Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

Chinese debt worries and growth

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Key points

> Chinese debt levels are rising too fast and the growth of its shadow banking sector poses risks. However, providing the authorities continue to gradually try and slow both down the risks should be manageable.

> Chinese growth looks like coming in around 7.5% this year. No boom, but no bust either.

> Chinese shares remain very cheap, providing the prospect of good medium term returns.

Introduction

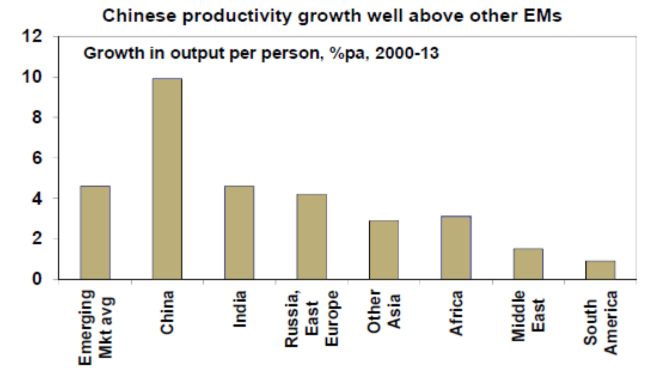
China bears have always been around. At their core seems a disbelief a so called "communist" country could grow so fast. But with China now being the world's second biggest economy and the largest contributor to global growth their concerns get a lot of airplay. Last year it seemed "ghost cities" were the big worry. This year it's shaping up as debt, shadow banking and wealth management products – particularly following defaults in the latter. To be sure China is not without risk – it will one day have a bust like all countries do periodically – but concerns still look overdone.

The China worry list

Putting politics aside, the concerns of China bears are primarily structural and relate to four key areas: excessive investment; falling competitiveness; a housing bubble; and excessive growth in debt. Putting the debt issue aside for now, our view on the first three remains relatively benign.

Rebalancing growth to consumption needs to be slow. First, China's investment share of GDP is overstated as its national accounts system grossly understates services. Second, China's urbanisation rate at 50% is still low with a move to Korea's urbanisation rate of 80% over say 30 years meaning an extra 400 million people moving to cities. This will require a lot of infrastructure investment. Second, China's level of investment per person is around one third of US and German levels. So it's hard to say it's over investing. Third, China has been able to grow strongly and avoid the inflation and balance of payments problems of countries like India, Indonesia and Brazil because it has invested a large share of its GDP. The bottom line is that claims that China is overinvested and too reliant on investment are misplaced.

China is not losing its competitiveness. Chinese wages are rising rapidly but there is no evidence this is causing a loss of global competitiveness: rapid productivity growth in China, which is far stronger than in other emerging countries, is offsetting labour cost increases; Chinese exporters have been moving to higher value adding exports; and Chinese exports are continuing to gain share, rising from around 3% of total global exports in 1997, to 10% in 2008 to nearly 12% now. And with inflation stuck around 2.5% there is no sign of inflation trouble.

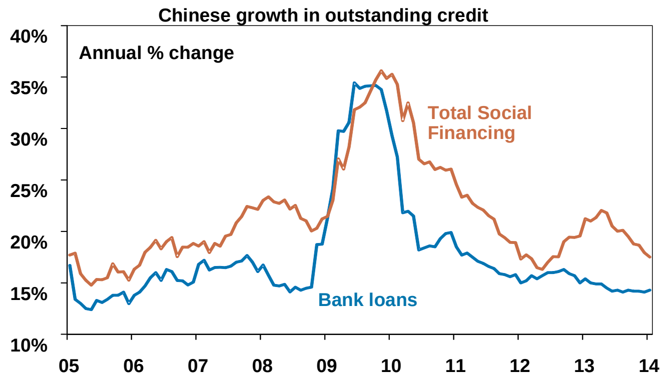


Source: BCA Research, AMP Capital

No generalised housing bubble. Yes there are ghost cities where excessive development has occurred. But the real issue is an undersupply of affordable housing. Household debt is very low at 30% of GDP, average deposits are around 40% of values, 20% of buyers pay in cash and 90% of new home buyers are owner occupiers. There is very little securitization of mortgage debt so it is not packaged and sold to investors everywhere like US mortgages which caused so much strife. Over the period 2006-13 household incomes rose 12% pa on average and house prices rose 9% pa, which is hardly the stuff of bubbles.

But what about debt and shadow banking?

Perhaps the biggest concern relates to debt. On this front there are three main worries. First, debt has grown rapidly in recent years. Total outstanding credit, or "Total Social Financing", rose an average 22% pa over the last decade.



Source: Bloomberg, AMP Capital

Second, as China gradually deregulates it will mean higher interest rates. Current rates around 3-6% are way below normal levels for an economy with nominal growth around 10%. The adjustment will mean bouts of nervousness.

Thirdly, much of the growth in credit has occurred outside the more regulated banking system, ie via what is called the "shadow banking" system. And much of this has been channelled though wealth management products. There has been rapid expansion in the latter in recent years as investors have sought higher returns than available from bank deposits. Recent defaults or near defaults by some of these products related to coal companies have raised concerns of broader problems in the sector.

However, there are several points to note. First, while China's growth in debt is excessive, its aggregate debt level is not high by global standards. See the next table.

Global domestic debt comparison, % GDP

Country	Corporates	House-holds	Public sector	Total
China	125	32	56 *	213
Australia	99	101	27	227
US	112	85	106	303
Korea	161	107	34	302
Italy	130	66	127	323
UK	116	101	90	307
Spain	185	76	84	355
Japan	158	77	235	470

* Includes local gov't debt of 33% of GDP. Source: IMF, BCA, AMP Capital

Second, the rapid rise in outstanding debt in China partly reflects a very high savings rate and those savings being recycled via the credit system rather than via the share market. It's not that China is borrowing internationally, which has led many emerging countries into trouble in the past.

Third, the People's Bank of China is more than aware of the risks noting that "growth has become increasingly dependent on…debt accumulation" and has been seeking to slow it.

Fourth, China's shadow banking system is relatively small. At around 30% of Chinese banking sector assets it is less important than is the case in most major economies. In the UK, Brazil, Korea and the Eurozone it's 50% or more and the US shadow banking is around 100% of official banking (150% prior to the GFC!). What's more Chinese shadow banking companies like trusts are not particularly leveraged, cross holdings of assets between institutions is low, products are very simple and securitisation (or the repackaging of loans and on selling them) is virtually non-existent. This all serves to limit counterparty risks and contagion and stands in stark contrast to the problems that arose in the US with sub-prime debt where the combination of securitisation, massive gearing and financial complexity led to major problems.

Finally, while the growth of lending via wealth management products is concerning, the potential investments at risk is small. The next table shows a breakdown of wealth management products by institutions that manage them.

Wealth management products by institution

	Renminbi, bn	Comment
Trust companies	10,131	
Banks Products	9,920	Mostly invest in low risk assets like gov't bonds
Insurance Cos	7,687	
Fund Mgrs	3,620	Mostly invest in equities with usual disclaimers
Brokerage Firms	3,420	
Other	1,100	
Total	35,880	

Source: BCA Research

Those ran by banks and insurance companies tend to be low risk whereas those run by fund managers and brokerage firms are mostly tied equities, with no default risk. That largely leaves the RMB10 trillion in trust companies most at risk. Of this, around a third is equity related and so not subject to default and of the remainder the portion invested in loans to industrial and commercial companies (like coal ventures) is at most risk of defaults – of which there will surely be more. But the point is that the total amount of trust assets most at risk is likely no more than RMB5 trillion, which compared to China's RMB70 trillion in bank loans is unlikely to be enough to constitute a systemic threat. It should also be noted that most trusts are state owned and the authorities have unlimited resources to respond if a crisis develops.

It is also hard to see a big direct global threat from problems in the Chinese shadow banking system. China's shadow banking system is only around 3-4% of that globally, compared to a 37% share for the US and global institutions have very little exposure given low levels of gearing. If a Chinese shadow banking crisis is going to threaten the global economy it would likely be via trade flows.

Growth no longer 10% plus – get used to it

Chinese authorities have clearly come to the view that GDP growth of 10% plus is not sustainable. But the conscious slowing in GDP growth and the PBOC's often opaque efforts to slow credit growth has unnerved investors and so the Chinese share market has gone from being about the world's most expensive several years ago to amongst its cheapest. However, Chinese leaders have repeatedly stated that the floor to acceptable growth is around 7 to 7.5%. And despite occasional volatility GDP growth seems to have settled around this level. Consistent with this the much watched Chinese business conditions PMIs also look range bound.

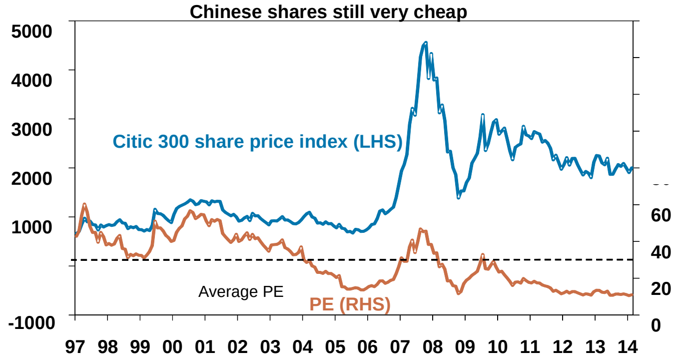
Business conditions indicators point to stable growth

Source: Bloomberg, AMP Capital

The overall impression is that growth is stable with no sign of a boom or a bust. Our expectation remains for Chinese growth this year of 7.5%, little changed from last year's 7.7%.

Chinese shares trade on a price to historic earnings ratio of 11 and a forward PE of 7.5. This makes it one of the cheapest share markets globally and suggests good returns in the years ahead as Chinese growth remains solid.

Chinese shares still very cheap



Source: Thomson Reuters, AMP Capital

Concluding comments

China faces various risks, but these look to be manageable. While a return to the China driven commodity boom of last decade looks unlikely, Chinese growth around 7.5% should still provide reasonable support to global growth and provide a reasonable backdrop for Australian resources shares.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital