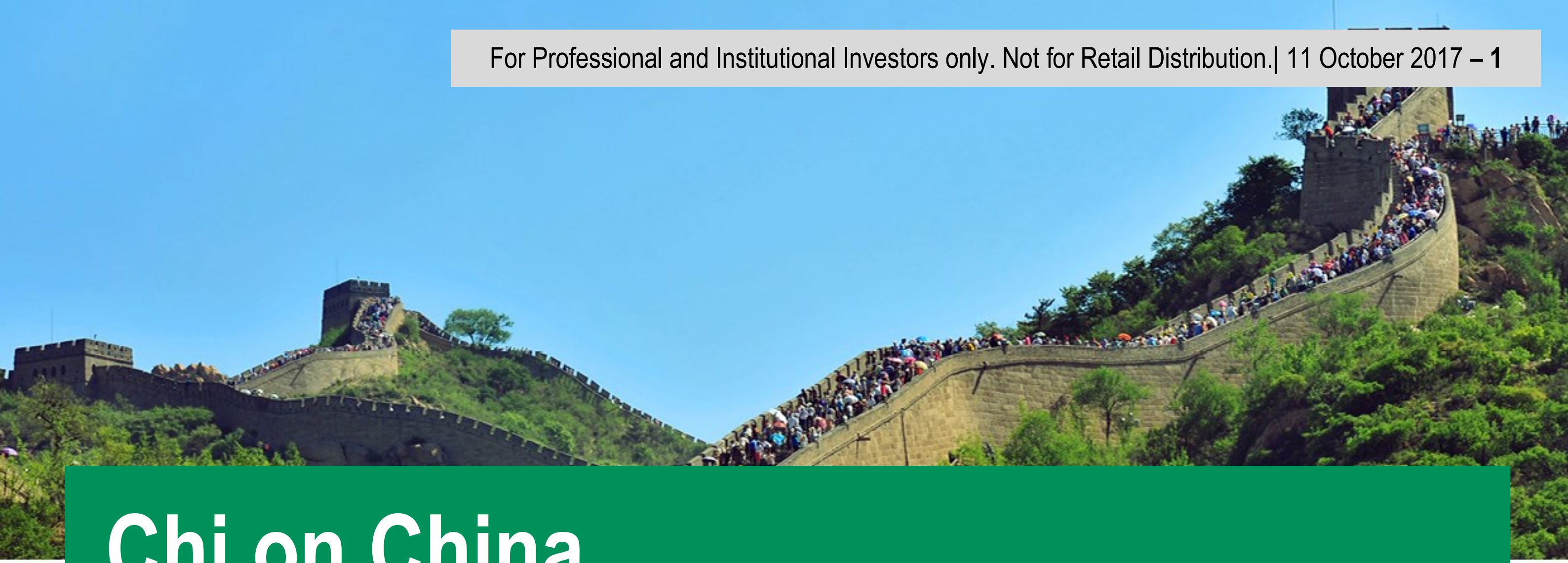

Chi on China

WHAT WE DON'T SEE IN CHINA'S DEBT RISK (II)

Look up at the stars and not down at your feet. Try to make sense of what you see, and wonder about what makes the universe exist. Be curious.

Stephen Hawking

Summary

- China's credit growth has risen rapidly from less than 150% of GDP in 2008 to an estimated 260% of GDP in 2016, with the bulk of the increase coming from the corporate sector. Mortgage debt has also soared and is seen as a potential new trigger for the "debt bomb".
- Conventional analysis only focuses on the problem of diminishing marginal efficiency of credit in China. However, it has missed the impact of financial deepening on boosting the system's debt-to-GDP ratio but not necessarily making credit unproductive.
- China is going through financial deepening and the sharp rise in mortgage debt is a result of this process. Concluding that all the increase in China's debt-to-GDP ratio reflects worsening credit quality overstates the true debt risk.

Further to my recent argument that the debate on China's debt risk had been partial (by focusing predominately on the liability side of the economic balance sheet and missing the asset side that has positive growth implications from debt accumulation)[1], here is another side of the debate that the market has missed – financial deepening. This refers to a process that increases the provision of financial services to economic agents in the system at any given level of GDP. It includes the development of financial markets and an increase in the number of financial institutions providing diversity in financial instruments.

[1] See "*Chi on China: What We Don't See in China's Debt Risk*", 10 May 2017.

The conventional wisdom

A rapid increase in debt relative to GDP growth leads to diminishing marginal efficiency of credit as each unit of credit increment produces a declining amount of output. Much of this unproductive credit will eventually turn into non-performing loans (NPLs) when borrowers cannot generate enough revenues to service their debt. The NPL problem may be hidden when GDP growth is strong, but will emerge and inflict losses in the system as growth slows.

Furthermore, as in China, when fast debt accumulation is accompanied by financial innovation, which includes a proliferation of new financial players and instruments creating multilayer lending and regulatory arbitrage, systemic risk becomes bigger and harder to regulate. Arguably, this was what happened in the US in the years before the subprime crisis, with the rise of poorly-understood securitised loans spawning into a diversity of leveraged products. Arguably, something similar is happening in China, with the rise of shadow banks (including non-bank financial institutions) as conduits for disguising loans as "investments" that require less capital backing and are exempt from NPL provisions[2].

The missing factor

These arguments are all valid, but they only describe a partial picture in China. A rise in the debt-to-GDP ratio does not necessarily indicate that credit is becoming unproductive, causing efficiency losses in output. It could also be a result of financial deepening when households and companies have more access to credit for financing their expenditures. Since one person's debt is another person's asset, this means that on the other side of the balance sheet, economic agents also hold more financial assets as investment.

Financial deepening transforms a cash-based system into a credit-based one, allowing the expansion of spending power. Europe and the US went through this process in the 1960s through the 1990s, when their average private-sector credit-to-GDP ratio went up from less 50% to over 100%. But no one argued during that time, as they do about China today, that financial disaster was imminent as the incremental credit was generating less and less GDP growth. Instead, analysts praised the rise of consumer finance and financial innovation as new growth catalysts, allowing people to buy more and companies to produce more, despite the ostensible decline in the marginal efficiency of credit.

China is undergoing financial deepening. Banks dominated China's financial system a decade ago, and they only lent to state-owned enterprises (SOEs). Since then, deregulation has improved access to credit for households and non-state companies via various channels, including shadow banking, wealth management products and internet finance. This credit expansion has its most obvious link to the mortgage debt build-up.

Mortgages not a new debt bomb

Since the mid-2000s, mortgage loans in China went from a little over 8% of total loans to more than 18% (Chart 1), which is still low by international standard, and they account for almost 80% of all consumer loans (Chart 2). Crucially mortgage loans have often grown significantly faster than nominal GDP (Chart 3), reflecting the rapid rise in urban land values prompting households to borrow to fund purchases. Not surprisingly, the bulk of the mortgage lending is concentrated in the major cities where land prices have gone up most rapidly.

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[2] See "*Chi on China: Where Does China's Financial Risk Lie?"* 23 November 2016.

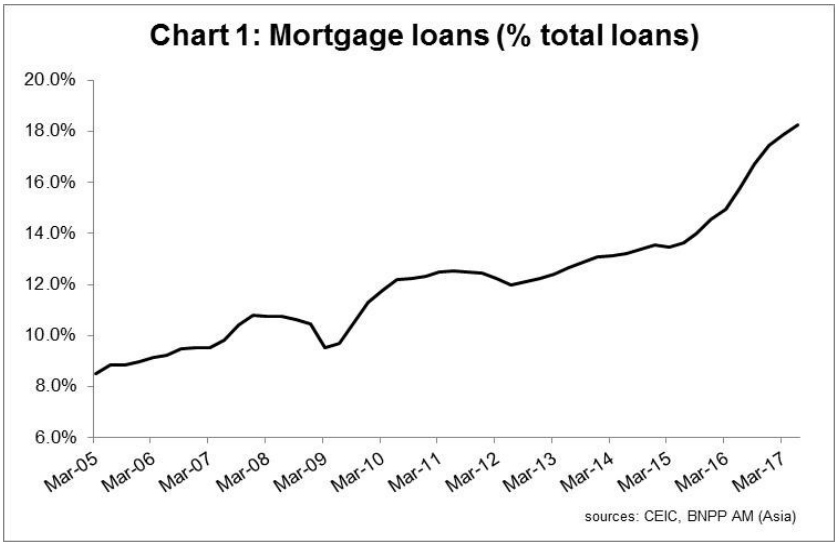


Chart 1: Mortgage loans (% total loans)
20.0%
18.0%
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
Mar-05
Mar-06
Mar-07
Mar-08
Mar-09
Mar-10
Mar-11
Mar-12
Mar-13
Mar-14
Mar-15
Mar-16
Mar-17
sources: CEIC, BNPP AM (Asia)

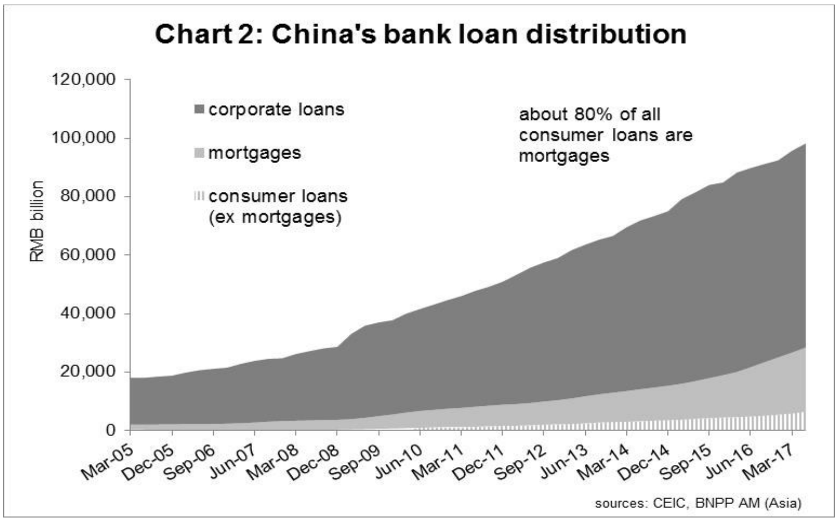


Chart 2: China's bank loan distribution
120,000
100,000
80,000
60,000
40,000
20,000
0
RMB billion
corporate loans
mortgages
consumer loans (ex mortgages)
about 80% of all consumer loans are mortgages
Mar-05
Dec-05
Sep-06
Jun-07
Mar-08
Dec-08
Sep-09
Jun-10
Mar-11
Dec-11
Sep-12
Jun-13
Mar-14
Dec-14
Sep-15
Jun-16
Mar-17
sources: CEIC, BNPP AM (Asia)

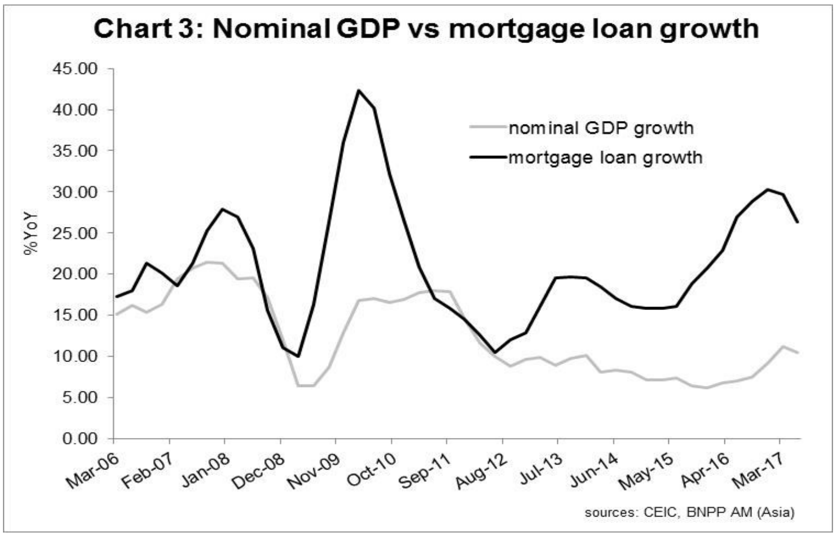
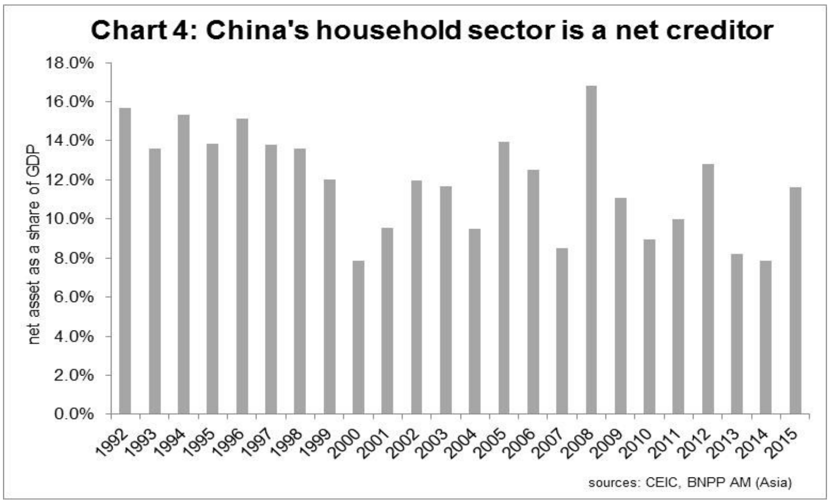
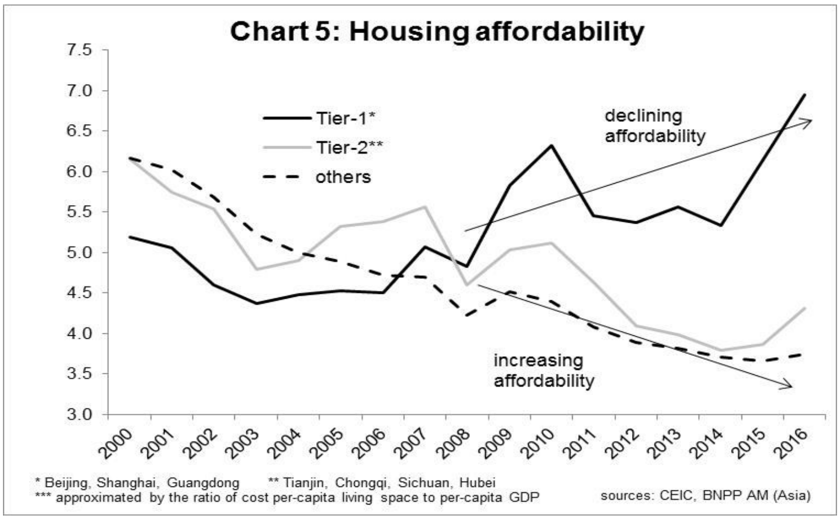


Chart 3: Nominal GDP vs mortgage loan growth
45.00
40.00
35.00
30.00
25.00
20.00
15.00
10.00
5.00
0.00
%YoY
nominal GDP growth
mortgage loan growth
Mar-06
Feb-07
Jan-08
Dec-08
Nov-09
Oct-10
Sep-11
Aug-12
Jul-13
Jun-14
May-15
Apr-16
Mar-17
sources: CEIC, BNPP AM (Asia)

To the extent that the increase in mortgage debt is reflecting the rapid rise in land values prompting households to fund home purchase through mortgages, it is entirely possible for debt to rise faster than nominal income growth associated with the property market. As long as households have enough income to service their debt, and housing prices are not out of line with economic reality, the debt build-up should be manageable.





Contrary to perception, these seem to be the conditions in China's property market. The household sector is a net creditor in the system (Chart 4), housing affordability (as approximated by the ratio of cost per-capita-living-space to per-capita-income) has only worsened for the Tier-1 cities but improved for the smaller cities (Chart 5).

This is not to deny the existence of unproductive credit in China; it certainly has a lot of it. The point is that the rise in the debt-to-GDP ratio also imbeds a significant element of financial deepening resulted from deregulation. The process has created more ways for SOEs and local governments to finance dubious projects, but it has also enabled non-state firms previously starved of credit to get financing.

Financial deepening means that more firms have access to credit now, and they have more options for how to finance investment. Thus, concluding that the entire increase in China's debt-to-GDP ratio reflects deterioration in underlying credit quality overstates the true debt risk of China.

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