Is the global economy becoming more vulnerable to China's debt situation?

Deepanshu Mohan considers rising debt levels in China and the possibility of China exporting its debt, and asks what can be done

Recently, the IMF head cautioned countries across the globe against the nature of rising debt levels in China and the possibility of China 'exporting its debt' to other countries through infrastructural projects (via the One Belt One Road initiative).

Analyzing the possibility of debt export from China may be difficult to assess without empirical proof on the actual extent of debt exposure (from China to other countries). However, the note of caution does throw some questions on the extent of macro-economic vulnerability that countries recipient to Chinese foreign investment (including long-term infrastructural loans) face from China's widening debt situation.

China is currently the second largest economy in the world and the biggest trading nation, and is the third-largest bond market. Scholars continue to argue how the Asian Dragon's expanding geo-economic position along with rising debt levels pose systemic risks to global financial stability. But, how did China's debt (crisis) situation get this far? What kind of systemic risks does China's debt situation impose on other recipient countries? And, what can some of these countries do to be more macro-prudent? This article discusses some of these questions.

Breaking-down China's rising debt situation

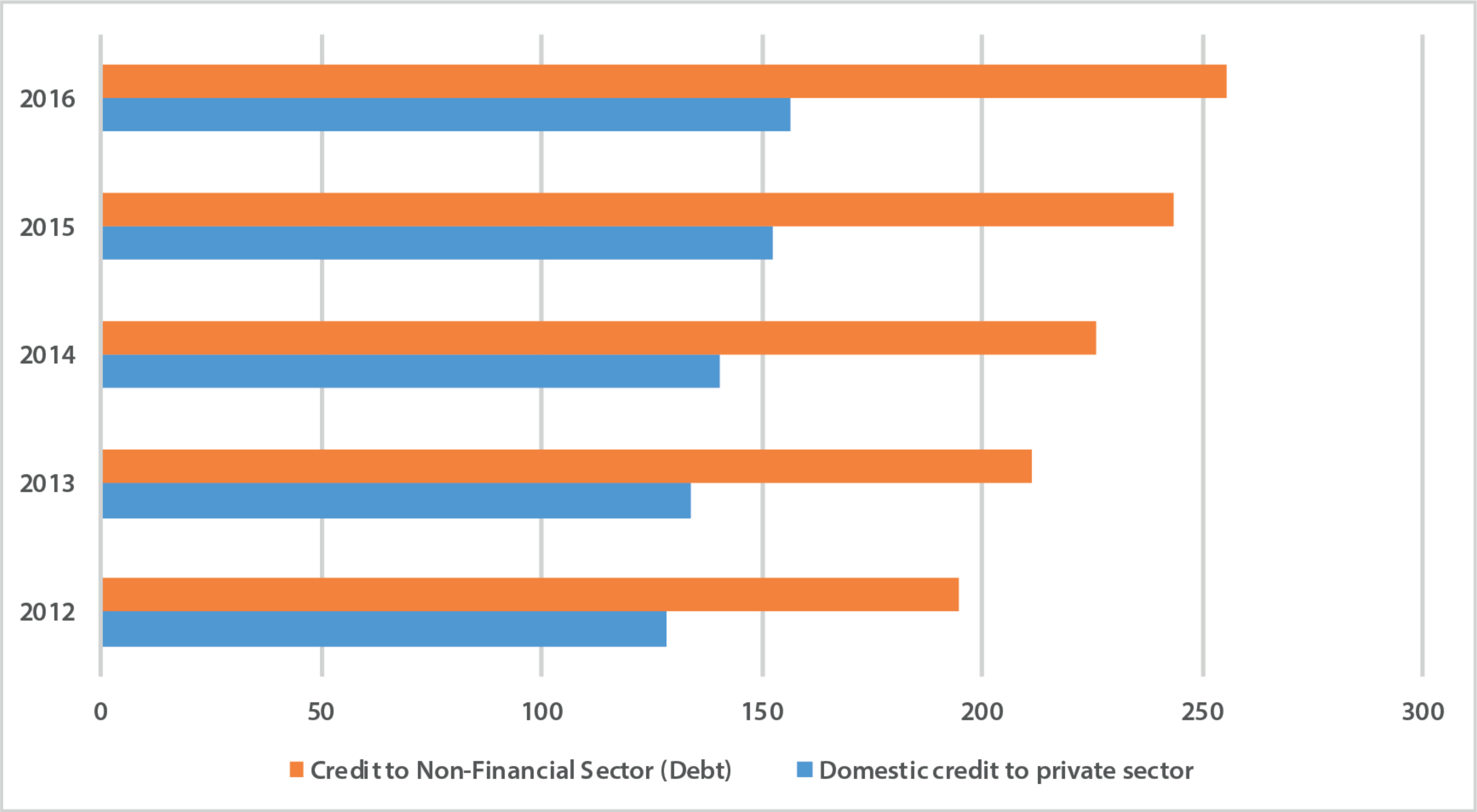
Since the global financial crisis of 2008-09, China's robust economic growth has been fueled by a rapid credit growth in its domestic private and public sector (shown in Figure 1). A rapid expansion of credit finance remains key in encouraging infrastructural growth and in supporting private investment opportunities in any developing country. In China's case, however, the relationship between domestic credit growth and the total volume of nonfinancial sector debt remains troubling, particularly since 2011-12.

One of the key reasons for this mismatch has been a loose monetary policy followed by the People's Bank of China over a longer period of time. The Bank kept its quantity based monetary instruments relaxed in combination with the other price-based instruments (ie. lending rates, deposit rates and open market operations) for a longer duration to facilitate the credit growth boom. The subsequent growth of credit in the domestic private sector further exacerbated the growth of nonfinancial sector debt.

If additional credit growth across sectors created a similar amount of value added in the past (ie. during the 1990s and early 2000s), China's credit-to-GDP ratio would have remained much more stable, which, before 2008-09 was around 135% of its GDP, and is somewhere around 240-250% of the GDP now.

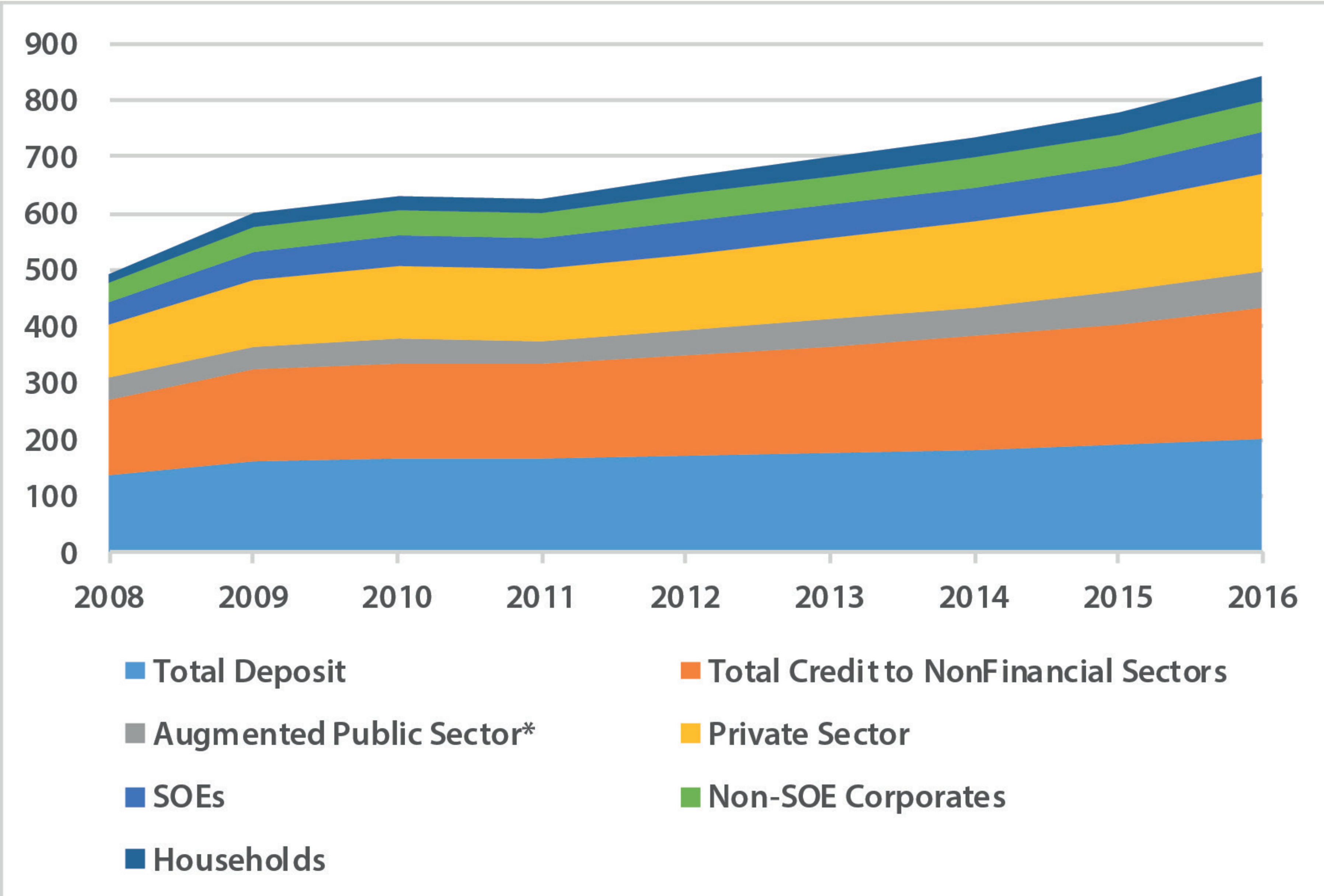
With its current level of credit expansion through rising OFDI levels, the debt bubble-like situation may continue to inflate further over the longer time, increasing global financial fragility

Figure 1. China's credit growth advancements and debt (2012-2016)



Source: Author's Calculations from BIS database

Figure 2. Breakdown of non-financial sector debt in China (% of GDP)



Source: *CEIC Data; Ministry of Finance and IMF estimates*

Figure 2 above provides a breakdown of the volume of non-financial sector in debt in China over the last ten years or so. The concentration of overall debt in China over the last decade has increased in areas of household owned debt; private sector (or corporate) owned debt (including state-owned enterprises; and debt owned by government owned public sector companies. What explains the high scale of state owned debt across the public and private sectors across China?

Widely observed in the Chinese political economy literature, government control in China's business environment remains quite different to most other countries. In most provinces across the mainland, the central and local governments exercise more control over firms (including private sector firms) in areas of managerial ownership through State Owned Enterprises (SOEs); financing development in Local government financing vehicles (LGFVs), which features most debt-ridden Chinese companies (in public and private sector) having greater state influence and support. Scholars like Yuanzheng Cao, Y Qian, Yijiang Wang have written extensively on the subject of the nature of state influence on directing private and public investment patterns across sectors.

Similar to the domestic investment patterns, most outward foreign investment from China is also financed through some of their big public sector companies ie. via SOEs and LGFVs or similar government financed special purpose vehicles. China's outward foreign direct investment abroad stood at about US$1 trillion in June 2015 and accounted, on average, for over 10 percent of recipient countries' output in Hong Kong SAR (175 percent of GDP), Lao PDR, Mongolia, Luxembourg — a hub for Chinese investment into Europe – Kyrgyz Republic, and Liberia. China's rising degree of *credit imperialism*, gives an opportunity for most debt-addicted Chinese firms to transport their investments to other countries, posing systemic risks.

But, how do recipient countries remain vulnerable to China's debt situation?

Within East Asia alone, where intra-regional financial spillovers to China remains the highest, as per a recent estimate, a 1% decline in China's growth reduces growth by a sharp 1% point in the trading hub of Singapore, Hong

Kong and by 0.4-0.5% in Indonesia, Malaysia and Thailand (in less than a year's time). A debt crisis in China would seem to bust most of such regional economies which are highly dependent on Chinese money.

Outside the East Asia region, over the last few years, China's OFDI (and export) strategy has remained focused on promoting long term infrastructural investments in other emerging markets and developed countries (in Europe) through bilateral, multilateral institutional channels (ie. Asian Infrastructural Investment Bank-AIIB), including members part of projects of its One Belt One Road initiative.

For example, there has been massive Chinese cash investments focused on infrastructure projects in some of the distressed European economies from the eurozone crisis like Portugal, Greece, Italy, Spain etc. The unilateral increase in investment financed from domestically debt-ridded firms exposes nations to not only China's debt concerns but also increases financial volatility (as seen in some parts of Europe recently).

In a recent IMF study on analyzing financial spillovers, scholars observed an increase in recent episodes of financial volatility in emerging (and other) financial markets following from news on China's domestic debt situation and slowdown in growth. As China's international portfolio assets and liabilities within its capital account continue to rise (with increased OFDI levels), a higher financial volatility has been observed in the equity prices, exchange rates and bond yields of countries like South Korea, Indonesia, Vietnam, Malaysis, US and parts of Europe.

On cross-border banking exposure to China, disclosures from HSBC's financial statements (from end of 2015) reflect an amount of US$143 billion (ie. 110% of the group's total common equity Tier 1 capital) in terms of exposure to China, while Standard Chartered's exposure amounted to US$50 billion (131% of the group's total capital). The combined exposures of these two banks (US$193 billion) accounted for almost all the United Kingdom's direct banking exposures to China.

Over time, failure of such large banks could reverberate to other banking systems, given their systematically important financial institution (SIFI) status. Further, it is pertinent to note that in a post-2008 financial crisis world, the rise of cross-border banking regulations have reduced the incidence of riskier lending from banks, which has made more risk-based financing to be absorbed and facilitated by China's *shadow-banking* segments.

What can recipient countries do to minimize financial (debt) exposure to China?

If we domestically assess the future possibilities of Chinese debt situation, most experiential wisdom extracted from a study of credit-led booms and busts of the past would suggest that China's current rapid credit growth is not sustainable, and its economy remains susceptible to a major financial crisis and/or a sharp growth slowdown in years to come (unless it can transport debt to other regions of the world).

Even though many believe that China-specific factors of low reliance on inward foreign direct investment, low government debt, and state control were responsible for its unique growth story and such factors may help its case in the future; still, these country-specific factors may only help mitigate near-term risks to its current debt situation. With its current level of credit expansion through rising OFDI levels, the debt bubble-like situation may continue to inflate further over the longer time, increasing global financial fragility.

As the debt crisis warning light flashes in China, it would be prudent for central banks of most countries (as part of the OBOR initiative) and other recipients to China-led infrastructural investment projects (say Sri Lanka, Pakistan in South Asia) to closely monitor their debt exposure levels (via Debt-GDP ratios) and exercise macro-prudential policies through independent monetary and fiscal policy discretion. Containing the exposure to a debt-bubble poses opportunity costs for monetarists and central bankers in emerging markets (which require easy capital mobility for growth).

Albeit, too much of leverage reflects an abundance of credit and limiting leverage would require slowing down credit growth. It thus, becomes vital for central bankers (acting in convergence with fiscal actors) to effectively manage (domestic) short-term interest rates in a way where necessary capital mobility is maintained at a threshold where debt-levels and inflation are kept in check for macroeconomic stability.

The degree of financial integration made possible through global supply chains of production and distribution of which China is the most vital part, makes most countries dependent to Chinese macroeconomic systems (and vice-versa). Macro-prudential decision making to monitor debt while ensuring capital account mobility, exchange rate stability for trade and investment remains vital for countries, dependent on Chinese investments. ■

Deepanshu Mohan is Assistant Professor of Economics and Executive Director, Centre for New Economics Studies at Jindal School of International Affairs, OP Jindal Global University. He is a Visiting Professor to the Department of Economics, Carleton University