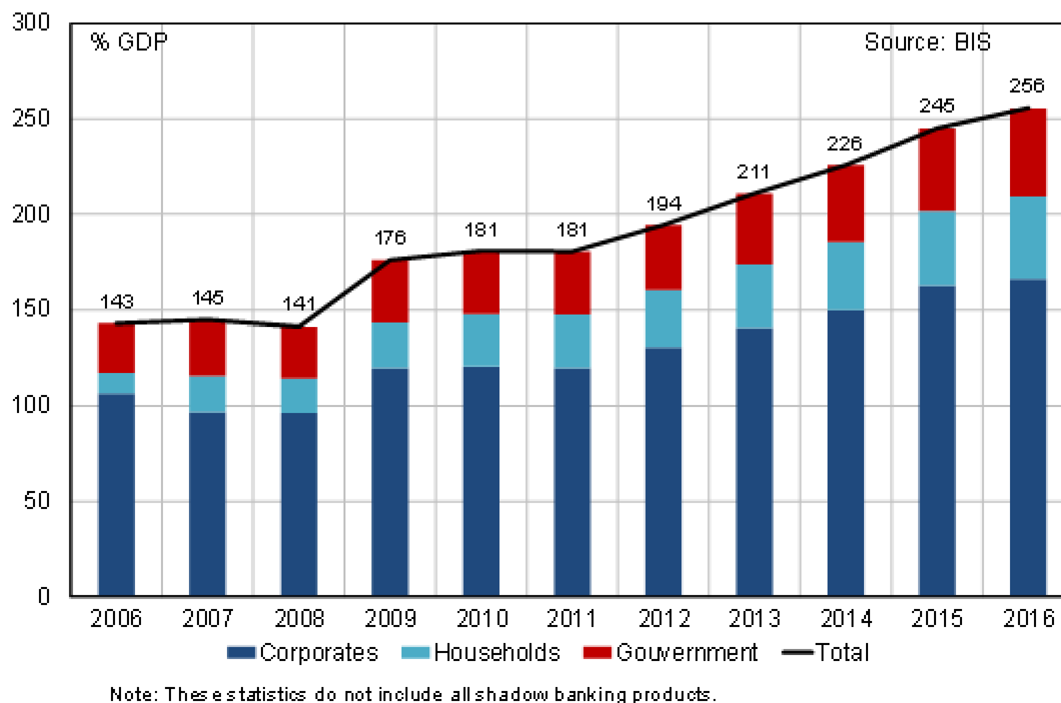
China: what are the risks related to corporate debt?

By Cristina Jude

The surge in Chinese corporate debt, against the backdrop of declining industrial profitability, is worrying for financial stability in China and beyond its borders. However, the risk of a banking crisis appears to be contained at this stage, although we should remain vigilant.

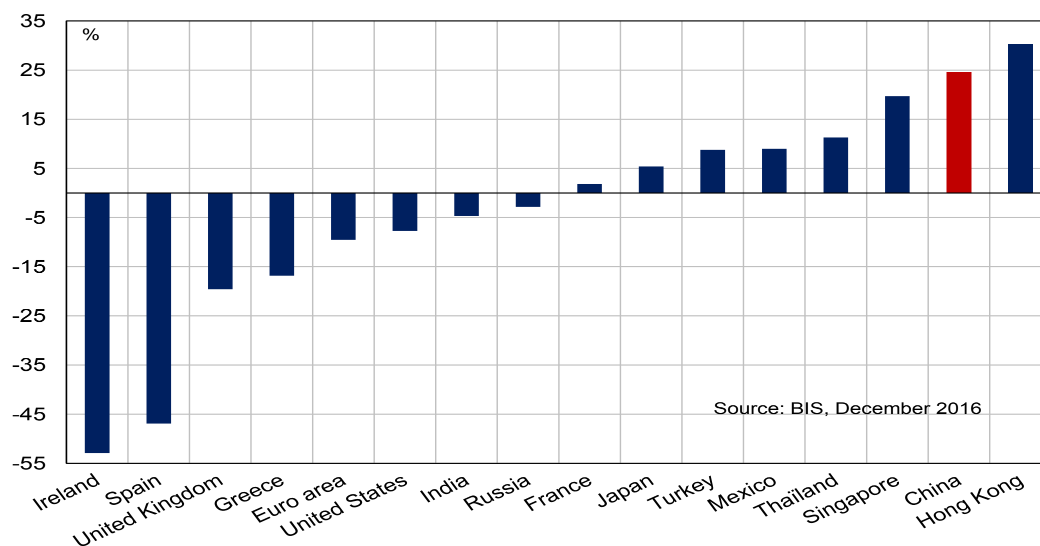
Chart 1 Change in non-financial sector debt in China



The total debt of the Chinese non-financial sector has ballooned since the Great Recession from 141% of GDP in 2008 to more than 250% of GDP in 2016 (see Chart 1). China has sought to compensate the effects of muted global demand with a broad investment plan that state-owned enterprises and local governments have financed by taking on excessive debt.

This has led to a persistent deviation of the credit-to-GDP ratio from its long-term trend (commonly referred to as the credit-to-GDP gap). According to the Bank for International Settlements (BIS), China's credit-to-GDP gap reached almost 25% in 2016 (see Chart 2), which is wider than those reported in Asia before the 1997 crisis or in the United States before the subprime crisis. This therefore raises questions about the risk of a banking crisis in China.

Chart 2 Deviation of the credit-to-GDP ratio from its long-term trend (Credit-to-GDP gap)



A marked increase in Chinese corporate debt

While household and government debt have been kept in check, levels of corporate debt are soaring, and amounted to 166% of GDP in 2016. This figure includes bank lending, non-bank loans (from the shadow banking sector, and thus unregulated) and bond issuance. The excessive increase in borrowing seen in the past few years, against the backdrop of economic slowdown, has led to the misallocation of capital, the emergence of excess production capacities in certain sectors and less return on investment (see Albert, Jude and Rebillard, 2015).

Therefore, the Chinese industrial sector, and particularly state-owned enterprises, faces decreasing profits, resulting in deteriorating solvency, with longer payment delays and greater difficulty to meet debt servicing obligations. Real estate, mining and steel are the least profitable and most indebted sectors.

There is a risk that the industrial sector's deteriorating situation could weaken the Chinese banking system. The official non-performing loans (NPL) ratio apparently remains low at 1.74% of total loans at end-2016, but is thought to be considerably underestimated. According to our calculations, the NPL ratio would instead amount to around 5-6% if Chinese banks were to book non-performing loans in accordance with the international accounting standards. The IMF estimates that the ratio could even be as high as 15% if the loans of financially distressed companies unlikely to meet their repayment schedules were taken into account. That said, during the banking crisis at the end of the 1990s, the NPL rate of China's four largest banks was estimated at 42%.

The risk related to the interconnection between the shadow banking sector and the traditional banking system

The expansion of the shadow banking sector, as well as its interconnections with the official banking system, adds an extra risk factor. Shadow banking currently represents around 60% of GDP and more than USD 4 trillion of assets (although this estimate is uncertain). Its expansion has largely resulted from the private sector (SMEs, property developers) being partially crowded-out from the traditional banking system in favour of the public sector (state-owned enterprises and local governments) (see Song, Storesletten and Zilibotti, 2011 and Poncet, Steingress and Vandenbussche, 2010). In addition, low interest rates on deposits have encouraged households to search for better returns elsewhere.

According to UBS, fully taking into account the shadow banking sector would accelerate the growth rate of total non-financial sector debt from 12% to 15-16% year-on-year in 2016 (i.e. twice as fast as nominal GDP). One of the shadow banking sector's main vulnerabilities is the maturity mismatch: loans, essentially long term and high risk, are covered by short-term deposits (usually three to six months). The functioning of the

system is therefore highly dependent on investors, essentially individuals, renewing their supply of financing.

Chinese banks are exposed to the shadow banking sector both on the liability side and on the asset side. On the one hand, they raise funds via wealth management products (WMP) that they distribute to their customers. On the other hand, banks grant loans via intermediary vehicles (trusts, brokers and asset management funds), in which they purchase shares. The IMF estimates that WMPs could represent 8-10% of banking assets. These loans are booked as investment products and therefore are not subject to the same prudential regulations or loan quotas. Thanks to this mechanism, banks are able to finance entities in difficulty while pushing back the actual recognition and provision for non-performing loans. These interconnections between the official banking system and the shadow banking sector make it particularly difficult to precisely measure the share of NPLs.

The probability of a banking crisis is, however, limited at this stage

Despite these worrying developments, other factors suggest that the risk of a banking crisis in China is relatively contained. Chinese banks are far more profitable than their US and European counterparts, and their capitalisation remains satisfactory with a capital ratio of 13.3% at end-2016. In contrast to the majority of the countries that experienced banking crises, almost all of the debt in China is financed by domestic savings, and banks are mainly financed through deposits. Bank recapitalisation would only be necessary in an extreme scenario, which China should be able to absorb given its fiscal space.

The IMF estimates that a stress scenario would lead to losses of around 7% of GDP, which the Chinese banking system could absorb without any significant risk to financial stability. According to an analysis by CLSA (one of Asia's largest brokerage companies), these losses could rise to 10-11% of GDP if the shadow banking sector is taken into account. The difficulties that could hit small and medium-sized banks should not lead to a liquidity crisis like the one seen in the United States and Europe in 2008. Many liquidity management tools are available to the Chinese central bank. In addition, capital flight should be avoided due to the existence of capital controls.

Government control over the banking sector as well as its main debtors (state-owned enterprises) suggests that a debt restructuring could be phased in progressively rather than in a disorderly manner, without market constraints. The Chinese authorities appear to be aware of the vulnerabilities built up in the financial system and have already implemented a certain number of measures, such as including shadow banking products in the prudential ratios, to better control high-risk practices.

As for the risk of financial spillover to the rest of the world, any contagion would be passed on through a psychological herding mechanism. The effective exposure of foreign investors to China is limited due to the exchange controls. However, we cannot rule out a loss of investor confidence or contagion to international financial markets in the context of an increase in US interest rates, followed by a global redistribution of capital flows.