China Economic Update

by NAB Group Economics

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Casting a wider net over China's total debt

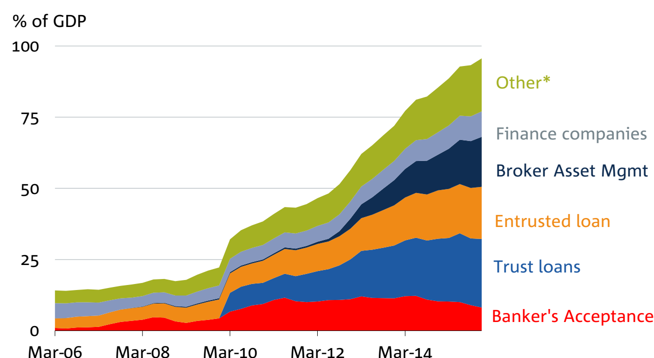
Last month, we highlighted China's debt as one of the key concerns around its economy in 2016. Debt levels have risen sharply since the Global Financial Crisis, particularly outside the traditional banking system – where the scale of borrowings is frequently under-estimated. This month, we're digging a little deeper into the China's debt, to provide a little more transparency around a very opaque picture.

How large are China's debt levels?

Putting a firm figure on China's total debt levels is far from an easy task – at best we can produce an estimate which has a series of caveats – which reflect the importance (and opacity) of non-traditional financing in China's economy over the past few years. A starting point is China's aggregate financing data – which incorporates bank loans, corporate bonds and equity financing with some (but not all) components of the shadow banking sector. This measure was almost 215% of China's gross domestic product (GDP) in December 2015, but this doesn't provide a complete picture on the country's debt – excluding government debt, parts of shadow banking while including equity financing.

Aggregate financing excludes government bonds, which totalled 39% of GDP in December 2015. However, this may not paint a complete picture of government debt, with local government bonds comprising just over 7% of GDP in this measure. The National Audit Office reported that local government debt in China was around 31% of GDP in mid-2013 (the most recent available data), comprising a mix of bank loans, bonds, shadow finance and other sources. Some of these elements may be captured within aggregate financing, but it is impossible to be sure, highlighting the uncertainty around overall debt estimates.

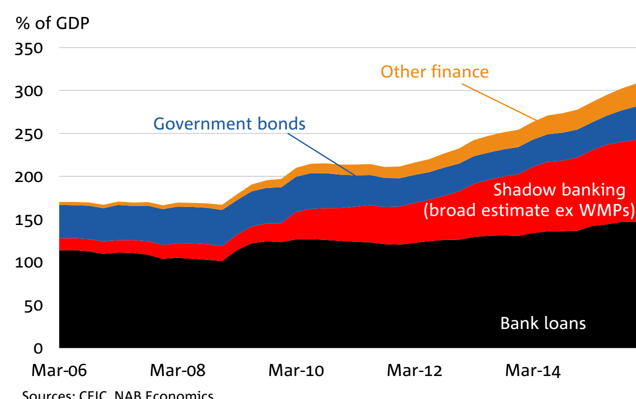
Shadow banking has been the key contributor to China's debt growth over recent years



* Other includes: lease finance, guarantee companies, microfinace, pawn shops and underground
Source: CEIC, NAB Economics

Finally comes shadow banking – a part of the finance sector that has grown rapidly since the global financial crisis. Estimates of the scale of shadow banking vary widely, with a lack of consensus among observers as to what should be included in this measure. We favour a broad measure, based on research by the Institute for International Monetary Affairs, that includes wealth management products (WMPs) and trust investment in financial assets (which is excluded from aggregate financing), but excludes newer developments such as P2P lending (due to a lack of suitable data). Broad measures increase the likelihood of double counting – some observers argue that WMPs should not be counted, suggesting that they are a funding source for shadow banking, rather than a component of the sector, therefore we've excluded it from our broader debt calculation. Our estimate of shadow banking (excluding WMPs) stood at around 95% of GDP in December 2015.

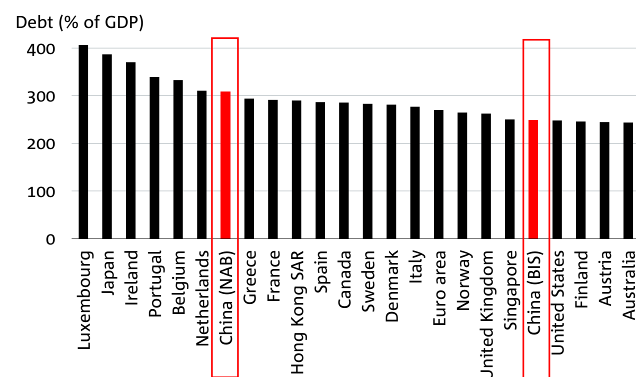
Our broad measure provides a much larger total for China's debt – at over 300% of GDP



Sources: CEIC, NAB Economics

Combining bank loans, shadow banking, government bonds and non-shadow banking aggregate financing provides us with a wider estimate of China's total debt – which stood at 308% of GDP in December 2015. Given the exclusion of WMPs and newer products such as P2P loans, this estimate may err on the conservative side.

China's total debt levels are comparable to advanced economy levels



Source: BIS, CEIC, NAB Economics

For some time it has been argued that the scale of China's debt was less concerning that the rate of its growth, but this position now appears more difficult to argue – with our

estimate of China's debt above the average level of advanced economies (according to the Bank for International Settlements) – a highly unusual outcome for a still developing economy.

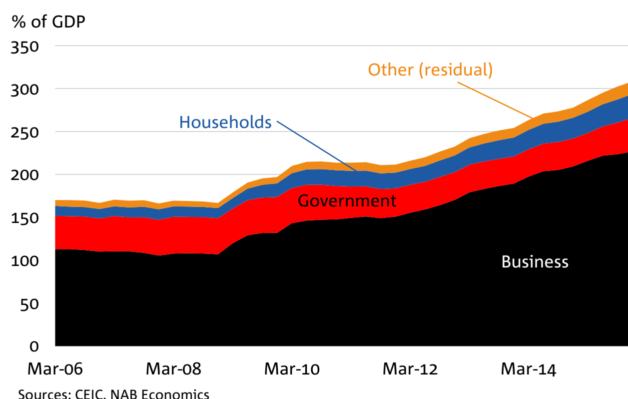
The BIS estimate of China's debt is more narrow – at around 250% of GDP – a similar level to estimates that we have previously. We argue that our broad measure (which better accounts for the shadow banking sector) presents a more comprehensive picture.

Who are the borrowers of China's debt?

Clearly identifying the borrowers of Chinese debt is also a challenge – given the important role the state plays in the corporate sector. Around three-quarters of total debt can be allocated to the business sector for December 2015, while almost 13% was government based. However the line between these categories is blurred – according to the Ministry of Finance, total liabilities for state owned enterprises (SOEs) were RMB 79 trillion in December 2015 (around 52% of total business sector debt) – debt for which the central or local governments have some degree of liability, via either explicit or implied guarantees.

Potential cross overs continue with local government debt. As noted above, local government debt extends beyond just bonds, with a range of other lending options explored in recent years to meets funding requirements. This includes bank loans to Local Government Financing Vehicles (LGFVs), which would be counted in either the business or residual categories. The major concern around local government funding in recent years has been the mismatch between maturities, with short term, often high interest debt being used to fund long term infrastructure projects – increasing the risk around these projects.

The business sector is China's key borrower, but SOEs blur the lines between business and government



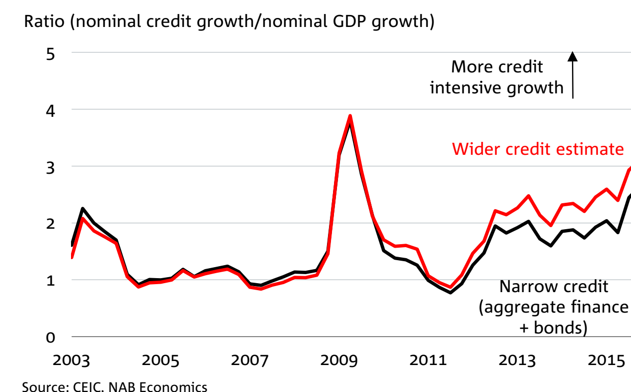
Sources: CEIC, NAB Economics

Compared with most advanced economies, household debt levels are quite small – at around 28% of GDP in December 2015.

Is China's debt becoming less effective?

Debt – in of itself – is neither a good or bad thing – indeed low household debt in countries like India and Argentina reflect a lack of credit worthiness, rather than financial prudence. An assessment of the quality of debt depends on the use of the funding and the ability of the borrower to service the debt. At an aggregate level, this can be approximated by comparing the ratio of nominal credit growth to nominal GDP growth. While there are typically significant lags between investment and returns, similar rates of growth for credit and GDP (or a credit intensity close to one) tends to indicate effective use of debt – as was the case between mid-2004 and late 2008.

China's slowing growth has seen its credit intensity deteriorate since 2011



Source: CEIC, NAB Economics

From late 2011, this ratio has deteriorated – with economic growth starting a sustained slowdown, while credit growth picked up across 2012 and 2013 (with shadow banking driving the increase). The deterioration is far more significant using our wider estimate of total credit – with debt growing around three and a half times the rate of nominal GDP in December 2015 (approaching the emergency levels seen during the GFC).

There is little doubt that credit has been used less efficiently since the GFC. The infrastructure investment boom used to ward off the crisis led to wasteful projects – with examples of under-utilised high-speed rail and airports – however more recently concerns likely lie in the business sector. Some lending to large SOEs is used to roll over existing debts, or continue funding uneconomic operation. This lending fails to add meaningfully to GDP, as well as crowds out other potential borrowers – usually private sector firms, who are either unable to access finance or seek higher cost funds from the shadow banking sector.

In this regard, the announced employment cuts across a range of heavy industries may show a greater appetite for SOE reform than previously.

Conclusion

Chinese policy makers are facing a significant dilemma regarding the country's debt. They can no longer afford to allow debt to grow unchecked – as this would increase the likelihood of a major financial crisis and the potential for a hard landing. On the other side, real economic growth is unlikely to be sustainable at the new five year plan target (6.5%) without growth in debt – bringing down the ratio would mean tolerating a considerably lower potential rate for economic growth (something that policy makers are unlikely to tolerate).

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