FOR PROFESSIONAL INVESTORS – 4 February 2022

Chi on China

CHINA'S DEBT VULNERABILITY (V) – DEFYING DIRE PREDICTIONS

Delete the negative; accentuate the positive!

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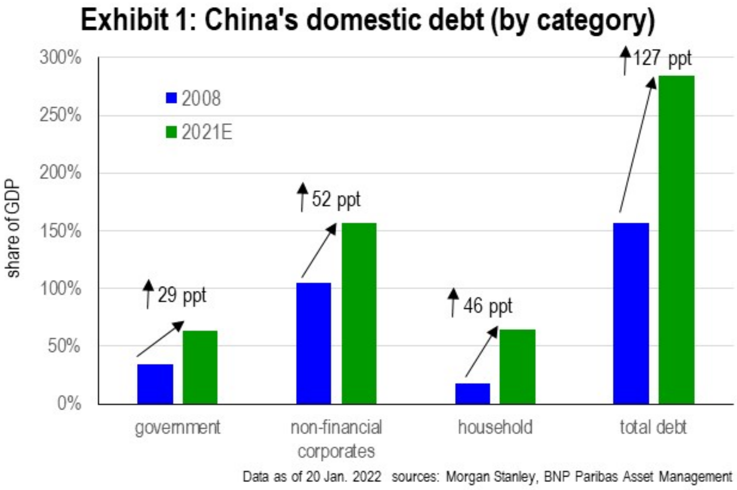
SUMMARY

- Despite rising defaults, China's debt dynamics have not weakened and the country's economic fundamentals remain strong enough to head off a debt-currency crisis. While the accumulation of local government debt remains a major concern, using 'shock treatment' to cut China's debt would not work.
- Worries about China's debt have mainly focused on the liability side of the economic balance sheet. The debt debate has overlooked the asset side, which shows that some local governments are investing in productive investments and improving their financial stability.
- The combination of a closed capital account, the self-funded nature of the debt and a strong political will to cut debt should minimise systemic risk. China will likely allow market forces to play a bigger role in its future debt reduction efforts.

While many market observers have long foreseen a debt crisis in China, their predictions have been wrong. China has managed to keep the so-called 'ticking debt bomb' from going off. Perhaps more dangerous than the country's debt problems is a lack of insight into the nature of China's development, as this can lead to a misunderstanding of China's debt dynamics and thus to poor investment decisions and policy reactions. Strong economic fundamentals, Beijing's ability to manage financial crises and its resolve to tackle the debt problem argue that China's debt is sustainable.

DEBT RISK CONCERNS…

Slowing economic growth and rising defaults – notably by some major borrowers in the state and property sectors – since the Sino-US trade tensions and Covid-19 shocks hit China in 2018 have revived concerns about China's debt sustainability. Indeed, debt in the non-financial corporate, government and household sectors has risen sharply since the 2007-08 Global Financial Crisis (GFC), pushing total debt up by a whopping 127 percentage points (Exhibit 1).



Note that the problem is not central government and recognised local government debt[1], which rose at the slowest rate among the debt categories (see Exhibit 1) and amounted to only 45.7% of total debt in 2020[2]. Rather, implicit local government debt is the issue. Since there are no proper records, it is hard to quantify accurately[3].

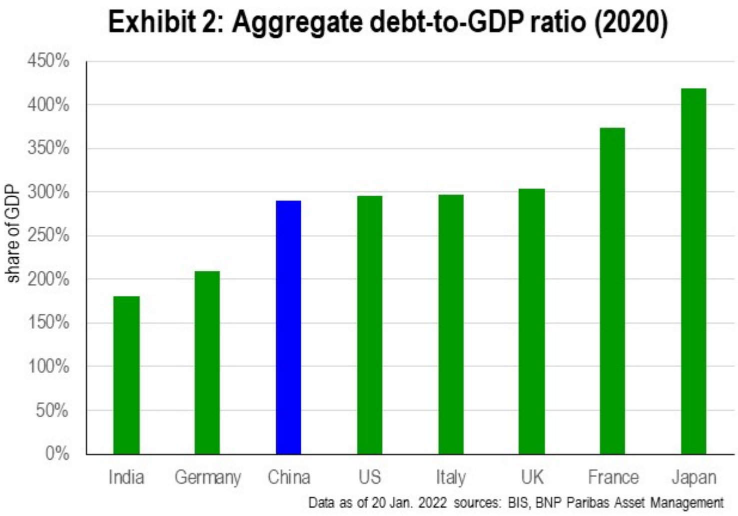
… SHOULD NOT BE EXAGGERATED

These concerns are not new. In aggregate, China's debt ratio is not as alarming as news headlines have depicted it. Many other countries have higher debt ratios (Exhibit 2). The opening-up of the capital account, albeit slowly, has aggravated worries over a debt-currency crisis in China. However, as we argued earlier, China has very low external funding risk[4]. Its macroeconomic fundamentals remain strong and have enabled it to avoid systemic crisis.

What distinguishes China from other countries struggling with debt is that its leadership has recognised the debt risk and has started to address it proactively (see below). Evidence shows that Beijing's debt reduction efforts have continued in tough times[5], with the most recent examples being the decline in the debt-to-GDP ratio during the trade war with the US and the Covid pandemic.

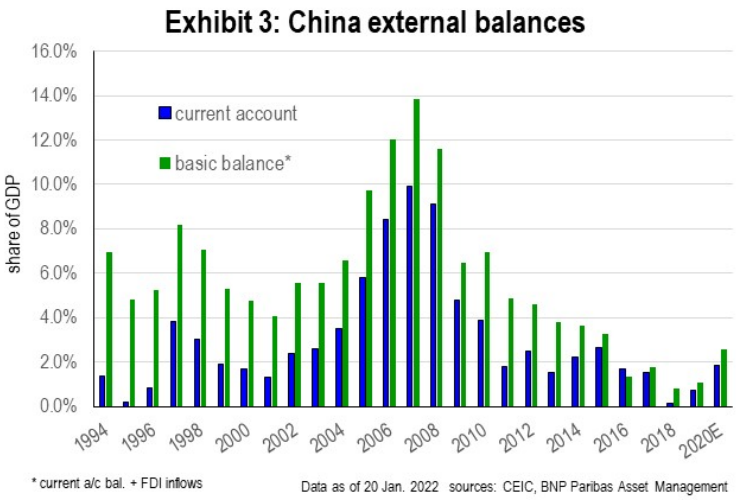
Meanwhile, China's underdeveloped financial system, which lacks the sophisticated derivative instruments that can create a criss-crossing debt web, has made its debt problem simpler to deal with[6].

[1] Since 2014, the central government has recognised some local government financing vehicle (LGFV) debt as official repayment obligations.
[2] According to official data from the Centre for National Balance Sheets (CNBS), reported by CEIC, a database vendor.
[3] See "*Chi Time: China's Debt Vulnerability (III) – Demystifying the Local Government Debt*", 18 December 2019.
[4] See "*Chi Time: China's Debt Vulnerability (I) – Déjà vu*", 19 November 2019.
[5] See "*Chi on China: When Structural Objectives Clash with Cyclical Forces*", 7 January 2022.
[6] See also "*Chi on China: China's Debt Conundrum (I): The 'money black hole' & the day of reckoning*", 16 October 2013, and "*Do Debt Service Costs Affect macroeconomic and Financial Stability?",* by M. Drehman and M. Juselius, BIS Quarterly Review, September 2012.



China's external accounts are strong. It is still running a current account surplus – repeatedly defying market expectations of a deficit[7] – and attracting foreign direct investment (FDI) inflows. Both have helped to sustain a basic surplus[8] (Exhibit 3).

Steady portfolio inflows, prompted by the opening of the capital account and inclusion of Chinese assets in international benchmarks, have bolstered China's financial account balance. The sum of these net flows has kept China's balance of payments in surplus, boosting the renminbi exchange rate and foreign exchange reserves (Exhibit 4).



[7] We have long argued that China's current account would not likely fall into a sustained deficit any time soon. See "*Chi on China: The Fuss About China's Current Account Deficit and Global Cost of Capital*", 17 April 2019.
[8] The basic balance is the sum of the current account balance and long-term capital inflows (approximated by FDI flows in China).

SELF-FUNDED DEBT

China's foreign currency debt was only about 9.0% of GDP in 2021, compared with its foreign exchange reserves of 24% of GDP, indicating that it can more than cover all its foreign liabilities. Furthermore, foreign reserves equated to more than twice the country's short-term foreign debt and 13.5 months of import cover. This is significantly higher than the international safety standards of 100% of short-term debt and three months of import cover. Hence, there is little risk of a debt-currency crisis in China.

All this underscores our long-held argument that China's debt is denominated in local currency and self-funded by high national savings[9]. Debt arises when an economy transforms its savings into investment either through borrowing or equity financing. If all national savings are transformed via the equity market, the economy incurs no debt. In reality, there is always a portion of national savings being transformed into investment via borrowing through bank loans or bond issuance. When that happens, the economy builds up debt.

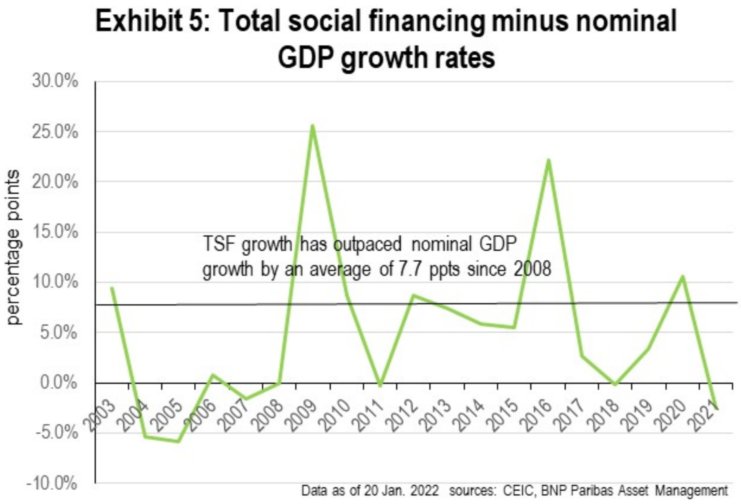
Being a high saving country, with national savings amounting to more than 45% of GDP, China naturally builds up debt. By design, the Chinese system is predominately debt-financed (mostly through bank loans) with equity financing accounting for less than 4.0% of total aggregate financing in 2021. This situation has not changed despite Beijing's long-stated intention to move away from debt-financing to equity-financing. In contrast, the US system is predominately equity-financed, with a stock market capitalisation of 188% of GDP in late 2021.

In the absence of a developed equity market, debt has naturally financed China's growth. This suggests that China's debt ratio might not be as excessive as it appears due to its underdeveloped capital market. It also argues that while China has a debt problem, the risk is manageable.

DELEVERAGING CANNOT GO FAST…

Beijing is not in denial of this risk, though it has been criticised for moving too slowly on cutting debt. To be fair, cutting China's debt-to GDP ratio swiftly, as many players have urged, would be impracticable. This is because aggregate financing growth has outpaced nominal GDP growth by an average of 7.7 percentage points since the GFC (Exhibit 5). Cutting debt abruptly would mean slowing credit growth by 7.7 percentage points below the nominal GDP growth rate. This would crush the economy before the benefits of deleveraging could even emerge.

[9] See "*Chi on China: China's Debt May be Different From What You Think*", 11 May 2016.



… BUT IT HAS STARTED

To improve transparency, Beijing has attempted to quantify local government debt by launching national audits, which have now become a *modus operandi*, on the local government financing vehicles[10] (LGFVs). The central government has also formally recognised some LGFV debts[11] since 2014, effectively putting some hidden debt back on the government's budget. Beijing has also taken measures to separate the LGFVs from local governments and turn them into independent economic entities or close them down if they are insolvent. This ongoing reform will bring more off-budget borrowing back onto the official budget.

At the national level, Beijing has taken a practical debt-reduction approach involving:

- Starting a debt-swap programme in 2015 to pare down the debt burden of the LGFVs
- Implementing a debt-equity scheme to deal with non-performing bank loans[12] and
- Setting up provincial asset management companies to absorb regional bank loan losses
- Encouraging equity financing, though has limited success so far, to reduce reliance on debt for growth.

At the local level, to resolve the local governments' 'soft budget constraint' problem, which was responsible for the huge build-up of local government debt, Beijing introduced a new Budget Law in 2015 to rein in local government borrowing and put local budgets under the strict scrutiny of the Ministry of Finance.

In April 2021, Beijing introduced new rules to bar local governments from raising any implicit debt in any form. The rules also require them to dispose of existing implicit debt and improve borrowing transparency by publishing regular reports. The central government now scrutinises all local government investment projects with a strict approval process to force local governments to adhere to their budgets.

The trend of rising defaults reflects Beijing's resolve to retreat from implicit guarantees and enable market forces to pick losers and force them to exit the system. It is President Xi Jinping's reform policy to use the market as a

[10] Local government financing vehicles (LGFVs) are special purpose vehicles (SPVs) set up in the 1908s by local governments to skirt central government's borrowing restrictions and raise funds for local infrastructure construction and investment projects.
[11] The market regards LGFV debt as corporate debt. See "*Chi Time: China Deleveraging (Part 1 of 2): Re-pricing Risk Premium*", 15 April 2015.
[12] China's debt-equity swap scheme only serves as a stop-gap measure to reduce debt under the constraint of protecting GDP growth; in our view, it does not address the incentive problems in the system. See "*Chi on China: China's Debt-Equity Swap Programme – the Good, the Bad and the Ugly (Incentive Problems in Debt-Reduction Efforts)*", 4 November 2020.

strategic tool for economic liberalisation and structural reforms, so that market forces will play a bigger role in future efforts to reduce debt and allocate resources.

THE GOOD LGFVS

We have long argued that the debate on China's debt risk had focused predominately on the liability side of the economic balance sheet and ignored the asset side where there are growth implications from debt accumulation[13]. Recent research by the Bank for International Settlements (BIS) further underscores this argument. It shows that many local governments had borrowed through LGFVs and invested in diversified and productive sectors[14]. The BIS stated:

"*China's local government financing vehicles are often viewed as platforms that are used to evade borrowing constraints and make inefficient investments. They are even accused of harbouring potential fiscal and financial risks. By contrast, anecdotal evidence suggests that some LGFVs contribute to local economic growth through successful investments*."

Investment in diversified and productive sectors improves LGFVs' financial viability, which in turn creates more investment opportunities and contributes to future economic growth. This positive implication from the asset side of the economic balance sheet offsets some of the risk from debt accumulation and argues that China's debt problem is far less critical than many observers believe.

THE EVIDENCE

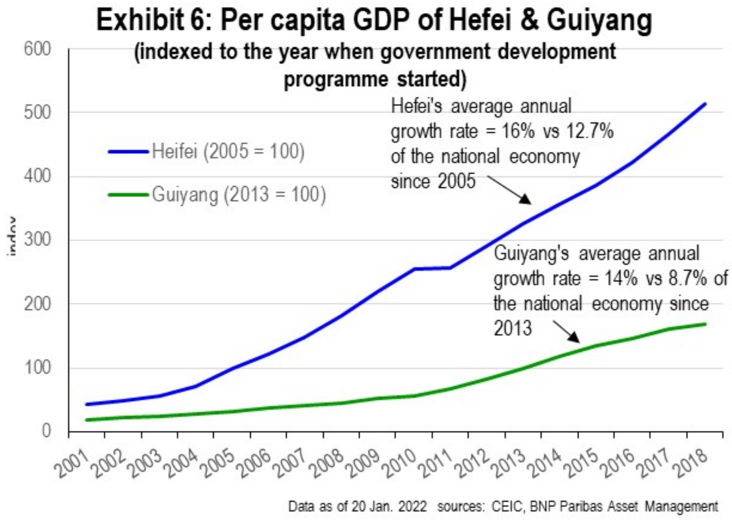
Two notable anecdotal examples of effective LGFVs are the spectacular economic transformations of Hefei, the capital city of Anhui province, and Guiyang, the capital city of Guizhou province. Both provinces are among China's poorest, but their local governments have taken the initiative to transform their economies by using LGFV borrowing to invest in private-sector and sunrise industries.

Hefei was once highly underdeveloped and had a weak industrial base. In 2005, the Hefei government launched a development strategy to transform the city into a scientific research and industrial hub. Its per capita income growth has since rocketed, outperforming national per capita growth by an average 3.3 percentage points a year since 2005 (Exhibit 6).

The city now is home to successful start-ups including Hikvision, iFLYTek and Kingsoft. It was ranked sixth among 169 high-tech zones in 2019 in China[15], and the Hefei government was crowned the best venture capital investor along with Huawei and Alibaba.

Similarly, in 2013, Guiyang's per capita income was the lowest in China. Yet, since launching an economic transformation campaign in 2015, it has transformed itself from a landlocked backward city into one with a diversified economy focused on tertiary production, scientific research and big data. Major investment was funded by local LGFVs. As a result, Guiyang was ranked one of the world's top 500 science cities by scientific output in 2018, according to the Nature Index[16].

[13] See "*Chi on China: What We Don't See in China's Debt Risk?"* 10 May 2017.
[14] "*Investing Like Conglomerates: Is Diversification a Blessing or Curse for China's Local Governments?*", by Jianchao Fan, Jing Liu and Yinggang Zhou, BIS Working papers, No. 920, 18 January 2021.
[15] "*Technological Innovation Will Be a Major Driving Force in Anhui*", EXBulletin, October 23, 2020 https://exbulletin.com/tech/487806/
[16] "*Nature Index 2018 Science Cities, Nature Index Supplements, Nature Index*" https://www.natureindex.com/supplements/nature-index-2018-science-cities/global-city-map
The Nature Index is a database that has tracked the scientific output of institutions and countries since 2016. Each year, the index ranks the leading institutions (which can be companies, universities, government agencies, research institutes or NGOs) and countries by the number of scientific articles and papers published in leading journals.



Guiyang has quickly emerged as an innovation hub and built a sizable pharmaceutical industry. Its per capita income growth has outpaced that of the national economy by an average of 5.7 percentage points each year since 2013 (see Exhibit 6). The Milken Institute named Guiyang the Best-Performing City in China in terms of economic and income growth and job creation in 2016. It is now a base for tech giants such as Microsoft, Foxconn, Huawei, Tencent, Alibaba, Qualcomm and Hyundai Motors.

A MANAGEABLE RISK

In short, we believe China's debt is a manageable risk.

Over the economic cycles, China will alternate between leveraging and deleveraging according to the ebbs and flows of demand. When economic growth is strong and steady, the authorities will intensify their debt-reduction efforts; during economic slowdowns, they will lift their foot off the debt brake.

In the long-term, increasing incomes and productivity are the best means to lower the debt ratio. Cutting debt too quickly may do more harm than good by killing the system before reaping the benefits. China needs to implement structural reforms to climb the value chain and sustain technological progress alongside its deleveraging efforts.

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