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Les Matinales du Club

China debt restructuring: the beginning of the end

Compte-rendu

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Christophe Destais

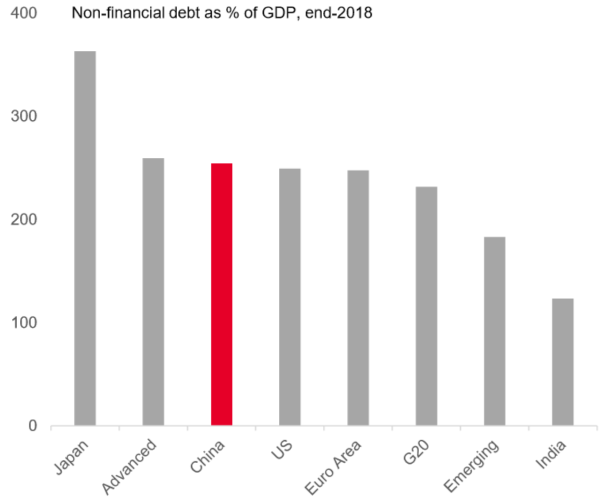
At the turn of the century, China already had a debt problem, but it was easily fixed through capital injections to banks and SOEs' restructuring in a high growth environment.
For at least the last five years, China debt restructuring has been on the radar screen of the Chinese economy watchers.
Moreover, the Chinese economy has been affected by the Trump protectionist policies and more recently by the Covid-19 virus.

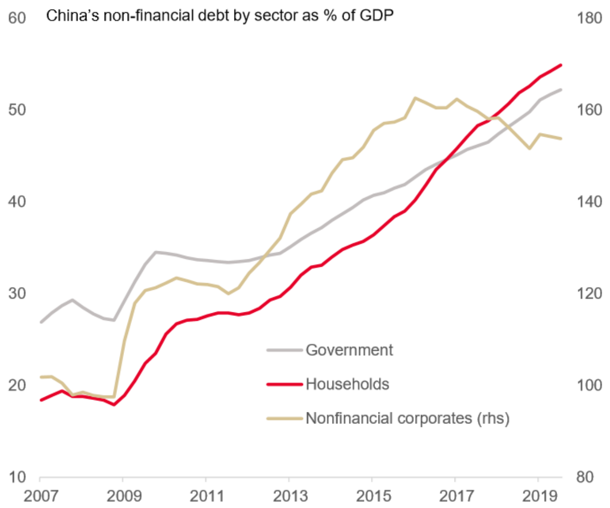
Wei Yao

Some of you might be interested in knowing more about the economic impacts of corona virus. I will talk about it, but what really matters for the Chinese economy in the medium and long term is the debt issue. However, as the corporate debt in China is already very high, some large-scale bankruptcies will be unavoidable if the economy gets shutdown for one month or more.
We hope that China can resume normal capacity by the end of this quarter.

The total debt level is now comparable to that of developed economies.
Out of the 250% GDP (total debt level of the non-financial sector):

- **The majority is corporate debt: 150% GDP.** It seems thus that China has a corporate debt issue, while in Europe or the US, the corporate debt is significantly lower than this.
- The share of household's debt has been rising very fast and is now equal to 50% of GDP.
- The government debt is also around 50% GDP.





- **China's total debt level remains high and continues to rise, but there has been some progress in containing corporate sector debt since 2017.**

"Corporate debt" in China is not exactly the same concept as in the EU, because China has a very large SOEs (State-owned enterprises) sector. Do they fall in the corporate or public debt? In terms of managing business - making profit, these firms often look like any other private enterprise ; however if they go bankrupt, the government would step in to avoid a threat on the financial and economic stability of the whole economy.

The corporate sector debt is 150% of GDP, when the SOEs debt is 90-100% of GDP. Given that SOEs are less profitable than the private companies, how come they get more credit? **It is in fact due to the implicit government guaranty in case of bankruptcy. This implicit guaranty is the main issue of the system.**

There is also the local government financing vehicles (LGFVs): they borrow money for infrastructural programs. Their debt is about 30% of GDP, and they are seen as part of the local governments. Investors are thus more likely to lend them money, disregarding their profitability. On the one hand, **this suggests a massive misallocation of credit.** On the other hand**,** that is also, why China has not had a financial crisis until today. Indeed, people know that the worst-case scenario would be the government intervening to bail these companies out.

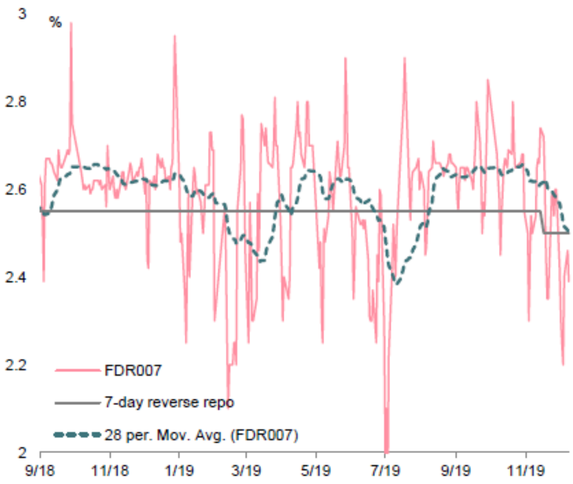
But this system of implicit guarantees extended by the government cannot be maintained forever as **China is eager to open its capital account to attract foreign investments.** This is all the more necessary as China will not be able to maintain a large current account surplus for much longer.

The good news is that China has been dealing with this issue for the last three years through three principals:

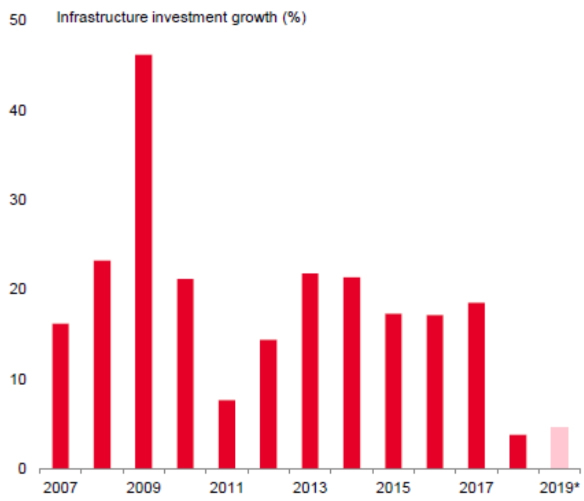
- <u>1st principal: Calibrate macro conditions to discourage re-leveraging and cushion deleveraging => measured cyclical easing.</u>
  - ⇨ Indeed, the current debt situation is due to the excessive stimulus in 2009, 2012 and 2016. The government should not use the same macroeconomic management to smooth the economic cycle. Fiscal and monetary policies have not been accommodating. Last year, interest rates have just been lowered by 5 bases points, which is very little. The major fiscal tool in China has never been tax cuts, but fiscal borrowing for infrastructural projects. In 2009, infrastructural investment growth was 40%, and then from 2013 to 2017 it was 20% every year. In 2018, the infrastructure growth dropped significantly. Instead, the government offered tax cuts to the private sector and the households, so that they could decide what to spend on and how, which was supposed to result in a more efficient allocation of resources.

    I think the reason for China's last year slowdown is not only trade war, but also the decision of the Chinese government not to spend too much money on infrastructural programs.

No liquidity binge, limited declines in interest rates



No massive infrastructure stimulus

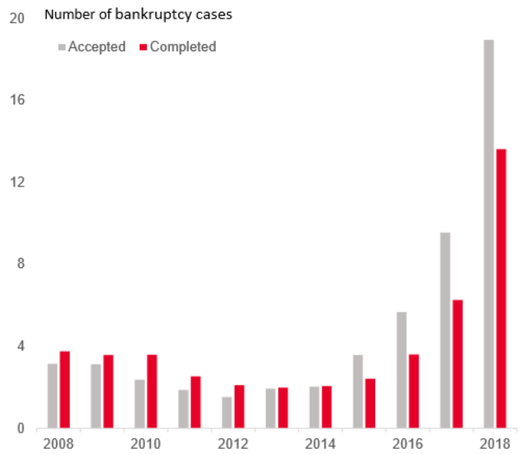


▷ **No major credit/infrastructure stimulus, longer policy lag than before, limited growth upside**

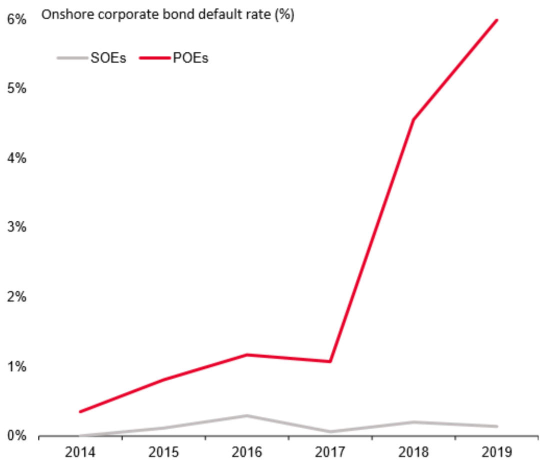
- <u>2nd principal: Start exposing debt risks and allow defaults at a controlled pace</u>
  - ⇨ SOEs and even some non-SOEs are protected by the government. The Chinese corporate bond market has been created in the 1990s, but the very first default only occurred in 2014. **Since 2014, the government has been accepting failures, and the number of defaults and bankruptcies increased every year**. Indeed, if the government

bails out every single enterprise, the risks can never be properly priced, and the resources can never be properly allocated. The government reformed the bankruptcy law, borrowing the US model, **with a dedicated bankruptcy court that is more independent of the interference of local governments**. Usually, local governments do not want their companies to go default and try to hide their difficulties, but this is much more difficult for them now with this separated court.

Defaults and bankruptcies are increasingly common



But SOEs are still largely shielded by implicit guarantees



+ Markets/investors are beginning to learn to price risks, and companies are more careful with leverage
- Disproportional tightening of private sector credit conditions impeding monetary policy transmission

However, as shown on the chart below, **the POEs** (Private Owned Enterprises) **are seeing a normal level of default, whereas that of the SOEs is very low**. This shows that the government is still very reluctant not to bail out SOEs. This is understandable as 80% of the bonds are held by SOEs. This leads us to the third principal.

- 3rd principal: Apply different restructuring approaches depending on the borrower's systemic significance

The government allow the companies that are of a systemic importance to keep running, and let go the less important ones.

Overview of the differentiated approaches to debt restructuring
(from left to right: entities least to most covered by implicit state guarantees)

	POEs	SOEs	LGFVs	FIs
Debt as share of GDP	60%	90%	35%	SMB assets: 100%
Realised NPA ratio	6-8%	1-2%	Near zero	Only 1 interbank default so far
Signs of greater distress	Always >10% of industrial POEs are loss-making	Always >20% of industrial SOEs are loss-making	Significantly higher indebtedness and lower profitability than other corporates	Low capital adequacy among SMBs
Main restructuring methods so far	Market-driven pricing: bankruptcies, distress debt sales/auctions, bank NPL write-offs	Mergers, DES, capital raising via mixed-ownership	Debt extension via bank lending & bond financing	Recapitalisation
Main participants of debt restructuring	AMCs, private distress funds/investors	SOEs, AMCs, FAICs, State-owned FIs	Large banks, policy banks, AMCs	Large banks, AMCs, State-owned FIs
Haircut on principals when restructured /disposed	50-70%	Limited overall, except for few case of zombie SOEs, 50-70%	Very limited	Limited overall; 10-20% for large creditors of Baoshang

Pecking order of borrowers' systemic importance

- *Large > small*
- *State > private*
- *Financial > Non-financial*
- *Market instruments > formal loans > shadow credit*

There is a discrepancy between the NPA ratios (Non-performing asset ratio) of the POEs and SOEs, especially if compared with the importance of their debt.
When the POEs debt as a share GDP is 60%, their NPA ratio appears normal, at 6-8%. On the other hand, the SOE's NPA ratio is just 1-2%, when their debt amounts to 90% of GDP.
Regarding the LGFVs, their NPA ratio is even lower, at 0%, as no LGFVs has been in default yet.
We can conclude from these figures that China Debt reduction is thus definitely not over.

We can understand why the Chinese banking system shows very few defaults. It is due to the decision to bail out the SOEs and LGFVs. This consists in a massive misallocation of capital, **as investors prefer to borrow to SOEs rather than POEs, even if these private firms are more productive or innovative than SOEs.**

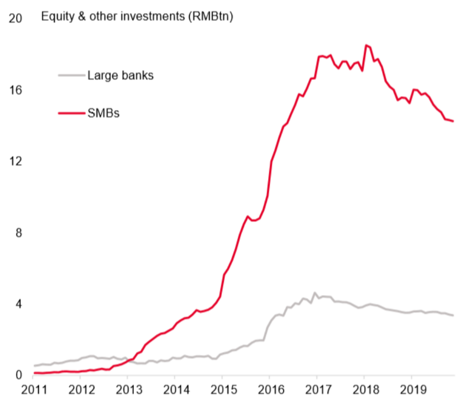
The government pledged to shut down the "zombie SOEs" starting 2017. So far, only 5% of the SOEs fell in this category. However, over 20% of the industrial SOEs are constantly making loss, and so a large part of these companies should normally be considered as zombies SOEs and thus be shut down.
Instead of shutting them down, the government decided to merge the big companies together. Three years ago, there were 120 central government level SOEs (the giant conglomerates), now there are 97 such companies. The consequence is that these companies get more monopoly power. Because they can control the production volume better, particularly in the coal and steel sector, prices for their products started to recover, which helped improve their profitability.

<u>About the "Default Equity Swap" issue</u>. Default Equity Swap is a very powerful tool. A company can swap it into equity, which decreases its debt and increases its equity, making the leverage drop quickly. The government has been promoting this tool for debt restructuring. And in most of the cases so far, the debt is swapped into equities at 100% face value, suggesting insufficient risk pricing. Not surprisingly, SOEs have used this tool much more than POEs.

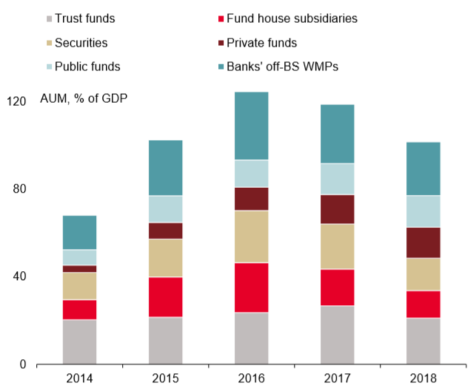
<u>About LGFVs debt</u>: This part of the debt is even more problematic. One third of these companies have very low cash flows because they are in the infrastructural sector. Infrastructural projects are known to have low cash flow at the beginning. There are no solutions yet. The government is now much more selective with new infrastructural projects. On top of that, the government makes some banks refinance the existing debt to lower the cost of funding.

<u>About financial deleveraging</u>. It is the most successful program yet. What was the problem with the financial sector? The shadow banking sector grew very fast in China between 2010 and 2016 with almost no regulations or asset management rules. The government realized it was a significant issue. Many banks were raising money by selling "asset management products" that did not make part of their balance sheet, as the risk of these products were supposed to be borne by investors but this was not often the case in reality. **The President himself decided 2 years ago that this had to stop and that banks had to go back to their previous activities: deposit and lending.**
Policymakers launched a massive regulatory upgrade to formalize the shadow banking system into a properly supervised asset management sector.
This led to a contraction of Chinese banks' shadow balance sheets, as shown on the chart below (on the left):

Significant contraction in banks' shadow book…



… and in the asset management businesses

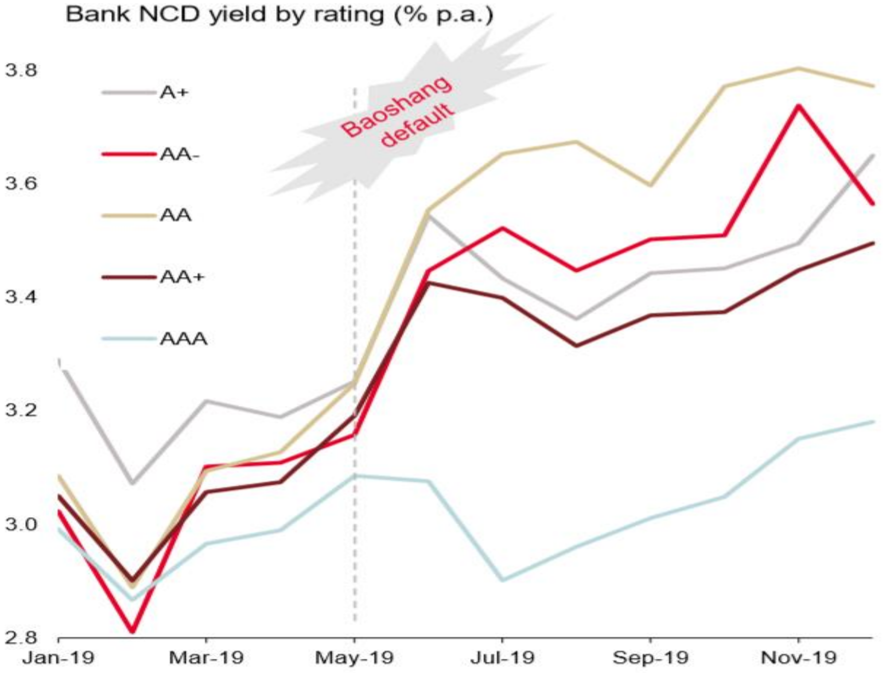


▷ Next steps: make sure that all the new rules are fully and consistently implemented
◉ Risk: small banks' ability to fully the tightened regulatory requirements in time

Whereas the big banks, being closely watched by the government, could not really engage massively into shadow banking activities, the smaller ones could and did it. At their peak, the SMBs (small and medium banks) shadow books represented almost 16 trillion RMB, 16% of GDP in 2017, but contracted afterwards by a good 5 trillion RMB.
When the banks are shrinking their balance sheet, it is definitely negative to the economy. Given that there was a credit contraction in China, no wonder the economy slowed during the years of financial deleveraging?

Another extraordinary thing they did is forcing the banks to recognize non-performing loans more thoroughly and more quickly. Before 2017 there was a category of loans called "special management loans" that were not recognized as "non-performing loans", when they actually were. Proper recognition of these problematic loans increased the explicit NPL ratio. Another reason for this increase is the fact that the government is pushing the banks to integrate the shadow loans to their formal balance sheets.

Small banks have lower capital adequacy than big banks to begin with, but some of them virtually bankrupted under the weight of financial deleveraging. **Last year, there were 3 cases of banking restructuring in China. The first one was an extraordinary experiment.** In May last year, a small bank called Baoshang was taken over by the regulator and the very first interbank default occurred. This changed the perception of everyone, as it was clear now that banks in China could go bankrupt. **The government had underestimated the liquidity shock and the experiment almost went too far for a while. To avert an outright liquidity crisis, the government asked some big banks and large brokers to pass their money down to the smaller banks**.
After the Baoshang default challenged liquidity stability, policymakers switched to pre-emptive announcements of restructuring for other small banks.



Through its management of this default, the Chinese government proved capable of averting systemic financial crisis, by quickly and easily issuing new rules and regulations, regarding interbank default.

After this stress test, the Chinese government did not let the two other banks go default. They just said that some investors would bail them out. With this pre-emptive announcement, the second and third potential liquidity crisis were avoided. **Given that the government is now careful to take pre-emptive measures, I don't see how a banking crisis could happen this year or next year. This could maybe happen after some time, after they introduce more market rules especially by opening up the capital account further for instance.**

The NPA ratio continues to rise in China because the process of debt restructuring is not over. After the corona virus shock, the major airline company went bankrupt, but the government accepted to deal with it. The corona virus may shorten the runway of debt restructuration, as the government will have to offer solutions faster.

I don't think a financial crisis will occur in the near term, but some stress cases surely will. As the government keeps trying to allow the markets play their role in managing the bad debts, accidents can happen.

Q&A

About LGFV debt (30% of GDP): is it part of the total 250% total number? Is it part of the 160% corporate number?

About the insurance company called Anbang. How did the government restructure it? How much did it cost?

Wei Yao: It is a very interesting case study. First, they sent the CEO in jail and figured out how big the hole on their balance sheet was. Then they injected enough capital and asked another state-owned insurance company to make sure the operation continues.
There are already some state-owned capital pockets that the government can tap without using their own fiscal money: social security funds, asset management companies, state-owned financial institutions, etc.

About the disasters in P2P lending: it costed much more than what the small banks had cost?

Wei Yao: The reason I did not even mention P2P is that these loans only totaled 3 trillion RMB at the peak (3% GDP or 1,5% of the banks' balance sheets). It is not an issue at the macro level, but it is more of a social issue because many people are involved in P2P lending.
Now the P2P sector is close to 1 trillion, as the number of P2P platforms has dropped by 80%.

About Huawei: it received 75 billion US$ from the Chinese government: is it supposed to continue? What is the prospect for this type of company?

Wei Yao: Huawei is a very profitable company and did not really need the financial support of the government to begin with.
However, last year Huawei was put on the US entity list, which decreased its overseas sales (for instance it's not possible anymore to install some applications like Facebook on Huawei phones).
As a result, Huawei started to raise funding for the financial market: eg. last year they issued some bonds at a very low interest rate as everybody knows Huawei is profitable and I don't think it is part of the debt problem.

About the IMF debt sustainability analysis.

Wei Yao: The figures from the IMF are much higher than that of the Chinese government, as they include the LGFV debt or government debt for instance. The analysis of the IMF is based on the assumption that the Chinese government will continue use the infrastructural projects to boost the economy. But it appears that the Chinese government has decided to do less of that.
This raise the following question: how will the government restructure the LGFV debt? They will probably do something similar to what has been done with SOEs: they will let the worst go and try to restructure the ones that can be bailed out.

What is the amount of previous and current shadow banking loans?

Wei Yao: It amounts to 50 to 60% of GDP.

How did the foreign Chinese debt is evolved through 15 years of globalization? What is the share of the financing from the rest of the world?

Wei Yao: China foreign debt is around 10% of GDP. China still has much more external assets than liabilities, but both figures are low compared to the size of the economy. The level of financial integration is still very low.

Some rating agencies lowered their macro growth forecast for 2020, whereas the IMF and the Chinese official institutions maintain the figure of 5.6%-5.7%. How do you position?

Wei Yao: I would admit that 5.6% might be a bit optimistic. Again, the situation is changing every day and the forecasts are likely to change by the end of next week.