Chinese Credit Problems Arise

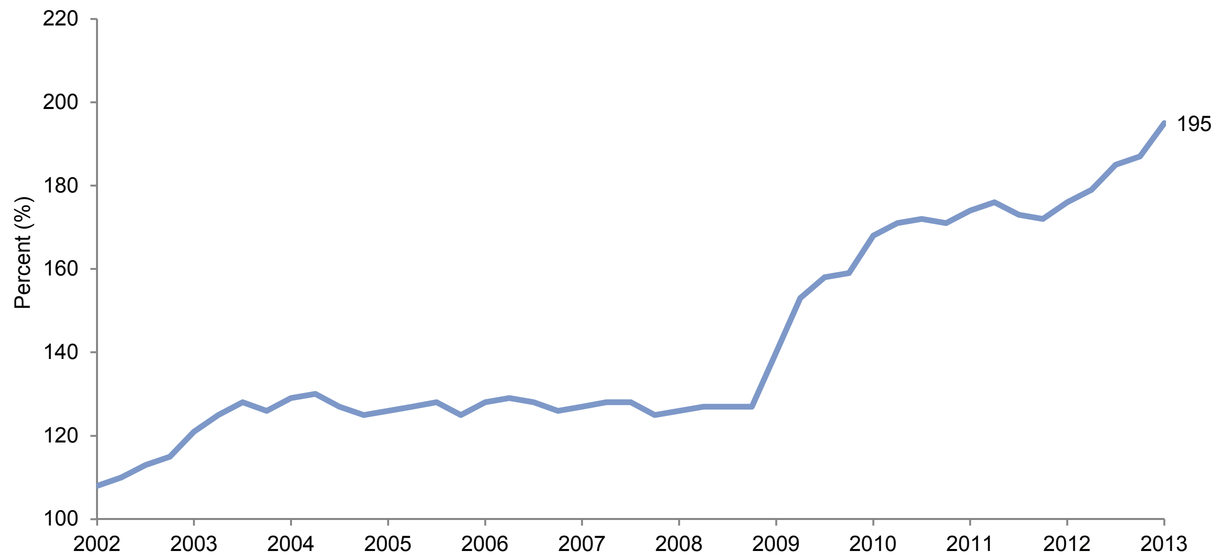
Given the tremendous growth in debt-financed activity, investors are rightly wondering whether China is near a tipping point where its credit boom becomes a credit bust. China recently made headlines when it allowed its first ever bond default. A second smaller bond default has occurred in the weeks since. Add to that various news stories regarding firms' increasing inability to repay or roll debts and investors may be right to worry. In this brief we take a look at recent credit events in China as well as the country's continuing deregulation and reform efforts, and how the two may affect each other.

China's Credit Growth in Context

In the wake of the 2008 financial crisis, China's largely export dependent economy suddenly found itself severely exposed to a lack of global demand for its products. To mitigate the slowdown, China's government developed a RMB 4 trillion stimulus package along with a monetary expansion plan. While the stimulus had the desired effect on the economy, it also kicked off a period of growth fueled almost entirely by debt.

After generally rising in line with GDP for most of the decade, credit growth in China began to outpace economic growth after the stimulus, rising from about 130% of GDP to nearly 200% by early 2013. Such a large increase in credit over a five-year span has never been seen in a major economy. In both Japan and the United States, credit growth before their crises was only about 40% of GDP, not the 70%+ that China has achieved. Chinese bank balance sheets have grown from RMB 61 trillion to RMB 145 trillion over the last half decade, and a ~RMB 30 trillion shadow banking industry has also emerged.

Chinese Credit as a % of GDP
First Quarter 2002 – First Quarter 2013



China's First Default

On March 7, Chaori Solar, a solar panel manufacturer, became the first onshore Chinese corporate bond in recent history to default when it failed to make an interest payment on time. Traditionally, China has protected creditor's interests in failing businesses and investments. Struggling firms and local governments could tap the central bank for loans to pay off local debt holders. The purpose was ostensibly to maintain "social stability," but it also had the knock on effect of injecting moral hazard into China's financial system. Chaori's default is the first real signal yet from Beijing that the state will no longer freely bail out creditors, and that investors must bear the risk of financial loss.

So far, the Chaori default has been taken in stride by the markets. Investors had been expecting the government to let a default occur—as Beijing had been signaling its desire to instill market discipline by allowing select defaults—and Chaori fit the bill. With a face value of only RMB 1 billion, the default would be small enough not to spook investors. Indeed, the missed coupon was only for about RMB 89 million and principal was not due. And investors were aware of Chaori's financial troubles—the firm recently posted its third straight year of losses and the bond had been halted from trading last July.

The challenge for China is balancing the desire to let weak firms fail while simultaneously maintaining investor confidence so as not to cause a significant credit run.

A Harbinger of What's to Come?

While the Chaori default made headlines, other credit activity has had less news coverage. A second corporate bond default occurred somewhat unexpectedly on March 28 when a small construction materials company failed to make an interest payment. Although this bond was even smaller, at RMB 180 million, and was again a missed interest payment versus principal due, the fact that it came so close on the heels of the historic Chaori default isn't comforting. And as we went to press today, another Chinese company announced it would default.

Some companies face other debt repayment issues. Several industries—such as coal mining, steel production, and heavy industries like ship building—are known to be in poor financial shape with heavy debt loads and issues of industry overcapacity:

- **Coal mining:** In January, a Shanxi region coal miner nearly defaulted on RMB 3 billion of loans before an unknown third party made investors whole. Another Shanxi coal miner is in an ongoing dispute over RMB 1 billion it cannot repay.
- **Steel production:** Late last month, China's largest private steel maker, Highsee Group, failed to repay RMB 3 billion in outstanding debt. According to China's Iron and Steel Association, members suffered a collective loss of over RMB 3 billion in the first two months of the year.
- **Ship building:** Rongsheng Heavy Industries is asking its convertible bondholders not to exercise their upcoming early redemption option worth RMB 1.9 billion. The company lost nearly RMB 9 billion last year.

In the previously red-hot but now cooling real estate sector, a Zhejiang province property developer is on the verge of bankruptcy after being unable to pay off RMB 3.5 billion in debt.

What to Watch

While these individual examples are small relative to China's RMB 57 trillion economy, China's recently released banking statistics reinforce the potential of a possible turning point in the credit cycle. China's top five banks wrote off RMB 59 billion in loans in 2013, up 127% from 2012 levels, and the largest amount since the banks were recapitalized and floated by the PBOC in the mid 2000s. Taking write-downs on NPLs (non-performing loans) normally reduces a bank's NPL ratio, so it is not an encouraging sign that the ratio still ticked up in 2013 to 1.0% from 0.95%. On the whole, banking sector profits still grew in 2013, although at a slower pace than in previous years. This could be caused by lower loan growth, loan write-downs, or increases in loss provisioning.

Changes in both official bank and shadow bank lending are another statistic to watch. Due to the Chinese New Year, borrowing is generally robust in January, weak in February, and rebounds in March. January and February 2014 have followed this path: official lending fell from RMB 1.32 trillion to RMB 648 billion, while shadow lending fell from RMB 1.09 trillion all the way to RMB 169 billion. The March lending number, due out on April 10, could give some indication of whether the weak lending environment will continue.

Recent studies looking at credit gaps, defined as the rise in credit to GDP over a five-year window, do not augur well for China. Since 1970, researchers have identified 33 extreme credit booms. Of these cases, 22 resulted in a credit crisis and all resulted in a significant economic slowdown, with average annual GDP growth falling from 5.2% to 1.8%. Prior to China, the top five worst credit binges belonged to Thailand, Malaysia, Chile, Zimbabwe, and Latvia, all of whom suffered credit crises and major economic downturns. Their rise in credit to GDP all exceeded 60%, but did not reach China's current level of 70%+.

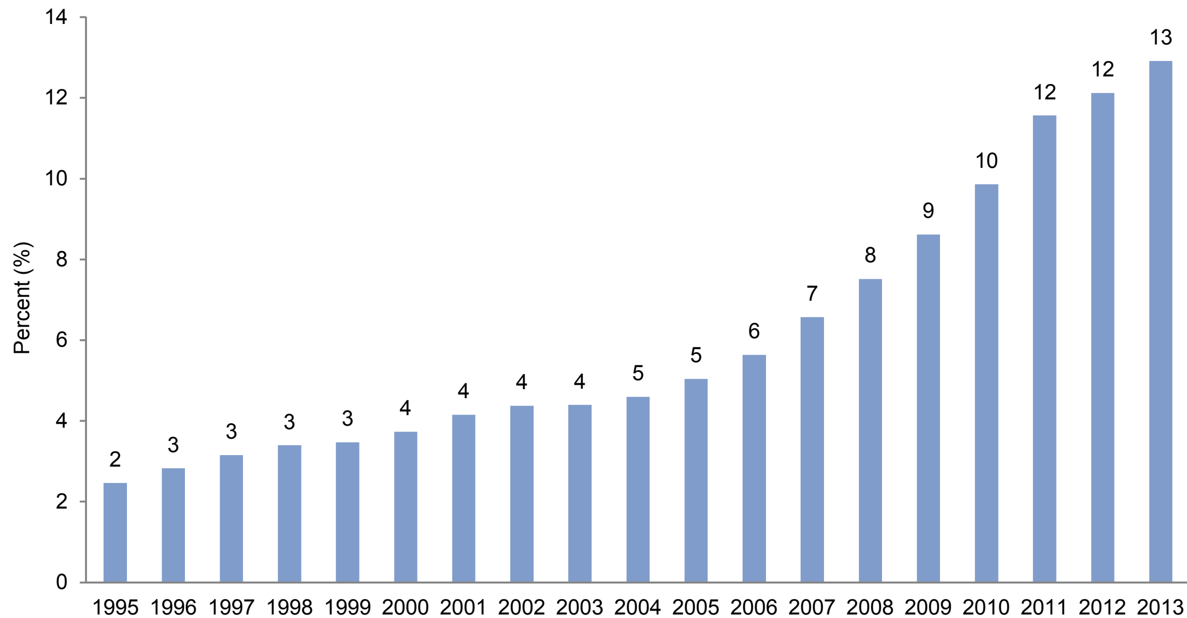
The Broader Implications

Given that much of China's financial system is closed to outsiders and total foreign claims on Chinese banks are just over 3% of Chinese bank assets, according to the BIS, it is unlikely that problems in China would create a global financial crisis on the level of 2008. Also, China is much stronger financially than the other worst credit gap offenders, and the country has experience in managing large scale write-downs. In the 1980s and 1990s, China's Big 4 banks racked up NPLs that peaked at a whopping 30% of GDP. Between 1998 and 2005, China underwent a massive NPL work out that included substantial write-downs as well as a total infusion of state capital to the tune of RMB 5 trillion. Yet throughout this period, China was able to maintain strong GDP growth.

Could the country do it again if necessary? The stakes are different this time. China is no longer a small but booming economy in a global growth environment. It is now the second largest global economy trying to transition to a consumer-led growth model in a deleveraging global environment.

Over the last decade, China has contributed approximately 20% of global GDP growth and currently represents 13% of the global economy. If China's GDP growth rate were to fall the average 75% post-crisis, that would imply sub-2% growth in China and lead to an approximately 75 bp hit to global growth.[1] And this is without the downstream affects that would certainly arise—with China the largest or second largest trading partner for

[1] Given its 13% share of the global economy, if China's growth rate fell 75% from 7.7% to 1.9% that would be a weighted decline of ~75 bps (13% * 5.8% decline in growth) on an annual basis.



several countries in Asia and an important export market for a number of others, a hard landing in China could put serious negative pressure on several economies (including Australia, where the China/Australia trading relationship is estimated to account for nearly 10% of Australia's GDP). China accounts for 7% of US exports and 8.5% for Europe, so a downturn, while negative, should not be crushing in these regions, though a commodity price collapse and subsequent economic downturn in producer countries could create significant deflationary forces for the global economy.

The Bottom Line

China has fueled its growth over the last half decade via an influx of credit unprecedented in size for a large economy. It has historically papered over creditor losses, leading to the moral hazard that Beijing is now keen to clamp down on, allowing poorly managed business to fail, with creditors suffering the consequences. At the same time, China cannot allow investor confidence to fall too far, lest it unleash a vicious cycle of credit unwinds. It is unclear how China will thread this needle, or if it will even be able to. ■

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Exhibit Notes

Chinese Credit as a % of GDP
Source: International Monetary Fund.

Growth of China's GDP as a % of Global GDP
Sources: International Monetary Fund and Thomson Reuters Datastream.

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