TYCHOS

China Commentary 9-16-20

Commentary:

For the first quarter, overall five-year country-level private debt growth to GDP provides moderate concern, accelerating to 15% from the previous quarter's 12%, but down from 42% in 2016. However, within that, household debt growth is still skyrocketing at 57% and brings a high level of concern. Non-financial corporation debt to GDP moderated to a 5% growth rate.

Our concern is generally mitigated by China's demonstrated expertise in pro-actively solving credit problems, which is almost unique among the Big Seven, and stems from China's ownership the largest banks and corporations. China has shown a preemptive capacity to support larger banks, direct capital replenishment, and assist in bad debt disposal. Therefore, while crisis is still possible because of continued debt-based creation of overcapacity, we believe it will most likely lead only to continued slowing growth, and a continued longer term level of downward pressure on non-agricultural prices.

This data predates most of the COVID issues, and growth has declined in the subsequent period, but China has shown the greatest prowess thus far among the Big Seven in recovering from COVID. Unfortunately, the mechanism for that recovery has been large amounts of additional debt, so we would expect this will boost short-term growth will also add to the longer term trends of slower growth and the exporting of deflation.

The advantage of China's high net export position has largely disappeared in the aftermath of the Great Recession. That advantage, which reached as high as 8% in 2007, is now roughly 1%, and so China can no longer look to exports for growth to nearly the same degree. In the period of highest net export advantage, 2003-2008, the private debt to GDP ratio, unsurprisingly, *improved* by 16%. Since that advantage collapsed, private debt has had to take up the slack as China's engine for growth, and has grown by an extraordinary 102% to GDP.

The specific non-financial corporation sector of greatest concern is real estate. For households, all areas appear to be high risk, led by mortgage and credit cards

The financial institution type that shows the highest growth and is thus most deserving of scrutiny is banks, most notably the Postal Savings Bank, China Merchant Bank, China CITIC Bank, and Industrial Bank.

We can observe no material cross border risk.

We can find no information on derivative risk in China.

China's general government debt continues to grow rapidly, and now has reached 56% of GDP.

Country net worth:

Aggregate country financial net worth was previously high, but with China's disappearing net export advantage, is now intermediate compared to others in the Big Seven and is falling. Household financial net worth is intermediate and rising, Non-financial corporation financial net worth is tied with US for the lowest and is falling. China's government financial net worth is by far and away the highest, since much of corporate ownership is held by the government.

The reported non-financial assets of non-financial corporations and financial institutions appear to be plug values, and thus of no analytical value.

Background:

Accelerating private debt for a country is normally a signal for some level of economic boom, which is then often followed by some type of economic reversal or calamity. The same is also true for rapid debt growth within an economic sector. At the point credit growth becomes excessive, the result is credit problems for that country or sector. The reason is this: rapid growth in credit, while usually favorable in the short run, if sustained can lead to oversupply or overcapacity—e.g. too many houses or too much oil extraction capacity—at the country level, or within a given industry or sector. In fact, overcapacity is only possible through rapid debt expansion. Significant overcapacity is generally followed by two events—a drop in sector activity and the necessity of sector layoffs during the period while demand catches up, along with high credit losses for lenders in that sector.

There is no hard and fast measure for the level of growth that leads to overcapacity, since the nature of policy responses and other qualitative variables have a significant influence on how events play out. Nevertheless, what has been a useful threshold measure is that if overall private debt to GDP increases by 20% in a five-year window, and reaches 150% in that time frame, credit problems are a likely result. Within a given sector, if sector debt to GDP increases over 40% within five years, credit problems of increased likelihood within that sector. If the sector is large enough, e.g. the real estate sector, that sectors problems can spill over into other sectors bringing systemic national risk.

Disclaimer:

All data in this report is as current as is readily available. Certain data is less timely than desirable, especially sector level data. However, most adverse volume trends must hold for more than a year or two to create significant credit concerns, so this lag in data, while unfortunate, does not preclude of significant trends.

https://www.tychosgroup.org Email: Contact@tychosgroup.org