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HD **China Gets Too Much Credit For Managing Its Debt - Marketwatch**

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SYDNEY (MarketWatch) -- All eyes are watching how China handles its debt burden. Pessimists fear a catastrophic crash of the Chinese economy. Optimists expect a soft landing, with gradual reforms correcting the systemic issues.

In truth, China's options are narrow and challenging, and a successful outcome to its debt problem is by no means guaranteed.

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The crash prediction hinges on continuing increases in China's debt, poor investments, and government action that comes too late. In this scenario, authorities tighten credit aggressively, triggering failures in the financial system and a sharp slowdown in economic growth.

Under this grim scenario, the rapid decline in credit availability staggers leveraged borrowers, such as those in local governments and property sectors. Larger banks, which are likely to benefit from a flight to quality, are unable or unwilling to expand credit to cover the shrinkage from smaller banks and the alternate, shadow banking sector, due to risk aversion or regulatory pressures.

As a result, economic activity slows drastically. Combined with cost pressures and weak external conditions, Chinese businesses, which are major suppliers of cash to the economy, experience a decline in cash flows, which compounds the liquidity problems.

Also, foreign capital inflows -- which have enabled the People's Bank of China, the country's central bank, to provide liquidity to the financial system -- slow and then reverse. At the same time, capital outflows, especially from corporations and the politically well-connected and wealthy, increase, driving further contraction in credit.

Optimists counter that the debt levels, while high, are manageable because of high growth rates, the domestic nature of the debt, high savings rates and China's essentially closed economy. They argue that the banking system has low leverage, a large domestic funding base, and low levels of non-performing loans. Also in China's favor: a high level of foreign-exchange reserves and modest, at least by developed country standards, central government debt.

The optimists believe that reform programs, albeit slow in implementation, will ensure a smooth transition. China will rebalance its economy from investment to consumption. Deregulation and structural changes will improve the resilience of the financial system.

Middle Kingdom's middle path

The strength of the banking system is probably overstated, primarily because of the understatement of bad loans and the relationship with shadow banks. Real levels of non-performing loan may be as high as 5%-10% of assets, about five to 10 times reported levels. Moreover, a significant portion of assets held in shadow banks ultimately may leach into the traditional banking system.

China's foreign exchange reserves (invested in high-quality securities denominated in U.S. dollars, euro and yen) may prove difficult to realize without triggering losses or currency issues. More fundamentally, the reserves are not true savings, being matched by renminbi and paid to domestic entities in exchange for foreign currencies.

In effect, the flexibility of Chinese authorities to deal with any problems may be more constrained. But the risk of a major collapse is, at this stage, low. Bank failures, depositor runs, massive outflows of foreign investors, or a sovereign default, is unlikely. The central government is seeking to steer a middle path, which is both difficult and has significant risks.

The strategy will entail continued credit expansion, providing liquidity, managing non-performing assets and using transfers from households to the financial and corporate sector.

In addition, the central bank will continue to provide abundant liquidity to the financial system through a variety of mechanisms. Lenders have been instructed to rollover loans to local governments, which cannot be repaid out of cash flow. Maturities are being extended to alleviate refinancing pressures on the roughly $1.5-$2 trillion of debts that mature over the next three years.

Chinese authorities evidently believe that "a rolling loan gathers no loss."

Defaults in the shadow banking will also be managed. Where considered appropriate, banks and state entities will intervene to minimize investor losses, by taking over the loans or reintegrating assets into regulated banks.

In a recent case, investors in the $500 million Credit Equals Gold No.1, managed by China Credit Trust, one of the country's biggest Trust Companies, faced losses. The Trust principal asset was a loan to an unlisted mining company Zhenfu Energy which could not meet repayments. Investments in the vehicle had been distributed by ICBC, China's largest bank, to around 700 wealthy individuals expecting a return of around 10% per annum.

With default threatening, ICBC made it clear that it had not guaranteed or assumed liability for returns or investment. After a period of uncertainty, an unnamed third party agreed to purchase an equity stake in the underlying venture, which then was granted a valuable mining license. With the borrower's ability to repay restored, investors in Credit Equals Gold No.1 suffered only modest losses.

This case is not isolated. Authorities have intervened to avoid a loss of confidence in these vehicles, which have become an important source of credit within China. One analyst told a reporter: "Moral hazard in China is state policy."

Price to pay

As in previous Chinese episodes of bad lending, non-performing loans will be sold to asset management companies, established to deal with previous banking crises, to avoid a banking crisis.

In effect, instead of resolving the debt problems, the Chinese government will oversee a process of supporting over-indebted borrowers and the banking system. As in a shell game, bad debts will be shuffled from entity to entity, delaying the recognition of losses.

The actions will reduce the immediate financial pressure, but merely defer the debt problem. The primary objective of the strategy is to maintain high growth for as long as possible and also preserve social order. It reflects the fact that a financial and economic crisis in China is synonymous with a loss of confidence in the state itself and the Chinese Communist Party.

The ultimate price of this strategy will be to lock the Chinese economy into a lower growth path with the risk of a destabilizing crash.

Over time, increasing amounts of investment capital and resources will not generate sufficient returns to service the debt incurred to finance it. If returns on investment are insufficient, then there must be a transfer from one part of the economy to another to cover the shortfall. This cost will be borne by households, with slower improvement in living standards and erosion of the value of their savings.

Authorities will have to keep saving rates high to provide the capital needed to pursue this strategy. But high saving rates will impede the rebalancing from investment to consumption. It will also impede the development and deepening of the financial system. China will also have fewer resources available to improve health, education, aged care and the environment.

In the short run, continued malinvestment and deferring bad debt write-offs will provide the illusion of robust economic activity. Over time, Chinese households will discover that the purchasing power of their savings has fallen. Wealth levels will be reduced by the decline in the prices of overvalued assets. Businesses and borrowers will find that their earnings and the value of their overpriced collateral are below the levels required to meet outstanding liabilities.

The alternative is equally problematic. If the government moved to liquidate uneconomic businesses and unrecoverable debt, then it would need to finance the recapitalization of businesses and banks. This cost would require a sharp increase in taxation, which would also result in a slowdown in economic activity, eventually slipping into a Japan-like stagnation.

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