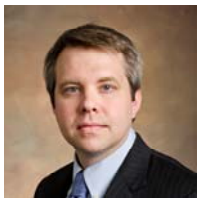
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China

CHINA'S RISING DEBT: WHEN DOES A BUBBLE BECOME TROUBLE?

KEY POINTS

- China's spiraling level of debt is an increasing source of concern. The investment-intensive growth model that has driven spectacular economic gains in China in past decades is no longer working, yet authorities continue to increase debt and investment in pursuit of evermore difficult growth targets.
- The combination of rising debt and slowing growth has pushed China's debt-to-GDP ratio to unprecedented levels. With capital efficiency declining, many believe that China may be facing a full-blown debt crisis.
- However, while China's high debt is concerning, we do not subscribe to the view that a crisis is imminent. Importantly, liquidity risk remains low in our view, with the government ready and able to step in, if required, to ensure that liquidity is maintained.
- While efforts to reduce China's growing debt have been made in recent years, the overriding priority for authorities has been to deliver targeted economic growth. As such, they have been relatively content to allow debt to accumulate in pursuit of this aim. However, there are various measures that authorities can implement to put growth on a more sustainable path and, in turn, work through problem loan issues.

Global markets are growing increasingly nervous about China's spiraling level of debt. Over the past decade, China's investment-driven growth has become increasingly credit funded, and the double-digit results have been quite spectacular. However, in recent years, this formula seems to have stopped working. Despite rapidly rising credit growth in China, the economy continues to stagnate. With cracks in the system beginning to appear, could China be looking over the edge of a potential debt crisis?

DEBT RATIO HAS RISEN TO UNPRECEDENTED LEVELS

The scale and pace of China's debt buildup in recent years has been breathtaking as authorities have looked to engineer a debt-fueled stimulus to offset weak global export

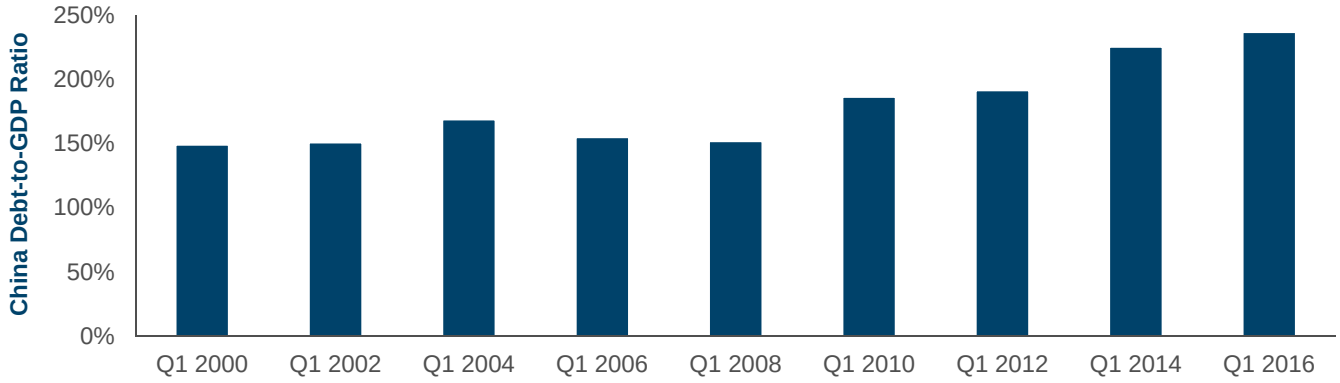
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demand. However, the hoped-for turnaround has failed to eventuate and, with China's debt-to-gross domestic product (GDP) ratio rising to unprecedented levels, some are speculating that a full-blown credit crisis is all but unavoidable.

Although we agree that China's high level of debt needs to be addressed, and some tough decisions taken, we do not subscribe to the view that a crisis is imminent. While authorities have generally been content to let debt accumulate in the pursuit of growth, if necessary, they have various measures that can be implemented to ensure that a debt crisis is avoided.

Exactly how China got to this point is largely attributable to two factors. First, in the wake of the global financial crisis in 2008, the government turned on the stimulus taps in order to support growth and, at the same time, ordered banks to lend aggressively. However, once the immediate threat had passed, the taps were never turned off with credit growth essentially rising continuously ever since. The second is the deceleration of the Chinese economy. GDP growth in China is decelerating as the economy becomes more mature and returns on past investments decline. The government's response to this has been to throw more and more money at the problem, with limited results. The combination of these two factors has seen China's debt-to-GDP ratio balloon to almost 250%,[1] raising fears of an impending crisis.

Figure 1: **The rise and rise of China's debt**



Sources: Bank of International Settlements, PBOC, and IMF, as of March 31, 2016.

LIQUIDITY RISK APPEARS LOW

It must be remembered that China's economy is not like most others. China has huge foreign currency reserves, a strong balance of payments position, and a low level of external debt. China also boasts one of the world's highest savings rates. The fact that China is still a relatively closed system, with administrative barriers limiting the free outflow of capital, is also significant. As long as a degree of control over capital outflows is maintained, policymakers will have the flexibility to bail out companies and individuals where necessary, thereby preventing a potential run on the system. If you consider what has triggered financial crises in the past, it has most often come down to issues of liquidity, not solvency. If the central bank can ensure ongoing liquidity, then the risk of a financial crisis is modest in our view.

HOWEVER, CAPITAL EFFICIENCY IS FALLING

In analyzing China's debt, it is clear that the real area of concern is the corporate sector, where ever-rising leverage is coupled with a declining capacity to pay. Nonfinancial corporates have seen a sharp rise in leverage in recent years, particularly within industries plagued by excess capacity, such as construction and property development, and in the commodity and energy sectors. As leverage continues to rise, these companies are borrowing more just to cover their debt obligations, some of the worst offenders being large state-owned enterprises, many of which are unproductive or failing. The result is a vicious economic circle, with increasing

[1]Bank of International Settlements, as of March 31, 2016.

amounts of capital being allocated to the most inefficient borrowers, which inevitably leads to lower productivity and growth. Consequently, despite credit expanding at a rapid rate, its contribution to new growth-generative investment is diminishing. Capital efficiency in China is clearly declining, and if there is any prospect of this situation being reversed, the government cannot continue to shore up these struggling enterprises. Clearly, reform of some kind is necessary, be it consolidation, mergers, or allowing them to fail.

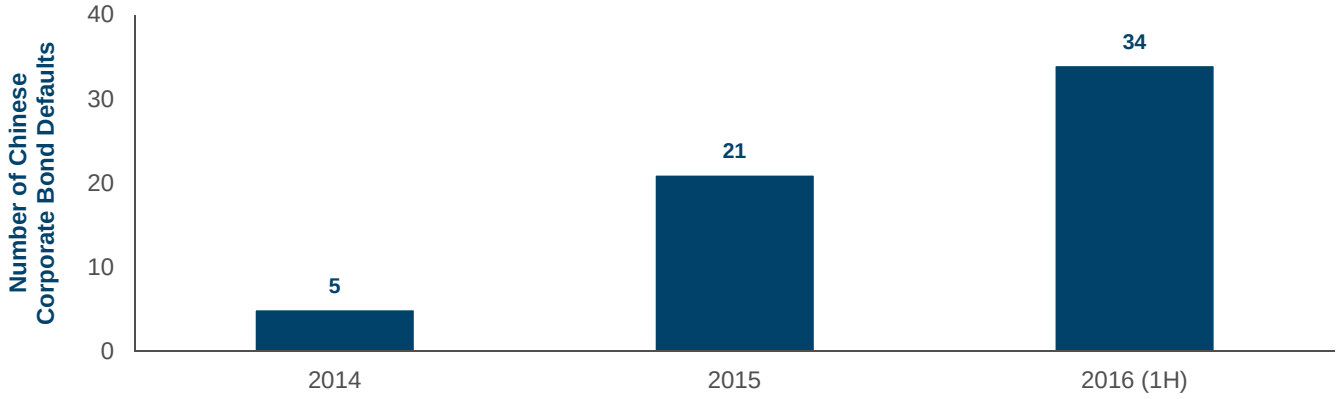
TACKLING THE DEBT PROBLEM

While Chinese authorities acknowledge the financial risks associated with the country's growing debt stockpile, they remain reluctant to aggressively tackle the problem, given the negative implications for growth. What we have seen instead is a stop/start pattern: The government tries to contain credit growth, causing economic growth to threaten to fall below the official target. This alarms authorities, so they engineer a loosening of policy to jump-start growth again. Nevertheless, authorities have various tools that they can draw upon to try and rein in spiraling debt. Some of the measures currently being tested are detailed below, along with our view on their likely effectiveness.

1. Recapitalizing China's banks

The most effective means of addressing China's debt problem, but also the most economically painful in the near term, is for the government to recapitalize the banking sector. Bad loans to state-owned enterprises are rising at a rapid pace, putting increasing pressure on the banking system. However, while instances of the government providing support to individual banks are rising, a widespread recapitalization of China's banking system is unlikely anytime soon, given the negative implications for the economy. While few doubt that a state-funded recapitalization would put China's banking system on a sounder footing, most also believe that any such action would only be a partial solution if the underlying causes of the original bad lending were not addressed. In the past, Chinese lenders have also relied heavily on government-controlled asset management companies (AMCs) to buy up nonperforming loans, often at face value. However, in recent years the level of bad loans, many of them from failing state-owned enterprises—so-called zombie companies—has exceeded what the AMCs are able to absorb (See Figure 2).

Figure 2: **Chinese corporate bond defaults are rising**



Source: Wind Analysis, as of June 30, 2016.

2. Securitizing loans/debt-to-equity swaps

Securitizing nonperforming loans is another option that authorities are testing. In 2016, the securitized debt market in China reopened, some eight years after being shut down by regulators. Pooling nonperforming loans and selling them as securities is certainly an effective strategy in the short term, allowing companies to rid the debt from their balance sheets. Chinese banks, for example, are under constant pressure to dispose of distressed/at-risk debt. However, the longer-term implications are harder to gauge. Given that a lot of the bad loans in question come from struggling state-owned enterprises in distressed industries, it is arguable that these

companies should be allowed to go bust rather than be propped up by securitization of bad loans. Moreover, a lack of transparency means that it is difficult to accurately assess the risks associated with these securities, leading to potential problems down the road.

Chinese authorities have also singled out debt-for-equity swaps as a way to reduce corporate leverage. The proposed exchange would allow China's commercial banks to swap the debt they hold in underperforming companies for stock holdings. Such an arrangement would help cut banks' debt levels and lessen their capital reserve requirements. However, many see such debt-for-equity swaps as a bad deal for banks, effectively swapping bad loans in zombie companies for bad equity in those same companies. The equity stock will have little value given the zombie companies will not pay dividends, the equity will not be attractive to buyers, and capital charges are high for bank equity holdings. Once again, this means the least productive companies are being propped up rather than being allowed to fail. This does not make for an efficient capital market.

3. Evergreening loans

Chinese authorities have so far shown little inclination to make the hard decisions that will lead to tangible improvement in China's debt situation. What we continue to see are measures that, instead of dealing with the problem, simply push it down the road. A prime example of this is the practice of "evergreening" loans. Rather than cutting off lending to troubled companies or penalizing them for defaults, banks are instead being directed to extend these problem loans, or provide new ones, in order to support the companies in question. Increasingly, we are seeing instances of companies defaulting on payments and nothing happens, with the owed interest and capital possibly being paid at some point in the future. This evergreening of loans once again allows unprofitable companies to remain afloat, which keeps excess capacity high and contributes to falling prices. The practice also impacts the profitability of China's banks and is a contributing factor in the rise in banks' nonperforming loans seen in recent years.

ISSUES OF TRANSPARENCY

While signs of stress in China's system are evident, the opaque nature of official data makes it very difficult to assess just how serious the problems might be. Manipulation and misrepresentation by authorities is an ongoing problem and makes any official data unreliable. The China Banking Regulatory Commission, for example, recently announced that the ratio of nonperforming loans within China's commercial banking sector rose to 1.81% in the second quarter of 2016. Despite this being the highest level since the global financial crisis, it is still widely regarded as significantly understating the actual level of nonperforming loans in China, with some observers placing the true figure as high as 20%.

CHINA'S SHADOW BANKING SYSTEM—MIRACLE OR MENACE?

At least some of the potential discrepancy between official and actual nonperforming loan data, for example, can be attributed to the increasing amount of lending being carried out on China's shadow banking system, much of which is simply not captured in official data. The shadow banking system—an intermediary network actively lending under the official radar—emerged in direct response to companies and individuals looking for more informal and flexible financing options, outside of official channels. The system flourished, in part, because the traditional banks also saw benefits in evading capital requirements and charging higher fees. The authorities initially took a tolerant view, seeing it as a form of financial innovation and a means of broadening China's financial system. However, over time the investment structures have become increasingly complex and opaque, with growing instances of bad loans and increasing levels of risk.

Claims that the shadow banking network is a serious structural threat to China's financial system seem extreme. While concerns about transparency and regulation are valid, nonbank financing offers an additional source of credit to individuals and businesses in an environment where formal banking is either expensive or absent. Prior to the development of shadow banking, China's financial system was dominated by a handful of large state-owned banks supported by a network of provincial banks. These banks were discouraged from lending to certain industries and mandated to offer frustratingly low interest rates on deposits. The initial function of the shadow

banking sector in China was to provide investors with an alternative to the banks for deposits. In this way, it is important to distinguish between the type of shadow banking that genuinely represents a broadening of financial alternatives (money market-like funds, the development of a corporate bond market, private lending) and that which is designed to deliberately evade regulations—either to hide bad loans or engage in aggressively speculative activity.

China faces a challenging period ahead. Despite the best efforts of policymakers, economic growth continues to generally disappoint. China's debt burden has already risen well beyond prudent levels as authorities continue to chase seemingly unrealistic growth targets. Financial pressures are rising, and this will inevitably impact longer-term growth prospects. Clearly, there are some hard decisions that authorities need to make over the coming years in order to address China’s spiraling debt problem. While periodic attempts have been made, and some measures implemented, reform on a larger scale is necessary at some stage. However, for now, the negative implications for growth make this an unpalatable option for Chinese decision makers. Despite the high level of debt, we believe that warnings of an imminent crisis are overdone as authorities have the means and the will to ensure such a scenario is avoided. In our view, it is more likely that China will continue to maintain a high level of debt, muddling through over the coming years, with growth slowly declining over an extended period.

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