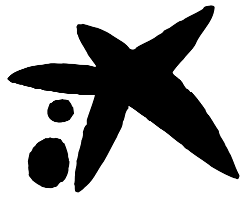

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Article

Financial markets

China’s economic policies: tightening, but not too much

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Javier García Arenas
Senior economist

China’s high level of corporate debt, which stood at 160% of GDP at the end of 2017 according to the BIS, has become a major source of concern for the country’s Executive.[1] This concern is well-founded: since late 2008, corporate debt as a proportion of GDP has grown by 64 pps and, compared to other countries, China is the only major economy with such high levels of both debt and debt growth (in the US and in the euro area, corporate debt stands at 73.5% and 101.6% of GDP, respectively). To put these numbers into context, ratios above 90% usually

represent a significant obstacle for an economy. In addition, bearing in mind the systemic importance of China's economy, doubts over the sustainability of this level of debt could have an impact on macroeconomic and financial stability worldwide.

Therefore, reducing this heavy burden and controlling financial risks have become two main priorities for the Asian giant's economic authorities. This emphasis by the Chinese authorities on mitigating the problem follows the impasse experienced in 2017, caused by the renewal of the country's power institutions. At the end of this political cycle, Xi Jinping has strengthened his leadership, giving him room to propose more decisive policies to reduce the high levels of debt.

In the first half of this year, significant steps have been taken towards deleveraging, focusing on three key economic pillars: companies, public finances and macrofinancial supervision. Nevertheless, following lower-than-expected economic activity indicators in Q2 2018 and the difficulties experienced by some Chinese companies (there have already been 23 defaults on bonds by Chinese companies between January and May, almost the same number as in the whole of 2017), the Chinese authorities have been forced to soften the measures taken. As such, we are currently in an environment we could call «softened tightening», which seeks to reduce indebtedness but without slowing the pace of the economy. It is interesting to note that this pattern (tightening and subsequent softening) is common to the three pillars in which the measures have been focused.

Let's start with the company pillar, which requires major reforms if we consider that almost two-thirds of corporate debt has been incurred by state enterprises. Nevertheless, the Chinese authorities have set only a modest objective: to reduce these enterprises' debt-to-assets ratio by 2 pps between 2018 and 2020, following the 0.4 pp reduction seen in 2017. Although a significant measure, this is not overly ambitious if we take into account that these companies' debt-to-assets ratio stands at 66%. In addition to this is the plan to convert them into joint stock companies,[2] as well as an ambitious anti-pollution campaign which has served to correct many of their inefficiencies. The softening at the corporate level has occurred through fiscal and credit support measures offered to small and medium-

sized enterprises in the private sector.

With regards to the public finances, the Chinese authorities have taken the problems arising from the debt of local governments very seriously. This is by no means trivial: corporate debt includes a large part of the debt of Chinese local governments, which have used special vehicles, known as LGFVs,[3] to finance expensive infrastructure projects and real estate developments. Since March, the Ministry of Finance has prohibited public banks from financing local governments either directly or indirectly, including funding through LGFVs. This is a significant measure to help slow the rise of local debt, which stands at over 40% of GDP. However, there has also recently been a softening of policy in this field: the Ministry of Finance has asked local governments to accelerate the implementation of the budgeted fiscal expenditure for local infrastructure projects, and it is considering increasing these governments' participation in public-private initiatives (currently, local governments cannot spend more than 10% of their total budget on funding such initiatives).

Finally, if we look at the changes in the macrofinancial sphere, we see that a significant effort has been made, making this the flagship of the new measures. The Chinese Executive has applied much stricter control measures to shadow banking products, which are largely responsible for the excessive growth in credit, and it has taken steps to curtail their links with the real estate sector. This process took on a new dimension in April with the issuance of new rules on the features which asset management products offered by Chinese financial institutions must have, both in the banking sector and the shadow banking sector. This process is due to be completed in June 2020. These guidelines will mean that the 27 trillion yuan in wealth management products (which represent a notable 32% of China's GDP) – savings products that offer high returns but are a source of significant risk –[4] will not be rolled-over and will have to be fully adapted to the new regulations in just three years. These are demanding regulations: wealth management products (and all other asset management products) will need to have longer maturities to avoid maturity mismatches, the yields will need to be aligned with the risks and returns of the underlying products (which are often in the construction sector) instead of offering guarantees, and these products will not be allowed to be used to

invest in other similar products that are considered high-risk. The measures implemented have already begun to curb the issuance of shadow-banking financial products and have led to a significant slowdown in the growth of credit, as we can see in the chart. However, the increase in companies' borrowing costs observed following this tightening of the regulations has led the Chinese central bank to soften its approach. In particular, measures have been taken to ease somewhat the financial conditions and to inject liquidity into the financial system, in order to make the impact of the new macrofinancial regulations more bearable (the reserve ratio[5] for banks has been reduced by 100 bps in April and by 50 bps in June, and the collateral requirements for accessing funding from the central bank have been relaxed). These are one-off measures and the Chinese authorities still have room to introduce new expansionary measures if necessary.

Over the coming months, the measures being introduced to reduce the high levels of indebtedness are likely to continue apace. All in all, we expect new measures to be implemented to soften and temper their scope, especially if there is an excessive slowdown in credit and activity – a scenario which cannot be ruled out if global protectionist tensions increase. The challenge faced in the current complex global context is significant and the Chinese authorities will need to tread carefully to bring the situation to a successful conclusion.

1. See J. García-Arenas (2018), «A closer look at the macrofinancial conditions in China», Working paper 01/1, CaixaBank Research.

2. Converting them into joint stock companies entails partially privatising them, due to the entry of private capital.

3. LGFVs stands for Local Government Financing Vehicles.

4. They are a source of risk for two reasons. The first is that a large part is invested in high-risk assets, with a significant weighting in the property sector (in which fears of a bubble are

all too well known). The second is that there is a risk of maturity mismatch between assets and liabilities, as the asset management products that are sold tend to have short-term maturities (six months), whereas the assets behind these vehicles have much longer maturities and are less liquid.

5. This is the percentage of deposits that financial institutions are required by law to deposit in the Chinese central bank.

Javier García Arenas

Senior economist

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