The Roving Scout

ADITYA BIRLA
SWISS SINGAPORE

CHINA's DEBT ADDICTION

Historically it has been seen that rising debt in any economy has always resulted in slowdown in GDP growth, and often a 'CRISIS'. A rapid change in the ratio of Debt to Gross Domestic Product (GDP) is more important than its level. China's Debt as percentage of GDP stood at about 250% of which Private debt has been 200% of GDP. The credit expansion has outpaced the growth in real economy. The acceleration in lending started in response to global financial crisis that cause the global meltdown in 2008. We in this note try to touch upon China's rising debt issue; Sectors and Provinces with high debt to GDP ratio; China's slowing wage growth and its likely impact on economy; steps likely to be taken by govt. to address the debt pile and further room for stimulus, if any?

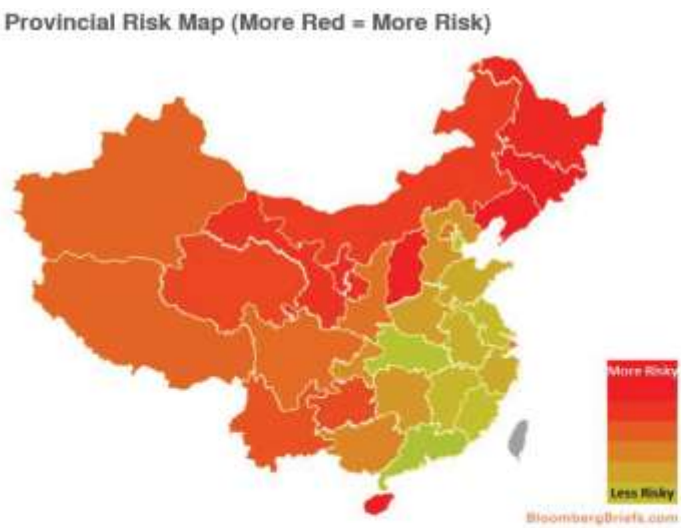
CHINA DEBT PILE:

Economy wide debt has rose to about 250% of GDP in 2015 up from 160% in 2008. On the current trajectory, by 2020 outstanding credit could be +310% of GDP. Rising defaults, frauds in financial sector are piling up at rapid pace and that's a sign of increasing stress, as growth slows, debt-servicing cost rises and profitability shrinks. '***More than 66% of total debt belongs to corporate sector***'. The govt. is stubbornly keeping the economic growth rate high by using more and more debt. If more and more credit is required to drive less and less growth, sooner or later the outcome is not likely to be good.

In 2015, the number of reported incidents of financial stress rose to 38, up from 12 in 2014 and 3 in 2013. By allowing corporates to continue accumulating debt, and encouraging investors to reach further for yield, it will likely allow problems below the surface to continue to grow. Low interest rates and ample avenues of credit (Shadow Banking) has helped to keep the lid on defaults. There is no denial that China's borrowing is almost entirely domestic. But weak demand from consumer sector; slowdown in economic growth; wishful decline in exports resulting in overcapacity issues; heavily leveraged corporate sector and high banking sector exposure to bad debts is likely to put economy in liquidity constraints. If that so happens, ***govt. would be forced to pump in more liquidity to avoid any liquidity crisis***. Much of the rise in debt is concentrated in the property sector. It is estimated that around 45% of Chinese debt is either directly or indirectly related to real estate. So one immediate debt risk overhang is of fall in property sales and prices leading to fall in property investment and fall in revenues of property developers. And that is the reason why govt. has taken measures to boost the property sales as further slowdown could be a big risk for China.

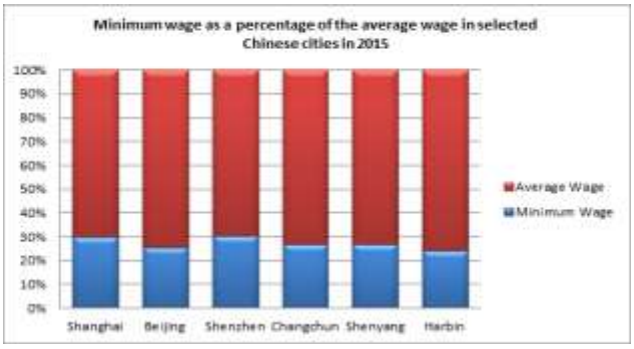
PROVINCIAL DEBT:

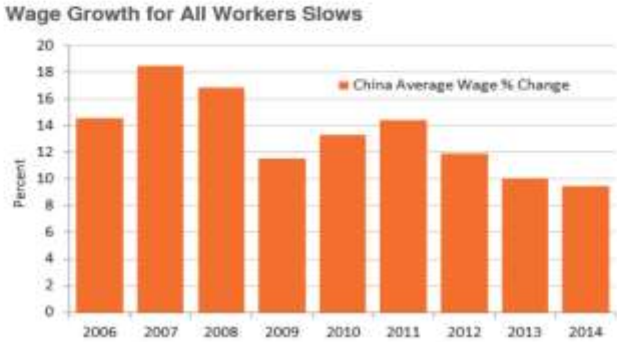
China's local government debt pile was meant to shrink. Instead, it's grown. A review of debt levels in 29 of the country's 31 provinces at the end of 2015 shows borrowing continued to expand at a rapid pace. The burgeoning debt highlights China's continued reliance on off-balance-sheet stimulus to support growth. Some provinces with rising debt and stagnant tax revenue are vulnerable to heightened financial stress. At the end of 2015, total borrowing by 29 of China's provinces totalled 16.2 trillion yuan ($2.5 trillion), up 53% from 10.6 trillion yuan in 2013. It's possible that some of that expansion represents



local governments taking responsibility for loans they had previously guaranteed. Even so, a continued and rapid expansion in borrowing is a worrying sign. S&P stated that although local govt. debt in China is not rated, if it was, about half of the debt would have junk status credit rating. As a ratio of provincial tax revenue, local government debt has risen to 195% in 2015 from 153% in 2013. In many cases, debts are the highest in the provinces with the lowest capacity to repay. Despite of slowdown in GDP for last 2 years, there has been substantial increase in off-balance sheet stimulus. Liaoning and Jilin in China's rusting northeast score as the country's riskiest provinces. They both suffer from slow growth, a weak tax base, high reliance on land sales as a source of revenue and a shrinking population. Liaoning is also among China's most indebted provinces.

FADING WAGE GROWTH:

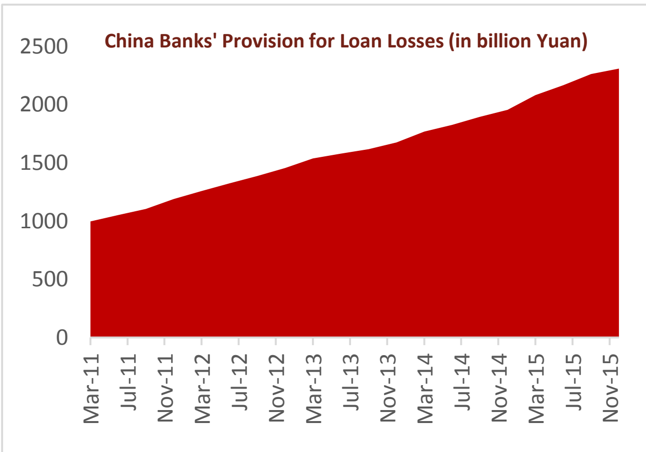




As per the regulations, minimum wage should be set between 40% and 60% of the average wage in each region. However, the minimum wage level in the majority of Chinese cities have often failed to reach even 40% level. China's average wage growth rate has been on decline since 2011. The economy that aims to shift from export led economy towards domestic consumption led economy - the falling wage growth is bigger challenge for China if it aims to keep economy running at current growth rate. The disposable income is likely to fall thereby creating problems for officials trying to boost domestic consumption. The stress is visible post the announcement by Guangdong province, China's biggest exporter and one of the biggest destinations for rural job seekers, that it will freeze minimum wages for next two years. The three provinces in the northeast rust belt, Heilongjiang, Liaoning and Jilin, haven't raised their minimum wages since 2013. You cannot expect wage growth to continue to rise if business conditions and profitability are weaker. As the economy slows down, corporate profitability shrinks due to weak demand and rising debt continues to put stress on company's balance sheet the final outcome would be ***increase in unemployment***. Further as China aims to reduce overcapacity problems and shifting the workforce – the problems are likely to only aggravate further.

SOLUTIONS TO ADDRESS DEBT PROBLEM:

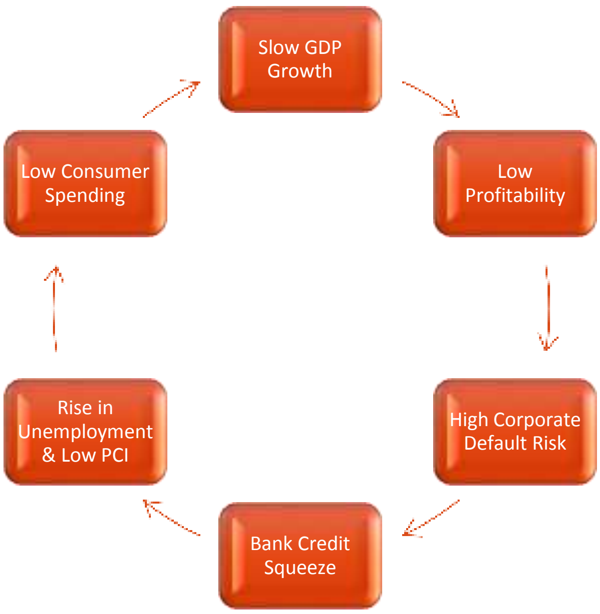
- ✓ **DEBT – EQUITY SWAP:** Till 2015, China's banking sector total debt to equity ratio was about 434%. With the rise in incidents in defaults and financial stress – Chinese banks have more than doubled their bad-debt provisions over the past 5 years. Bad debt in China's banking industry jumped 51% last year to a decade high of 1.27 trillion yuan. China's policymakers are seeking ways to clean up the mounting bad loans of nation's banks amid slowing economic growth and curbing overcapacity in manufacturing sector. "***China is soon expected to make it easier for banks to convert soured debt into equity probably by end of this month".***



The govt. may allow to convert as much as 1 trillion yuan of bad loans under the Debt-Equity swap plan. The caveat to this move is though the banks would clean its balance sheet and increase profitability – banks would face liquidity crunch. China's central bank will have to inject liquidity in to the system through short term and medium term lending facility (MLF) to keep the smooth functioning of banks. This is evident with the increase in MLF since mid-2015. Premier Li Keqiang stated that the country may use debt-equity swaps to cut the leverage ratio of Chinese companies and to mitigate financial risks.

✓ **LOW GOVERNMENT DEBT MEANS MORE ROOM FOR FISCAL STIMULUS:** China clearly has debt problem but is not as bad as some western countries. China does not have central government debt problem; it even does not have household debt problem; but it has a big corporate debt problem. In the past, Chinese monetary policy has always done the bulk of the work to support growth. And while this has proved to be effective, it has come at a cost. China has huge business and local govt. debt burden on its shoulder. Even if there is room for monetary stimulus at this point the space to do so is limited. A cut in rates would also open a wider interest-rate differential with the U.S. and add to downward pressure on the yuan, something the China's central bank may be keen to avoid in the immediate future. We believe going ahead china would provide fiscal stimulus to support economic growth. China is likely to expand the fiscal deficit to 3% of GDP in 2016, up from 2.3% in 2015. In the past, the focus of fiscal stimulus has been roads, rails and power plants. Shifting the focus by increasing spending on education, health care and other social services would deliver a similar boost to growth, while also supporting robust employment, rising incomes and more importantly boosting domestic consumption led growth in the economy as desired.

HOW IT MATTERS FOR SSoE BUSINESS:



China has two options to get out of this vicious circle: **EITHER INCREASE PRODUCTIVITY / PROFITABILITY AND OR CONTINUE TO DEPEND ON EXPORT LED ECONOMIC GROWTH**

1. **INCREASE PRODUCTIVITY / PROFITABILITY:** This looks difficult task immediately, as China aims to cut down overcapacity and relocate people in service/other sectors. Tackling overcapacity might be a

painful transformation as some (loss-making) firms will face bankruptcy. This is gradual process and would take hit on corporate profitability. With low profitability and high unemployment rate govt. aim to shift from export led economic growth to domestic consumption led growth would be defeated. Which means China can't afford to ignore exports as primary source for GDP growth.

2. **EXPORT LED ECONOMIC GROWTH**: Given this, we believe China shall continue to depend primarily on export led growth in short-run. While shift from export led economic growth to domestic consumption led growth would depend on how efficiently the govt. handles the rising corporate debt problem. China has to maintain delicate balance between maintaining rapid growth through slow deleveraging process and at the same time address the overcapacity problems especially in Steel and Coal sector.

In conclusion, going forward commodity prices – which has been historically demand driven for China – would henceforth be supply driven. In the meantime, till the China overcomes its debt problem and structure domestic consumption driven economic growth there are likely to be many casualties during the process and should keep the commodity prices volatile with no firm direction.