Global Perspective

China’s misunderstood debt challenges

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China’s misunderstood debt challenges

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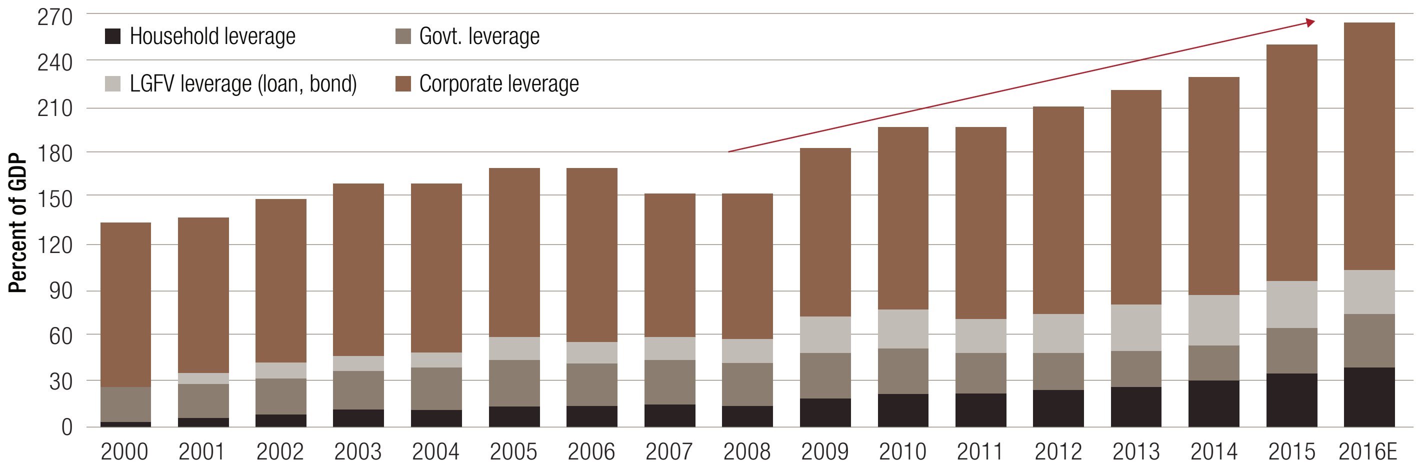
China’s mounting debt continues to garner much attention and concern from investors. According to a recent report by the Bank for International Settlements (BIS), an early warning of financial overheating – the credit-to-GDP gap – hit 30.1 (as the total debt to GDP ratio hit 250%) in the first quarter of 2016, which is by far the highest of the countries assessed. According to the BIS, an indicator value above 10 is seen as a strong sign of fast leveraging, which in the past has been associated with financial crises in the countries experiencing fast credit growth.

To put this increase in a debt perspective, China’s debt to GDP has risen from 154% in 2008 to nearly 250% in 2015 – a more than 95pp increase, ranking it in the 98th percentile of debt build-ups in modern history.

The growth of credit throughout the Chinese economy, particularly since the global financial crisis, has also led to the development of a huge and difficult-to-quantify shadow banking sector.[1] These financial intermediaries provide lending services to businesses and create wealth management products for households looking for higher yields from pooled loans.
A genuine worry is that these unregulated activities could exacerbate underlying credit problems within the banking system and generate systemic risk because a surge in such off-balance-sheet lending would push the figure even higher.

[1] Economic Studies at Brookings, Shadow banking in China: A primer, March 2015.

FIG. 1 SHARP RISE IN TOTAL DEBT SINCE THE GLOBAL FINANCIAL CRISIS



Source: CEIC, PBoC, NBS, FactSet, Goldman Sachs Global Investment Research.

There are several drivers behind this debt boom that have become particularly pronounced over the last eight years. Firstly, activity growth, and by extension employment conditions, are political as well as economic goals for the ruling authorities. The sharp contraction in advanced economies and the related banking sector shock in 2008/09 were addressed through a combination of monetary and fiscal stimulus measures as China shifted policy to restore growth in the aftermath of the Great Recession. However, as noted by a Goldman Sachs study, the more fundamental cause of this re-leveraging, particularly since 2010/11, is the decline of the strong positive tailwinds China enjoyed during its integration into the global economy by way of its export-driven growth model. As this source of economic expansion weakened, policy levers such as credit were deployed by monetary authorities to prop up above-trend economic growth in China. This specifically manifested itself in increased activity in infrastructure and in the property sector, where investments were largely financed through private, local government and state-owned enterprise balance sheets.

Of course, the experiences of Japan in the aftermath of the 1980s debt boom, highly leveraged Asian economies during the 1997/98 financial crisis, and the US after the sharp increase in credit during the 2000s are reasons enough to be concerned about the susceptibility of the financial system and economy to shocks. Those concerns rise dramatically if they develop into a balance of payments crisis, as witnessed by several EM countries in the late 1990s.

Taking into account the backdrop of a very high debt burden in China, a key fear is the likelihood of a financial meltdown where a banking sector/balance of payments crisis forces China to shed its debt-financed overcapacity.

Developments in China are hugely significant for the world economy. Much of the focus in recent years has been on the growth of China's export-driven manufacturing sector. However, China is now also the world's second largest importing country. Last year, China imported USD 1.682 trillion[2] of goods from around the world, representing 9% of the total. Therefore, the effects of a "hard landing" scenario will have significant repercussions elsewhere. In our view, as discussed in our recent paper,[3] the likelihood of a financial meltdown in China remains low over the next two to three years. There are a number of reasons for this view and we explore each of them below.

[2] Central Intelligence Agency, The World Fact book – China.
[3] Emerging markets – last refuge in a low-return desert, September 2016.

Strong external balance sheet

First and foremost, the key differentiating economic factor is that China is a net creditor to the world. At the end of 2013, when capital outflows started in earnest, this figure was on the order of USD 2 trillion (see Figure 2). Two years later, this number stands around USD 1.6 trillion level,[4] still very large in absolute terms. To put this amount in context, China's net credit position represents around 9% of nominal US 2015 GDP and implies that China is the world's third largest supplier of external capital.

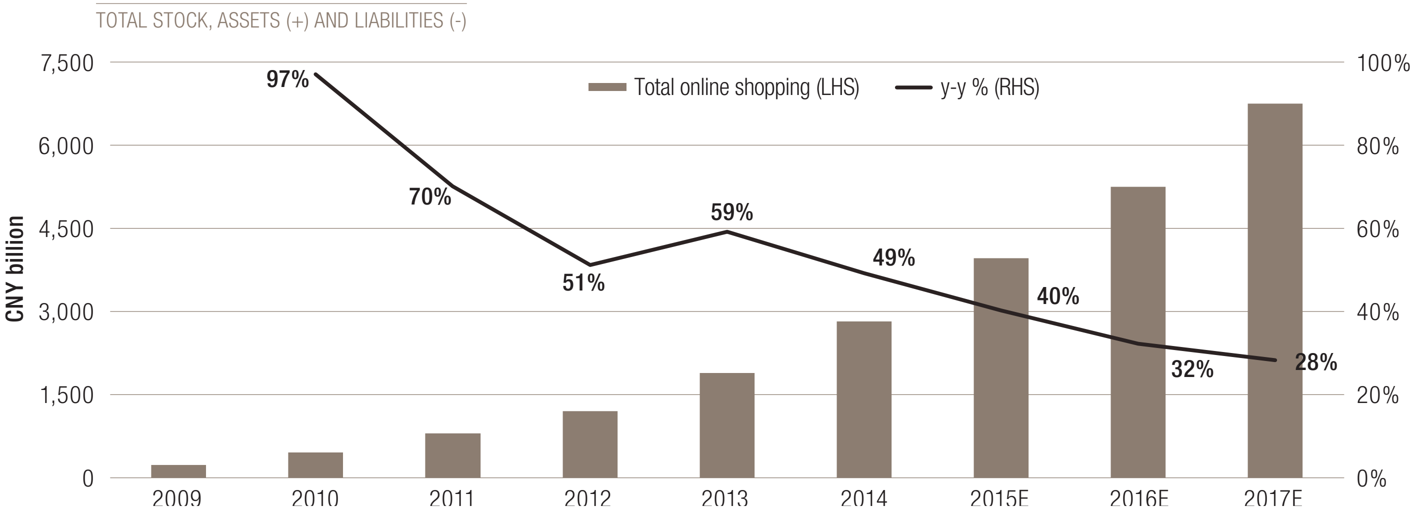
Secondly, looking at the make-up of Chinese external assets, they remain predominantly in very liquid US debt securities, including FX reserves of around USD 3.2 trillion, and this can be deployed very quickly if needed. Chinese authorities have already used FX reserves extensively during 2015, when FX reserves fell by USD 512.66 billion[5] as capital outflows from China intensified.

Here, it is also important to note that part of the fall in foreign reserves that took place in 2015 (see Figure 3A) was driven by a decline in the external liabilities of Chinese firms, as USD-denominated debt was switched back into domestic CNY (Renminbi) obligations (Figure 3B). Indeed, as the foreign reserves were used to pay down outstanding foreign debt, they helped to rebalance China's balance of payment.

Even considering the FX reserve burn rate witnessed in 2015 (which was quite extreme, given the experience of 2016 so far), we believe Chinese policy makers have enough dry powder on the table to avoid a sharp de-leveraging of the system over the next two to three years.

FIG. 2 CHINA'S INTERNATIONAL INVESTMENT POSITION IS AN IMPORTANT BACKSTOP TO THE SYSTEM

TOTAL STOCK, ASSETS (+) AND LIABILITIES (-)



Source: PBOC, SAFE, Bloomberg.

[6] Other investment categories include credit loans, currency, deposits and other investments.

[4] Source: Bloomberg, "China Loses World No.2 Creditor Rank to Germany Amid Yuan Woes," May 2016.

[5] PBoC.

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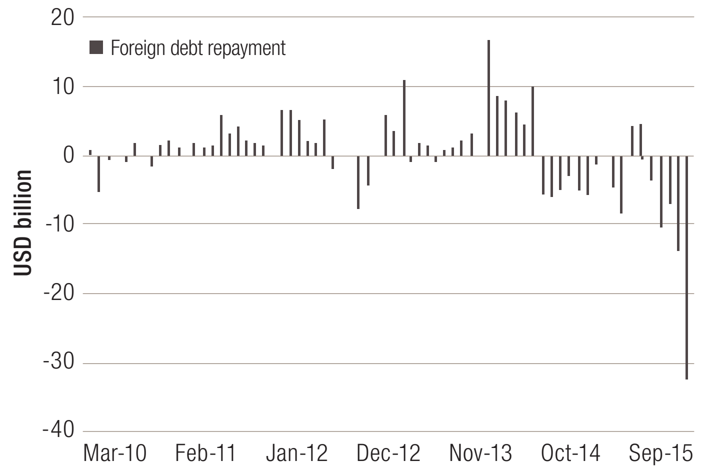
FIG. 3A CHINA'S FOREIGN RESERVES DECREASED SHARPLY IN 2015

FIG. 3B THE CORPORATE SECTOR'S INCREASED FOREIGN DEBT REPAYMENT



Source: CEIC and BBVA Research.

M2 Risks

The very high level of broad money (M2) in China is often cited as a key weakness in China's external backstop arsenal.

The main worry is a scenario wherein the domestic capital represented by M2 were to leave the country. It would put China's FX reserves under severe pressure, as capital outflows exceed the current account surplus. Unchecked, China would have inadequate FX reserves to service its balance of payment needs, leading to further capital flight and eventually a full-blown crisis.

Indeed, the International Monetary Fund (IMF) has warned of this risk, advising central banks to maintain a minimum level of FX reserves of at least 20% in relation to M2.[7] What concerns the IMF and others is that China's ratio has now fallen to around 14% against a capital-outflow biased backdrop (a buffer which is significantly below the EM average – see Figure 4).

[7] International Monetary Fund, Guidelines for Foreign Exchange Reserve Management, September 2001.

FIG. 4 AVERAGE FOREIGN RESERVES TO M2 RATIO[8]

[8] Five-year average. Source: Bloomberg.
EM countries: Russia, Thailand, Malaysia, Mexico, Indonesia, Turkey, Poland, Philippines, South Africa, Peru, Chile, Colombia, Romania, Hungary, Brazil.

Role of strong capital controls in blunting risk of domestic capital flight

Unlike most other countries, China runs a relatively closed capital and financial account, with monetary authorities regularly applying capital controls as a policy tool to prevent capital flight. This gives them the ability to interrupt the free flow of capital across borders and effectively ring-fence their economy from domestic or international speculation. This is a very important and underappreciated tool at the disposal of policy makers in the context of the very weak reserve coverage of domestic broad money in China.

It is an ad hoc tool that foreign banks regularly contend with during times of heightened economic stress. In January, for example, China was reported to have temporarily suspended[9] some foreign banks, including Standard Chartered, Deutsche Bank and Singapore's DBS, from conducting certain FX transactions designed to arbitrage the gap between the onshore and offshore renminbi exchange rates. The country's foreign exchange regulator was also said to have given verbal instructions to banks in Shenzhen to limit dollar buying by both individual and corporate clients.

The PBoC has also been known to impose higher reserve requirements on banks to increase the cost of currency hedging and to instruct financial institutions to step up checks and controls on all FX transactions. Last year, the central bank applied a 20% reserve requirement[10] to all currency forward positions in order to reduce speculation on a further devaluation of the renminbi.

The measures detailed in the box below, both formal and informal, outline some of the recent actions that Chinese authorities have taken to curtail capital outflows.

[9] Financial Times, China steps up capital controls to stem outflows, January 2016.
[10] PBoC.

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CHINA'S RECENT CAPITAL CONTROLS

- **Increased scrutiny of overseas transfers** – (20 January 2016): Some Shanghai banks have recently asked their outlets to closely check whether individuals sent money abroad by breaking up foreign-currency purchases into smaller transactions, advocating punitive action if violations were discovered, according to people familiar with the matter. Each individual is permitted to send USD 50,000 abroad annually.
- **Curbing the offshore supply of yuan to make shorting costlier** – (25 January 2016): The PBoC instructed some onshore lenders to cease offering cross-border financing to offshore counterparts late last year, and advised some Chinese banks' units in Hong Kong to suspend offshore yuan lending unless necessary. It also widened the scope of reserve requirements to include some yuan holdings of overseas financial institutions.
- **Restricting companies' foreign-exchange purchases** – (28 January 2016): Companies can only buy overseas currencies a maximum of five days before they make actual payments for goods, having previously been free to make their own decisions on timing.
- **Suspension of foreign banks** – (6 January 2016): DBS Group Holdings Ltd. and Standard Chartered Plc were among the overseas banks suspended from conducting some FX business in China until the end of March 2016.
- **Outbound investment quotas frozen** – (28 February 2016): China has suspended new applications under the Renminbi Qualified Domestic Institutional Investor programme, which allows yuan from the mainland to be used to buy offshore securities denominated in the currency. Since March, it has also refrained from granting new quotas for residents to invest in overseas markets via its Qualified Domestic Institutional Investor programme.
- **UnionPay debit-card clampdown** – (11 December 2015): New measures were introduced in December 2015 to crack down on illegal China UnionPay Co. card machines, which were suspected of being used to channel funds offshore via fake transactions, most notably in Macau casinos.
- **Underground banking clampdown** – (20 November 2015): China busted the nations' biggest "underground bank," which handled 410 billion yuan (USD 62 billion) of illegal FX transactions, the official People's Daily reported in November 2015.

Source: Bloomberg.

Current account surplus and rising export share reduce incentives for sharp devaluation

Another key metric to consider when assessing the risk of a financial meltdown in China is the still healthy trade surplus – which is running at around USD 45/50 billion per month and acts as a natural source of FX inflow.

It is an important indicator of China's continued manufacturing competitiveness that its private sector is gaining global market share in higher value goods, even as labour costs rise. China's share of global exports rose to 13.8% last year from 12.3%, according to data from the United Nations Conference on Trade and Employment, marking the highest share any country has enjoyed since the US in 1968.

We believe these trends imply limited incentive for the government to use currency devaluation as a policy stimulus tool, as it has done twice in the past 12 months. Indeed, such a move might incentivise capital outflows and renew the pressure on reserves that occurred in 2015.

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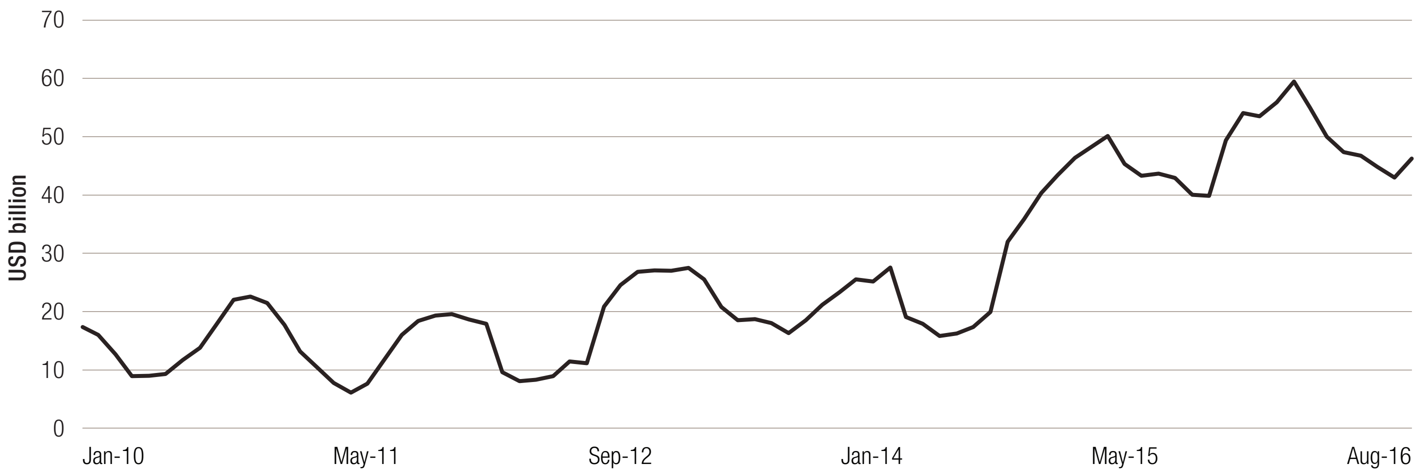
FIG. 5 CHINA'S TRADE BALANCE REMAINS HEALTHY [11]



[11] Six-month moving average. Source: Bloomberg.

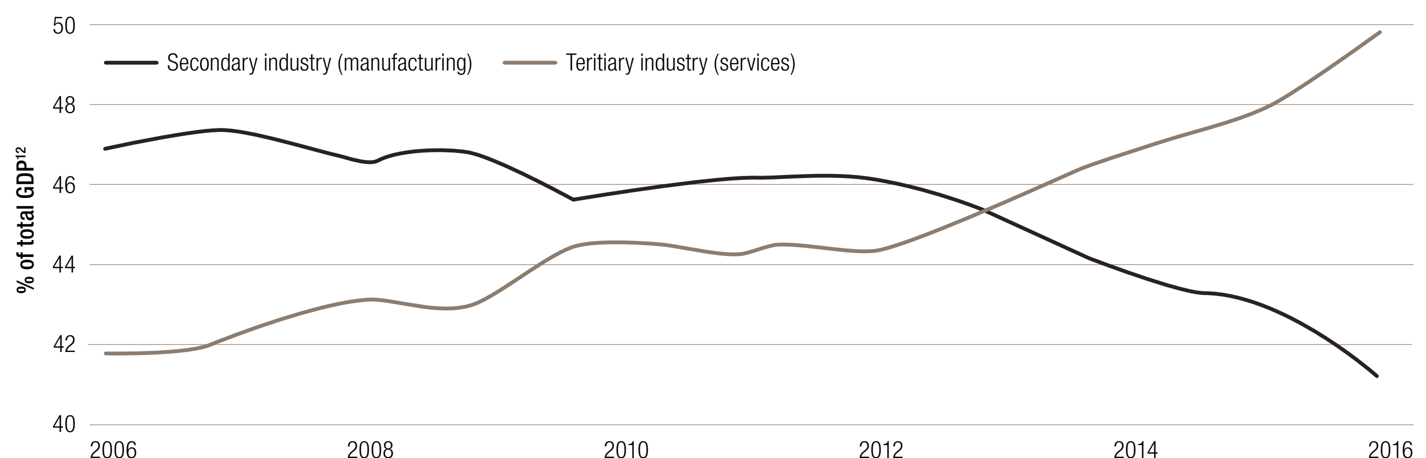
How will Chinese imbalances unwind? Rebalancing and Accelerating Reforms

Considering our view that the likelihood of an outright financial meltdown is low, the question remains how the visible excess capacity, rising NPLs and increasing signs of stress in some sectors of the economy will eventually be resolved.

We believe the answer will come from China's shift towards greater reliance on the expanding services sector. Looking ahead, we continue to see sustained growth in China, though at a slower pace than in past decades. Clearly, both the fiscal and monetary levers are being used to support the economy this year. However, underneath the hood, we continue to see strong signs of rebalancing in the Chinese economy.

For instance, as shown in Figure 6 below, since 2012, the services industry has grown to nearly 50% of GDP, from 44%, while the share attributed to manufacturing has fallen sharply – a trend we think has further room to run.

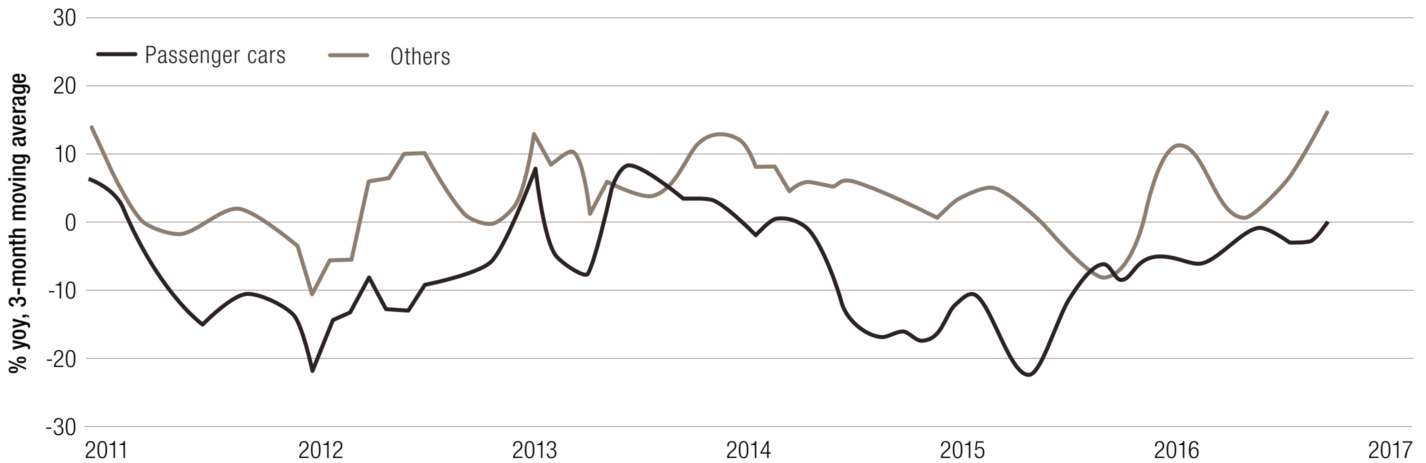
FIG. 6 CHINA'S GDP COMPOSITION IS REBALANCING



Source: NBS.
[12] Fourth quarter moving average.

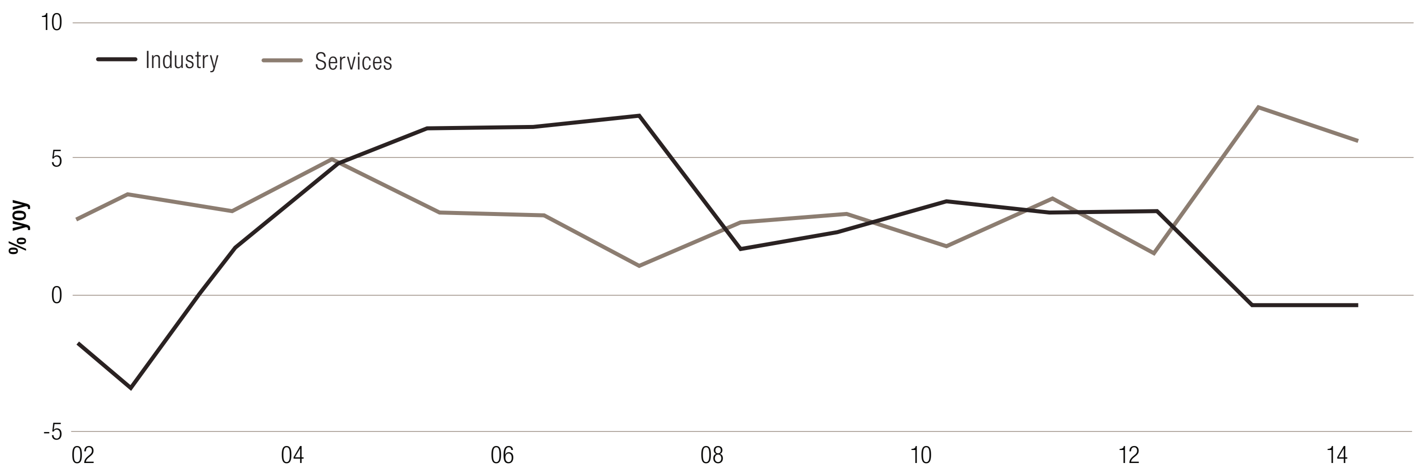
On the consumer demand side, we are seeing positive trends developing in the recent sharp rise in auto sales growth (passenger cars) and consumer discretionary areas such as e-commerce, where sales growth remains in the high double digits (nearly 30% annual sales growth).

FIG. 7 CHINESE AUTO SALES REMAIN ROBUST



Source: NBS.

FIG. 8 REBALANCING VISIBLE IN LABOUR MARKETS AS WELL



Source: MHRSS.

The flip side of this rebalancing is evident in labour market dynamics: China's employment by sector shows a sharp growth in services employment, which has more than offset declines in manufacture-focused sectors.

Taking the above factors into account, major structural reforms still need to be implemented to manage the overcapacity issues in manufacturing and in the property sector, which has again picked up pace on the back of this year's renewed expansion of credit. Examples of these reforms include new investment in health, education and the social safety net, which will help reduce precautionary savings and further help to rebalance growth towards domestic demand.

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New opportunities abound

We believe that overall, there is no shortage of domestic risks to consider as China undertakes the massive challenges of reducing its high level of indebtedness, restructuring its state-owned industrial enterprises and supporting growth as it moves towards a service and household consumption-based economy.

The challenges could be further compounded by Republican Presidential candidate Donald Trump if he prevails in the current election campaign in the US (although, this scenario is looking increasingly unlikely). Any outcome that results in punitive tariffs on Chinese exports or efforts to more broadly roll back the globalisation that has benefited China's economy over the past 20 years could compound the difficulties China faces. Policy changes unrelated to the US vote, such as a more hawkish interest rate policy from the Fed due to changing economic conditions, are other risks that will need to be taken into account – especially if they accelerate capital outflows. Here, our view remains one of a cautious Fed, taking into consideration any interest rate increases in the context of a world of very high external risks.

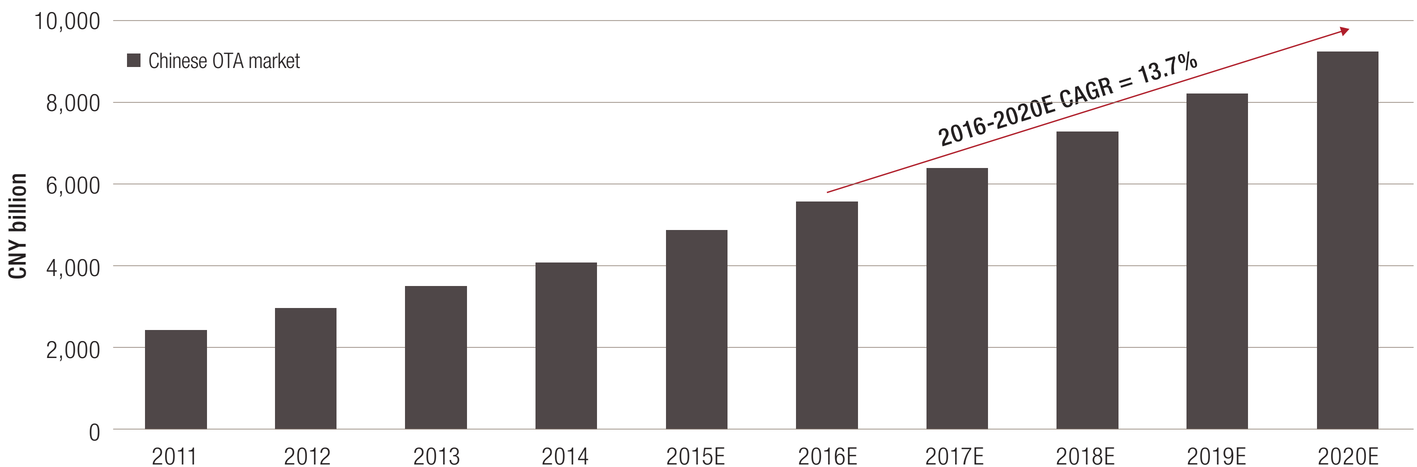
Longer term, we believe there are a number of very specific investment opportunities in China that look attractive, especially in the absence of a worst-case scenario. Specifically, we believe the structural changes that are underway in the country are yielding promising ways to generate returns from the growth of the service sector – an area we continue to focus on within our EM and Asia High Conviction equity strategies.

Here, considering the size and scale of China's domestic market, dynamic growth in e-commerce, telecommunications services and travel stand out as areas that deserve particular attention.

For instance, in travel services, the growth has already been enormous, but appears to still be in its early stages. Consider that today less than 8% of the population has travelled as tourists and yet the market has grown to around USD 155 billion in size.

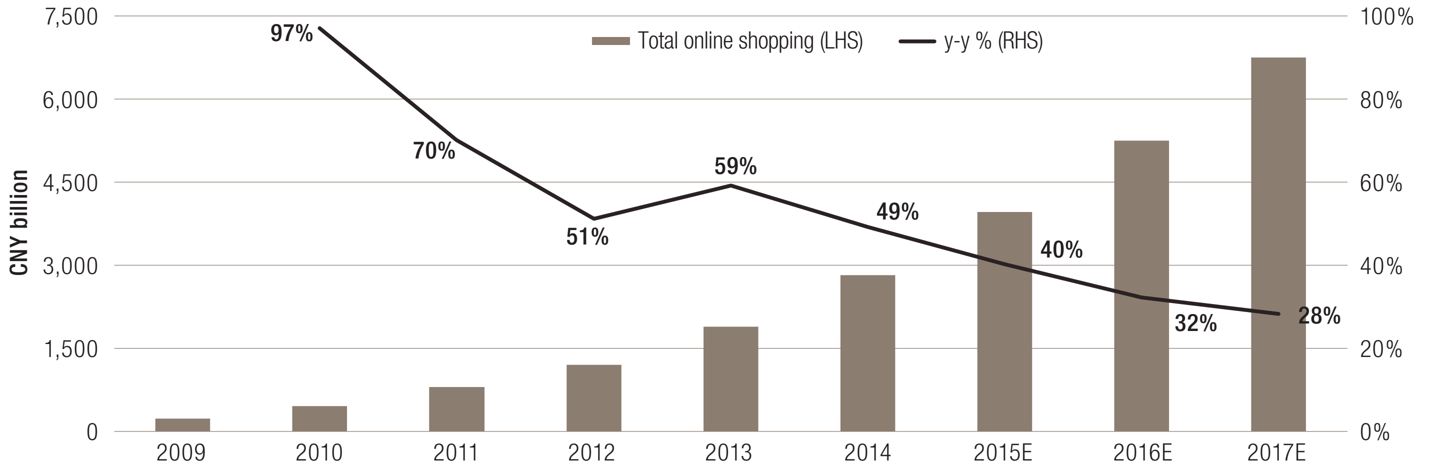
In telecommunications services, the growth of mobile phone usage has been significant. We know that demand for mobile handsets has been a big driver of profits for western companies like Apple. Even more ubiquitous is the need for mobile card services, the growth of which has been exponential in China.

FIG. 9 CHINESE TRAVEL MARKET REVENUE AND GROWTH



Source: NBS, Nomura estimates.

FIG. 10 ONLINE SHOPPING MARKET SIZE AND GROWTH[13]



Source: Sootoo.

[13] iResearch, Nomura estimates.

Conclusion

China's debt challenges continue to be a source of worry for investors. However, we think that its external balance sheet, stringent capital controls and healthy trade balances provide strong backstops against a financial meltdown scenario. We envisage a sustained period of slower growth in China alongside rebalancing towards the services part of the economy. That said, further reforms would be needed to facilitate this transition, as China prepares for an era of slower potential growth against a backdrop of high debt and gradual deleveraging.

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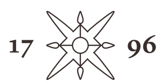

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