corporate sector to achieve organic deleveraging by improving operational efficiency.

THE TRUE RISK

Although the risk of a debt blow-up is low, the structural risk to the system is subtle. Gradualism as a debt clean-up strategy may make sense in the short-term. The question is this: In the longer-term, will Beijing bite the bullet to resolve the debt problem?

"Kicking the can down the road" is unsustainable in the long term because gradualism only trades today's growth through continued capital misallocation for tomorrow's economic efficiency. Growth will eventually suffer under the debt mountain. Bad debts will rise, prompting banks to siphon off a lot of capital to stay afloat under the implicit guarantee policy and eschew private-sector lending which is seen as risky in a weak growth environment. The government will respond with more fiscal spending to support demand. But this will reduce investment efficiency and, hence, returns on capital, prompting private investment to shrink further.

The message is clear. The longer Beijing avoids dealing with the debt problem, the harder it will be to manage a shock, as the potential fallout will become more serious over time. Initial signs show that Beijng still deserves the benefit of the doubt in its deleveraging strategy, as the recent surge in bankruptcy cases indicates both economic stress and progress in its efforts in dealing with indebted zombie companies and excess capacity.

Official data shows a 54 percent year-over-year jump in bankruptcy cases accepted by Chinese courts in 2016 to 5,665 cases. Sixty-four percent of these were resolved, with 85 percent of the resolved cases resulting in liquidation. This is a sign of Beijing retreating from its implicit guarantee policy, albeit still very slowly because it is still using "stealth" measures, notably debt-equity swaps and public-private partnerships, to keep many insolvent firms afloat. The International Monetary Fund estimates that the real bankruptcies in China could be 100 to 250 times more than the official insolvency data suggests.

Time will tell if Beijing will bite the bullet later. Let's hope it is not entering into a Faustian bargain to trade short-term gains for long-term pains. ◆