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TalkingPoint

China's local government loans: another bubble?

The numbers might look frightening, but China's local government debt problems can be managed if its leaders proactively address them and make genuine moves to rebalance the economy, writes Robin Parbrook, Head of Asia (ex Japan) Equities

August 2011

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The next five years will be crucial for China. However, it is hard to say for certain whether the country's leadership will take the bitter medicine that is necessary to move the economy from an investment-led to a consumption-led model. What we can say for certain is that the country must undertake a long and, maybe, painful process to deal with the issue of inflation and the extent of bad loans in the banking sector. Saying this, these issues can be managed over time if China proactively addresses them and genuinely moves to rebalance its economy.

Inflation nation

Chinese premier Wen Jiabao triggered much excitement among the China stockmarket bulls by saying: 'China has made capping prices the priority of macro-economic regulation and introduced a host of targeted policies. These have worked!'

However, twenty-five years ago, the first thing I learned in my first year studying economics at Edinburgh University was that 'inflation is always and everywhere a monetary phenomenon.'

In this instance, I'd prefer to put my faith in economic orthodoxy and years of financial history rather than in Premier Wen. Capping price rises on selected goods clearly does not contain inflationary pressures; removing excess liquidity from the system, however, might.

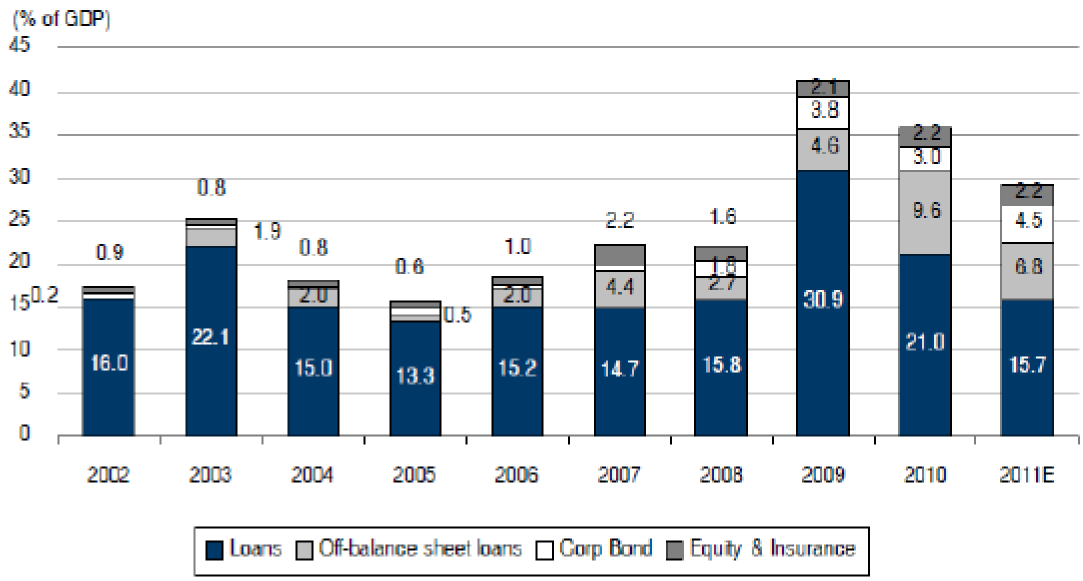
There is little real evidence of a slowdown in inflationary pressures in China. A look through China's online chatrooms will tell you that most people in the country laugh at the official CPI rate. Much of the CPI basket is in controlled items. Over this year, we have seen numerous examples of companies being refused price increases (power utilities to Unilever shampoos, to toll roads and airports being told to cut rates contrary to their regulatory frameworks). The government has also released strategic pork supplies (clearly China's equivalent of oil) to contain inflation.

> "The good news is that China's starting government debt to GDP is quite low so, while the losses are large, the numbers should be manageable over time"

We also do not think China has really got to grips with the root of its inflationary problems which is, in our view, the significant credit overhang created by the extraordinary loosening of monetary policy over the 2009/10 period. In a recent paper, Vincent Chan of Credit Suisse concluded that now the PBOC has started to release total system financing data (i.e. including shadow banking), the credit overhang is much larger than expected. To put some numbers into perspective, in 2009 Chinese banks lent the equivalent of 31% of Chinese GDP and in 2010, 21% of GDP. These are big numbers! However, if we include the off-balance sheet loans, the total system growth was 39% of GDP in 2009 and 34% in 2010 – even bigger numbers!

Basically total system funding grew 71% over a two-year period, and credit to GDP jumped from 120% to 166%. This is easily the highest in the emerging market universe. Chart 1 separates out the numbers in detail and demonstrates quite clearly the extent of credit growth in China (and why we have a few inflationary pressures there).

Chart 1: China's New Supply of Total System Funding

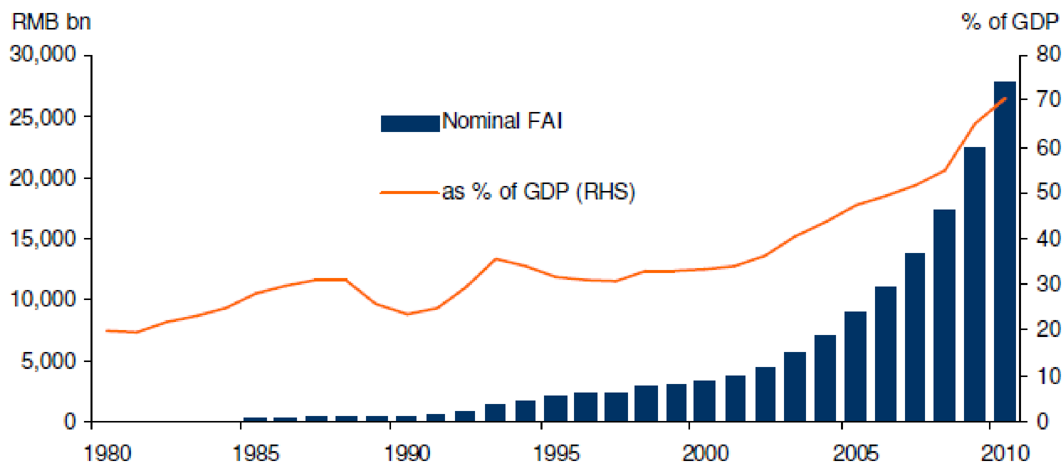


Source: CEIC, Credit Suisse, June 2011

China's credit to GDP is now well above its long-term trend line, and well above what the Basel Committee recommend as a level at which counter cyclical capital buffers should be imposed to get credit down to a less dangerous and more sustainable trend. As Vincent Chan points out, there is a very high incidence of financial crises subsequent to a banking system breaching the critical point.

In our view, any loosening of monetary policy at the current time is likely to be limited and China's inflation problems are much more structural than cyclical. There is far too much credit in the system. The latest fixed-asset investment numbers (still growing 25% yoy and rising as a percentage of GDP as shown in chart 2) and the property investment numbers (rising 35% yoy as inventories continue to grow as shown in chart 3) do not suggest an economy suffering under extremely tight credit conditions.

Chart 2: China Fixed-Asset Investment still growing a % of GDP



Source: UBS

Chart 3: Property investment accelerating not slowing

Source: Morgan Stanley Capital Markets

Property investment accelerating as the bubble shows stretch markets

The politically sensitive property market remains aggressively valued and, mostly, a speculative playground for China's wealthy minority. According to figures from Deutsche Bank, China Overseas Land (the country's largest developer) has seen its average selling price per square metre double in four years, and treble in six years. This, if anything, understates the extent of price rises given the trend is now towards small, lower-tier (i.e. cheaper) cities in China, compared to six years ago.

Given the constraints discussed above, we think it's unlikely that China will dramatically loosen policy given this would further inflate the property bubble, cause further problems with declining returns on capital (due to excessive fixed-asset investment) and exacerbate local government debt problems, if they try this 'trick' again.

Back in 2007, in one of Premier Wen's more realistic quotes, he described China's growth model as 'unsteady, unbalanced, uncoordinated and unsustainable' – we would wholeheartedly agree with this. However, given all of the above, we think any major loosening of Chinese policies in the near term is unlikely, so a drastic rise in the market on the back of such talk should be sold into.

If we're wrong and China panics and genuinely loosens, pumping more credit into the system through the banks (in a move that would be extremely worrying and very inflationary), markets are likely to bounce strongly in a wave of euphoria.

China banks – 'whoops, they did it again'

During the first half of the year, it became evident that Chinese banks piled on a huge amount of bad loans in 2009/10 by lending to state-owned enterprises (SOEs) and local government financial vehicles (LGFVs) where repayment has become uncertain. The numbers are quite staggering in their size – local government debt alone on official numbers – is RMB10.7 trillion (c. 25% of 2010 GDP) – and this does not include local government SOE-related debt and other potential contingent liabilities.

The key questions are, of course, how big is the black hole likely to be and who is going to pick up the tab. We expect a long and painful work out – with much ambiguity and inconclusiveness. Rumours of a bailout are already starting to swirl. If this were to happen, the government would have to put up RMB2 to 3 trillion to take the worst of the local government loans off the banks.

Recently, several research groups have attempted to qualify the problem: Merrill Lynch, CS, Fitch, Moody's, HSBC have all had a go at this rather large task. None of the resulting papers have made cheery reading. HSBC's report looked into the creditworthiness of corporate bond issues and each banks' exposure to them. Without delving into too much detail, it makes disturbing reading. Financial guarantees to third parties are widespread which makes many issuers more indebted than they first appear, they also estimate that a lot of bond proceeds (c.25% according to HSBC numbers) go straight into property speculation/investment. This compares with the official classification of 8% of corporate loans granted to property developers. More worrying still, when they look at repayment capabilities, around 40% of issuers' return on capital is below the benchmark lending rate (5.3%). The situation gets worse when they look at LGFVs where many entities are not even in a position to fund any interest payments on their loans.

As auditor-general Liu Jiayi said in the first official report on local government finances: 'Some local government financing platforms' management is irregular, and their profitability and ability to pay their debt is quite weak.' We have a bad feeling that this may prove to be one of the great understatements of 2011. However, full credit to the auditor-general for highlighting, at an official level, the seriousness of the situation.

In summary, the numbers are bad. The market had focused principally on LGFV loans which may well be particularly rotten but it is also the case that many SOE loans extended in 2009/10 could go bad too.

The good news is that China's starting government debt to GDP is quite low so, while the losses are large, the numbers should be manageable over time. If China proactively deals with the issues and genuinely moves to rebalance its economy away from its fixed-asset, state-led investment model, to a more consumer-led economy, we can be optimistic. The next three to five years will be a key period for China – any move to repeat the mistakes of 2009/10 should be viewed very negatively.

What of the rest of Asia?

Despite the general gloom, we are largely upbeat on the rest of Asia. Economies are generally in good shape to weather any storms. GDP growth is generally healthy and in most countries is being driven by a good balance of consumption, investment and exports.

Inflationary worries remain but, if we are correct, and the US recovery is sluggish, inflationary concerns in much of Asia should start to ease (unless a new round of QE unleashes further spikes in commodities prices and/or a collapse in the dollar). Similar to China, in many countries, monetary conditions are too loose. In Asia, however, conditions have been nowhere near as loose as China over the last two years and many countries have allowed their currencies to appreciate rather than stubbornly try to sterilise all capital inflows.