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IMF on China: A Downturn is Inevitable

A recent working paper from the IMF titled "Credit Booms – Is China Different?" provides a good summary of many of the key issues facing China's economy. Rapid credit growth since the global financial crisis is record setting for both its total expansion and its duration. Credit is being poorly used with the most inefficient sectors and firms grabbing large shares of new debt. Banks have seen rapid growth in their size and complexity and when combined with a heavy reliance on short term funding this creates a major risk of a liquidity crisis.

Whilst using diplomatic language the working paper makes clear that China may be able to continue its current trajectory for the medium term but in the long term a downturn, likely accompanied by a banking crisis is inevitable. This paper reviews the key points from the IMF paper and adds commentary on issues that the IMF paper omits.

Record Setting Credit Growth

The IMF identified 43 precedents where the credit to GDP ratio of a country increased by at least 30% over a five year period. China's recent credit growth tops all but one of these on this measure, and given the historical underreporting of credit growth it is likely that China is number one on this measure. Of the 43, 40 subsequently had a major growth slowdown, often accompanied by a banking crisis. The three that didn't suffer provide little comfort as they all began with much lower levels of debt and were effectively catching up to international equivalents.

Emerging Market Financial and Institutional Development

Perhaps it is because the IMF is too polite, but its report fails to mention that China is still an emerging market based on its GDP per capita, the development of key institutions and the development of its financial system. This distinction is critical, as China is carrying a developed market level of debt. The now common comparisons of China's debt levels with the US, Japan and Europe are non-sensical. China's relatively short development timeframe, particularly when accompanied by substantial central planning and government intervention, means its financial system and investors have simply not had the time to learn from smaller mistakes before taking larger risks.

China's nationalism has largely prevented it from learning from the mistakes of developed countries in the lead up to the global financial crisis. China is repeating many of those mistakes now including widespread lending to unprofitable businesses and consumer mortgage fraud. The development of the technology and venture capital sectors in China look very similar to the American tech boom and bust of 1998-2002. Businesses with almost no prospect of making a profit are able to raise substantial capital, allowing over-investment and under-pricing to continue unabated.

Inefficient Use of Credit

Sound economic development is built on efficient asset allocation. Those that supply goods and services in demand and that make a reasonable profit are rewarded with greater availability of debt and equity funding. China's debt boom has seen unprofitable and barely profitable state-owned enterprises attract a strong share of new credit, particularly in industrial and construction sectors. Northeast provinces dominated by old industries, which have amongst the lowest growth and productivity, continue to attract new credit. This misallocation of credit continues as lenders assume government related debt is low risk and will always be bailed out.

Bank Sector Weakness

Whilst the rapid growth in debt across the whole of the economy is concerning, the even faster growth of debt at China's banks should cause panic attacks. Lending quality is routinely poor, whether it be lending to government entities, businesses, household debt, asset management products or lending to other banks. Officially, bad debt levels are below 2%, but unofficial estimates often exceed 20%.

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Rather than pursuing simpler and better capitalised banks since the financial crisis, Chinese regulators have allowed their banks to become virtual black boxes. The rapid growth of repackaged debt and investment products is enabled by funding from and distribution by mainstream banks. Extraordinary gaming of capital ratios has flourished, where high risk long term loans are categorised as low risk short term loans that require miniscule levels of regulatory capital. Added to all of this is the heavy reliance on short term funding, which can quickly turn a handful of investment losses into a widespread panic and liquidity crisis.

The Workforce has Peaked

Just like Japan has experienced since the late 1990's, China's working age population has been in decline since 2012. The low level of dependents relative to the size of the workforce is changing as the population ages. The one child policy reduces the number of workers entering the labour force. Ageing populations are associated with higher welfare payments and taxation levels, reduced savings and investment, and lower productivity. It has been argued that slower growth rates in Europe, Japan and the US since the global financial crisis are in part due to their ageing populations.

Delaying a Downturn will Increase the Severity

The IMF paper lists several factors commonly given as reasons why China won't suffer a downturn including state control of the economy, a current account surplus and low external debt. After considering these factors it concludes that China can delay the onset of a downturn, but by holding back necessary reforms it will increase the severity of the inevitable downturn. History contains many examples of non-capitalist models showing early promise but fading or collapsing as inefficient resource allocation bites.

The Soviet Union's central planning was long admired but the poverty it ultimately delivered sped up its collapse. The comparison of East and West Germany and North and South Korea show that even with similar cultural roots, capitalism beats central planning hands down in the long term. Japan's decades of near zero growth is a good historical example for China. Just like China is seeing now, Japan had resource misallocation, speculative bubbles and excessive debt growth before its economy stagnated.

Conclusion

It's often said that the most dangerous words in finance are "this time is different". China's credit boom is setting records for being the largest and longest ever for an emerging market, yet many believe that it won't suffer the same fate as its historical precedents. The central control of the economy has allowed the credit boom to continue longer than would have occurred in a free market economy. However, that short term blessing is a long term curse as the inevitable downturn will be deeper as a result of delaying necessary economic and financial adjustments. China won't be different from the historical precedents in the long term. It is simply a matter of when the inevitable downturn begins.

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