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thequarterly**dragon #4**

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Deleveraging? 明天, ming tian, tomorrow!

China's overall debt position is manageable – today. While many companies in ailing industrial sectors and many local governments are heavily indebted, the debt load of private households is low. This distinction is important because it means debt is no obstacle to further consumption growth. The risk, however, is that there is no end to debt creation in China as the government prioritizes growth over reform and continues stimulating the economy. A true solution to China's debt woes is not in sight. The existing debt burden will continue to reduce economic growth. Many state-owned companies are heavily burdened by the excesses of the past. But there are no signs that the debt levels will trigger a systemic crisis.

Who carries China's debt – and who does not?

- *China's debt is concentrated in specific sectors of the economy, it is not ubiquitous.*
- *China has been a net creditor nation for many years, not a net debtor nation.*
- *China's foreign currency reserves are adequate, China has had a big trade surplus for more than 20 years.*
- *The total private and public debt (without debt of the financial institutions) amounts to 243% of GDP – high but not scary when compared to other countries with much lower rates of economic growth.*
- *But **the increase in debt levels since 2009 is alarming.***
- *Especially local governments and many state-owned enterprises (SOE) carry a high debt burden.*
- *The central government's debt is low.*
- *The private households' debt levels are low.*
- *China's outstanding debt is primarily denominated in Renminbi.*

*This quarterlydragon #4 is a partial excerpt from the forthcoming book **«China: der nächste Horizont – Ein Kompass für Anleger und Unternehmer»** by Joachim Rudolf und Elisabeth Tester, with a foreword by Mr. Roland Decorvet, former Chairman and CEO of Nestlé China, 272 pages with 66 tables and charts, NZZ Verlag, publishing date: early June 2016.*

China's debt should be looked at in a nuanced way. Pointing out big numbers without context, which supposedly will lead to the imminent demise of the Chinese economy, does not lead to any meaningful conclusions. China's debt problem is real and it is big, but it is concentrated on specific groups of debtors – and, already today, **most of the debt ends up in the hands of the government.** This reduces contagion risk because no systemically relevant, privately owned financial institution runs the risk of going bankrupt because of a wave of defaults.

Measures to de-escalate the debt problems have been initiated, but a true solution is not in sight. High levels of debt in certain economic sectors will continue to hamper economic growth and may repeatedly lead to turbulences in the currency and A-share markets. But **the currently outstanding debt does not pose a systemic risk** to China, a collapse of its economy because of the debt levels is unlikely. If, however, the increase in debt levels continues at the pace of the last seven years, the ramifications may become serious. It is **the increase in debt levels since 2009** (see table #1) and the **continued, debt-fuelled government stimuli** which are worrisome.

Substantial debt increase since 2009 ❶

Selected countries	Total debt[1] in % of GDP	Change in total debt[1] from 2009 to mid-2015 (in percentage points)
Japan	387	34
Portugal	340	33
Netherlands	313	10
France	291	42
Spain	283	14
Italy	274	30
UK	260	–2
Switzerland	248	21
USA	247	1
China	**243**	**60**
South Korea	232	24
Germany	187	–7
Brazil	142	27
India	126	–3

[1] Debt of private households, non-financial companies and the governments

Source: Bank of International Settlements (mid-2015)

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High debt level, continuing to grow

The total amount of debt in China's economy, without financial institutions, amounts to 243% of GDP. Financial institutions are excluded from this figure because they can easily increase or decrease their debt by expanding or shrinking their balance sheets. A debt level of 243% per se is not scary, many industrialized countries with significantly lower economic growth rates than China are more heavily indebted.

The disturbing fact about China's debt is its increase over the last years and the lack of signs that there is an end to the debt increase. This is what worries some investors, and rightfully so. The central government's growth target of between 6.5% and 7% implies the need to further stimulate the economy, which may lead to a further debt buildup. While this may not happen at the speed of the previous government's increase in debt to stimulate the economy after the 2007/08 global financial crisis, China's debt levels will be closely watched. The temptation to get higher growth rates by increasing debt is real, not only in China, but also in China. If it continues for too long, the currently manageable debt problem may turn into a fatal millstone.

The main reason China's debt increased so significantly in recent years was the global financial crisis 2007/08, which led to a precipitous drop in economic growth and employment. In order to counter this economic weakness, the Hu/Wen government launched a massive stimulation package. Vast sums of credit were made available to local governments, SOEs and private companies, large infrastructure investments were realized.

Many economically beneficial uses of the money spent in the past

A debt increase must not necessarily be a problem for a country. What matters more is what the money was used for. On the one hand, China implemented an important upgrade of its infrastructure, including high-speed trains, highways and airports. The economic benefit of many of these projects is high. On the other hand, many questionable projects and companies were financed. They have not and probably will never create any economic value. Later on, many outstanding loans have been rolled over again and again in order to keep them from becoming non-performing, despite the obvious lack of economic rationale for the money used. These loan extensions, many of them for SOEs, have but one goal: to keep jobs and local economic structures in place.

The creditor in all these cases of economic stimulus was the government, irrespective of whether the loans were actually issued by one of the three policy banks[1], the five large commercial banks[2] or the local governments. The fact that producer prices today are lower than at the beginning of the financial crisis 2007/08, and that consumer prices are increasing slightly but at a declining pace (disinflation), means that the real debt burden has increased for many companies.

Uneven distribution of the debt load

The central government itself does not have much debt outstanding. The tax system in China is primarily responsible for this. To put it simply, most tax revenues first flow to the central government, which then distributes some of them to the provinces and large municipalities(see table #2).

The local governments, on the other hand, are heavily indebted. They carry more than half of the debt of all the governmental bodies. The burden of financing the vast infrastructure investments was put on their shoulders. Economic growth targets imposed by the central government added to the debt burden, since growth has been more easily achievable by keeping the spigots open and letting debt build up. As a result, the local governments have totaled up Renminbi debt in the amount of approx. 3.7 trillion US- Dollars (about equal to one third of China's GDP), mostly in the form of bank loans[3]. The ongoing costs for this debt are approx. 7.5% per year. Their maturity typically is one year, although the investments financed by them have a life that is much longer. The interest burden and continued loan renewals put a heavy strain on the local governments, which have a rather weak revenue base from taxation. Rather, they have financed themselves through the sale of land-use rights in the past, which is one reason land prices have increased – it was in the interest of the local governments to sell land-use rights at high prices. Needless to say, this source of revenues cannot persist.

The central government-imposed replacement of outstanding bank loans taken out by local governments through newly issued bonds (local government financing vehicle swap, LGFV swap) should ease the burden by roughly cutting interest rates in half to 3.5% per year. In addition, debt maturities should be extended to about six years. However, since the majority of these local government bonds will be purchased by the (state-controlled) commercial banks and other government institutions, the LGFV swaps really are similar to a transaction between the right and the left pocket of the same person: the obligations stay with the government. The loans don't disappear, but some of their burden is distributed to the commercial banks, which henceforth will not receive the (high) loan interest payments but the (much lower) bond coupons. They are partially compensated for this loss of income by a partial tax exemption of the bond coupon revenues. In addition, the risk weighting of these bonds on the balance sheets of the commercial banks is lower, reducing the equity requirements and the costs associated with holding the bond positions. At the end the government indirectly keeps paying, but the burden of servicing the debt is not put squarely on the local governments' shoulders.

Non-financial companies are heavily indebted in many cases (see table #2). The re-

Private households carry little debt ❷

Selected countries	Total debt[1] in % of GDP	Portion of total debt owed by (in%) Private households	Non-financial companies	Government
Japan	387	17	27	56
Portugal	340	24	37	39
Netherlands	313	36	42	22
France	291	20	45	35
Spain	283	25	39	36
Italy	274	16	31	53
UK	260	35	29	36
Switzerland	248	49	37	14
USA	247	33	29	39
China	**243**	**15**	**67**	**17**
Germany	187	29	31	40
Brazil	142	18	35	48
India	126	7	40	53

[1] Debt of private households, non-financial companies and the governments

Source: Bank of International Settlements (mid-2015)

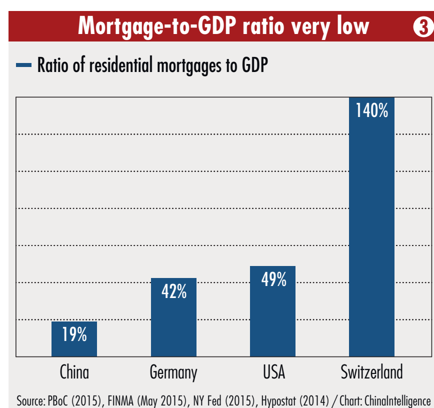
[1] Policy banks are the China Development Bank, Agricultural Bank of China and Export-Import Bank of China, large bond-funded government institutions created in 1994 in order to support the economic development of the country by providing financing to state and private institutions and companies. The policy banks are wholly owned by China's central government.

[2] Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Bank of Communications, all listed in Hong Kong and Shanghai and majority-owned by China's central government.

[3] According to China's state council, August 29, 2015.

spective figures also include many SOEs, the debt obligations of which really are government obligations. The companies typically have to pay interest rates which are closer to 10% than to 5% per year, and suffer heavily from the high level of interest rates in China.

Private households are not heavily indebted. This is important because private debt will **not be an obstacle to increased consumption spending.** Mortgages or loans to finance a small enterprise account for most of their debt. Credit card and consumer loans, which are ubiquitous in other countries, are negligible. Private households traditionally are thrifty in order to cushion the blow from future uncertainties such as the risk of a costly health problem of a member of the family. The level of mortgage debt is low in China, although more than 80% of the population live in an apartment they own. **Total residential mortgages in China amount to only 19% of GDP** – the respective figures in most industrialized countries are several times higher (see chart #3).



Most debt in China is owed to creditors inside China. Property developers, some of which are heavily indebted in US-Dollars, are the exception. The gross foreign debt of China amounts to 13% of GDP[4]. This is important for the Renminbi currency market. **A Renminbi crash as a result of a China foreign debt crisis is unlikely.**

The debt burden in the Chinese economy in aggregate is large and expensive. It is concentrated on local governments and companies, many of which are state-controlled. Was can be done? The LGFV swap shows that the government knows that it has a problem and is **working on reducing and more broadly distributing the burden.** In addition, interested rates have been lowered six times since November 2014. Heavily indebted business sectors still have access to ample liquidity in order to muddle through and help them extend their obligations. **A true solution of China's debt woes is not in sight. But there are no signs that the debt levels will be a trigger for a systemic crisis.**

Non-performing loans to increase

Official figures report the amount of non-performing loans of Chinese banks overall as 1.59% of total assets[5]. The true amount of non-performing loans is estimated at between 4% and 8%. The 1.59% figure is not entirely wrong, however, in the sense that few loans will end up being not serviced and thus written off in the near future. Instead, they are being rolled over, even though there is no reasonable prospect for their repayment. Or they are being **transferred from the commercial banks to other government-owned institutions,** either through the pooling in asset-backed securities or through other transactions. This way, non-performing loans can officially be kept at low levels, which is important because the largest commercial banks in China are listed in Hong Kong and Shanghai and thus audited externally.

Similar mechanisms are being used for the countless investment products which cannot meet their obligations, many of which were issued by the large commercial banks. At first, official statements point to their imminent demise, but in the end they are being rescued by government forces anyway. A truly big default of an investment product issued by one of China's banks has yet to occur.

But the resulting moral hazards are all too obvious. High-ranking government officials have thus hinted at the need to «allow small tremors in order to avoid big earthquakes»[6]. **Expect more news of defaulting investment products and bank loans as part of efforts to restructure state-controlled companies and to discipline financial markets.**

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[4] SAFE, as of Q3 2015, http://www.safe.gov.cn/wps/portal/
[5] As of September 30, 2015, according to the China Banking Regulatory Commission.
[6] Zhong Yi, Chairman of SASAC (State-owned Asset Supervision and Administration Commission), quoted in the Financial Times, January 26, 2016.

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