4 Does the mounting corporate debt in China signal a future crisis?

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Certain economists have been expecting a hard landing in China... for 15 years. There's been no emergency landing, but China's business model has changed over the past decade. Growth is not as focused on exports as it was, so domestic demand has become the primary growth driver. This balances out growth and makes it more favourable to global financial stability, but the (still ongoing) transition results in excessive use of credit (more than half the increase in the emerging world's corporate debt has been in China); public debt has soared, industrial competitiveness has eroded, and productivity gains are down. In other words, potential growth has taken a dive (10% 15 years ago, currently around 5%) while debt has grown: a rather unappealing combination.

A change in growth models

Chinese economy is slowing down as the country moves from an investment- and export-led growth model to a consumption-driven growth model. These transitional phases have always been delicate. After years of overinvestment comes overcapacity and the competitiveness deficit of the «old economy» enterprises. The government's tendency to promote credit expansion among state-owned enterprises has led to an accumulation of debts. These companies live with loose budgetary constraints, low profitability ... in short, situations that we have already experienced in the periods of great transition of the Soviet Union and many countries of Central and Eastern Europe.

The question is not whether future and potential growth will be lower. That is already a given. Rather, it's whether growth can sink much lower than its current potential and if the excessive levels of debt could generate a financial crisis. To put it another way, is China headed for a large-scale economic crisis? The most recent indicators have reduced this risk, with annualised growth in GDP stabilising around 6.7% over the past three quarters. A forced landing / fears of a forced landing would have a very negative impact, and its cascade effects would be especially disastrous:

- Vulnerable banking systems,
- Vulnerable international financial system,
- Vulnerable public and private debt in China,
- Impact on commodities and emerging countries,
- Impact on the currencies of commodity-exporting countries (advanced countries and EMG countries), and so on.
- The Fed would stop 'tightening', while the ECB would continue/accelerate its QE.

Rising debt: a major risk for global financial stability

China has changed its model, it is a fact. Its growth is now driven more by domestic demand. This does not mean that it is less vulnerable, it means that vulnerability is now more domestic. Among these factors, debt is one of the most critical. China was able to weather the crisis of 2007-2008 and the period of major recession (2008-2010) fairly easily thanks to monetary expansion and the use of credit. This was one of the prices to pay. The International Monetary Fund (IMF) and the Bank for International Settlements (BIS) recently (late 2016) alerted the financial community to the soaring debt of China. The IMF was mainly concerned with private debt, which reached 145% of GDP, fueled in particular by enterprises in the traditional sectors, where precisely the overcapacity remains high. According to the IMF, total non-performing loans in 2016 amounted to around $400 billion (of total loans of $2.8 trillion, i.e. around ???% of the total). China's four largest (state-controlled) commercial banks reported a substantial increase in non-performing loans on their balance sheets in the first half of 2016.

The essential

China's economy is slowing down as the country moves away from a growth model driven by investment and exports toward a consumer-driven growth model. Such transitions have always been tricky. After years of overinvestment, China is facing overcapacity and «old economy» enterprises are struggling to compete.

The government's tendency to promote credit expansion among state-owned enterprises has also led to an accumulation of debts. These companies have loose budgetary constraints and low profitability. In short, the situations are similar to those seen during the major transitions in the former Soviet Union and many countries in Central and Eastern Europe. The question then is not whether future and potential growth will be lower. That is already a given. Rather, it's whether growth can sink much lower than its current potential, and if the mounting debt could provoke a genuine financial crisis. It's still too early to say for sure, but it's clear that the situation needs to be monitored very closely given the spectacular increase in corporate debt since the financial crisis. This trend is completely unsustainable and unsound.

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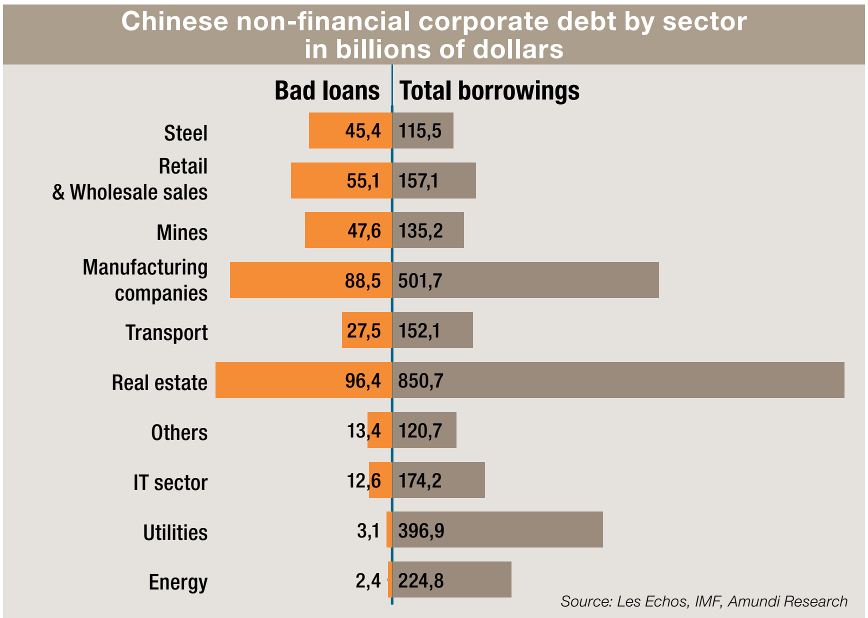

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The BIS has taken a wider perspective, looking at overall debt and taking into account both public and private sector debt. Among all debt components, corporate debt has seen the greatest rise since the financial crisis.

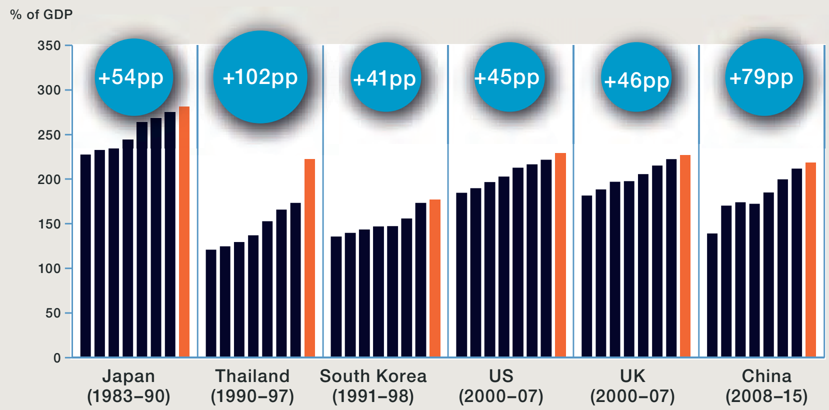
According to the Chinese Academy of Social Sciences, China's total debt reached nearly 170 trillion yuan ($25 trillion) at the end of 2015, which is equal to 250% of the national GDP.

Three remarks:

- China's debt level calculated by the BIS in its report is the highest of the 43 countries studied: higher than the United States, Greece and the United Kingdom.
- What is even more worrying is the rise in debt: from 120% about 10 years ago, the total debt-to-GDP ratio has reached 250260%, which makes this increase one of the highest in recent history. This is clearly evidenced in the following illustration, which compares the most dramatic episodes of debt expansion in recent times: episodes that did not end very well in economic and financial terms.

> "The total debt-to-GDP ratio has reached the 250% mark, which makes this debt expansion episode one of the most dramatic in recent history"

Debt relatuve to GDP: a significant increase

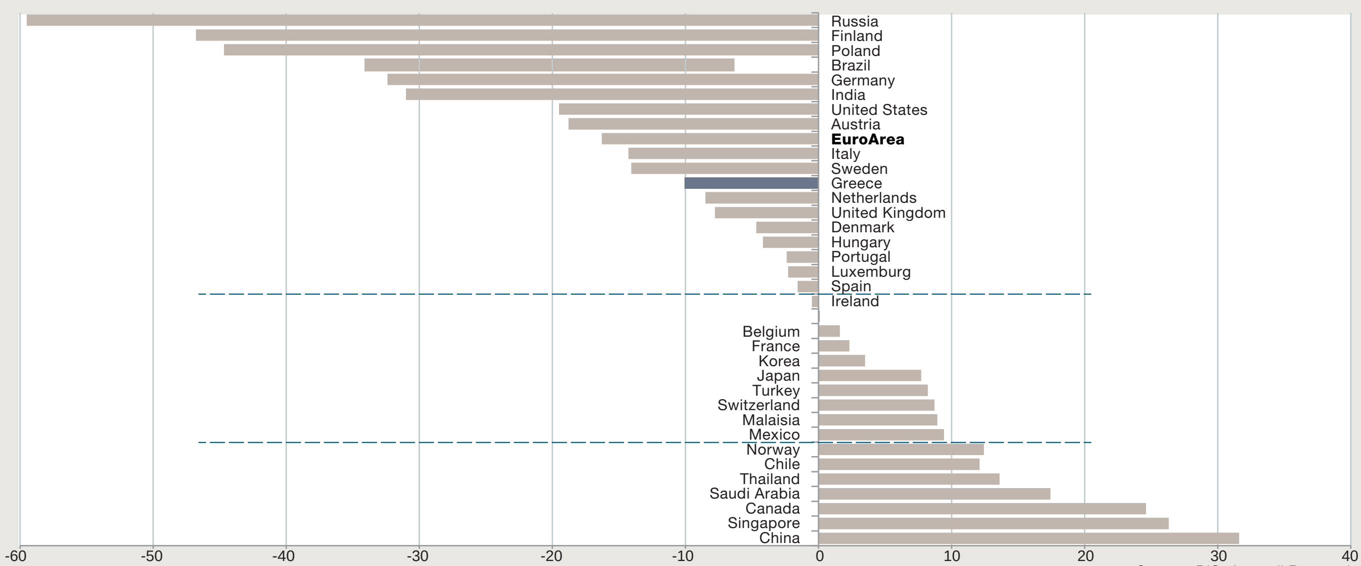


Data through 2015.
Note: Includes gross government, household and nonfinancial corporate debt.
Source: Investment Strategy Group, Bank for International Settlements, IMF.

- Academic and empirical papers emphasize the comparison between the credit-to-GDP ratio and its long-term trend, commonly known as the credit-to-GDP gap, and show that this is the best indicator of financial crisis. Essentially, based on the historical record, any level above 10 signals a likely crisis within three years. The Chinese ratio, at zero in 2009, is now 30! This level is by far the highest in the world: less than 2% in France, less than 5% in Japan, Argentina, Korea, close to 5% in Switzerland and the Czech Republic, less than 10% Brazil and Russia, around 15% in Thailand and Singapore, less than 20% in Chile ... and close to 25% in Hong Kong.

> "The credit-to-GDP gap: China is atypical"

Credit-To-Gdp Gaps In Q3-2016



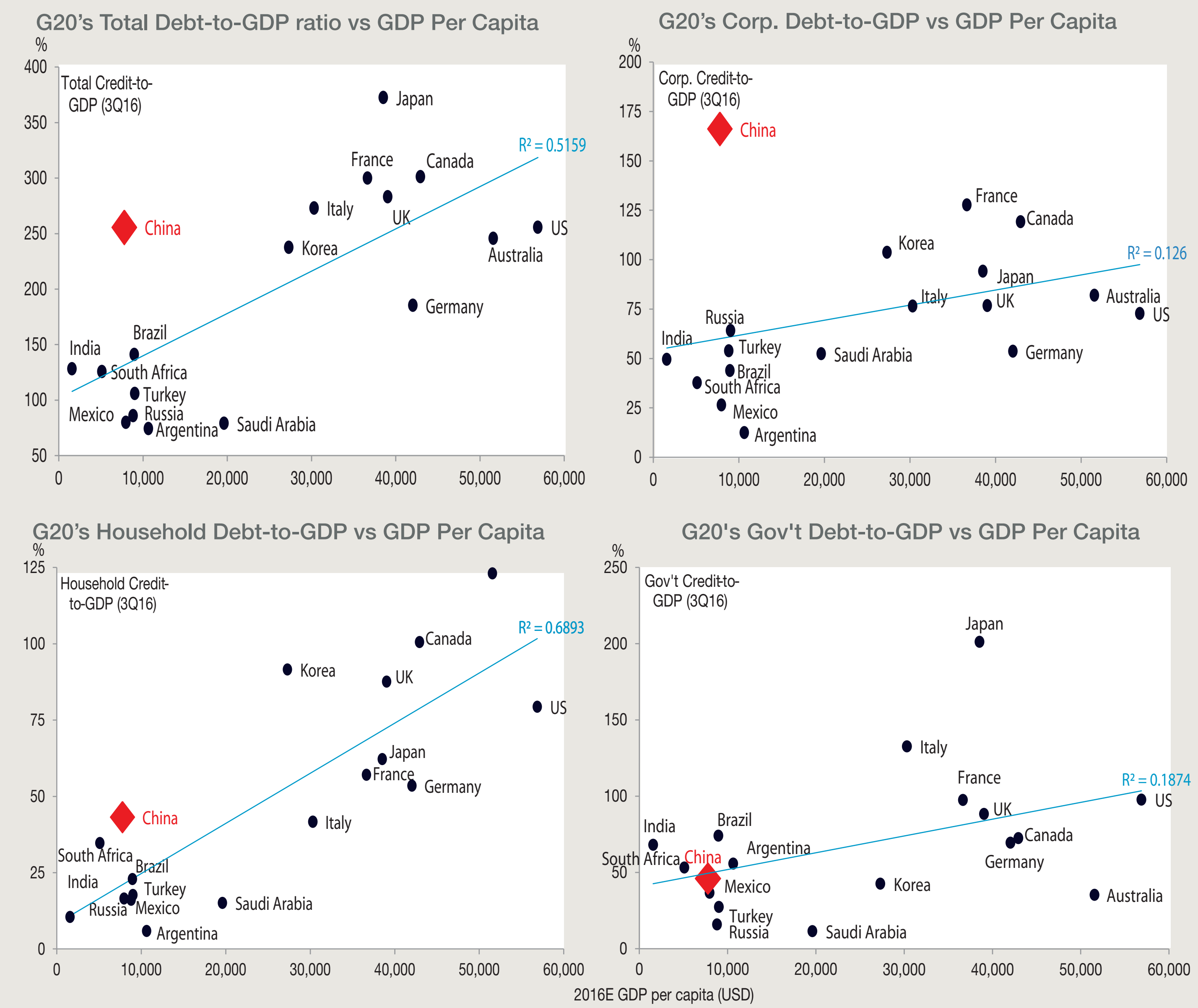
Source: BIS, Amundi Research

The illustration above provides spectacular results, and shows just how atypical China and Hong Kong are, particularly compared to the situation in Europe. However, one should be careful of making hasty judgements and look at all of the indicators carefully, especially when making comparisons between countries. There are several reasons for this:

- First of all, the credit-to-GDP gap of certain countries is currently extremely low because some countries have recently emerged from a situation of excessive debt and have undergone forced and severe debt reduction. Their current debt may still high in terms of volume, but low when looking at the longer-term trend. That explains why the indicator is so low in countries like Ireland, Spain and Portugal.
- The ratio might also be very low (and judged not to be greatly concerning) when a country has low structural debt (such as the case of Germany), or when it has had excessive debt over a long period: two very different situations that result in a similar indicator reading.

> "For emerging countries, the dynamics of the debt situation should be monitored. China is a good example of this"

China's corporate debt: a comparison of G20 countries



Source: Datastream, Amundi Research

- Finally, the ratio may be very high if past trends were particularly weak. The development of the financial markets, the impact of globalisation and growth driven by investment or consumption are all factors that could explain an increase in the credit-to-GDP gap without being particularly worrying. In such cases—often in the emerging markets—it is the dynamics of the indicator that should be monitored. China is a good example of this (see graph below).

«Credit-to-gdp gap» since 1995

Source: BIS

> It is obviously difficult to predict exactly when a financial crisis will occur, but an analysis of various indicators of vulnerability reveals that China is in a fragile state

Conclusion

The observation of this ratio and all of the graphs clearly shows the exceptional character of the progression of the Chinese debt. It is obviously difficult to predict the exact moment of a financial crisis, but the analysis of other vulnerability indicators highlights the fragility of China on this point:

- Debt servicing in the non-financial private sector increased from 14 per cent in 2009 to more than 20 per cent by the end of 2015. By comparison, this ratio is higher than in the United States - and similar to United Kingdom - at the time of the subprime crisis of 2007/2008 crisis.
- Bank crises also tend to occur when exposure to falling asset prices is high, particularly real estate.

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