Growing Risks in China

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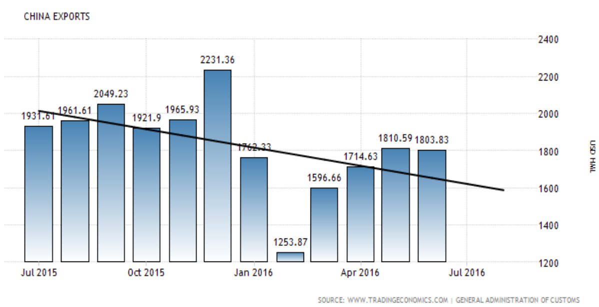
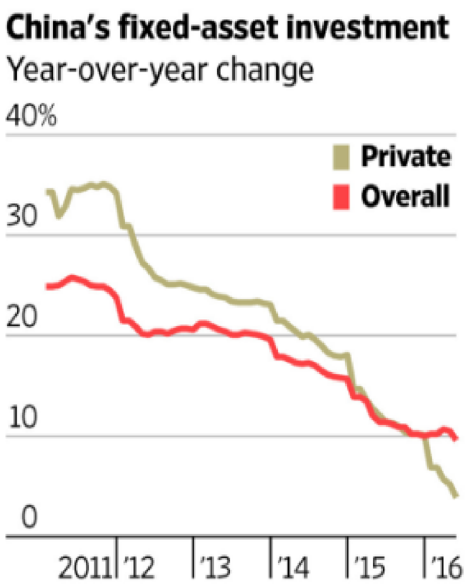
Overview of Chinese Economy

Figures released showed a economic slowdown in China, despite a significant stimulus has been taken by the Chinese autorities. Overall situation of the economy is in line with expecatations. However, data related to exports and invetment indicate the Chinese economy continues to decelerate. Plunge in private sector investment and growing debt are causes for concern, which could tirgger a financial crisis and low economic growth in coming years.



The Chinese economy grew at an anuual 6.7% in the second quarter of 2016, at the same pace as in the previous qarter. Industrial production expanded 6.2% year-on-year, while retail sales grew at a 10.6% rate. Data on Chinese trade show continued weakness in exports but a slower pace of decline for imports. Exports fell 4.8% year-on-year in June 2016, while imports was down 8.4% in the same period of time. Weak exports reflect slugglish global demand, especially in both Europe and the United States after the British's decsion to leave the European Union. Although the Chinese yuan has been devalued, it has fallen far less than that of other emerging countires. The Chinese currency is expected to gradually depreciate in 2016 and coming years, which may drag down its exports.

Slowing Private Investment

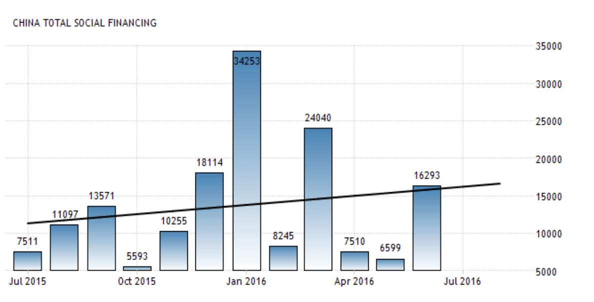


Sources: CEIC Data; National Bureau of Statistics
THE WALL STREET JOURNAL.

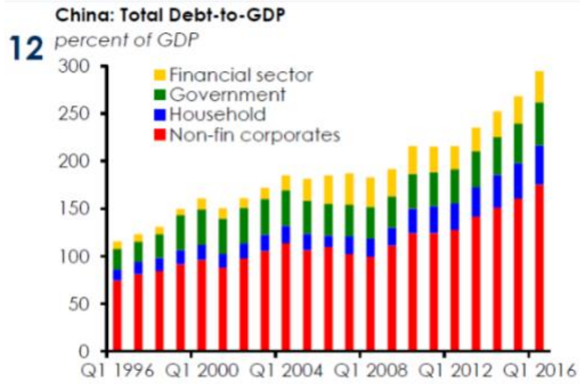
Since China transitions from an investment-driven to a consumer-driven economy, the private sector is a curial driving force for China's growth, generating around 60% of China's GDP and 80% of jobs. Facing a slump in export manufacturing and deteriorating business confidence, China's private investment growth has been slowing for the first half of 2016, increase only by 2.8%. This far lower than the growth seen over the last decade, which was over 20% each year. China's fixed-asset investment dropped further to 8.1% in January-July from 9% in the January-June period, marking the lowest in more than 16 years. . Investment by state firms grew 21.8%, while private investment cooled to 2.1%. Private firms hold up investment in manufacturing and real estate which only offer marginal profits and avoid projects with high risks. While, investment by stated-owned enterprises (SOEs) reported a double-digit growth.

Official surveys showed private firms having difficulties to raise funds and suffer from heavy financial burdens, compared to State-owned Council. Some local government failed to fully implement the pro-private investment measure. Therefore, the Chinese government is expected to intensify efforts to promote more standardized, rapid development of public-private partnerships, especially for public services and accelerate the legislation of PPP. Since a surge in investment in tourism and high-tech manufacturing, the government is also expected to encourage private investment with more preferential policies to improve public investment management and remove barriers over the entrance of electricity, telecommunications and other emerging sectors. The Chinese government may also loosen its policies to open to foreign capital.

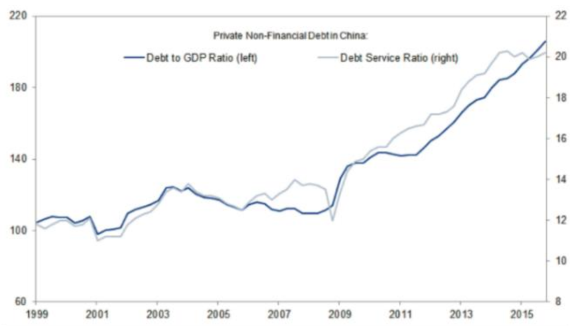
Worries grow over Chinese Corporate Debt Pile



However, the most worrying risk in China is whether the Chinese government is capable to control corporate debt. With the rapid increase in credit growth in 2015 and early 2016, the problem of corporate indebtedness is growing as the investment continues to grow.



Source: PBOC, BIS, IMF, IIF.



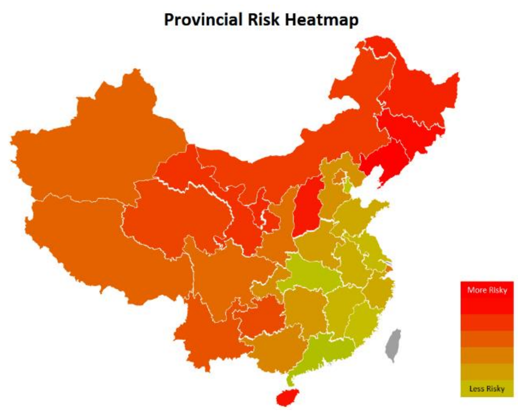
Source: BIS

Figures revealed Chinese corporate debt has risen sharply as a proportion of GDP since the mid-2000s, from around 100% to 145% now. China's corporate debt is high by international standards. For reference, this ratio is 67% in the United States and 103% in Japan.

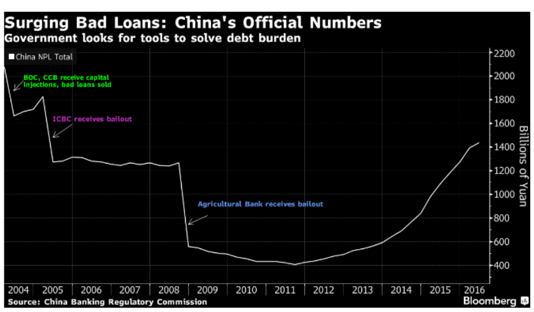
According to the International Monetary Fund's recently published annual report on the Chinese economy, credit is growing about twice as fast as output. The IMF expressed its concerns over this issue. "Corporate debt remains a serious — and growing — problem [in China] that must be addressed immediately and with a commitment to serious reforms," The deputy managing director of the IMF, David Lipton warned. He also indicated efforts to address China's corporate debt load — which at 145 per cent of GDP was "very high by any measure" — had seen only "limited progress". The rapid build-up of debt has added concerns regarding China's macroeconomic and financial stability.

China is overweight in old industries, such as real estate, materials and metals and infrastructure. A report released in July by the National Academy of Development and Strategy at Renmin University in Beijing found 51.43% of listed steel firms surveyed could be classified as zombie firms. SOEs which account for around 22% of economic, account for 55% of corporate debt in China. Many SOEs have accumulated a massive amount of assets in old industries, showing a weaker repayment capacity. The rise is attributed to the credit-fueled macroeconomic stimulus following the 2008- 09 global financial crisis, which policies were widely thought to favour state-owned enterprises at the cost of the private sector. The rise in corporate debt after 2008 is contributed by a deterioration in operating performance, fueled by the real estate and construction industries. Current monetary and fiscal stimulus may ease the problems in the old industries but old industry revenues will not regain their original levels as China rebalances. These corporates are also far less profitable than private enterprises. Some SOEs borrowed heavily from government-backed banks which could trigger systemic risks in the economy and banking crisis.

China's official Securities Daily newspaper reported China's state firms account for 66.5% of total debt defaults so far this year. It is an essential issue for the Chinese government to address the underlying problems of poor performance of the debtor companies, especially SOEs. The measures taken by the government are not sufficient to improve the situation. China has grown more reliant on inefficient state firms to generate economic growth amid slowing private investment, raising doubts about whether the government will press ahead with reforms. Several provincial governments are withholding information on zombie borrowers from banks as they fear the banks would cut off financing immediately.



Jiangxi province is struggling to a serve situation as its non-performing loan ratio among banks reached 2.5 % last year which was higher than the national average and lenders are not willing to extend credit.



Banks' financial health is intimately tied to that of SOEs as many banks are holding more and more nonperforming loans. Deputy Governor of People's Bank of China says "We will permit financial institutions to go bankrupt in an orderly way, restructure those that need restructuring, shut those that need to be shut, and strengthen market discipline." This shows a willingness to let failing companies.

The current Fiver-Year Plan aims to reduce excess capacity in the coal and steel sectors, identify and restructure "zombie" SOEs and fund to support affected workers. We hope to see China to allow banks to let companies default which would possibly close some unprofitable and highly inefficient companies in the coming years. China may move bad loans off bank balance sheets and recapitalize the banks, as well as downsize companies. Meanwhile, the government should implement debt-to-equity swaps. This could boost long-term productivity and allow the economy to restructure away from loss –making businesses. However, if the Chinese government do little to tackle the problems, this could add to the liquidity concerns, excess capacity, no economic growth and deflation.

It is likely for the debt-to GDP ratio to rise in the coming years if recent trends in broad credit creation are sustained.

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