China

Too close to the state to fail

6 October 2017

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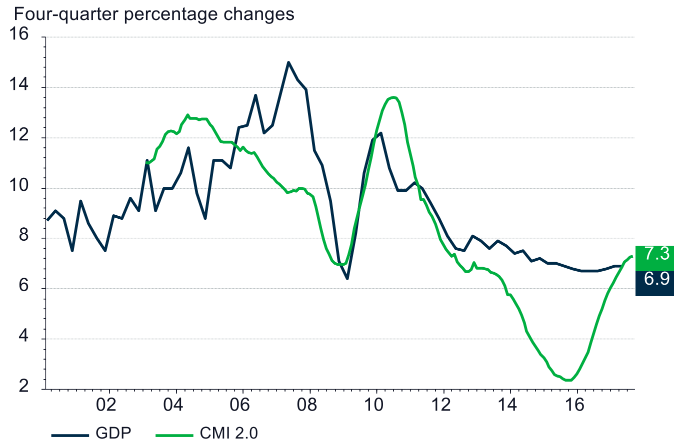
The China Momentum Indicator 2.0, Fathom's measure of economic activity in China, rose to 7.3% in August. The pace of growth has almost tripled in the last two years. Unable to tolerate the slowdown associated with a rebalancing, which could threaten the position of President Xi Jinping, the Chinese authorities have recommitted to the model of export- and investment-led growth. This means more credit being channelled to unproductive industrial state-owned enterprises, of which one in three are operating at a loss. The state's preference for maintaining social stability, rather than allowing the forces of creative destruction to eliminate unprofitable firms, adds to China's long-run problems of total debt at 260% of GDP, non-performing loans at 30% of GDP and slowing productivity growth.

According to our China Momentum Indicator 2.0 (CMI 2.0), real economic growth in China rose to 7.3% in the twelve months to August. At a five-and-a-half year high, this marks a significant rebound from the trough of 2.4% in September 2015. This pick-up in economic activity will have been actively encouraged by President Xi Jinping in the lead up to the Communist Party's twice-a-decade National Congress, scheduled to take place on 18 October. Putting on a show of prosperity ahead of this will have been seen as mandatory amongst government officials trying to gain favour with Xi, who will begin his second five-year term as party chief.

GDP and Fathom China Momentum Indicator 2.0



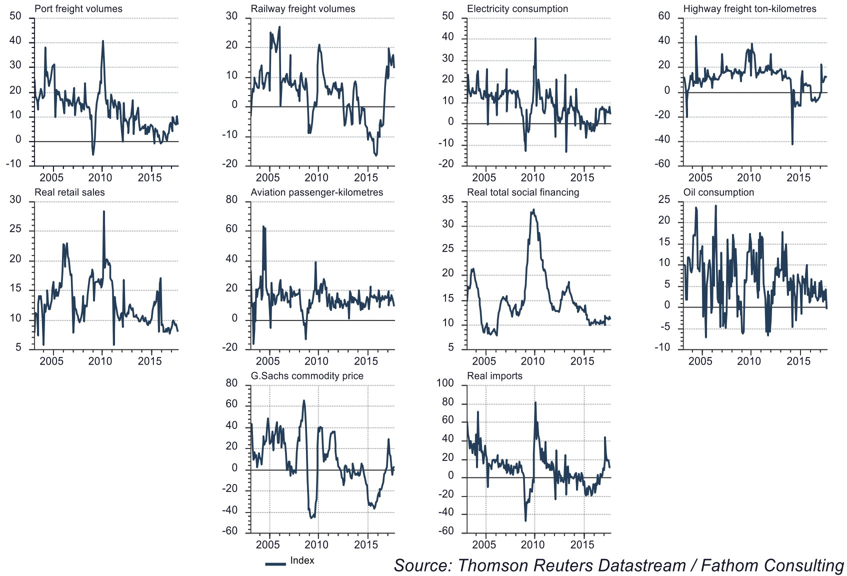
Source: Thomson Reuters Datastream / Fathom Consulting

Activity has picked up from 2.4% in September 2015 to 7.3% in August 2017, according to our CMI 2.0

However, at what cost? Of the ten indicators included within our CMI 2.0, half have expanded at significantly higher rates than in the slump of late 2015: railway and port freight, electricity consumption, real imports and the commodity price index. Meanwhile, growth in those indicators representative of the services sector of the economy — financing, retail sales and air passenger volumes — remains subdued. This supports our call made in the first half of 2016 that Chinese policymakers have doubled down: unable to tolerate the slowdown associated with a rebalancing, which could threaten their own position and control. They have chosen to recommit to the model of export- and investment-led growth rather than a reorientation towards the consumer.

CMI 2.0 indicators

Twelve month percentage changes



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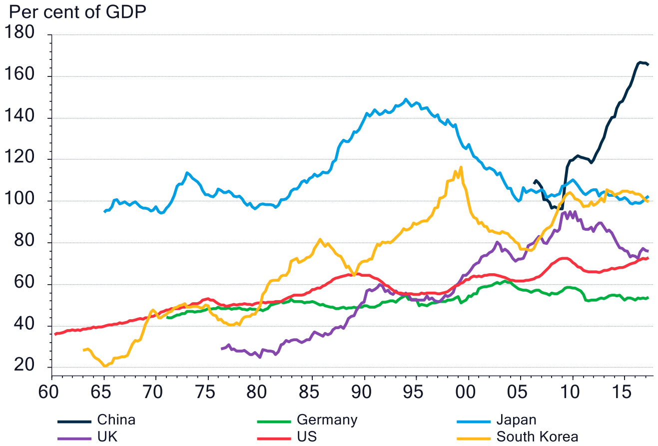
This amounts to a continuation of credit being channelled to unproductive assets within the economy, adding to China's long-run problems of high debt, ever-increasing stack of non-performing loans and slowing productivity growth. As we have highlighted previously, the accumulation of non-financial debt beyond 250% of GDP stops being effective and starts to damage growth significantly. China passed this point in the third quarter of last year. Over half of its debt is held by non-financial corporates — at 165% it is higher than that of Japan at the peak of its banking crisis in the 1990s. Referring to similar concerns, last month S&P Global Ratings became the second credit rating agency this year to downgrade China.

Subcomponents of the CMI 2.0 primarily responsible for the rebound are associated with China's old growth model

Credit to non-financial corporations



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China's total debt is at 260% as a share of GDP. Further debt accumulation will damage growth

When China's policymakers said at the beginning of this year that the time had finally come for them to "rein in financial risks", many took them at their word. Numerous monetary tightening policies aimed at curbing fresh lending were introduced. At the time, we described this as merely a new chapter in China's love-hate relationship with credit, anticipating that if and when growth fell substantially below the government's comfort level, the monetary taps would be turned back on. Three of the five indicators which have been driving CMI 2.0 higher have turned down over the past couple of months. As if on cue, on Saturday, the People's Bank of China (PBoC) announced the reserve requirement ratio (RRR) will be cut by between 0.5 and 1.5 percentage points at the beginning of next year. Although packaged as a way to encourage lending to small and agricultural businesses by applying the cut only to those banks who lend more to these types of firms, the threshold for eligibility is so low that the PBoC admits there will be few exemptions. So this is really a loosening of liquidity across the economy.

We predicted at the beginning of the year it would not be long until policymakers would turn the monetary taps back on — we were right

We agree with the rationale behind the PBoC's latest move, diverting credit to more efficient firms, not those most closely linked to the state. However, in reality this policy is unlikely to have much of an impact. The ethos introduced in the first Five Year Plan (FYP) in 1953, that large state-owned enterprises (SOEs) should play a central role to the economy, rather than small independent ones, remains intact today. Indeed, according to official manufacturing PMI data for September which registered the highest reading since April 2012, it is the larger, typically state-owned, firms that are expanding, while the smaller, typically privately-owned, firms contract.

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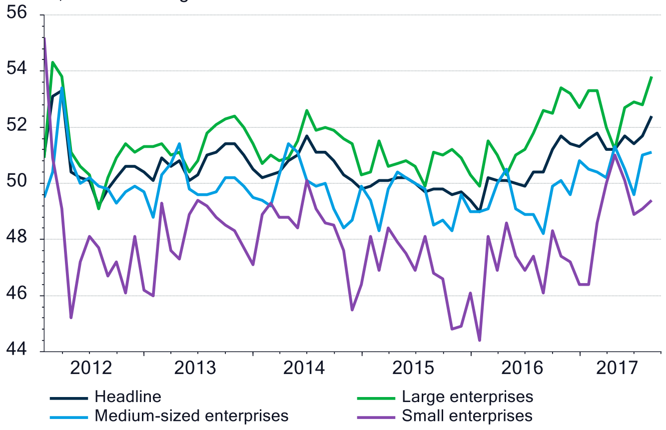
China manufacturing PMIs by size of enterprise

Index, 50 = no change



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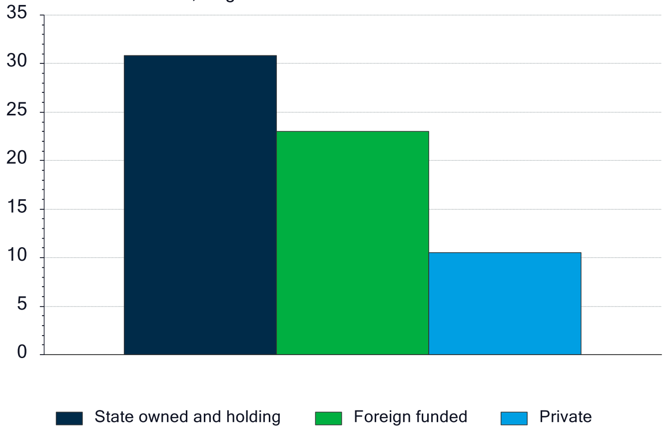
Xiao Yaqing, the top administrator for central government-owned manufacturing companies said last month that the framework for China's state-owned enterprises is "basically complete". This is particularly concerning as data for August shows that close to a third of industrial firms partially or wholly owned by the state are operating at a loss. The equivalent statistic for private industrial firms was just 10%.

One in three industrial firms partially or wholly owned by the state are operating at a loss

China loss making industrial firms by enterprise

Per cent of total firms, August 2017



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The state is reluctant to allow the forces of creative destruction to eliminate unprofitable firms, prioritising social stability instead. Heavy borrowing combined with weak profit growth has left SOEs struggling to fulfill their debt obligations. A firms' interest coverage ratio (ICR) — the ratio of earnings before interest and tax to interest expenses — is commonly used to assess a firm's financial health. The next two charts show this ratio for both local and central SOEs by industry. At this year's Financial Work Conference President Xi said "deleveraging SOEs is of

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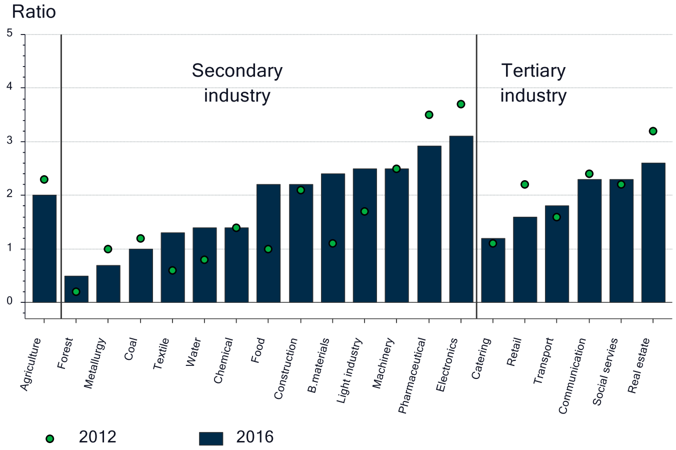
the utmost importance”. However, since he came to power the situation has, if anything, worsened. Between 2012 — when Xi Jinping was elected as General Secretary of the Communist Party — and 2016 the average ICR for central SOEs fell or stayed the same in 11 out of 20 industries. Reducing excess capacity in traditional manufacturing industries such as iron and steel was classed as urgent in 2013. However the average ICR for both central and local SOEs operating in the metallurgy industry remained or fell below one by 2016. In other words, the operating earnings of these firms were insufficient to cover their interest payments for just one year. This is setting the path of destruction for the future, adding to China’s non-performing loan pile which we estimate to be in the region of RMB 20 trillion.

China interest coverage ratio local SOEs



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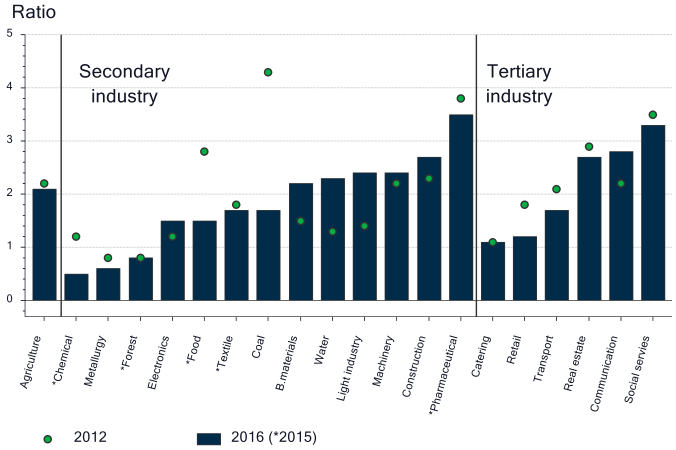
China interest coverage ratio central SOEs



Source: Thomson Reuters Datastream / Fathom Consulting

Absent of creative destruction, SOEs are struggling to fulfil their debt obligations

The chart below calculates the difference between an industrial bond issued by private enterprises, local SOEs and central SOEs with the policy bank financial bond with the same maturity (used as the benchmark for this analysis). As the default risk of the issuer increases in the eyes of the investor, the spread widens. Based on the ICR measure described above, local SOEs’ financial performance was better than central SOEs in 12 out of 20 industries in 2016. Despite this, investors have charged a higher risk premium for lending to local rather

The lower risk premium attached to lending to SOEs relative to private enterprises reflects the implicit government guarantee given to SOEs

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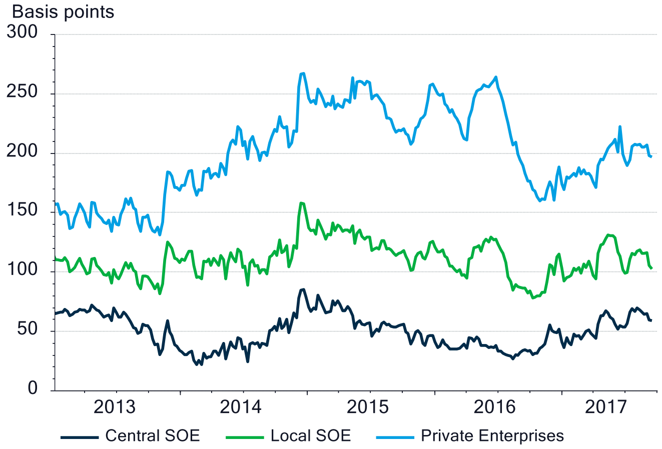
than central SOEs throughout the time period shown in this chart. The risk premium placed on lending to private enterprises is four times higher than for central SOEs. The only way to explain this is that investors are relying on the state to step in to fund those struggling SOEs. Until preferential access to finance and implicit government guarantees to unproductive SOEs is stopped, new investment will continue to be channelled to the wrong places. In the past we have found strong evidence to suggest an implicit government guarantee does not just undermine long-term growth, but also increases financial vulnerability, thereby acting as a marker of an impending financial crisis.

China industrial bond credit spreads



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Our view is that the upswing in growth achieved by opting for the easy route to stimulate the economy will ultimately threaten China's long-term growth prospects. Those hoping that Xi Jinping's second five-year term as party chief will lead to significant progress in tackling overcapacity are likely to be disappointed. Evidence from his first term shows that prioritising social stability and achieving official growth targets remains his key focus. In our central scenario for this quarter's *Global economic and markets outlook* we expect GDP growth as measured by CMI 2.0 to fall back to 6.4% by 2019. Our central forecast for the long term, relating to 2020-25, is for growth of around 4.5%, ending the period close to 3%, as maintaining the tactic of low consumption and continued investment in unproductive assets results in a falling return on capital which undermines growth. Of course, the authorities, under instruction from President Xi Jinping, will likely continue to report faster growth.

The choice to double down and support unprofitable firms puts China on a lower long-term growth path

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