Debt picture offers cause for confidence

Close examination of the figures shows that China's finances put it in a favorable position to weather current uncertainties

By ANDREW KP LEUNG

China's debt-to-GDP ratio has risen to unprecedented levels, stoking fears of a looming full-blown debt crisis. Such fears are reinforced by related economic risks: (a) a possible hard landing; (b) excessive liquidity coupled with deflation; (c) overcapacity; and (d) sluggish international trade.

As China's economy is beginning to show signs of stabilizing, fears of a hard landing and deflation have largely receded, at least for now. Nevertheless, despite continuing efforts to rein them in, problems of overcapacity remain. Meanwhile, excessive liquidity is being ameliorated, with surging outbound direct foreign investments and outflow of capital driven by expectations of a weakening renminbi. This is partly reflected in China's foreign exchange reserves, which peaked at nearly $4 trillion in June 2014 and fell to about $3.2 trillion by January 2016.

Against this backdrop, I now focus on China's debt problem.

According to a recent McKinsey report, the level of gross debt in 2014 was 282 percent of GDP. This includes government debt (55 percent of GDP) and debt owed by financial institutions (65 percent of GDP), nonfinancial corporations (125 percent of GDP) and households (38 percent of GDP). Recent estimates suggest that corporate debt may have risen above 150 percent of GDP by early 2016.

China has traditionally had a low level of foreign-currency external debt. At $800 billion (753 billion euros; £645 billion) or 7 percent of GDP in 2015, it is much lower than virtually any other major emerging market.

China has an exceptionally high level of corporate deposit holding, equivalent to 90 percent of GDP, compared with 7 percent in the United States. Albeit a sign of low efficiency of capital utilization, loans are often recycled back to the lending bank as deposits. Nevertheless, this enables the banks to earn high interest spreads and acts as a cushion against exigencies. According to the People's Bank of China, at the end of 2014, total bank deposits amounted to some $19 trillion, while the total loan book stood at $14 trillion. About 45 percent of bank deposits were personal savings while 50 percent came from enterprises.

China's household debt (and gearing) remains comparatively low. Housing price inflation and speculation notwithstanding, the contention of a massive mortgage crisis is not borne out.

Despite a rise in credit volume, China's economy is not overly indebted, and the government possesses adequate capacity to absorb losses. There are also massive private savings, offering scope for the corporate sector to undertake debt-equity swaps.

Nonperforming bank loans are estimated to range from 6 to 7 percent to as much as 25 percent for some smaller banks. However, unlike those in the West, thanks to "financial repression" limiting deposit interest rates, Chinese banks derive a vast proportion of their funding and profits from stable bank deposits, rather than loan spreads. Moreover, China's banks are mandated to have about 17 percent of required reserves at the People's Bank of China. By way of further insurance, a bank deposit insurance program has been in operation since May 2015.

The balance sheet of the government as a whole is healthier than sometimes surmised. The state has a treasure trove of assets — including its massive foreign exchange reserves, ownership stakes in state enterprises and foreign investments through the sovereign wealth fund.

"Despite a rise in credit volume, China's economy is not overly indebted, and the government possesses adequate capacity to absorb losses. There are also massive private savings, offering scope for the corporate sector to undertake debt-equity swaps."

Moreover, a significant proportion of China's debt, particularly at the local government level, is going into building infrastructure for the largest and fastest urbanization drive in human history. The aim is to turn China into a middle-class country, with long-term social, economic and political benefits. These loans cannot be adequately evaluated in purely commercial terms.

As for state-owned enterprises, risks should not be based solely on liabilities. Taking into account their massive asset base, their loan-to-equity ratios remain largely manageable.

The International Monetary Fund computes a measure of augmented public debt, which includes various types of local government borrowing, including off-budget borrowing by local government financing vehicles via bank loans, bonds, trust loans, and other funding sources. By this measure, China's public debt-to-GDP ratio was estimated to be 60 percent in 2015, still below the public debt-to-GDP ratios of major advanced economies.

Moreover, China's net foreign assets amounted to $1.6 trillion at the end of 2015, more than enough to cover all of its foreign liabilities.

The author is a leading China commentator and chairman of Andrew Leung International Consultants. The views do not necessarily reflect those of China Daily.

Balance sheet doesn't provide simple explanation

Difficult measures need to be taken soon to prevent current situation from escalating into something much more serious

By GEORGE MAGNUS

China's nonfinancial debt, now estimated to have risen to about 250 percent of GDP, is one of the most talked-about economic phenomena on Earth. Doomsayers see it as the harbinger of imminent economic collapse. Optimists say it's nowhere as bad a problem as made out because debtors have assets, China has a high savings rate and doesn't owe much to foreign creditors. Both are wrong.

Instead, we have to understand that we can't look at China's assets and liabilities the same way we might look at those of a company. We also have to recognize that even creditor countries such as China that borrow in their own currency cannot sustain rising debt when repayment capacity is deteriorating.

It is also imperative to focus not so much on the asset side of China's debt balance sheet but on the liability side, and especially the funding structure of the liabilities. Without a major change in policy fairly soon, China's debt will lead to instability within the next 2-3 years and a protracted hit to economic growth.

After a period of credit policy restraint from 2012 to 2014, there was a remarkable U-turn in 2015. The new commitment to 6.5 percent annual growth — as provided for by the 13th Five Year Plan (2016-20) — took the focus away from economic reform and underscored a new borrowing surge by local governments, including local government finance vehicles, state-owned enterprises and new outlets such as public-private partnerships, development funds and policy bank programs. There was also a strong expansion in the balance sheets of banks, and nonbanking financial intermediaries, including trusts, insurance and securities companies, pension and wealth management product providers and other finance companies.

Nonbanking intermediaries and providers of new financial products that raise deposits to fund loans accounted for barely 20 percent of the total banking system assets of around 250 percent of GDP in 2008-09. Now, though, they account for 35 percent of assets and total nearly 450 percent of GDP.

This gives rise to four crucial observations. First, the strong acceleration in credit creation hasn't been an accident. It bears the hallmark of financial liberalization and clear top-down policies designed to support economic growth.

Second, because direct banking exposure to borrowers, and that of China's major four banks in particular, has declined relatively speaking, the focus necessarily falls on the intermediaries that generate both deposits and loans. Many, but not all, of these fall within the so-called shadow banking sector.

Third, these institutions do not respond as easily to control as, for example banks do to lending guidance. They also depend much more heavily than banks on short-term (overnight to one month) and volatile forms of deposits.

In its October 2016 Global Financial Stability Report, the International Monetary Fund estimated that wholesale funding of banking sector lending — for example in the interbank and repurchase markets — had risen 10 to 30 percent since 2010, and was a much larger issue for smaller banks and the NBFI's.

Fourth, China's debt and banking system vulnerability is therefore not so much the surge in asset growth and the rise in bad assets and nonperforming loans, important as these are. On the asset side, according to private estimates, nonperforming loans now account for perhaps 20 percent of banking sector assets. The government, PBoC and China's Banking Regulatory Commission are doubtless keenly aware of the problem, and they can freeze or mitigate the problem of bad loans and loss recognition for awhile by "evergreening" — that is, by rolling the problem into the future, or by creative accounting.

But it is much harder to hide or offset the problems on the liability side. If and when the providers of very short-term deposits want their money back, the PBoC can of course step in to fill the gap in the formal banking sector. Yet the central bank's liquidity does not extend to other players in the same way, and it would be hard to stop the contagion of illiquidity spreading from one institution to another, especially as one could imagine collateral values — for example property and land prices — falling, and a significant rise in capital outflows.

This is the way financial crises happen. The government will certainly be keen to prevent any financial instability. But the timeline for macroeconomic policies to switch toward lowering credit and economic growth — which would almost certainly raise unemployment — and rebalancing state and private sector asset ownership is shortening all the time. Without a change soon, China's debt will continue to expand, and by 2018-19 instability metrics will have risen further to dangerous levels.

The author is an Associate at Oxford University's China Centre and a senior independent economic adviser at UBS. The views do not necessarily reflect those of China Daily.