CHINA SPECIAL UPDATE SEPTEMBER 2016

Warning signs for China's financial sector don't guarantee crisis

NAB Group Economics

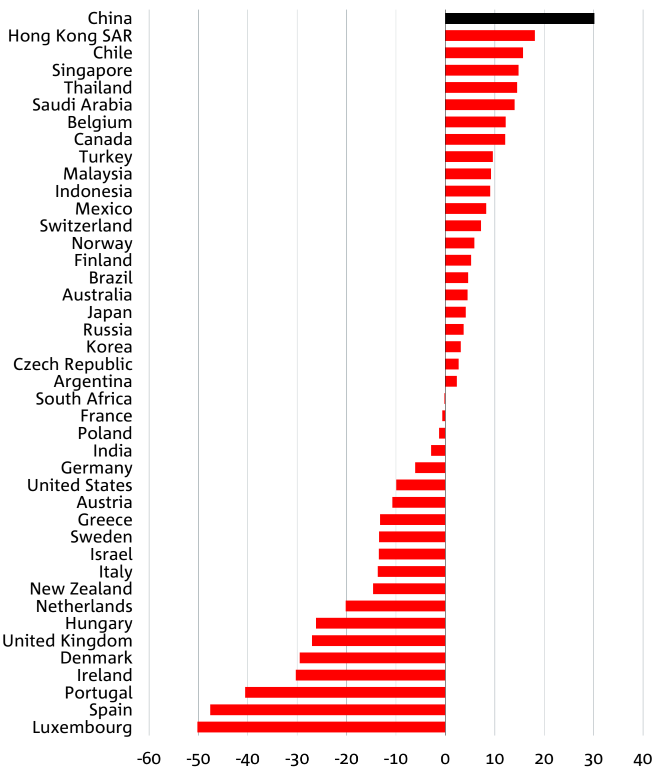
Recent data from the Bank for International Settlements has raised concerns around China's financial stability. The 'credit gap' – a measure that seen as an early warning sign for financial crisis – has increased rapidly, and is three times higher than the 'danger' level.

CHINA'S RAPID DEBT ACCUMULATION RAISES RED FLAGS

In September, the Bank for International Settlements (BIS) released its latest data on global private sector debt. China's rapid accumulation of debt in recent years captured the headlines, with the country's credit gap – the percentage that the current credit-to-GDP ratio exceeds the long term trend – at 30% in Q1 2016. The BIS consider 10% to be a danger level, an early warning that debt accumulation may be unsustainable.

CREDIT TO GDP GAP

China's gap flashes warning lights

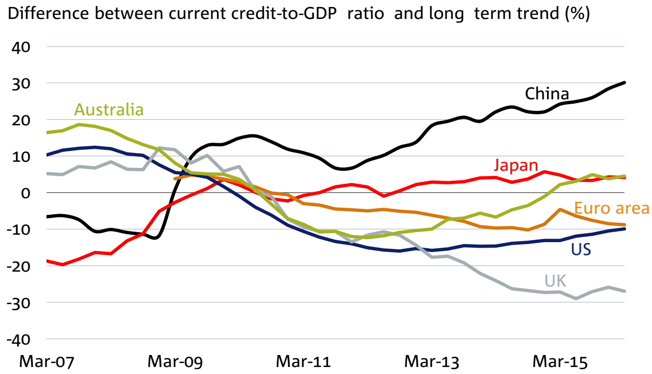


Source: BIS, NAB Economics

While this result generated a considerable amount of press attention, the story is not new – China's credit gap exceeded 10% for the first time in September 2009, and only briefly dipped below this mark during 2011 and early 2012, prior to fresh stimulus to underpin economic growth.

CHINA'S CREDIT GAP RISING

Above 10% danger level since mid-2012



Source: BIS, NAB Economics

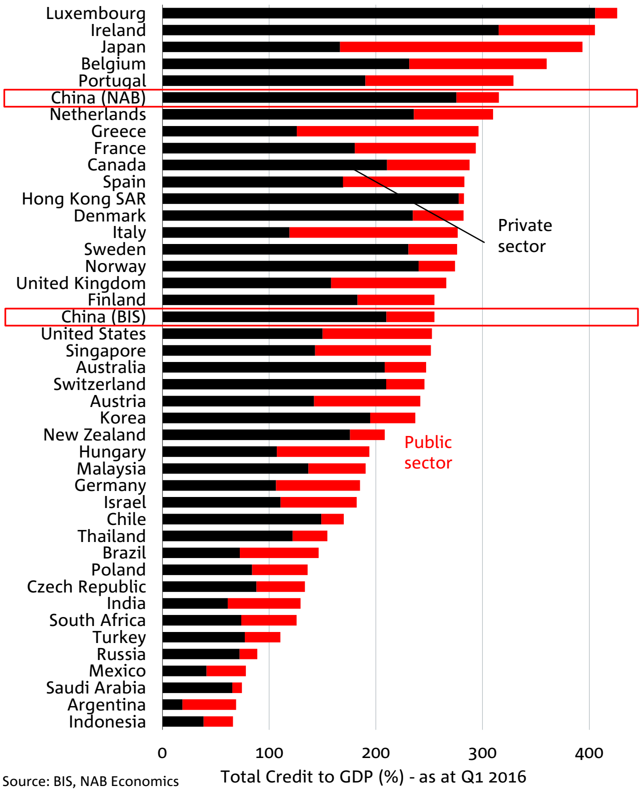
In a large part, this reflects the growth of China's shadow banking sector from around 2012 onwards, initially in response to the attempts of authorities to limit the growth of traditional credit.

As we have previously outlined, the size of the shadow banking sector is often under-estimated – including by the BIS – leading to an inaccurate picture of China's overall debt level. We estimated China's total debt level (including public) at 315% of GDP in Q1 2016 (compared with 255% for the BIS).

Date **September 2016** | Author **Gerard Burg** – Senior Economist – Asia

CHINA'S TOTAL DEBT TO GDP

BIS likely under-estimates the scale

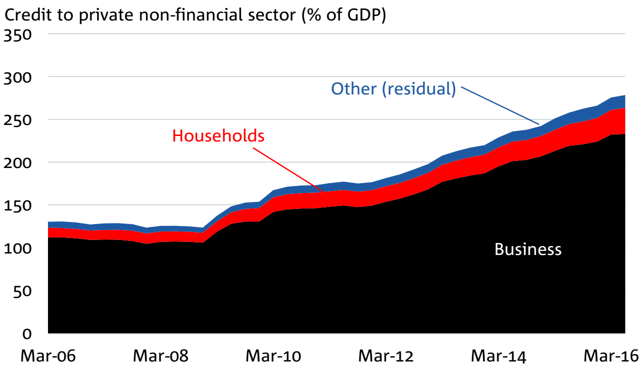


Source: BIS, NAB Economics

The distinction between these differing measures is significant when making international comparisons. Either measure puts China above the average for advanced economies (at 245%), however our measure places China among the highest debt advanced economies – an unprecedented position for a still developing economy.

BUSINESS SECTOR DOMINATES CREDIT

Households lowly leveraged



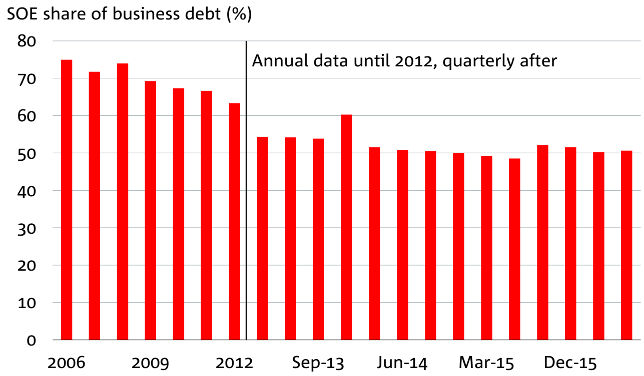
Sources: CEIC, NAB Economics

The bulk of China's private sector credit is contained in the business sector – at around 84% of the total in Q1 2016. Compared with other economies, Chinese households have a low level of leverage.

A large proportion of business credit is directed to China's State-Owned Enterprises (SOEs) – that at around 50% of total debt have an outsized share relative to their share of the output – around 22% according to the IMF.

SOES SHARE OF BUSINESS DEBT

Outsized credit share a negative for China



Sources: CEIC, NAB Economics

The growing rate of the credit gap, and similar measures such as credit intensity, demonstrate that the efficiency of China's debt is decreasing. 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.

The IMF has warned Chinese authorities to address these issues – noting that banks are holding an increasing number of non-performing loans and that recent credit growth is exacerbating the problem. The Fund's conservative estimate of China's potential banking losses from bad corporate loans is 7% of GDP – with exposure to shadow banking increasing the risk.

CONCLUSION

We have previously noted concerns around China's debt levels, and the difficult choices authorities face between short (slower growth) and medium term (potential debt crisis) challenges in addressing the issue.

That said, we do not anticipate a Chinese financial crisis in the short term. This largely reflects the low level of foreign debt, the still relatively restricted capital account and the level of state control in the banking sector. However, continuing to allow credit growth – particularly to highly indebted SOEs – adds to medium term risks for China.

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