Insight INVESTMENT

GLOBAL MACRO RESEARCH

CHINA: RISING RISKS OF A BALANCE-SHEET RECESSION

JANUARY 2023

BNY MELLON | INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

- The pandemic response has caused a period of severe economic volatility; corporate and local government balance sheets have become impaired, and the property sector appears to be in a structural slowdown that could last for years. This has led to fears of a balance-sheet recession in China. // 3

- Although aggregate debt levels are concerning, and growth is structurally weakening, there are still significant policy options available. // 5

- Comparisons with Japan in the late 1980s suggest some similarities, but key differences are also apparent. // 7

- We do not believe that China is in a balance-sheet recession yet, but the risks are meaningfully higher than they were a few years ago. A transfer of leverage from corporates and local governments to central government seems a likely solution. // 8

A BALANCE-SHEET RECESSION

A balance-sheet recession is a recession driven by high levels of private-sector debt rather than fluctuations in the business cycle. It is characterised by a change in private sector behaviour where debt repayment is prioritised above spending and investment, which ultimately leads to slower growth. This can become a self-reinforcing spiral, as slower growth can make debts appear even less sustainable in the medium term, and the debt overhang can depress economic activity for a prolonged period. Typically, such events are characterised by the bursting of an asset bubble following a period of excessive borrowing. Japan in the early 1990s and the US subprime crisis in 2007 are oft cited examples. Falling asset values can compound the impact if debts have been secured on those assets.

FEARS OF A CHINA BALANCE-SHEET RECESSION HAVE GROWN

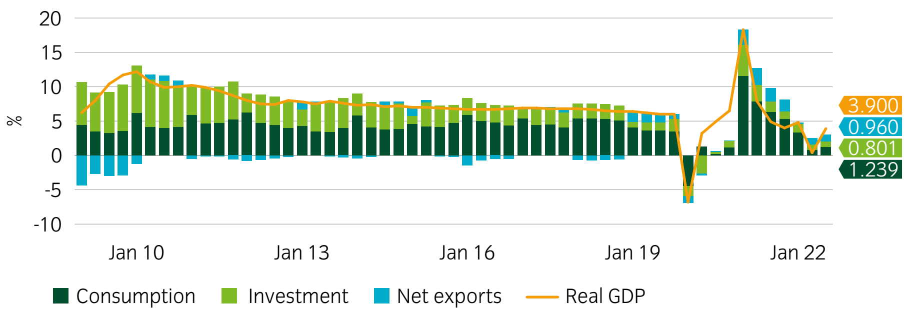
COVID POLICIES HAVE LIKELY CAUSED LONG-TERM ECONOMIC DAMAGE

Although few places in the world escaped recession during the pandemic, China took a different approach to many other countries. The implementation of a strict zero-COVID policy has prolonged the economic pain and potentially caused long-term economic damage. Policymakers have focused their support on corporates, many of which have had to deal with a long period of negative cashflows. Debt repayments have been termed out, tax payment deadlines continuously extended, and access to financing has been made available. Without this support, bankruptcies would have soared, leaving many businesses in survival mode with business models that may prove unsustainable in the post pandemic world.

Households have been provided with more limited support, causing saving rates to rise as they seek to build safety buffers, and with mobility restrictions shifting consumption towards online and digital.

The impact of these factors has led to the most volatile period of Chinese economic activity for at least 30 years (see Figure 1). It is still unclear how long it will take for the balance-sheet damage caused by the pandemic response to normalise, but it has raised fears of a balance-sheet recession that could take years to unwind.

Figure 1: China has experienced the most volatile period of economic activity in at least 30-years[1]



//

The implementation of a strict zero-COVID policy has prolonged the economic pain and potentially caused long-term economic damage.

[1] Source: China real GDP breakdown (%yoy). China National Bureau of Statistics (NBS). Data as at 30 June 2022.

THE PIVOT AWAY FROM 'GROWTH FIRST' COULD COMPOUND THE PROBLEM

In late 2020, early 2021, Chinese growth rebounded strongly as the authorities were able to eradicate the initial wave of the pandemic and global demand for Chinese-sourced medical equipment and personal protective equipment soared. During this period policymakers enacted a meaningful change in policy – pivoting away from the 'growth first' agenda of the previous two decades towards a more ideologically driven position. Regulatory adjustments were made in the property market and several sectors were targeted based on their embedded social significance, including education, big tech, internet platforms, finance and gaming.

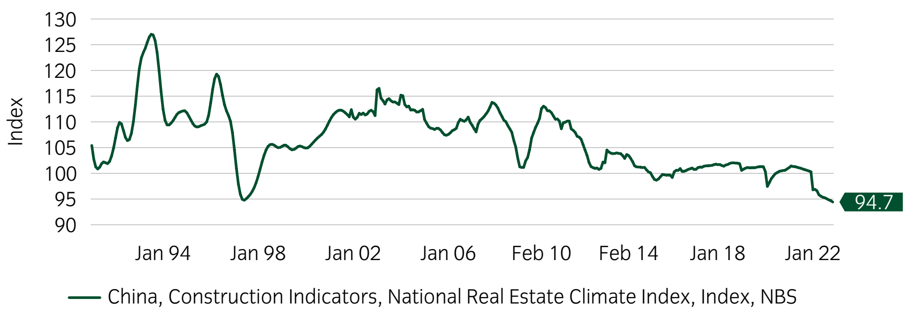
Increased regulation reduced the long-term growth outlook for those sectors, and in some cases impaired solvency where investment plans and debt burdens proved to be based on overly optimistic outlooks. For those companies, the focus on investment and growth has switched to deleveraging as they battle to survive.

THE PROPERTY SECTOR IS A MAJOR CONCERN

Many developers remain excessively leveraged, face profound changes in the regulatory environment, and have businesses based on outdated growth models as a result. Given these factors, it is perhaps unsurprising that sentiment in the real estate sector is at the lowest level in decades (see Figure 2). Policy makers are attempting to engineer a soft landing, reversing some of the measures introduced during the regulatory tightening and providing financial support to key developers. However, the sector is likely to remain particularly susceptible to balance-sheet challenges going forward and, including second and third order channels, represents around 25% of Chinese GDP.

More broadly, housing represents a significant proportion of household wealth, and income from land sales accounts for roughly 30% of local government revenues. Real estate and land are a common form of collateral within China's financial sector, and price declines have the potential to impact not just the balance sheets of real estate companies but also local governments, households and corporates.

Figure 2: Sentiment in the real estate sector remains extremely depressed[2]



//

Many developers remain excessively leveraged, face profound changes in the regulatory environment, and have businesses based on outdated growth models as a result.

[2] Source: National real estate climate index. China National Bureau of Statistics (NBS). Data as at 12 December 2022.

DEBT AND GROWTH ARE CONCERNING, BUT THERE IS STILL POLICY HEADROOM

1 DEBT LEVELS ARE HIGH

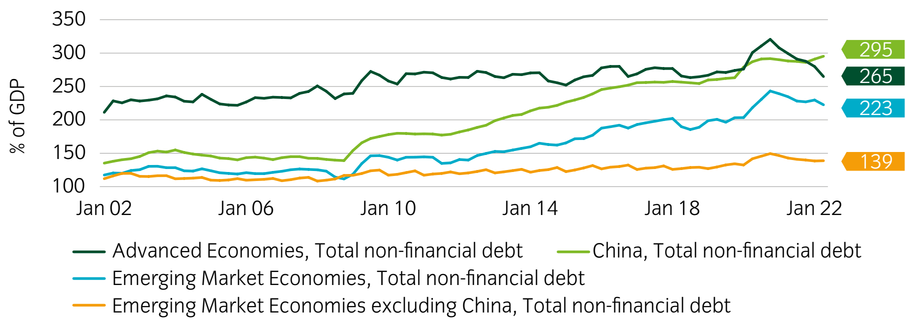
China's aggregate debt stock has surpassed the average level of advanced economies in the past two years (see Figure 3). Off balance-sheet debt is also a problem, making it difficult to accurately quantify the total debt stock in China.

Most of this leverage is concentrated in the corporate and local government sectors. Debt at a central government level is low relative to GDP, but a significant proportion of corporate debt is issued by state owned enterprises (SOEs).

Policymakers have used SOE and local government spending as a way to support economic activity through the pandemic, but weak levels of growth have weighed on both corporate and taxation revenues, with deficits being funded by growing levels of debt. This has been compounded by a sharp decline in land sales, a key revenue stream for local governments.

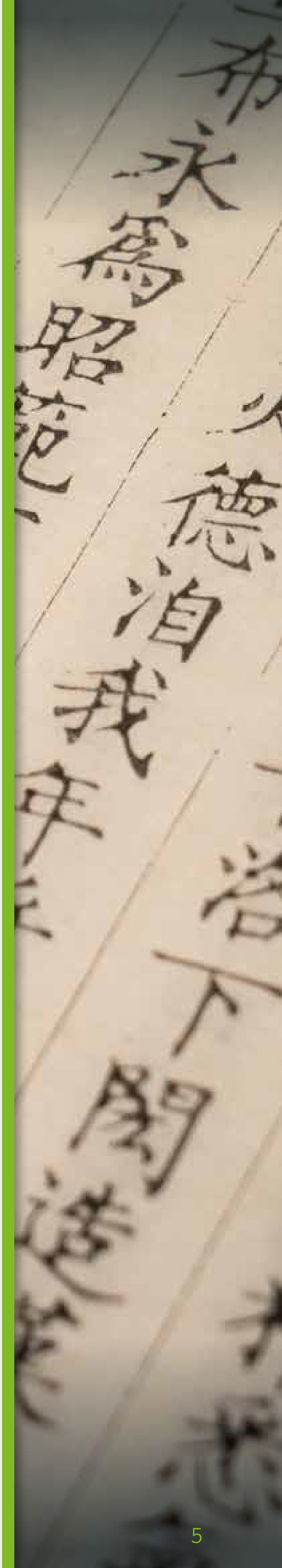
Household debt is more moderate by international comparison and has declined in recent years. However, this is partly due to a need to build cash buffers against the weak economic backdrop, and partly a reaction to declining house prices. Housing is a significant proportion of household assets, and when prices decline households need to save to maintain their aggregate level of assets.

Figure 3: China's aggregate debt to GDP ratio is above that of many developed markets[3]



//

Weak levels of growth have weighed on both corporate and taxation revenues, with deficits being funded by growing levels of debt.



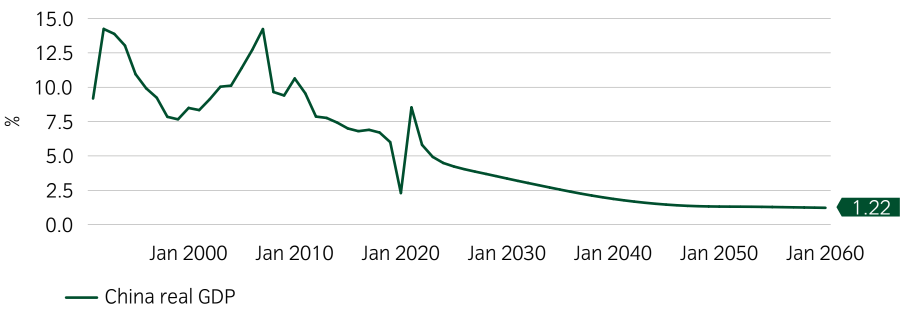
[3] Source: Bank of International Settlements (BIS). Data as at 12 December 2022.

2 THE GROWTH OUTLOOK IS STRUCTURALLY WEAKENING

The high level of debt within the economy is likely to become a headwind for growth in the years ahead, with ever greater amounts of new debt needed to generate each unit of incremental growth. The broader shift in political priorities from growth first to a more ideologically driven position is perhaps a recognition that the natural rate of growth is declining, and that high-quality growth is more important than growth alone.

Perhaps the most important headwind facing the Chinese economy is, however, demographics. The one child policy will result in a significant decline in China's population over the coming decades, and growth is expected to become increasingly elusive (see Figure 4).

Figure 4: Generating growth is expected to become increasingly difficult with time[4]



3 THERE IS STILL SIGNIFICANT POLICY HEADROOM

If policymakers became concerned that a balance-sheet recession was occurring, they have plenty of room to cut interest rates and would likely take rates closer to the lower bound. The Peoples Bank of China has a more complex monetary toolbox than most other central banks and would be almost certain to utilise unconventional policy tools to help maintain asset prices, reduce debt or repair balance sheets across the economy if necessary.

One significant advantage for China in such an event is the natural level of co-ordination between monetary and fiscal policy. The low level of central government debt could be utilised to directly deal with damaged balance sheets elsewhere. This could see liabilities directly moved from corporates and local governments to the central governments balance sheet. Special programmes could be used to replace and restructure existing debts, take on losses, inject capital to avoid passive deleveraging or acquire non-performing assets of corporates, local governments, and financial institutions where appropriate.

//

One significant advantage for China in such an event is the natural level of co-ordination between monetary and fiscal policy.

[4] Source: OECD (Organisation for Economic Co-operation and Development) as at 12 December 2022.

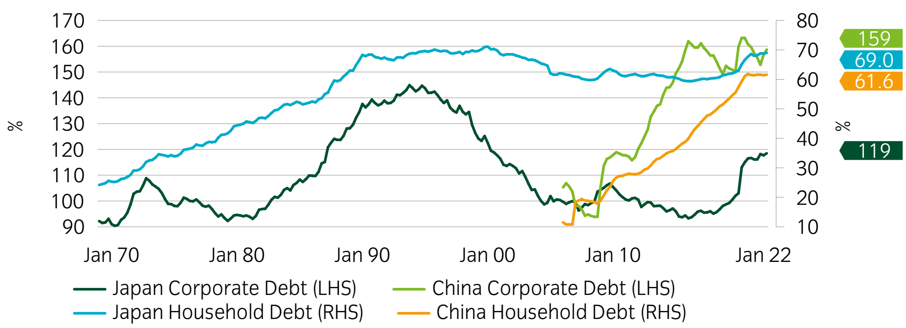
COULD JAPAN OFFER CLUES TO CHINA'S FUTURE?

The slowdown in the Chinese property sector has drawn many commentators to question if there are similarities between China today and Japan in the late 1980s. When reviewing the financial imbalances, leverage and demographic profile of the two economies in these periods it is hard to argue that similarities don't exist. Indeed, the demographically driven structural decline in housing demand is likely to play out far faster in China than it did in Japan.

However, there are key differences. China is at a far earlier stage of development than Japan in the late 1980s, with a materially lower GDP per capita. Perhaps the most significant difference is the role that the government plays within the economy of each country. For example, China can likely prevent major house price declines through guidance and restrictions – sacrificing transaction volumes to protect prices. This is in stark contrast to Japan, where property prices were allowed to decline until they found a level at which markets started to function once again. This resulted in price declines in the region of 50% to 60% and took 15 years to achieve.

Of course, stabilising prices meaningfully above the level at which they would naturally clear is not without consequence and can result problems emerging elsewhere. The direct risk to the banking sector appears manageable, but the complex funding structures that property developers have entered into create spill over risks beyond the banking sector. Corporate leverage in China is considerably higher than Japan's was at the same stage (see Figure 5), and any loss of confidence in corporate debt markets stemming from fears of government interference could have a severe impact. Mitigating this, however, strict capital controls mean there are limited options available to investors, which is likely a key reason as to why housing plays such a prominent role in the balance sheets of households in China in the first place.

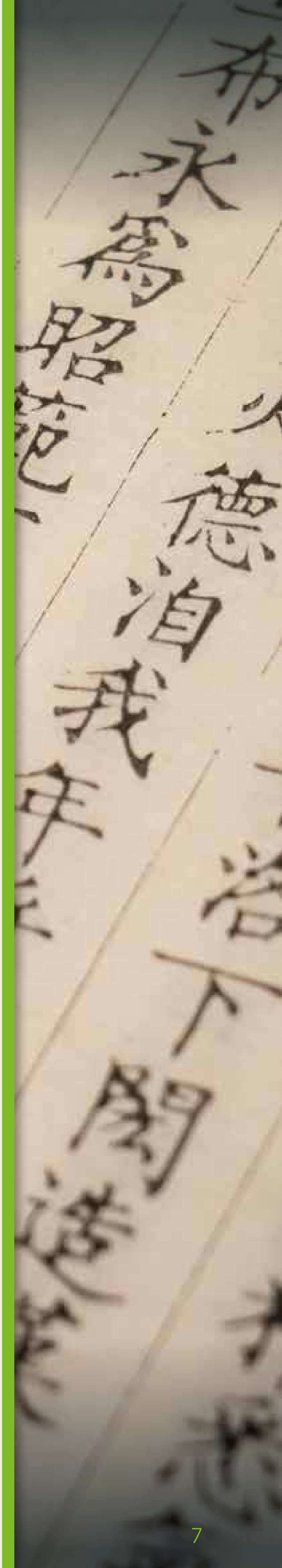
Figure 5: Debt as a % of GDP by sector[5]



//

The direct risk to the banking sector appears manageable, but the complex funding structures that property developers have entered into create spill over risks beyond the banking sector.

[5] Source: Bank of International Settlements (BIS). Data as at 12 December 2022.



CONCLUSION

We do not believe that China is in a balance-sheet recession at this stage, but the risks are meaningfully higher than they were just a few years ago. If a balance-sheet recession were to occur in the short to medium term, trend growth should be sufficiently high to keep aggregate growth in positive territory, but it could result in a prolonged period of sub-trend growth.

The pandemic response and deflating property sector have impaired balance sheets and increased vulnerabilities in the short term. But high levels of aggregate debt and a slowing growth trajectory are structural problems that are more difficult to solve. The command-and-control economy gives China more levers to pull to avoid an experience similar to Japan, but continued policy reform and enhancements to the economic model are critical. These are necessary not just to avoid a balance-sheet recession but also to help escape the middle-income trap by allowing corporates to move up the value chain.

We believe that a transfer of leverage from corporates and local governments to central government is likely over time. As part of this we expect a greater focus on investment in high-tech manufacturing, semiconductors, the green economy, artificial intelligence, and new infrastructure. This could see a two-speed economy emerging, with targeted sectors experiencing high levels of investment and growth, but with sectors such as property more focused on deleveraging and survival.

CONTRIBUTORS

Harvey Bradley,
Portfolio Manager, Fixed Income Group,
Insight Investment

Simon Down,
Senior Investment Content Specialist,
Insight Investment

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

IMPORTANT INFORMATION

Material in this publication is for general information only. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. This document must not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or otherwise not permitted. This document should not be duplicated, amended or forwarded to a third party without consent from Insight Investment.

This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. Forecasts are not guarantees.

Past performance is not indicative of future results.

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Index returns are for illustrative purposes only and are used in the context of our macro-economic models and analysis only. Returns cannot be linked to any fund or investment strategy and results do not represent or infer any links to actual fund or strategy performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Insight does not provide tax or legal advice to its clients and all investors are strongly urged to seek professional advice regarding any potential strategy or investment.

References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Assumptions, opinions and estimates are provided for illustrative purposes only. They should not be relied upon as recommendations to buy or sell securities. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.

The information and opinions are derived from proprietary and non-proprietary sources deemed by Insight Investment to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by Insight Investment, its officers, employees or agents. Reliance upon information in this material is at the sole discretion of the reader.

Telephone conversations may be recorded in accordance with applicable laws.

For clients and prospects of Insight Investment Management (Global) Limited: Issued by Insight Investment Management (Global) Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 00827982.

For clients and prospects of Insight Investment Funds Management Limited: Issued by Insight Investment Funds Management Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 01835691.

For clients and prospects of Insight Investment Management (Europe) Limited: Issued by Insight Investment Management (Europe) Limited. Registered office Riverside Two, 43-49 Sir John Rogerson's Quay, Dublin, D02 KV60. Registered in Ireland. Registered number 581405. Insight Investment Management (Europe) Limited is regulated by the Central Bank of Ireland. CBI reference number C154503.

For clients and prospects of Insight Investment International Limited: Issued by Insight Investment International Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 03169281.

Insight Investment Management (Global) Limited, Insight Investment Funds Management Limited and Insight Investment International Limited are authorised and regulated by the Financial Conduct Authority in the UK. Investment Management (Global) Limited and Insight Investment International Limited may operate in certain European countries in accordance with local regulatory requirements.

For clients and prospects based in Australia and New Zealand: This material is for wholesale investors only (as defined under the Corporations Act in Australia or under the Financial Markets Conduct Act in New Zealand) and is not intended for distribution to, nor should it be relied upon by, retail investors.

Both Insight Investment Management (Global) Limited and Insight Investment International Limited are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the financial services; and both are authorised and regulated by the Financial Conduct Authority (FCA) under UK laws, which differ from Australian laws. If this document is used or distributed in Australia, it is issued by Insight Investment Australia Pty Ltd (ABN 69 076 812 381, AFS License No. 230541) located at Level 2, 1-7 Bligh Street, Sydney, NSW 2000.

For clients and prospects of Insight North America LLC: Insight North America LLC is a registered investment adviser under the Investment Advisers Act of 1940 and regulated by the US Securities and Exchange Commission. INA is part of 'Insight' or 'Insight Investment', the corporate brand for certain asset management companies operated by Insight Investment Management Limited including, among others, Insight Investment Management (Global) Limited, Insight Investment International Limited and Insight Investment Management (Europe) Limited (IIMEL).

15736-01-23