China Briefing

China's Goldilocks Debt Situation

Executive summary

China's debt problem is back in the spotlight following a spate of defaults by state-owned enterprises (SOEs). The defaults were a good thing, mostly. China's SOE default rate is extraordinarily low.

China getting its debt situation right is essential; apart from the impact on China's own economy, it is now the second-largest bond market in the world. We cannot ignore China's financial system. But investors will need to be mindful that SOEs, and their potential debt issues, come in many different flavours. Beijing's central champions are a world removed from small local SOEs struggling to cope with COVID. And both are not as efficient as China's private firms, which are, however, struggling for credit.

So China's leaders are left in a pickle: they need to have some defaults, not too many, mostly SOEs. But they cannot have too many defaults, as that will scare away investors; nor too few, as that will make the reaction look token.

China's Goldilocks Debt Situation

Goldilocks is a famous fable: a lost young girl needs to pick a bowl of porridge for bears that is neither too hot, nor too cold, but just the right temperature. Spare a thought for Chinese policy makers: a decade ago, when the world economy was on the ropes, they unleashed what seemed at the time to be the mother of all stimulus packages. China's banking system went from USD 9tn to USD 40tn in a little more than a decade. And foreign capital has started to flow in, too; while currently around USD 700bn, it is increasing rapidly.

But they also face the need to cut debt. Xi Jinping declared three "wars" in his time on office. The other two, on poverty and on air pollution, have both been very successful. Having a war on debt when the banking system has grown so rapidly is much harder.

In the time of Coronavirus, it also leads to a vicious cycle. Beijing keeps a tight hold of China's banks and financial system and often steps in when it looks like companies will go bust and affect social stability. But it also criticises banks, tells them to rein in risky lending and even, last year, let one of them go.

Banks, for their part, prefer to loan to state-owned enterprises, and not to private enterprises: if you are going to take on a credit risk, it is always safer to take on a politically-well connected one.

And so China's consumers, private sector and even, at times, local governments, are forced to find their own ways to fund things. This year, however, there isn't the natural economic growth — China's official economic growth will be around 2% this year, down from an average of more than 6% — and so there isn't the credit growth to keep rolling debt over. One must be creative. Yet when this ingenuity comes to Beijing's attention, they grip the reins yet tighter, and the cycle repeats.

Strifes in SOEs

Debt risk in China is based on projection of future risk, based mainly on analysing China's state-owned companies ("**SOEs**"). That is because private firms already face considerable market discipline. Following Xi Jinping's rallying cry of a war on debt, and some vigorous regulatory action, private companies had their paper called in and conditions tightened. Local securities firm Huatai estimates that Chinese private companies' loan default rates rose from 1.8% in 2017 to 5.3% in 2018 alone (2019 data is not yet available).

SOEs on the other hand face too little market discipline. In comparison, SOEs' default rate was 0.02%. At some point, that percentage will need to grow — estimates put it that private firms' median return on assets is 8.4% p.a., publicly traded SOE subsidiaries' return is 5.6% and SOEs' median return on assets less than 2%. The issue, based on this, is that it is a matter of when and not if SOEs begin to face more market discipline.

So the three recent SOE defaults attracted great attention. The firms were Yongcheng Coal, a Henan-based mining and energy company; Tsinghua Unigroup, a conglomerate attached to world-class Tsinghua University, China's MIT; and Brilliance, a car manufacturer in the northeast that has a joint venture with BMW. All have managed to scrape by, it appears, although Tsinghua Unigroup paper is reportedly selling at 14 cents to the dollar, Yongcheng has billions of bonds due again soon.

Credit is based on credibility, and that was what has roiled the markets: all of these SOEs are unusual default risks. Tsinghua is a central university, the pride (and alma mater of many) of China's leadership. Henan is fiscally a fairly sound local government, and coal a traditionally safe investment. Brilliance is far from China's worst carmaker. So the defaults shook the notions that defaults won't occur to central champions, will be limited to regions with weak fiscal positions, and will start with the worst companies.

Here we get to the idea of fear: China's debt defaults are lower than one might expect, and therefore concerns come that one day the financial house of cards may tumble down. Already, China's debt defaults are set to top 100 billion yuan for the third year. The fear is of SOE collapse.

Private companies' credit risks have been relatively fully exposed. That means even a large wave of defaults by private companies wouldn't disturb the market. But the risks related to borrowing by SOEs are much greater: they have very rarely defaulted but account for more than half of China's nearly USD 4tn corporate debt market. Should SOEs begin to default, then things would get very ugly, very fast. The market is already rattled. At least 20 Chinese companies suspended plans for new debt issues totalling CNY 15.5bn (USD2.4bn) in the past week, all quoted as being due to "recent market turmoil".

And foreign investors have been caught up in this turmoil. A major Chinese commodities trading firm, Tewoo Group, became the first state-backed company to miss a payment to foreign investors in two decades (foreigners own very limited amounts of Chinese debt, and while money has been flowing in recently, it has mainly been in government rather than corporate bonds). The Tewoo Group default is particularly significant given the attractiveness of China's fixed income market to foreigners. Figure One below shows how China compares favourably to rival jurisdictions for foreign investors.

Old problem, new dynamic

China has weathered the pandemic far better than any other big economy, but still has suffered a downturn. Full-year growth is projected to come in at just under 2 per cent — posing a severe test for companies used to 6 per cent or higher.

Central SOEs, however, have done well this year. SOEs saw their aggregate net profits after taxes rise by 62.7 percent year on year last month, while operating revenues climbed 7 percent, according to data from the Ministry of Finance released at the end of November.

The problem lies with local SOEs. Disproportionately, local governments were previously seen as the backstop for investors, stepping in to rescue local firms before they have to sell assets. Today, the governments themselves can be those causing some of the risks. This really matters for debt: current estimates by external research firms such as Gavekal have it that local SOEs account for 60 per cent of all company debt. What local governments think and do drives markets.

China's bond market is too big to ignore

GDP, Outstanding Debt Securities and Yield Comparison

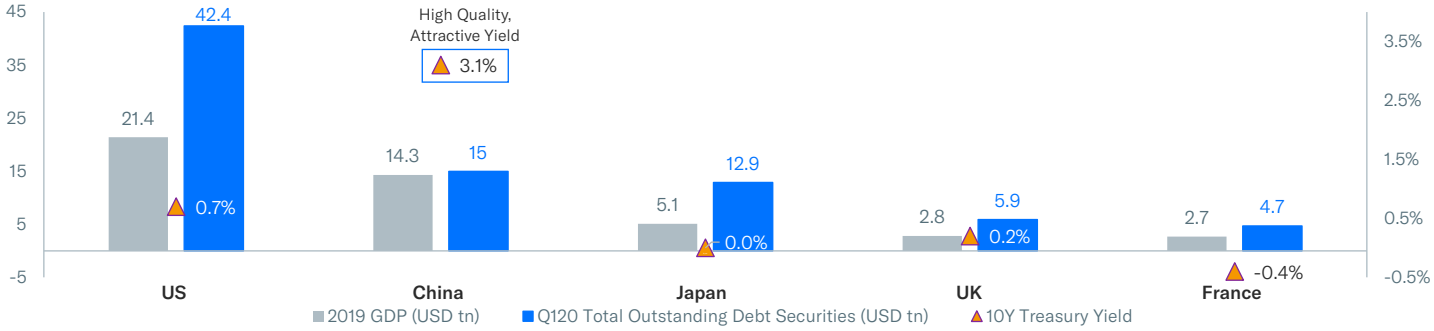

Figure One: GDP, Outstanding Debt Securities and Yield Comparison
Source: Neuberger Berman; 2019 GDP data from World Bank. Total outstanding debt securities from BIS, as of Q1 2020. Credit rating by S&P, as of 30 Sep 2020. 10-year Treasury yield from Bloomberg, as of 30 Sep 2020. Note that 10Y Treasury yields are in triangles.

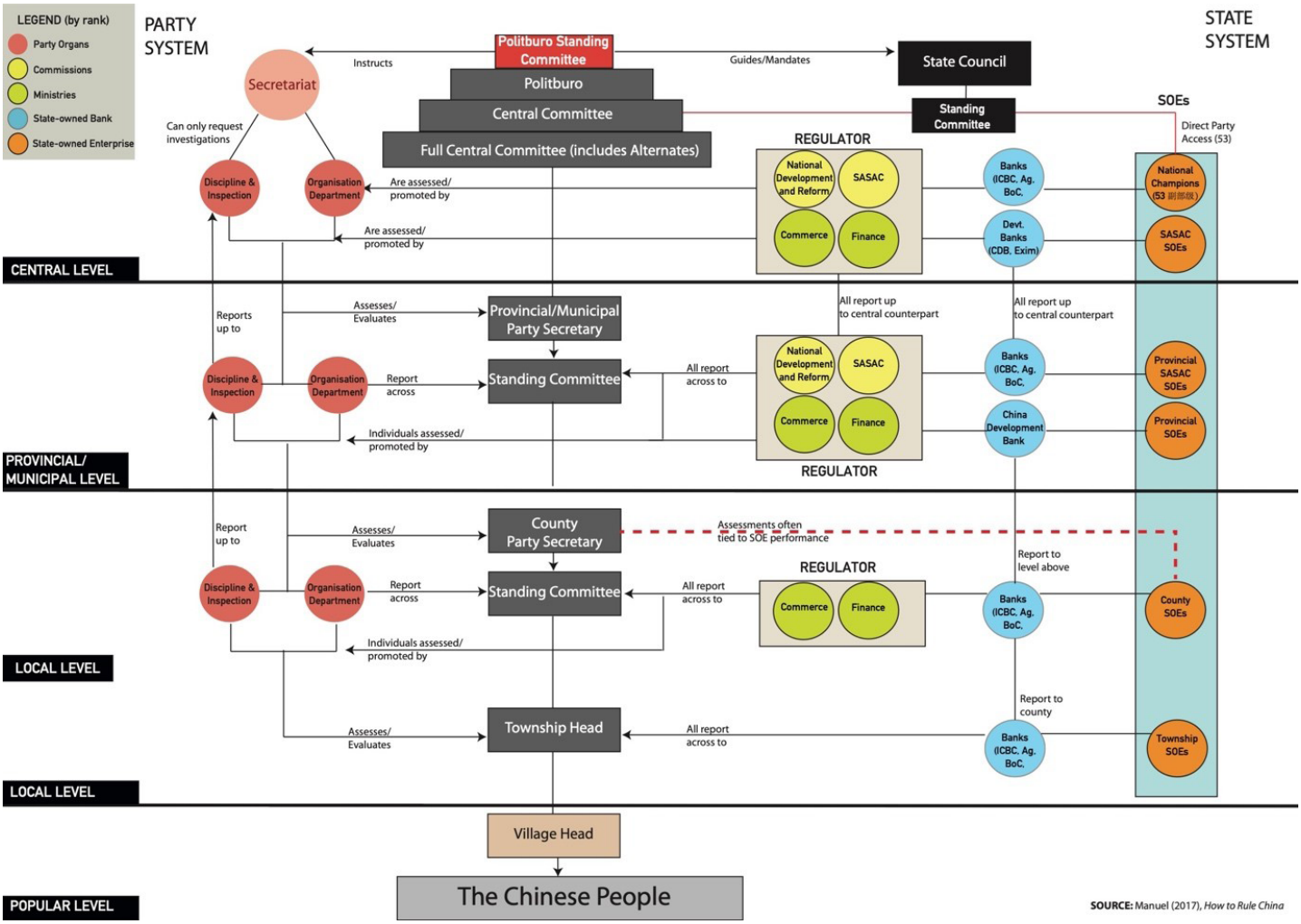

Figure Two: China's regulatory environment for SOEs

The reason for this disparity is that there are, as Figure Two above helps to explain, very different relations between governments, SOEs and banks at different levels. The nation's capital Beijing has a different ecosystem. There are, as Figure Two shows, many more regulatory binds for companies controlled in the nation's capital.

What is essential for investors to understand is that the structures outlined in Figure Two greatly affect how businesses function. First, the Party is at the centre of the ecosystem, rather than the banks. Similar to how Korean chaebol firms use family ties, the Party uses its personnel powers to ensure that it has eyes and ears on every decision. Most SOE decisions are made for commercial reasons. But as Figure Two above shows, there are always Party (the left hand side) and regulatory (the right hand side) considerations, too. Secondly, the Party ensured that state-owned banks do most of the lending; as they are a part of the same ecosystem, that means that the Party has some say, but that giant SOEs do not develop their own banks, unlike their Japanese keiretsu cousins. Finally, Singapore's Temasek and its close ties to Singaporean leaders offered a model for seeking return on state assets but also holding the reins tight. Beijing created its own state asset supervisor (SASAC, in orange on the right hand side).

Given these structural binds, Beijing, for its part, can be far more tolerant and encouraging of defaults. The lower down you go, however, the more that local leaders feel tied to the performance of their local champions. Thus the assumption that local governments will always bail out troubled firms. Everyone, from Xi down, knows that this distorts China's economy. But here is the Goldilocks problem: how can they let defaults occur and the market take over, and yet still have control and sufficient investor confidence?

Perhaps the biggest interest group is local banks. Bank lending is estimated to be around five times as great a source of local financing than bonds. But the banks themselves are not only credit allocators, but also major investors. They provide around two–thirds of total credit and are the biggest holder of local government bonds. A form of implicit guarantee can always come about: banks can keep rolling over credit, and local governments can steer lucrative resources and deals the banks way, and so banks can usually recover lending to SOEs through this channel. This gets harder, but, when the macro economy struggles, as governments cannot provide financial support and banks may be unsure of how valuable a local credit guarantee might be.

Local regulators and assessors are weak. Current estimates put it that 70 per cent of all outstanding Chinese corporate and government debt is rated triple A. And the government body that is meant to take care of SOEs (and indeed, all state assets), SASAC, can only review whether or not asset transfers result in the loss of state-owned assets (i.e., asset stripping) but not whether or not asset transfers might harm the interests of creditors — often themselves also state-owned.

Local governments are cash-starved, and with an ever-growing to do

list. They too have a form of moral hazard: they need to restructure SOEs and that requires developing better and deeper capital markets. But if the SOEs default and they are not held responsible for the default (say, because they argued that they wanted to get a higher level government their money back), then they get an underperforming business off their books. Bond investors fear SOEs that avoid paying their chits by defaulting, banks fear SOEs collapsing, and local governments are torn figuring out how to shift credit risks from banks to investors.

Defaults are a good thing, but structures are not going to change

Let us be clear: some defaults are not a bad things at all. And letting people know that the implicit guarantee isn't totally iron-clad may bring some very useful discipline to the Chinese political economy.

Concerns are instead likely to be about how the debt is called in and discipline established. Xi Jinping's administration has made clear that he wants to have the Party leading: the Party's charter had a specific clause added in 2017 to ensure that SOE leaders knew that they must 'ensure the implementation of Party policies and principles'. In practice, this means corruption policies. The 2020 SOE leader manual, for example, is called the anti-corruption policy following guide.

This is a simple illustration of a popular perception that is very unpopular in Beijing, which is that SOE defaults are due to corruption. (For background, Yongcheng, the coal company, reportedly attempted to transfer its better assets out before default). A common pattern with bank crises is that the bank's leaders are investigated for corruption. (Take Hengfeng, for example, a bank in Shandong which was on the brink of default until a unit of China's sovereign wealth fund injected funds into it... and its two previous chairmen were investigated).

Either way, Beijing is most likely to focus on holding individuals accountable for fraudulent or criminal behaviour, in an attempt to boost trust. Local governments are likely to do the safest thing in this situation: nothing. Beijing has been cutting their freedom to move for quite a long time. What is more important for them about the SOE defaults is how Beijing is pressuring them not to commit any form of malfeasance. China's top financial official and Xi confidante Liu He, said that Beijing would have "no tolerance" for misconduct. If you are a local leader or head of an SOE, the motivation therefore becomes to not be the one caught out. We expect a lot of work to rule in the next period. There is little incentive to be creative or entrepreneurial. There is a strong incentive to keep one's head down. This will last until the new legal guidance on managing state-owned assets is released at Christmas time.

Going after corruption does not solve the structural problem: local governments (and their associated SOEs) and private firms are short on credit.

Banks prefer larger SOEs. Many local governments now lack the funds to help their hometown champions. If they have to go to banks for credit, these same local governments are more constrained by the war on debt, and therefore local SOEs are likely to have to pay higher interest rates.

Private firms, perhaps paradoxically, may win out. In May, Chinese regulators seized a bank, Baoshang Bank, for the first time in two decades. In response, smaller banks across the country raised their rates for lending to riskier banks and companies — and without any form of government support, no matter how implicit, that usually means private firms. Private firms are so desperate that they resort to internal IOUs, some of which can be sold for less than face value. This is particularly common for property companies, who often can promise land for security (and also account for a large proportion of loans; nearly 40% of all bank loans are used for real estate). Any improvement in the performance of small banks will aid private firms: discipline on the highest level policy banks (the top level in Figure Two) will ease the pressure on the local state banks to invest, which will mean that local governments have less need to force small banks to support the state banks. The perfect bowl of porridge may, surprisingly, be made by regulators.

What does this mean for foreign investors? First, it will make more legally sophisticated and capital market capable jurisdictions — Shanghai, Guangdong — more attractive. The last two years have already seen an explosion in corporate bond issues being arbitrated and resolved in Shanghai. These areas tend also to be wealthier and already have more fiscal space.

Investors should also remember the multiple tracks of Chinese enterprise. SOEs, in Xi Jinping's formulation, should become 'stronger, better, and larger.' Central SOEs are already some of the largest companies in the world. SASAC, as is its wont, wants to make them even larger; recent mergers include in shipbuilding, coal, and train building. There will be a number of winners: State Grid with its ultra high voltage powerlines; Railway Corp and high-speed rail equipment; PolyCorp and nano-tech etc. As Jude Blanchette recently argued, China's industrial planners have adopted a "venture capitalist" approach, knowing that most of these might fail and that state banks will have to provide a back stop. The downside of this, as explored in this piece, is that some SOEs need to default. The upside is that some might succeed — and if that is the case, Goldilocks will not be the only fairy tale.

Another consideration is that a consistent story might be the best outcome of all. At present, it is hard to invest across all parts of the credit curve. China's credit market is far more lumpy. Smoother porridge, or in other words a nicely predictable policy regime, might be the best story ending for all.

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