

## How worried should we be about the Chinese debt situation?

9 January 2014

**In the final week of 2013 alarming messages about the state of China's debt position resurfaced. Some observers were quick to predict that a Chinese debt crisis with global consequences was (yet again) just around the corner. While the debt explosion over the last five years is clearly not sustainable, we think these calls are misplaced. China is not on the brink of a financial crisis but it is clear that the much needed deleveraging process will soon send growth rates lower from current levels (7.6% in 2013).**

The rise in interbank interest rates (from 4.5% to 9%) just before Christmas and the publication of the local public debt report by the National Audit Office (NAO) at the end of last year have led some commentators to suggest that an implosion of China's financial system poses one of the biggest economic risks for 2014. In line with our reasoning back in June when the Chinese interbank market also experienced a sharp cash crunch (graph 1), we argue once again that the doomsayers' predictions are premature. True, local debt has risen a lot since 2008 and total public debt (central plus local) is much higher than the frequently presented number of around 20% of GDP. But even though public debt is fairly high relative to other EM (graph 2), it's still no cause for alarm. At 56% of GDP the figure remains far below the levels seen in DM. Moreover, the debt snowball-effect witnessed in a large number of DM whereby the debt level increases automatically as the implicit interest rate exceeds nominal GDP growth is not present in Chinese debt dynamics. In China nominal GDP growth (around 10%) is higher than the implicit interest rate (estimated at 7%). The latest report of the NAO, therefore, is no reason to ring the alarm bells. And neither are the occasional spikes of interbank interest rates. These upward moves reflect deliberate monetary policy to curb credit growth and do not point to an escalation of the situation. At the end of the day China's monetary officials will continue to make sure that sufficient liquidity is in place.

This does not mean that all is fine, on the contrary. The debt picture is in fact far more worrying when private debt is included. Total (private + public) outstanding debt in China comes close to 230% of GDP, unusually high for an EM close to the already very high levels seen in DM (graph 3). In general, more developed countries (measured by GDP per capita) have higher overall debt ratios. Going by the level of China's debt burden one would think of China as a DM with a general living standard similar to the ones of Italy and Spain. In reality, however, China's prosperity level is three times less. Credit growth in China is used as a stop-and-go policy instrument by authorities in order to meet the economic growth targets. The large presence of state-owned companies makes this possible. This was clearly visible shortly after the start of the global financial crisis in 2008. Whereas credit growth in most countries of the world collapsed back then, quite the opposite happened in China. Similarly, although to a lesser extent, when hard landing fears appeared in 2012 Chinese authorities stepped in and jumpstarted the credit engine to avert an outright crisis.

As Chinese credit growth in the wake of the 2008-2009 crisis far outpaced nominal GDP growth, this resulted in mounting debt levels (graph 4). That said, fears of an imminent debt crisis seem overdone for now. Debt crises are generally preceded by a combination of high credit growth and a large buildup of external debt (in foreign currency). In the case of China only the first condition is met. By far the largest part of Chinese debt is held at home in CNY. Therefore, a self-fulfilling panic reaction with foreign investors fleeing the country is just not possible. Moreover, China runs a current account surplus. At 49% of GDP domestic investment in China is very high but this is totally financed out of an even larger domestic savings base (graph 5). Finally, capital controls make sure that capital can barely escape the country. All this suggests China is not on the brink of a huge financial crisis in 2014.

The important Third Party Plenum back in November suggested Chinese authorities are getting serious about rebalancing the economy and restraining credit growth. Chinese authorities are likely to take more measures to tackle the debt explosion seen over the last five years. The implication of this is that economic growth will slow down further from current levels (graph 6). China currently still sticks to its official growth target of 7.5% but it seems highly unlikely that this number can be sustained for much longer. The reason is that it is not consistent with the goal of rebalancing the economy. Financial market consensus is that Chinese growth will be as high as 7.5% in 2014 and 7.2% in 2015. We estimate that these numbers are too optimistic and that growth could easily fall back to 6.5% as of next year and gradually lower in the years thereafter. Paradoxically, this evolution should be welcomed as it significantly reduces the chances of a hard landing further down the road. For now, however, financial markets are still reasoning the other way around.

