China Deleveraging: Domestic and Global Impacts

A multiyear path to reduce financial risk and improve credit allocation.

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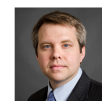

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KEY INSIGHTS

- Deleveraging returned in 2021 as a key focus of China's economic policy, with a multiyear strategic aim of controlling the debt-to-GDP ratio.
- For China, deleveraging means a period of slower economic growth and larger external surpluses, with short-term costs followed by lower but higher-quality growth.
- For the rest of the world, China deleveraging means fewer growth opportunities. It is unlikely that China will drive another commodity "supercycle," for example.

China's focus on deleveraging began in earnest in 2017. After an interruption last year due to the pandemic, it returned in 2021 as a key focus of economic policy. We view China's deleveraging campaign as a multiyear agenda with the strategic aim of controlling the country's debt-to-gross domestic product (GDP) ratio. It marks a sea change of policy by the Xi Jinping administration that will impact the Chinese domestic economy and financial markets significantly in the years ahead. It is also a relevant theme for international investors given the importance of China to the global economy, with a broad potential to impact asset classes and regions, especially in Asia.

In this Insights, we look at the origins of China's debt issues, why Beijing came to regard deleveraging as a critical objective to be pursued even at the cost of lower economic growth, and assess the progress that is being made. In analyzing deleveraging, we focus both on the financial system, such as the commercial banks and shadow banking, and on end borrowers, particularly government-related entities (GREs) such as state-owned enterprises (SOEs) and local government financial vehicles (LGFVs).

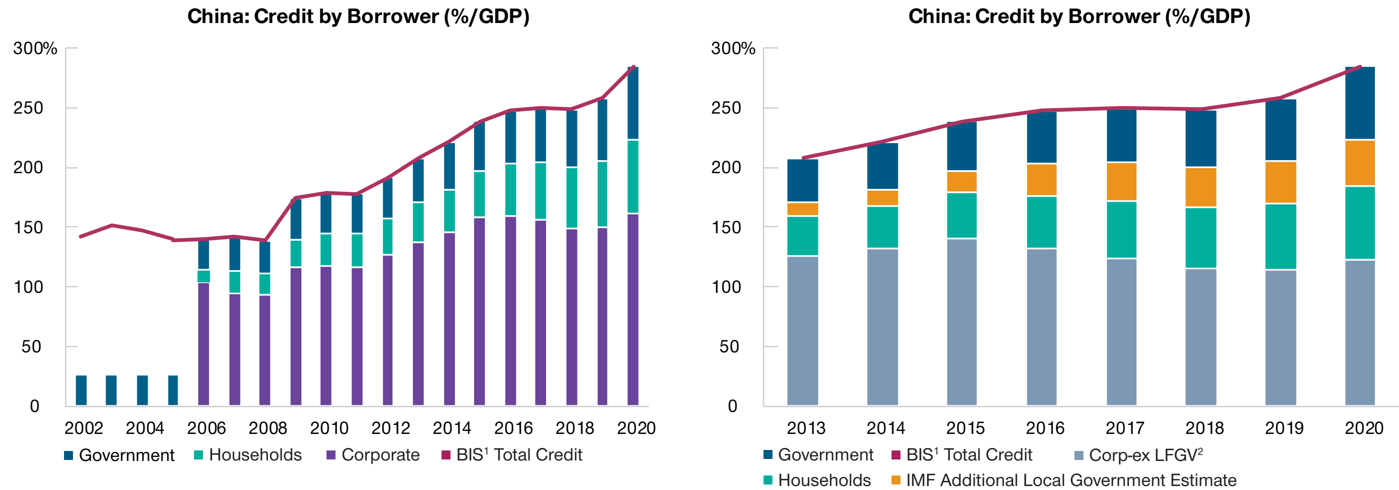
Among private sector borrowers, we consider the property sector, which came under the spotlight following liquidity problems and financial stresses at several highly leveraged residential developers that led to several defaults in the offshore USD bond market. Having examined the impact of deleveraging on China's financial system, we briefly consider its macroeconomic implications, such as slower growth, higher domestic savings, and larger external surpluses.

Leverage Surged After the Global Financial Crisis

Figure 1 shows that China's credit-to-GDP ratio surged after the massive fiscal stimulus introduced in response to the global financial crisis.

China's Rising Leverage Over Time

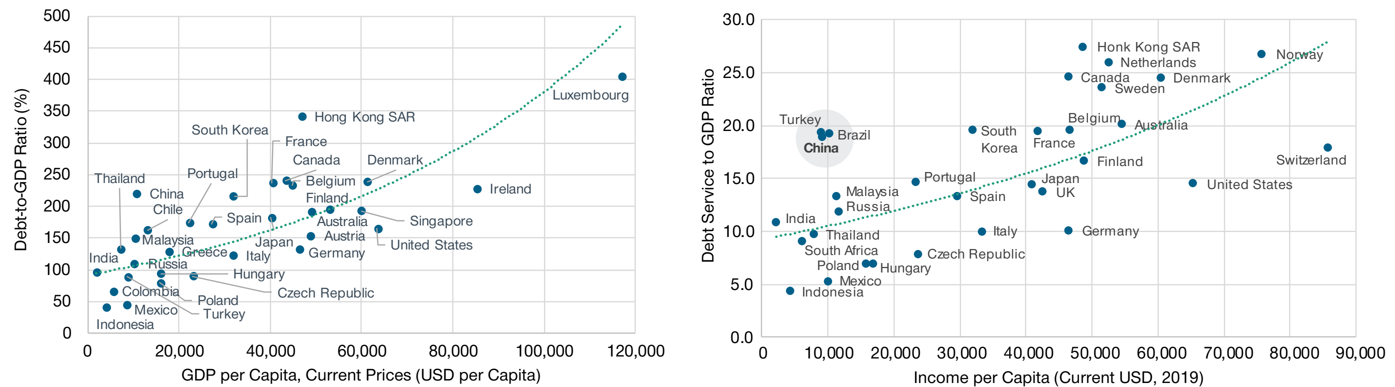
(Fig. 1) Deleveraging stabilized credit before the pandemic caused a jump in 2020



As of December 31, 2020. Most recent available annual data.
Source: BIS/Haver Analytics.
[1] BIS = Bank for International Settlements
[2] LGFV = Local government financial vehicles

China's Leverage High in an International Context

(Fig. 2) Debt level and debt service look high for China's relative per capita income



As of December 31, 2020 (debt-to-GDP), and December 31, 2019 (debt service). Most recent available data.
Sources: BIS/IMF/Haver Analytics, plus T. Rowe Price calculations.

It later stabilized over 2017–2019, thanks to President Xi's deleveraging campaign, but unsurprisingly jumped in 2020 after the exceptional policy measures to counter the coronavirus pandemic. By December 2020, this aggregate measure of leverage had risen to 285%, far above that of other emerging market economies (Figure 2). China's credit-to-GDP ratio lies closer to that of a developed economy, although at a much lower level of per capita income, which ultimately is the bedrock upon which debt repayment capacity must be based.

Figure 1 reveals a change in the composition of debt by sector in the past. Corporate leverage (including SOEs),

Financial stability is increasingly seen by China's leaders as a policy objective....

the sector of most concern initially, stabilized at a high level. In contrast, both household and government debt (including LGFVs) relative to GDP has continued to rise. Thanks to the downward trend in interest rates, China's debt service burden has been broadly stable since 2015. So like Japan before it, lower interest rates in recent years enabled China to increase its macro leverage without encountering higher debt service costs.

From Figure 1 it is very clear that—apart from 2020—China has already done a lot to restrict the growth in macro leverage since 2016. For many, it is the sudden surges in the debt-to-GDP ratio where the greatest systemic risks lie, rather than in a high but stable debt level. The delta or change in the credit ratio has historically been a better predictor of financial risks and stresses than the overall level. On this basis, one might argue that China's credit boom peaked around 2015/2016, with private sector leverage broadly stable in 2019. The year 2020 brought a temporary but warranted setback in macro leverage due to the coronavirus shock.

We believe that investors should not underestimate the commitment of the Xi Jinping government to tackle China's growing financial sector risk by continuing to stabilize the debt-to-GDP ratio while also gradually improving the allocation of domestic credit over time. In 2017, President Xi declared that "Financial stability is the basis of national stability." Coming shortly after his declaration that "Houses are for living in, not speculation," Xi's statement in 2017 marked a major turning point for China. From the government's recent actions during China's post-pandemic recovery, one might reasonably conclude that the era of debt-fueled all-out economic growth pursued by previous leaders, including Presidents Jiang Zemin and Hu Jintao, is over.

China's western critics have long pointed to the debt-driven era of ultra-rapid growth as a high-risk development strategy. In 2007 when China's debt-to-GDP ratio was less than half of its current level, Premier Wen Jiabao famously said that the country's economic growth trajectory was "unstable, unbalanced, uncoordinated, and unsustainable." We believe that President Xi recognizes the need for China to continue to deleverage, with the end result likely to be somewhat slower, but more sustainable, higher-quality economic growth. Deleveraging will continue to be guided by Vice Premier Liu He, President Xi's closest economic adviser. It is unlikely to be a straight line process over the medium term, as China will not sacrifice growth at any cost. It may be a case of two steps forward, one step back. For example, we might see some moderate policy easing next year if China's GDP growth continues to slow in the fourth quarter of 2021, following a disappointing set of third-quarter numbers.

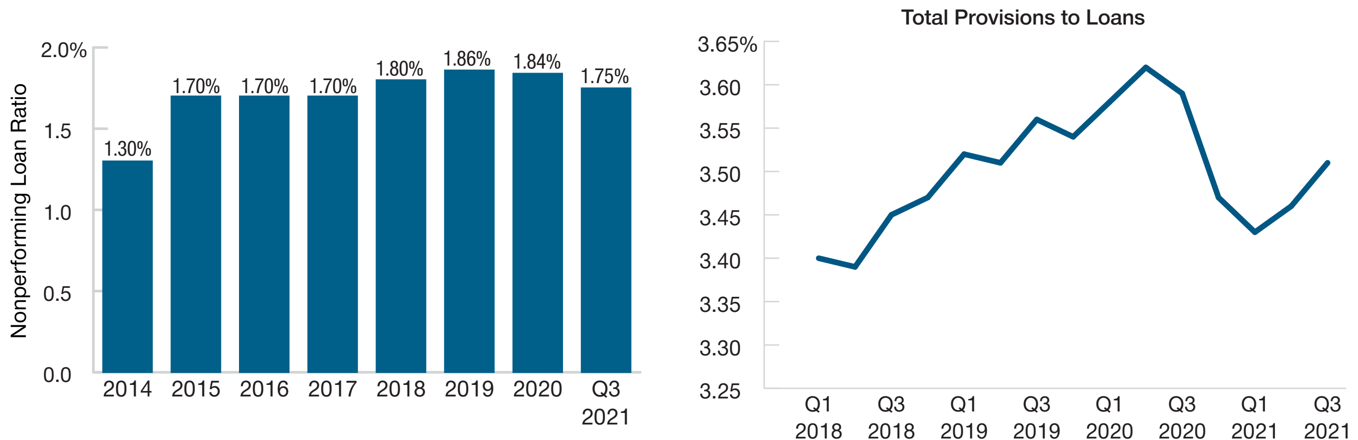
Deleveraging Focus on the Financial System

We believe that a key objective of the deleveraging campaign for China's financial system is to revert to a simpler, better-capitalized banking sector capable of delivering a more efficient allocation of credit via better risk pricing (though government window guidance on credit allocation is expected to continue). If China is to achieve high average growth without rising leverage, then efficient credit allocation is vital, especially in the light of poor demographics and a declining labor force.

Financial stability is increasingly seen by China's leaders as a policy objective that is crucial for a healthy Chinese economy and which is also important for national security. It has many aspects, such as improving capital buffers, reducing large duration mismatches and the scope for regulatory arbitrage, relying more on efficient credit allocation than quantitative targets, and encouraging institutional investment vehicles over retail manias, to name a few. Key steps in the recent reform of China's financial

Some Progress Since 2016 in Bank Deleveraging

(Fig. 3) Pre-pandemic, nonperforming loans stabilized while provision buffers increased



As of September 30, 2021.
Source: Haver Analytics/China Banking Regulatory Commission.

> “...China’s financial authorities have worked steadily...to..reduce risks in the banking system....

regulatory system include the merger of the banking and insurance regulators into the combined China Banking and Insurance Regulatory Commission (CBIRC) in 2018. This has produced more unified guidance for financial institutions while also reducing the scope for regulatory capture/arbitrage. Another landmark step was the creation in July 2017 by President Xi of the Financial Stability and Development Committee (FSDC). At the pinnacle of the deleveraging campaign, the committee is headed by Vice Premier Liu He and is tasked with overseeing major reforms for the financial sector, coordinating with the regulators and with other government bodies on issues concerning monetary policy, fiscal policy, and industrial policy.

Bank lending lies at the heart of China’s (nonmarket) financial system. This will continue to be the case. In our view, any challenges that threaten the status of China’s banks, such as the Ant Financial IPO in November 2020, will not be permitted. It is an underappreciated fact that China’s financial authorities have worked steadily since 2016 to gradually reduce risks in the banking system, with some success. We have seen an increased pace of nonperforming loan (NPL) disposals and write-offs, NPL recognition has gradually tightened, and provision buffers have increased. The preferred strategy has been for Chinese banks to gradually digest their NPLs over time and thereby “earn” their way out of the problem.

Within the banking sector, the biggest financial risks at the institutional level lie with the smaller banks following an earlier period of all-out expansion. This remains a vulnerability today, as smaller banks, particularly the rural financial institutions, face higher NPLs and weaker capital buffers. The rescue of Baoshang Bank in June 2019 raised the funding cost of bank capital instruments at China’s smaller banks. In its annual survey of over 4,000 banks and nonbank financial institutions, the People’s Bank of China ranked 2%/10% of institutions by assets/number as high risk. China’s smaller banks do not pose a systemic threat, as “red zone” banks (most at-risk banks) only account for 2% of total banking assets, or about 1% of GDP, so that recapitalization costs are manageable.

Turning to shadow banking, this is a relatively new part of the Chinese

financial system that has attracted a great deal of concern and attention in recent years among overseas investors. It was tolerated initially, but rampant growth and unabashed regulatory arbitrage soon worried the authorities, and the sector peaked in 2016 after strong regulatory action. We have seen a reconsolidation of financial assets back onto bank balance sheets. Shadow banking in its present form is likely to remain under pressure and to shrink further over time, greatly reducing its potential as a source of systemic risk. Trusts—once leading promoters of shadow banking—have seen their role shrink over time.

The share of total banking assets controlled by China's big five state banks and policy banks has fallen to around 50% from 60% to 70% before the global financial crisis. With the diversification to a broader set of banks, we have also seen asset management companies (AMCs) rising to become the second-largest group of financial intermediaries. The "Asset Management Guideline" released in April 2018 has been a key regulation in taming shadow banking activity over the last few years by discouraging wealth management financial products in favor of less risky net asset value-based products such as mutual funds, which are seeing strong growth as China's asset management industry matures.

China's reliance on external debt is relatively limited, and foreign institutions, in general, have had a limited presence in China. This is now changing following recent financial reforms, and there are good opportunities open to foreign financial firms to expand their presence in China.

Deleveraging Focus on End Borrowers

The health of China's financial institutions only represents one side of deleveraging risks; the other side is the repayment capacity of end borrowers.

Here, we look at two important groups of borrowers—GREs (including SOEs), LGFVs, and the residential property sector. The health of the latter is particularly important to China given its importance as a pillar industry for the economy; rapidly rising house prices could cause speculative "bubble" conditions and the rapid accumulation of financial risks.

Borrowing by Government-Related Entities

State-owned enterprises were once viewed as borrowers with a voracious appetite that were the major driver of the rise in China's debt-to-GDP ratio. So in the deleveraging campaign that began in 2016, they were given targets to hit by 2020, often in the form of a liabilities-to-assets ratio. The 97 large SOEs that report directly to the central government generally made good progress in meeting their targets. But the 70,000 or so regional SOEs have performed less well, and many may face greater financial risks today than they did in 2016—in many cases protected by their local government sponsors. So the deleveraging campaign for regional SOEs is ongoing, as it is for LGFVs, and the default rate for SOEs is expected to rise over time. Without a standard framework, SOE defaults have been on a case-by-case basis, with a recovery rate of 25% to 50%. China's high yield (HY) default rate still appears low compared with other HY markets.

In March 2021, Beijing requested banks to no longer lend to LGFVs with high, off balance sheet debt that, in their view, are financially unviable. As a result, markets are waiting for the first-ever LGFV default. While there is a playbook for SOE defaults (such as Hainan Airlines, Anbang Insurance, etc.), how markets will respond to an LGFV default is unknown. The question is not if, but when the authorities will allow such an event to happen, with some expecting a

delay until after the 20th Party Congress in October 2022.

An earlier attempt by former Finance Minister Lou Jiwei to end LGFV borrowing in 2014 was unsuccessful and had to be rolled back, as it caused a sharp slowdown in infrastructure investment. This proved too painful for the Chinese authorities as it threatened economic growth. Policy toward LGFVs was in limbo for a while until the recent push to control funding channels. Going forward, we expect tighter controls over new borrowing to prevent any further rapid buildup in leverage, though total LGFV debt may continue to increase gradually. New LGFV loans can only be project-based, providing an incentive for LGFVs to improve their cash-generating capability.

Over time, we expect GRE borrowers to be subject to greater fundamental credit analysis, with more efficient risk pricing and increased credit spreads. The main problem is that domestic investors have looked through the weak credit quality of many SOEs and continued to fund based on implied/assumed government backing. Because of this, until now, China's credit markets have not played a meaningful role in deleveraging SOEs—leaving regulatory targets as the primary tool (Figure 4).

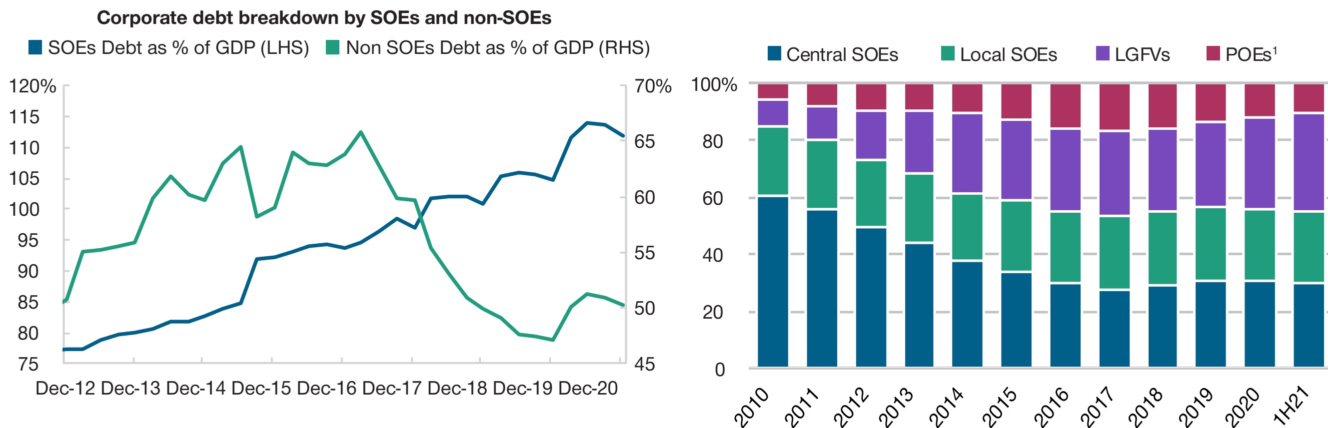
Borrowing by the Property Sector

Recent financial problems at China Evergrande and a small number of other highly leveraged developers were extreme and were not typical of the Chinese property sector overall. Nevertheless, many investors and financial analysts still view the sector with great concern. This is not surprising as, historically, property has been the most significant sector driving China's economic development during the past two decades. As a result, the financial health of the property sector came to be closely linked to that of the financial sector, where the banks' exposure to real estate as broadly defined is large, at around 40%.

Property also accounts for the largest share of household wealth (around 80%), while mortgage loans are the largest share of liabilities. China's household leverage ratio has grown rapidly in recent years. Local governments rely heavily on revenues from land sales, thereby tying their fiscal position to the health of the property sector. Overall, analysts believe the contribution of property investment to GDP may be as high as 20% once construction sector

SOE Deleveraging Has Lagged Privately Owned Enterprises

(Fig. 4) SOEs with better access to funding have been under less market pressure



As of December 2020, estimated by Citi Research in March 2021 based on a study by the Chinese Academy of Social Science.
Source: Citi Research.

As of June 2021.
Source: BofA Global Research.
[1]POEs = privately owned enterprises

…we expect a significant macroeconomic impact from…financial deleveraging.

value added is included with real estate investment and property services.

Markets were surprised with the news that Evergrande had paid the outstanding interest on its USD bond before the October 23 deadline, avoiding default. Together with recent supportive messages from top policy officials like Vice Premier Liu He and from the central bank, it suggests Beijing will do what it can to limit contagion and spillover risks from Evergrande to the broader property sector. In view of the complexity of the case, the authorities may need more time to implement a comprehensive restructuring solution that avoids triggering a cross-default of Evergrande debt.

Going forward, we believe that Beijing will no longer use the property sector in a countercyclical role as an arm of fiscal policy. It will likely adjust policies at the margin, however, in order to prevent the sector from slowing too much. We are seeing this at present, after the People's Bank of China and CBIRC in their third-quarter press release called for banks not to overtighten but to support first mortgages for home buyers. The authorities are very aware that too sharp a fall in house prices could undermine Chinese households' belief in residential property as an asset. Nevertheless, we believe the "three red lines" that restrict developer funding (Figure 5) and the "two red lines" for banks' property funding[1] are here to stay.

While the red line policies restrict property funding channels in the short to medium term, we believe, over the longer term, that they should result in a healthier property sector with lower levels of systemic risk. Property developers will likely become less inclined to hoard land and will likely rely less on presale revenues for funding, while consolidation in a fragmented industry is expected to continue.

Three Red Lines Marks the Start of Property Deleveraging

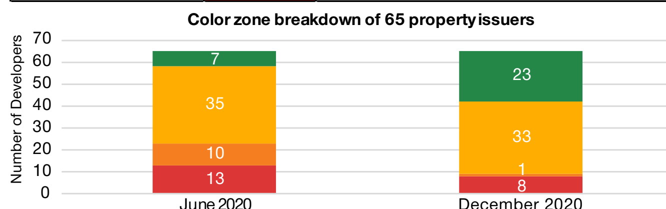
(Fig. 5) Property developers must meet the three targets by June 2023

- The three red lines policy was introduced in August 2020 with 12 developers in a pilot program.[1] Using June 2020 financials as the base, developers need to get all the three metrics compliant in three years (by June 2023).
- In early 2021, there were headlines saying more developers had been included in the program, but there was no official announcement. The top 50 developers, for the most part, have plans to get compliant in time (even if they are not explicitly included in the program), as banks are using the three red lines as a guideline for lending.
- In the second half of 2020, developers already achieved progress in meeting the three red lines requirement. There are 56 out of 65 developers in offshore bond market in the green or yellow zone as of December 2020 (versus 42 as of June 2020).

Financial metrics	Breach trigger	Note
Net gearing	>100%	Defined as net debt / equity with leases excluded from debt and perps as equity
Unrestricted cash / ST debt	<1x	Leases excluded from debt
Liabilities / assets	>70%	Contract liabilities (presales deposit) are excluded from both numerator and denominator

# of red lines breached	Zone	Debt growth allowed per annum
0	Green	15%
1	Yellow	10%
2	Orange	5%
3	Red	0%

Color zone breakdown of 65 property issuers



Sources: Company data and HSBC.
Note: The 12 developers in the pilot program are Country Garden, Evergrande, Vanke, Sunac, Zhongliang, Poly, Seazen (Future Land), COLI, Overseas Chinese Town, Greenland, CR Land, and Ya. **For illustrative purposes only. Subject to change.** The specific securities identified and described are for informational purposes only and do not represent recommendations.

[1] The three red lines for property developers are 1) net gearing must not exceed 100%, 2) ratio of free cash to short-term debt must be less than 1.0, 3) ratio of liabilities to assets must be above 70%. The two red lines for banks are another instrument for restricting leverage in the property sector. On December 31, 2020, the government announced caps for property-related loans (mortgages and construction loans) and, more specifically, for mortgage loans as a percent of total bank loans.

> For the rest of the world, China's financial deleveraging means fewer growth opportunities.

Macroeconomic Implications of Deleveraging

Over time, we expect a significant macroeconomic impact from China's commitment to financial deleveraging. First, for a large economy like China, deleveraging means a period of slower economic growth and larger external surpluses/lower deficits. We believe the Xi Jinping administration understands that there may be short-term economic costs but still prefers to aim for a lower, higher-quality growth trend for China. What is not known is whether a stable debt-to-GDP ratio is compatible with average growth around 5.0%, which may be the lower acceptable bound for Beijing. Since China has recently been contributing up to one-third of global growth, a slower China will imply a notable drag on global growth, both directly and indirectly.

For China's public sector finances, we view one key implication of deleveraging is that the imbalances built into the current system between the limited financial resources directly available to regional and local governments and their much greater expenditure responsibilities must change. Financial stability requires that local governments end their overdependence on revenues from land sales in favor of a national property tax, a long-overdue financial reform. Given that vested interests have long resisted a property tax, while the potential risks increase if it is introduced in a slowing economy, this reform may have to wait until after the Party Congress in October 2022.

The Potential Impact on Emerging Market Economies

For the rest of the world, China's financial deleveraging means fewer growth opportunities. It is unlikely, for example, that China will drive another commodities supercycle. Emerging market (EM) economies have limited scope to increase their share of exports to China, except for some low-value-added products or a few specialized high-value items, such as South Korean or Taiwanese technology exports. EMs could thus find themselves under pressure to develop new growth sources or underperform. We think that one potential growth source is tourism. Once China reopens its borders, outbound tourism to other Asian countries, especially Southeast Asia, is likely to expand rapidly.

More generally, however, as China becomes a richer, wealthier country, it may demand relatively less of what EMs currently produce, switching to more sophisticated, higher-value-added imports from developed economies. This, in turn, is already opening up space in the low-value-added segment and the lower part of the middle-value-added segments for more EMs, particularly frontier markets, to move into. However, none can offer the full package of low wages, infrastructure efficiency, and a favorable business environment that China has offered foreign direct investment investors, which means there is unlikely to be any single winner from this process.

And in financial markets, larger external surpluses as China slows are more likely to be recycled via foreign direct investment in "Belt and Road" projects than in purchases of overseas financial assets like U.S. government bonds. Over the past two decades, China's credit cycle has had a strong influence on EM assets, particularly credit and foreign exchange. This link may weaken over time, although we still think it will play a significant role.

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