Does China Have a *Debt Problem?*

By Chi Lo

Yes and no, says a leading expert.

Debt arises when an economy transforms its savings into investment. The concern about China's debt is whether it is backed by domestic savings or by borrowed savings from overseas. Debt built on borrowed savings under an open capital account is more susceptible to financial instability. The financial structure of an economy also affects the amount of its leverage. So how much foreign debt does China have and how different is China's financial structure from that of other countries? Will more debt-fueled growth by Beijing only exacerbate China's excess capacity and delay the needed structural changes? How bad is this situation and what is the evidence?

Some observers argue that China's debt-to-GDP ratio, estimated at close to 250 percent in 2015, has reached a point that could trigger a systemic collapse soon. This ratio is high by international standards, but not as high as many have feared. It ranks only in the middle of the world debt league, according to data from the Bank for International Settlements, with countries such as Japan, Belgium, Portugal, Ireland, the Netherlands, and Greece recording significantly higher debt ratios.

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HOW MUCH IS TOO MUCH?

Does China have too much debt? To assess this situation, let's go back to the basics. Debt arises when an economy transforms its savings into investment. There are two ways to do that, either through borrowing or through equity financing. If all national savings are transformed into investment via the equity market, the economy incurs no debt. In reality, there is always a portion of national savings being transformed into investment via borrowing either through bank loans or bond issuance. In this case, the economy builds up debt.

The debt "Armageddon" outlook for China is based on the perspective of an open, market-driven, financial system, which is just not the case in China.

In a closed system, given a stable structure of financial intermediation between equity and debt financing, the higher the national savings, the higher the level of debt. So debt is bound to arise and there is nothing good or bad about it. Empirical evidence shows that there is a positive relationship between a country's national savings and debt level (see Figure 1). China is high up on the chart due to its high national savings.

However, in an open system, a country can borrow foreign savings from abroad. This means that it can build up an amount of debt larger than its stock of domestic savings by incurring foreign liabilities. Conversely, a country can accumulate foreign assets by lending its savings to foreign borrowers.

If a country lends more to foreigners than it borrows from them, it builds up net foreign assets, and vice versa when it accumulates net foreign liabilities. In China's case, not only does it have a small foreign debt (less than 15 percent of GDP in early 2016), but it also has a net international investment position; that is, it is a net creditor to the world.

In principle, a low-saving country can run a large debt by borrowing from abroad, but a high-saving country almost always runs a large debt even it does not have any foreign borrowing. This is apparent in the steady increase in the debt levels in both the Anglo-Saxon and Asian economies over time. China falls in the latter high-savings-high-debt category.

However, the backdrop behind the debt increase of these two groups of countries is quite different. The Anglo-Saxon countries have accumulated large net foreign liabilities due to inadequate domestic savings (see their current account deficits). So their debt is financed by foreign savings. The Asian countries have accumulated large net foreign assets due to large domestic saving surpluses (see their current account surpluses). So Asia's debt is financed by domestic savings.

BORROWED VERSUS DOMESTIC SAVINGS

Debt financed by foreign (borrowed) savings is generally more risky and susceptible to instability than debt financed by domestic savings. However, the link may not be definite. While there are examples of financial crises due to excessive foreign borrowing, some countries such as Australia have managed to attract a steady inflow of foreign savings for a long time without hitting a "debt wall." Japan's debt load has also risen steadily over the years without detonating any debt-currency crisis.

In a nutshell, China's debt is mostly domestically financed and is denominated in local currency. It is a net global creditor and is running the largest trade surplus in the world (at the time of writing). Its capital account is still relatively closed, which helps restrict foreign borrowing. Thus, China's debt is likely to be much more stable than other countries that have similar or even lower debt ratios. Its high debt load is a reflection of its high savings, the bulk of which is intermediated through the banking system. This brings us to the structure of the financial system, which can affect a country's debt level.

China's debt is structurally different from that of the crisis countries.

A DIFFERENT FINANCIAL STRUCTURE

The United States has a deep and highly liquid equity market, which has long been a key form of capital allocation in its economy, while banks and the bond market have played a secondary role. However, in both Europe and Asia, bank loans and bonds tend to be more important

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than equity as a funding source. This means that they are more leveraged than their U.S. counterpart.

In China, debt financing (including mostly bank loans and other types of borrowing) accounted for 95 percent of its total financing in 2015, while equity financing accounted for only 5 percent (see Figure 2). Hence, in the absence of a developed equity market, China's growth will have to be financed by debt in the form of bank loans and bonds. So China's debt ratio may not be as excessive as it seems due to its underdeveloped capital market. However, this does not mean that China does not have a debt problem.

THE DEBT-SERVICING AND EFFICIENCY PROBLEMS

Indeed, Chinese corporate profitability has been falling, thus tightening companies' cash flows and eroding their debt-servicing ability. This is especially worrying in the face of diminishing margin efficiency of credit, as an increase in each unit of credit in China is generating a decreasing amount of incremental output. This also means that companies will need to borrow more to finance working capital, or in some extreme cases borrow more to service the existing debt.

This has led to renewed concerns about Beijing's debt-financed stimulus measures to boost GDP growth by sustaining the "zombie" companies, and thereby exacerbating excess capacity and delaying structural changes. However, evidence suggests that the situation may not be too bad.

The recent government-led investment spending focuses on two areas: housing and infrastructure. The former is not necessarily good, as housing is non-productive investment. The latter is good, as it is focused on improving transport links between the developed and less-developed regions and urban infrastructure, including water supply, sewage systems, and rail transit systems, and environment protection. Meanwhile, investment in the excess capacity sectors, notably steel, coal, and chemicals, has been contracting, and investment in manufacturing has been growing at the slowest rate in over a decade.

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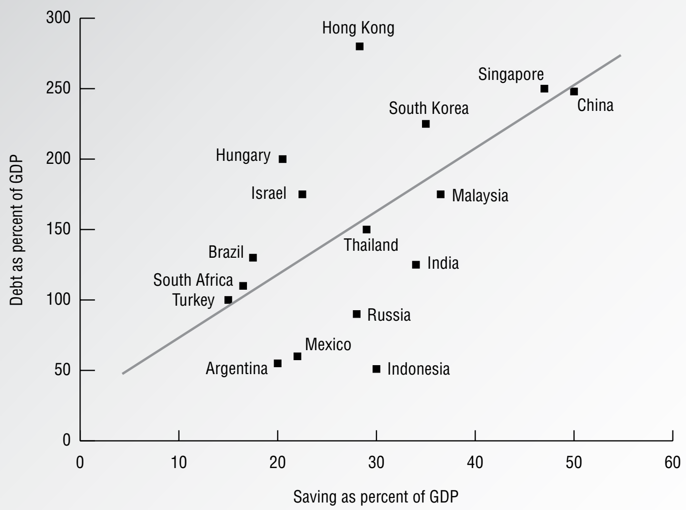
HOW MIGHT CHINA'S DEBT PROBLEM END?

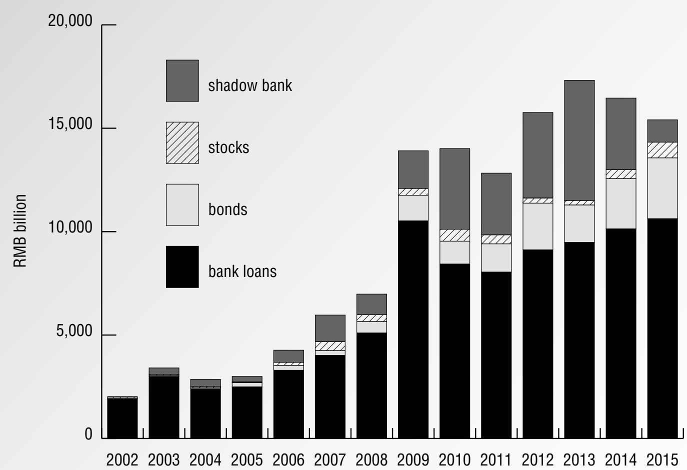
Pessimists argue that a debt-currency crisis could result soon. But our analysis here suggests that this scenario would be a low-odds outcome. In a 2013 analysis, I arrived

Figure 1 Higher savings, higher debt



Sources: CEIC, BIS debt data as of 2014, BNPP IP (Asia)

Figure 2 Components of Total Social Financing flows



Sources: CEIC, BNPP IP (Asia)

at the same conclusion by comparing China's debt with international experience. The world was then worrying about a "money black hole" on the verge of triggering a "Minsky Moment" in China. Three years on, nothing to that extent has happened.

Critics may retort that China cannot kick the can down the road much longer. They may be surprised because China's debt is structurally different from that of the crisis countries. China's very small foreign debt, abnormally high domestic savings, under-developed financial system that is largely owned or influenced by the Chinese government, implicit guarantee policy, and closed capital account have acted as protective factors today as they did in 2013 to sustain the Chinese system.

This is not to deny China's debt problem. It needs to be fixed. But the protective factors mean that no one can easily pull the plug on China's financial system. Chinese creditors have a different behavior in that they will not as likely run the banks and investment funds as their developed market counterparts will. These factors help buy time for Beijing to sort out the debt problem through structural reforms.

The likely outcome, in my view, is that Beijing's short-term policy shift towards boosting GDP growth will stabilize the economy at the cost of a rise in the debt-to-GDP ratio and slower structural reforms. Beijing is facing a dilemma of structural adjustment racing against GDP growth. Opting for a "shock therapy" would risk killing the economy before giving structural reforms a chance to succeed.

However, opting for a slow adjustment process does not mean that Beijing is sitting on the debt problem. For example, the debt swap program that it has implemented since 2015 is a way to cut the overall debt burden by reducing the system's total interest expense, even though the headline debt-to-GDP ratio continues to rise. The saving in the interest expense is estimated at more than 8 percent of total government spending in 2015. It is deleveraging by stealth, arguably, and the money saved can be used to boost growth and manage potential debt problems.

While Beijing is taking steps to address the structural woes, including the debt problem, the point of contention remains over the pace at which China's structural adjustments are taking place. At this structural transition crossroads, the judgement depends on whether one sees the China reform glass as half-full or half-empty. The debt "Armageddon" outlook for China is based on the perspective of an open, market-driven, financial system, which is just not the case in China. ◆