China Is Ripe for a Sharp Downturn

By Francisco Torralba

When the country deleverages, GDP growth will be substantially lower than the consensus forecast.

In the years since the 2008 financial crisis, China has posted impressive growth in GDP despite a lackluster global recovery. The country managed to do this by creating an investment boom, which in turn was powered by a surge in credit. Total debt, private and public, rose from 125% of GDP in 2008 to 215% in 2012. Corporations alone have racked up debt worth 111% of GDP. A lot of that capital has been misallocated. China has built more ports, railways, smelting plants, and residential complexes than it should have, given its productivity level. Because those projects will not deliver significant returns for a long time, if ever, bad debt is piling up. The balance sheets of Chinese banks, in particular, are laden with dubious assets.

Financial Fudging

The official reported rate of non-performing loans is less than 1%, which belies the actual quality of bank assets. Financial institutions use all kinds of maneuvers to inflate profits and dress up their balance sheets. In 2012, there was evidence of misclassification of dud debts as "special-mention loans," which do not need provisioning but are expected to face difficulties. Loan officials enjoy substantial discretion in such classifications. More recently, banks have introduced shady financial innovations. One instrument now on the rise is "trust beneficiary right investments," according to a recent report by HSBC Research. These quasi-loans circumvent the loan-deposit ratio requirement and the provisioning requirement that applies to regular loans. In one year, the balance of these trust rights has almost doubled for the largest Chinese banks, according to HSBC Research. The upshot is that balance sheets, especially those of midsized banks, are increasingly opaque.

Another type of fudging consists of rolling over loans that are in danger of falling behind schedule. This rescheduling of bad debt can be done directly in the books, by extending maturities. It also happens indirectly, by repackaging it as wealth-management products offered to individual investors. These products are sold by banks at much higher yields than bank deposits and have attracted a lot of buyers among small savers. They also have short maturities, which mean they are less reliable as a source of funding than traditional deposits. The groundwork for a bank run has been laid out.

Unhappy Endings

The financial system may be reaching a breaking point. Twice in 2013 the interbank interest rate spiked above 10% when the central bank initially provided fewer funds than the wholesale loan market expected. Each time the liquidity crisis could have set off a domino of defaults, resulting in a systemic solvency crisis. Both times the central bank saved the day, pouring more money into the system and allowing the economy to keep investing, borrowing, refinancing, and accumulating bad debt. China is unable to stop this merry go-round.

Two immediate consequences of China's credit boom are the rise of real estate valuations and the concentration of household wealth in housing. The real (inflation-adjusted) price of land was increasing at an annual rate of almost 12% as of the second quarter of 2013, according to the Wharton/NUS/Tsinghua Chinese Residential Land Price Index. Between 2007 and 2013, real prices doubled (see exhibit). This rate of appreciation attracts more and more households, especially as the stock market has been flat since 2010 and bank deposits yield a pittance. About 66% of family assets were in housing in 2013, according to a national survey. Mortgage debt as a ratio to disposable income rose to 30% from 18% in 2008. The market is closer and closer to a price correction, and when it happens it will wipe out the net worth of many small savers.

Stories of financial excess seldom have happy endings. It is hard to characterize the end of such episodes, because so much depends on how debt was accumulated in the first place and how the leverage is unwound. A financial crisis, in particular, may or may not occur, depending on monetary and fiscal responses by policymakers. But at a very minimum history suggests that China's economic growth should decline sharply as the economy starts deleveraging, whether a hard landing happens or not.

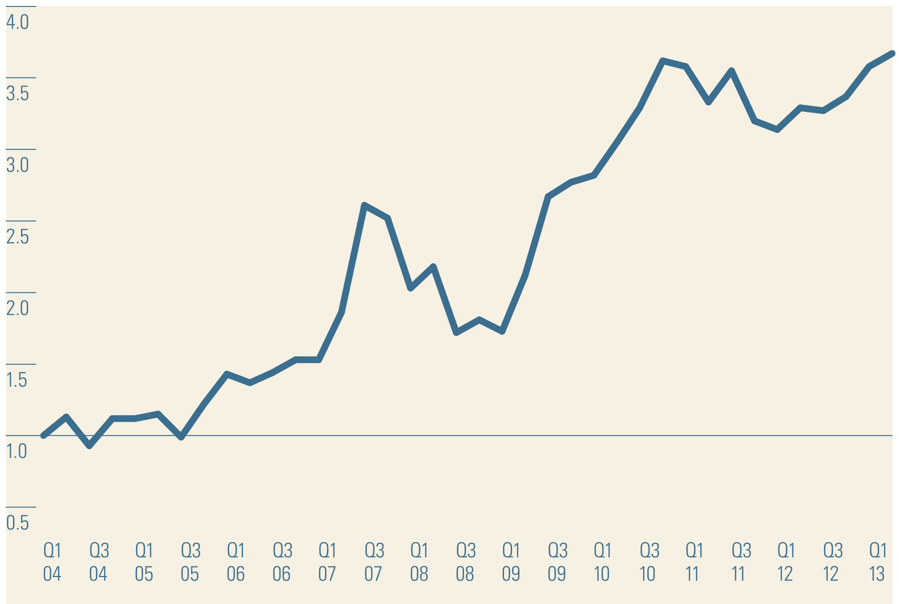
China's Strengths Overestimated

China optimists not only downplay the possibility of a crisis, but make five-year projections of growth between 6% and 7%, just a notch below the current 7.5% pace, and much higher than what a deleveraging China would allow—most likely below 4%. Some of these high-growth projections depend on two arguments. At best, I find that they overestimate China's strengths. At worst, they are completely irrelevant.

The first argument is that the level of China's total government debt, which includes central, provincial, and local jurisdictions, is modest. Direct obligations stand at just under 40% of GDP, using recent data from China's National Audit Office. That is a modest amount by the standards of most large countries in the world. But if one adds explicit and implicit guarantees the figure rises to a less flattering 60%. Even at that level, optimists might say, China's government has less debt than most advanced economies. Beijing, the argument goes, has plenty of room to bail out its financial sector and cope with a recession if a financial crisis strikes.

Chinese Residential Land Price Index

First Quarter 2004 = 1.00



Source: Wharton/NUS/Tsinghua Chinese Residential Land Price Index.

The problem is that healthy public finances did not help the United States, Spain, or Ireland to dodge the 2008 crisis. In 2007, U.S. general government debt was a modest 64% of GDP, according to the International Monetary Fund. Spain's and Ireland's were 36% and 25%, respectively. Japan in 1991, arguably a better parallel to present-day China, had government debt of just 66% of domestic output and still suffered a 20-year malaise as a consequence of the excesses of the 1980s. The level of government debt does not predict the occurrence of a banking crisis or a real estate crash.

The second argument is that China can rely on a strong external position. China's debt is presumed to be mostly domestic. It is denominated in renminbi and held by Chinese investors. That is less true than what the official numbers show. Over the past couple of years a significant share of China's "shadow financial system" has been taking advantage of low interest rates on the dollar to borrow abroad and speculate in the property market at home. To circumvent capital controls, that external borrowing is disguised as export revenue or foreign direct investment, so it does not show up in the official statistics as what it really is: short-term external debt. Estimates of this debt are hard to come by, but ballpark guesses are terrifying. According to Bank of America, in the first four months of 2013 China's actual trade surplus, after removing fake exports, was one tenth of the official number.

Not only is China's current account surplus smaller than it appears, but the country is more vulnerable to flows of "hot money" than generally recognized. When quantitative easing in advanced economies goes in reverse, capital will leave China, pulling the rug under property prices.

What China's ultimate fate will be is uncertain. Bad debt, rampant speculation and the unregulated shadow financial system could precipitate a sudden collapse. Alternatively, Chinese authorities might be able to rein in credit growth and engineer a gradual reduction of investment growth. I certainly hope for the second outcome. But one thing I have little doubt about is, as China deleverages one way or another, GDP growth over the next five years will be substantially lower than the consensus forecast. M

Francisco Torralba, Ph.D., CFA, is the economist at Morningstar Investment Management.