Special Report 2011/18

The risk of a hard landing in China

This article is part of a series of Special Reports that discuss the downside risks to the global economic outlook. In this piece, we take a closer look at the risk of a hard landing in China.

China's good track record?

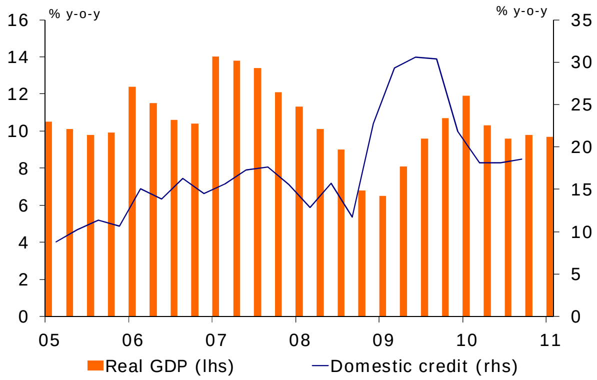
If Isaac Newton was asked to create a law on China's economy it would perhaps be the following: *To every Chinese optimist there is always opposed an equal pessimist*[1]. Over the past 30 years of economic miracle, many experts have predicted doom and gloom in China. Yet every time the Chinese officials have proven the nay-sayers wrong. The poor track record of the pessimists has made it difficult to forecast a hard landing. After all, everyone is almost sure that the experienced Chinese captains (read Communist Party) will, one way or the other, prevent a disaster from happening given that so much is at stake.

Their successful management of the global crisis during 2008-09 was touted as a perfect example of how a determined government must act in desperate times. When external demand plummeted as a result of the financial crisis in the West, the Chinese government, fearing large scale domestic public unrest, responded with a massive stimulus programme. Augmenting existing investment plans and pulling ahead investments initially planned in the future, quarter-on-quarter real GDP growth recovered swiftly (see figure 1). The government's stimulus programme did what it was meant to do: keep the yearly real GDP growth rate above the psychologically important 8% figure (9.2% over the whole of 2009) in spite of exceptionally strong external headwinds. To that we have to say, a job well-done!

[1] Based on quote by Isaac Newton: For every action there is always opposed an equal reaction.

But, the more important issue is whether the Chinese government managed to avoid a hard landing during 2008-09 without exacerbating the country's long-term problems? The pessimists believe that not much attention has been given to the long-term effects of the stimulus programme and this is likely to blow up in their face in the not-so-distant future. An array of adverse economic side effects is now materiallising and, as a result, China may finally experience the hard landing some doom-mongers have been expecting for years. But how would the country be able to go from hero to zero in such a short time span? Let's investigate.

Figure 1: Credit boosts growth in 2008/2009

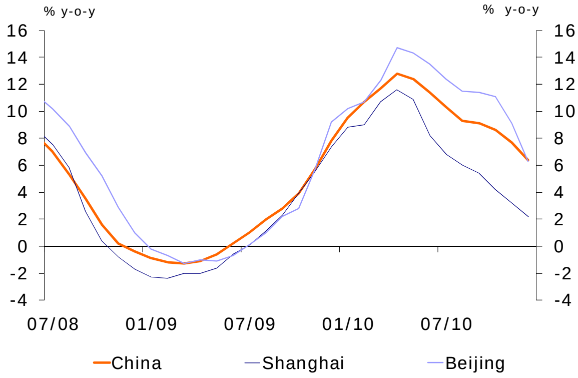


Source: EIU

The origin of today's challenges

The origin of many of the most pressing challenges that China faces China today can, in fact, be traced back to the massive stimulus programme in 2009. Although the central government conceived the stimulus plan, its execution was delegated to local governments. With local governments having few options to generate the needed cash for the central government's mandated investments, they turned to banks for financing. Local government investment vehicles (LGIV's), set up especially for the job, were able to borrow large sums of money from commercial banks. If the revenue generating capacity of the proposed investment project was doubtful, local governments simply guaranteed that the debt would be repaid. As a result, credit growth leaped to stellar levels (see figure 1). Armed with sufficient funds, these LGIV's went ahead and invested handsomely, mainly in infrastructure. Roads and high-speed railway lines were a particularly favourite investment, as these would unlock the inland regions' economic potential. China's central bank, the People's Bank of China (PBoC) also lent a helping hand by easing monetary policies substantially to support credit creation. Investments, already the main driver of growth, increased sharply, and nicely compensated for weaker external demand. So far, so good.

Figure 2: House prices



Source: Reuters EcoWin

Signs of trouble are emerging

As time progressed, however, the government started noticing that money spent quickly is usually not spent wisely. Even worse, many investments were carried out on political - rather than commercial – grounds. Therefore, at some point problems would inevitably surface. And so they did.

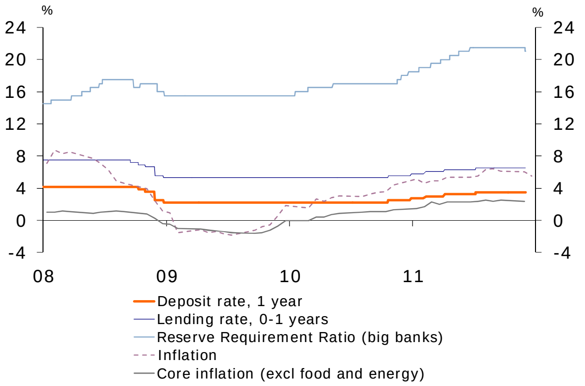
The formation of a real estate bubble in 2010 was one of the first signs of trouble. A combination of strong monetary growth and low interest rates – ingredients for an asset bubble – pushed up investment in real estate. As a consequence, house prices rose rapidly, rising by a peak of nearly 13% y-o-y in April 2010 (see figure 2). This average figure hides the fact that house prices increased more sharply in the major coastal cities. Noticing that a bubble was forming, the government implemented three rounds of macro-controls aimed at cooling down the real estate sector in 2010 and early 2011. To ramp up supply, the government investment heavily in social housing. It looked as if the plan worked, as house prices started to rise more slowly from May 2012 onwards.

A second sign of trouble was increasing inflationary pressures. While inflation was negative during the first three quarters of 2009, it increased in the months thereafter to around 5% by end-2010. There was also a 'bad luck' element involved, though, as bad harvests and cattle diseases pushed up food prices strongly. In any case, the Chinese government now saw itself confronted with a major challenge given that high inflation could stoke social unrest. Meanwhile, overall inflation accelerated more rapidly than anticipated, helped by the strong economic recovery. As a result, the Chinese economy started to show signs of overheating. The economy grew by 11% y-o-y in the period October 2009 to mid-2010 (see figure 1).

To address the overheating problem, the government decided that monetary reins had to be tightened. To drain liquidity from the market, the share of deposits that banks have to keep at the central bank (the reserve requirement ratio, RRR) was increased to record levels (21.5% for big banks) and loan growth was restricted by a quota on new loans, on top of the existing loan-to-deposit ratio of 75%. When all this proved insufficient, the authorities eventually raised interest rates as well (see figure 3). It took some time for the measures to work through to the economy, as inflation did not start to ease until August 2011.

In addition, the government's reluctance to raise interest rates had led to real deposit rates turning negative since early 2010. Depositors had to search for alternative, higher yielding opportunities. At first real estate was a preferred option, but this opportunity faded as the real estate market cooled. Meanwhile, banks, restricted in their loan growth and only allowed to lend at a rate slightly above the official lending rate, preferred to extend new loans to large state-owned enterprises.

Figure 3: Inflation, RRR and interest rates



Source: Reuters EcoWin

The small and medium enterprises (SME's), which are responsible for the majority of jobs in China, were finding it more and more difficult to obtain credit. Seizing the opportunity, banks turned to off-balance sheet lending, providing wealth management products that offer yields rather than interest to get around the government's annoying interest rate cap and loan growth restrictions.

Informal lending also exploded in the past year, also at far higher interest rates than the official rates. Credit growth continued to expand as a result, but now no longer under the direct control of the government and not showing up in official statistics. The official figure of the increase of total credit to GDP (see figure 4) is therefore likely to be an understatement. In spite of the government clamping down on off-balance sheet lending facilities in the past months, credit-to-GDP increased to a whopping 168% of GDP when off-balance sheet lending is taken into account and an even higher (173% of GDP) when informal lending is included (according to one estimate[2]). With banks having a major incentive to expand loans as much as they can to maximally profit from the government mandated interest rate gap between loans and deposits, the true figure may even be higher than that.

A 'perfect' storm?

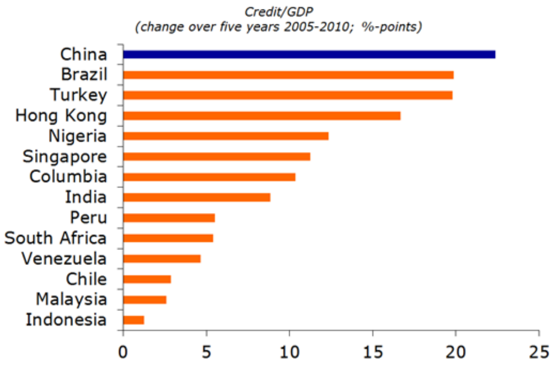
Expansive government policies and the reaction thereto have led to a multiple facet storm brewing up that could potentially have a devastating impact on the financial sector and, in turn, on economic growth in China. Given the sharply increased level of credit, the Chinese economy is far more vulnerable to any problems in the financial sector today than it was three years ago.

For one, the real estate market is highly fragile. Already house prices have started to fall in a number of major cities (by an average of 0.3% year-on-year in cities in coastal provinces during September). Meanwhile, the number of homes for sale has increased sharply in most cities, with China's housing inventories rising by 40% by the end of 11Q3. With credit becoming more difficult to obtain, real estate developers find themselves forced to lower prices in order to generate much needed cash flows. A sharp correction in the real estate market would impact banks, which, on average, have a direct exposure of around 20% of total assets to the real estate sector. In addition, the indirect exposure to adverse developments in the housing sector may be even larger through other sectors that will suffer from a sharp downturn. Finally, Chinese investors in the real estate market will potentially suffer a wealth loss and, as corporates have reportedly also invested in real estate using bank loans meant for other purposes to finance these investments. Banks could thus be impacted through this channel as well. A stress test carried out by China's banking regulator concluded that banks would be able to manage a 50% real estate price drop.

[2] HSBC Global Research. China Banks, Shadow Banking Conundrum, 19 October 2011.

However, this figure is probably overly optimistic, just as a 50% fall in home prices across the board is likely to be overly pessimistic. In addition, banks will also have to brace themselves for the risk that LGIV's will not be as creditworthy as initially expected. Many LGIVs were financed with 3-year bullet loans that will be due in 2012. Repayment of the LGIV debt has become more and more questionable, as their income is mainly derived from transfers from local governments. Even those LGIV's that do have a commercial source of income tend to have a weak financial position. An investment in a highway that is to be repaid by toll fees, for example, will hardly earn back the investment in five years (supposedly the average tenor for such infrastructure investments). Estimates of the total amount of LGIV debt differ. While the official and most widely used figure is CNY10.7trn, the estimates range from CNY 9 to 14 trillion, or between 23% and 37% of GDP. With land sales, a favourite cash-generating method for local governments, becoming less lucrative in light of the slowing real estate market, it seems unlikely that all the LGIV debt can be repaid in full. It is, however, unclear exactly how dire the situation is. A maximum of 30% of banks' balance sheets are seemingly exposed to LGIV debt and estimates of bad LGIV debt range between 20% and 30% of total debt. As much as 70% of total LGIV debt could be questionable, presents a significant risk to banks' financial health.

Figure 4: Credit to GDP



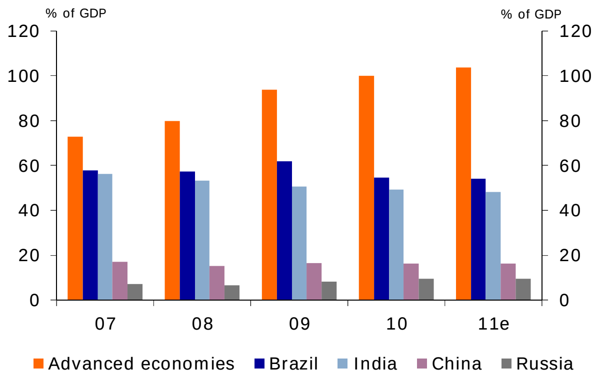
Source: IMF

Making matters worse, these pressures on banks' asset quality come at a time that the external outlook is deteriorating rapidly. Although China is less dependent on export today than it was in 2008, exports still amount to roughly 30% of GDP and China's economy will therefore not be immune to a weakening external environment. A number of SME's have already run into financial problems, especially those that are highly leveraged. In Wenzhou, a particularly entrepreneurial city, numerous small business owners literally went into hiding to avoid creditors claiming repayment. In Guangdong province, mass protests recently broke out in a number of cities, as workers demanded to continue to be able to work overtime after this was cut following a contraction in demand for Guangdong's exports. In addition, HSBC's purchasing managers' index (PMI) fell sharply from 51 in October to below 48 in November. China's official PMI later confirmed the downward trend. If GDP growth slows sharply, the problems hanging over the financial sector will be impossible to manage and a financial crisis looms.

Do results from the past matter after all?

The question, however, is if this storm will actually materialise. Aside from the weakening external environment, which is outside China's control, a lot still depends on the future actions of the Chinese government. In this respect there is hope. As it has proven in the past, maintaining stable growth is imperative for the Communist Party. Even more so as the top positions within the Party and the Government will change hands in the coming two years. The willingness of the authorities to act to maintain economic stability is therefore even higher than usual. In addition, inflation, has been easing rapidly in October (5.5% y-o-y) and November (4.2% y-o-y). This means the government will also be able to act. Loosening monetary policies, which, some argue were tightened too much, will allow credit growth to increase more rapidly again. This would relieve the stress on the economy and would support growth. With tight credit conditions being largely responsible for many of the problems in the first place, monetary easing will take significantly less time to work through to the real economy than the rounds of tightening in the past year-and-a-half. A first move that indicates the People's Bank will shift its policies from fighting inflation to supporting growth was made when the reserve requirement ratio was lowered by 50bp's on November 30th, effective per December 5th. The central bank has also injected liquidity in the banking system by more silent means through its open market operations and banks have been requested to increase credit growth (or, in other words; to throw worse credit after bad credit). The sharply increased loan growth in the last week of October indicates that banks are complying.

Figure 5: Public debt



Source: EIU

If the outlook deteriorates further, interest rates may be cut and even the loan-to-deposit ratio might also need to be adjusted, as the scarcity of deposits is currently a main impediment for banks to grant new loans. Although there it is likely that the government will act more aggressively than expected before, such moves don't seem imminent. In addition to monetary policy adjustments, the government has started to address problems in other ways. Tax cuts have been handed to SMEs and banks have been called on to be 'kind' regarding rolling over SME debt – this is a popular way to postpone dealing with debt problems China. Action is also being taking with respect to the LGIV debt problem. An easing of regulations to make rolling over LGIV debt easier is underway and a pilot that allows local governments to issue bonds is underway. Depositors, who still face negative real deposit rates – even more so if interest rates are lowered - will likely prefer to lend to local governments than to private companies, as the local governments are de-facto guaranteed by the central government. This will allow local governments to dip into households' savings to service their debts, which will relieve acute repayment pressures although, of course, it will not reduce their overall debt level (but let's cross that bridge when we get to it, the government likely thinks).

In addition, the Chinese banking system is still rather strong and well capitalised. This is the result of the high margins banks are able to make. With mortgages in China requiring a substantial down payment, home sellers will bear the first impact of house price falls. In its first analysis of China's banking system, the IMF called the country's banking system 'robust'. The banking system will therefore be able to weather the storm up to a point without government help. However, if the storm gathers momentum, non-performing loans – that are still very low according to official statistics – are likely to rise rapidly. In that case, the government will be required to bail out banks to prevent a financial meltdown, especially if the economy is already slowing on the back of weaker exports. Given the central government's still solid financial position (see figure 5), this should not be a problem, although it remains to be seen in what way the government will finance any large-scale bailout. As inflation should not be a problem when growth is weakening, this will likely not stop the government from acting either. Of course, this may come back to haunt the government at a later stage.

Bottom line: In spite of the increasing headwinds, we see the soft landing scenario as the most likely for 2012, which implies the real GDP growth rate will slow yet remain between 7% and 8% next year. However, as achieving this is becoming more and more likely to depend on strong growth-supporting policies, this scenario is subject to the Chinese government being able to engineer a soft landing. If not, a hard landing scenario, with growth slowing to below 7%, could materialise after all. We can therefore conclude that you can count on China to support global growth next year, as long as you have faith in the expertise of the Chinese captains to navigate through stormy waters.

December 2011
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