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Red ink rising

China cannot escape the economic reckoning that a debt binge brings

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HOW worrying are China's debts? They are certainly enormous. At the end of 2015 the country's total debt reached about 240% of GDP. Private debt, at 200% of GDP, is only slightly lower than it was in Japan at the onset of its lost decades, in 1991, and well above the level in America on the eve of the financial crisis of 2007-08 (see chart). Sooner or later China will have to reduce this pile of debt. History suggests that the process of deleveraging will be painful, and not just for the Chinese.

Explosive growth in Chinese debt is a relatively recent phenomenon. Most of it has accumulated since 2008, when the government began pumping credit through the economy to keep it growing as the rest of the world slumped. Chinese companies are responsible for most of the borrowing. The biggest debtors are large state-owned enterprises (SOEs), which responded eagerly to the government's nudge to spend.

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The borrowing binge is still in full swing. In January banks extended $385 billion (3.5% of GDP) in new loans. On February 29th the People's Bank of China spurred them on, reducing the amount of cash banks must keep in reserve and so freeing another $100 billion for new lending. Signs of stress are multiplying. The value of non-performing loans in China rose from 1.2% of GDP in December 2014 to 1.9% a year later. Many SOEs do not seem to be earning enough to service their debts; instead, they are making up the difference by borrowing yet more. At some point they will have to tighten their belts and start paying down their debts, or banks will have to write them off at a loss—with grim consequences for growth in either case.

An IMF working paper published last year identified credit growth as "the single best predictor of financial instability". Yet China is not obviously vulnerable to the two most common types of financial crisis. The first is the external sort, like Asia's in 1997-98. In such cases, foreign lending sparks a boom that eventually fizzles, prompting loans to dry up. Firms, unable to roll over their debts, must cut spending to save money. As consumption and investment slump, net exports rise, helping bring in the money needed to repay foreign creditors. China does not fit this mould, however. More than 95% of its debt is domestic. Capital controls, huge foreign-exchange reserves and a current-account surplus help defend it from capital flight.

The other common form of crisis is a domestic balance-sheet recession, like the ones that battered Japan in the early 1990s and America in 2008. In both cases, dud loans swamped the banking system. Central banks then struggled to keep demand growing while firms and households paid down their debts.

China's banks are certainly at risk from a rash of defaults. Markets now price the big lenders at a discount of about 30% on their book value. Yet whereas America's Congress agreed to recapitalise banks only in the face of imminent collapse, the Chinese authorities will surely be more generous. The central government's relatively low level of debt, at just over 40% of GDP, means it has plenty of room to help the banks. Indeed, with the right policies, China could survive a deleveraging without too much pain.

By borrowing and spending, firms boost demand; when paying down debts they subtract from it. In the absence of new borrowing elsewhere in the economy, growth will atrophy. China's government could try to compensate by borrowing more itself to finance a fiscal stimulus. It might also use low interest rates to encourage households to borrow more. (This week's cut in banks' reserve requirements seems designed to buoy China's property market.) But orchestrating such a switch in growth engines is not easy. Firms and households might instead be forced to deleverage simultaneously, exacerbating the pain. Household debt in China is low but rising fast, raising the risk of a double crunch in future.

Moreover, China would have to ensure that existing bad debts are written down and bankrupt SOEs shut—a tall order politically. Reports this week claimed it plans to lay off 5m workers, but big firms will resist a proper reckoning. The bumbling response to the stockmarket and currency wobbles of the past year calls into question the leadership's competence. The government may be able to prevent an outright banking crisis, but the slump that usually accompanies a deleveraging will be harder to avoid.

Foreign demand could perhaps help make up for the shortfall in domestic spending. Deleveraging commonly occurs alongside large depreciations; as spending in indebted economies falls the value of the currency declines, giving exports a boost. That, in turn, helps put idle capacity to work and bolsters the income of firms repaying loans. Big depreciations can also boost inflation, helping keep the deleveraging economy out of a debt-deflation trap, in which falling prices and incomes make debts with fixed values more expensive to service. Countries that see big depreciations while deleveraging, as many Asian ones did in 1997-98, typically suffer sharp but short downturns before reverting to growth. In contrast, in countries that resist depreciation, as Japan did in the 1990s and peripheral Europe has done recently, deleveraging is slower and more painful.

China's government seems determined to prop up the yuan. But it may struggle to do so while the economy deleverages. The grinding recovery that would imply has political costs. And cutting rates to boost borrowing elsewhere in the economy would place further downward pressure on the yuan, forcing the government either to tighten capital controls yet more, run down its foreign-exchange reserves or let the currency drop.

With a deft enough touch, China's debt bomb could fizzle. The rapid pace of credit growth makes a benign outcome ever less likely, however. Given China's size, a prolonged deleveraging would place a dangerous drag on global demand growth, which the world's weakened economies would struggle to cope with. The sooner China turns off the credit taps, the better.

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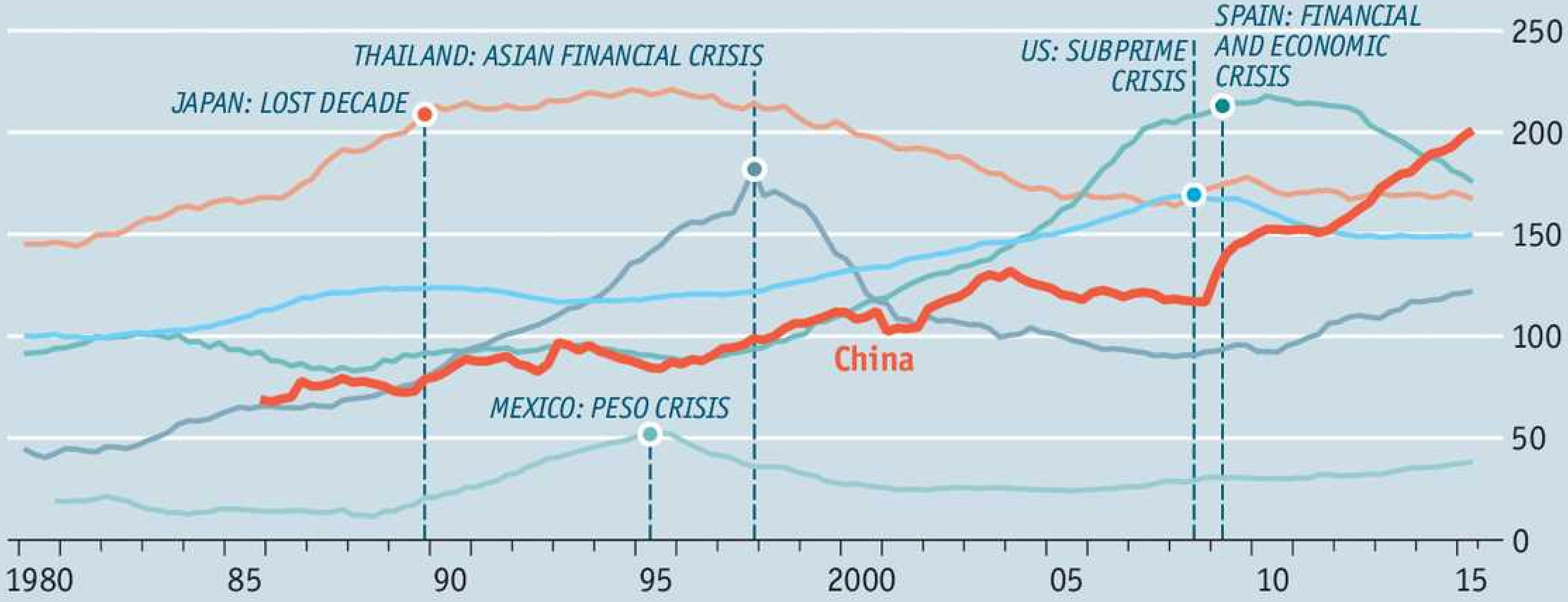
No boom without a bust

Private non-financial sector credit as % of GDP



Source: BIS