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GLOBAL MACRO RESEARCH

CHINA: RISING RISKS OF A BALANCE-SHEET RECESSION

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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 characterized by a change in private sector behavior where debt repayment is prioritized 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 characterized 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

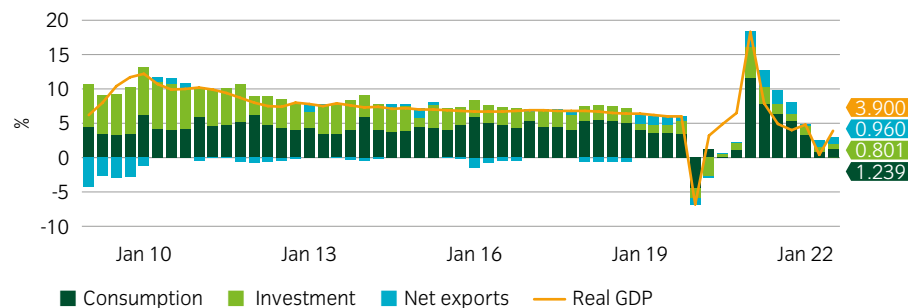
COVID POLICIES HAVE LIKELY CAUSED LONG-TERM ECONOMIC DAMAGE

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 normalize, 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-years¹



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 of June 30, 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.

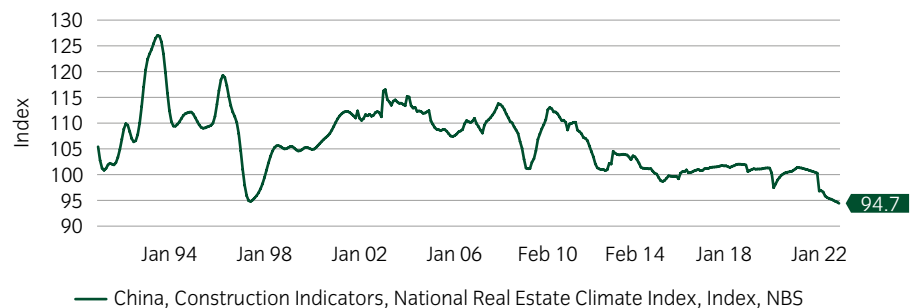
Increased regulation reduced the long-term growth outlook for those sectors, and in some cases impaired solvency where investment plans and debt burdens proved to be based on overly optimistic outlooks. For those companies, the focus on investment and growth has switched to deleveraging as they battle 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 depressed²



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 of December 12, 2022.

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

1 DEBT LEVELS ARE HIGH

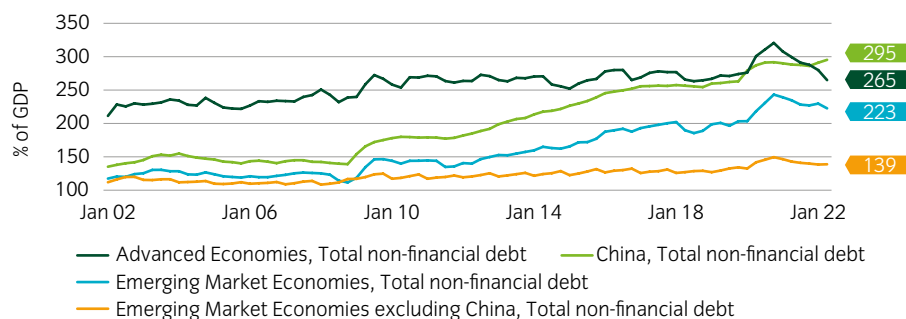
China's aggregate debt stock has surpassed the average level of advanced economies in the past two years (see Figure 3). Off balance-sheet debt is also a problem, making it difficult to accurately quantify the total debt stock in China.

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 markets³



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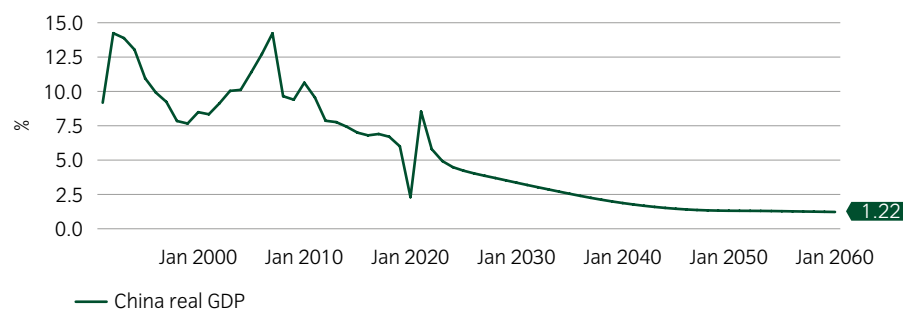
³ Source: Bank of International Settlements (BIS). Data as of December 12, 2022.

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 time⁴



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 utilize 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 utilized 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 programs 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.



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⁴ Source: OECD (Organisation for Economic Co-operation and Development) as of December 12, 2022.

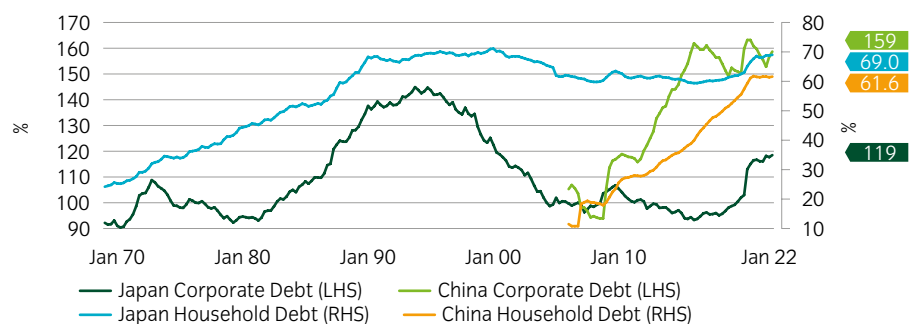
COULD JAPAN OFFER CLUES TO CHINA'S FUTURE?

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, stabilizing 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 sector⁵



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 of December 12, 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.

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