

China Debt After COVID-19: Flattening The Other Curve

June 4, 2020

Key Takeaways

- Total credit in China will rise about 14% in 2020, year on year, as the country uses debt to stimulate the economy.
- Beijing has given China's local governments US\$530 billion in quota to issue special purpose bonds to fund infrastructure.
- We expect that the authorities will try to bring credit growth back in line with economic growth next year, circumstances permitting.

The arc of China's debt curve bends toward policy. The COVID-19 outbreak should slow the country's economic growth to just 1.2% this year, prompting a rapid expansion in credit. This will escalate China's debt-to-GDP ratio, which we estimate will rise 24 percentage points to 273% in 2020. So far, so normal. GDP slowdowns typically lead to credit expansions in China. But S&P Global Ratings believes this crisis may be different in how aggressively China may restore debt discipline.

In recent years China has started to become less reliant on using credit to extract itself from a crisis. One way of reading China's decision to not commit to a GDP target at the National People's Congress (NPC) in late May was that it was reluctant to over-use debt to hit growth targets. Chinese government officials have told us that Beijing viewed its decision to turn on the credit tap during the 2008-2009 global financial crisis as a mistake it does not want to repeat.

Bank lending to companies and households increased by Chinese renminbi (RMB) 23.6 trillion (about US\$3.4 trillion) between 2008 and 2010, growing by more than 82% in those three years. That resulted in a lot of investment in infrastructure, not all of which has been well used.

China has not given up on using credit to support growth during difficult times, however. As the economy slowed in 2012 and 2014-2015, policy easing resulted in a material increase in the net flow of credit to the economy.

Indeed, the pick-up in credit in recent months is comparable to these recent episodes. Moreover, efforts to tighten policies and stem the flow of credit once economic activity stabilized has not always been smooth (see chart 1).

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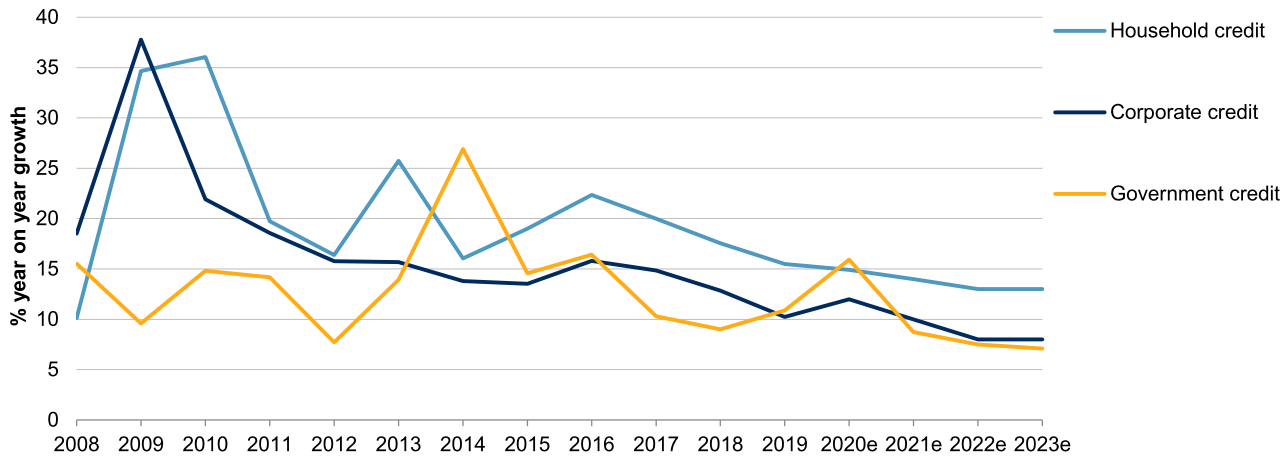
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Chart 1

China's Credit Growth Has Been Volatile Over The Years



e--Estimate. Source: S&P Global Ratings.
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The scale and longevity of China's credit expansion during the outbreak will give us insights into its willingness to use debt to stimulate the economy. If China is more cautious than it has been in the past on using debt when it is facing its lowest GDP growth since Mao--with a trade war ongoing and the global economy teetering into recession--we might believe Beijing is succeeding in reducing its long dependence on debt. This might signal more tolerance for a more moderate pace of growth and greater reliance on productivity as the underlying driver of the economy.

So while China increased credit by about one-quarter in 2009, year on year, in response to the global financial crisis, we assume the credit growth this year will be about 14%.

China wants to project policy stability, in our view. Beijing has ramped up central government issuances and quotas for local governments' special bond issuance this year. But we believe officials will quickly revert to policies designed to curb such issuance in 2021.

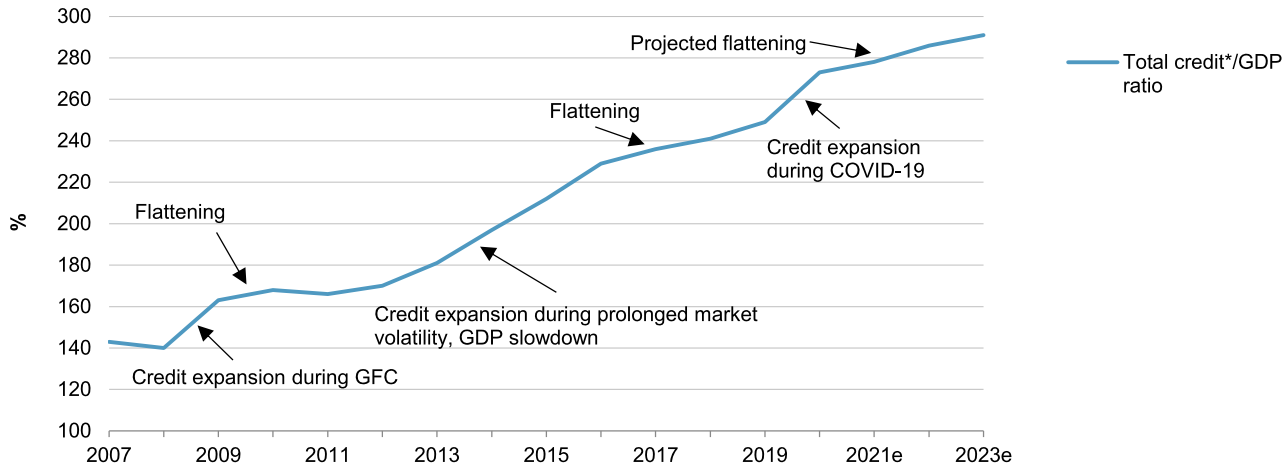
A smooth transition to self-sustaining growth is far from guaranteed. As policies are tightened, as in past cycles, pockets of stress may emerge where reliance on debt has been high. Growth may also slow more than policymakers wish, triggering another round of stop-go policies.

Much will depend on how quickly policymakers can foster a return to full employment. Jobs data in China may not provide a full picture of the labor market but what we do know is that the service sector is the engine of job creation. The service sector is lagging the recovery as social distancing, both enforced and voluntary, weighs on activity. If the service sector rebounds quickly, the prospects of a swift withdrawal of stimulus are much more likely.

We note that China's policy targets tend to land when Beijing puts its full weight behind them. This was apparent in 2010, when Beijing flattened credit expansion after its radical 2009 injection, and in 2018, when China began its most recent debt-reduction program. This does involve trade-offs and the government may need to tolerate slower growth to achieve its aims or speed up structural reforms to lift productivity (see chart 2).

Chart 2

China Has Recently Shown A Willingness To Curtail Credit Expansions



Note: Government debt figures from 2014 onwards include off-budget debt; this makes it difficult to compare debt growth rate trends of prior year GFC--Global financial crisis. *Includes all corporate, household, and government credit periods. Source: S&P Global Ratings. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

Ensuring A Health Crisis Does Not Turn Into A Financial Crisis

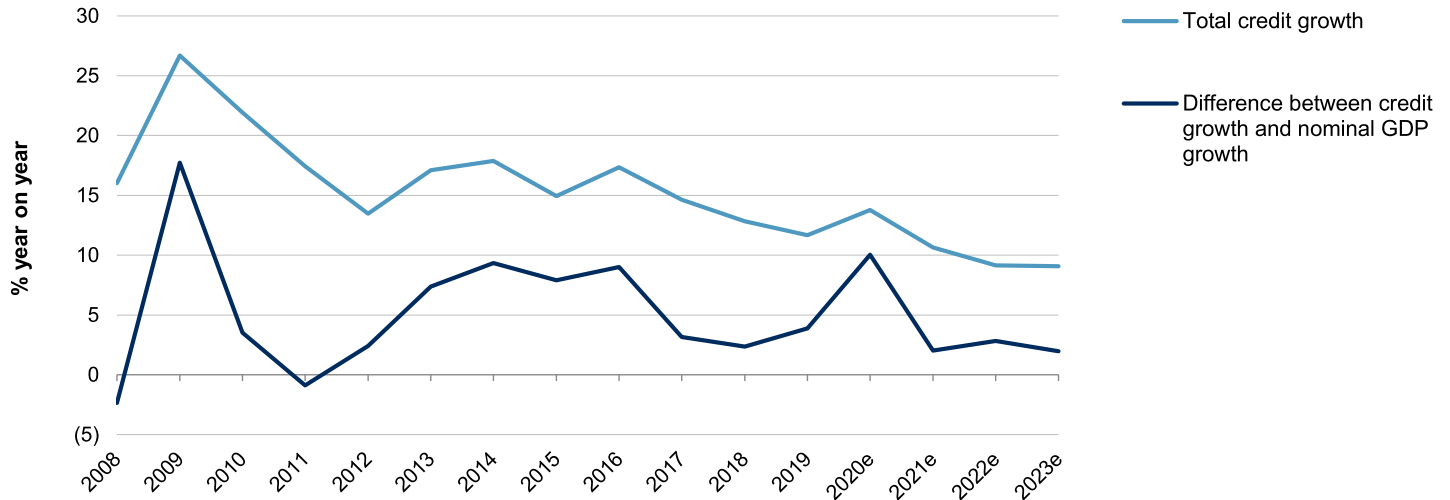
The Chinese government is sensitive to the possibility the country may succumb to a financial crisis, given the country's high total debt. It's a vulnerability that concerns Beijing, and one it wants to pre-empt.

The recent NPC highlighted the government's priorities of ensuring financial stability, and creating jobs. Authorities aim to create 9 million new jobs in mainland China in 2020, translating into an unemployment rate of 6%. Beijing's financial stability goals will likely be about controlling debt levels (see "China's New Stop-Go Cycle," published on RatingsDirect on May 25, 2020).

For all these reasons, China has been strategic in its use of credit as stimulus during the pandemic. It has been cautious about growth in corporate credit, for example, which can lead to defaults and may create financial instability. It has been more relaxed about bond issuance by local governments, on the view it has control of this debt, and that it is less crisis prone.

Chart 3

China's Credit Growth In 2020 Is Moderate Compared With Expansions In 2009 And 2013



Note: Government debt figures from 2014 onwards include off-budget debt; this makes it difficult to compare debt growth rate trends of prior year periods..e-Estimate. Source: S&P Global Ratings. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

China has another hidden weapon in the form of its RMB9 trillion of state-owned assets. Whenever a state-owned enterprise (SOE) lists on an exchange, it contributes 10% of its proceeds to China's National Social Security Fund, which supplements pensions. The government can sell these assets when it needs cash to make up for budget shortfalls, or it can instruct profitable entities to buy indebted SOEs, absorbing their debt and liabilities in the process.

We must heavily caveat our view. Our assumption that the growth in China's debt to GDP ratio will stabilize in 2021 is a somewhat best-case scenario. We assume a number of things to get there, including an expectation that real Chinese GDP will rebound, to 7.4% in 2021. Tighter credit, in the past, has also revealed underlying weaknesses in the economy and financial system that may need to be addressed. Over the long run, China must address its declining productivity growth if it is to prevent its structural deceleration from gathering steam.

We don't know perfectly how key variables will play out, such as the course of the U.S.-China trade war, or when the pandemic will stabilize globally. If China does not generate the kind of growth it needs to hit the employment targets it wants, it may have to extend 2020's credit expansion.

Financing Conditions Are Accommodative

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China implemented numerous measures to address a funding squeeze early in the year, including increasing bank liquidity through a RMB3.3 trillion (International Monetary Fund data) repo

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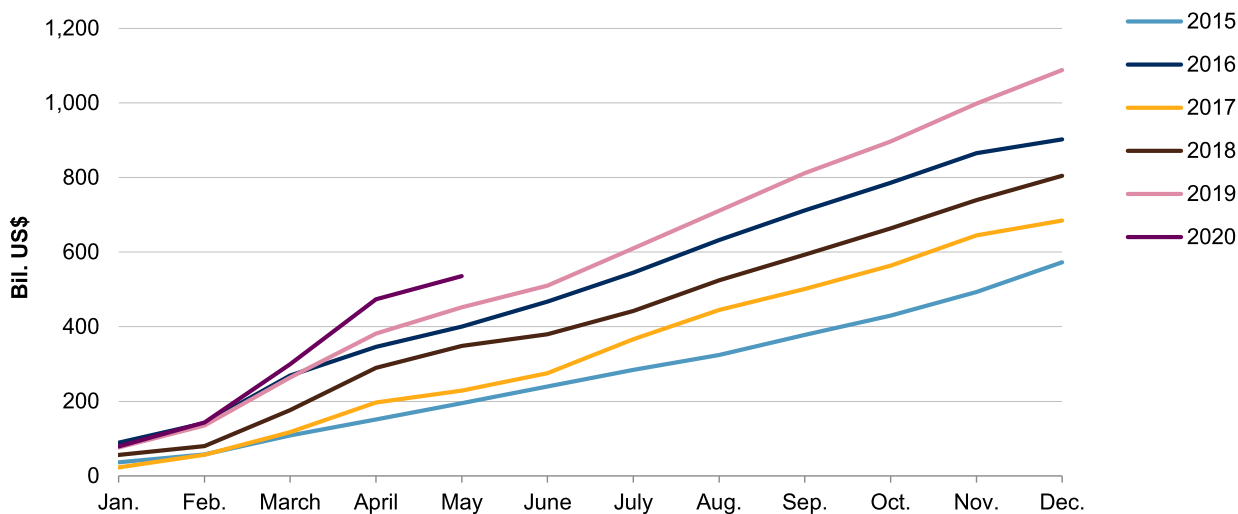
operation, lowering of interest rates, and explicit steps to support bond issuance by financial institutions to bolster the financial system.

The measures have boosted cumulative new corporate (financial and nonfinancial) bond issuance to US\$536 billion (as of May 26, 2020), ahead of volumes at this time last year. While capital growth will likely slow, given markedly slacker economic growth, financing conditions will likely be accommodative for those able to finance--especially higher quality, investment-grade companies with less aggressive financial policies (see chart 4).

Chart 4

Despite A Tough Operating Environment Chinese Corporate Bond Issuance Has Been Strong In 2020

Cumulative issuance



Note: Data as of May 26, 2020, including unrated bonds. Financial and nonfinancial issuance, onshore and offshore. Bil.--Billion. Sources: S&P Ratings Research, Thomson Reuters.

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Corporate Debt--The Waxing Before The Waning

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Chinese corporate debt will likely grow a little faster in 2020, mainly driven by bank loans and bond issuance. This has been helped by monetary easing--including interest rate cuts--aimed at boosting economic growth. Companies also need to borrow to make up the cash flow shortage stemming from operational outages triggered by the outbreak. Meanwhile, China's economic recovery that has unfolded since the second quarter has also increased firms' borrowing appetite.

After 2020, however, we expect corporate debt growth to return to its pre-COVID-19 pattern. As the economy reverts to trend, monetary supply will track nominal GDP growth.

China will likely resume its campaign to limit what it deems as wasteful uses of credit. For

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example, in 2018 the government established guidelines for SOEs, under which they are required to keep their debt-to-asset ratios in line with the average of their industry. This was accompanied by other, prior programs to cut the number of highly indebted and unprofitable SOEs, by forcing entities into mergers or encouraging lenders to accept debt for equity swaps (see "China's Corporate Debt-For-Equity Swaps Need Strong Reforms To Fully Work," March 21, 2017.)

China's National Development and Reform Commission (NDRC), an economic planning body, in 2019 limited property firms' and LGFVs' issuance of offshore bonds for refinancing only, to better control the sector's access to debt, and leverage levels.

Regulators have also chipped away at use of wealth management products, typically used to raise debt for Chinese property firms, which were off banks' balance sheets. The People's Bank of China kicked off this process in November 2017, when it issued a consultation document aimed at closing regulatory loopholes for the products (see "China's Proposed Overhaul Of Wealth Management Regulations Will Be A Game-Changer For The Shadow Banking Sector," Nov. 23, 2017.)

All of these initiatives have been part of a common project: recognizing and then reducing Chinese corporate debt growth. Some of these measures have went into hiatus as the country grappled with COVID-19. For example, we expect that SOEs, including LGFVs, to add debt to invest, in line with government stimulus policies. As China's economy stabilizes, the state will likely reapply its deleveraging measures.

Capex--the x-factor. We note, however, our difficulty in estimating capital expenditure (capex) levels in 2021. This is a key debt variable as capex is typically debt funded. Capex will likely stay muted in 2020 given the softness of the global economy and the tremendous degree of uncertainty about the direction of the trade war, and the lingering effects of the outbreak on demand. Chinese fixed-asset investment slumped 10.3%, year on year, in the first four months of 2020. Corporate capex will likely rebound in the second half of 2020 as the economy stabilizes, which should increase debt demand.

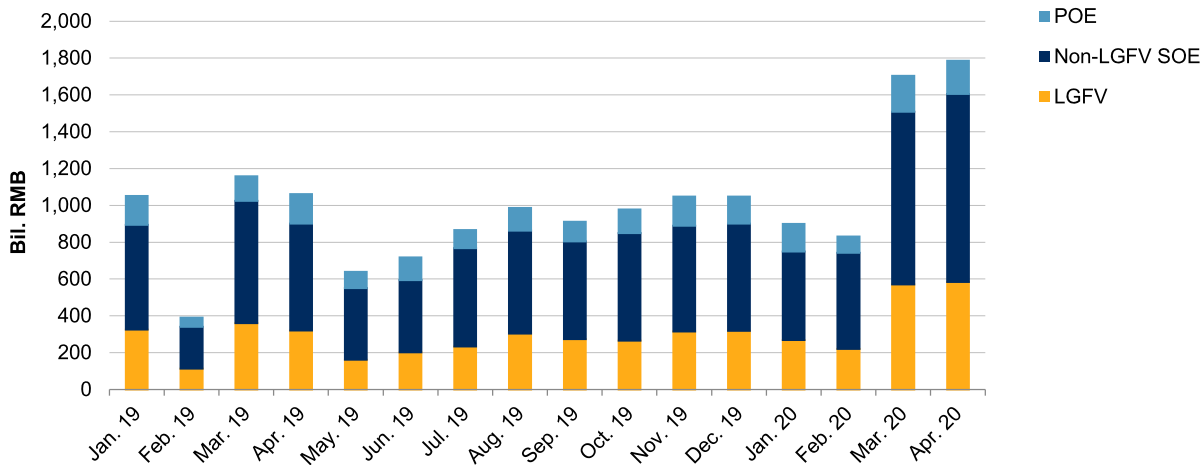
Assuming that corporate borrowing reverts to trend in 2021, and broadly tracks GDP growth, the more interesting question is how credit trends will play out among China's corporate sectors.

Given the focus on employment we believe the government will direct capital to the high technology (in line with Beijing's strategic goals) and manufacturing sectors. Unproductive SOEs will likely continue to be weaned off overly supportive loan capital.

We assume discussions on corporate borrowing in 2021 will revolve around these sector dynamics, which fits our assumption that policy will shape the main credit trends.

Chart 5

China's State-Controlled Firms' Bond* Issuance Has Surged During The Outbreak



*Non-financial corporate issuance, all onshore. Bil.--Billion. RMB--Chinese renminbi. LGFV--Local government financing vehicle. SOE--State-owned enterprise. POE--Privately owned enterprise. Sources: Wind, S&P Global Ratings. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

Government Debt--Special Purpose Bonds Today, LGFV Curbs Tomorrow

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China has loosened its controls of local government debt growth to cope with the economic fallout of COVID-19. China will report an official deficit at 3.6% or more of national GDP and record high issuance of new special purpose bonds, used to ramp up spending during the crisis.

However, the government will likely be able to resume its debt controls in 2021 as the domestic and global economy stabilizes. We believe both central government and regional governments will swiftly return to the unofficial--yet implied--target of keeping deficits below 3% of GDP.

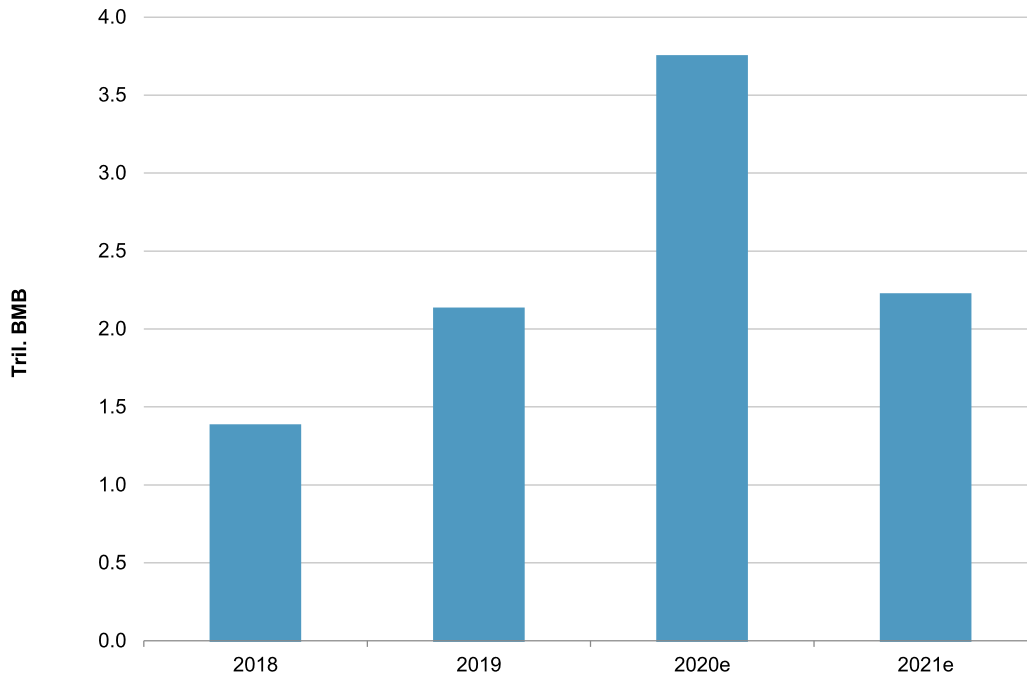
Much of China's current credit expansion is happening at the local government level. Local governments can sponsor infrastructure projects, which are a quick way to stimulate the economy.

Infrastructure investments will likely grow about 8%-10% this year, compared with 3.8% in both 2018 and 2019.

At the NPC, Beijing set a target of RMB3.75 trillion for local governments' special-purpose bond issuance in 2020. This is a sharp rise from the full-year quota of RMB2.15 trillion in 2019. The bonds are used largely to fund infrastructure works (see "Credit FAQ: Why China's LGFVs Are Back In The Spotlight," May 13, 2020).

Chart 6

China's Local Governments Are Ramping Up Issuance Of Special Purpose Bonds In Response To The COVID Crisis



Tril.--Trillion. RMB--Chinese renminbi. E--Estimate. Source: S&P Global Ratings.

Also at the NPC, China announced an additional RMB1 trillion of "COVID" bonds. The central government will pass the proceeds to local governments, to spend largely as they see fit.

This is part of a pattern for China to ramp up infrastructure spending during economic slowdowns, and then to rein in such spending when things stabilize.

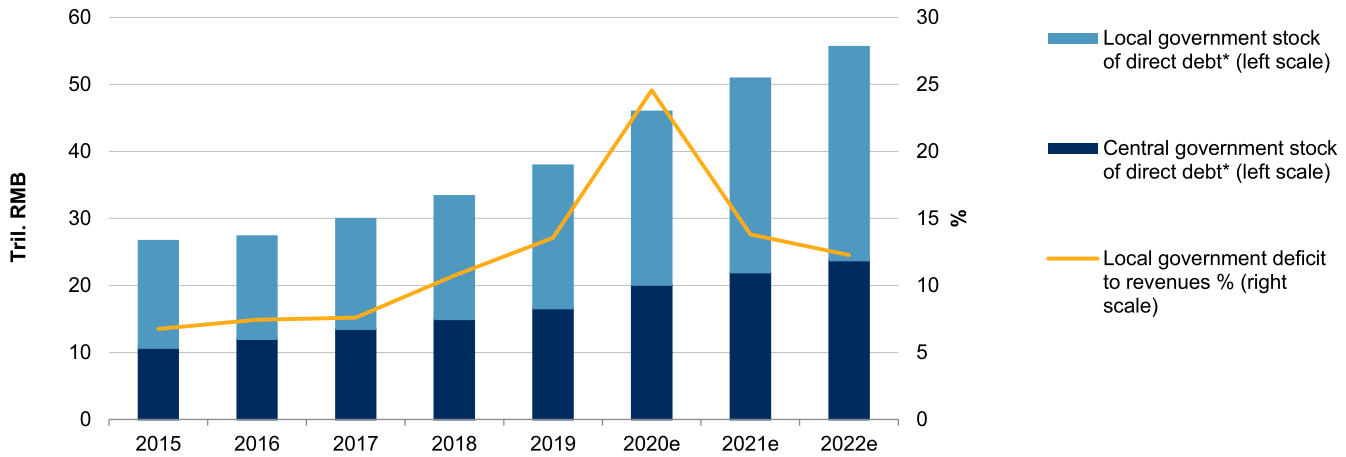
However, infrastructure spending is not a great way to create jobs. Local governments' infrastructure-related debt raising should return to normal next year.

Local governments' fiscal deficit will likely widen to 25% of revenues over 2020, compared with an estimated 14% over 2019, and then return to 15% of revenues or below in the following years.

Governments will continue to curb the growth of off-budget debt of SOEs, especially LGFVs. Monetary easing has promoted issuance by LGFVs in China's onshore market. However, the state will likely resume its controls on the entities spending on new projects, particularly those without revenue streams to support their debt. Authorities will continue to press for more transparency on projects.

Chart 7

China's Local Government Deficits Will Spike In 2020 And Then Revert To Trend Growth



*Debt issued under the government's legal name. e--Estimate. Tril.--Trillion. RMB--Chinese renminbi.

Sources: Ministry of Finance of the People's Republic of China, Wind.

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Household Debt--Small Business Retail Loans Drive Growth

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Mainland Chinese consumer credit has been affected by the collapse in China's economic growth during the pandemic. We estimate that the sector-wide credit card loan balance declined in the first quarter of 2020. Banks' rising sense of risk toward this segment could curb growth next year and beyond.

China's credit card debt had grown quickly in recent years and we were already seeing signs of nonperformance before the pandemic. The hit on consumption during lockdowns diminished product demand, as people are went out less. We assume the balance of credit card debt will be just about flat for the year, versus 2019.

Mortgages have remained resilient. Banks perceive this segment as a haven in difficult times. Moreover, there is a reasonable chance that all the stimulus playing out in mainland China, including interest rate cuts, will boost the property market. We assume that mortgage lending will rise 14% in 2020 in mainland China, year on year.

The new engine for household debt growth is operating loans, which overlaps with the strong policy signal to support small businesses. This is especially for borrowers that fall within financial inclusion initiatives, typically involving loans under RMB10 million in size. The government is encouraging banks to lend to so-called "micro" enterprises--typically family-run businesses that were underrepresented in the country's credit system. We assume that these operational loans will grow by almost one-third in 2020. The mega banks will lead the effort, with a 40% growth

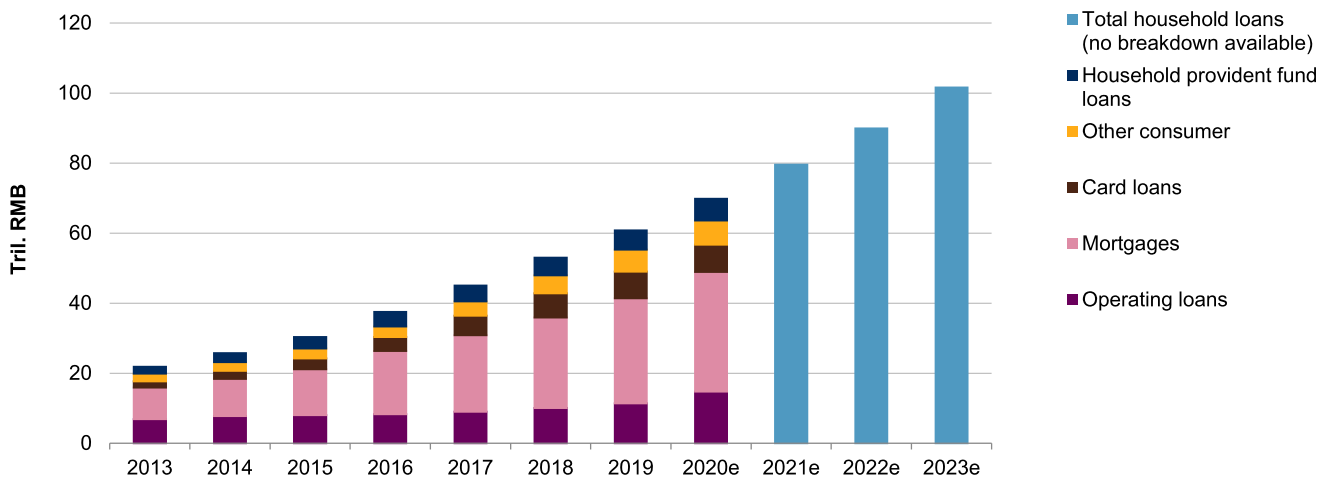
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target.

The overall picture, then, is for household lending to rise by about 15% this year, and remain above average in ensuing years. Over the longer run, we could see the growth in consumption loans pick up as the economy moves to a more consumption-led model. Household debt grew at an annualized rate of 10.2% in April 2020 (see chart 8).

Chart 8

China Household Debt Will Continue To Grow Strongly During, And After, The Pandemic



e--Estimate. Tril.- Trillion. RMB--Chinese renminbi. YoY--Year on year. Sources: People's Bank Of China, S&P Global Ratings. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

Credit Comes, Credit Goes, But The Tone Is Shifting

China's ability to contain the credit expansion it has initiated in 2020 will speak volumes about its commitment to curb use of debt. We have seen, and mainland authorities recognize, that excessive debt has been a crutch repeatedly used by authorities to hit GDP growth targets. We are struck, however, by the fact that 2020's credit expansion has been relatively modest compared with big pushes in 2009 and 2013, especially given the severity of China's growth slowdown. We are also struck that government officials tell us repeatedly they want to restore debt control policies as soon as early 2021.

Much will rest on the strength of China's GDP recovery next year. If growth is strong, it will take pressure off government to inject credit to assist a stuttering economy. If growth is not so strong, we may expect the message to change. Regardless, we are mindful the tone in Beijing has shifted. Planners are moving away from a credit-led economic model as soon as conditions allow.

Related Research

- China's Local-Government Deficits Could Rise To 25% On NPC Targets, May 26, 2020
- China's New Stop-Go Cycle, May 25, 2020
- U.S. Dollar Liquidity Returns, Selectively, To Asia, May 21, 2020
- Decamping Factories Unlikely To Unplug China's Growth Advantage, May 21, 2020
- U.S. And China Kick Trade Deal Can Down The Road, May 13, 2020
- Pandemic Upends Finances Of China's Weak Local Governments, March 27, 2020
- COVID-19 Credit Update: The Sudden Economic Stop Will Bring Intense Credit Pressure, March 17, 2020
- Coronavirus To Inflict A Large, Temporary Blow To China's Economy, Feb. 7, 2020
- Global Trade At A Crossroads: U.S.-China "Phase One" Deal Is Mildly Positive As Bulk Of Tariffs Remain, Jan. 17, 2020

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