Topic 3: China – It May No Longer Be Possible to Engineer a Soft Landing

- A year ago we said credit risks in China had risen (defaults subsequently tripled in 2018); this year we update how credit itself has kept rising
- Over the coming four years, China may see a **very rocky landing,** lasting 5-6 quarters with unpleasant sectoral implications
- The primary driver of China's slowdown is *not* the Trade War, but local credit problems

Year-ago warnings of China credit risks saw defaults triple last year

Our China Topic one year ago in this publication – "Credit Risks Are Still Rising" – subsequently saw Chinese defaults *triple* over 2018, by both value and number counts. (We also extended our caution to an Asia-wide context for an outside publication.

We review Chinese indebtedness, where concerns have grown

As such we thought it opportune to review the overall state of China indebtedness, a topic re which we have express serious concern since late Summer 2015. Though we have tried not to cry Wolf! too early, our concerns have increased.

We propose the possibility of a **very rocky landing** for China's economy, sometime in the coming four years

At this juncture we propose the following scenario: In the coming four years (2019-22), don't be too surprised to see a roughly 15-18 month window (5-6 quarters) when the Chinese economy experiences what we will call – not crash nor crisis – but a **very rocky landing.** Such a landing will involve unpleasant consequences for many sectors, including those for which one might have presupposed would be well-shielded from debt problems. The reaction of one client recently summed it up best. While this client is currently in a booming sector, he told us, "I'm a squirrel," meaning that when times are good as now, he wants to store as many nuts as possible for when times don't turn out so swell. We thought that was wise.

We update a continued and unsustainable pace of Chinese debt growth

In what follows our main purpose is to update the continued (and unsustainable) pace of debt growth in China. We add in a very serious additional problem, of unreported and unrecorded debt (**hidden debt**). The worst news, however, is after waiting five years for signs of true debt restructuring, we have concluded there is little onshore enthusiasm to truly de-leverage. In fact, at the end of 2018 China's leaders seemed to have declared the problem of industrial overcapacity licked. Since the other side of the overcapacity problem is debt, this implies they think there's no need to restructure debt either.

Not all debt is bad

First, we point out for developing nations, there is no general presumption all debt is bad. This is the "good" part behind Chinese debt. There are genuine reasons for EM countries to resort to debt, especially for ones with as high a growth rate as China has had. Countries may, eg, want to pursue countercyclical fiscal policy, or build infrastructure, or promote the local bond market – all of which have figured among official Chinese goals. International economic mandarins have long held prudent rules of thumb for public debt/GDP ratios: 60% for developed countries (the Maastricht Criterion) and 40% for LDCs. These numbers are not model-derived but well-regarded nonetheless as rules of thumb generated by experience (as is also the notion that when a nation's total debt/GDP ratio exceeds 100%, it warrants closer scrutiny).

But the problem for China is it long ago passed beyond prudency norms

The problem for China is it long ago crossed beyond any such quaint notions of prudency. IMF figures showed China's debt has far exceeded past historical experience, including indebtedness during the Japanese financial bubble, the Asian Financial Crisis, the US subprime crisis and the Spanish housing crisis. Curiously, the IMF has stopped showing such comparisons in their Article IV reviews. But its separate breakdown of debt/GDP ratios by major sectors (corporate, government and household) showed a continuous rise between 2014-17, which begs the question of where all the ballyhooed "de-leveraging" went (and was the point of our theme article last year)?

China also disguises public and semi-public obligations

China's official public debt/GDP ratio remains < 60%, but the problem is China camouflages public obligations. It doesn't, eg, include state-owned enterprises, which nobody will believe isn't an obligation of the general government should they run into debt difficulties. It also disguises local government debt, and is further bedevilled (below) by the revelation of hitherto unreported hidden debt. Even some supposed private sector indebtedness – eg, HNA – might be considered public, judging by the way state institutions have stepped in to manage clean-up of obligations.

While China, Inc. has shown no willingness to restructure debt

Finally as stated above, having watched Chinese debt closely for a decade, and especially over the past five years, we think it's fair to now conclude China, Inc. has shown NO willingness to restructure debt. This is the primary reason why debt has continued to grow to historic dimensions. Besides the declaration of victory over overcapacity at the end of 2018 discussed above, generally the government's approach to debt management has been any pool of liquidity in a storm, approaching, and possibly this year, leading to more overt directed lending.

An overwhelming proportion of local government financing vehicles can't cover costs

For the past several years the IMF has presented an interesting breakdown of China's local government financing vehicles (LGFVs). The latest such tabulation suggested that an overwhelming proportion of LGFVs are not generating enough revenues (2017, latest year available) to cover even operational costs. This seems as good as any of a definition of a zombie company. In this environment of course the appropriate market response is lower credit spreads (we're being sarcastic)! We explained in this month's CNY section why such tactics are unlikely to stimulate growth. Eventually credit spreads and costs will continue widening if the underlying credit problem is not solved.

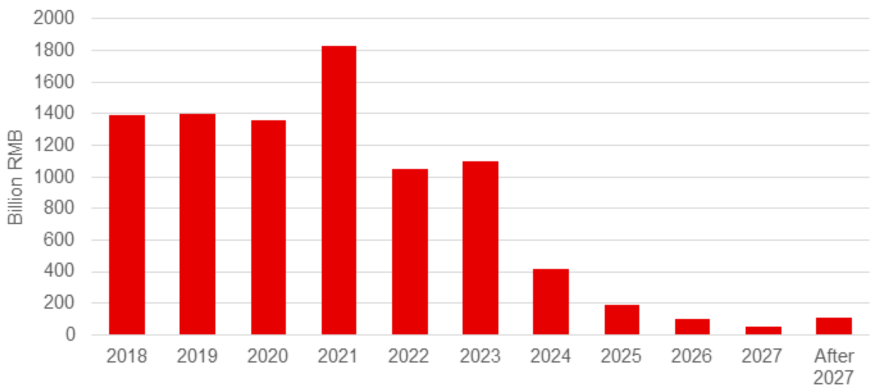
S&P's **hidden debt** estimates would more than double previously tallied local government debt

The latest development has been suggestion by S&P China's local government debt may ignore huge hidden debts (note our note last year discussed our suspicions then re credit that is not measured); the rating agency's calculations suggested numbers may total CNY31-42trn! Without delving into details over the past five years we have seen estimates of supposedly total local government debt balloon from CNY9trn to CNY18trn to CNY24trn to now, roughly, somewhere between CNY55-66trn!

A slowdown resistant to stimulus + an even larger refi problem imply **it may no longer be possible to engineer a soft landing**

Given that the economy has entered into a challenging slowdown – the point being the slowdown is primarily driven by local debt and not the Trade War – and with our doubts stimulus alone can fix it; and given the refinancing problem, if anything, may be more challenging this year than last; our conclusion to this note is that **it may no longer be possible to engineer a soft landing**.

CHINA'S REFI PROBLEM DOESN'T END JUST BECAUSE IT'S 2019



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