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IT'S NOT JUST TRADE: DON'T OVERLOOK CHINA'S CREDIT BUBBLE

Many investors are focused on the outlook for trade talks with the U.S., fearing an all-out trade war that would negatively impact equity markets. But investors may have overlooked the mounting problems caused by the recent and rapid expansion of credit in China.

Fears about a U.S.-China trade war have been grabbing the headlines—and spooking investors—in recent weeks. This is particularly evident in China where, as trade discussions soured between the two countries in May, the Shanghai Composite Index fell by around 10% from April's levels.[1]

With U.S. President Donald Trump threatening to authorize the next tranche of trade tariffs (and subsequently postponing some of them) and with China considering countermeasures, the effect of a continued trade war on the Chinese economy could be significant.

A trade war is certainly a concern. But we feel markets are underpricing other potentially bigger systemic risks to the Chinese economy: particularly, the rapid and worrying expansion of credit in recent years.

Growth has been faltering in China, falling from more than 14% annually before the financial crisis, to less than 7% now, a major contraction for the world's second largest economy.[2] The Chinese authorities have responded by turning on the credit taps, stimulating the economy with increased borrowing. The problem is that the further credit expansion extends, the less effective this strategy becomes.

[1] Bloomberg, June 2019.

[2] Why the world is unprepared for the economic dangers ahead, New Statesman, March 6, 2019.

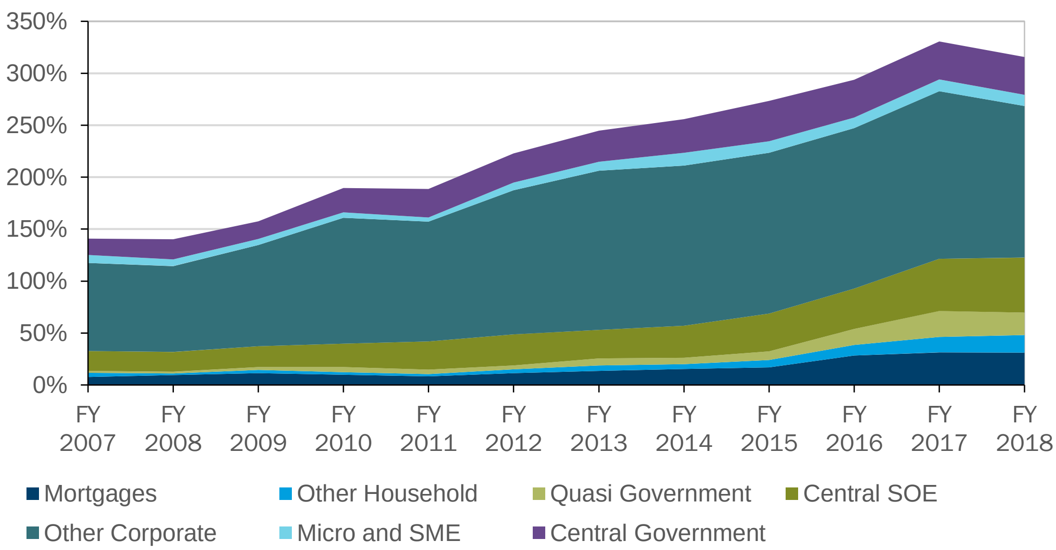
In 2008, the return on credit, which measures how effective new credit is at stimulating growth, was running at around 0.75. So each yuan of credit generated 0.75 yuan of nominal gross domestic product (GDP). Since 2014, this ratio has averaged only 0.25.[3]

Worrying still are the rising tail risks. However you look at it, China's massive expansion in credit should be cause for concern. Key measures tracking the growth in credit tell us that this rate of expansion is not only unsustainable but will also lead to a significant hike in non-performing loans, and at some point have a major impact on China's fixed income and equity markets.

Unsustainable credit growth

Consider the credit-to-GDP ratio, which measures the level of credit in relation to the size of an economy. When both on- and off-balance sheet credit is included, some estimate that it has grown in China to around 300% since the financial crisis from a base of almost 150% (Exhibit 1).

Exhibit 1: China total credit to GDP ratio



Sources: Source: Peoples Bank Of China, China Trustee Assoc., Hong Kong Monetary Authority, Bank for International Settlements, CEIC Data, Wind (CN), Bloomberg, Columbia Threadneedle Investments

[3] CEIC, PBOC, Bloomberg, Wind, China Trustee Association, HKMA, BIS company data/ Columbia Threadneedle Investments estimates, as well as Autonomous Research: 'China Macrofinancial. Unproductive credit continues to mount.' Charlene Chu and Yundi Zhang, July 2017.

In comparison, during the 2000–2008 run up to the global financial crisis, the U.S. measure grew by 80% to around 350%. Indeed, research has shown that every time credit has expanded by more than 30 percentage points over a five-year period from a base in excess of 100% it has ended badly.[4]

The credit-to-GDP gap, a measure favored by the Bank for International Settlements, which tracks credit-to-GDP in relation to its long-run trend, is also worth noting. In China this gap has been running at more than 20% in recent years. Looking at previous banking sector crises over the past 50 years, a gap of this magnitude has been a very good indicator of impending banking issues.

We believe investors in China should be preparing for an increase in the default rate. Official Chinese data shows non-performing loans at just 2%. But history tells us that when credit has been expanding at the rate it has been in China, non-performing loans are more likely to be at levels of around 20%.[5]

So where are these non-performing loans? The answer is in three places: local government lending, which is often used to finance infrastructure projects; banks' off-balance sheet exposure (particularly the hugely popular wealth management and asset management products that are used to take lending off banks' loan books); and China's smaller banks, which have grown much faster than their larger rivals in recent years.

The numbers are big. As a whole the Chinese banking sector has expanded around 3.5 times to $36 trillion since 2008. The off-balance sheet loan book in China alone is estimated at around $4.5 trillion, bigger than the total loan book of the four biggest U.S. banks (Bank of America, J.P. Morgan, Citi and Wells Fargo).[6]

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[4] Federal Reserve March 2019/IMF Working Paper, Credit Booms – Is China Different?, Sally Chen and Joong Shik Kang, January 2018.

[5] IMF Country Report 17/358. People's Republic of China, Financial System Stability Assessment, December 2017/Emerging Advisors Group, Why are Chinese NPL Ratios So Low? Crystal Cheng, January 2019/World Bank IMF Working Paper, Systemic Banking Crises Revisited, Luc Laeven and Fabian Valencia, September 2018.

[6] Emerging Advisors Group, Just How Big is China's Financial System?, Crystal Cheng, January 2018/Autonomous Research/PBOC March 2019.

Implications for equity and bond markets

The good news is that, with the exception of the corporate sector, foreign currency borrowing in China is low. So a rerun in China of the 1997 Asian crisis, where high dollar borrowing was the trigger, is not a concern.

However, there are around $45 trillion of banking assets in China when off-balance sheet assets are included. With China holding an estimated $3 trillion in foreign currency reserves, it would not take much in the way of capital withdrawals for these to be quickly eroded.[7]

In the event of a need to shore up its banks, China's authorities would be forced to take a more radical step. This could see the government recapitalizing the banking sector, a move we calculate could dramatically increase the country's official debt-to-GDP levels from their current levels of around 48% to more than 70%.[8] This would still be in line with many western governments, but it would be no easy fix.

China could become the first nation to absorb such a sharp expansion in credit without experiencing problems, either by skillful deleveraging and lower growth, devaluing the currency, or more likely via an expensive recapitalization of the banking sector. However, the risk of an abrupt and painful bursting of the Chinese credit bubble, with serious ramifications for global growth due to its importance in the global economy, cannot be ruled out.

Either way, investors should be aware of the possibility for even more dramatic movements in equity and bond markets than those caused by the current U.S.-China trade war fears.

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[7] Ibid.

[8] Columbia Threadneedle Investments analysis, May 2019.

Past performance does not guarantee future results.

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