DOES CHINA STILL HAVE A DEBT PROBLEM?

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This briefing is part of a continuing EBOT series on prominant U.S.-China trade issues, and explains the origin, rise, and implications of China's persistent domestic debt problem. With its $588 billion economic stimulus package during the 2008-09 global financial crisis, China's government attempted to shore-up domestic infrastructure investment and offset the effects of diminishing global demand for its exports. To do so, Chinese authorities made new capital available and relaxed borrowing requirements for many local firms, most of which were state-owned enterprises (SOEs).[2] These SOEs did not use the newly borrowed capital as efficiently as their private sector counterparts, resulting in overinvestment (e.g., steel and aluminum sectors), low investment returns, and frequent defaults.[3] This misallocation of capital and surging debt in 2009-16 increased China's financial risk exposure and inhibited China's economic growth potential, as funds were increasingly diverted from new investment to debt servicing.[4] Through strict policy measures, Chinese authorities have arrested the growth of debt in 2017, [5] lowering China's high financial risk exposure. However, the persistently large stock of corporate (and now household) debt is still likely to inhibit China's long-term economic growth and affect U.S. firms.

SURGING DEBT (2009-2016). China's stock of domestic debt[6] surged in the past decade, exceeding 250% of GDP since 2016 and overtaking the United States as the fourth most indebted country by 2017 (Figures 1&2).[7] China's debt started to accumulate during the global financial crisis of 2008-09, when its authorities pursued monetary easing policies (by decreasing interest rates, ending lending quotas, and lowering borrowing requirements and Central Bank deposit ratios) and used much of China's $588 billion economic stimulus to promote highway, railway, and airport infrastructure investment.[8] Many economists considered China's stimulus to have been instrumental in offsetting diminished global demand for Chinese goods and for containing the global effects of the crisis given economic interdependencies. [9] Paul Krugman even stated that China's was a "much more aggressive stimulus than any Western nation – and it worked out well".[10] However, the easy borrowing policies of the past appear to have contributed to China's current problem of today.[11]

Fig 1. Stock of China's Domestic Debt (2006-17, % of GDP)

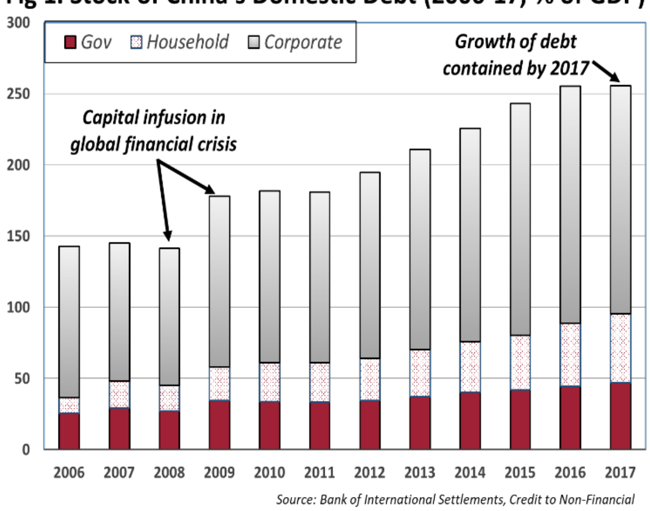
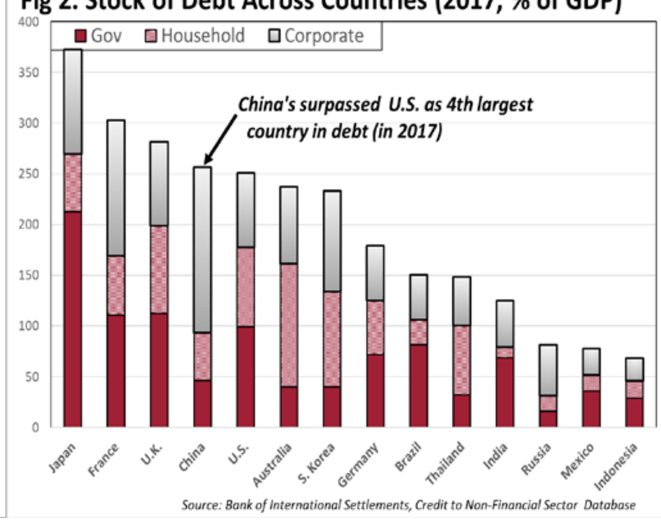


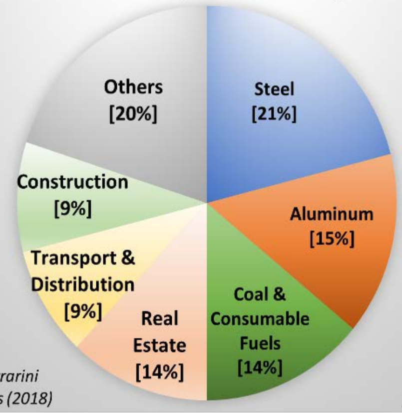
Fig 2. Stock of Debt Across Countries (2017, % of GDP)



[1] The authors gratefully acknowledge the insight provided by Dylan Carlson.
[2] Center for Strategic and International Studies (CSIS), "Does China Face a Looming Debt Crisis?" 2017.
[3] OECD Working Paper (Molnar), "Boosting Firm Dynamism and Performance in China," No. 1408, 2017.
[4] IMF, "Selected Issues: China Country Report," No. 17/248, Aug. 2017.
[5] The Economist, "China Has Made Progress in Tackling Financial Risk", June 2018; Bank of International Settlements, Debt Database (accessed July 2018).
[6] Domestic debt mainly consists of corporate (from both state and private sector firms), public (national and local), and household debt.
[7] Bank of International Settlements (BIS), Credit to Non-Financial Sector Database (Accessed July 1, 2018).
[8] Lardy, Nicholas, "China's Response to the Global Crisis," Chapter 1 in *Sustaining China's Growth After the Global Financial Crisis*, 2012.
[9] Hammer, "China's Growth Recession and Policy Response," USITC *Executive Briefings on Trade*, Mar. 2009.
[10] Brookings (Bai, Hsieh, and Song), "The Long Shadow of China's Fiscal Expansion," *Brookings Papers*, Fall 2016; Krugman, "Keynes in Asia," NYT, July 2010.
[11] Center for Strategic and International Studies (CSIS), "Does China Face a Looming Debt Crisis?" 2017.

RISING SOE DEBT LOWERED CHINA'S PRODUCTIVITY. Most of China's lending was provided by China's state banking sector to SOEs (many of which were non-viable "zombie" firms"[12]) with soft budget constraints, ties to local government, and experience pursuing non-commercial functions (e.g., development strategies, social service functions).[13] These SOEs account for 70% of China's corporate debt,[14] and given China's mostly closed capital account, those investments have remained mostly domestic.[15]

Fig 3. China's SOE Debt (Estimate Compositon, 2015)*



Source: Ferrarini & Hinojales (2018)

* Components sum to 102% from rounding

The IMF found that productivity among SOEs at that time was about 25% below that of private sector firms.[16] As such, lending to less viable SOEs crowded out more efficient private sector investment, and this capital misallocation led to lower productivity.[17] Bai and Zhang found that China's total-factor productivity growth fell given this misallocation of funds.[18] Other studies found that the incremental amount of capital needed per extra unit of output increased threefold from 2009 to 2017, and that progressively more funds were needed simply to service accumulating stocks of debt.[19]

MUCH DEBT FROM STEEL & ALUMINUM SECTORS. While sectoral breakdowns of SOE corporate debt is not public, Ferrarini and Hinojales estimated that over a third of it derived from China' steel and aluminum sectors in 2015 (Figure 3).[20] Lam *et al* also found that zombies were prevalent in these overcapacity sectors.[21]

CONTAINING DEBT GROWTH. The rapid 2009-16 growth of China's corporate debt concerned the IMF and credit rating agencies such as Moody's and Standard & Poors.[22] The IMF identified 43 similar international cases which ended in major economic slowdowns or financial crises, and noted that China's escalating debt problem has been the longest lasting.[23] As a result, China placed the containment of its debt as one of its top 2017 economic priorities.[24] In that year, it (a) imposed higher debt-equity thresholds on bank lending; (b) ended shadow banking and off-balance sheet lending; (c) encouraged zombies to file for bankruptcy; and (d) provided a larger proportion of credit to private firms.[25] Largely as a result, non-performing loan ratios began decreasing and the growth of domestic debt was virtually arrested in 2017. In that year, China's debt to GDP ratio grew by only 0.4 percentage points compared to 14.8 percent per annum in the prior 5 years.

IMPLICATIONS. Many institutions (e.g., IMF, Moody's, S&P) believed that China's growth of debt in 2009- 16 significantly increased its financial risk exposure. The problem may not be as monumental now. China was able to arrest the growth in debt in 2017, the government has the fiscal resources to pay it off if needed (as done in the past), and China's stock of debt has remained domestic (so not subject to strict repayment schedules).[26] Nevertheless, China still has a debt problem and its persistent high stock is likely inhibiting long-term economic growth, as resources are split between debt servicing and new investment. These conditions could also pose challenges to U.S. firms expecting sustained high demand in China, and opportunities for others (e.g., U.S. banks) seeking better market access to compete with debt-saddled Chinese firms.

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[12] China's government defines "zombie firms" as SOEs with at least 3 years of losses that don't align with national industrial policies or standards, and rely heavily on government support. The IMF defined such firms as having persistent losses with interest payment costs below market lending rates.
[13] IMF, "Selected Issues: China Country Report," No. 17/248, Aug. 2017.
[14] OECD Working Paper (Molnar), "Boosting Firm Dynamism and Performance in China," No. 1408, 2017.
[15] One notable exception has been lending in support of China's Belt and Road Initiative, further explored in a forthcoming paper.
[16] IMF, "China Article IV Consultation Staff Report," No. 16/270, Aug. 2016; IMF, "Selected Issues: China Country Report," No. 17/248, Aug. 2017.
[17] OECD Working Paper (Molnar), "Boosting Firm Dynamism and Performance in China," No. 1408, 2017.
[18] Song and Xiong, "Risks in China's Financial System". NBER Working Paper #24230, Jan. 2018.
[19] Center for Strategic and International Studies (CSIS), "Does China Face a Looming Debt Crisis?" 2017.
[20] Asia Development Bank (Ferrarini & Hinojales),"Chinese SOE Leverage As A Contingency In Public Debt Sustainability Analysis," Working Paper, Jan. 2018.
[21] IMF (Lam, Shipke, Tan, Tan), "Resolving China's Zombies: Tackling Debt and Raising Productivity," IMF Working Papers, Nov 2017.
[22] Reuters, "S&P Downgraded China as Credit Growth Still Too Fast," Sept. 2017; "China's Reforms Not Enough to Arrest Mounting Debt: Moody's." May 2017.
[23] IMF, "Selected Issues: China Country Report," No. 17/248, Aug. 2017
[24] Economist Intelligence Unit (EIU), "China: Country Report," June 28, 2018.
[25] The Economist, "China Has Made Progress in Tackling Financial Risk", June 16, 2018; EIU, "China: Country Report," June 28, 2018.
[26] McKinsey Global Institute, "Debt and Not Much Deleveraging," Feb. 2015; Center for Strategic and International Studies (Huang and Bosler), "China's Debt Problem: Deleveraging While Generating Growth," CSIS Paper, Sept. 2014; and EIU, "China: Country Report," June 28, 2018.

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