

## Is China inflating away its corporate debt?

by Edoardo Campanella (UniCredit Bank Milan)

- The stabilization of the Chinese economy in 2016 was artificially orchestrated through “Beijing-style” supply-side reforms (restrictions on production) and demand-management policies (ultra-cheap credit and SOE intervention).
- This policy mix has translated more into inflationary pressures at the firm level than into real GDP growth, lowering the real costs of borrowing for companies, increasing profits and, in turn, helping pay back their voluminous corporate debt.
- The growth recipe adopted by Beijing so far is not self-sustaining and likely self-defeating, with the old economy and the state seeing their role increase – and not decrease.
- It would be better for the government to opt for truly market-based, supply-side reforms, coupled with debt write-offs and the recapitalization of banks when necessary.

### The reflation trade

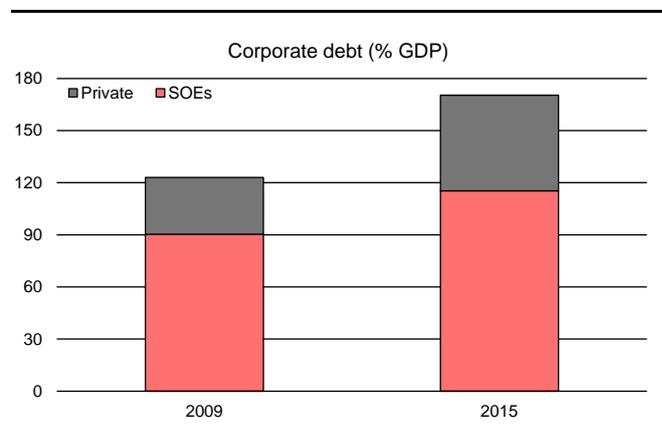
The reflation trade – long in equities, short in bonds – is as much a US story as a China one. Yet, so far attention has been more on the former than on the latter. President Donald Trump’s promised tax cuts, deregulation measures and fiscal stimulus have set financial markets on fire since the US elections in November. However, as shown by the failed attempt to repeal Obamacare, it is far from certain whether the new administration will live up to expectations. China’s unexpected stabilization in 2016, on the other hand, is something real, and has prompted strong rallies in commodity prices and in emerging markets, contributing to shift global market expectations from deflationary to inflationary. And the preliminary annual GDP growth estimate of 6.9% for 1Q17 confirms that the Chinese economy is back on track.

But the rebound in economic activity has not been spontaneous. It has been artificially orchestrated by Beijing through ultra-cheap credit that, with traditional sectors already at full capacity, has translated more into inflationary pressures at the firm level than into real GDP growth. This strategy has boosted profits, reduced the real cost of debt and made the mountain of corporate debt of Chinese firms a bit more sustainable. Consciously or not, it seems that Beijing, having to strike a balance between mounting growth constraints and challenging financial risks, is opting for inflating away its corporate debt through old-style demand-management policies, with the state regaining a leading role in the economy. But the combination of rising prices and more state intervention will hardly pay off in the future.

### Sharp recovery in producer prices

In mid-2015, China’s industrial sector, which includes construction too, was about to go into recession. It was barely growing at 1% yoy in nominal terms as opposed to a long-term average of about 15%. With prices at the firm level in negative territory and the old industries plagued with overcapacity, Chinese manufacturers were struggling to stay afloat and pay back their mountainous corporate debt. The issue was especially acute in the public sector, with SOEs’ debt amounting to 120% of GDP (chart 1).

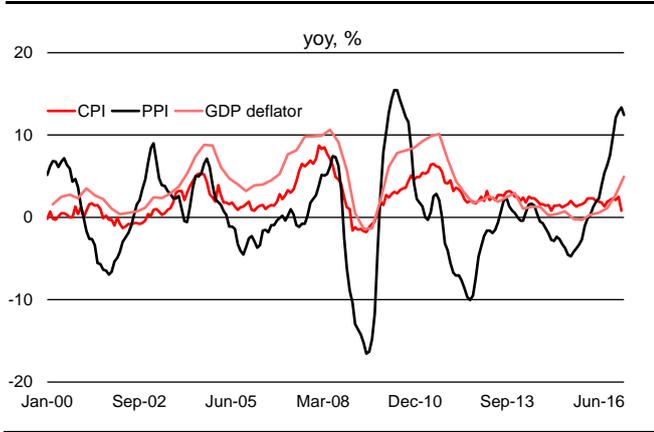
CHART 1: A MOUNTAINOUS PROBLEM



Source: BIS, UniCredit Research

Then, eighteen months later, at the beginning of 2017, the PPI accelerated, jumped out of red territory, and is now growing at above 10% yoy (chart 2). This is the key price indicator for the most troubled SOEs that are active in upstream industries, whose products are used as primary inputs in both domestic and global value chains. These price developments bode well for China’s financial stability, because they lower the real costs of borrowing for companies, increase their profitability and, in turn, help pay back the pile of corporate debt accumulated over the years. Also the GDP deflator, which had turned slightly negative in mid-2015, has rebounded. Inflationary pressures at the consumer level, instead, remain contained for a couple of reasons. First, it takes time for prices at the firm level to be passed through to consumer prices. Second, the CPI basket does not include real estate prices which were extremely volatile over the last couple of years.

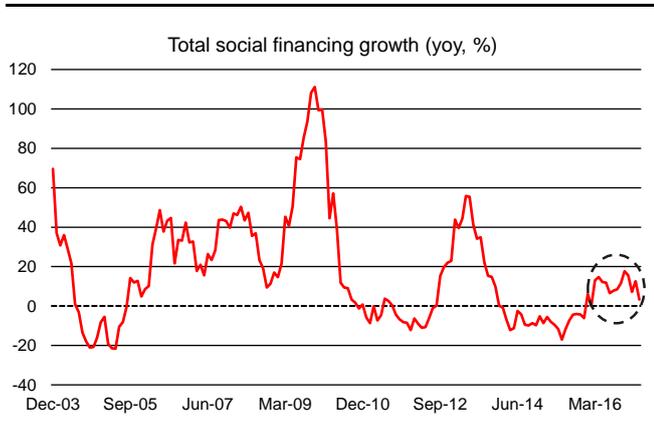
**CHART 2: RISING INFLATIONARY PRESSURES AT THE FIRM LEVEL**



Source: NBCS, UniCredit Research

But this price recovery has not happened by chance. It has mostly been driven by the activism of the People Bank of China, which eased credit in 2H15, accelerating the injection of cheap money into the system at the beginning of 2016, when markets were concerned about the health of the Chinese economy (chart 3). Compared to previous episodes, credit growth looks slow. But it is still twice as high as GDP growth, and so it represents a major element of fragility of the financial system.

**CHART 3: CREDIT GROWTH REACCELERATES**



Source: PBoC, UniCredit Research

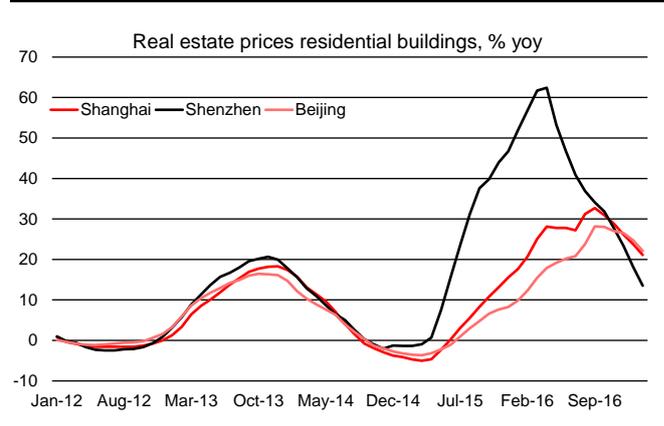
This led to a boom in construction and housing sales, and hence to a spike in housing prices in the largest cities (chart 4).<sup>1</sup>

<sup>1</sup> In Tier-1 cities such as Beijing, Shanghai and Shenzhen, land supply is rationed because land sales represent a major source of revenues for local governments. This is another factor that has contributed to rising housing prices. What has partly tamed the real estate market was the tightening of home purchase restrictions such as increased mortgage down-payment ratios and restrictions on non-local buyers. These measures were initially adopted in Tier-1 cities and were then extended to Tier-2 ones. See OECD 2017.

With more potential buyers willing to enter the real estate market, by 1Q16, developers had ramped up construction starts and investment in new projects.

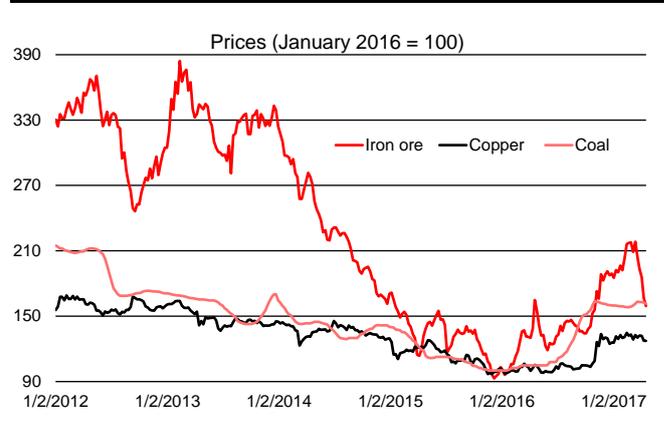
What followed was a rise in demand for construction equipment and materials, which ultimately triggered the expansion in industrial production and a rise in commodity prices (chart 5).

**CHART 4: SPIKE IN HOUSING PRICES...**



Source: NBCS, UniCredit Research

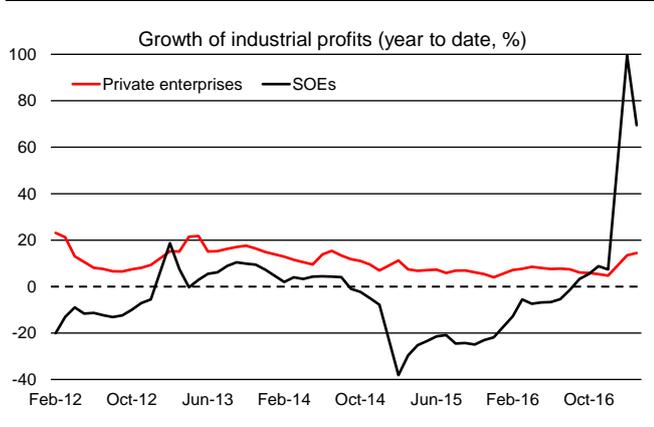
**CHART 5: ... AND JUMP IN COMMODITY PRICES**



Source: NBCS, UniCredit Research

The impact on profits of SOEs became visible at the beginning of the year: they grew by a staggering 100% yoy in February and by 70% yoy in March, while the growth of profits at private companies only marginally accelerated (chart 6). To be sure, the spike in profits at SOEs is partly due to cyclical factors. The disastrous decline of more than 20 percent in 2016 created room for a positive base effect. But considering the sharp increase in the share of profits of SOE firms, this is also the result of a fundamental realignment in the roles of state and private firms.

**CHART 6: BOOMING SOE PROFITS**

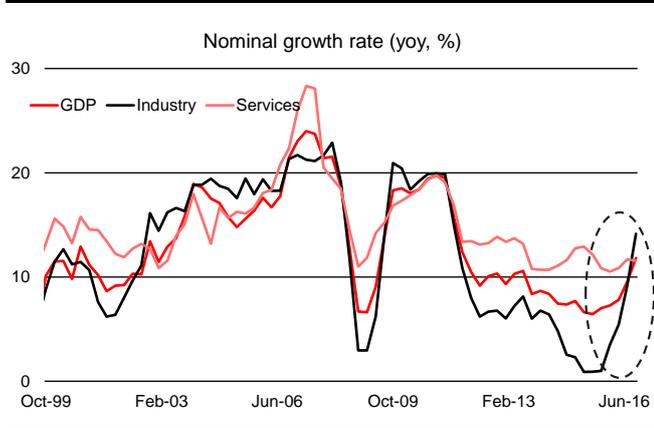


Source: NBCS, UniCredit Research

**GDP growth does not pick up**

With credit flooding the Chinese economy and inflationary pressures accelerating so fast, in 2Q16 the value added growth of the industrial sector sharply rebounded in nominal terms and is now growing at 14.2%, outpacing by a large margin the growth of both the services sector and the economy as a whole (chart 7).

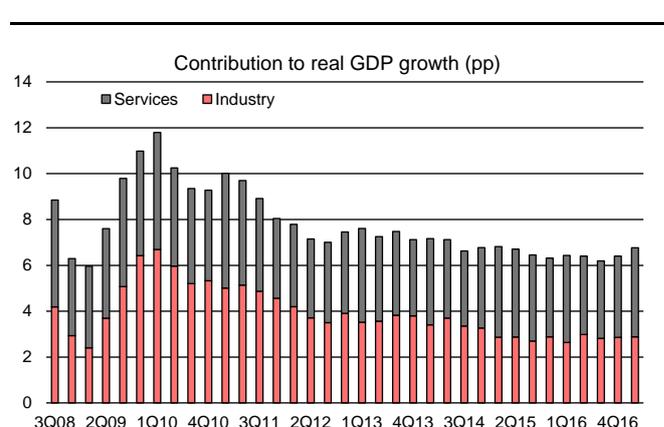
**CHART 7: THE INDUSTRIAL SECTOR HAS BOUNCED BACK**



Source: NBCS, UniCredit Research

While the impressive performance of the industrial sector has been instrumental in avoiding a hard landing, its contribution to real growth has been flat and constant at about 2.5pp (chart 8). Before enormous amounts of credit started to flow into the economy, nominal growth in the industrial sector was declining, mostly as a result of the price component. However, it is fair to assume that without the rebound in nominal growth, the contribution to real growth would have been lower and GDP would have not stabilized.

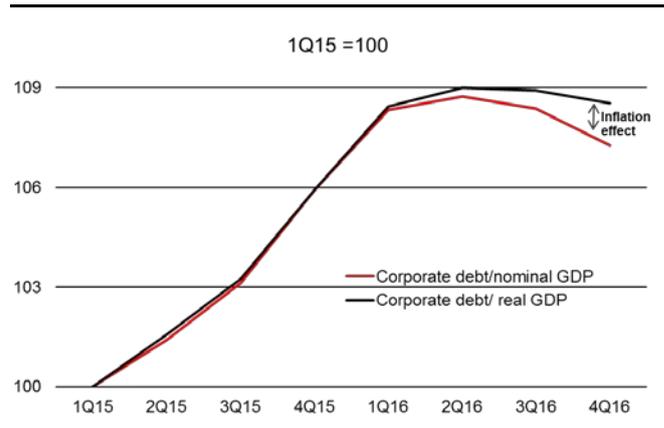
**CHART 8: LITTLE IMPACT IN TERMS OF REAL GROWTH**



Source: NBCS, UniCredit Research

While growing profits help stabilize crumbling corporate finances, the reacceleration in inflation, as measured by the GDP deflator, is making a positive contribution too (denominator effect). Chart 9 shows corporate debt as a percentage of nominal GDP (the variable usually used to assess the health of finances) and of real GDP, with 1Q15 equal to 100. As can be seen, before the strong credit intervention of the government, when China was close to entering a deflationary spiral, the two lines moved together. Then, in mid-2016, when credit was tightened marginally, they started to stabilize. Since then they have decoupled. This divergence is due to the inflation effect – which is, so to speak, inflating away debt.

**CHART 9: INFLATING AWAY DEBT?**



Source: BIS, UniCredit Research

**The state is back**

To understand why credit growth fuelled prices at the producer level, with little impact on real growth, we need to better understand what was happening behind the scenes. To solve its debt problem, Beijing had three options: growth, inflation or default.

The latter has always been anathema to Chinese authorities, who are reluctant to let even the least profitable firms go bust. Real growth at 6.5% remains high by advanced economies' standards and it would have been difficult for China to accelerate it further without a major cleanup of the industrial system aimed at unleashing the entrepreneurial potential of those firms that are discriminated in favor of SOEs.<sup>2</sup> The third option was inflating away debt by generating inflationary pressures at the firm level to boost profits and make debt more sustainable.

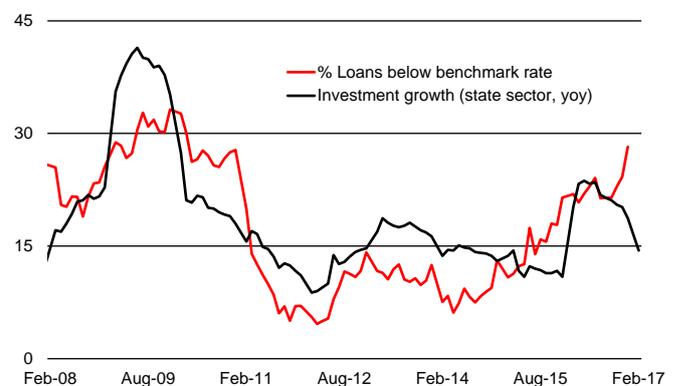
The Chinese government formally opted for growth through a combination of 1. supply-side reforms and 2. demand-management policies that have lifted nominal but not real growth. But the result was actually closer to the inflation option.

**Supply-side reforms.** The so-called supply-side reforms adopted by President Xi have little to do with the pro-market reforms implemented by the Reagan administration in the US in the 1980s. Rather than boosting supply and letting the market allocate resources efficiently, the policies of the Chinese government have tried to curtail production in a centrally planned manner by cutting down overcapacity in traditional sectors such as coal, steel and iron, while shutting very few "zombie" companies. The goal is to drive out low-quality supply, leaving the remaining players with increased pricing power. These policies have succeeded up to a point but they have mostly stabilized rather than cut production substantially. The adjustment process is inevitably slow because sub-national governments are struggling to find funds to relocate, compensate, re-train and re-employ redundant workers. With SOEs amounting to 155,000 and dominating network sectors, retail, construction, and wholesale trade, any major improvement would take long to materialize in a significant way. In the real estate sector, after loosening restrictions on property investment in 2015, last year the Chinese government introduced macro-prudential regulations to cool markets. But considering that the IMF estimates that it could take over three years to work off housing inventories in China's smallest cities, even absent new residential construction, the real estate market is far from having stabilized.<sup>3</sup>

**Demand-management policies.** On the demand side, when the credit-induced impulse from the real estate sector fed through upstream industries, on the whole state-controlled actors were the ones that were able to carry out these new investments, while private firms were busy trying to deleverage and their investment growth started to decelerate.

The share of loans below the benchmark rate – which is usually related to lending to SOEs and other public entities that carry implicit government guarantees – almost doubled between mid-2015 and the end of 2016, shifting from about 15% to almost 30%. Meanwhile, investment growth led by the state strongly accelerated, jumping from 13% in mid-2015 to 24% at the end of 2015 (chart 10). Now the two have decoupled, suggesting that this tool is not working as effectively as it used to. This induced loan growth is still expanding very rapidly, but investment growth is declining. In other words, the marginal benefit in terms of growth of an additional dose of cheap credit is decreasing over time.

**CHART 10: THE STATE STEPS IN**



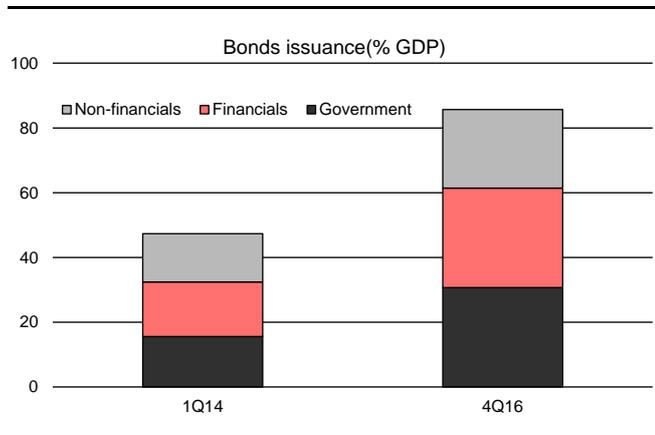
Source: NBS, UniCredit Research

In addition, the kick-start of sub-national government bond issues in 2015 and, more recently, the surge in special bonds to support infrastructure projects, have expanded the bond market, providing new lifeblood to state-controlled entities. Although the three main issuer types (the government, financial institutions and the non-financial corporate sector) seem to account for similar shares of the bond market, in fact most issuers are government-related (chart 7). Policy banks are the largest issuers of financial bonds and SOEs, alongside local government investment vehicles, are the largest non-financial corporate issuers.

<sup>2</sup> But these measures, besides being recessionary in the short term, might not be enough to boost GDP growth beyond a certain threshold. When countries climb the development ladder, their growth performance tends to approach the mean of 2% on an annual basis.

<sup>3</sup> IMF (2016), 2016 Article IV Consultation – Staff Report, International Monetary Fund, Washington D.C.

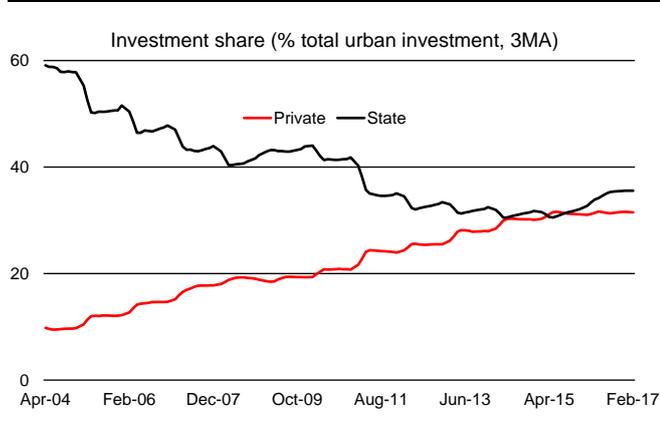
**CHART 11: NEW LIFEblood FOR GOVERNEMENT-RELATED ENTITIES**



Source: OECD, UniCredit Research

As a result of this highly interventionist stance, the state has regained its leading role in the economy. The investment share of the public sector had continually declined from 2004 to mid-2015, when for the first time it matched that of the private sector. Over the last 18 months, it has increased again to 39%, above the private sector share (chart 12).

**CHART 12: SHIFTING ROLES**



Source: NBS, UniCredit Research

## Conclusion

Corporate debt in China is approaching a dangerous level by both historical and cross-country standards, which clearly represents the number-one risk to the global macroeconomic outlook. The recipe adopted by Beijing so far is not self-sustaining and likely self-defeating. It opted for the old actor (the SOEs), the old economy (heavy industries) and the old instrument (demand-management policies through higher credit) to grow out of debt.

So here is the dilemma for the Chinese authorities: If they continue with this policy strategy, they might end up temporarily boosting profits.

But, at some point, inflation will likely rise materially and the benefits in terms of real GDP growth will be pretty limited, requiring an even stronger intervention of the state to calm down markets, adding inefficiencies to inefficiencies. Eventually, these raw material price rises will be passed on to consumers, particularly for finished manufacturers, squeezing real income growth and consumption, which would be the opposite of the rebalancing that China needs. For firms that are not raw material producers, input costs will increase and this will squeeze profit margins, if they do not fully pass on the price rises (making their leverage coverage ratio worse). And if it's passed on fully to the consumer then it will squeeze real income growth and consumption, which would be the opposite of the rebalancing that China needs. In addition, by pushing up the prices of raw materials via credit-fuelled housing demand, they are increasing debt in the household sector too, creating another source of financial vulnerability.

However, without this accommodative monetary stance and highly interventionist attitude of the government, many firms will struggle to create enough profit to stay afloat. The cleanup of the industrial system is just at its beginning and many potentially efficient companies are being pushed out of the system by discriminatory practices that promote the public sector.

Beijing should not just attempt to curtail production but adopt market-friendly, supply-side reforms that unleash the unexpressed entrepreneurial potential of the many aspiring producers. At the same time, it should selectively let the least-efficient SOEs go out of business. The short-term losses due to output and employment cuts would lead to higher and more sustainable growth in the future thanks to better resource allocation. But tackling the overcapacity problem is not enough if the related financial implications are not properly addressed. Debt write-offs combined with the recapitalization of banks, as recently suggested by the IMF, would allow the financial system to redirect lending to more-profitable sectors.

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