

ChinaPower Project

Does China Face a Looming Debt Crisis?

After decades of near double-digit growth, Chinese leaders have turned to using turbo-charged stimulus financing to maintain moderate growth. A consequence of this strategy has been a dramatic and rapid rise in debt. As of 2017, China's total debt amounted to 255.7 percent of its gross domestic product (GDP). While a debt-to-GDP ratio exceeding 100 percent is not unusual, because China's credit expansion over the past decade has risen so quickly, this trend has contributed to growing financial vulnerabilities that could threaten the long-term health of its economy.

Debt to Percentage of GDP

This interactive uses data from the Bank for International Settlements (BIS) to compare China's corporate, government, and household debt with those of other countries. All three forms of debt are represented as a percentage of total Gross Domestic Product (GDP). Each bubble represents one percent of a country's overall debt. Choose up to four countries to compare with China for a given year.

Select Year

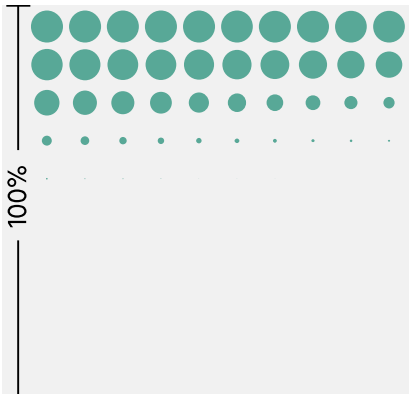
Corporate

Government

Household

Each bubble represents 1% of debt.

China



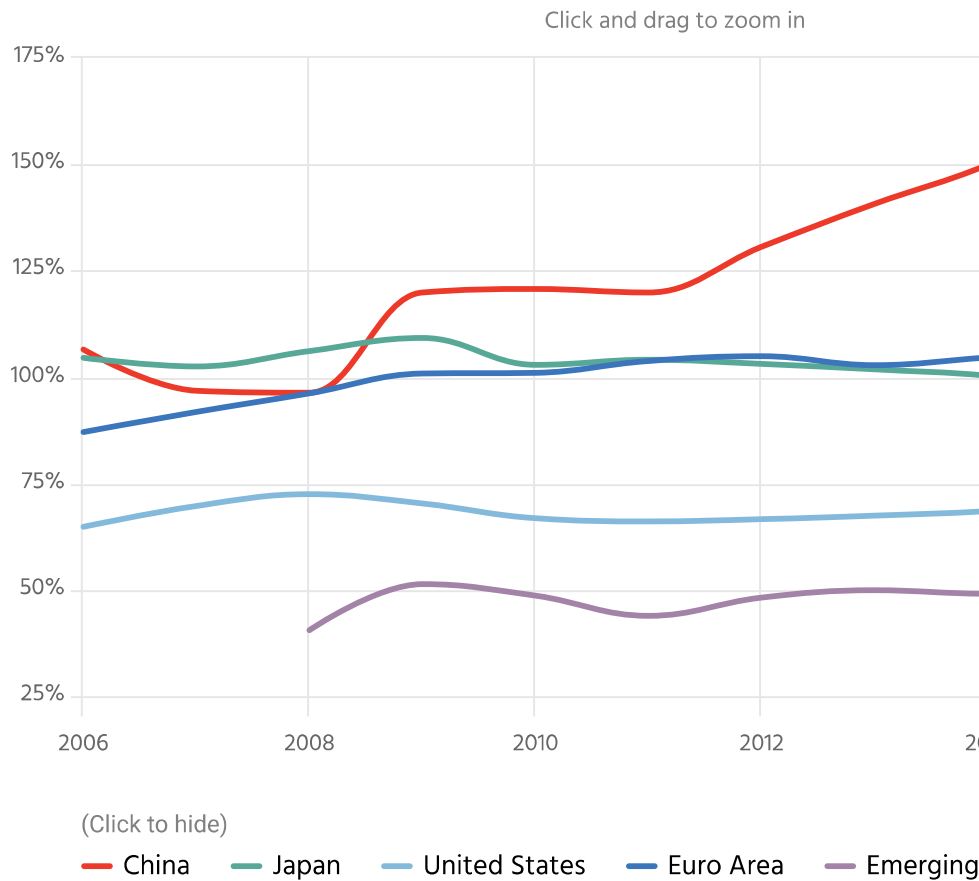
Breaking Down the Types of Debt

Although China was less affected by the 2008-2009 global financial crisis than other countries, its economy still suffered from a sharp decline in exports and a major stock market correction that wiped out an estimated two-thirds of its market value. To stem the tide of the crisis, China pushed out a massive \$600 billion stimulus package in late 2008 to boost domestic demand and spur economic growth. The value of the stimulus was close to 13 percent of China's GDP in 2008, and was considerably larger than stimulus packages offered by the world's first and third largest economies – the US and Japan pumped a comparatively meager \$152 billion and \$100 billion, respectively, into their much larger domestic markets.

The government stimulus was largely funded through loans from the state banking system, which contributed to an increase in debt that with time has become unevenly distributed across different industries and regions. To assess the economic challenges China faces regarding its growing debt, it is necessary to consider the composition of the debt that is variously held by households, the government, and companies. The Bank for International Settlements¹ provides country-level data on all three types of debt as a percentage of total GDP.

Household debt refers to the amount owed by individuals and households to financial institutions, often in the form of mortgages or personal loans. On average, household debt in China increased by 18.5 percent of GDP annually between 2008 and 2017, reaching 48.4 percent of GDP by 2017. This percentage is slightly above those of emerging market economies, with household debt averaging 40 percent of GDP. According to the OECD, China's level of household indebtedness is moderate.

Corporate Debt as % of GDP



Government or sovereign debt refers to the total amount owed by a country's government. In China's case, this refers to general debt owed by the Chinese central government as well as that explicitly held by local governments, which as a percent of its GDP rose from 27.1 percent in 2008 to 47 percent in 2017. China's government debt is slightly larger than that of South Korea (40.1 percent), but is dwarfed by the United States (97.1 percent) and Japan (201 percent). Although China's general government debt is relatively low, there is some concern that a significant amount of debt has been accumulated by local governments in the wake of the financial crisis. Importantly, much of the debt accumulated by China is a product of government policy that has offered implicit financial backing to state-owned enterprises (SOEs) and state banks, which in turn increases the government's cost of servicing debt.

Corporate debt refers primarily to bank loans and corporate bonds to finance their investments and operations. China's corporate debt has risen sharply since 2008, jumping (as a percent of GDP) by over 60 percentage

points over the last eight years. As of 2017, China's corporate debt stood at 160.3 percent, placing it behind Hong Kong's (232.2 percent), but well ahead of Japan (99.9 percent) and the United States (73.6 percent). Similarly, China's corporate credit levels has surpassed those of emerging market peers like Brazil (43.9 percent) and Malaysia (67.3 percent). China's considerably high level of corporate debt presents several challenges for its economy, several of which are explored in the following sections.

Explaining the Debt Problem

Although China's total debt stands at 255.7 percent of GDP, it is important to understand this figure within a global context. A 2015 McKinsey report showed that worldwide debt has steadily risen and most major economies have displayed higher levels of borrowing since 2007. According to the Institute of International Finance, global debt amounted to \$247 trillion – 318 percent of the global GDP – in the second quarter of 2018. This increase was mostly due to a surge in emerging market borrowing. In the case of China, easy access to credit following the financial crisis paved the way for large-scale spending for domestic infrastructure and real-estate development. This spending binge also contributed to greater overseas investments.

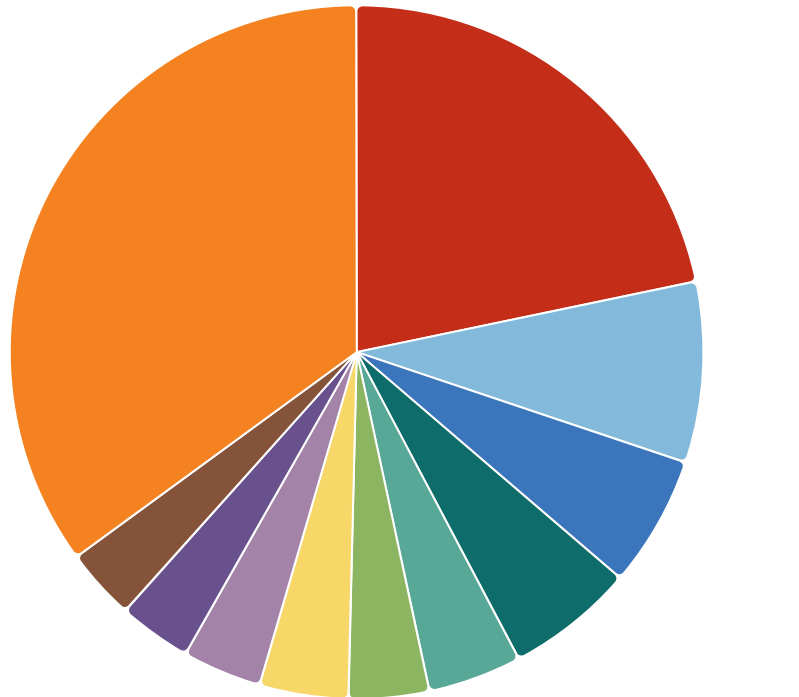
More concerning than the amount of debt China carries is the rate at which its total debt has grown since the financial crisis. China's total credit growth averaged a rate of about 20 percent per year between 2009 and 2015. In particular, China's high level of corporate debt is worrisome. Chinese corporate leverage – the ratio of debt to equity – has steadily risen since the financial crisis, indicating that Chinese firms are increasingly using loans to finance assets and taking on increased risk.

In 2018, China suffered from widespread overcapacity, with 11 percent of factories producing (on average) 20 percent more goods than the market demanded.

China's credit boom also led many firms to produce more goods than what market conditions demanded. A 2018 survey of 2,000 companies conducted by the Cheung Kong Graduate School of Business found that one-third of China's industries suffered from overcapacity and that 11 percent of factories produced (on average) 20 percent more goods than the market demanded. This is a slight decline from 2016, when more than half of these industries experienced overcapacity.

As a result, there has been a notable decline in efficiency, with firms generating less value-added output over time with the capital they have at their disposal. This capital inefficiency is reflected by the Incremental Capital Output Ratio (ICOR), which measures how much capital input is needed per extra unit of output. The Chinese corporate sector's ICOR has increased more than threefold from 2009 to 2017, which means an increasing amount of capital was needed for the next unit of production. In other words, China's credit-heavy financing spree was not matched by a corresponding boost in productivity, but by an increasingly inefficient use of credit, which suggests China's corporations may have a deteriorating capacity to repay their existing debts. Data from BIS reveals that the private nonfinancial sector in China has a debt servicing ratio – the share of income used to service one's debt – of 20.1 percent, which is nearly identical to that of South Korea (20 percent) yet significantly higher than that of the US (14.6 percent) and Japan (14.2 percent). Heavy borrowing, combined with falling profits, further exacerbates China's corporate debt problem by leaving many Chinese firms with significant debt overhang – where existing debt reaches such a level that borrowing becomes difficult.

Number of Chinese State-Holding



During the financial crisis, China's SOEs were a key policy instrument employed by Beijing to mitigate the effects of the crisis on the Chinese economy. Banks were directed to lend to SOEs, which in turn used this financing to build new factories and equipment despite there being limited market incentive for expansion. SOEs accounted for over half of all China's corporate debt, but only contributed to 22 percent of China's total GDP in 2016. It is worth noting that SOEs further complicate corporate debt measurements in China. Differentiating between public and private debt in China is difficult when many corporate entities are partially or wholly owned by the Chinese government.

The exact number of SOEs operating in China is unknown. According to the *China Statistical Yearbook*, there were a total of almost 19,000 state-holding industrial enterprises in China, but foreign estimates place the total number as high as 150,000. These enterprises are most concentrated in chemical manufacturing, mineral manufacturing and the production of electricity and heat. In general, SOEs show greater levels of leverage and

lower levels of profitability than private enterprises.

Size of China's Shadow Banking Sector (Unit: 1 Billion RMB)

Year	Size (Billion RMB)
2013	24,952
2012	19,207
2011	14,180
2010	11,111
2009	5,995

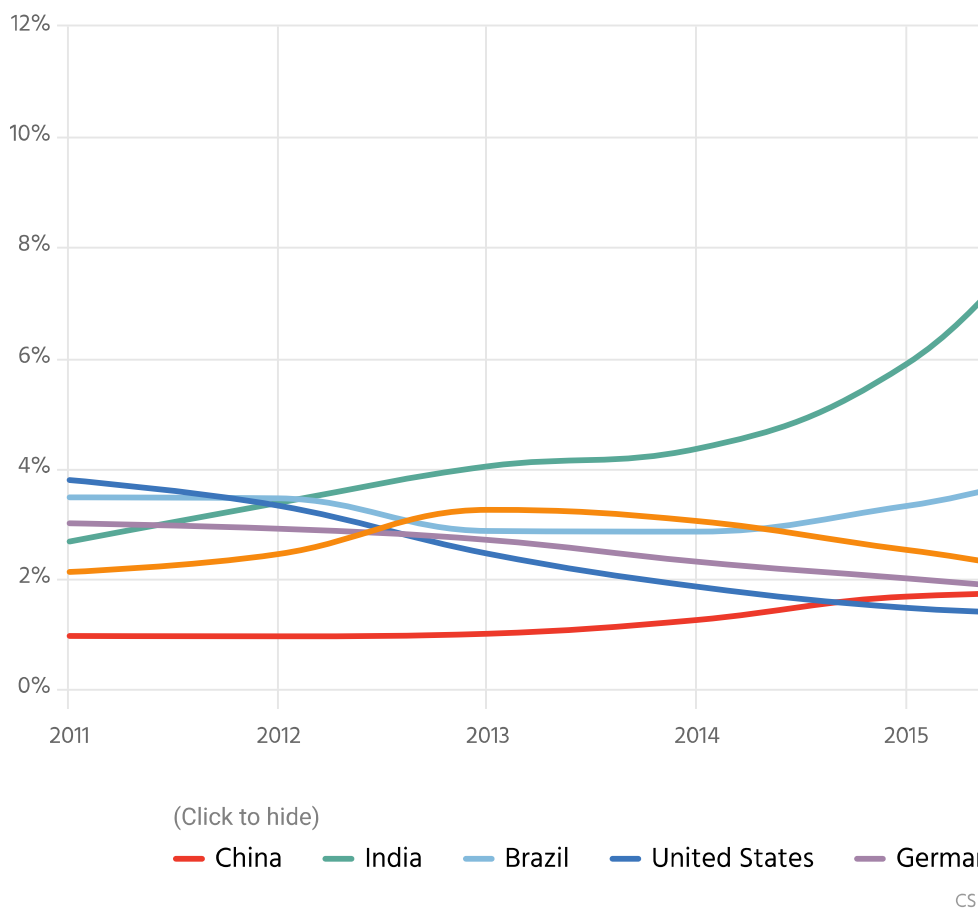
Brookings Institution

While China's lending traditionally comes from the major state-controlled banks, there has been a gradual shift towards less transparent alternative lending sources that can produce high-risk loans and contribute to China's debt woes. This lending is at times done through smaller local and provincial banks that sell lightly regulated investments. The rise of wealth management products (WMPs) adds additional complexity to the debt environment by making it difficult to distinguish between the debt of different organizations and determine how this debt is tied together. Financial transparency is further obfuscated by shadow banking, with financial activity operating outside the formal banking sector and thus less visible to government oversight. China's shadow banking sector grew in size from \$80 billion USD in 2006 to almost \$9. trillion USD in 2018.

China's corporate sector is also plagued by problem loans. The IMF estimates that 15.5 percent of all commercial bank loans to China's corporate sector can be deemed "at-risk," where a firm's earnings cannot sufficiently cover the interest expenses of its loans. Assuming a 60 percent loss ratio, the IMF forecasts that these at-risk loans could result in losses equal to 7 percent of China's GDP. Per the World Bank, China's

nonperforming loans amount to 1.74 percent of total gross loans in 2017, which is higher than the United States' 1.1 percent, but significantly smaller than India's proportion of nonperforming loans, which sits at 10 percent. Notably, large banks like the Bank of China reported improving nonperforming loan ratios in the first half of 2017. This outcome is partly due to the offloading of bad assets to companies like China Cinda Asset Management (the second-largest of four asset managers set up in the 1990s to clean up bad loans) in order to improve China's financial image to investors.

Nonperforming Loans as % of Total Gr



Concerns over the health of China's financial system have prompted the international financial community to respond. In May 2017, Moody's Investor Services cut China's sovereign debt rating for the first time since 1989, pegging it down one rank from Aa3 to A1. In response, China's Ministry of Finance dismissed the Moody's downgrade as "inappropriate" and pointed towards the ongoing structural reforms (discussed below) designed to rein in the debt

problem. In September 2017, Standard & Poor's Financial Services LLC also cut China's credit rating from AA- to A+, declaring that "a prolonged period of strong credit growth has increased China's economic and financial risks."

A 2016 IMF report showed that of the 43 economies whose credit-to-GDP ratio grew by at least 30 percentage points in the last five years, 38 of them "experienced severe disruptions, manifested in financial crises, growth slowdowns, or both." China's total credit-to-GDP over the last five years (2012-2017) grew by 48.4 percentage points. It is unclear if this mounting concern will materialize in the form of a slowdown or crisis, but either possibility could be devastating for both China and the rest of the global economy through which China is integrally linked.

In May 2017, Moody's Investor Service downgraded China's credit rating for the first time since 1989. Learn more about the concerns over China's debt with this Freeman Chair in China Studies' China Reality Check Event.

Government Response to Debt

The Chinese government has undertaken steps to redress the growing debt problem. Xu Zhong, head of the research bureau at the People's Bank of China, acknowledged in May 2017 that high stimulus over-spending and poor corporate management were key contributors to China's rising leverage levels, asserting that "financial security is achieved via reforms, not bail-outs." Two months later, President Xi Jinping highlighted the importance of developing financial laws and regulations to guard against systemic risks at a National Financial Work Conference. Xi also declared that the Chinese government will "deleverage the economy by firmly taking a prudent monetary policy and prioritizing reducing leverage in state-owned enterprises."

In the 2015 13th Five Year Plan, Chinese authorities outlined several

financial reform measures designed to tackle corporate debt-related vulnerabilities. The plan aimed to reduce capacity in coal and steel industries by 10-15 percent. The plan also outlined a \$100 billion RMB restructuring fund (equivalent to 0.1 percent of China's GDP) that was set up to absorb the welfare costs for an estimated 1.8 million displaced workers. Over the first half of 2017, China cut 128 million tons of its coal capacity and 42.4 million tons of its steel capacity, reaching 85 percent of its annual reduction targets in both coal and steel.

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The Chinese economy is also burdened by the existence of zombie firms, companies which have run losses for consecutive years. In many cases, these consist of SOEs that face high levels of debt or overcapacity and that are propped up by government subsidies. Tighter government reforms have focused on allowing zombie firms to go bankrupt, which in part resulted in a 54 percent spike in Chinese insolvency cases from 2015 to 2016. In 2016, the State-owned Assets Supervision and Administration Commission (SASAC) further identified 345 zombie firms to focus on shutting down within the next three years.

Many of the policies introduced by the Chinese government focus on reducing local government debt. These include the State Council's Document No. 43 – issued in October 2014 – that called for strict supervision of local governments' financing channels, and a 2015 bond-swap program, where local government liabilities could be swapped into municipal bonds. As of May 2016, China has accumulated a total of \$1.58 trillion RMB (\$240 billion USD) in loan-for-bond swaps. China's Ministry of Finance has also employed public naming and shaming tactics against municipalities for financing irregularities and vowed to hold officials accountable for regulatory violations.

In 2016, Chinese regulators introduced even greater restrictions to control

the country's debt. In November 2016, the State Council cracked down on debt-financed overseas investments, declaring that government agencies had to sign off on foreign acquisitions valuing over \$10 billion and that all SOEs were to halt all foreign real-estate purchases in excess of \$1 billion. These tightening regulations were also introduced to counter the immense downward pressure exerted on the RMB after it depreciated by a record 5.8 percent in 2016. The China Banking Regulatory Commission has also strengthened its oversight of wealth management products by requiring lenders to more clearly disclose risks to investors and prohibiting WMP issuers from investing in their own products.



Driven in part by Beijing's "Going Global" strategy, Chinese firms have actively expanded their overseas investment in recent years. Learn more about China's foreign investment.

In November of 2017, the government also established the Financial Stability and Development Committee. Headed by the Vice-Premier of China, Liu He, the committee is responsible for deliberating financial reforms and coordinating regulations between financial regulators to better address the risks. In early 2018, the committee published stricter guidelines regarding WMPs, including prohibiting financial institutions from implicitly guaranteeing the principal or returns on these products. The new regulations are expected to come into full force in 2021.

Moody's officials stated that China's structural reforms may "slow the pace of debt build-up but will not be enough to arrest it" and warned of another rating downgrade if Chinese credit is not kept in check. In August 2017, the National Development and Reform Commission stated that it has

seen “initial results in lowering corporate leverage and debt risks have been effectively controlled,” but that leverage ratios for non-financial Chinese firms are still excessively high and that China must “firmly adhere to the direction of deleveraging.” However, structural reforms aimed at lowering debt levels may be temporarily set aside as a result of the ongoing trade dispute with the US.

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KEYWORDS [corporate debt](#) [debt to GDP](#) [foreign direct investment](#)
[loans](#) [shadow banking](#) [State Owned Enterprise](#)

DATA SOURCES

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