CHINA ECONOMIC UPDATE AUGUST 2019

How successful has China's deleveraging program been in managing the country's debt?

NAB Group Economics

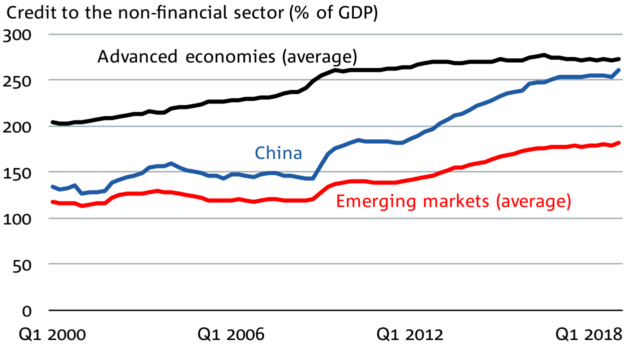
There have been regular concerns around the scale and complexity of China's debt in recent years. From 2012 onwards, China's debt to GDP ratio ballooned, as uncontrolled growth in the country's shadow banking sector swelled credit issuance. Starting in 2016, Chinese authorities began to address these debt concerns, starting the deleveraging program that was intended to control and reduce risks in the financial sector. However, priorities now appear to be shifting as policy makers attempt to support an economy negatively impacted by trade tensions with the United States.

HOW HAS CHINA'S DEBT CHANGED DUE TO DELEVERAGING?

It is extremely difficult to get an accurate picture of China's total debt, due to the opaque nature of shadow bank lending. There is variable data quality between different categories of lenders, which makes it challenging to compare debt with international peers or within China over time.

CHINA'S DEBT EVOLUTION

Rising towards advanced levels before stabilising



Source: IIF, NAB Economics

A narrow approach can partially address these issues – while acknowledging that the absence of shadow banking segments results in an under-estimate of the overall scale of debt. The Institute of International Finance produce a measure of credit (based on data from the Bank for International Settlements) covering advanced and emerging market economies. It suggests that credit to China's non-financial sector – encompassing lending to households, non-financial corporates and government entities – has transformed over the past fifteen years, moving from levels typical for emerging markets and towards those of advanced economies.

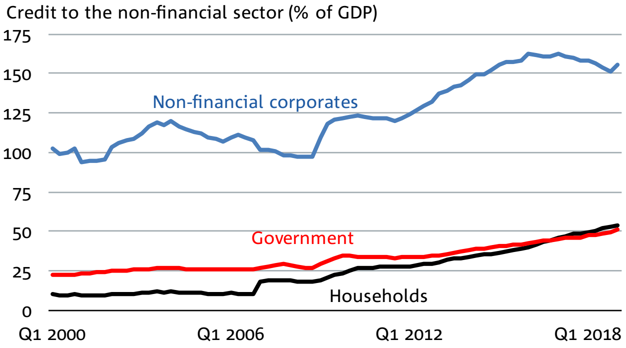
Between late 2011 and early 2017, debt-to-GDP (based on this measure) rose from around 183% of GDP to 253% of GDP – an increase that was clearly unsustainable, as additional credit was not generating in an equivalent quantity of economic growth. However, from early 2017 through late 2018, China's debt ratio remained relatively flat – suggesting some degree of success from deleveraging.

Over this time, there has been considerable changes in the profile of debt by sector. Lending to the non-financial corporate sector (which dominates China's credit demand) peaked as a share of GDP in Q1 2016 at almost 163%, before declining to around 152% of GDP in Q4 2018. Much of the debt concerns relate to excessive lending to state-owned enterprises, particularly so-called zombie firms, where loans are used to prop up inefficient and potentially insolvent companies. At a high level, the decline in the credit ratio for corporates appears positive, however it doesn't tell us much about the composition of lending within this sector.

Date **August 2019** | Author **Gerard Burg** – Senior Economist – International

DEBT BY SECTOR

Corporate debts off peaks, households and government higher

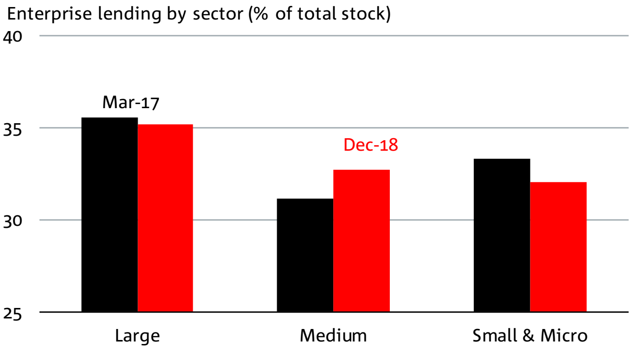


Source: IIF, NAB Economics

Enterprise loan data suggests that there has been little change in composition. Despite efforts by the People's Bank of China to boost lending to small and micro businesses, their share of enterprise lending is little changed between 2015 and 2018. Major banks continue to favour loans to large state-owned enterprises (SOEs), given the implicit guarantees provided by the government. According to the OECD, SOEs accounted for around 82% of the stock of corporate debt in China, far outweighing these firms share of output or employment.

ENTERPRISE LOANS

Small business remains credit constrained



Source: CEIC, NAB Economics

In contrast to the drop off in debt in the corporate sector, there has been an increase in credit to both the household sector and government. Household debt rose from around 40% of GDP at the start of 2016 to around 53% at the end of 2018 – due in a large part to the increase in mortgage debt required to purchase housing in major cities. This is not particularly high by international standards – in advanced economies the average was over 72% of GDP at the start of 2019 – however there is some evidence to suggest that debt servicing costs are constraining household consumption. Government debt increased from 43% of GDP to 50% of GDP over the same period.

WHAT DOES A BROADER ESTIMATE OF CHINA'S DEBT LOOK LIKE?

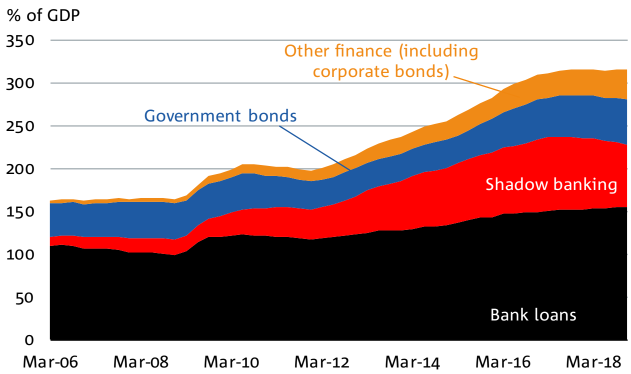
There are a range of caveats around any estimate of China's shadow banking sector. The opaque nature of lending, including lending through multiple shadow banking products in a single transaction, risks double counting. That said, new developments in sectors – such as the rapid development of peer-to-peer lending over recent years – means there is potential to overlook some lending entirely. Given data limitations, our estimate of shadow banking errs on the conservative side – likely underestimating its scale.

This estimate excludes Wealth Management Products – which are a source of funds for shadow bank lending, rather than a loan product themselves – and lending by insurance firms (due to a lack of data) but includes lending by securities firms, finance companies and peer-to-peer lenders (among others). It is interesting to note – given it is a key source of funding – that the outstanding balance of Wealth Management Products has contracted sharply – down from almost RMB 30 trillion in September 2017, to around RMB 22 trillion in December 2018.

The tighter regulation and improved supervision of shadow banking has resulted in a shrinking of the sector – down from around 86% of GDP in Q1 2017 to around 73% of GDP at the end of 2018. Broadly this trend has been positive for the overall health of the financial sector, but has not come without some unintended consequences. Shadow banking (particularly peer-to-peer lending) had become a major source of financing for motor vehicle sales – which have plunged since the second half of 2018 when regulation around p2p platforms tightened loans. Similarly, smaller firms who struggle to access traditional bank financing – due to the perceived higher risk and lack of loan guarantees – have faced a considerably tougher lending environment.

WIDER DEBT ESTIMATES STABLISED

Shadow banking contracted from Q1 2017



Sources: CEIC, NAB Economics

Our overall measure of debt (combining shadow banking with bank lending and government bonds) remained essentially stable from June 2017 through December 2018, at around 315% of GDP. The decline in the share of lending from shadow banking was offset by increases in bank loans and government debt.

CONCLUSIONS – DEBT TRENDING UP AGAIN IN 2019

China's deleveraging program came at considerable cost – contributing to the slowing trend in the country's economic growth over recent years – but was successful in reining in unsustainable credit growth. Given the need to support continued growth at this stage of China's economic development, it was generally assumed that Chinese authorities were seeking to stabilise overall debt levels – which was achieved across 2017 and 2018 – rather than lower them (which would have come at a greater economic cost).

Efforts to reduce lending via shadow banking channels have been a clear positive – reducing risk in the broader financial sector – however the inability to significantly extend bank credit to smaller firms, and away from large state-owned enterprises, has been disappointing.

The impact of trade tensions with the United States appears to have shifted the priorities of Chinese policy makers – away from addressing medium term concerns around debt levels towards supporting short term growth. This has resulted in an increase in debt levels – with aggregate financing (excluding equity finance) and government bonds increasing to 280% of GDP in mid-2019, compared with 273% at the end of 2018. China's fixed asset investment data has shown a pickup in investment by state-owned enterprises, while private sector investment has grown more slowly since the start of the year – a potential warning sign of the quality of recent debt issuance that could present greater medium term risk.

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