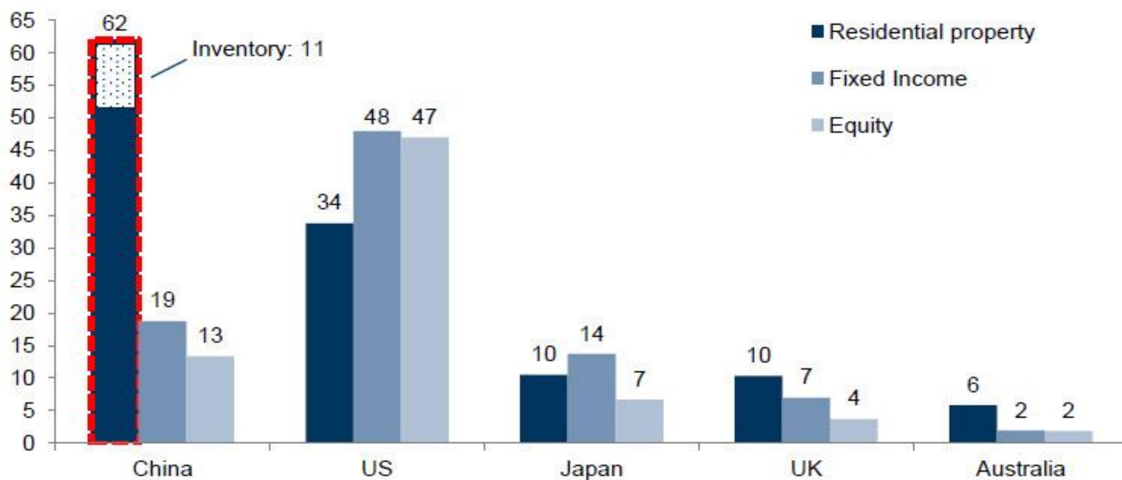
China: The Rising Tide of Uncertainty

Michael Nicoletos I February 2024

The economic landscape in China is currently burdened with significant challenges, presenting notable risks to its future growth trajectory. Of particular concern is the ongoing downturn in the country's stock market, coupled with turmoil in the real estate sector, where major developers are grappling with mounting debt obligations. Since its peak in 2021, the combined market value of equities in China and Hong Kong has experienced a staggering decline of nearly $7 trillion, representing a substantial drop of approximately 35%[1]. Compounding these issues is the weighty role of the property sector, which, as outlined in a 2021 report by Goldman Sachs, was valued at approximately $62 trillion and constitutes more than 60% of Chinese household wealth. Adding to the stock market losses, according to investor Kyle Bass, real estate losses could exceed $4 trillion[2], highlighting the severity of China's economic situation.

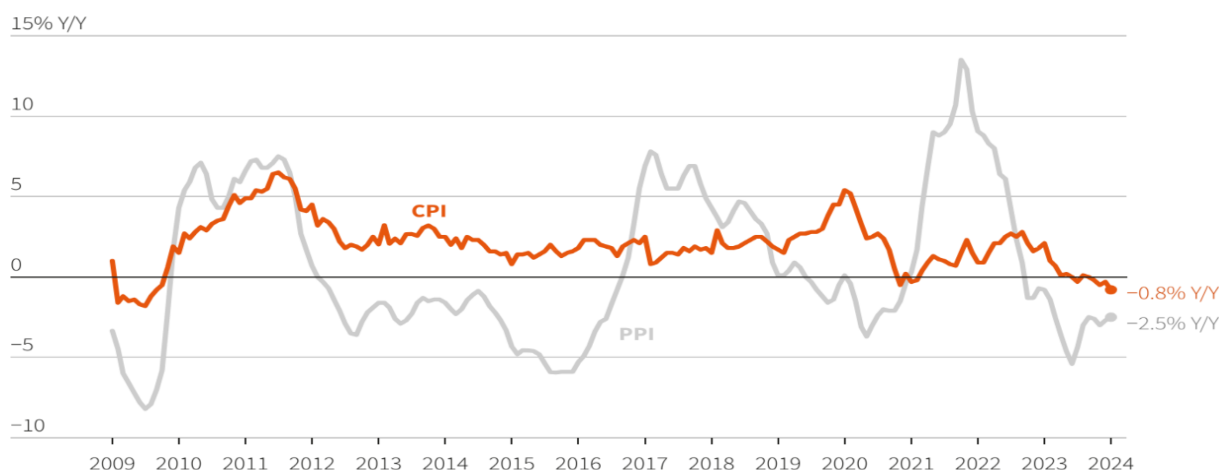


Source: WFE, CEIC, Japan Cabinet Office, Halifax, Goldman Sachs Global Investment Research.

In response, the Chinese government endeavors to pivot from an investment-heavy economic model to one centered towards manufacturing. This strategic shift is necessitated by the diminishing yields on unproductive investments in industries that have historically propelled China's rapid economic expansion. Emblematic of the challenges faced is the phenomenon of "Ghost Towns" - entire urban areas filled with deserted buildings, raising questions about the viability of past economic strategies.

[1] The Economist Feb 24: -https://www.economist.com/leaders/2024/02/08/can-xi-jinping-win-back-the-markets
[2] China's $4 trillion in real estate losses Dec 23: https://twitter.com/Jkylebass/status/1733097062617550946

An economic downturn in China would not only impact its economy; the repercussions would be felt globally, given its status as the world's second-largest economic powerhouse. The severity of China's current real estate crisis surpasses that experienced by the United States during the financial crisis. At a juncture where global concerns are centered around inflation, China's deflationary pressures could spill over to the rest of the world.



Growing concerns also shadow the banking sector, which is believed to be inadequately capitalized, considering the vast but undisclosed volume of non-performing loans (NPLs). Chinese banks are unlikely to have taken sufficient provisions to cover the current downturn in the property sector. According to an IMF report[3], Chinese Banks disclose that less than 2% of the total loans on their balance sheets are non-performing. Given that Chinese banking assets constitute 53% of global GDP, the threat of systemic risk cannot be overstated. This concern becomes even more pronounced when comparing the current size of China's banking sector with historical data from the United States and Japan. Specifically, at their zenith, banking assets in the United States accounted for 32% of global GDP in 1985, while Japan's banking assets comprised 27% of global GDP in 1994.

Further complicating China's economic landscape is its substantial debt burden. Total debt surged to an alarming 286% of GDP[4] at the end of 2023, including a considerable 40 trillion yuan ($5.6 trillion) directly owed by local governments[5]. However, these figures do not account for the substantial debt accumulated by China's Local Government Financing Vehicles (LGFVs)[6], estimated at 64 trillion yuan ($8.9 trillion). Local government obligations reach a staggering 104 trillion yuan ($14.5 trillion), equivalent to 81% of China's GDP.

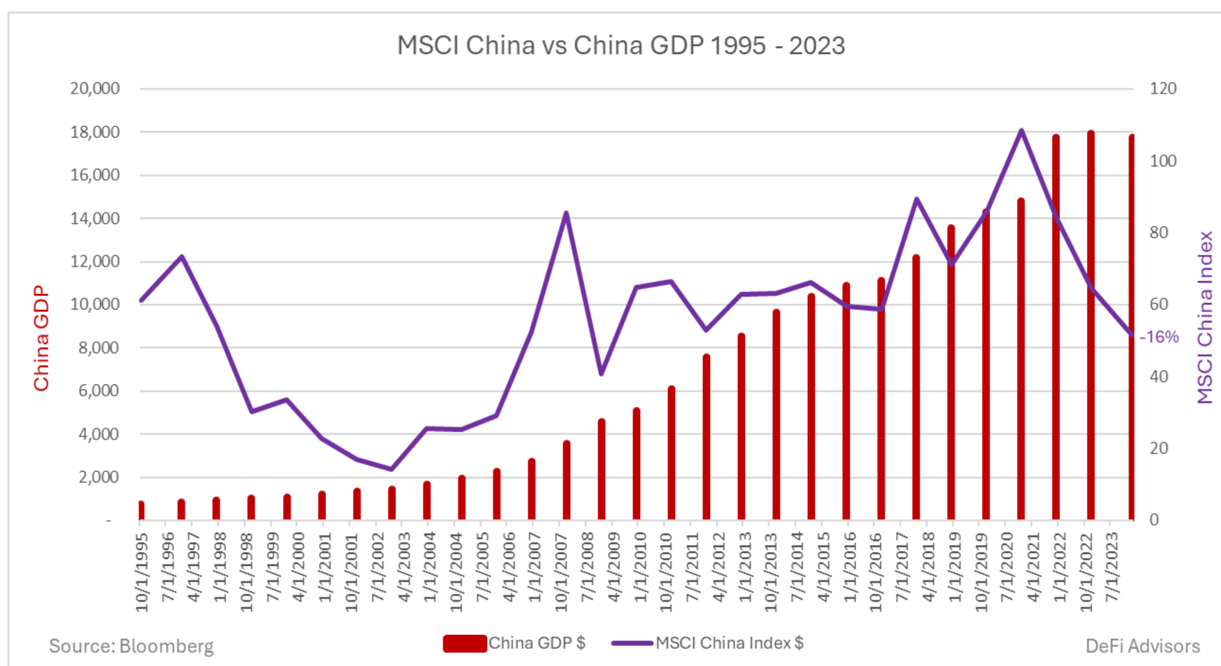
[3] IMF Feb 23: https://www.imf.org/en/Publications/CR/Issues/2023/02/02/Peoples-Republic-of-China-2022-Article-IV-Consultation-Press-Release-Staff-Report-and-529067
[4] Bloomberg Jan 2024: https://shorturl.at/nuCMU
[5] PRC Dec 23: https://english.www.gov.cn/archive/statistics/202312/30/content_WS658fd9d7c6d0868f4e8e2a63.html
[6] IMF Apr 23: https://www.imf.org/en/Publications/GFSR/Issues/2023/04/11/global-financial-stability-report-april-2023

In conjunction with the beleaguered real estate and stock markets, this debt has prompted government interventions, including a $278 billion infusion into the stock market to stabilize prices and safeguard household wealth. This amount is likely to prove to be insufficient.

Further exacerbating China's precarious economic stance is the disproportionate size of its money supply (M2) – the total amount of money readily accessible for spending – relative to its foreign exchange reserves, highlighting vulnerabilities to capital outflows during crises. China's M2 is 12.7 times larger than its foreign exchange (FX) reserves, which at the end of 2023 stood at $3.2 trillion.

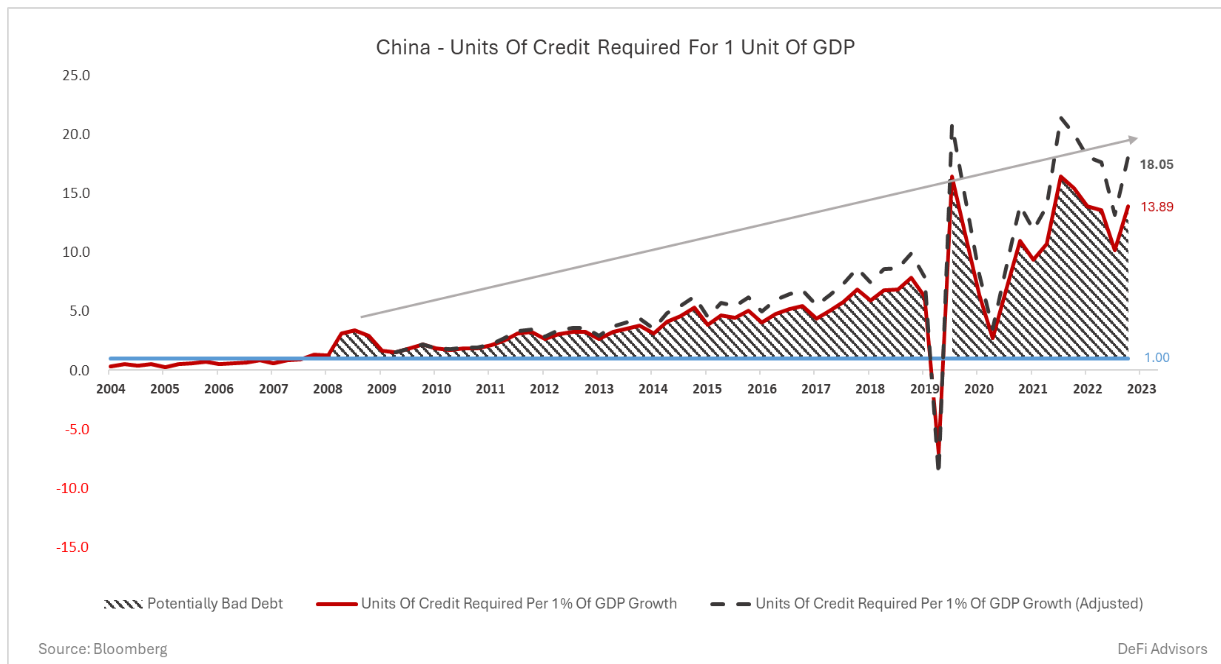
The situation evokes memories of the 1997 Asian financial crisis, during which nations faced currency devaluations of over 50% due to insufficient foreign exchange reserves. At that time, the currency pegs failed when the M2 money supply was roughly 4 times greater than the foreign exchange reserves, demonstrating that these reserves were inadequate to prevent currency collapse. Despite the implementation of stringent capital controls to prevent capital flight, the long-term sustainability of these measures is dubious. This concern arises particularly as the real estate market experiences a significant downturn and the stock market faces collapse, factors that could exacerbate an economic decline.

Moreover, doubts have surfaced regarding the reliability of China's reported GDP. As highlighted in analyses such as one conducted by the Brookings Institute[9] suggest a potential overestimation by as much as 20%, exacerbating the concerns about the country's economic health. The underperformance of the MSCI China Index, which has experienced a decline of 16% since its inception in 1995, further fosters skepticism regarding the accuracy of the data on China's growth.



[9] Brookings Mar 19: https://www.brookings.edu/wp-content/uploads/2019/03/BPEA-2019-Forensic-Analysis-China.pdf

For decades, China's economic engine boomed thanks to massive capital investments, which comprised 43% of GDP (2021)[10]. However, this reliance created a concerning trend: increasingly unproductive debt. Currently, China requires a remarkable 13,89 units (or 18.05 units if we consider that China's GDP could be inflated by 20%) of credit to generate just 1 unit of GDP.



To counteract this unsustainable model, policymakers are now trying to make crucial shifts. The government is attempting to prevent a property-sector slowdown (a primary debt driver) from dragging down overall investment. Their strategy? Diverting funds from the struggling property sector towards manufacturing.

This pivot faces hurdles, however. Manufacturing makes up a hefty 27% of China's GDP, much higher than the global average of 14%[11]. At a time when most countries are reshoring, and global growth is slowing, this ratio is more likely to go lower rather than higher. After years of solving its economic problems through constant capital investment, it will be challenging to switch strategies, especially when excess investment has been the very problem.

A more sustainable alternative would be transitioning to a more consumption-oriented economy; this, however, seems even more difficult. Compared with economies such as the United States, where private consumption accounts for nearly 68% of GDP, China's equivalent figure is significantly lower at just 38%[12]. Additionally, Chinese household debt as a percentage of disposable income skyrocketed to 131%[13] in 2021 (up from 43% in 2007), with most of the debt tied to the property market. This rising debt is likely to limit consumer spending in the future.

[10] China: Capital investment: https://www.theglobaleconomy.com/China/Capital_investment/
[11] Michael Pettis Nov 23: https://x.com/michaelxpettis/status/1720309805871468592?s=20
[12] WSJ May 23: https://www.wsj.com/articles/chinas-fading-recovery-reveals-deeper-economic-struggles-31f4097b
[13] South China Morning Post Aug 21 https://shorturl.at/kqIMS

As China faces these challenging times, shifting towards a more durable, consumer-led economy is critical. However, the path to achieving such a transformation is far from straightforward. Transitioning from an investment-driven model to a sustainable, consumption-led growth path poses immense challenges. Addressing high debt levels, fostering domestic demand, and navigating structural imbalances is bound to be a journey marked by significant upheaval. The extent of this turbulence remains to be seen, underscoring the uncertain road ahead for China's economic restructuring.

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Appendix - Understanding China's Government Debt: Implicit and Explicit

China's government debt is a complex mix of explicit and implicit liabilities, reflecting the intricate financial mechanisms and fiscal strategies employed by the central and local governments. To understand the full scope of China's government debt, it is essential to differentiate between these two types of debt.

Explicit Debt [14]

Explicit debt refers to the direct obligations of the government, which are clearly stated and recorded in official accounts. This includes bonds issued by the central government, local governments, and other formal borrowing instruments. Recent reports show China's explicit local government debt reached 40 trillion yuan (approximately $5.6 trillion).

This figure nearly doubled over five years, indicating a significant increase in formal borrowing to support various government functions and infrastructure projects.

Implicit Debt [15]

Implicit debt, on the other hand, encompasses obligations that are not directly recorded on government balance sheets. This includes liabilities associated with Local Government Financing Vehicles (LGFVs), bank loans to LGFVs, and other interest-bearing debts indirectly backed by the government. Implicit debt is estimated to be 64 trillion yuan (approximately $8.9 trillion), with some estimates suggesting it could be even higher. This type of debt has been used extensively to finance infrastructure and real estate development, often at the urging of the central government to stimulate economic growth.

The distinction between explicit and implicit debt is crucial for understanding the fiscal health and risks associated with China's government finances.

[14] PRC Dec 23: https://english.www.gov.cn/archive/statistics/202312/30/content_WS658fd9d7c6d0868f4e8e2a63.html
[15] IMF Apr 23: https://www.imf.org/en/Publications/GFSR/Issues/2023/04/11/global-financial-stability-report-april-2023