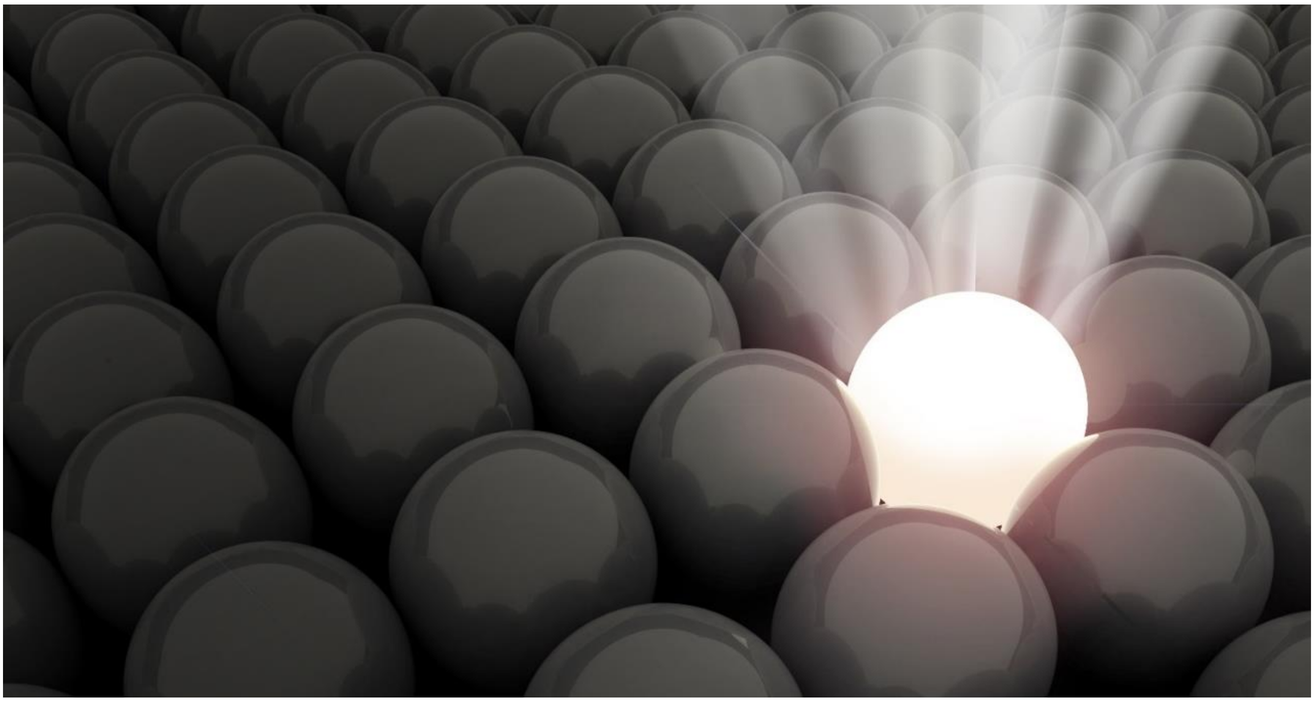
# The Frontier Line

Thought leadership and insights from Frontier Advisors

## China credit growth

Issue 95, **April 2014**



David Xu is a member of the Capital Markets Team responsible for dynamic asset allocation and general capital markets research. David also has client responsibilities for one of Australia's largest industry superannuation funds and one of Australia's leading rollover funds. Prior to joining Frontier, David completed the ANZ Institutional Banking Graduate Program and completed an internship with KPMG in their consulting division. David holds a double degree in Commerce, majoring in finance and economics, and Science, majoring in statistics, from the University of Melbourne. David has passed all three levels of the CFA program.

# Rapid credit growth in China

In February 2002, US Secretary of Defence Donald Rumsfeld made this now famous (infamous?) comment at a Pentagon press briefing:

> *"…there are known knowns: there are things we know we know. We also know there are known unknowns: that is to say we know there are some things [we know] we do not know. But there are also unknown unknowns—the ones we don't know we don't know."*

While these remarks were made as a general comment on the limits of human knowledge and understanding, they are just as accurate when describing the limits of analysts' understanding of the Chinese economy, its policymakers and its impact on global capital markets.

In this issue of *Frontier Line* we focus more on the *known knowns*, as limited in number as these may be when discussing such a complex and large an economy as China's, and our reading of some of key issues it faces today. These include the perennially mentioned reforms, China's rapid credit growth and its consequences – an issue which has been receiving increasing mainstream coverage, and the context behind these topics.

# Politics and policy

The political and policymaking situation in China is an especially important issue given its economy remains largely centrally controlled. In November 2012, China completed a once-in-a-decade leadership transition, bringing to power President Xi Jinping and Premier Li Keqiang (second in charge).

Unlike previous regimes, which have primarily targeted economic growth, the current leadership's focus will be on enacting structural reforms, such as financial sector liberalisation and reform of the State Owned Enterprise (SOE) sector. At the same time, the Chinese leadership will need to engineer a smooth transition to a lower, but more sustainable growth path.

At this stage, regular China followers may be asking how this time is any different? Don't the authorities, regardless of the individuals in charge, always mention reforms? While this scepticism is entirely understandable, there are key differences that make us more optimistic about the likelihood of implementing reforms and their impact on the economy.

Firstly, the conditions for reform appear to be better aligned this time around. Secular conditions, primarily the maturing Chinese economy, mean previous "quick fixes" such as infrastructure spending are no longer as effective or productive. The key leadership appear to be convinced reforms are needed to ensure the continued sustainable growth of the Chinese economy.

Secondly, in the years ahead, China faces a structurally lower growth rate, a rising middle class and the demographic challenge of an aging population. On the leadership side, they possess the willingness and capability to enact reforms (the leadership retains the support of key Communist Party factions and the military). As for the ordinary citizens, they want official corruption stamped out or at least reduced, along with a more equitable distribution of wealth and opportunities.

However, it is important to recognise this will likely be a gradual and bumpy process as long standing economic imbalances are addressed. It will take time for the economy to move from being managed by central control and quantity control to an economy increasingly driven by market priced signals.

# Economy

In many ways, the term economic imbalances neatly summarises the key issues the Chinese economy faces, especially when attempting to discern their origin. Before we describe some of these imbalances, we note the key drivers of China's economic growth over recent decades.

The first stage of China's economic growth story was driven by exports and the second by investment (mainly infrastructure and property). Neither of these engines can continue to be the driver of China's growth.

The Chinese economy has become so large that trade surpluses (exporting more than it imports) would, if maintained, likely become a source of rising global trade friction and a sign of stalled reform efforts.

At the same time investment spending is becoming increasingly unproductive with symptoms of wasted investment becoming apparent.

The economy needs to mature, and become increasingly driven by private demand (demand not driven by government intervention).

The relative importance of private demand (primarily private consumption) in China, in this second period is significantly lower than other comparable economies in part due to an excessive savings rate. The lack of a wide spread and effective social safety net has been a major driver of this excessive saving.

Interest rate repression, keeping the cost of borrowing low and therefore keeping the interest paid on deposits low as well, has also been key to this.

A related impact has been the effective redistribution of wealth from the individual to the state. A general lack of attractive alternatives to bank deposits has also played its part.

As a consequence, so-called Wealth Management Products (WMPs) have emerged in recent years. These have been marketed as safe, high yield investments for both retail and high net worth individuals (more follows). Even before WMPs, the degree of property price appreciation across the country has some commentators labelling it a bubble (more follows).

The economy is dominated by SOEs which have historically received preferential access to capital and been the recipients of other quasi-state support. This has manifested itself in a corporate culture focused on growth in sales or market share, rather than profitability. In turn, this has fuelled significant overcapacity issues in key industries such as steel manufacturing.

Another sector which may be showing signs of excess is China's residential property market. The rapid appreciation of property prices across China over many years, and its importance to the economy, has led to some observers pointing to the sector as a material source of risk. In the near term, the property sector is indeed very important as the economy undergoes its transition away from an infrastructure investment driven model of growth. There is also a significant portion of household wealth tied up in property.

While it is inevitable excesses exist across some parts of the sector, to label it a bubble is to overlook the valid underlying drivers of its growth – urbanisation of China's rural population and the lack of viable alternative forms of investment or stores of wealth.

# Property

Beginning in July 2010, Chart 1 shows that from 2013 average prices have steadily increased across China. Average prices in tier 1 cities, with the exception of Shanghai, have rapidly outpaced growth across the rest of the country. By way of comparison we have also included the US Case-Shiller 20-City Composite home price index, indexed to the same date, which shows the magnitude of the recovery in US house prices since their trough.

In the past one to two generations, there has been a deliberate program to encourage mass urbanisation – the migration of rural dwellers into urban areas and even the urbanisation of once rural centres. This is particularly true in tier 1 (the largest and most economically dynamic cities – Shanghai, Beijing, Shenzhen, Guangzhou) and tier 2 cities (other large cities, provincial capitals) where there are greater work and education opportunities.

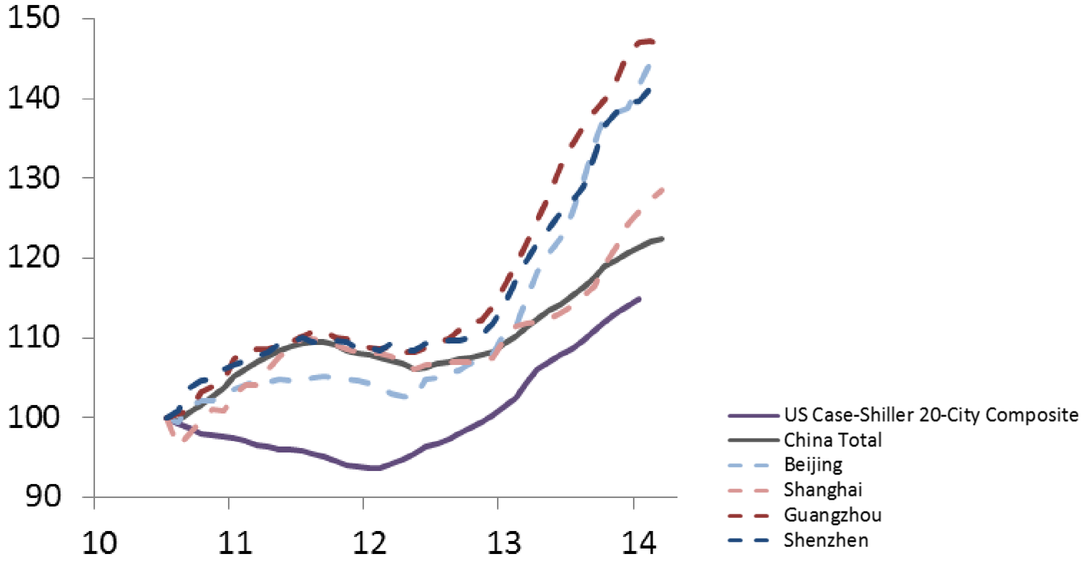
We also note the lack of alternate sources of investment or stores of wealth other than bank deposits.

Property is one of the few. Over many years, prices have grown more often than not, and at a rapid pace. It is also a real asset, providing a degree of inflation protection, which is particularly important in a country where real interest rates (interest rates adjusted for inflation) have rarely been in positive territory.

Beyond property though, there are few widespread alternatives. China's capital markets (equity market and domestic debt markets) are still developing, while its wealth management industry is still in its infancy.

For this reason, demand for property remains strong in China. Whilst there are pockets of overvaluation, debt levels in the property market are not high and the likelihood of a significant housing downturn across the country appears low.

Chart1: Average Residential Property Prices – China vs. US – Indexed to July 2010




Source: China Index Academy, S&P Indices, Frontier

# Credit growth

An area where we agree with the consensus view is the rapid pace of China's credit growth over recent years.

Since the Global Financial Crisis (GFC), China has indeed experienced a significant increase in the level of borrowing. At the same time, the efficiency of credit has declined (each additional unit of credit growth has produced a successively lower unit of output).

This phenomenon appears to have its origins in the GFC-era stimulus measures which targeted infrastructure investment and increases in productive capacity. While the stimulus was effective in shielding the economy from the impact of the GFC, its withdrawal has seemingly contributed to the rise of shadow banking (more below) and the generally high level of credit growth.

Another key driver has been the tendency for corporations to grow capacity, often by drawing on cheap credit, rather than committing to increase profitability.

While the rapid growth in credit is concerning and does present a material risk to the economy over the medium term, we believe there is a lack of evidence suggesting an imminent crisis is set to occur.

In addition, there are a number of factors which make us suspect that any fallout can be largely dealt with.

Firstly, the latest national audit results (released December 2013) show the aggregate level of assets is more than enough to cover the aggregate level of liabilities and that ratio of the two remains low compared with other economies. This suggests if mass defaults do occur, or if a significant crisis erupts, the authorities have sufficient resources to stabilise the financial system and economy.

Secondly, the authorities recognise the potential for dangers and are unlikely to let things get out of control. There has been increasing evidence of an evolution in their approach to this issue over the past 18 months ranging from how the Peoples Bank of China (China's central bank) has dealt with fluctuations in short term interbank interest rates (the interest rates banks charge to each other on short term loans), to more numerous reports of debt defaults without bailouts.

These developments seem to be initiatives by the authorities to introduce market forces to the evaluation and use of credit (for both borrowers and investors), and to reinforce that the Government will not necessarily step in as a backstop. Investors do need to take account of risk.

This is not to say there are not significant bad loans in China. Clearly there are many loans made that will never be paid back. However, the problem is not as large currently as was the case in the late 1990's. The Government retains the ability to contain the problem as long as it acts judiciously.

# Shadow banking

One of the consequences of this rapid credit growth is the emergence of the shadow banking sector. Shadow banking refers to credit creation or financial intermediation that occurs outside of the formal banking channel. It has emerged in recent years as the proportion of bank lending in total credit growth has declined and WMPs and other trust/entrusted products have become more widespread.

It is important to recognise this is neither a strictly positive nor negative development. For instance, shadow banking is a symptom of a developing and broadening financial system, diversifying risk away from the banking sector towards other holders of capital.

In this sense, shadow banking is a natural (to a certain extent) evolution of China's capital markets and is hardly unique to China.

However, WMPs, trusts and other vehicles for credit creation, such as local government financial vehicles, have contributed to an increase in systemic risk. Some of these structured products take advantage of the asset-liability mismatch (long dated liabilities met with assets that can be called at relatively short notice), are opaque in nature and contain a pool of poor quality assets.

# Conclusion

There is a credit issue in China, many loans have been made with a low probability of being repaid and more defaults are likely. However, the Government retains significant financial assets and has the legislative authority to contain the issue. Indeed, the debt crisis in the late 1990's was a more significant issue as a proportion of GDP than the current credit concerns.

The changes in China will mean slower growth and less resource intensive growth as consumption rather than investment becomes the key driver. Other things being equal this is a negative for Australian resource companies. This needs to be seen within the context of much larger demand for commodities than a decade ago which will continue to be strong albeit with much lower potential growth.

Level 16, 222 Exhibition Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

**www.frontieradvisors.com.au**

**@frontier_adv**

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a wide range of services and solutions to some of the nation's largest institutional investors including superannuation funds, government/sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis, and general investment consulting advice. With around $200 billion in funds under advice we have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients. At Frontier, we're on your side.