IMF sharpens its warning on “dangerous” Chinese debt growth

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The International Monetary Fund has issued its sharpest warning yet of the dangers that the build-up of debt in China poses to the country’s financial stability and the global financial system as a whole.

The IMF has been sounding the warning bell over Chinese debt for the past couple of years but the language it employed in its annual review of the country’s economy, issued earlier this week, showed that the concern is rising.

The review said the Chinese economy would grow faster than previously estimated over the next three years because of the government’s determination to meet its pledge to double the size of the economy between 2010 and 2020, and its use of debt to achieve its target. The IMF revised upward its estimate of Chinese growth rates. It said the economy would expand by an average 6.4 percent in 2018–2020, compared with its previous estimate of 6 percent, and by 6.7 percent in 2017, compared with its earlier forecast of 6.2 percent.

The rise in debt began in response to the 2008–2009 financial crisis, during which the Chinese economy shed some 23 million jobs. Since then, total debt has quadrupled, reaching $28 trillion by the end of last year.

According to the IMF, the rate of debt growth will accelerate over the next few years. It said China’s non-financial sector debt was now expected to reach 290 percent of gross domestic product (GDP) by 2022, compared with 235 percent last year. Previously the IMF estimated that debt would stabilise at around 270 percent of GDP over the next five years.

“International experience suggests that China’s credit growth is on a dangerous trajectory, with increasing risks of a disruptive adjustment and/or a marked growth slowdown,” the IMF said.

“Since 2008, private sector debt relative to GDP has risen by 80 percentage points to about 175 percent—such large increases have internationally been associated with sharp growth slowdowns and often financial crises.”

The report highlighted the growing dependence of economic growth on rising debt, noting that if credit growth had been kept at a sustainable rate, GDP growth in the five years between 2012 and 2016 would have averaged 5.5 percent, rather than the recorded level of 7.25 percent.

The Chinese government rejected the IMF’s warnings. According to Jin Zhongxia, China’s representative at the IMF, the expected stronger performance of the Chinese economy was not merely driven by policy stimulus. It was a “reflection of rebalancing and structural adjustment,” he said. The IMF scenario “of an abrupt slowdown of the Chinese economy … is highly unlikely.”

Chinese authorities are no doubt acting in the belief that the expansion of debt will be countered by economic growth.

Figures produced by the IMF, however, show a marked decline in the effect of credit stimulus on the economy. In 2008, new credit of 6.5 trillion renminbi produced a rise of 5 trillion renminbi in nominal GDP. In 2016, it took 20 trillion renminbi in new credit to obtain the same result. In other words, the impact of additional credit has fallen by two-thirds in the space of eight years.

While Chinese authorities have been somewhat dismissive of the IMF’s warnings, they are well aware of the problems posed by increased debt and have been trying to rein in expansion of credit in the so-called shadow banking system.

But government policy is not driven by purely economic considerations. Politics is a major factor.

Having long ago abandoned any commitment to socialism and social equality, the regime is seen by the population as ruling in the interests of major corporate and financial elites. Its political legitimacy rests solely on its ability to continue economic expansion. It lives in mortal fear that any significant economic slowdown will lead to the growth of opposition from the multi-million working class.

The fate of the Chinese economy has major international implications. Since the global financial crisis of 2008, China has been the major contributor to the expansion of the global economy, accounting for more than half the increase in world GDP in recent years.

With growth in the US economy stuck at 2 percent and below for the foreseeable future, that dependence is increasing. The IMF revised down its estimate for US growth in its most recent review of the American economy. Yet continued Chinese growth depends, in turn, on an increase in its debt levels, threatening to set off a financial crisis.

The IMF report also pointed to the rapid growth of the Chinese banking system. It said China now had one of the largest banking sectors in the world. At 310 percent of GDP, it was above the average for advanced economies and more than three times the average level for so-called emerging markets.

"The sharp growth in recent years reflects both a rise in credit to the real economy and intra-financial claims. The increase in size, complexity and interconnectedness of these exposures have resulted in sharply rising risks," the report said.

The situation may be even worse than indicated by the IMF. According to Charlene Chu, a long-time analysis of the Chinese financial system, bad debt is some $6.8 trillion above the levels indicated by official figures. Government intervention, while providing stability in the short term, has allowed problems to grow.

Speaking to the *Financial Times* in the wake of the IMF report, she said while everyone knew about the credit problem in China, "people often forget about the scale. It's important in global terms."

Chu estimated that bad debt in the Chinese financial system would reach as much as $7.6 trillion by the end of this year, more than five times the official estimate of loans classified as either non-performing or one grade above. This implies a bad debt ratio of 34 percent, compared to the official ratio of 5.3 percent.

Chu said she appreciated how the authorities managed to orchestrate the financial system and an acute crisis did not appear imminent because Beijing could delay the emergence of problems longer than in a purely market-driven system.

"The upside is that it creates stability," she commented. "The downside is that it can create a problem of proportions that people would think is never possible. We're moving into that territory."