



FOR PROFESSIONAL INVESTORS – 16 August 2023

Chi on China

IS CHINA FALLING INTO A BALANCE SHEET RECESSION?

Long run is a misleading guide to current affairs. In the long run we are all dead.

John Maynard Keynes

SUMMARY

- Bursting of an asset bubble in a high-debt economy may trigger a balance sheet recession which would destroy wealth and confidence, force economic agents to cut spending to deleverage and create a debt-deflation spiral and prolonged economic stagnation. See Japan's experience since 1990.
- Financial engineering adds to the problem by 1) transforming debt into financial instruments and selling to investors as assets and 2) funding asset churning. This pushed most of the developed world into a balance-sheet-recession adjustment after the 2007-8 subprime crisis.
- China's economy does exhibit some balance sheet recession symptoms. However, little wealth is being destroyed, China's debt is simple, there is limited financial engineering, and its economic balance sheet does not look impaired.

A 'balance sheet recession' results when high levels of private sector debt force individuals and companies to focus on debt reduction by cutting spending and investment. This is unlike a recession caused by business cycle fluctuations or macroeconomic policy tightening.

Talks about China falling into a balance sheet recession has emerged recently as its post-Covid economic recovery has lost momentum and 'animal spirit' failed to recover. Notably, the resulting drop in confidence has caused private sector investment to decline steadily (Exhibit 1). This not only deprives the economy of growth momentum but also reflects a balance sheet recession symptom of confidence loss forcing economic agents to cut spending and minimise debt rather than maximise profit or utility.¹

¹ The term utility here is used in an economics context, meaning the total satisfaction or benefit a consumer derives from consuming a good or service. Economic theories assume that a typical consumer is rational and strive to maximise her/his utility.

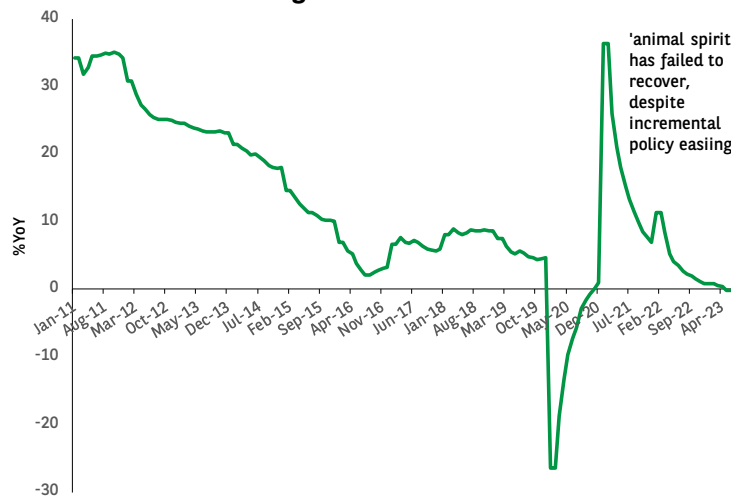


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Exhibit 1

Private sector investment growth



sources: CEIC, BNP Paribas Asset Management 4 Aug 2023

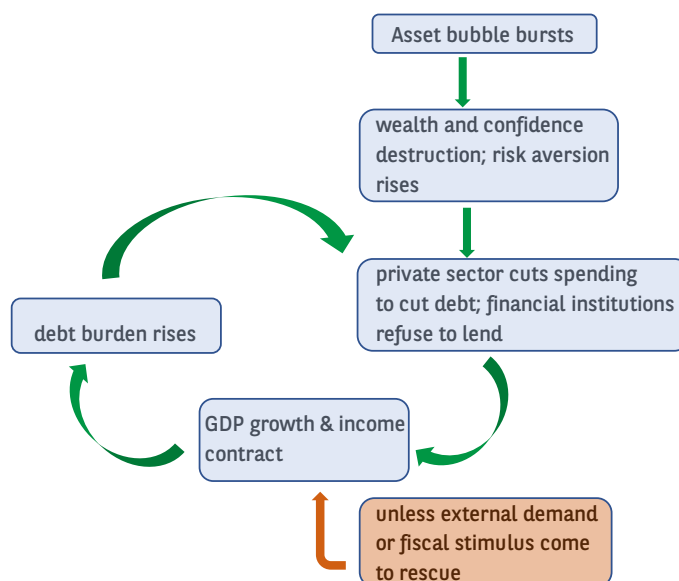
THE CURSE OF DEBT-DEFLATION

In a balance sheet recession, trouble starts with high debt accumulation. When an asset bubble bursts, it destroys wealth and impairs the economy's balance sheet. Public confidence collapses, forcing the private sector to cut spending to reduce debt and the impaired financial institutions to cut lending. Credit implosion ensues.

Unless external demand comes to rescue via a surge in the trade surplus or there is massive fiscal stimulus, private income falls, pushing up the debt-to-income ratio (or debt burden) and aggravating the debt reduction effort. This soon creates a vicious debt-deflation cycle with spending cuts leading to income contraction which, in turn, raising the debt burden and forcing the private sector to cut spending further to reduce debt (Exhibit 2).

Exhibit 2

A debt-deflation spiral of balance sheet recession



source: BNP Paribas Asset Management

FINANCIAL ENGINEERING BACKFIRES

The crux of the problem is wealth destruction and risk aversion forcing the private sector to deleverage and the impaired financial institutions to cut lending. Financial engineering adds to the root of the problem that laid behind the 2007-08 subprime crisis and pushed the developed world, notably the US, into a balance sheet recession that was [manifested](#) in the adjustment process after the Global Financial Crisis (GFC)².

In a highly indebted system, financial engineering transforms debt into investment products sold to the public that become assets. Many players also borrow to engage in asset churning. These transactions inflate the value of the asset side of the balance sheet, prompting players to borrow more to fund those transactions and inflating the asset values further. As the party goes on, such debt-funded investments do not create any real assets. Such financial engineering only creates asset bubbles like by building a pyramid upside down on sand.

So, when the asset bubble bursts, the debt-fuelled assets deflate. Initially, the value of the liability side of the economy's balance sheet remains unchanged but the value of the asset side collapses, making companies insolvent and impairing the system's balance sheet. Later, when companies go bust, the value of the liability side also goes to zero, causing the economy's balance sheet to implode and pulling the rug from under the financial system. In the absence of new sources for growth, prolonged economic stagnation ensues.

While much of the financial engineering is absent in China, it exhibits some classic balance sheet recession symptoms, including high debt, a loss of confidence, a bad property market, high risk aversion cutting consumption and bank lending, and system-wide deleveraging. So, many observers compare China with Japan's experience after its asset bubble burst in 1990 and [argue](#) that China is falling into balance sheet recession.

Really? Let us assess the hallmarks of balance sheet recession – debt, wealth destruction, financial engineering, loss of confidence and deleveraging – in China's perspectives.

DEBT RISK

China has a high debt ratio (Exhibit 3), but as I have [long argued](#) it is not dire. China has persistently [defied](#) predictions of it falling into a debt-currency crisis because its debt is self-funded³, its capital account is relatively closed, and Beijing is pursuing a selective 'implicit guarantee' policy to uphold systemic confidence.

Exhibit 3

Debt-to-GDP for non-financial sector (2022)



sources: BIS, BNP Paribas Asset Management 4 Aug 2023

² See "China After the Subprime Crisis – Opportunities in the New Economic Landscape", Chi Lo, Palgrave Macmillan, 2010, Chapter 1.

³ China has a small foreign debt of 13.6% of GDP (in 2022), compared to a national saving rate of over 40% and foreign exchange reserves of 19% of GDP.

This combination makes China's debt a manageable risk. The China debt debate has been [distorted](#) by observers totally ignoring the asset side of China's economic balance sheet and [financial innovation](#) that have positive growth implications. Conventional wisdom has exaggerated China's debt problem, in my view.

WEALTH DESTRUCTION

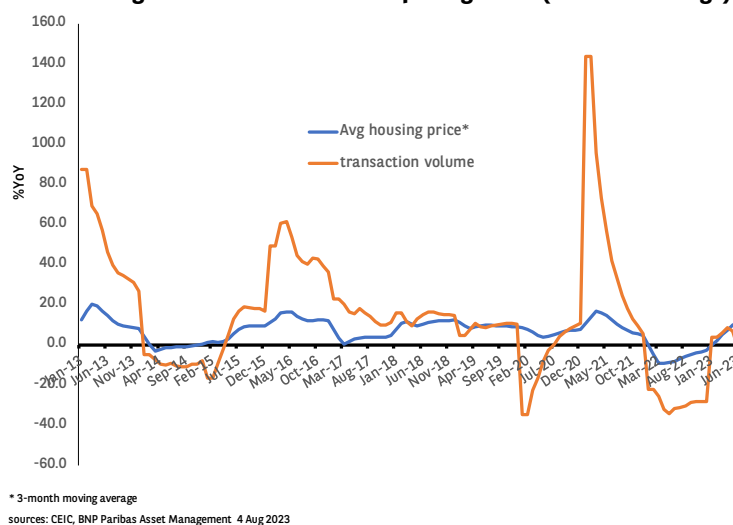
The wealth effect from the stock market on China's private sector spending is limited because the bulk of Chinese assets is not held in financial assets but in property. And despite the property market woes, there is limited wealth destruction and little risk of large-scale negative equity on mortgages.

Estimates of the share of Chinese household's financial assets (including stocks and bonds and products in insurance, trusts and wealth management) range between a mere 20% and 30% of total wealth. China's stock market (CSI300) dropped by only 6.8% during the pandemic (2020 – 2022). Hence, the negative wealth effect of the stock market on Chinese household is limited.

About three quarters of China's household wealth is held in property. The decline in housing prices throughout Covid was also limited, thanks to Beijing's restrictive property market measures, including lending restrictions and at least 30% down-payment for the first home and 60% for the second before the recent relaxation. Thus, property market correction in China typically comes from contraction in transaction volumes but not in price crash (Exhibit 4). Here too, wealth destruction has been contained.

Exhibit 4

China housing transaction volume and price growth (national average)



FINANCIAL ENGINEERING

Overall, China's housing market indebtedness is not high. Despite a rising trend, mortgage loans account for only about 20% of total bank loans. Crucially, there are no financial derivatives, such as collateralised debt obligations (CDOs) and asset-backed securities (ABS), and no organisations such as the US's Fannie Mae and Freddie Mac, for leveraging up the housing market. Hence, few residential mortgage loans are in negative equity.

China's immature credit system and limited financial innovation has also barred many high-risk buyers from entering the property market. Thus, it is [unlikely for China](#) to experience a 2007-08 subprime crisis US-style housing crash and a 'Minsky Moment', which is an abrupt and significant drop in asset values because of

rampant speculation funded by borrowed funds on the back of prolonged economic prosperity⁴, that would lead to massive wealth destruction.

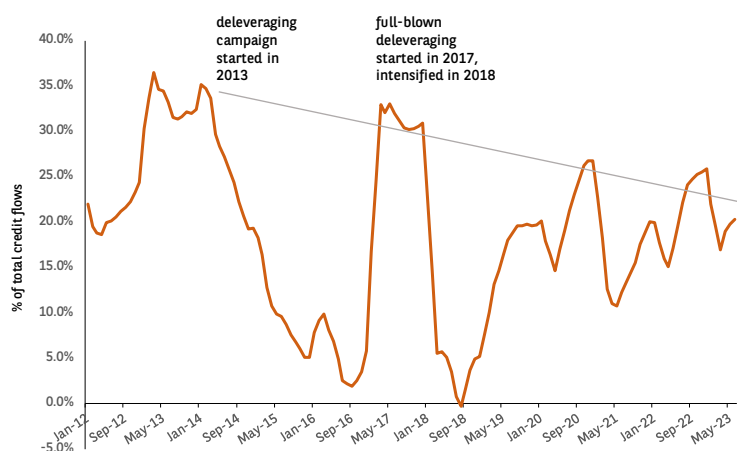
LOSS OF CONFIDENCE AND DELEVERAGING

Hence, it is not high debt and massive wealth destruction, but the combination of a bad property market and three years of [Zero Covid policy](#) (that caused prolonged, severe and disruptive quarantine and lockdowns), that has killed public confidence. Crucially, deleveraging in China is a policy decision. It is not forced by any bursting of asset bubbles triggering a collapse in confidence and private-sector spending.

Beijing launched a debt-reduction campaign as early as 2013 to end the unprecedented post-GFC credit expansion. In 2017, it curtailed shadow banking activities (Exhibit 5) and forced SOEs to cut their leverage ratios. In 2018, regulators imposed sweeping rules to rein in commercial banks' wealth management products, which was closely related to underground financing activities, to reduce systemic risk. All these efforts resulted in a fall in China's debt ratio between 2017 and 2019 (Exhibit 6). The campaign was only shelved in 2020 when Covid hit.

Crucially, China has persevered with its [debt-reduction resolve through tough times](#) (Exhibit 7) by upholding the financial de-risking policy between 2018 and 2021, despite the trade war with the US (which started in 2018) and the Covid crisis (which emerged in late 2019). This deleveraging resolve sets China apart from other financial crisis countries whose governments left it too late to deal with the debt problem.

Exhibit 5
Share of shadow credit* flows in China's financial system



* Includes trust loans, entrusted loans, bankers' acceptances & curb loans
sources: CEIC, BNP Paribas Asset Management. 4 Aug 2023

⁴ There are three kinds of borrowers in the Minsky world. 1) The hedge borrower (who can repay principal and interest from cash flow), 2) the speculative borrower (who can only repay interest and needs to roll over the principal by further borrowing) and 3) the Ponzi borrower (who can repay neither interest nor principal and must borrow, or sell assets, to meet the interest bill). Professor Minsky argued that prolonged and robust growth would breed economic 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.

Exhibit 6

China's domestic debt-to-GDP ratio

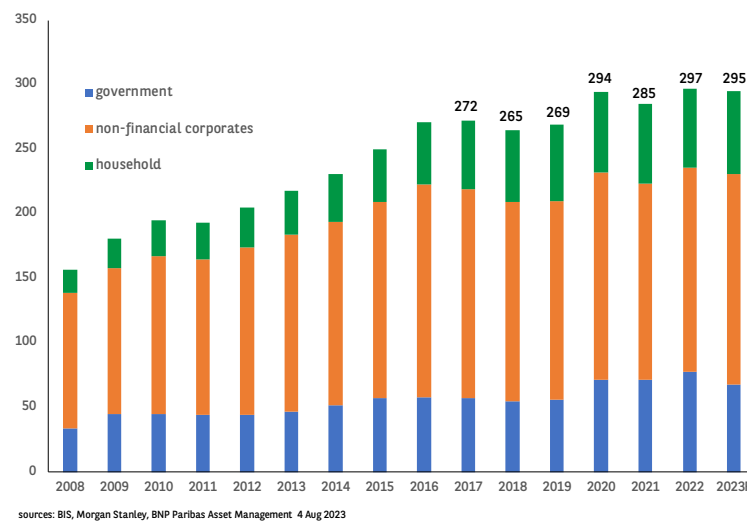
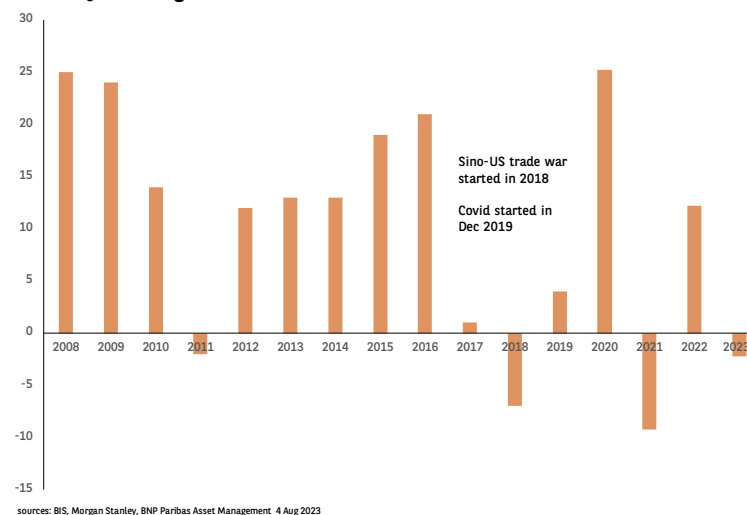


Exhibit 7

Year-on-year change in China's domestic debt ratio



POLICY LEVER AND GROWTH SOURCES

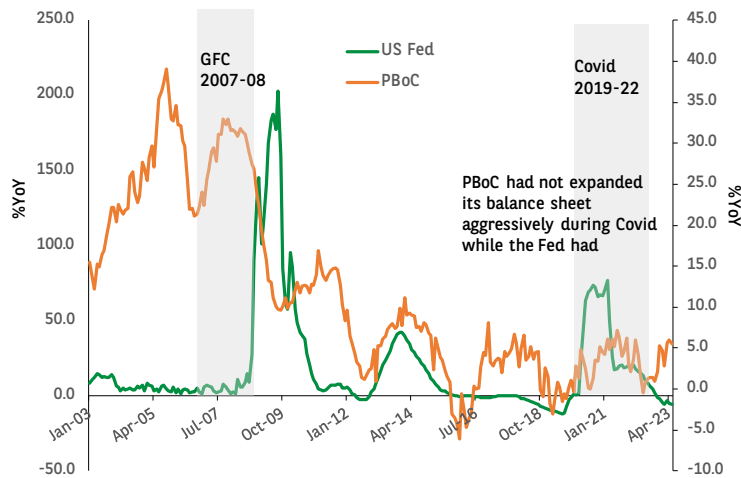
The property market is the weakest link in the Chinese system that could potentially push it into a balance sheet recession. Beijing is aware of this and has started to provide [more support](#) to the economy and the property market as a short-term measure to keep the threat from creeping into reality.

With the private sector being highly risk averse, monetary policy alone is ineffective in pulling the economy out of the liquidity trap. As Keynes argued long ago, the government needs to step in to mobilise and deploy the private saving in fiscal spending and public investment to revive animal spirit and growth momentum.

If push comes to shove, the PBoC could monetise debt to fund fiscal spending. Throughout the pandemic, the PBoC had not expanded its balance sheet aggressively to pump-prime the economy, despite all its talks about policy easing, while its developed market counterparts engaged in quantitative easing through massive central bank balance sheet expansion (Exhibit 8).

Exhibit 8

Central bank balance sheet growth



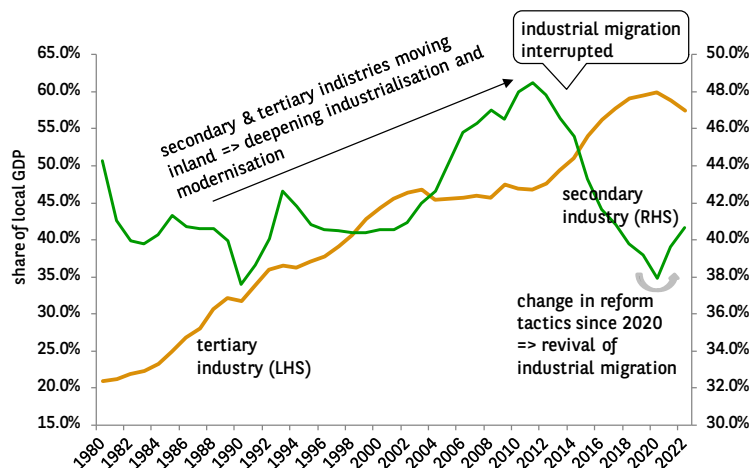
sources: CEIC, BNP Paribas Asset Management 4 Aug 2023

How about growth sources, the lack of which is a key tenet of balance sheet recession? China's '[dual circulation](#)' development strategy, implemented since 2020, is re-discovering and deploying new resources for sustaining long-term growth to counter external exigencies and global demand shift. It focuses on supply chain security, high-value manufacturing, high-tech development and [new infrastructure](#), including inter-city railway, research and development on energy and environmental technology, 5G/6G networks, artificial intelligence, and Internet of Things.

This strategy is reviving the industrial migration trend, which was started in 2005 but was interrupted in 2013,⁵ to the interior provinces where untapped and cheaper resources are available, with high value-added industries leading the way (Exhibit 9).

Exhibit 9

Chinese industrial migration to the inland* has resumed



* include 20 inland provinces

sources: CEIC, BNP Paribas Asset Management 4 Aug 2023

⁵ The process was interrupted in 2013 when the then reform policy focused on shifting the economic growth drivers from investment and manufacturing to services and consumption.

If China gets this new development strategy right, it could make the economy more productive and create sustainable growth momentum, leaving the balance sheet recession an even more remote possibility. The world should [reassess](#) China's growth outlook based on its new structural reform direction but not dwell on the stock of its past problems.

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