Focal Point
China: Tackling the "Grey Rhinos"

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– China's strong recovery from the Covid-19 crisis has allowed Beijing not only to withdraw some monetary and fiscal support but also to start tackling again potentially big, but less visible structural risks on financial markets ("grey rhinos"). This mainly concerns the real estate sector and state-owned enterprises (SoEs).

– While the PBoC already slowed credit growth on cyclical grounds (but is wary of a too strong CNY appreciation), tackling the structural issues will add to the deleveraging of the economy implying some softer growth.

– Regarding the real estate sector, authorities have already introduced the three-red-lines approach, caps on property lending and a land supply policy reform. Regarding SoEs, Beijing is gradually withdrawing implicit guarantees.

– We expect the deleveraging process to be appropriately cautious and to help China to shift to more qualitative growth. However, investors need to pay more attention to idiosyncratic credit risks to avoid negative surprises.

China's economy has strongly recovered from its Covid-19 induced slump by -6.8% yoy in Q1 2020 to a plus of 18.3% yoy in the first quarter of this year. The rebound has enabled the government to withdraw some of its monetary and fiscal support. The cuts were already made official at the NPC meeting in March. However, China's problems are not only cyclical in nature. After four years of stabilising leverage until 2019, the sanitary crisis has induced a marked rise of the non-financial debt-to-GDP ratio.[1] Policymakers have increasingly made clear[2] that they will also address these "grey rhino"[3] risks, i.e. the inherent risks within credit markets and financial industry. Besides keeping an eye on the shadow banking sector (its deleveraging already started several years ago), the focus will lie on controlling:
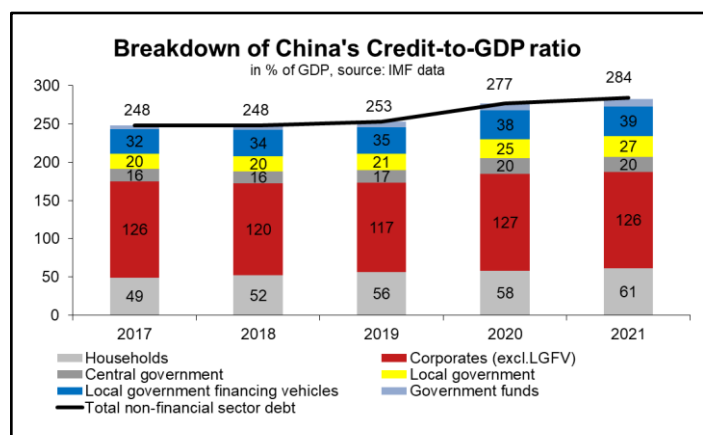
- the leverage within the property sector
- default risks of state-owned enterprises (SoEs) including implicit debt of local governments by their financing vehicles (LGFVs)

These risks will likely be resolved primarily with macro-prudential and administrative measures rather than blunt monetary policy tools. Nevertheless, the PBoC sets the general framework and needs to step in if larger credit events were to unsettle markets.

Breakdown of China's Credit-to-GDP ratio
in % of GDP, source: IMF data

Less monetary policy support
The NPC set the monetary policy stance as "neutral" in 2021[4]. This implies that the growth rate of credit aggregates like total social financing (TSF) will be broadly in line with nominal GDP growth and much less ample than last year. In 2020, the stock of TSF rose by 13.3%, while fresh TSF and new bank loans accelerated strongly. These figures have already peaked. Stock TSF came down to 11.0% yoy in May 2021 and will likely recede to 10.0%-10.5% by year-end. We expect M2 growth to average about 8.5% in 2021. The tightening pace has been rela-

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[1] Exact numbers are different between various sources ranging from 22 pp to 25 pp. IMF numbers are here.
[2] For instance, the chairman of the China Banking and Insurance Regulatory Commission (CBIRC) was quoted by saying that China's property market is the biggest "grey rhino".
[3] The "grey rhino" is a term coined by author Michele Wucker to describe obvious risks that are neglected despite (or often because of) their size and likelihood.

[4] We will not discuss fiscal policy here. At the NPC meeting, it was announced that the general budget deficit should decrease to 3.2% (after 3.6% in 2020) of GDP, that the local government bond quota will be reduced to RMB 3.65 tr (after 3.75 tr in 2020 and expected RMB 3-3.5 tr) while no special Chinese Govies will be issued. The negative fiscal impulse likely be close to 1.5 pp.

tively swift. The monetary impulse (which is the second derivative of TSF stock growth) has recently turned negative, hinting at a slowing growth momentum in H2.

China: Growth of TSF and Monetary Impulse
— Monetary Impulse — TSF Growth (yoy)
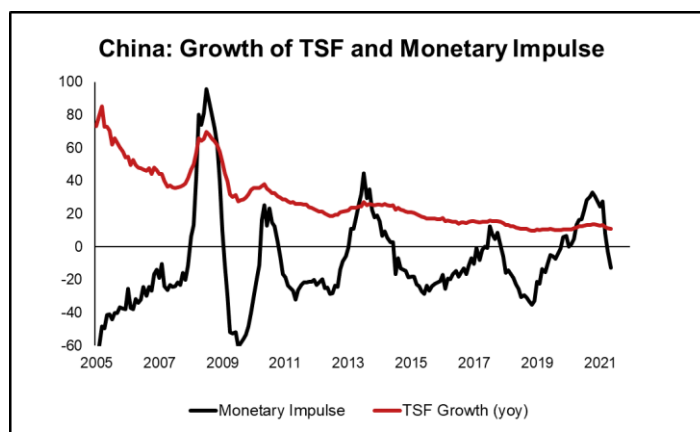
Looking ahead, monetary policy primarily serves China's domestic business cycle. The cycle has been dominated so far by industrial production in conjunction with buoyant exports, while domestic consumption is lagging. In H2 2021, we expect China's growth drivers to be a bit more balanced. On the one hand, the urban unemployment rate decreased to 5.1%, which is in line with pre-crisis levels and tends to support income and improve consumption. On the other hand, Covid-19 related goods exports into AE will probably slow, given the progress in vaccination and the shift in AEs to local services sectors. China's capex is expected to improve. Looing further ahead, we expect the PBoC to maintain its neutral stance also in 2022 unless new (sanitary or international) business cycle shocks occur.

Recent additional issues were the strong rise of PPI inflation (to 9% yoy) and the appreciation of the yuan. The spill-over effects from PPI into CPI inflation have been low historically, and the consumer goods component of PPI has remained subdued so far. Accordingly, the PBoC is not in a hurry to restrain money supply even further. This is also true for any interest hikes which had also played a minor role at the beginning of the crisis. The PBoC cut the MLF rate only by a cumulative 30 bps in early 2020. We expect a first hike of 10-15 bps only once private consumption looks to return to "old strength", i.e. not before late this year. Risks are for no hike at all. However, the policy outlook may change if the recent marked appreciation of the yuan were to continue. Were the PBoC forced into buying US dollar, this would run counter to its current stance and likely motivate her to mop up this liquidity by RRR hikes. However, as we expect GDP growth dynamics to slow, the CA surplus to mitigate and the interest differential to soften, we see only moderate further appreciation of the CNY.

Policymakers to cool down the real estate market
Various top financial regulators have repeatedly voiced concerns about hidden risks in China's real estate market. One of the problems is that the market is hugely diverse. Based on national averages, the floor space sold (in sqm) increased by 2.6% in 2020 while on a value basis it rose by 8.2% yoy. House price inflation slowed from 6.3% yoy in January 2020 to 3.8% by year-end. Thus, while these figures do not look too worrying, the Jan/Feb readings show how explosive numbers may get. Sales rose 105%

yoy (sqm) resp. 133% (in value terms), much more strongly than even the significant base effect can explain. However, the main problem is the market's regional diversity. Bubbly developments mainly occur in the top-tier cities and major city clusters, especially Beijing, Shanghai and Guangdong. Price increases were much stronger there. Shenzhen and Beijing are reported to have property-price-to-income ratios above 40, and Shanghai and Guangzhou above 30 (compared to 5.7x in the US). Thus, housing affordability is a major policy concern.

China: Floor Space
sq.m., yoy in %, cumulative
— Started — Under Construction — Completed — Sold
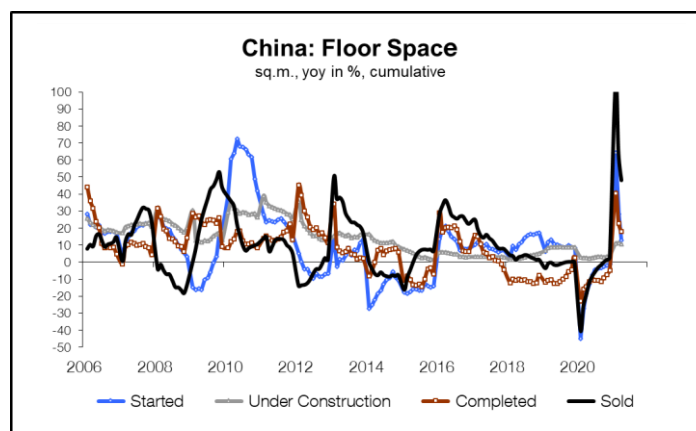
China's economy is highly exposed to the real estate market. Housing activities directly account for about 10% of GDP. With upstream and downstream sectors, its weight is estimated to 20%-25%. Moreover, local governments' land sales are an important funding source of public infrastructure investment. Thus, the real estate sector is a major growth driver which policymakers want to shield against pricing bubbles and financial risks. Against this backdrop, alarm bells rang in last autumn about a substantial default risk of Evergrande, China's biggest property developer, which was reported to have no positive cash flow.

The banking sector is heavily exposed to the real estate market. Property-related loans accounted for more than a third of total loans. Moreover, real estate is widely used as collateral, which is estimated to add another 10-15% indirect exposure. On top, other funds have been (hiddenly) channelled into the property sector, masked as other types of loans (e.g. so-called operation loans). However, there are also reassuring factors: the minimum down-payment for mortgage loans is as high as 30%, so that banks enjoy a sizeable buffer.

To limit financial risks, China has opened a new chapter of deleveraging. Last August, authorities already introduced the so-called "Three red-lines approach". It clusters the financial situation of developers according to the following criteria:

- Total liability to total asset ratio below 70%
- Total debt to total shareholders' equity below 100%
- Cash to short-term debt ratio above 1

If a property developer fails to meet all criteria, its total interest-bearing debt must not increase. If a developer meets one, two or all three criteria, its debt may rise by 5%, 10% or 15%. Initially, these rules were only binding for the 12 largest developers, but policymakers have signalled that they may be broadened to all developers. While pro-

gress has already been made, it was reported that 80% of listed developers do not meet all three criteria. This could slow land acquisition and housing investment over the next two to three years.

Secondly, the PBOC introduced caps on property lending and mortgage loans by commercial banks (effective on Jan 1, 2021), which aims to manage the exposure of the banking sector to real estate risks.[5] In addition, via mortgage lending, Beijing not only puts restraints on the loan supply side but indirectly also on the demand side. This will help to keep property inflation in check. Other PBoC measures to restrict property demand are certain ratios (debt service ratios (DSRs), loan-to-value (LTV) ratios and debt-to-income (DTI) ratios) which home buyers need to respect. Last October, the PBoC announced to plan DSR and possibly DTI ratios.

China: Real estate exposure of banks
in %, *Based on domestic loan breakdown

Source: HSBC, Beijing s property bubble concerns, March 30, 2021

The latest measure concerns a land supply policy reform, initialised by the Ministry of Natural Resources for 22 major cities. The number of land sales by local governments will be limited to three per year and changes the current piece by piece land auctions to batch auctions. The batch sale gives more certainly about the number of lots supplied, thus improving transparency and limiting information asymmetry and arbitrage. Eventually, this should lead to more stable land prices and thus property prices.

In sum, Beijing already moved to limit financial risks on the supply and demand side, based on macroprudential measures. More measures could follow, but the focus will likely lie on local tools, given the diversity of the property markets. Given its importance, Beijing will not risk cooling the market dramatically but proceed incrementally. However, as property is highly valued, cooling demand is a difficult task. We therefore expect prices to only grow less strongly at best.

Gradually introducing SoE bond defaults

China looks to change its stance versus bond defaults again gradually. Since the first-ever default of a solar firm in 2014, Beijing allowed defaults of private firms' bonds to rise significantly in 2018/19. In 2020, the government then tolerated bond defaults of SoEs, among them three high-profile cases in autumn. However, regarding the latest "big" case, Huarong, a large state-owned financial asset
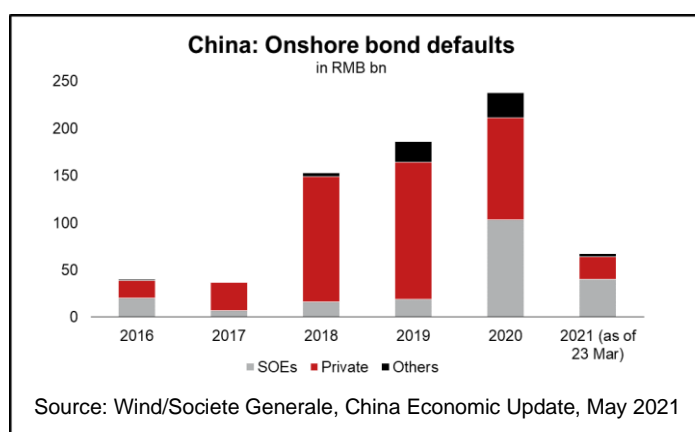
management company (total debt of about US$ 161 bn as of last June, including US$ 22 bn of US$-denominated bonds), press reports suggest a government rescue or at least an orderly restructuring.

Basically, we expect Beijing to become much more selective and to step up withdrawing implicit guarantees as a trend, going forward. This will lead to much more differentiation between quality SOEs and loss-making ones. It also implies an improvement of market functioning by correctly pricing risks and reducing moral hazard. As SoEs (including LGFVs) account for about 85% of onshore corporate bonds outstanding, the process is of systemic importance.

Moreover, policymakers have recently reemphasized their willingness to curb the growth of implicit debt among local governments. According to IMF figures, LGVF's debt continued to rise from 2017 to 2020 by 6 pp of GDP to 38% of GDP, which is 1.5x the official local government debt. However, in the short run, an overly sharp reduction in implicit guarantees could lead to a loss of confidence across credit markets. In a risk scenario, this could result in too strong a repricing of credit (especially visible on lower-rated credit), tightening conditions (credit availability, collateral), eliciting a large rise in funding costs and potentially a liquidity squeeze and a systemic credit crunch in the worst case.

Accordingly, we expect the government and the PBoC to manage the process very carefully. The government will likely use step-by-step tactics, deciding in a case-by-case manner whether the incident could bear systemic implications. The PBoC will stand ready to calm markets by means of liquidity injections, window guidance and other targeted tools. Regarding local governments, a recent study by HSBC finds that "most local governments no longer have the fiscal resources to support every LGFV and SOE."

China: Onshore bond defaults
in RMB bn

Source: Wind/Societe Generale, China Economic Update, May 2021

Conclusions

China's strong recovery enabled the country to go ahead with structural issues. Tackling the "grey rhinos" will likely not result in a systemic crisis but add to deleveraging of the economy and tend to soften growth. We expect the measures to cost about 0.5 pp to 1 pp annual growth over the medium term. Beijing's approach will overall be cautious, not risking too strong a cooling or a systemic crisis. Bond investors, however, should still be more selective regarding bond quality to avoid negative surprises. Over the longer run, the deleveraging will help China to develop more qualitative growth.

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[5] The share of property loans as a percentage of total loans outstanding shall not exceed 40% /27.5% and the share of mortgage shall not exceed 32.5% /20% for large/medium-sized commercial banks. The PBoC offers a grace period of 2 years (which can be lengthened to 4 years for banks with high exposure).

Imprint

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