China's Debt Crisis

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By 2015 the size of China's total debt, held by government, financial institutions, and non-financial corporates, had reached a level seen as a national burden and an international concern. The explosive growth of this debt is a relatively recent phenomenon going back to the government stimulus in 2008. In order to evaluate the nature of this growth in credit, it is necessary to look at historic events, outside influences, actions by local government entities, and policies undertaken by central government in Beijing.

INTRODUCTION

It is widely estimated that China's current total debt is over 250 percent of GDP. But it may be more and growing. It is particularly difficult to accurately assess because of "murky" record keeping at the level of the central government and local government. Explosive growth in Chinese debt is a relatively recent phenomenon and most of it has accumulated since 2008 when the government started pumping credit through the economy to maintain growth. China's leaders view this debt overhang as eminently manageable, yet it impacts every level of society. China's debt is national and it is local. It is public and it is private. It is related to national reform policy, but also deeply influenced by globalization (Interviews). This concern over the size of China's debt calls for closer investigation. To get a better understanding it is necessary to look at internal historic events, but also at the impact of changes in the world economy. The International Monetary Fund reports that China will run a budget deficit of 3 percent this year with a total manageable debt load of 46.8 percent of the economy. This gives it a ranking of 100 out of 184 countries (IMF figures). But this is deceptive as we explain in the analysis.

China's economy has been in an economic transition since the 1970s, a transition which is ongoing and will affect the economy for years to come. China's GDP grew at 10 percent annually since Deng Xiaoping's market reforms began in 1978 until the financial crisis, with some growth rates as much as 40 percent in places like the Pearl River Delta (Interviews). This growth and transition created a far reaching demand for investment and debt financing. The economic reforms attracted a vast and penetrating foreign direct investment, which reached $650 billion in the 6 years immediately preceding the financial crisis of 2008 (Interviews). At the same time domestic investment contributed to the expansion, especially at the local level.

Central to Deng's reforms and his market oriented policies was the emphasis on decentralized stakeholders. This decentralization inevitably led to increased local government spending on infrastructure and certain real estate transactions. It is the regional and local actions which heavily contributed to the growth of China's debt. As it turns out, spending by local governments is one of the major sources of the debt overhang (Interviews).

Historically, the debt has been building over the years of economic transition. Policy changes during the 1997-1998 financial crisis, and then again in 2008, had direct impact on the nature and size of the debt. Outside influences, such as globalization, impacted the Chinese economy, both expanding its growth and slowing its growth as a result of the financial crisis. Policy measures taken by the central government also played a role. A closer look at the build-up of debt in the different sectors of the economy and its characteristics is warranted. In the following pages we will examine this indebtedness and local government debt in particular. Issues to be addressed include central government involvement, debt and economic liberalization, response to global downturns, regionalism and the local problem.

METHODOLOGY

A significant portion of this research is based on conversations with more than 350 key influencers in Shanghai, Beijing, Hong Kong, Singapore and Washington, D.C. over a period of 26 years beginning in 1988 and most recently in the summer of 2016. A significant effort has also been made to examine traditional data and documents from a variety of sources when and where they were available. One author most recently did research in Shanghai in the summer of 2016 as well as teaching at Shanghai Finance University in 2013 and 2014. It is important to note that many of the professionals and experts in China wish to have their comments kept confidential. Therefore, we choose to respect their request of confidentiality in all cases. We have referred and documented data where they are public.

The methodology for this study where it involves interviews can be described as a focus on the policy view of key stakeholders and influencers. In general, the interviews were conducted with professionals from such organizations as the Economist Group in Hong Kong, Shanghai, and London, the old Bear Sterns Investment firm, Goldman Sachs, Chase Investment Bank, U.S. Chamber of Commerce, and Boston Consulting Group in at least two locations, Microsoft, and a host of other public and private professionals. The interview format did not include a formal survey but did include structured questions.

LOCAL GOVERNMENT DEBT, REACTIONS TO GLOBAL INFLUENCES, CENTRAL GOVERNMENT ACTION

The Local Government Debt

A key factor in China's historic transformation is understanding decentralization and regionalism. Deng's market oriented reforms and policies in the 1970s underlined the importance of decentralized stakeholders. This policy is directly related to increased local government spending on infrastructure and certain real estate transactions which eventually added to the debt overhang (Interviews).

Perhaps 80 percent of public spending comes from local governments (Interviews). If we assume local governments incurred the statutory maximum debt last year (16 trillion yuan) - you double total public borrowing raising it by 47 percent of GDP (Balding, 2016). Goldman Sachs reports higher debt figures (Balding, 2016). Overall, sine 2007, China's total level of debt, held by government, financial institutions and non-financial corporates, has quadrupled. According to a partner with Autonomous Research Asia in Hong Kong, it represents the biggest debt bubble the world has ever seen (Bremner, 2015). Of the overall government debt, much is held by local governments. A national audit conducted at the end of 2013 revealed that the "local debt" was the equivalent of about a third of China's GDP, amounting to a total of about 17.9 trillion yuan. These "local" debts had grown fast enough to become a national burden and an international concern (Interviews).

The borrowing by local leaders in the 1990s took the form of direct borrowing from banks and led to a lending crisis. Beijing's major fiscal reform in the mid-1990s banned local governments from borrowing directly from banks and from issuing bonds. The local government response was to create a vast unregulated industry in the form of so called local "financial vehicles" (Roberts, 2013). Local governments used these “off-balance-sheet” financial companies, which can borrow from banks, to fund their real estate and infrastructure projects (Hamlin, 2015). Local governments often engage in shadow banking and use off - balance sheet - loans to pursue projects. Often they create state-owned enterprises to pursue projects. Thus debts are huge and off the records (Interviews).

These “finance companies” and shadow banks were created by provinces and municipalities were able to borrow from banks. They used state land as collateral for bank loans (Hamlin, 2015). Many of the financial companies are technically owned by state enterprises. Then again, many state enterprises are owned by local governments, adding to a total confusion of who actually owns what and who is responsible for the debt.

The nature of this debt is also problematic. Due to its strong connection to the property market, a severe downturn in the real estate market could cause numerous defaults. The opacity and lack of regulation is another danger zone. Furthermore, many local governments are reliant on land sales in order to make payments. Thus, any downturn in the property market will aggravate the debt situation (Roberts, 2015).

Reactions to Global Influences

As the efforts toward open market reforms are continuing, China’s transition economy will be ever more affected by the global economy. Now, China’s policies are influenced by the crosscurrents of globalization. As the world economy has slowed, the Chinese economy has slowed. Impacted by internal, but above all external events, the Chinese economy will no longer be driven by foreign direct investment and dramatic growth in export manufacturing as in the past (Interviews). Going forward, China has embarked on a proactive policy of outward foreign direct investment to insure commodity and natural resource access (Interviews). The continued open trade policy concentrates on expanding regional trade. Internally, the leadership seeks to move toward an economy more heavily depending on internal demand.

Outside events had a dramatic impact with the financial crisis of 2008. China’s economy was affected by the global recession as was every country in the world. The global downturn, starting with the market crash and bank failures in 2008, was reflected in China by slower GDP growth, which contracted to a two-decade low of 6.1 percent (Interviews). The export sector had already been slowing prior to the financial crisis, but was now hit really hard, losing some 20 million jobs in Guandong Province alone (Interviews). To maintain GDP growth and avoid a recession, the Chinese government employed a massive yuan 4 trillion ($585 billion) stimulus package and an expansionary monetary policy aimed at moderating the impact of the global downturn (Jian, 2010).

The stimulus of 2008 was aimed at maintaining growth in the economy and avoiding a recession and its consequences on the local economy and employment. Of the total stimulus package only about yuan 1.18 trillion came from central government. The rest came from local governments, banks, and state-owned enterprises (Jian, 2010). This has dramatically added to the debt overhang in general and to local government indebtedness in particular. As scores of cities and local governments built roads, commercial centers and other projects, local government entities sold more than yuan 4 billion of bonds since 2008 (Sanderson & Forsythe, 2011). Since local governments were prohibited by law from taking out direct loans, they used financing vehicles like trusts and finance company bonds to get around the legal restrictions.

As mentioned above, the response to the financial crisis of 2007-2008 dramatically added to the build-up of government debt. Earlier upswings were the 1995 change in local government finance due to the reduction in the ability to raise funds. This was followed by China’s long property boom throughout the last decade which saw developers take on increasing amounts of debt. But it was from 2007 on that the real build-up in credit began – from then until mid-2014. Total debt accelerated from 148 percent to 205 percent of GDP over the period of 2008-2013 (Russel; Foroohar, 2014).

The Real Estate Situation

The 2008-2009 lending spree that rescued China’s economy had unintended side effects. It resulted in inflation, overpriced property markets and soaring debts owned especially by local governments

(Interviews). Many state-owned companies were the recipients of stimulus money. But as it turned out, a good portion of the loans made by Chinese banks in 2009 was spent on skyscrapers and other commercial properties. The industrial loans made to state-owned enterprises were partially used to invest in real estate or found their way into the stock market rather than into industrial production (Interviews).

The consequences were considerable overbuilding in the commercial real estate sector. As a result of this, the authorities faced the challenge of balancing the need to maintain monetary stimulation against the risk that the flow of bank lending, if extended too long, would lead to misallocation of resources into stocks and real estate speculation. Such a misallocation could erode bank asset quality, lead to inflationary pressures, and possible investment bubbles (Jian, 2010).

The Role of Banks

The role of banks has been central to the debt crisis. Historically China's banks have carried a huge overhang of non-operational loans (Interviews). At the same time many of the banks are owned or directly supported by the central government guaranteeing their survival.

The last time banks were forced to support the government's policy was during the Asian financial crisis in 1997-1998. The effect at that time left the Chinese banks with a large portfolio of non-performing loans. Although the argument is made that China's banks are in a much stronger position today than they were in 1998, the danger of a rise in non-performing loans is still a real possibility (Jian). Before the financial crisis in 2008, the Chinese leadership had made substantial progress in reducing the number of non-operational loans (Interviews). Now, in 2008, banks again were instructed by the State Council to flood the system with liquidity (Interviews). Thus, the problem will arise again that the banks will be saddled with large amounts of non-performing loans, which will further aggravate the overall debt situation (Interviews).

This massive expansion of bank credit increased the possibility of potential asset bubbles in the real estate sector and an increase in the non-performing loan ratio in the banking sector. From the perception of the Chinese banking leadership, inflation could have a devastating political and economic impact (Interviews). Not only would inflation directly affect the millions of Chinese who still live in extreme poverty, but it might also cause political and economic turmoil among the Chinese people. Thus there is a continual tension in the policy-making machinery between the banking leadership and the State Council (Interviews).

Central Government Action

In 2014, China's central government undertook a radical reform of the way provinces and municipalities manage their finances. The target was the unsustainable levels of debt accumulated by local governments. Finance Minister Lou Jiwel cracked down on off-balance-sheet financing, which means finance company borrowing, and allowed local governments to issue bonds in the bond market instead. In order to sell bonds, the governments must reveal financial data to investors, which would lead to more transparency (Hamlin, 2015).

The State Council, China's top decision-making body, outlawed Local Government Financial Vehicles in order to make local government debt more sustainable, transparent, and manageable. But in May 2014 Beijing made exceptions and grandfathered in cases involving ongoing projects (Russel, 2015). Regarding bond issues, as of August 2014, the Finance Ministry allowed local governments to issue long-term, low-interest bonds to pay off maturing loans (Russel, 2015).

For years there has been the perception that the central government would guarantee local government loans, creating a moral hazard where investors assume that they will be bailed out should a default occur. That impression has only served to encourage risky lending (Russel).

In March 2014, China had its first corporate bond default. Shanghai Chaori, a solar-energy-equipment firm, was small, private, highly leveraged and not very important. Beijing may let a small company like Chaori fail to show that they are dealing with the debt, but provincial governments and state-owned enterprises are still too big to fail (Foroohar, 2014). In the case of Chaori, however, eventually investors were bailed out through a debt restructuring plan with heavy involvement by central government.

Since then, other companies joined the list of defaulters. In April the first state-owned company defaulted on an onshore bond: Baoding Tianwei Group. This time there was no bailout. One commentator, Shen Jianguang of Mizuho Securities Asia, believes that this was an isolated case. He does not expect that there will be massive bankruptcies by state-owned enterprises (Russel).

According to our interviews from 2016, the economy is growing between 5.5 percent and 6.5 percent (Interviews). When growth falters, "the government usually falls back to the old path", says Tao Dong, an economist at Credit Suisse in Hong Kong (Bremner, 2015). The reforms from 2013-2014 are now being reversed because President Xi Jinping's top priority is to shore up the economy (Hamlin, 2015). In May of 2015 the State Council ordered banks to keep funding local development projects approved in 2014, even if the local governments and their finance companies could not meet payments (Hamlin, 2015). The State Council order is "the most significant policy-easing so far in 2015", wrote Deutsche Bank economists. It is a 180-degree reversal of the fiscal policy tightening to loosening (Hamlin, 2015).

The consensus among many is that the leadership will not allow the economy to fall below a 7.5 percent growth rate. Slower growth underlines a poor job market and the fact that state-owned enterprises still dominate the economy while private companies, especially small business, are still having difficulties to get access to funding (Interviews).

CONCLUSION

China's government has repeatedly pledged to its citizens that it would keep the lid on borrowing and push through key reforms (Curran, 2016). But China's President Xi Jinping has promised to deliver economic growth of 6.5 percent. Basically, Xi has to walk a tightrope: he has pledged to keep annual economic growth from falling below 6.5 percent through 2020 and prevent rising debts from spiraling out of control (Dieterich, 2016). China's leaders seem to be leaning towards stimulus rather than reform. Instead of tackling the debt that is two and a half times the nations GDP, policy makers are extending more loans to strengthen the economy (Curran, 2016). Reforms originally undertaken in 2013 to curb the expansion of credit growth, policy makers reversed course by the end of 2014 as the economy showed definite signs of slowing down.

As of the summer of 2016 interview date clearly indicates that the Chinese central governments continue to support substantial spending across the board to counter slowing growth. Despite rhetoric to the contrary and "official" policy much of the reform program is on hold. Moreover, many state-owned enterprises remain first in line for subsidies. Moreover, it would appear that the government has engaged in substantial debt for equity swaps to relieve debt (Interviews). The debt crisis continues to grow at an alarming pace but the Chinese leadership cannot afford slow growth.

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