

Private property developers are really driving China's debt, research suggests

October 28 2016, by James Laurenceson

China has a debt problem. But [research shows](#) that it's not the industrial sector or state-owned enterprises (SOEs) to blame but the booming private property market.

The [global financial crisis](#) illustrated how debt problems in one part of the world (in this case the US and Western Europe) could have widespread negative consequences. As China is now the world's top goods trader, second largest economy and third biggest credit nation, a debt meltdown there would have [harmful effects](#) well beyond its borders.

The latest data from the Bank of International Settlements [shows](#) that since 2008 China has been responsible for nearly one in two dollars of new borrowing globally. China's debt has reached 254.9% of GDP, up from 147% at the end of 2008. That's even higher than in the US, where per-capita incomes are nearly [four times greater](#).

Two-thirds of China's debt is accounted for by corporates, while the remainder is in the hands of governments and households. Many [commentators](#) blame inefficient and loss-making SOEs for the problem, particularly those in the construction sector and areas of industrial overcapacity such as steel.

Recent [research using survey data](#) from China's National Bureau of Statistics confirms businesses in steel, coal and electricity have indeed got increased debt levels, relative to their own equity and assets. But

when expressed as a proportion of GDP this increase has been small and mostly offset by firms in other parts of the industrial sector with falling debt levels.

Relative to GDP, between 2008-2015 the debt of industrial firms rose by just 4.4 percentage points, while those in construction increased by 7.0 percentage points. Towering above both was businesses in the real estate sector, where debt leapt by 29 percentage points.

So while it might be true to say that construction and an over-producing [industrial sector](#) are contributing to China's debt problem, they aren't the main drivers.

How real estate and private firms are driving debt in China

A recent [chapter](#) by economists at the Reserve Bank of Australia (RBA) looked at data from Chinese listed companies and came to similar conclusions.

Industrial firms (manufacturing, utilities and mining) subtracted from rising overall debt levels from 2008-2015.

Between 2008-12 it was construction firms that were mostly responsible. Since then it has been businesses in real estate.

In terms of how debt is held between state and private firms, survey data [shows](#) within the debt-laden real estate sector, private developers have been increasing their debt levels, while those of state developers have been falling.

Across all sectors, state-owned or controlled businesses accounted for

three-quarters of the increase in overall debt levels between 2008-2012, [evidence](#) from listed companies reveals. But since then these businesses have actually subtracted from rising debt levels, leaving private firms entirely responsible.

What China's government can do about it

China's overall debt trajectory is unsustainable. Research [from the International Monetary Fund \(IMF\) finds](#) that very few countries have experienced a similar rapid build up of debt and escaped without an eventual bust.

The question for the country is how to reduce the reliance of corporations on borrowing while still maintaining a robust rate of economic growth.

If state banks throwing good money after bad at SOEs in construction, coal, steel and so on is the problem, then the policy prescription is clear.

In August, deputy managing director at the IMF, David Lipton [argued](#):

"To tackle the problem, the Chinese government must, in the words of Premier Li Keqiang, "ruthlessly bring down the knife [on] zombie enterprises",...It is especially important to restructure SOEs. Many are essentially on life support."

SOE reform is undoubtedly valuable but alone is unlikely to solve the problem. This is because the big driver, particularly in recent years, appears to be increasingly [speculative behaviour](#) by those in the real estate market.

On the supply side, this has often involved private developers, albeit sometimes with minority state shareholders, while the demand side is

comprised of households. The fact that the private sector looms large in China's debt in some ways makes the problem more complicated to deal with.

Direct administrative measures such as forcing a merger between a weak state firm and a stronger one may not be possible with private sector players because the government does not own or control these companies.

At the same time, the unemployment created by the collapse of a large private company would not be attractive for a government obsessed with social stability either.

Adding further complexity for China's regulators is that sometimes households do not buy real estate assets directly but [instead](#) do so via financially engineered wealth management products, sold by financial institutions.

The growing [importance](#) of mortgage lending in China also creates a potentially destructive link between any problems in the housing market and the stability of the financial system more generally.

When house prices began to fall in the US in 2006, banks were left with massive bad debts as households defaulted on their mortgages. That said, [downpayment requirements](#) in China tend to be high relative to other countries, providing banks with some degree of protection.

In weighing up China's debt outlook, another positive consideration is that the household debt to GDP ratio in China is [only 40.7%](#), compared with 78.4% in the US and a whopping 125.2% in Australia.

Still, given the central role that real estate and the private sector play in China's debt challenge, [moves](#) by the Chinese government to curb

property market speculation should be welcomed. Similarly, [tighter](#) rules on wealth management products also make good sense, such as limiting the involvement of smaller banks that have less capital to offset potential losses.

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