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Chi on China

China's Debt Conundrum (I)

The "money black hole" & the day of reckoning

SUMMARY

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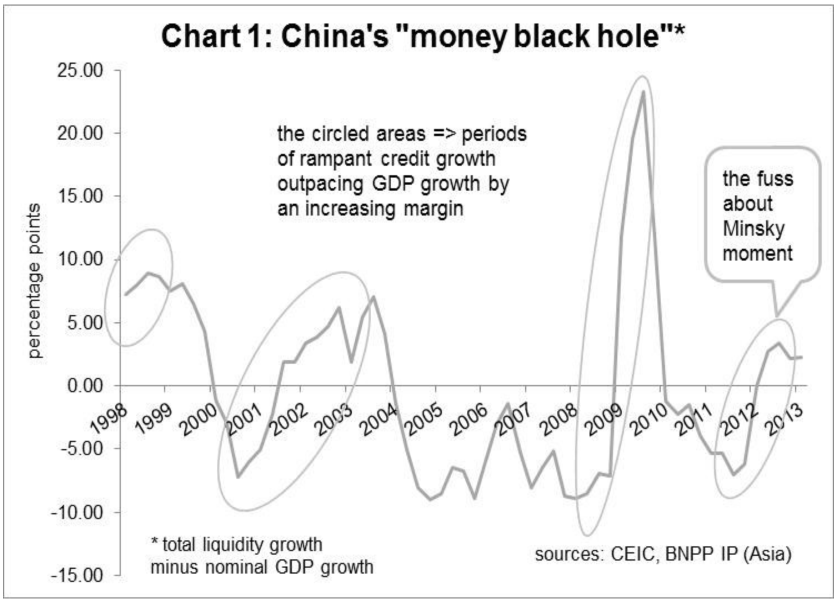
- China's systemic risk is rising. Its debt-service ratio is estimated to be high enough to trigger a financial crisis, leading some analysts to argue that a "Minsky moment", or the day of reckoning, may be near.
- May be not. China's debt problem is not yet fatal, as the crisis triggers in these other countries, including aggressive financial deregulation, a heavy foreign debt load and an open capital account, are not present in China.
- The high (300%) NPL coverage will help China muddle through its deleveraging process and break its implicit guarantee by enabling slow and orderly defaults. To prevent any systemic fallout, limited capital account opening and selective regulatory forbearance will remain in place in the medium-term.

A Minsky moment, based on Professor Hyman Minsky's 1992 financial instability hypothesis, refers to an abrupt and significant drop in asset values as a result of rampant speculation funded by borrowed funds after prolonged economic prosperity. There are three kinds of borrowers in the Minsky world.

First is the hedge borrower, who can pay principal and interest from cash flow. Second is the speculative borrower, who can only pay interest and needs to roll over the principal by further borrowing. Third is the Ponzi borrower, who can pay neither interest nor principal and must borrow (or sell assets) just to meet the interest bill. Minsky argued that prolonged and robust economic growth would breed complacency and increase the number of speculative and Ponzi borrowers. They are the culprits who cause asset bubbles that eventually burst with devastating economic effects.

The "money black holes"

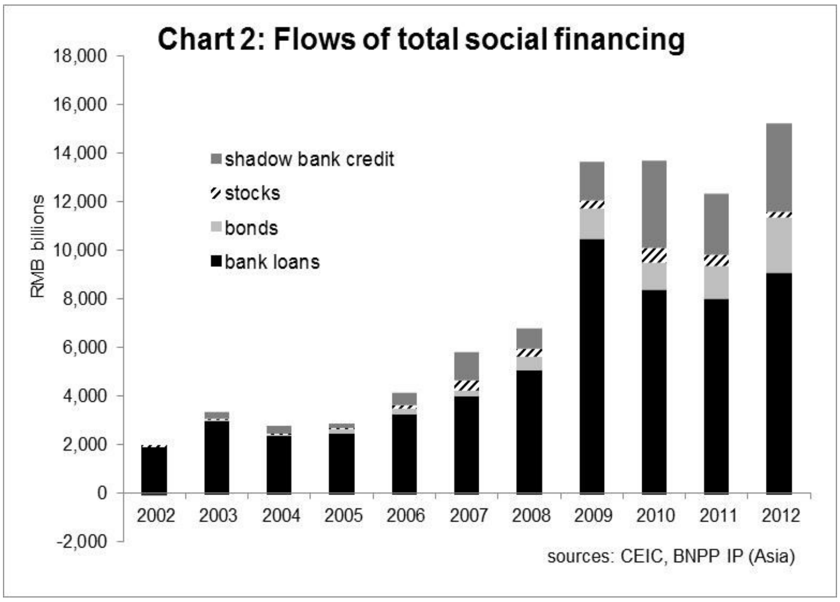
Official data show that China's GDP growth rate has been trailing its credit growth rate by an increasing margin since late 2011 (Chart 1). This suggests that rising debt has been supporting Chinese assets to produce income that is not sufficient to service the debt. This diminishing marginal efficiency of debt-financing has produced a "money black hole" that some analysts argue will eventually bring about a day of reckoning, or Minsky moment, for China's growing debt burden.



Money black holes have appeared in the Chinese economy before. In the last 15 years, there were three episodes when rampant credit growth exceeded GDP growth significantly (Chart 1). So why all the fuss about the Minsky moment this time? The reason is that in all the earlier cases, the credit binge was driven by deliberate monetary policy expansion. Beijing "ordered" indiscriminate bank lending to salvage the economy from the impact of the external shocks stemming from the Asian crisis in 1998-9, the bursting of the US IT bubble in 2001 and the Great Recession in 2008-9.

However, the latest money black hole (which opened in 2012) is not the result of an exogenous policy shock. It is shadow banking flows, not bank credit, that have driven the rise in total liquidity since 2009 (Chart 2). The shadow banking flows include funds from the capital market, trust company loans, money market funds, bank acceptance bills, entrusted loans and curb-market lending. They accounted for nearly half of the total new liquidity flows into the system in 2012, compared to zero before 2002.

Granted, the shadow banking market is part of the financial system and it helps the under-privileged Chinese borrowers escape financial repression. However, it also tends to create an adverse selection problem, as only those who cannot get bank loans have to tap the shadow banking market on unfavourable financing terms. This is dangerous when shadow banking activities are not properly regulated.



The day of reckoning

China's debt situation is drawing international attention as it is growing so fast. A recent BIS research paper[1] brought it into the spotlight. The BIS found that when there was a fast run-up in the private sector debt-service ratio to above 25% of GDP a year, a financial crisis would follow in that economy. It cited the experience of the high-profile financial crises in Finland in 1991-2, South Korea in 1997-8, the US and the UK in the early 1990s and more recently in 2007-8, which were all followed by severe economic recessions.

Worryingly, China's non-public sector debt-service ratio is estimated at over 35% a year! At the end of 2012, total non-financial corporate debt and local government financing vehicle (LGFV) debt was about 150% of GDP. With an average interest rate of about 6.0%, the annual interest burden was 9.0% of GDP (=150% x 6%). The rest was principal (i.e. 141.0% of GDP). The average maturity of these loans was about five years. Assuming no roll-overs of the loans and a regular payment schedule, like a mortgage loan (which are what the BIS and market research assumed), the estimated debt-service ratio for China is more than 35% a year, hence the fear of a Minsky moment in China!

Not so soon

The comparison of China's situation with the other crisis countries is not appropriate at this point because the crisis triggers in the other counties, namely financial deregulation, a heavy foreign debt burden and an open capital account, are not present in China. Finland, South Korea, the UK and the US all aggressively deregulated their capital, banking and foreign exchange markets years before their financial crises erupted. All of them have open capital accounts, which make a rising debt burden detrimental as foreign capital pulls out *en masse* when foreigners lose confidence. China's financial system and capital account are still closed. Almost all of its debts are domestically owned, so China is not held hostage by foreign creditors at times of financial stress.

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[1] Drehman, M. and M. Juselius (2012), "Do Debt Service Costs Affect Macroeconomic and Financial Stability?" BIS Quarterly Review, September

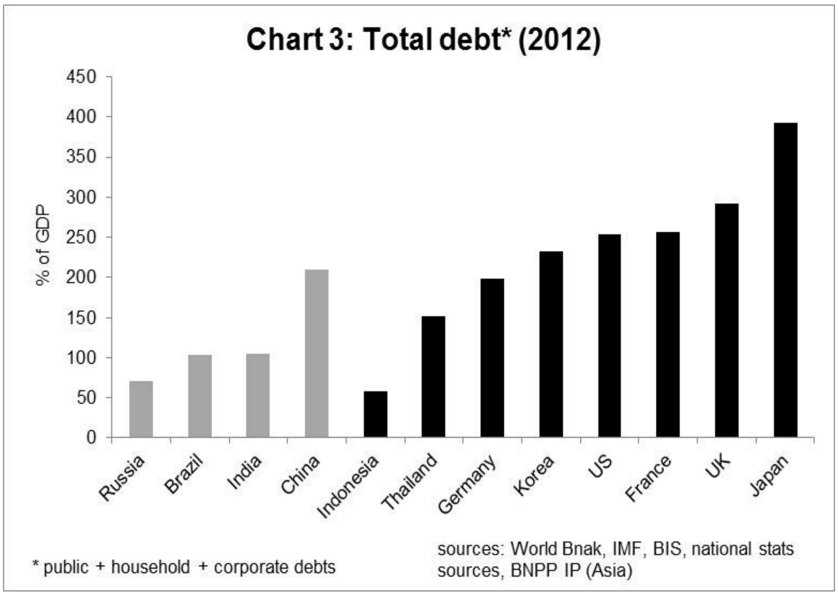
In all the estimates for China's debt-service ratio, including ours above, the key assumption is no debt rollover upon maturity. But Beijing has been rolling over domestic debt, especially that of the LGFVs. Debt-rollover will remain an effective measure to prevent the advent of a Minsky moment under a closed capital account.

The day of reckoning would come if China were to sit on its hands. But it is not. The leadership is moving, albeit slowly, to push for regulatory and structural reforms to help China deleverage. Its toleration of slow growth and resistance to indiscriminate monetary expansion in this cyclical downturn is a significant departure from the old "bail out" model. It is reacting to the adverse selection problem in the shadow banking market with new regulations restricting bank lending to LGFVs, trust company loans to the local governments and banks' and other financial players' exposure to wealth management products.

Problem is not fatal, yet

Given the significant amount of rigidity and distortion in the system, China can only deleverage slowly. A "too-big-to-fail" policy and selective regulatory forbearance will remain in place in the medium-term as costs for maintaining systemic stability. Small players, such as trust and other shadow banking products, may be allowed to fail in the coming years as a transition to break the "implicit guarantee" conundrum. But defaults by the SOEs or LGFVs or any large players will be unlikely due to systemic concerns. Beijing must strike a balance between stability and structural reforms.

True, China's systemic risk is rising. But it is not yet fatal, and Beijing is starting to tackle the problem. Its total (corporate, household and government) debt is lower than that of many countries, though it is the highest among the BRIC countries (Chart 3). Further, Chinese banks have high non-performing loan (NPL) coverage that can help absorb some potential defaults without much difficulty. The official NPL ratio in the system is about 1% of total banking assets; although some market estimates put it at 5%.



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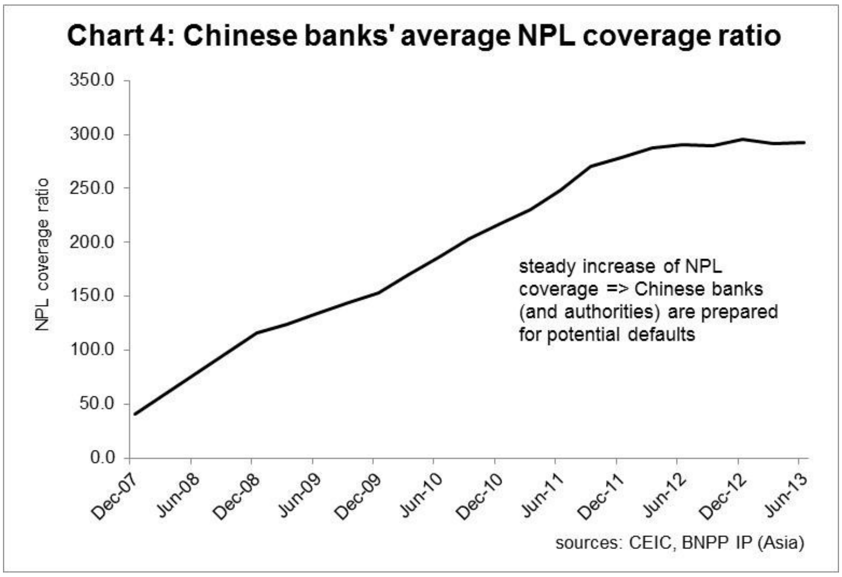

Meanwhile, NPL coverage is about 300% (Chart 4), up from 40% in 2007 before the global financial crisis hit. This means the banking system could withstand a rise of the NPL ratio to 4% from the official 1% before bank earnings (and equity) are hit. Even among European banks, which have been struggling with an enormous amount of financial stress in recent years, their average NPL coverage has only risen by about 100% since 2008. Unless some financial disasters arise, the odds of bank equity being wiped out (a common concern in the market) are low. Crucially, the steady increase in China's NPL coverage implies that the authorities might be preparing for some potential defaults. This is structurally positive if it indicates a policy shift from implicit guarantee that distorts credit pricing to market forces that impose proper discipline on pricing capital.

Chi Lo
Senior Strategist, BNPP IP

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