Asia: Cutting Through the Noise Series

Issue II - China's Debt Profile **August 2017**

Key Takeaways:

- China is moving toward correcting its economic imbalances by reducing investments and nurturing consumption.

- A necessary cost of China's transition into a consumer-driven economy is the use of debt to maintain social stability and steady economic growth.

- Investors fearing a crisis underappreciate China's low dependence on foreign debt, a trait that characterized Japan's debt profile 30 years ago.

- While the scale of China's debt is not yet a concern, the pace of increase is unsustainable and can become problematic if left unchecked, as illustrated by Korea's currency crisis and Japan's asset price bubble.

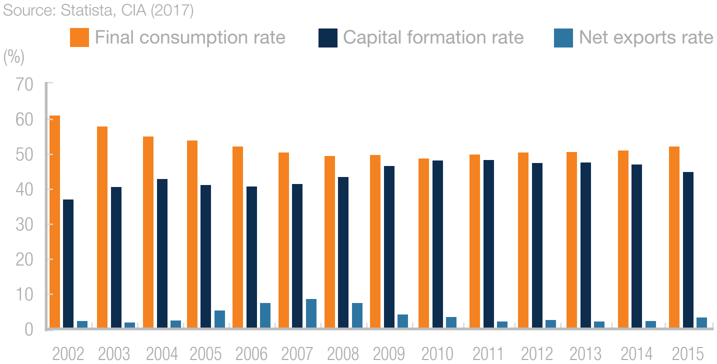
China's Grand Makeover

As China attempts to transform itself into a consumer-driven economy, worries over its growing debt pile are mounting. But a deep dive suggests that such concerns may be overblown.

After joining the World Trade Organization (WTO) in 2002, China launched an unprecedented push for urbanization and industrialization that helped it become an economic powerhouse and the dominant driver of emerging market (EM) growth. However, since the global financial crisis, China has faced headwinds from muted global growth and structural imbalances developed during its rapid ascent. Against this backdrop, China has made clear its intentions to reduce its dependence on fixed investments and manufacturing, in pursuit of a more consumption-driven economy.

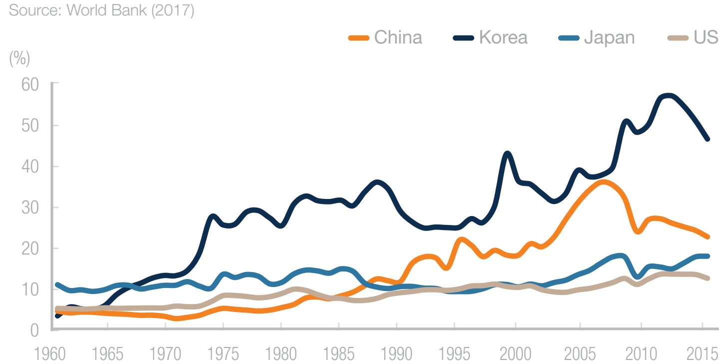
Chinese Economic Growth Composition

Source: Statista, CIA (2017)



Asia Reducing its Exports for Growth

Source: World Bank (2017)



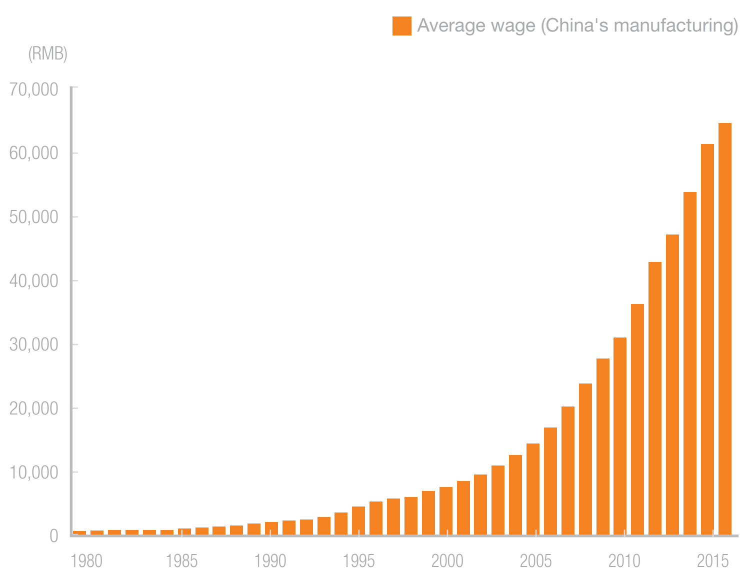
The process of smoothing out China's imbalances by fostering a major economic transition could potentially take decades to play out. And as policymakers are determined to achieve their goal without setting off a recession, China is running up an imposing mountain of debt, triggering global concerns over the possibility of another classic EM debt crisis. However, we believe that China's debt structure is significantly different from the profiles of peers (e.g., Korea in 1997-98) that suffered massive crises in the past. These differences, coupled with the fact that President Xi Jinping's administration has more arrows in its quiver than many of its counterparts, suggest that China should maintain some measure of stability for many years—likely buying enough time to avoid a black swan event altogether.

In Pursuit of Wage Growth

One tool China is using to transition into a consumer-driven economy is the promotion of wage increases to establish a consumer class capable of providing sustainable growth without the debt-fueled stimulus.

China Wage Growth

Source: CEIC (2017)

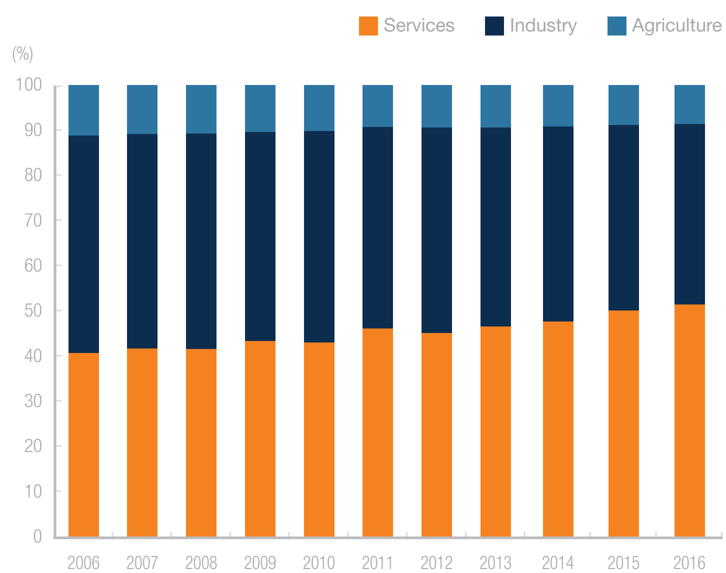


Currently, China's gross domestic product (GDP) per capita remains well below US$10,000, the widely accepted threshold for the full-fledged consumption of big-ticket items (e.g., durable goods).[1] As such, opinions on the timeline for the emergence of China's consumer class are mixed. However, GDP per capita may not be the most useful indicator for China, given the sheer size of its population and the sharp differences between the trends and consumption patterns of its three major income classes.

We are already seeing some signs of the transition, as services surpassed manufacturing as a total share of China's economy several years ago.[2] Nevertheless, by any measure, China still has some distance to cover before it completely transforms itself into a consumption-oriented economy. At present, policymakers are leaning on debt to facilitate the economic growth necessary for the transition. Indeed, Beijing has channeled significant lending through national banks into state-owned enterprises (SOEs), hiking leverage on the balance sheets of public companies. Thus, some investors and pundits are concerned that a Chinese debt bubble will be the next crisis to hit financial markets. However, it is important to understand that many major debtors and creditors fall underneath the remit of the Chinese government to form a closed domestic system, affording greater flexibility in managing debt profiles and repayment schedules. Moreover, comparisons with the Japanese and Korean cases of the 1990s suggest that a full-blown crisis is unlikely.

GDP Breakdown for China (2006-2016)

Source: National Bureau of Statistics (2017)



> *"China should maintain some measure of stability for many years—likely buying enough time to avoid a black swan event altogether."*

[1] Mirae Asset Daewoo (2017)
[2] National Bureau of Statistics (2017)

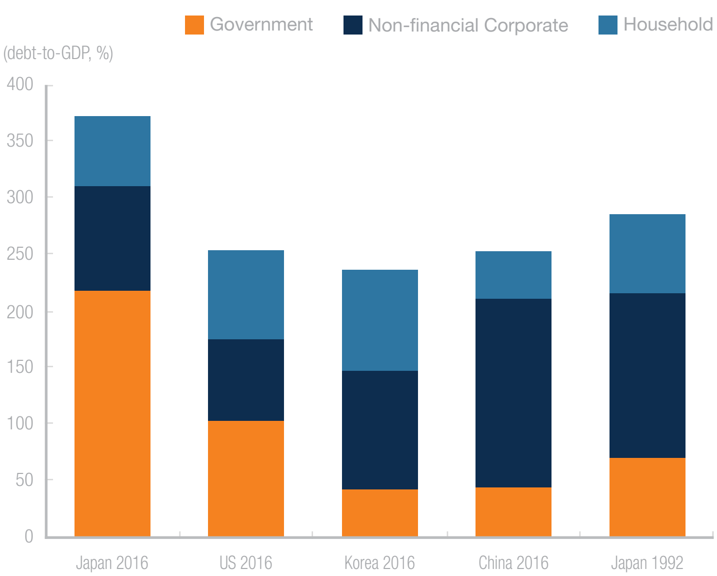
Lessons from Japan and Korea

We believe fears of a Chinese banking crisis are overblown, as the evidence suggests that China today is more similar to Japan in 1992 than Korea in 1997-98.

Back in 1997, Korea was forced to accept a strings-attached bailout from the International Monetary Fund (IMF) after ballooning corporate borrowings and the sudden exodus of foreign creditors gave rise to a crisis. This sequence was in line with a familiar formula for EM crises: a currency collapse caused by a structurally weak banking system, rising corporate borrowings, and high reliance on foreign debt. However, we note that China today differs significantly from the Korean case in that its exposure to foreign debt has not yet risen to alarming levels.

Differing Debt Problems for Japan, China and Korea

Source: BIS, Mirae Asset Daewoo Alpha Strategy Team (2017)



We believe that China's current situation is more reminiscent of the conditions that Japan faced ahead of and during the collapse of its asset price bubble. Significantly, Japan succeeded in countering the meltdown of its domestic property market through the use of monetary stimulus, and managed to successfully avoid a devastating financial crisis during the ensuing decades (although the tradeoff was structurally slower growth). Given the similarities between present-day China and the Japanese case—most notably ample domestic savings, considerable trade surpluses, and elevated headline growth—we believe that China is well-positioned to ward off a crisis. Adding to our relative optimism is the fact that China has bullets at its disposal, including a managed currency, that Japan did not enjoy.

Picture of Present-Day China

The decrease in China's forex reserves since 2015 is a natural consequence of the country's high savings rate and large trade surplus. Significantly, pressure on the RMB is driven not by foreign creditors but by mainland savers and investors. The annual limit for overseas money transfers by Chinese individuals stands at US$50,000.[3] If all 60 million mainland Chinese earning more than US$35,000 (estimated) were to max out their quotas, this would lead to US$3 trillion in capital outflows—almost equivalent to China's forex reserves.[4] We believe that outflows from wealthy households reflect local discontent over a not often cited structural imbalance—the mismatch between the liberalization of financial markets and political system reform.

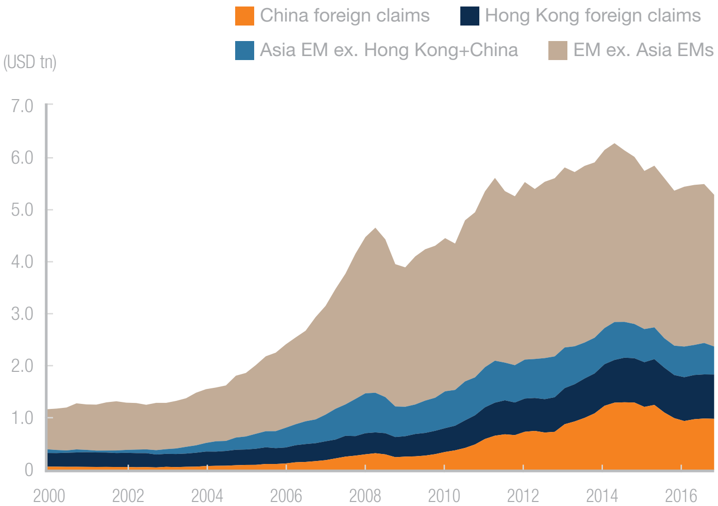
Importantly, the People's Bank of China (PBOC) has the means to manage currency and forex reserves via numerous policy levers that were not available to Korea during its currency crisis. While currency devaluation could pose a long-term issue for Chinese equities, systemic risk could be contained via policy countermeasures. And although any significant weakening of the RMB would be unsettling, it would be far from a flash point. Simply put, the volatility that we are witnessing is the result of an inefficient financial system that is increasingly being judged according to global standards. In effect, China currently finds itself in a bind, as it must manage multiple policy goals while trying to keep its slowing economy on a stable growth path. The recent market liberalization developments, particularly the MSCI A-share inclusion and the launch of the Bond Connect scheme, are positive steps toward strengthening the country's capital markets and potentially easing pressure on forex reserves.

> *In the coming years, China's key challenge will be to make similarly difficult decisions that may be negative in the short term but necessary for long-term growth.*

[3] Various Media Reports (January 2017)
[4] Mirae Asset Daewoo (2017)

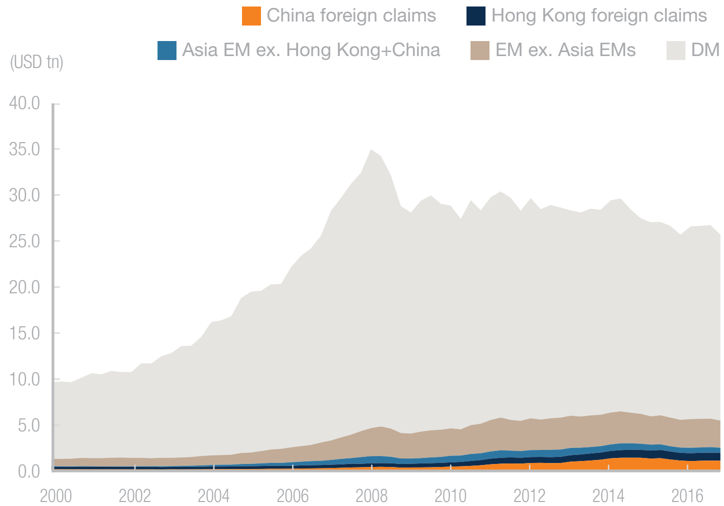
Asian Debt is Conservative Relative to the Rest of EM

Source: BIS (2017)



On a Global Basis, China's Debt is Not Yet Overwhelming

Source: BIS (2017)



Although China today is not dependent on foreign debt, its exposure has been growing over the past few years. But while the pace of the rise is noteworthy, the scale is not yet large enough to signal a financial crisis. As keen students of history, China's policymakers are almost certainly taking into account the cases of Japan and Korea as they endeavor to ensure that a debt crisis does not take shape. However, over the long term, simply preventing a financial crisis may not be sufficient, as the risk of following in Japan's footsteps and slipping into a decades-long growth slowdown should be a concern for any economy sensitive to potential social unrest.

Long-Term Foundations

Structural reform is not only a policy option but also a key barometer for investors seeking sustainable growth in corporate profits. In fact, market-driven, SOE-led industry rationalization and/or the establishment of a solid foundation for foreign investors (via enhancements to governance and transparency) could hold the key for China going forward. In light of this, it is worth exploring a nagging Achilles' heel shared by China, Japan, and Korea: inefficient capital allocation from their politically-controlled banking sectors. Indeed, both Japan and Korea have failed to fully liberalize their respective banking sectors, stunting market-driven capital allocation and thus long-term growth potential. Yet some recent developments suggest that positive changes are underway. For example, over the past year, the Korean banking sector has started to dial back its once-unequivocal support for traditional export industries such as shipbuilding, shipping, and steel, which have been suffering from sluggish orders amid slowing global growth and oversupply. Acknowledging the structural nature of the current difficulties, Korean banks have moved to withdraw financial support from troubled companies, rather than simply reshuffling ownership. While the resulting bankruptcies represent a short-term challenge, we view them as an encouraging sign of easing resistance to market forces. Notably, Korean banking shares have rallied to outperform their Asian peers.

In the coming years, China's key challenge will be to make similarly difficult decisions that may be negative in the short term but necessary for long-term growth. Specifically, to ensure efficient allocation of capital, China's policymakers must first pursue further financial system liberalization (e.g., lending rates, currencies, and capital flows). Given the market's recent embrace of Korean banking shares—a prime example of the global investment community rewarding policy courage—perhaps China will become more open to such reform.

Contributors

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[3] Various Media Reports (January 2017)
[4] Mirae Asset Daewoo (2017)

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