TOWNELEY
CAPITAL MANAGEMENT INC
ESTABLISHED 1971

CHINA'S WORRIES: HIGH DEBT AND LOW GROWTH

By Shu Chin Li

July 2017

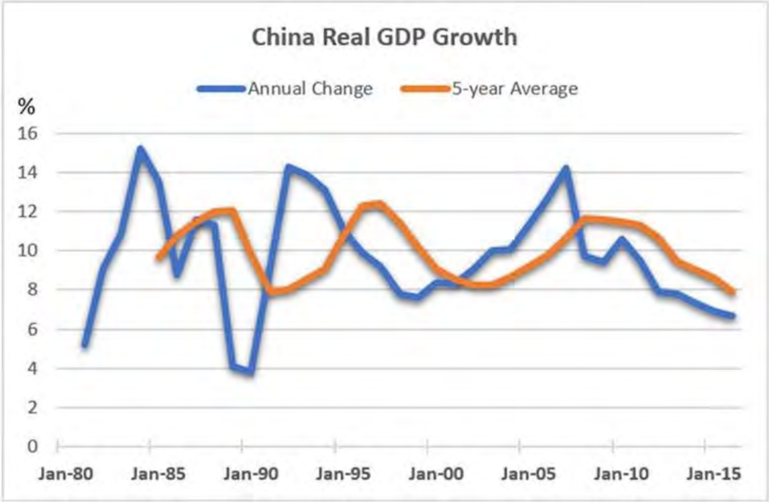
China had a strong start in the first quarter of 2017 with real gross domestic product (GDP) growth of 6.9% (annualized). The nominal figure expanded nearly 12%. It seems China's positioning to revive from the recent slump, and the satisfactory result, relieved some concerns over China's looming debt crisis. China's rise since 2000 has been the most remarkable story in the twenty-first century. With this strong start in 2017, could China continue to charge ahead?

In our view, China's meteoric era may be at risk. Near term, a looming credit crisis is on the horizon; in the mid-term, heavy corporate debt loads, faltering productivity, and a shrinking work force could quickly reduce China's real growth to less than 4%.

Investors should be aware that what happens in China will not stay in China. Consider August 2015 and January 2016, when China's growth stalled; a domino effect of global sell-offs hit financial markets.

The Ups and Downs of China's Growth Cycle

Growing at a real rate of nearly 10% per year for the past three decades, China's economic success has been spectacular. In 2010, China surpassed Japan as the world's second biggest economy behind the US, accounting for over 10% of world GDP. China has become the world's biggest exporter, it holds the largest foreign exchange reserves, and its currency, the yuan, joined the ranks of the global reserve currencies in 2015. Now, China rivals America as a world superpower. China has obviously changed.



Source: Bloomberg Data

Figure 1.

China’s rise can be seen in Figure 1, which shows three distinct cycles of China’s growth, but the last one that started in 2001 was the most transformative. Before then, the budding manufacturing facilities in southern China were only a sideshow. After 2001, China began to open its doors to the world economy. Two significant events propelled the shift: China, for the first time in its history, permitted private property rights, and they joined the World Trade Organization. Thanks to these two dominant forces, thousands of new businesses and factories joined the world economy through exports. Millions of workers left rural areas to seek better lives in cities. Also, individual property rights through home ownership drove expansive housing construction and massive infrastructure development in bridges, roads, airports and so on.

Everything went well until the 2008 global financial crisis hit China. Since then, its economy has been slumping, and the double-digit growth rate has all but vanished. Growth in 2016 was below 7%, the lowest level in 25 years.

The lower growth data reveal a worrisome picture; China’s 5-year growth rate for the first time slipped below the historic low of 8%. This 8% level was lower than during the disastrous currency crisis in Asia in 1997-8. Does this below-trend growth suggest an end to the Chinese growth miracle?

China’s economic ascent was rooted in neither innovation nor reinvention. Paul Krugman, the American economist, long argued that China simply copied Japan’s growth model. Japan sustained a real GDP of at least 6% for 30 years before its credit bubble burst in 1990. The four Asian tigers (Hong Kong, Singapore, South Korea, Taiwan), also adopted that model, which delivered years of stunning growth.

It is no secret that China mirrored Japan’s growth model, which depended heavily on the expense of fixed asset investments to expand. In Figure 2, the orange line represents China’s long-term potential growth, which is the sum of the annual increases of three major supply inputs: capital stock (the gray line), productivity (yellow), and labor force (light blue). The chart shows that increases in China’s capital accounted for 50% of the output growth.

In China's case, capital investment was the key driver of growth. The data show that labor has never been material, and after 2008 its contribution to growth turned negative. As for productivity growth, we see steady progress between 1990 and 2008. During this period, China's rising productivity doubled its contribution to GDP growth. After 2008, China's productivity as a factor in growth has been declining, and its recent trend has been flattened to 2.5%, the worst level in 20 years.

Source: Bloomberg Data

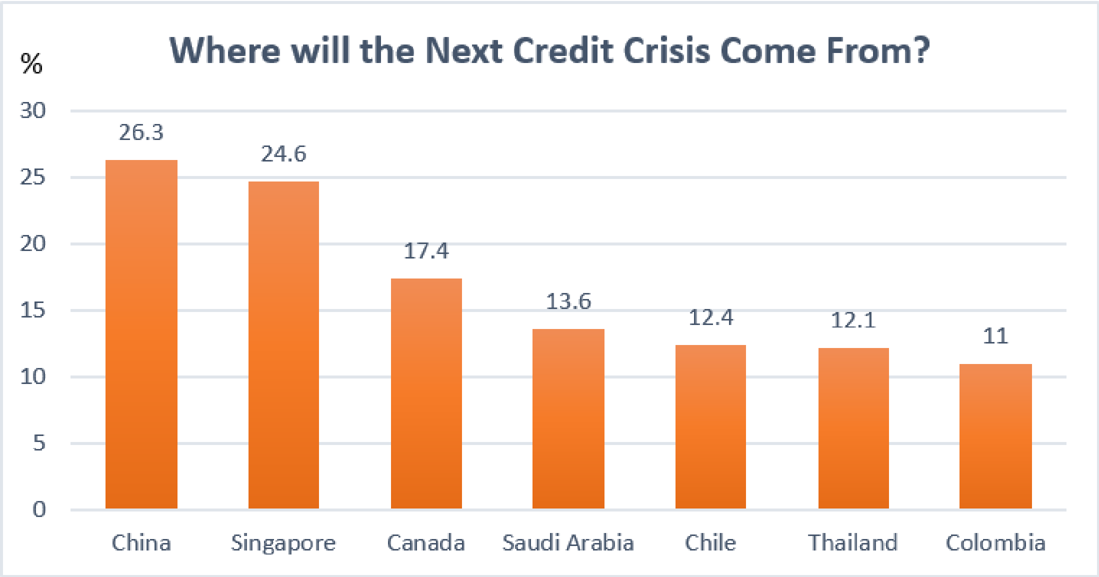
Figure 2.

Capital stock is what sustains China's growth, and its contribution to real growth stayed above 5% until 2015. Then, China's output slowed down abruptly, while its investment growth fell to around 4%. Despite the downturn, China maintained a relatively high level of capital investment as productivity faltered.

The diverging trend between falling productivity and relatively high capital investments is troublesome. This same scenario caused Japan to stagnate for almost three decades, resulting in national debt three times larger than its GDP.

Is China's Financial Bust Looming?

It seems China has fallen into a similar conundrum as Japan. Based on the Bank for International Settlements' (BIS) latest credit crisis data (see Figure 3), China ranked highest as the location of the next financial crisis.



Source: BIS Data as of September 30, 2016

Figure 3.

The gauge is considered the single most reliable indicator of looming financial crises. In its study of over 40 countries, the BIS concluded that readings above 10% preceded most banking crises.

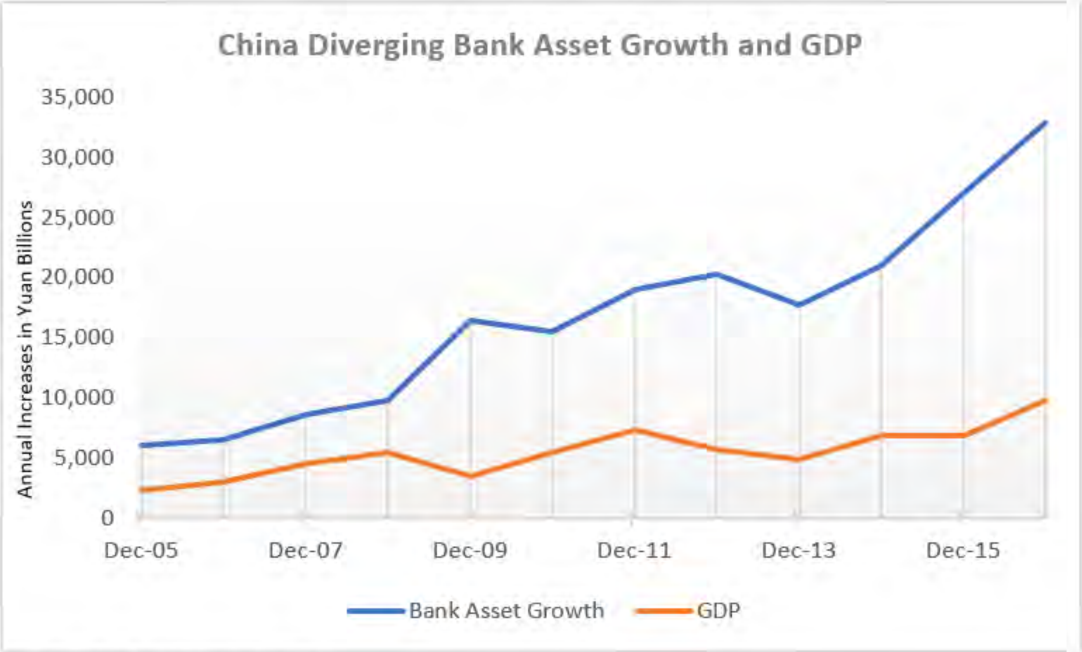
The indicator, measuring the relative size of the outstanding debt of the non-financial sector with respect to yearly GDP, detects the difference between current credit-to-GDP and long-term trends. It illustrates the burden that current decisions and activities place on a country's economic future. A higher positive gap means that the borrowing is at a level that is perhaps "not justified" by the current output-producing abilities of the economy. Banks in those countries in Figure 3 may experience abnormally high rates of loan defaults, which could lead to a crisis.

China's stunning rise in debt reveals how unique China's situation is. It's a country with relatively high savings rates where the banking system is owned by the government. During boom times, Chinese state-owned banks channeled loans to state-owned enterprises (SOEs) without applying rigorous credit assessments. Tons of capital was rapidly funneled to a vast number of infrastructure projects.

Easy credit sustained China's growth for over 15 years. When the global financial crisis happened in 2008, the world economy shrank and China's capacity utilization in many industries plunged to below 50%. Its capital investments suffered serious losses, and housing supplies exceed market demand to this day. In 2007-8, thousands of businesses went bust, which slowed growth in China. Productivity tumbled; at the same time, its labor force also started to decline.

Despite the economic crisis, Chinese leaders believed the situation was transitory, so they continued pouring money into fixed investments. Chinese banks functioned as normal, continuing to supply credit to state-owned companies to maintain economic activities as before the crisis.

Over the past 10 years, China's bank assets grew at a rate of 20%, twice as fast as GDP. At the end of 2016, China's bank assets reached $34 trillion, more than 300% of China's annual GDP, as shown in Figure 4. China's credit surge was the largest credit expansion in history. As China's economy slowed down, its debt piled up.



Source: Bloomberg Data

Figure 4.

The BIS's gauge has revealed a gap in China above 10% since 2010, warning of the nation's excessive credit expansion. Several analysts have forecasted a potential financial crisis there since then. Still other analysts argue that a banking crisis in China is unlikely because the Chinese government has considerable resources. The government owns the financial system, it can institute capital controls, and the country has limited foreign debt.

Delaying China's Debt Crisis

So far, no crisis has materialized in China, but the world did catch China's cold in 2015-16. In August 2015, global financial markets experienced a major sell-off because of a collapse of Chinese stock markets and the devaluation of Chinese currency.

At the beginning of 2016, China's yuan weakened after the Fed's second rate increase. During the rest of 2016, Chinese worries moved backstage, as its growth rate had met the target of 6.7% at the expense of faster loan growth. By year-end, Chinese currency dropped to nearly RMB 7 per USD, the cheapest rate in three years. This dip resulted in China's foreign exchange reserves falling below $3 trillion.

It seems that people have China's debt picture all wrong. Not really. In fact, the Chinese government has been secretly bailing out their inefficient SOEs. The rate of China's debt increases exceeded Japan's accumulation in 1985-90 and the US's during the 2000-2007 housing crisis. Since 2008, China's total debt level has risen to 260% of its GDP, nearly 50% of which is owed by China's state-owned enterprises. Now, China's corporate debt level is ranked the highest among G20 economies.

Here are the two major misconceptions: the Chinese government debt is low, and Chinese banks' bad loans are insignificant. First, if we combine the debts of SOEs, state banks, and local governments, the government's share of the debt could increase to 180% of GDP.

One should also be skeptical of the statistics reported by China's state banks. Despite a slumping economy, the official ratio of non-performing loans was less than two percent. This number is far below Fitch Ratings' estimate of 15% to 20%. Fitch's ratio implied $1-2 trillion of under-reported bad loans.

In the past three years, more than 30 bad banks were set up to absorb unpaid loans. Last year, the Chinese government, sensing risks associated with rising debt burdens, rushed to permit some SOEs to swap debt for equity.

Why rescue state-owned companies? One sentence sums it up: "They are too big to fail." Bloomberg data suggest China's SOEs produced revenues the size of Japan's GDP, accounting for 40% of China's industrial assets in 2014. They are dominant players in China's industries. Moreover, many of them are conglomerates. China National Petroleum, an oil and gas company, has expanded into hotels, hospitals, schools and utilities. Aviation Industry Corporation of China is a holding company of 100 entities. Despite its core business in aviation and defense, its main business accounts for less than half of its total assets.

China's SOEs have wide interests, but they aren't very profitable or efficient. In terms of return on assets, they have under performed private firms at home and abroad; their average return on assets was only 4%, half that of its private sector.

China's Dangers to Watch

There are two things investors need to pay close attention to; one is a possible credit crisis, and the other is an aging population.

In the past eight years, money for fixed investments wasn't entirely funded by bank loans. Some of the debt was funded by private savings, which was raised by small banks in the form of wealth management products (WMPs). They are intended to invest for the short term at a guaranteed profit of 4.3% on average. They've become popular because of their higher returns than local deposit rates. The assets have amassed to at least $4 trillion, half of which are invested in higher risk corporate bonds, stocks and real estate. Some commentators believe that China's credit crisis is imminent because of the asset-liabilities mismatch. It was the same problem caused the US subprime crisis in 2007. Today, China's WMPs with higher returns account for 10% of China's bank liabilities, while the US housing crisis involved two percent of total bank assets.

Chinese investors believe that the WMPs are backed by the government, and they can never go bad. But when the economy slows down, profits decline, bonds default, and bankruptcies rise. When an economy is in a dire situation, the deterioration of bank asset values could cause banks short of cash to miss payments.

The other not-easy-to-fix risk to economic growth is an aging work force as the result of its one-child policy. Since 2010, labor input to China's economy has turned negative, and the situation will get worse, as Japan's did from 1990 to 2015. Goldman Sachs projects that China's work force will shrink nearly 0.5% annually over the next 25 years.

No one can know whether China can succeed in transforming those well-connected state-owned companies and automate to make up for the decline in the work force. So far, the reform hasn't been promising.

About Shu Chin Li

Shu Chin Li, M.B.A., CFA, is Portfolio Strategist and Director of research at Towneley Capital Management, Inc. She is the firm's specialist in international equity analysis and quantitative global asset allocation strategy development. Acting initially as research consultant to the firm, she joined the Towneley team in 2002. Her background includes international banking and experience in currency trading and risk management for Taiwanese firms. Ms. Li later served as research analyst in emerging markets equities for Newgate LLP, which won 2000 Best Money Manager as surveyed by Emerging Markets Week. She earned her M.S. in statistics at the University of Toronto followed by an M.B.A. in finance and international business at the Stern School of New York University. She holds the Chartered Financial Analyst designation and is a member of the CFA Institute.

Disclaimers

The information contained herein is provided for illustrative purposes only. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. We believe the information contained herein to be reliable, but do not warrant its accuracy or completeness.

The views and opinions presented herein are those of Towneley Capital Management, Inc., are based on current market conditions, and are subject to change without notice. The investment strategies presented herein may not be suitable for all investors, and may differ from those presented for other purposes, in other contexts, or by other investment counselors or financial advisors.

This material is distributed with the understanding that Towneley Capital Management, Inc. is not providing accounting, legal or tax advice. Please consult your legal or tax advisor concerning such matters.

Past investment performance does not guarantee future results.

Additional information is available upon request.

www.towneley.com