# A Conversation On China's Growth-Leverage Dilemma

**November 26, 2018**

Caution is the watchword in China. Banks are more reluctant to lend, home sales are slowing, and companies are fretting about funding costs and availability. Substantial corrections in stock and bond prices indicate more trouble ahead, yet topline consensus growth figures continue to point to a gradual GDP deceleration. So what are the risks to an orderly scenario?

Senior analysts and economists in Asia-Pacific have been discussing the likely scope and direction of policy easing amid flagging confidence; and transmission issues on stimulating private-sector activity. Our conversation also touched on whether deleveraging goals will be sidelined as authorities seek to guide for gradually declining growth. We also bring other voices into the dialogue, based on our many interactions with investors, issuers, bankers, and China watchers around the globe.

Following our recent "China Credit Spotlight" events in four major cities in Asia, members of our in-house "think tank" on China reconvened to compare notes and exchange views. We share this discussion on key issues below.

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## Our Conversation

### China has managed to avoid a hard landing. Given low investor and business sentiment, can the country prevent a sharper deceleration in the coming year or so? And if so, will this involve abandoning its "deleveraging" push?.

**Shaun Roache (Asia-Pacific Economist):** China still has policy space to guide for a gradual growth slow down. This is why we see growth holding above 6% in 2019 even though risks are mostly on the downside. Past policy tightening combined with a more uncertain external environment, has slowed activity a bit more than expected. Policymakers are taking moderate steps to boost activity (see table 1). In our view the two key risks to growth are: (1) the U.S.-China trade dispute. The direct impact on the economy is limited. If things get worse, or stay unresolved, this could undermine already-fragile confidence; and (2) lack of response to policy easing. As banks and local governments digest all of the deleveraging policies over the last one to two years, responding to easing is harder. For example, bank funding costs are down but lending rates remain stubbornly steady and credit growth continues to fall.

**Ryan Tsang (Chinese Financial Institutions):** It's true, Shaun, that the transmission mechanism is not quite working. Bankers are not adequately incentivized to increase lending to small to midsized enterprises (SMEs), as policymakers have guided. There is limited upside to lending to SMEs and the same goes for many private-owned enterprises (POEs). Bankers are held accountable if loans go bad, and the risk-return equation may not work for the banks.

The government wants banks to lend to SMEs at "affordable" rates. But this runs the danger of risk mispricing. In general, banks assess higher risks for POEs than for state-owned enterprises (SOEs), and this is reflected in higher lending rates.

The government has set guidelines for increased lending to POEs...

On Nov. 9, 2018, banking and monetary authorities announced guidelines in relation to lending to POEs and SMEs. For example, no less than one-third of large banks' new corporate loans should go to POEs, and two-thirds of SME banks' new loans should go to POEs. And in three years, half of all new loans should go to POEs, according to these proposed guidelines.

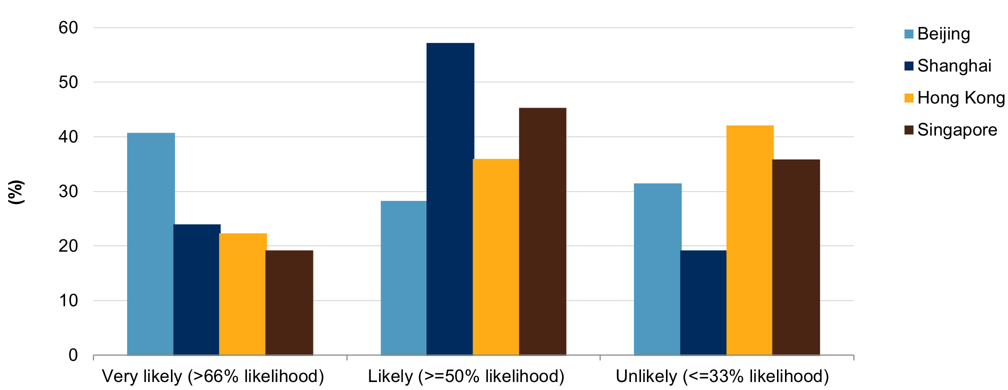
...as of yet, these are not hard quotas.

The impact on the banking sector depends on the implementation. If these guidelines are treated as hard targets, we expect banks would take various measures to achieve these targets, including justifying borrowers as "POE" as far as possible, and increasing short-term credits, such as trade bills, to minimize risk. Competition for good to reasonable POE credits could intensify, and banks without competitive advantages would have to go down the credit curve to fill the quota. Underwriting standards and profitability would also suffer. The effects on profits would be more significant if lending rates were restricted. We expect the impact on mid-small banks could be more visible in a hard-quota scenario.

**Vera Chaplin (Asia-Pacific Financial Services):** The government does not want to see the oversupplied heavy industry, or still-expensive property market, to re-inflate further as conditions ease. In that sense, stimulating private sector activity fits in with the deleveraging campaign to reduce debt-to-GDP levels. Yet the complexity and uncertainty over deleveraging implies that for the economy to grow at 6.3% in 2019, deleveraging may be less than originally anticipated. We aren't the only ones who feel this. We polled participants at our recent "China Credit Spotlight" events; those based in Hong Kong and Singapore particularly expect deleveraging to be sidelined (see chart 1).

Chart 1

**Will China Maintain Its Deleveraging Policy Despite Trade Rifts And Slowing Domestic Growth?**




Source: S&P Global Ratings poll.

**Lawrence Lu (Chinese Heavy Industries):** We've yet to see the easing of funds to heavy industry borrowers. The target of a 2% reduction in leverage for SOEs by 2020 remains in place. The reported value-added tax (VAT) cut could really benefit borrowers in heavy industry--if it materializes.

**Kim Eng (Sovereign Ratings):**
The Chinese government has been patient about slowing growth in the year to date. This is noteworthy. Aggregate financing continues to expand at a slower pace, staying just above 10% in the first ten months of 2018. We also haven't seen a sharp rebound in public investment similar to those in earlier episodes of economic weakness in recent years. Instead, the focus is on helping private businesses with their cash flows through tax cuts and access to financing. I believe that this shows the greater weight that policymakers are placing on financial stability. This attitude is supportive to the sovereign ratings and likely reflects the government's appreciation that, with major economic and external uncertainties in the near future, it needs to build confidence in financial system stability.

The government is focusing on boosting private-sector cash flows.

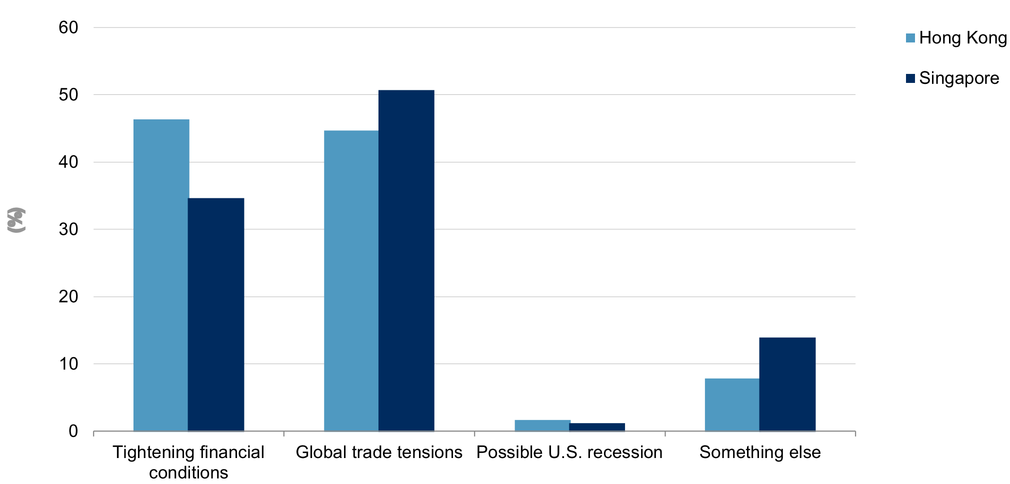
**Xin Liu (Public Finance Ratings, Greater China):**
Local governments have some space to ramp up infrastructure spending, given this year's slowdown. Infrastructure spending increased by only 3.7% year on year as of October 2018, compared with 18.3% in full-year 2017. Now that the State Council has signaled it's okay to loosen the purse strings a gain, more projects are currently under way and will likely show up in figures for the first quarter of 2019.

There is also some scope for increased infrastructure stimulus.

**Terry Chan (Asia-Pacific Analytics and Research):** At our recent "China Credit Spotlight" events in Hong Kong and Singapore, Shaun asked participants what they thought was the biggest threat to China's growth outlook in 2019.

Chart 2

**What Is The Biggest Threat To China's Growth Outlook In 2019?**




Source: S&P Global Ratings poll.

Trade worries ran neck-to-neck with tightening financial conditions (see chart 2 on previous page). Not a surprise. Even with slower real growth at 6.5% this year (more for nominal), businesses will be looking to grow by 8%-10% to maintain market share. If they can't get the credit, that's a constraint on their business growth and can come back to haunt GDP targets.

**Christopher Lee (Asia-Pacific Corporates):** Our China country specialist Chang Li attended this month's U.S.-China Business Council event, at which Vice-Premier Liu He said he was not optimistic of a U.S.-China trade breakthrough. The Council is asking members to prepare for a protracted dispute.

## How are volatile market conditions affecting confidence and business conditions?

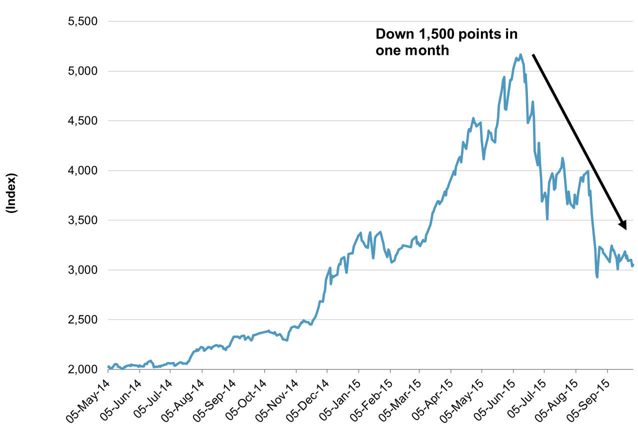
**Vera:**

China's stock market has fallen to levels not seen since 2014. However, the pace of fall has not been as swift as the 2015 market correction, when for example the Shanghai composite plunged 1,500 points from its peak in a month. This year, it took 10 months for that index to decline 1,000 points from the recent peak in April (see charts 3-4). Still, the decline is shaking confidence, and we're seeing efforts by authorities to stem sell-offs. Monetary support is not as big as the rescue in 2015 but interestingly, we see the support straddling both equity and debt instruments. For example, authorities are acting to stem liquidity stress for companies whose shares were pledged as collateral for obtaining bank loans

Equities have corrected but with less speed and magnitude than in 2015.

Chart 3

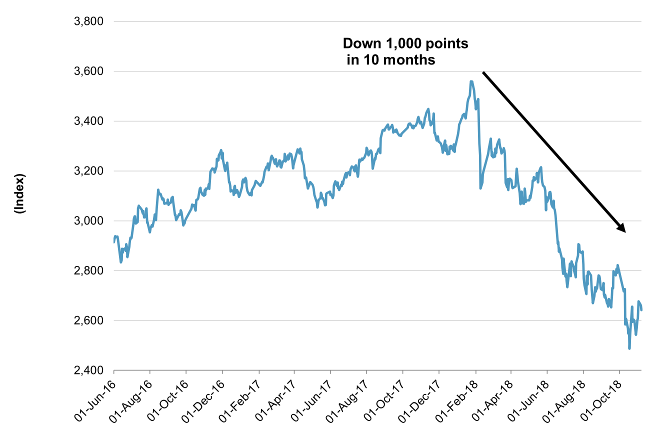
**China Shares Fell Harder And Faster In 2015...**
Shanghai composite index




Source: Bloomberg.


Chart 4

**...Than In The 2018 Correction**
Shanghai composite index




Source: Bloomberg.


**Eunice Tan (Greater China Insurance):** Insurers are playing a role in limiting market fallout. The China Banking and Insurance Regulatory Commission (CBIRC) recently solicited public feedback on a draft of new rules to remove limits placed on insurers' holdings in individual equities. CBIRC explicitly tied this to adding support to equities markets.

Regulators are more coordinated in trying to the support the stock market--which may hint that problems are more serious than they appear. But what we also see this time is support on the credit front as well. The central bank has provided special liquidity to allow the China Bond Insurance Co. to sell more protection on the same capital base, a form of capital easing. These often involves credit risk mitigation instruments, which are kind of like credit default swaps. SMEs can provide them to potential creditors to get better terms on financing.

**Terry Sham (Greater China Insurance):**
Given the merger of China's banking and insurance regulators in 2017, we expect more coherent and coordinated supervision as well as government support measures. But the bond insurance sector is still very small compared with the banking sector, so the impact on SMEs will be limited, in our view.

Insurers are being encouraged to buy equities.

**Terry Chan:** China's balancing act between deleveraging and stability in growth will endure for some time. Because there are no easy fixes, expect ongoing bouts of asset price volatility as markets react to policy shifts.

## Chinese authorities finally reined in the property market. Can they keep the lid on?

**Christopher Yip (Greater China Real Estate):** It's clear that leading indicators are turning south. Real estate investments are cooling and residential sales in China have been turning weaker in recent months. Although the government has said that restrictions will remain unchanged for now, it has room to maneuver and will likely selectively and moderately loosen policy if the downturn is too sharp. We forecast residential contracted sales will decline by 8%-12% in 2019, through a mixture of lower prices and volumes especially from lower tier cities.

Since we expect sales to only mildly deteriorate, the key risk actually stems from unfavorable credit conditions. We believe major funding channels could become less accessible and more expensive than they have been for some years. Selective smaller issuers that are highly leveraged and have weak liquidity positions may face difficulty in refinancing, causing them to collapse or be forced to sell off assets. Larger and stronger developers will likely take the opportunity to increase market share as they have in previous downturns.

Some small, stressed developers are vulnerable to default.

## Where are we seeing the most liquidity stress?

**Christopher Lee:**
POEs face more difficulty. They account for the majority of the Chinese renminbi (RMB) 66 billion (US$9.51 billion) in bond defaults we've seen year to date. Some government support is aimed at POEs, which could slow the default rate, and yet we still expect more defaults to occur. Vulnerable sectors include capital goods, property, and local government financing vehicles (LGFVs).

Private sector companies have been hit hard by the clampdown on shadow financing.

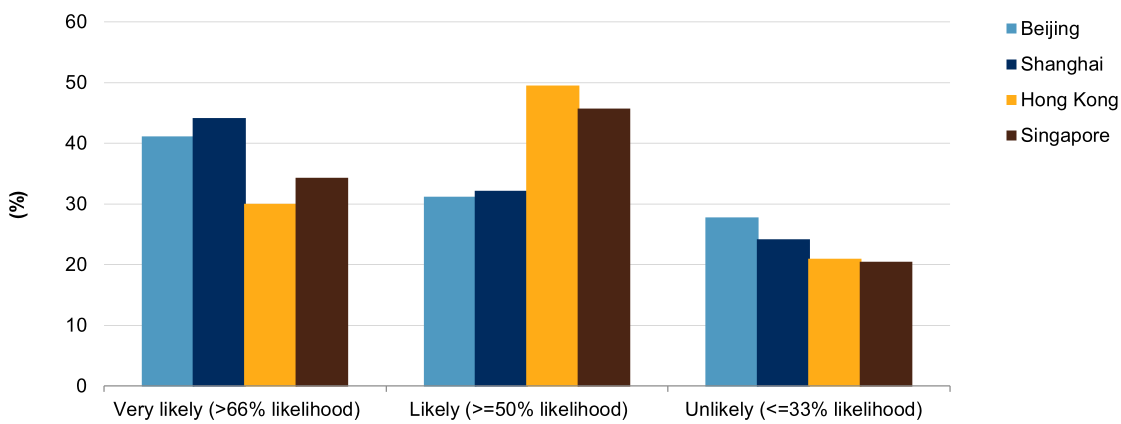
**Xin:** Local and regional governments (LRGs) are under pressure because revenue growth will slow further due to additional tax cuts, while it is very hard to cut back on operating expenditure. At the same time, LRGs still have to maintain reasonable infrastructure investment. All this means that LRGs' funding gap will widen. Over time, the central government's goal is to replace the LGFV model to finance public investment--a public financing model that creates opaque hidden debt for

LRGs. Even if LRGs' total new bond issuances double to RMB4 trillion in 2020, they still cannot replace the role of LGFVs, considering the sheer size of the infrastructure funding needs. The key thing authorities are currently trying to do is to slow down new borrowing, while restructuring existing off-budget debt stock.

We note that a substantial proportion of participants at our Spotlight events expect rising LGFV defaults, based on our polls (see chart 5).

Chart 5

**Will Bond Defaults By SOEs (Including LGFVs) Increase?**




SOEs--State-owned enterprises. LGFVs--Local government financing vehicles. Source: S&P Global Ratings poll.



**Christopher Yip:** We could see more defaults in the property sector if credit conditions remain tight. Previously the market thought onshore bonds for the property sector would hardly see defaults--but now five small property developers have done so (although the amount is tiny). One of the five has defaulted on offshore bonds as well.

## Does China has the capacity to provide adequate liquidity relief?

**Shaun:** The central bank has significantly improved its liquidity safety net over the past two to three years. This can be seen in the relative stability of short-term bank funding rates. The risk of a systemic liquidity shock capable of derailing the real economy now seems lower than before. Perhaps the bigger challenge is the transmission from liquidity to improved funding conditions for the real economy.

**Kim Eng:**

Various indicators suggest that policymakers have further room to ease funding and liquidity conditions if they want to. The current account remains in surplus today, suggesting that the economy continues to generate significant savings that add to the country's substantial savings stock. Many years of strong credit growth, especially the period just after the global financial crisis, has thinned the liquidity cushion that China's savings afford against economic and financial shocks. But financial indicators such as banks' liquidity ratios suggest that financial buffers

China's financial buffers are thinning but still robust.

remain in a relatively comfortable position even after the liberalization of liquidity ratio regulations and reserve requirement cuts.

## What about cutting taxes? Is that an option for boosting growth without putting an onus on banks to lend more?

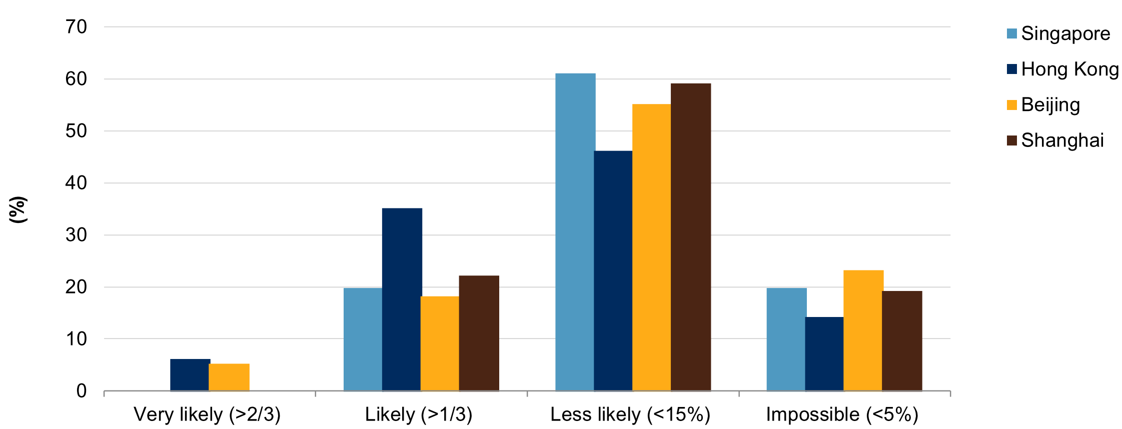
**Xin:** We've seen a lot of interest in the news media on cuts in VAT and personal taxes as a growth elixir. But it's not that simple. Personal taxes only contribute to 2% of the government's tax take and so this is not an easy consumption stimulus as it may be in some Western countries. The VAT is more impactful, representing 41% of the government's revenue.

## In your channel checks, do you see investors preparing for a hard landing?

**Terry Chan:** There's a lot of caution in China, and fragile confidence is one reason why we think the near-term outlook is slightly credit negative. Rising onshore defaults and weaker sentiment in China is also worrying investors. However, a strong majority of investors still believe a major financial crisis is an unlikely or even an "impossible scenario"--at least for the next three years (see chart 6).

Chart 6

**What's The Possibility Of A Financial Crisis In China In The Next Three Years?**
Financial crisis defined as nonperforming assets >15% of total assets




Source: S&P Global Ratings poll.


## Related Research

- Credit FAQ: How Far Will China Extend A Helping Hand To Private Companies?, Nov. 19, 2018Deleveraging While Disseminating: The Task Facing China's Banks, Nov. 8, 2018
- China Property Watch: Which Developers Will Be Dragged Down In A Sliding Sector?, Nov. 6, 2018.

- As China's Internet Firms Growth The Financial Services Pie, Banks Angle For A Larger Slice, Oct. 30, 2018.
- Credit FAQ: A Look At Why Share-Pledging Is A Credit Issue In China, Oct. 23, 2018.
- SOE Shake-Up: China's Support For Its Ailing Enterprises Will Become More Selective, Oct. 17, 2018.
- Credit FAQ: Lifting The Lid On China's Local And Regional Government Debt Levels, Oct. 16, 2018.
- China Inc. Will Struggle To Stay On The Deleveraging Path, Oct. 14, 2018.

This report does not constitute a rating action.

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