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China's Corporate Debt: On the Way to Crisis? Part 1

An Overview of Chinese Debt

- Features -

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Are Chinese corporations overleveraged? Since the central government injected massive sums of money in the economy as part of a stimulus plan to fight the Great Recession, debt levels in the Chinese economy have skyrocketed.

Total debt in China exceeds that of the US, and was estimated to be twice as high as the average of emerging market economies excluding China in 2015. Fueled by real estate and shadow banking, total debt has more than quadrupled since 2007, rising to 317% of Chinese GDP (*Goldman Sachs, 2018*). Throughout history and across countries, a rapid growth in debt has been shown to preclude financial crisis (*Minsky, 1986*). The challenge China faces today is thus to find a way to deleverage that will not harm economic growth.

In any given country, non-financial total debt is composed of government debt, household debt and the aforementioned corporate debt. In China, it is complicated to evaluate total public debt: research has been able to estimate central government debt with precision, but local government accounts are more obscure. The central government is not overleveraged and benefits from ample foreign currency reserves. But regional governments have expanded unsafe financial operations since 2007, and often resort to off-the-counter loans or shadow banking. As a consequence of anarchical borrowing across regions, the central government is currently trying to clean up local governments' accounts. However, this analysis will focus on China's corporate debt.

Corporate debt currently accounts for over two thirds of total debt, standing at 170% of GDP in 2015. This is more than twice the size of corporate debt in advanced economies (85%) and more than three times that of emerging market economies excluding China (50%) (*Ma and Laurenceson, 2016*).

Corporate debt includes both the debt of State Owned Enterprises (SOEs) and purely private companies. In China, it is difficult to evaluate for the precise reasons that make Chinese capitalism so distinctive. After the implementation of the reform and opening policies initiated by Deng Xiaoping in 1978, a purely private sector emerged and played an increasingly active role in Chinese growth. This private sector's main drivers are real estate and construction. But though reform policies led to increasing liberalization and massive waves of privatization (*Aglietta and Bai, 2012*), SOEs have remained major actors in the Chinese economy. SOEs still account for a big part of China's productive capital and capture the vast majority of investments in the corporate system (*Chen, 2015*). Moreover, SOEs have accumulated an increasingly high debt over the past decade.

How can we explain the persistent role of State Owned Enterprises in the Chinese economy? One reason lies in that local governments in China enjoy a large degree of autonomy and have historically faced high levels of indebtedness. This combination of factors has led local governments to borrow from local SOEs and the private companies they control to shore up their accounts (*Chen, 2015*). It has contributed to making the distinction between private and public in China very blurry, and has resulted in a chaotic indebtedness across different regions.

To tackle chaotic overleveraging, the Chinese government has cracked down on bad loans and corruption. The official policy of the central bank is now to lend much less, leaving many Chinese corporations floundering. Some, like Wanda, the Anbang insurance fund, or groups like HNA and Fosun, have taken to borrowing abroad.

Chinese foreign debt, previously negligible, has increased like never before since the Chinese government's post-Great Recession stimulus plan. However, companies' breakneck expansion was fueled by shady accounting at best, and unsustainable levels of indebtedness at worst. Though the Chinese government has been encouraging major companies to invest abroad for the past decade, it now seeks to limit the acquisitions of gluttonous

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associations. Moreover, as continental markets are now much more connected to foreign investors and have substantial ties with foreign entities through direct investment, we can wonder to what degree Beijing can intervene to stabilize them in the event of another financial or banking crisis.

In the past, Beijing has been able to clean up both its four biggest state-owned banks and domestic markets. But now that an increasing number of Chinese companies are listed on the Hong Kong Stock Exchange and vulnerable to international speculation, we can wonder whether such tactics would still be efficient or acceptable to international entities. Can the Chinese government still face a financial crisis with tight regulations and massive investments? Will it be able to face a debt crisis? In the event that Chinese corporations massively default on their loans, will the Chinese government seek to pay back foreign investors? These are the questions that this research paper aims to answer. In this first part, we will analyze the composition of Chinese debt and explore the fine line between Local Government Financing Vehicles (LGFVs), State Owned Enterprises and private companies in China. This will lead us to looking in an upcoming second part at the origins of the confusion between public and private by looking at Mao-era socialism and subsequent market reformsâ€”the Chinese economic regime structurally favored overblown corporate debt. In the third part, we will examine the recent shifts in debt and the problems central authorities must urgently tackle if they are to avoid the risk of a major credit incident. In our conclusion, we will consider whether China is at a tipping point, and what means Beijing has at its disposal in the event of a financial crisis.

Over the past three decades, China has developed spectacularly fast. According to the World Bank, from 1979 to 2010, China averaged an annual GDP growth rate of 9.9% and the size of its economy was multiplied by twenty (*Loong-Yu, 2012*). Never had a country sustained such high levels of growth for so many consecutive yearsâ€”China's economic rise is one of the most discussed developments of the 20th century. Many have tried to pinpoint the origins of China's growth and diverging analyses of China's economic regime emerged. Neoclassicals, Keynesians and Marxists all have their own views of the Chinese miracle.

Among Marxists, there is a debate around whether or not China has become a capitalist country (*Loong-Yu, 2018*). Some scholars distinguish between a market economy and a full capitalist model, and believe China has only gone through the implementation of the former. Michel Aglietta and Guo Bai (*2012*) state that within a theoretical framework that "equates capitalism and market economy entirely", China figures as "a kind of maverick". They highlight that central authorities maintain a tight control on finance that is antithetical to capitalism. Meanwhile, Michael Roberts argues that for China to be capitalist, the capitalist sector of the economy must override the public planned sector. In his view, this tipping point has not yet been reached in China, where "the state sector and public investment through one-party dictatorship still control investment, employment and production decisions" and "the private capitalist sector, although growing, is still subject to that control" (*Roberts, 2018*).

Though the author of this article admits that China's economy remains very particular, with a prevalence of the state, China will still be labeled as capitalist. The author of this report refers readers to the definition of capitalism outlined by Tom Bottomore in his *Dictionary of Marxist Thought*: (1) production for sale rather than own use by numerous

producers; (2) the emergence of the labor market; (3) predominant if not universal mediation of exchange by the use of money, which also gives a systemic role to banks and financial intermediaries; (4) the capitalist or his managerial agent controls the production (labor) process; (5) the universal use of money and credit facilitates the use of other people's resources to finance accumulation; (6) competition between capitals. It seems that China respects all the six conditions cited above.

The Economist (2012) classifies China's regime as "state capitalism"â€"Au Loong-yu (2012) goes further, labeling China's regime as "bureaucratic capitalism", a term highlighting "the central role of bureaucracy, not only in the transformation of the state which was once deeply hostile to capitalism to one which is thoroughly capitalist, but also in enriching itself through the fusion of the power of coercion and the power of money".

However, saying that China is capitalist does not mean adopting the neoclassical analysis of China's development. According to neoclassical economists, there are two key reasons for China's extraordinarily high growth over the past two decades: the existence of a wide pool of surplus labor and the development of market institutions since 1978. The wide pool of surplus labor led to a massive rural exodus in the 1990s, when 250 million Chinese workers left the countryside in search of higher urban wages. This overabundant labor force gave China a comparative advantage for labor-intensive exports, particularly those exports dependent on unqualified labor. When the well of surplus labor dried up, China's comparative advantage supposedly shifted to technology and capital-intensive goods, which accompanied and caused a slowdown in growth, according to neoclassical economists. Moreover, neoclassicals name a second cause for China's growth in the last decades: the development of market institutions by Deng Xiaoping after 1978 and the privatization of state-owned enterprises.

However, the neoclassical analysis is both unilateral and deterministic. The drying up of surplus labor and the shift to a model based on technology and capital-intensive production do not systematically lead to a rise in salaries, because state repression also plays a role in keeping the wages down. Secondly, even if privatizations have been massive and domestic markets have developed, state intervention and the public sector still play instrumental roles in structuring China's economy.

Indeed, China's economy has grown exponentially not only thanks to its cheap labor, but also thanks to smart and consistent state investment plans. The public sector in China has sustained economic development and welfare [1] despite progressive "reform and opening", and has also bolstered consumption. China did not only develop because of its exceptional export sector, but also thanks to its domestic markets. Though domestic markets were not the focus of government policy for many years, the sheer size of China means its internal markets play an important role in its economy. China's relative balance between exports and internal consumption is one of the complicated equations the central authorities are trying to solve by calling for a rebalancing of the Chinese economy towards internal consumption.

State intervention, meanwhile, resulted in a very high public investment rate ("every year, China's public investment to GDP is around 16% compared to 3-4% in the US and the UK" (*Roberts, 2017*)), which was the major drive of growth for decades, and helped the development of the domestic private sector. China's high domestic rate attracted hundreds of foreign firms. [2] But this growth model generated important contradictionsâ€"in bolstering investment and the private sector, the Chinese state suffered a relative loss of control of a previously very centralized planning system. Moreover, as is generally the case in an economy where capitals compete between each other in order to make profits, massive and disorganized investments caused overcapacity, particularly in heavy industry, and led to extreme leverage in the public and private sectors. This report will analyze the debt resulting from China's growth model. Has leverage become excessive, particularly private sector leverage? Could Chinese debt lead to a new economic crisis?

To summarize, this report adopts a political economy approach whereby economic factors are imbedded in historical

development, social conflicts, politics and state intervention. As we will see in the following section on the composition of the national debt, China's local governments, state-owned enterprises and private sector face highly specific challenges, resulting from the way Chinese communism evolved before and after the implementation of market mechanisms. We will cover this evolution of the Chinese economic regime under Mao Zedong, Deng Xiaoping and subsequent leaders in an upcoming part of this report. This look into the past will then enable us to understand the recent causes for overblown corporate debt, as well as how Chinese enterprises and financial vehicles export this debt abroad.

2. The Chinese debt: Supply and Demand

Unlike other capitalist countries, the supply of credit in the Chinese economy is still very much in the hand of the state, which commands the central bank of Chinaâ€"the People's Bank of China (PBOC)â€"and large state-owned banks. Stocks markets are growing, but still play a minor role in the supply of credit to enterprises and households.

The Chinese credit system is therefore heavily skewed towards the banks. Taken all together, the credit supplied by the central bank, large banks, midsized and small banks, adds up to 194.3 trillion renminbi. [3] Meanwhile, total debt in China in 2017 amounted to 262.1 trillion renminbi, including financial debt. In short, banking credit amounts to more than two thirds of total credit available in China.

Regional banks can be listed in stock exchanges. When the central government first allowed them to emit equities, they rushed to stock exchanges for more funds. Regional banks have accrued an enormous number of NPLs because they are forced to lend to local state-owned enterprisesâ€"so much NPLs, in fact, that national banks no longer lend to them. On May 11 2018, China Zheshang Bank went to the national banks for money in order to issue "3 billion yuan ($470 million) in certificates of deposit. It came back with just 700 million yuan and change" (*Cho, 2018*).

This is why regional banks, as well as companies and other financing vehicles increasingly turn to shadow banking loans. Shadow banking loans are credits that are not generated from the of?cial banking sector, but are provided by fund management subsidiary companies, securities companies, trusts, and by informal lending and microfinancing. These institutions form a "shadow" industry because they do not submit to banking sector regulations, in particular prudential regulations that impose a minimum of loan-to-deposit ratio and minimum capital requirements. [4] The shadow industry can therefore provide additional credits to non-financial companies that are already leveraged, but at the costs of increasing risks of bankruptcy if the borrowers cannot reimburse. Worse, many of these shadow banking companies are subsidiaries of official banks. The latter are allowed to lend money to their fund management subsidiary companies by the authorities, as well as to book these loans as investments. On paper, domestic Chinese banks are respecting the prudential regulations that apply to loans, while their investments in fund management companies actually expose them to much higher risks.

Overall, in 2017, the official banking sector provided 132.4 trillion renminbi worth of loans, which amounts to 50.6% of the total credit to the economy; the financial markets (bonds and securities financing) and PBOC lending provided 89.7 trillion renminbi (34.2% of the total); and shadow banking 39.9 trillion renminbi (15.2% of the total). The share of shadow banking may seem small, but its link with official banking, and the fact that it is much less controlled, makes it potentially dangerous. Fund management subsidiary companies were introduced in 2012, and the authorities let them grow rapidly between 2012 and 2016 to boost credit. In 2017, growth slightly slowed down as the authorities became aware of the accumulated financial risks, and attempted to tighten regulations. Nonetheless, shadow banking remains a source of concern and we will dedicate a part of this report to discuss it.

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On the demand side, the debt of a country can be divided into three sectors: government debt, household debt and corporate debt. According to Goldman Sachs (2018), at the aggregate level, Chinese debt stood at 317% of GDP at the end of 2017 [5]. Figure 1 shows that this level of indebtedness is extremely high, having doubled from around 150% in the year 2000. It is much higher than the average of developing countries and is converging towards the level developed countries (Wolf, 2018).

Figure 1: China's debt in international perspective.

Source: Martin Wolff, "China's debt threat: time to rein in the lending boom", *Financial Times*, July 25, 2018.

When the financial sector is excluded from calculations, Chinese debt is estimated at 282% of GDP [6]. It breaks down into total government debt (87.2%), households' debt (56.6% of GDP), and non-financial corporate debt (138%) (author's calculations based on Goldman Sachs, 2018, p. 4).

Compared to other countries, China's total government debt (87.2%) is not very high. It is at the level of the euro area (86,7%) and below that of the USA (99%) and Japan (212%) [7]. Its structure calls for more attention. It is divided into central government debt (32.4%), local government debt (17.8%) and Local Government Financial Vehicle (LGFV) debt (37%). As we shall see below, the latter is opaque, largely uncontrolled, and concentrates many contradictions that the central government must resolve. Chinese household debt (56.6%) is also at the same level as that of the euro area (58%) or Japan (57.4%) and much lower than other emerging Asian economies (Malaysia, 67.2%; Thailand, 68.2%; South Korea, 94.8%) or the USA (78.7%) [8] where it has become a source of concern. Still, Chinese households' debt has been rising quickly from a very low base (around 10% in 2006), increasing by 20% per year from 2015 to 2017, mainly for purposes of consumption rather than households' investments. This is a worrying trend for the future, as it can potentially fuel housing bubbles (*Hancock and Xueqiao, 2018*). Non-financial corporate debt (138% of GDP) is high, and the situation is even worse when the share of LGFV credit to corporates is included (17560%). This figure is much higher than comparable data in the USA (78%), Japan (103%), the euro area (101%), South Korea (98%), Malaysia (67.2%) or Thailand (48%). For Chinese non-financial private companies, total debt stands at 208%, much above all other countries.

Why is corporate debt so massive? A look at the composition of Chinese corporate debt provides a first explanation. Zhou Xiaochuan (2017), a Chinese governor of the central bank of China from 2008 to 2018 and deemed liberal reformist, sheds some light on the situation:

"*People may ask why the corporate sector had such a high leverage ratio and why the financial institutions, especially the commercial banks, were willing to lend so much to them. One of the reasons, as indicated by many economists, is that in China the local governments borrowed heavily through various financing platforms. Such borrowing was included in the statistics of corporate debt. Thus, the debt of the corporate sector has been overestimated.*"

[rouge]
2.1. Local government debt[/rouge]

As such, understanding how Chinese corporations accumulated so much debt across the board requires understanding how growth occurs at the local level. Regional governments in China are forced to borrow heavily every year: despite being responsible for most public missions (funding schools, hospital, transports, etc.), they have almost no power to raise taxes. The tax system is heavily skewed towards the central government, and regional government get very little from taxes levied in their territory (*Aglietta and Bai, 2012*). The gap between necessary expenses and available revenue is filled by borrowing. This functioning is, of course, detrimental to the interests of the Chinese

population, as local governments have to struggle to find the funds needed to finance basic public services.

What are the tools available for local governments to borrow? Regional authorities have been forced to rely on several mechanisms to shore up their accounts, such as proceeds from land sales, land-transferring fees, which remained at the complete disposal of local administrations despite various reforms [9], and the creation of LGFVs.

These shell companies are controlled by local officials and borrow heavily from the central banks or other companies. Many LGFVs were created in 2007 by the regional administrations, to attract a part of the money injected into SOEs as part of the central government's stimulus plan. The ambiguity of LGFVs' juridical status and of the nature of their transfers to local governments "has made it impossible to estimate China's true government debt, although guesses range anywhere from $5 trillion to $7 trillion" (Chen, 2015). According to our calculations, this is the equivalent of an interval ranging from 142% to 200% of the GDP at the time, instead of the 50% accrued by the central government.

It is important to understand the process of local indebtedness. In China, local governments de facto have the monopoly over the supply of land. Land sales, taxes included, account for half of their budget. This revenue is used to secure even more loans, and these loans are in turn used to finance the construction of highways, railways, electricity grids and other infrastructure projects. Because these are labor-intensive, they are a great source of political legitimacy vis-Ã -vis both the local population, and central authorities wedded to strong growth and high employment. This process of regional indebtedness is almost completely opaque, and favors both speculation and corruption. Shady transactions and investments became so widespread that the central authorities felt they had lost control.

This is why Beijing recently introduced policies to increase transparency in regional administrations. Local governments are now relying more and more on municipal bonds to borrow (*Goldman Sachs, 2018*). These bonds are "on budget" (while LGFVs' debts are off-the-book) and help the central government control and organize local governments' spending.

Following central government reforms, LGFVs' debt growth has slowed down, although a significant part of Chinese debtâ€"30.7 trillion renminbiâ€"is still detained by LGFVs. LGFVs' debt rose by only 5.9% in 2017, down from 13% between 2015 and 2016.

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2.2. State-Owned Enterprises' debt [/rouge]

As Zhou Xiaochuan stated, local government debt is an important part of the headline gross corporate debt figure of 175%. However, even if we exclude LGFVs' share, nonfinancial corporate debt still stood at 138% of GDP in 2011 -(Goldman Sachs, 2018)-. This nonfinancial corporate debt has increased significantly over the past decade. China's corporate debt is worth around two thirds of total nonfinancial debt in China, "compared to one-third for the advanced economy average and 43% for the average of emerging market economies, excluding China" -(Ma and Laurenceson, 2016)-. To say that corporate debt is excessive is an understatement.

Overall, SOEs accounted for more than half of total corporate debt, i.e. 72% of GDP in 2017 (*International Monetary Fund, 2017*). They were also responsible for most of the increase in corporate debt over the 2008-2016 period. Moreover, many of these SOEs did not manage to adapt to the introduction of market mechanisms. They were unable to make profits, to invest in research and development, to create new products, and therefore became progressively obsolete. They are nonetheless major sources of employment and remain crucial to regional economies, which is why local governments have kept them on life-support (*Lau, 2018*). Mainstream media and neoclassical economists label these struggling companies "zombie enterprises". The term has even gained quasi-official recognition, as politicians and public institutions now employ it.

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The Chinese State Council broadly defines nonviable “zombies” as firms that incur three consecutive years of losses, fail to meet environmental or technological standards, do not align with national industrial policies, and rely heavily on government or bank support to survive. Dongbei Special Steel is one example (*Xin, 2018*). This giant company, based in the North-East rust-belt province of Liaoning, defaulted no less than ten times since 2016 and has accrued liabilities worth more than â‚¬9.5 billion. Meanwhile, Shengyang Machine Tool has been incurring losses every year since 2013 and had to contract a loan worth $78m from Bank of Shengjing, the largest regional lender in Liaoning province (*Wildau and Jia, 2018*).

According to neoclassical economists, these companies should be eliminated because they make no profits. Implicit guarantees and the government’s desire to support growth encourage these firms to invest excessively, neglecting profitability. This supposedly leads them to a high leverage and a weak debt-service capacity. Of course, as these companies are public, one can wonder why profitability and debt-servicing should be at the core of their preoccupations.

In reality, these enterprises were not created and equipped to make profits in a capitalist economy. But they sometimes play an important role in local welfareâ€”Dongbei Special Steel operated a hospital and a school (*LeplÃ¢tre, 2017*). And they are vital sources of employment in rust-belt regions of China, creating livelihood for many. That is not to say that these companies are blameless. They produce goods that are harmful to the environment and enable energy overconsumptionÂ-â€”coal, for example. Other products are obsolete. As employees from Shengyang Machine Tool note, “people aren’t using geared lathes any more. We’re being forced out of the market” (*Wildau and Jia, 2018*). Many of these companies should indeed be left to die in peace. But workers must be offered state support and decent alternatives to their current jobs.

The share of these “zombie firms” in total corporate debt rose to 15% of total industrial liabilities in 2016, the highest level since 2009 (*Lam, Schipke, Tan Y. and Tan Z., 2017*). This shows the responsibility of the central government’s 2007 stimulus plan, which encouraged SOEs to take on more debt to relaunch the economy. At the time, State-Owned Enterprises, including zombies, were used as the main instrument for increasing the investment ratio, which reached historical highs (48% of GDP), and keeping the economy afloat. The massive injection of credit was effective in the short term. Despite being directly hit by a global slump in exports, China was one of the least affected countries of the last global crash and swiftly recovered, returning to a double-digit growth. But by systematizing credit-injections, central authorities were deepening the country’s overreliance on credit. This problem only grew in the years that followed.

Worse, not all of this cheaply-obtained credit was channeled into financing investment. Part of it was often re-lent by SOEs and LGFVs at higher rates, fueling speculation and an increase in non-performing loans across the entire banking system -(Handley, 2017)-. The reason why this massive indebtedness did not turn immediately into a serious issue is the fact that SOEs also made a lot of corporate deposits, resulting in a significantly lower level of net corporate debt than the headline gross corporate debt figure. While “gross corporate debt surged from 98% of GDP in 2008 to 170% in 2015, net corporate debt rose from 46% of GDP to just below 100%” (*Ma and Laurenceson, 2016*). However, in the most recent years weaker corporate earnings have led to smaller corporate deposits, and thus net corporate debt has been on the rise.

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2.3. Private sector debt[/rouge]

Meanwhile, purely private firms represent one third of all corporate debt. The private sector in China is very dynamic. It is mainly composed of small and medium-sized enterprises (SMEs), which serve as the engine of growth in both developed and developing countries (*World Bank, 2011*). In China, SMEs accounted for about 65% of GDP and 80% of job opportunities in 2010 (*Chen, Ding and Wu, 2014*). SMEs compose the vast majority of Chinese private

enterprises and also contribute to debt. Thus the term "private sector" has a different meaning in China than in advanced countries, where the term often denotes big companies and multinationals.

As for public company debt, private sector debt is derived from bank loans, bond offerings and shadow banking activities. Private sector leverage is also excessive (*Nikkei Asian Review, 2018*). Debt-laden companies are vulnerable to a drop in asset-price and rises in interest. In other terms, market fluctuations, slower growth or tighter government regulations can and have triggered many bankruptcies.

In a worrying trend, Chinese private companies often contract off-the-book agreements with counterparts to guarantee loans (*Handley, 2017*). This has established a chain of debt across the Chinese private sector, meaning that companies are increasingly exposed to debt. If one company with significant leverage were to default, it would most probably drag others down with it.

Though private firms account for a minority of corporate debt, there has been a sharp increase in leverage in the sectors of construction and real estate since the financial crisis, enough to potentially trigger a financial crisis (*Ma and Laurenceson, 2016*). Construction and real estate experience bubble cycles that make them particularly volatile and fragile (*Koss, 2018*).

As such, it is important to study variations in borrowing patterns across sectors, and not just between firms of different ownership type (SOEs being the counterparts of private firms). Sectoral-level analysis shows that China's corporate leverage landscape is more complex than a simple story of zombie enterprises in heavy industries facing overcapacity crisis, and relying on blood transfusions from state banks.

At sector level, the segments linked to real estate and construction have witnessed a credit boom, while other segments have experienced some measure of deleveraging. Within the real estate sector, which has been the main culprit behind China's bloated corporate debt, SOEs have deleveraged while private developers have accumulated more debt.

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2.4. Recent tendencies in Chinese debt[/rouge]

The central government understands that its 2007-stimulus plan has caused serious problems for the Chinese economy, and has taken measures to encourage deleveraging. But it must balance tighter regulations with the need for growth. Worse, global trends are now adverse to China's growth model: not only are countries importing less than before due to the economic slowdown, but some, like the US, have passed important protectionist measures. US President Donald Trump initially indicated the US would levy a 25 per cent tariff on $50 billion of Chinese imports. After retaliatory measures from China, he then announced a 10 percent tariff on China would concern an additional $200 billion of Chinese imports (*Office of the United States Trade Representative, 2018*). So far, tariffs have been effectively imposed on $68bn of goods, and the implementation of the other tariffs announced will certainly follow (*Hancock, 2018*). All this uncertainty impacts the Chinese currency and markets, which have suffered several falls over the course of the summer 2018. Such unfavorable conditions explain why the Chinese government is forced to play "stop and start" with deleveraging efforts.

To escape deleveraging policies, Chinese companies have taken to borrowing abroad, with debt increasingly being denominated in foreign currencies as a result. It is true that China's external debt, public and private, is still very low by world standards, reaching only 13% of GDP. [10] But debt issued overseas has grown significantly since the slowdown of China's credit boom. As central authorities have attempted to regulate credit, enterprises have borrowed abroad. This will be discussed more thoroughly in a later part of this report.

We will conclude this brief overview of Chinese debt by remarking that the Chinese policymakers have shown dedication in tackling the excesses of credit growth over the past few years. A number of reforms of the credit system were introduced from 2016 onwards, including macroprudential measures for the banking sector and regulatory guidelines targeting shadow banking activities. This has resulted in a significant slowdown in debt growth (*Goldman Sachs, 2018*).

In the next part of this study, we will look at the historical roots of Chinese debt. We will explain why SOEs are so important for the Chinese economy, look at the development of the private system, and explain local government's cozy relations with regional banks, SOEs, and their overreliance on land sales and real estate. These facts are vital for understanding the recent trends influencing Chinese debt, such as real estate credit boom, shadow banking and foreign lending, which we will detail in an upcoming third part.

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[1] “During this reform welfare housing units allocated gratis to urban dwellers before 1994 were sold to their occupants at highly concessional rates. As most of the SOE families benefited from welfare housing, this reform was a large one-shot transfer of public assets to individual families and boosted the universal wealth level of SOE employees.” â€” (*Aglietta and Bai, 2012*)
“The march to Universal Health Coverage (UHC) in China is unparalleled.”â€” From the World Bank: The long march to universal coverage : lessons from China

[2] “Attracted by the country’s investment opportunities and by its sheer size and growing domestic market, China received about 20 percent of all FDI to developing countries over the last 10 years and over $100 billion in 2008.” â€” (World Bank, 2010)

[3] All the figures quoted in this part of the report are taken from Goldman Sachs (2018) unless otherwise stipulated.

[4] According to the PBOC’s definition, shadow banking encompasses “all financial instruments that fulfil functions of credit intermediation typically performed by banks (such as liquidity, maturity, and credit risk transformation), but reduce the burden of or bypass banking regulation.”

[5] Making sense of the financial sector in China is a complex task due to the specificities of the Chinese economy and the opaqueness that the authorities have created. Goldman Sachs’ report is very recent (2 Feb 2018) and is very detailed, mapping out both creditors and borrowers, as well as recent tendencies in shadow banking and the rest of the Chinese economy. It relies on many sources, makes assumptions to delineate the extent of public and private debt that can, as always, be criticized. The IMF (2018, p 48) publishes alternative estimates which give roughly the same order of magnitude.

[6] The International Monetary Fund (2018, p 48) estimates non-financial debt at 253 % and the Bank for International Settlement, (BIS) at 255% of GDP. These lower estimates are explained by the use of different sources, dates and methodologies for the estimates of the central government debt, of the Local Government Financial Vehicles (LGFV) and the shares of the latter that accrue respectively to the government or to corporates. For corporates and households’ debt, the figures are of the same order of magnitude. Overall, the differences don’t change significantly the conclusions of our report.

[7] Source: BIS, total credit database, accessed 24 August 2018. All the figures are for December 2017.

[8] Source: BIS, total credit database, *op cit.*

[9] Notably the 1994 tax reform â€” “China created a unitary fiscal system with two sets of tax administrative bodies. One set of tax offices was under the direct control of central government and this national tax administrative body was responsible for the collection of central and shared tax items. The other set of tax offices, controlled by local governments, was in charge of collecting local tax items, such as corporate and personal income taxes.” Under this system, tax income is so centralized that regions capture very little tax revenue (*Aglietta and Bai, 2012*). “Central government revenues jumped in the years after 1994 as a result, while local governments saw their share of revenues fall from 78 percent in 1993 to 45 percent in 2002” â€”(Sanderson and Forsythe, 2012).

[10] Source: BIS, total credit database, accessed 24 August 2018. All the figures are for December 2017

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