Global Economics

April 28, 2016

Special Report

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China's Debt In Context

It is important to put some perspective to the bearish concerns about China's debt cycle. The fear is that the country has amassed so much debt that it is on the verge of a major financial crisis. This note cautiously leans against this interpretation that has been unrealized for many years but recently amplified following a surge in lending. It does so by slicing and dicing international comparisons of debt in an effort to grasp the totality of the picture.

This approach is necessary because countries pursue differing growth strategies and international indebtedness comparisons should compensate for this. For decades, China has emphasized company-led growth focused upon exports financed by high domestic saving rates while discouraging consumption. It is logical that the composition of debt numbers should follow this strategy with high corporate debt versus low household and direct government debt reflecting how the country has chosen to craft its financial system. A very distorted picture of China's market vulnerabilities can arise from cherry-picking the metrics versus looking at the broader picture.

For example, looking only at China's corporate debt in isolation of the rest of its financial system invokes somewhat of a normative judgement in slamming what are often described as China's corporate 'zombies.' Other countries could be accused of putting the emphasis upon 'zombie' households that may be over-stretched and that may pose scattered risks which may be more difficult to control from a centrally planned policy standpoint if China's households were comparably over-stretched.

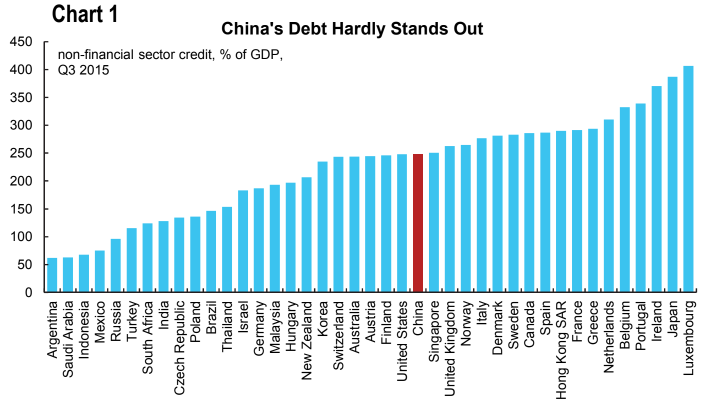
To this latter point, debt that is concentrated in state-owned enterprises (SOEs) and a banking system that is heavily government-run may be a lot easier to control than bloat elsewhere in the economy, particularly for a country with generally sound external finances. Recall that the last time China tripped up in a banking crisis of sorts well over a decade ago it 'gifted' reserves from the central bank to the banks and recapitalized them by stealth while shifting their problem loans off balance sheet. Signs of the latter approach have been evident for some time, but China's policy options are far from exhausted both in conventional and unconventional terms.

The bottom line is that there are risks associated with China's debt markets that are definitely worth monitoring, but, more importantly. caveats to those risks. Betting on, say, a 'Lehman event' in China poses the classic dilemma of running out of liquidity and patience long (years?) before the if-and-when on big risks to China's financial system particularly if they are judged through a less holistic framework of thinking.

China Doesn't Stand Out On Total Debt Comparisons

As chart 1 shows, China doesn't particularly stand out in international comparisons of its aggregate debt owed by households, governments and nonfinancial corporations relative to the size of its economy. This is the standard international comparison of debt that essentially avoids double-counting debt of financial institutions that issue in order to fund

Chart 1



Source: Scotiabank Economics, Bank for International Settlements.

Thank you to Juan Manuel Herrera Betancourt for his always superb research assistance, and to Jean-François Perrault and Tuuli McCully for their input.

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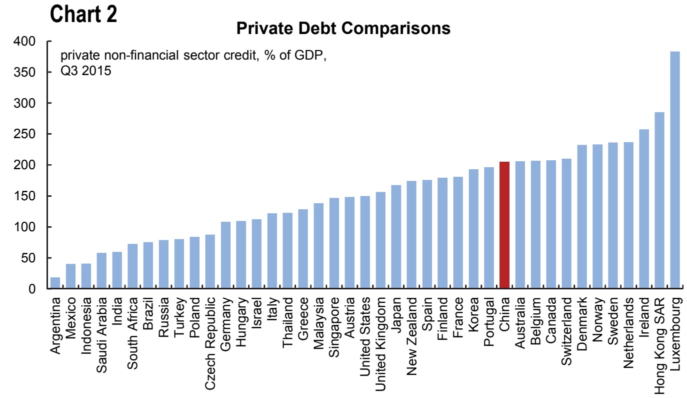
the loans to other sectors. The goal isn't to be, say, Japan on this chart but it's not clear to us that China's financial system is any more indebted or strained than the average which may or may not comfort!

China Has Above Average Private Sector Debt — But Is Not An Outlier

Chart 2 looks at debt in just the private sector (households and nonfinancial corporations) and shows that China creeps up the rankings somewhat but is still less indebted than, say, Canada or Australia in proportionate terms.

Chart 2



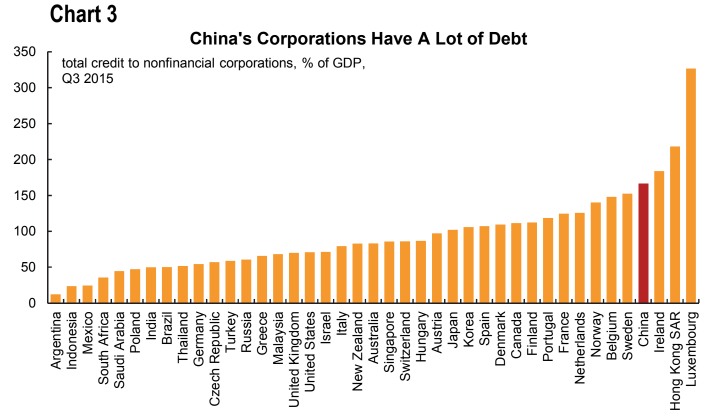
Source: Scotiabank Economics, Bank for International Settlements.

China's Corporations Are Heavily Indebted

Chart 3 breaks down chart 2 and shows one component indicating that China's corporate debt is indeed high as a share of GDP. This feeds into concerns that the so-called 'zombie' companies with bloated debt and weak productivity that are often State-Owned Enterprises face significant challenges. That China's SOEs have challenges in not being terribly market-driven is hardly news.

One factor that may help allay such concerns, however, is the nascent evidence of a much more positive profit cycle (chart 4). Debt serviceability would obviously improve significantly if the recent acceleration is sustainable. Much of the recent pick-up appears to be via expense controls which is part of the whole argument about making the corporate sector including SOEs more competitive in China.

Chart 3



Source: Scotiabank Economics, Bank for International Settlements.

China's surge in loan growth this year that drove a record Q1 for financing activity has nevertheless only added to concerns about rapid growth in borrowing by companies. **We wouldn't counsel reaching hasty conclusions.** For one thing, early signs of accelerating profit growth would be compatible with borrowing more. Further, recall that China re-sets its loan quotas on January 1st of each year and it's possible that the usual push to exhaust those quotas was more amplified earlier in the year than normal. A seasonal surge might have been even more powerful than usual and, if so, then credit binge concerns may abate over the duration of the year if there are fewer loans within quotas to draw upon and they were simply exhausted at a faster-than-usual pace at the start of this year.

Chart 4

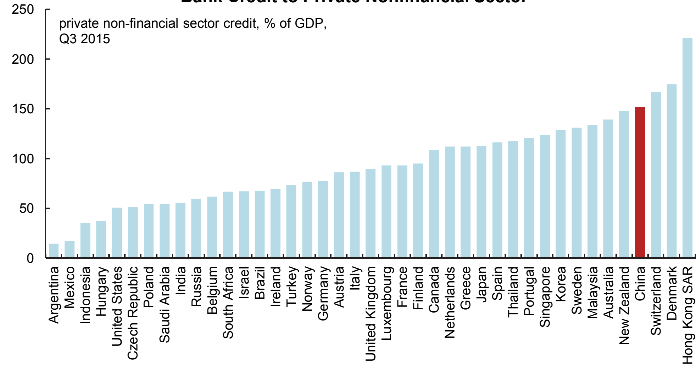
Source: Scotiabank Economics, Bloomberg.

It's how this surge in financing occurred that matters. **It is possible that what drove a surge in borrowings denominated in yuan was a perfectly rational response to China's volatile currency management.** If companies think the yuan is faced with persistent depreciation then it would make sense for them to borrow more in that currency and service it out of foreign export receipts via a depreciated yuan. This essentially uses debt as a currency hedging approach on company cash flows within a leaky but more closed capital account than elsewhere across major economies and fewer cash and derivative hedging vehicles than elsewhere. With the yuan stabilizing of late, if one thinks this will persist, then it will essentially cover this laborious way of shorting the currency by paying back the debt in subsequent months. Evidence of this would include harsher than seasonally normal cooling of debt growth over the duration of the year while the proceeds of debt growth get gradually deployed in the economy. If this happens and for this reason, then it may be of little consequence to variables that track economic activity.

What will be watched carefully as a further indication of the reason for this borrowing surge will be nonperforming loans. The People's Bank of China's official statistics continue to indicate that bad loans as a share of the book remain low and much lower than the early- to mid-2000s while the IMF warns of an elevated share of potential loans at risk. As argued, however, the policy options for addressing this risk are not to be overly discounted. China must reform its system of corporate governance and legal framework for the effective dissolution of company assets and handling of problem loans over time. Not doing so risks amplifying debt crises notwithstanding that the lack of a legislative framework may connote greater policy speed and flexibility in a system like China's than, say, muddling through the US Congress. In the intervening period ahead of further reforms, however, there are myriad other potential policy options in addition to the earlier-cited 'gifting' of capital that have been used previously should a rational price discovery process in China's debt markets within a deteriorating credit quality environment skid completely off the rails. Conversion to equity, loan securitization, conventional monetary policy easing via interest rate cuts or reserve requirement ratios, and unconventional monetary policy options at a central bank that has thus far employed them to a far lesser extent than in the US, Europe and Japan are among such options.

Chart 5

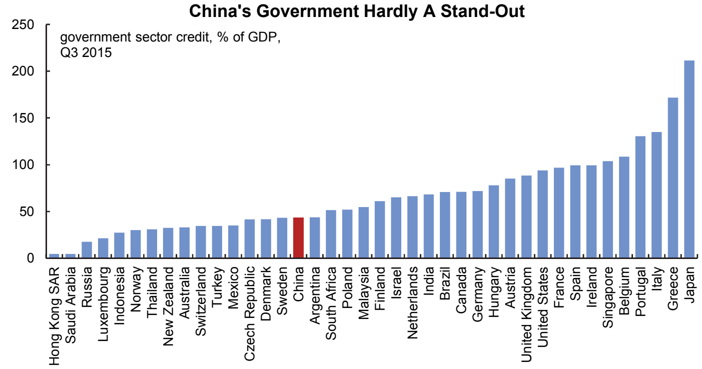
Bank Credit to Private Nonfinancial Sector



Source: Scotiabank Economics, Bank for International Settlements.

Chart 6

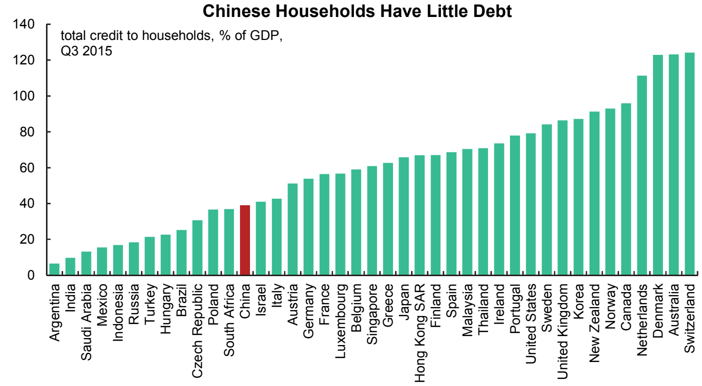
China's Government Hardly A Stand-Out



Source: Scotiabank Economics, Bank for International Settlements.

Chart 7

Chinese Households Have Little Debt



Source: Scotiabank Economics, Bank for International Settlements.

Banks Hold Most Of It

Chart 5 shows that much of the debt to the private sector (households and corps) is extended by banks and more so than elsewhere. Hence the focus upon China's banking system. That this must by definition pose greater risks to China than, say, more reliance upon capital markets debt used to finance households, businesses and governments is unclear. Once again it boils down to different approaches across economic regions and it isn't clear to us that more reliance upon market debt lessens risks versus bank debt particularly in a high saving economy. Recall that China financed much of the US housing boom and when sentiment toward the market debt turned, the ensuing deleveraging magnified the problems to the economy.

China's Governments Are Among The Least Indebted…

Chart 6 shows that China's governments are not directly among the more heavily indebted; in fact, there are many other nations with proportionately far more direct government debt and you don't have to go to extremes like, say, Greece or even Japan to make the point. Granted, a murky divide exists between the indebtedness of the government and the SOEs that are behind much of chart 3.

…And So Are Its Households

Chart 7 demonstrates that China's households are also not particularly indebted in aggregate relative to, well, almost everywhere else. This makes sense given that consumer spending is only about 37% of China's economy by contrast to, say, the United States where the share is about thirty points higher. That said, this will likely be an area of future debt growth as China attempts to place more emphasis upon the household sector to drive future economic growth. If it succeeds, then this could mitigate some of the corporate debt concerns directly through the impact on profit growth, and indirectly through the impact upon broader credit markets.

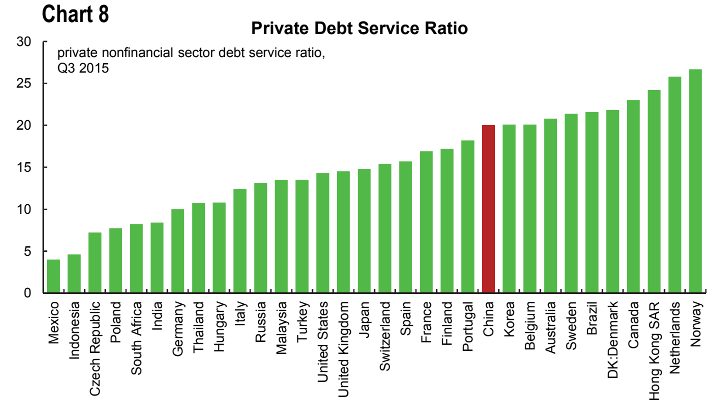
Faster Growth, Better Debt Serviceability

All of the charts to this point compare a stock concept (outstanding debt) to a flow concept (annual output of goods and services) and should be treated carefully in part because debt is financed out of years of future growth and not just one year of economic activity. Now, if a country is still growing much faster than elsewhere (which we believe China is against other attempts to re-invent growth statistics based upon arguably even more flawed metrics than GDP) then its ability to service that debt is proportionately greater in future and hence that country's stock of debt might naturally be expected to be higher in some sectors of the economy. What chart 8 shows is that debt payments relative to GDP in China are elevated but not appreciably more than the average and less than numerous other countries including, once again, good ol' Canada.

Captive Debt Holders

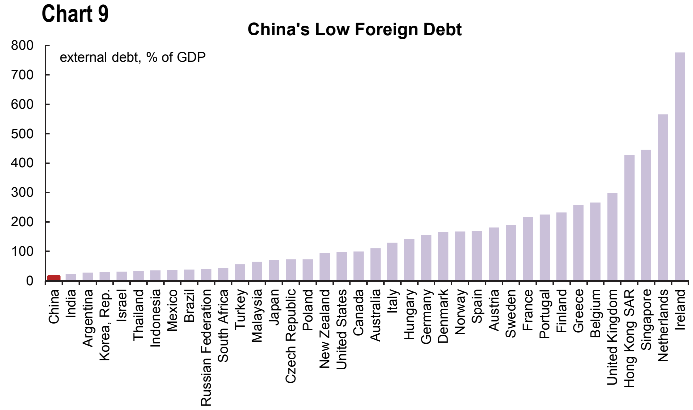
To whom China's borrowers owe all of this debt is also important. External debt is actually rather small in China scaled to the size of the economy (chart 9) or its foreign reserves (chart 10). Think of chart 10 as a net debt proxy in the absence of a full set of international accounts for the asset side of the ledger. Like Japan, the country's debt market is fairly closed and that mirrors its mostly closed but leaky capital account amid efforts toward becoming more open over time. This is important because usually full-blown and destabilizing balance of payments difficulties stemming from large indebtedness positions arise due to high levels of debt owed to foreign creditors which raises currency translation risk. When debt serviceability becomes challenged, the feedback loop of souring market sentiment and currency volatility or depreciation can feed upon itself. Witness the US into the global financial crisis, or, say, Greece. When debt is principally owed to domestic savers then it can bring greater policy flexibility before a captive market although the outcome could be painful.

Chart 8



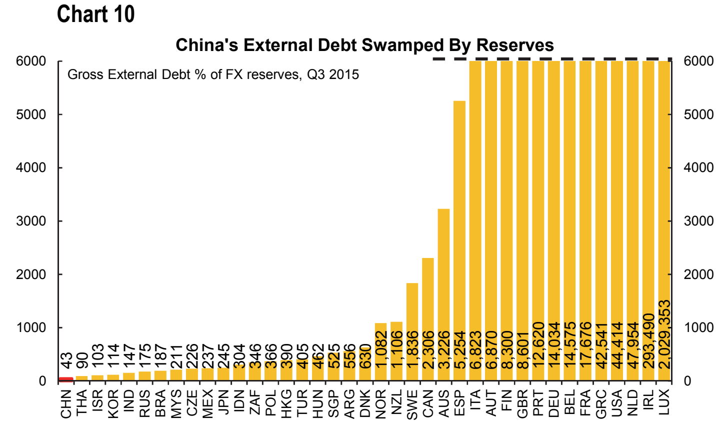
Source: Scotiabank Economics, Bank for International Settlements.

Chart 9



Source: Scotiabank Economics, World Bank, IMF.

Chart 10



Source: Scotiabank Economics, IMF.

Conclusion

In all, there are legitimate risks posed by high levels of debt in some parts of China's financial system and namely in the corporate sphere within the context of slowing growth. Such concerns must nevertheless be put in the context of a holistic approach to the financial system and through international comparisons. Those international comparisons should respect the fact that China is neither a pure emerging market economy per se, nor an advanced, mature growth economy and so we look at as wide an array of international comparisons as possible. We are still concerned about the possibility of further yuan devaluations and how policymakers manage this risk along a slowing growth trajectory, although the market and policy challenges at the start of this year partly reflected amplified seasonality in the leaky capital account given that USD conversion limits per head reset at the start of each year. This sparked a rush to the exits given the path the yuan was on and concerns about the value of yuan-denominated savings. To the extent to which this volatility has settled down as evidenced by convergence of the onshore- and offshore- yuan exchange rates, and to the extent to which one accepts the cautiously more holistic perspectives on China's debt markets offered in this note, it may well be that the more extreme China bears remain overly negative.