The Emerging Strategy For Debt

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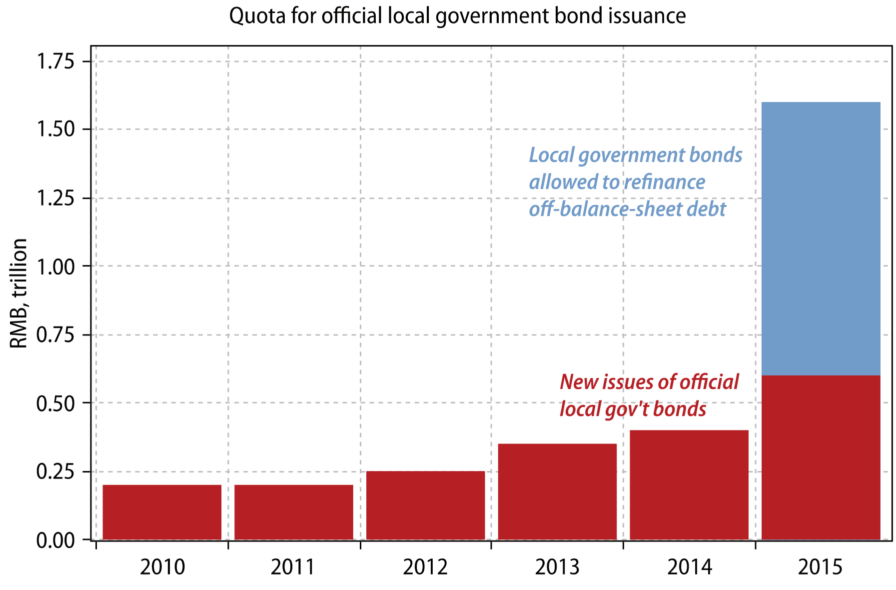
Over the next few months, Chinese provinces will start selling an unprecedented quantity of new bonds. Much of this debt will be new in name only: while most of the huge economic stimulus since 2009 was financed by unofficial, off-budget borrowing, this year RMB1trn of that will be transformed into official government debt. With the launch of this debt restructuring program, and the shift in monetary policy over the past several months, China's strategy for managing its mountain of debt is finally becoming clear. This strategy will shape the country's economic trajectory for years to come, and in particular will have big implications for the bond market. We see interest rates falling, bond issuance exploding, and pressure for capital-account liberalization rising.

The size of China's local government bond market will explode as the refinancing of off-budget debt begins

China plans a major restructuring of local government debt in 2015



Ministry of Finance, Gavekal Data/Macrobond

After putting off dealing with its debt problem for years, China now has an emerging strategy

The very fact that China has a coherent strategy for dealing with debt is good news. The previous administrations under Hu Jintao and Wen Jiabao allowed very rapid growth in total debt at relatively high interest rates—a recipe for financial stress. They also pushed local governments to borrow to fund stimulus projects, but refused to admit that Beijing had any liability for the resulting debts. All of those dubious decisions are now being reversed under President Xi Jinping and his economic team of finance minister Lou Jiwei and central-bank governor Zhou Xiaochuan.

The core of their strategy is a set of three choices: 1) slow the accumulation of debt, while avoiding a sharp deleveraging that would punish growth, 2) lower interest rates to reduce financial stress and avoid defaults, and 3)

Managing debt will lead to lower interest rates and rising pressure for capital-account liberalization

selectively use the power of the central government's balance sheet to ease the debt burden. We think the economic implications are clear. The combination of choices 1) and 2) means that domestic interest rates and bond yields will keep falling in coming years, though monetary policy may not feel much looser as credit growth will also slow. Choice 3) means that official government debt and deficits will rise, and the size of the local government bond market in particular will explode. Opening up the domestic bond market to foreign investors will look increasingly attractive as a way of absorbing some of that new bond supply.

Solvency vs. liquidity

To understand China's strategy for its debt problem, it helps to start from a basic point: the distinction between liquidity problems and solvency problems. If a borrower cannot make payments because of temporary difficulties, that is a liquidity problem. If a borrower will never be able to come up with enough cash to repay the debt, that is a solvency problem. But this theoretical distinction is difficult to make in practice. Neither borrowers nor lenders like to admit to solvency problems: companies think they can sort things out, and banks don't want to publicize their bad decisions. And the uncertainty over whether a problem is one of liquidity or solvency is often highest just when the question is most urgent. If an economic downturn is only going to last for a short time, then a late interest payment is likely to be a liquidity problem; if the downturn is going to be an extended one, then it's more likely to be a solvency problem.

Bad debts can be treated as either a problem of solvency or liquidity

The distinction between liquidity and solvency problems is thus less an objective one about the nature of debts and more of a subjective judgment about the strategy to deal with them. China today—much like the European Union does with Greece—faces a political decision between two approaches to handling debts. The first approach is to treat bad debts as a solvency problem: accept that debts are bad, and pay the costs now to avoid "throwing good money after bad." This strategy risks raising worries about the health of the banks, but allows them to quickly shift their lending to more productive parts of the economy. The second approach is to treat bad debts as a liquidity problem, which can be solved by time and generous terms on loans. Pushing down interest rates and making refinancing easy ensures companies aren't forced into default and can survive to, hopefully, repay in the future. This avoids shocks to the system and gives more time to find solutions, but risks making the final cost higher.

China has the luxury of choosing its strategy, which many developing countries do not

In fact, not every country can choose between these two approaches. Countries that do not control their own monetary policy, or are very dependent on foreign creditors, often do not have the option to treat bad debts as a liquidity problem. Developing countries who have borrowed heavily in US dollars cannot unilaterally push down the interest rates they pay, nor force foreign creditors to roll over those debts. When emerging-market borrowers get in trouble, skeptical foreign creditors tend to force them into the solvency-problem approach, where the adjustment costs are taken up front. China is therefore more like Japan than it is like other emerging markets: most of its debts are in local currency and held by local banks, and it can make monetary policy based on domestic considerations rather than being held captive by foreign capital flows.

Freedom to choose

China used a different debt strategy in its 1999 bank restructuring...

So China has the luxury of choosing the liquidity-problem approach, which is also much more politically acceptable—its leadership values stability above almost anything else. Yet it is worth recalling that China has not always gone for this option. In 1999, China's banks had an enormous burden of bad debts thanks to decades of lending to money-losing state enterprises. The government did in fact treat those debts as a solvency problem, but it minimized the adjustment costs by buying RMB1.4trn of bad loans from the banks at face value. The government did not pay cash for this huge sum—equivalent to 18% of GDP at the time—but instead swapped the debts for long-term bonds bearing a government guarantee. Arthur has called this trick the "magical debt-shrinking machine": allowing China's high rate of nominal GDP growth, compounded over time, to reduce the relative size of the debt until it became manageable.

...but today's much-larger debts and weak growth prospects mean that approach will not work this time

This time around, China faces a much higher stock of debt and much lower rates of nominal GDP growth, meaning the debt-shrinking machine cannot easily work its magic again. Without its assistance, the solvency-problem approach to debt management looks unnecessarily risky from Beijing's perspective. And the previous administration's strategy of ignoring the problem altogether—refusing to even choose between the solvency and liquidity approaches—was also becoming untenable. Corporate profitability has deteriorated as the economic slowdown since 2012 has deepened, leading to more and more problems for borrowers—evidenced by a steady rise in banks' nonperforming loans and a greater incidence of defaults and near-defaults in the corporate bond market. As a result, we believe China has now clearly chosen to treat its debt as a liquidity problem, and has developed a three-part strategy.

The first part of the new strategy is to slow the accumulation of new debt

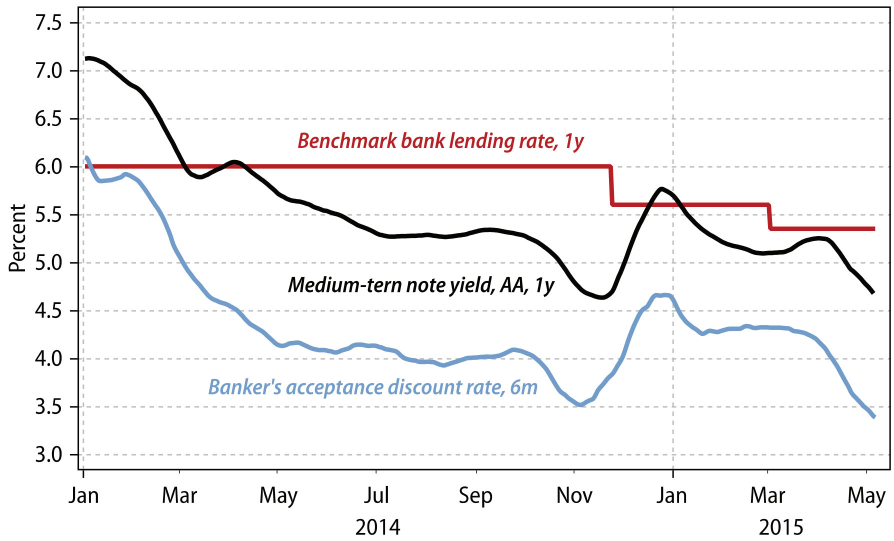
The first part of the strategy is to significantly slow, though not halt, the accumulation of new debt. Both central-bank governor Zhou and finance minister Lou recognize the financial risks that come with China's very large stock of existing debt, now equivalent to about 250% of GDP. They do not want to add much to the current stock, but neither do they wish to aggressively reduce it, as that would put even more pressure on economic growth. To control the expansion of debt, the central bank has set its annual target for money supply growth at 12% for 2015, the slowest in a decade, and has cracked down on fast-growing shadow finance. As a result, credit growth has slowed to about 13%, the slowest pace since 2006. This rate is still above nominal GDP growth, meaning that the debt-to-GDP ratio is still rising—but more slowly than it was at 20%-plus credit growth.

The second part of the strategy is to make it easier to live with a high level of debt by reducing the risk of defaults. The way to avoid debt defaults is quite straightforward in principle. As long as interest rates are low enough and existing debts can be rolled over, nobody will default on their debt. While the slowdown in credit growth has been government policy since early 2013, it took longer to arrive at the low-interest-rate strategy. In 2013 there was a period when the central bank pushed up interbank rates significantly to punish banks doing too much shadow financing. But the reaction to this strategy was very negative, and since then the central bank has moved to reduce both regulated benchmark rates and market-driven interbank rates. We believe the central bank will not again risk trying to force deleveraging through high interest rates, and that it will keep lowering rates to accommodate the slowing trend rate of economic growth.

Lowering interest rates reduces financial stress and lowers the chance of default

China's central bank is lowering financing costs

Cost of credit for corporate borrowers, by instrument



CEIC, Gavekal Data/Macrobond

The third part of the strategy is to *selectively* use the power of the central government balance sheet to make it easier for borrowers to roll over their debts and lower financing costs. China's central government, with outstanding official debt of less than 20% of GDP, certainly has room to assist the more-indebted sectors of the country. And in fact, Beijing helped create the local-government debt mess by putting pressure on local authorities to support growth, and turning a blind eye to their illicit borrowing. But the Ministry of Finance has always been reluctant to acknowledge this reality, and this part of the strategy was the last to emerge. Only in March did MOF announce that it would permit RMB1trn of off-budget local debt to be refinanced as official government debt.

The central government is also now willing to help resolve local debt problems

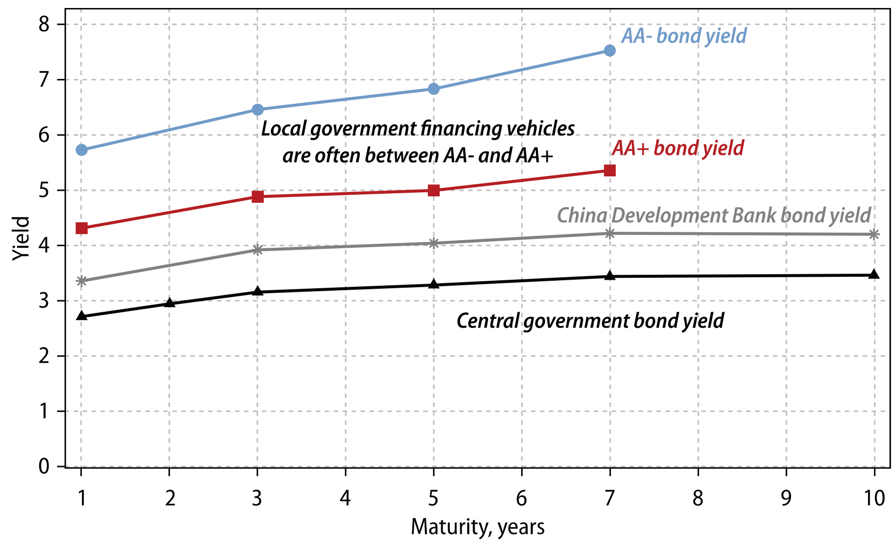
This plan for refinancing some local debt is a perfect example of the liquidity-problem approach, as the priority is on lowering debt service costs and extending maturities. The off-budget borrowings by local government financing vehicles (LGFVs) were never treated as true government debt, because of the uncertainty about how much support would be forthcoming (by law, local authorities could not offer guarantees). That kept interest rates relatively high. But once their debt is transformed into officially-sanctioned local government debt, with an explicit guarantee, the interest rate can be much lower.

This is straightforward in theory, but just how much less local governments will be able pay after the refinancing is a tricky question in practice. Although there is already RMB1.2trn in local government bonds outstanding, the market is very illiquid. Local commercial banks purchase these bonds at low yields as a favor to their local governments, and hold them to maturity. But banks can no longer do this as the size of bond issuance is going to explode this year. Therefore the local government bond yields of today are not going to be a good guide to pricing in the future.

Local governments are looking forward to reducing their interest burden

Local government borrowing costs will fall after refinancing

Onshore bond yield curve, by type



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But if rates on local bonds are too low, banks are not going to buy

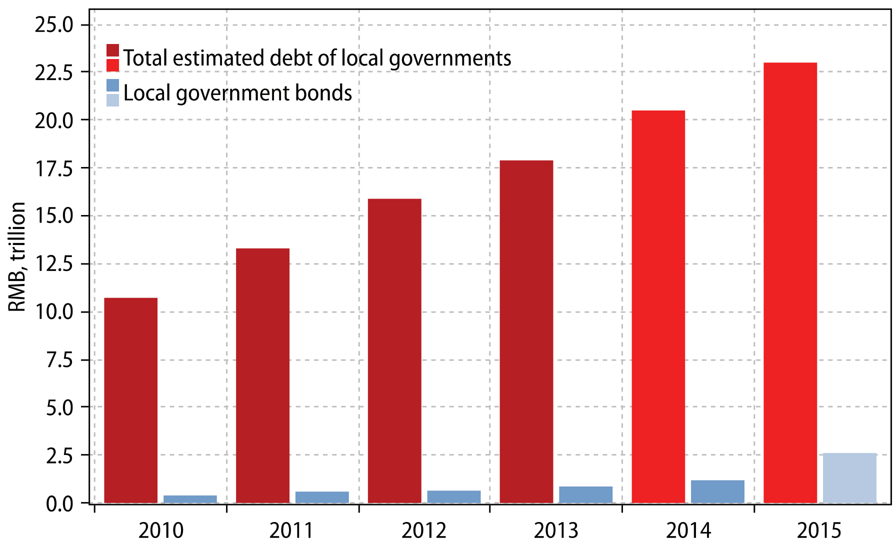
That will be disappointing to the local governments who have issued debt at rates close to those on central government bonds (CGBs), and are still hoping to pay those rates. Today the five-year CGB yield is at 3.3% and the five-year policy-bank bond yield is at about 4%. While provinces with a strong fiscal situation cannot expect to pay the same as the central government, we suspect they can probably bargain for a rate close to what policy banks are paying, so between 3.3% and 4% for a 5-year bond. But while banks do not have to set aside any capital for purchases of CGBs and policy bank bonds, which are considered risk-free, they do have to set aside 20% of the value of local government bonds. So banks will likely not be willing to buy lower-quality local government bonds unless they are getting a higher yield. Nonetheless, even in a worst-case scenario borrowing costs on these new bonds should be 200-250bps lower than the interest rate on bank loans and LGFV bonds, allowing local governments to save RMB20-25bn on interest payments this year.

We believe this year's refinancing will only be the first installment of a multi-year program. According to the last National Audit Office report, local governments were responsible for RMB10.9trn in debt as of mid-2013, with another RMB7trn in contingent debts. In 2015, RMB1.86trn of the direct debts will come due, so the RMB1trn bond refinancing program means about 54% of maturing debts will be rolled over. But the real coverage of the refinancing is almost certainly lower, as the total size of local government debt has increased since the last audit report—to RMB16trn according to some reports. And while each province is being allowed to refinance the same 54% of its maturing debt, this fails to recognize that some provinces will likely need more help. Northern and inland provinces are doing much worse than southern coastal ones: coal-rich Shanxi province, for instance, had GDP growth of just 4.9% in 2014.

The first trillion will not be the last

There is still lots of local debt that can be restructured

Outstanding amounts of debt, by type



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The finance ministry doesn't want to give local authorities a completely free lunch

So while MOF has come around to the necessity of central involvement, it is also clear that it doesn't want to completely bail out local governments. Not all of the debts accumulated by the companies associated with local governments are considered legitimate public debts. Beijing is happier to support a well-planned infrastructure project than a speculative property development. MOF also wants local governments to solve some of their own debt problems, by introducing public-private partnerships to manage projects, or raising funds by selling state assets. Local governments, of course, will try to get "official" status for as much of their debts as possible. The bargaining between Beijing and local governments is still going on, but we believe the ultimate outcome is not in doubt: official government debt and deficits will expand in coming years (see **The Inevitable Rise Of Fiscal Deficits**). The size of the local government bond market could easily reach RMB10trn in a few years' time.

The next question is who will absorb the explosion of bond supply. Chinese commercial banks are the primary creditors to local governments now and also the dominant players in the domestic bond market. But local governments' insistence on very low yields has put off banks, causing a couple of planned local government bond issues to be postponed. The solution will have to involve assistance from other authorities, namely the central bank and banking regulators. While we don't think the central bank will start buying government bonds directly (see [To QE Or Not QE]), it is plausible that it will try to facilitate local bond sales in various ways.

One possible option is for it to give long-term loans to the policy banks, such as China Development Bank, who would use the funds to purchase local government bonds. Since the policy banks' funding costs are relatively high, they are unlikely to buy low-yielding local bonds without such assistance. This is technically possible, but would not help market development: local government bonds would be very illiquid if they are mainly held by policy banks.

Riding to the rescue

The central bank can assist the bond sales by lowering banks' reserve requirements

The most straightforward way for the central bank to help is just to cut interest rates and the reserve requirement ratio even further. Currently Chinese banks must set aside 18.5% of their deposits as reserves at the central bank, a sum that amounts to more than RMB20trn. If reserve requirements are cut aggressively this year, as we believe will be the case (see The Relevance Of Bank Reserve Cuts), this will free up a lot of funds that can be used to buy bonds. The desire to support local bond sales could mean that reserve requirements will be cut by more than they otherwise would be. And if market interest rates also go lower, banks would no longer insist on quite such high yields on the local bonds.

The government is also encouraging domestic funds and individuals to buy local government bonds. Earlier this year the State Council said the National Social Security Fund (NSSF), which currently manages RMB1.5trn, could invest as much as 20% of its assets into local government bonds, up from the current 10%. But we think the government will also be keen to bring in foreign institutional investors. Currently, foreign access to the domestic bond market (as opposed to the offshore "dim sum" market in Hong Kong) is limited to a few central banks and the fund managers who have a quota under the Qualified Foreign Institutional Investor (QFII) program. So far foreigners own only RMB700bn of China's domestic bond market, which is less than 3% of total outstanding bonds.

Foreign investors could also be an attractive source of capital

We believe it won't be too long before China further open up the bond market to foreign investors. China has pledged to accelerate capital-account liberalization this year in order to qualify the renminbi for inclusion in the International Monetary Fund's Special Drawing Rights (SDR) currency basket—a symbolic recognition that the renminbi is truly a global reserve currency. Investor interest is likely to be strong given that China's bond yields are high by global standards: compare the 3.5% yield on a 10-year CGB to the 2.2% on US Treasury bonds, 0.6% on German bunds and 0.1% for Swiss government bonds. And even if foreign investors are skittish about buying local government bonds, if they buy more central government debt the additional liquidity will allow domestic investors to buy more local debt themselves. China's debt management strategy will in fact complement its strategy for internationalizing its currency.