China deleveraging: Domestic and global impacts

China increasingly sees financial deleveraging as a critical objective. The macroeconomic impact for China will be significant. For the rest of the world, it means fewer growth opportunities.

By *Chris Kushlis*

Chris Kushlis

Chief of China and Emerging Markets Macro Strategy, T. Rowe Price

China's focus on deleveraging began in earnest in 2017. After an interruption due to the pandemic, it returned in 2021 as a key focus of economic policy. We view China's deleveraging campaign as a multiyear agenda with the strategic aim of controlling the country's debt-to-GDP ratio. It marks a sea-change of policy by the Xi Jinping administration that will impact the Chinese domestic economy and financial markets significantly in the years ahead. It is also a relevant theme for international investors given the importance of China to the global economy, with a broad potential to impact asset classes and regions, especially in Asia.

Leverage surged after the Global Financial Crisis

China's credit-to-GDP ratio surged after the massive fiscal stimulus introduced in response to the Global Financial Crisis. It later stabilized over 2017-2019 thanks to President Xi's deleveraging campaign, but unsurprisingly jumped in 2020 after the exceptional policy measures to counter the COVID-19 pandemic.

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By December 2020, this aggregate measure of leverage had risen to 285%, far above that of other Emerging Market economies. China's credit-to-GDP ratio lies closer to that of a developed economy, albeit at a much lower level of per capita income, which ultimately is the bedrock upon which debt repayment capacity must be based.

Corporate leverage (including state-owned enterprises), the sector of most concern initially, stabilized at a high level. In contrast, both household and government debt (including local government financing vehicles) relative to GDP has continued to rise. Thanks to the downward trend in interest rates, China's debt service burden has been broadly stable since 2015. So like Japan before it, lower interest rates in recent years enabled China to increase its macro leverage without encountering higher debt service costs.

We believe that investors should not underestimate the commitment of the Xi Jinping government to tackle China's growing financial sector risk by continuing to stabilize the debt-to-GDP (D/GDP) ratio while also gradually improving the allocation of domestic credit over time. In 2017 President Xi declared that 'Financial stability is the

PHOTOS: ARCHIVE T. ROWE PRICE, SHUTTERSTOCK basis of national stability'. Coming shortly after his declaration that 'Houses are for living in, not for speculation', Xi's statement in 2017 marked a major turning point for China. From the government's recent actions during China's post-pandemic recovery, one might reasonably conclude that the era of debt-fueled all-out economic growth pursued by previous leaders, including Presidents Jiang Zemin and Hu Jintao, is over.

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Macroeconomic implications of deleveraging

Over time, we expect a significant macroeconomic impact from China's commitment to financial deleveraging. First, for a large economy like China, deleveraging means a period of slower economic growth and larger external surpluses/lower deficits. We believe the Xi Jinping administration understands there may be short-term economic costs, but still prefers to aim for a lower, higher-quality growth trend for China.

What is not known, is whether a stable debt-to-GDP ratio is compatible with average growth around 5.0%, which may be the lower acceptable bound for Beijing. Since China has recently been contributing up to one-third of global growth, a slower China will imply a notable drag on global growth, both directly and indirectly.

With regard to China's public sector finances, for us one key implication of deleveraging is that the imbalances built into the current system between the limited financial resources directly available to regional and local governments and their much greater expenditure responsibilities, must change. Financial stability requires that local governments end their over-dependence on revenues from land sales in favor of a national property tax, a long-overdue financial reform. Given vested interests have long resisted a property tax, while the potential risks increase if it is introduced in a slowing economy, this reform may have to wait until after the Party Congress in October 2022.

The potential impact on Emerging Market economies

For the rest of the world, China's financial deleveraging means fewer growth opportunities. It is unlikely, for example, that China will drive another commodities 'super cycle'. Emerging Market economies have limited scope to increase their share of exports to China, except for some low-value added products or a few specialized high-value items, such as Korean or Taiwanese technology exports. EMs could thus find themselves under pressure to develop new growth sources or underperform. We think that one potential growth source is tourism. Once China reopens its borders, outbound tourism to other Asian countries, especially Southeast Asia, is likely to expand rapidly.

More generally, however, as China becomes a richer, wealthier country, it may demand relatively less of what EMs currently produce, switching to more sophisticated, higher value-added imports from developed economies. This in turn is already opening up space in the low value added and lower part of the middle value added segment for more EMs, particularly frontier markets, to move into. However, none can offer the full package of low wages, infrastructure efficiency and a favorable business environment that China has offered foreign direct investment investors, which means there is unlikely to be any single winner from this process.

And in financial markets, larger external surpluses as China slows, are more likely to be recycled via foreign direct investment in 'Belt and Road' projects than in purchases of overseas financial assets like US government bonds. Over the past two decades China's credit cycle has had a strong influence on EM assets, particularly credit and FX. This link may weaken over time, although we still think it will play a significant role. ■

SUMMARY

Deleveraging returned in 2021 as a key focus of China's economic policy, with a multi-year strategic aim of controlling the debt-to-GDP ratio.

For China, deleveraging means a period of slower economic growth and larger external surpluses, with short-term costs followed by lower but higher-quality growth.

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