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Spectrum Insights

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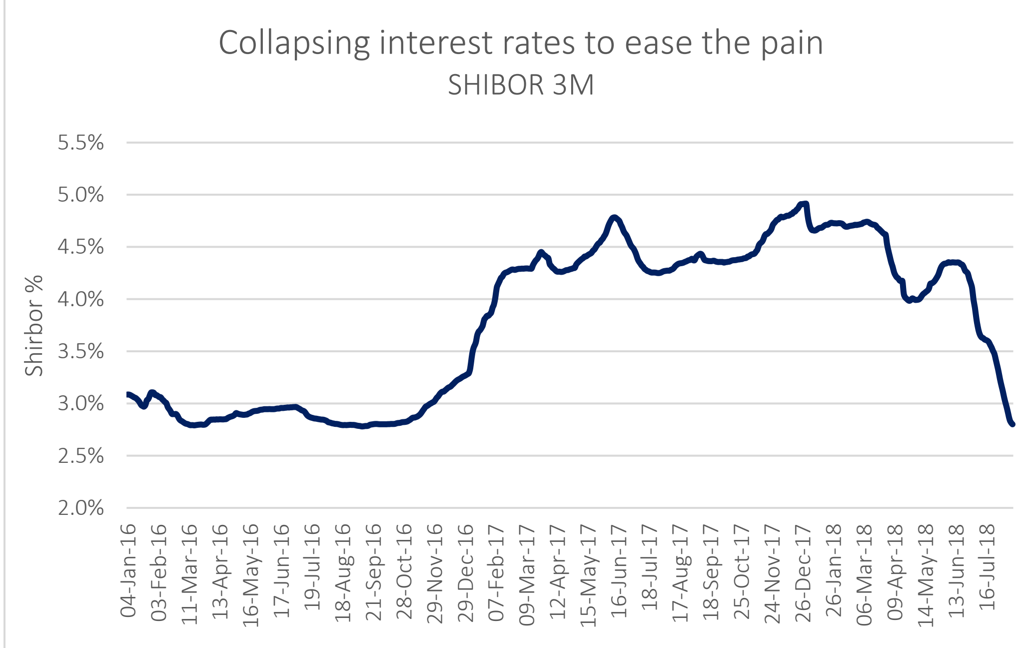
China – no hard landing – yet

China's government controls China's economy. The debt reform initiatives the Chinese government started in recent years were bearing nasty, but not unexpected, consequences. The fallout was accelerating of late. Those reforms have now lost policy primacy. Now, policy decisions are increasingly signaling near term economic stability as a priority. This means the Australian economy is unlikely to suffer a shock from its largest trading partner in the next 6 to 12 months. Likewise, our domestic corporate bonds have just seen one of their key indirect risks abate – for the time being.

Reform without pain

As we noted in the report Our double Minsky risk, China has a large debt problem. Too much debt held by corporates, too much financing from the shadow financial sector, and too much property speculation. It is not just our opinion. Many senior Chinese government officials have echoed these concerns. The challenge is how to reduce these imbalances while keeping the economy chugging along.



Sources: Reuters

The pain

Economic reform usually causes pain. Of late, China's corporate bond defaults have risen and credit spreads for the sector jumped. Total lending slowed. Economic growth tapered.

While the government was managing to move much lending from shadow lenders to official channels, the risk of a sharp economic slowdown looked to be building. This was occurring while a trade war with the U.S was looming.

The medicine

In response to the growing list of negative trend growth indicators, China's authorities responded with several measures including the following:

- The reserve requirement ratio of the banks was cut three times. This stimulates the propensity of the banks to lend.
- The commercials banks were directed to buy corporate bonds. This not only supports bond prices but may also be seen as a bidder of last resort function for bonds that need to be refinanced – thus reducing the risk of widespread bond defaults. [1]
- Banks were directed to lend to small businesses, the agricultural sector, and startup companies.
- Tax cuts.

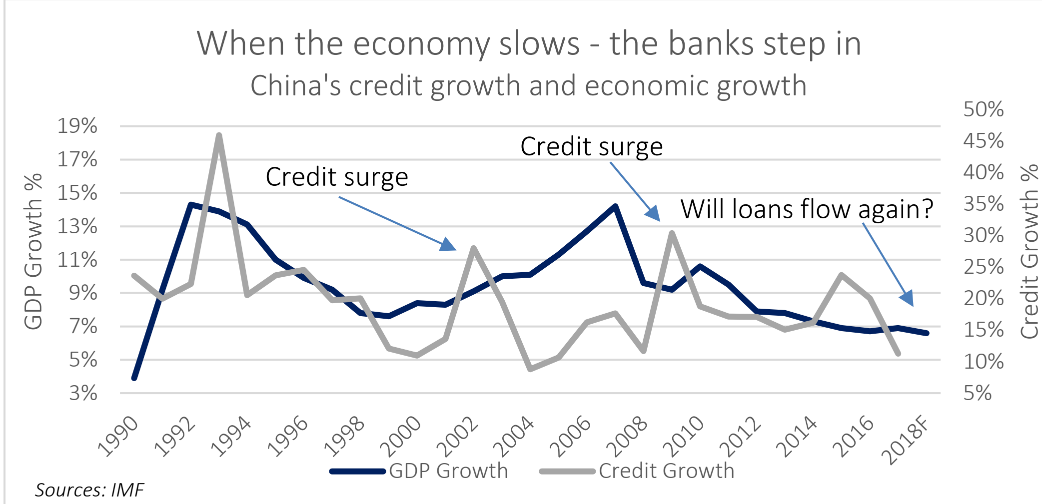
Strategic stimulus or sweeping under the carpet?

In recent decades, the Chinese government has thrown money at economic problems *as part* of a solution to avoid hard landings. The economic scoreboard shows it has been spectacularly successful.

In the mid to late 1990's some of China's banks had bad loans in the region of 40% of their loans books. In response, the authorities took many of the dud exposures off their books, set up asset management companies and funded the recapitalisation of the banks with some of China's abundant official reserves. Once the banks were fixed it gave them the capacity to lend rapidly again.

In the latter part of the 2007-8 GFC, China's authorities directed the banks to open the lending channels once again. Many pending and possible projects got quick funding. Then the Chinese economy boomed.

[1] On the 1st of June 2018, the PBOC broadened the range of collateral it accepts in its medium-term lending operations (MLF). It was expanded to accept assets including credit to small companies, credit to agricultural companies, and corporate bonds with lower credit ratings.



In the past the super stimulus worked. The economy responded - growing at a rapid rate. The net gains for the economy *appear* to have outweighed the extent of bad lending.

Now as a mid-wealth country and with a shrinking working age population, China's economic gains are probably going to be harder to generate. The impact of credit stimulus will likely have diminishing returns. The old play book of credit-fueled growth will eventually not work.

Judgement day awaits and waits and waits

Many critics of China's highly indebted economy look at it through a Western economic textbook lens. While their points are usually valid, forecasts of dire consequences that mirror what we have seen in other economies do not hold.

China has a controlled economy. Savings are aplenty. These savings can be directed. Stimulus can be targeted. Market forces can be corralled. What foreigners think should happen is nigh irrelevant to the Chinese economy. China is not dependent on foreign funding. External financial market forces on Chinese debt securities have little influence on China's policies. For a contrasting perspective see how Turkey – highly dependent on foreign currency funding – is currently faring when external sentiment sours.

This is not to say China does not face enormous challenges. Its private sector debt levels are what history shows are pre-crisis levels. Perhaps reforms can stoke productivity gains and the debt burden slowly eases and becomes more sustainable over the longer term.

The measures taken by the Chinese government to offset the fallout from reform are modest. However, the government's action and recent policy announcements, to us, send a strong signal that the responses will grow as and when needed to avoid a melt-down.

At this stage Spectrum believes China can and will avoid a debt crisis in the near term. The government target for economic growth is around 6.5% for this year. This seems feasible following recent actions from the Chinese government. More relevant to us is that China's growth will remain at a level that Australia's economy is not impacted, and this bodes well for Australian corporate bonds.

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