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Can China shield its economy from the impact of COVID-19?

EXECUTIVE SUMMARY

China will likely miss its 2020 growth target due to the impact of the coronavirus pandemic on the global economy. Although the government is taking proactive measures to limit the impact of this shock, an increase in corporate insolvencies and structural fragilities is unavoidable.

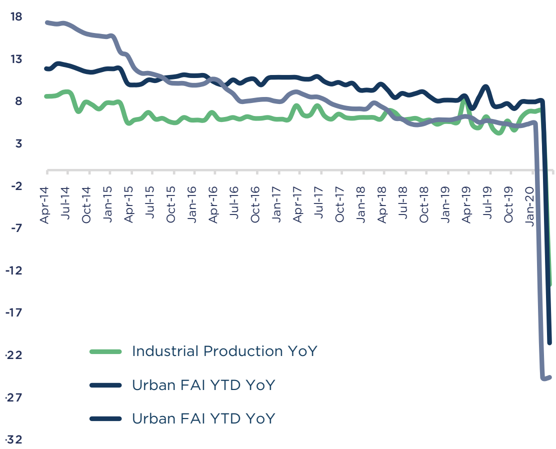
The Communist Party of China (CPC)'s government is hoping to achieve a moderately prosperous society before its 100th anniversary in 2021, requiring approximately a 5.6% growth rate in 2020. However, the coronavirus (COVID-19) pandemic will add significantly to existing growth headwinds, such as the US-China trade war, structural factors and demographics. While the government appears to remain confident regarding their 2020 targets, it is likely these will have to be postponed until July 2021: the spread of COVID-19 to key markets in Europe and North America (30% of total exports) will drag on activity throughout the second and third quarters of 2020. As a result, Coface expects China to achieve a growth of only 4.0% in 2020.

China will resort to aggressive monetary and fiscal easing to achieve stabilization, but these will come at a cost. For instance, foreign exchange (FX) reserves are not sufficient to cover outflows, and this may exert depreciatory pressures on the Chinese yuan. On the fiscal front, additional infrastructure investments will add to indebtedness at the local level, resulting in pressures on the banking sector and highly indebted corporations. Increases in bond defaults and corporate insolvencies are likely, as are restructuring efforts in the banking sector. Given the delicate balance that will be required, the chance of a policy misstep is higher than ever.

No "V-shaped" stabilization: China could miss growth targets

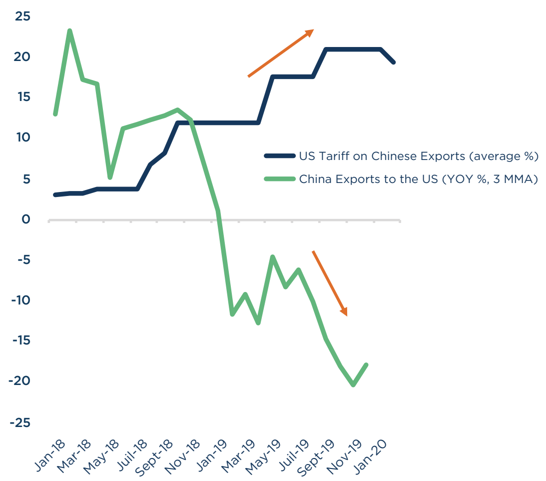
China's economy is expected to be hardly hit by the direct and indirect impacts of the COVID-19) pandemic and decelerate to the slowest pace in 30 years. Specifically, the large scale lockdowns and capacity closures that started in China the first quarter (Q1) of 2020 have escalated rapidly, spreading around the world. The Chinese Academy of Social Sciences estimates that the exogenous shock could have cost the Chinese economy up to USD 40 billion in February alone. However, this estimate does not price in indirect impacts or negative spill-over effects to other parts of the world. Activity indicators for the period of January-February 2020 point to a faster-than-expected contraction in Q1 **(Chart 1)**, with industrial production, retail sales and urban fixed asset investments (FAI) contracting for the first time in recorded history. Moreover, it will become harder for China to steer its economy out of this slump. First of all, the economy is structurally slower, a trend that is linked to the country's shift towards a more sustainable consumption-led growth model. This is imperative, as China also faces demographic headwinds (15% of the population over the age of 65). In addition, the trade war between China and the United States (US) will remain a drag on growth. Despite the optimism surrounding a "Phase-1" deal announced on 15 December 2019, average tariff levels on USD 250 billion worth of Chinese exports to the US remain at a record high of 19% compared

CHART 1
Key monthly activity indicators



Source: NBS, Bloomberg and Coface

CHART 2
Average tariffs on Chinese exports to the US and exports YOY



Source: China Customs, Peterson Institute for International Economics, Bloomberg and Coface

to 3% before the trade war started[1] **(Chart 2).** The case for a V-shaped stabilization is political. The Communist Party of China (CPC) set an ambitious overarching target for President Xi Jinping as part of his inauguration in 2013. The first "centennial target" is to achieve a full xiaokang[2] economy ahead of the 100th anniversary of the CPC in July 2021. China defines this goal as a doubling of 2010 nominal per capita income figures by 2020 – a hard target that will not be easy to achieve since it requires a yearly growth rate of 5.6%. However, the spread of COVID-19 to Europe and the US, China's largest trading partners, will make this goal unachievable. Both markets account for over 30% of China's total exports and demand will remain anaemic throughout Q2 and Q3 2020, because of capacity closures and mandatory quarantines in those regions. In other words, the external demand shock in Q2 and Q3 will be significant. As a result, the government will have to postpone reaching the centennial target this year. Growth is set to contract sharply by -1.8% YOY in Q1, before stabilizing at 4.0% in 2020 (baseline scenario). Favourable effects in the first half of 2021 would still enable the CPC to meet the target before the key deadline in July. That said, this would still require aggressive stabilization measures and the recovery would be more "U-shaped" than "V-shaped". Lexicological matters asides, the most important point is that China will have to change its policy settings quite drastically in order to achieve a semblance of recovery. Unlike 2009, when China had the capacity to act as a much welcome spare wheel for the global economy, this time round economic stimulus will come at a steep cost.

Stronger monetary policy support will require sacrifices

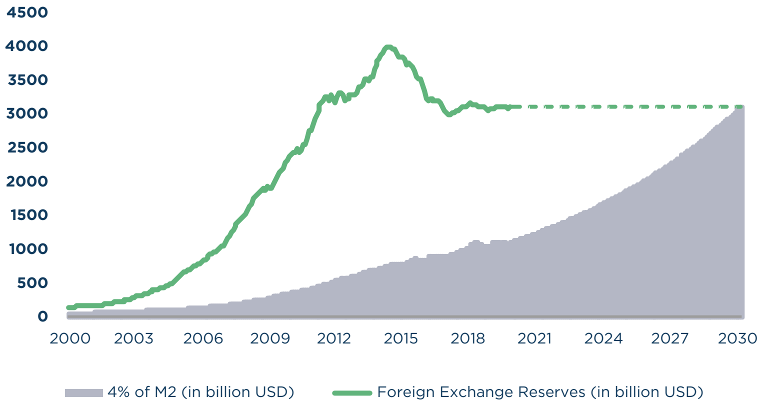
The People's Bank of China (PBOC) has maintained a "prudent" approach to monetary policy. The idea behind this setting is to enable productive sectors of the economy to continue accessing credit, without reinflating existing bubbles: high corporate debt (160% of GDP) and housing prices (ratio of house price to annual household income of 21 for Tier-1 cities). Qualitative fixes implemented in 2019 include linking the Loan Prime Rate (LPR) to the PBOC's medium-term lending facility (MLF). This grants the PBOC more direct control over interest rates **(Chart 3).** The bank also implemented targeted measures, including a cumulative 200 bps in Reserve Requirement Ratio (RRR) cuts and direct cash injections via open market operations (OMO).
However, the PBOC's "prudent" approach may prove to be insufficient. There were signs of this already in 2019, as interbank rates remained quite high in the second half of the year, following the rescue of five small state lenders[3]. Creditors were forced to incur losses, marking an end to implied guarantees[4]. Local lenders have been particularly hit by an increase in Non-Performing Loan (NPL) levels, as activity slows and investments decline on weaker sentiment. The COVID-19 pandemic only reinforces this narrative, which is concerning because the banking sector is expected to help absorb the shock. CBIRC told lenders not to downgrade loans to Small and Medium Enterprises (SMEs) for missed payments, or report borrowers' delinquencies to the country's centralized credit-scoring system before the end of June[5]. However, this may not be realistic given stretched bank balance sheets. According to a recent stress test conducted by the PBOC, nine out of China's 30 local lenders would not be able to meet capital adequacy ratios in case growth drops to 5.3% or below in 2020[6].
For this reason, we anticipate that the PBOC will deviate from its "prudent" approach and announce a bundle of targeted measures, in addition to regulatory forbearance. These include: 40 bps in LPR cuts, up to 400 bps in RRR cuts and net capital injections via OMOs to stabilize the interbank market. Many advocates of monetary easing and regulatory forbearance would argue that this is not a problem, as China's massive stock of foreign exchange (FX) reserves, which reached USD 3.1 trillion at the end of February 2020, should be enough to bail out its banking sector if necessary. However, this is a misconception. China does not meet the IMF's criteria for Assessing Reserve Adequacy[7] (ARA) in all cases. At the end of 2019, FX reserves covered only 11% of M2, whereas the IMF ARA indicators specify 20%. In addition, the "Greenspan-Guidotti"[8] rule – 100% cover of short-term external

1 - Chad Bown (2019). 'US-China Trade War Tariffs: An Up-to-Date Chart'. Peterson Institute for International Economics (December 17).
2 - 小康社会, or "moderately prosperous society".
3 - The PBOC and China Banking and Insurance Regulatory Commission (CBIRC) declared the takeover of Baoshang Bank (Inner Mongolia) on May 24. The regulators stepped in to rescue Bank of Jinzhou (Liaoning Province) and Hengfeng Bank (Shandong Province) on July and August; followed by Yichuan Rural Commercial Bank (Henan Province) and Harbin Bank (Heilongjiang) on October and November.
4 - PBOC (2019). 重庆中华人民共和国成立70周年活动新闻中心新闻发布会. Available at: *http://www.xinhuanet.com/politics/70zn/fbh2/index.htm*
5 - CBIRC (2019). 银保监会 人民银行 发展改革委 工业和信息化部 财政部关于对中小微企业 贷款实施临时性延期还本付息的通知. *Available at: http://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=892278&itemId=926*
6 - Lee (2020). 'Coronavirus: Chinese banks face test as bad debts tipped to rise while economic growth tumbles'. South China Morning Post, 19 February 2020. *https://www.scmp.com/economy/china-economy/article/3051400/coronavirus-chinese-banks-face-test-bad-debts-tipped-rise*
7 - Moghadam, Ostry and Sheehy (2011). 'Assessing Reserve Adequacy'. International Monetary Fund, 11 February 2011. Available at: *https://www.imf.org/external/np/spr/ara/#polpapers*
8 - Bussiere and Fratzscher (2006). 'Towards a new early warning system of financial Crises', Journal of International Money and Finance, Vol 25, pp 953–73.

CHART 3
China's interest rate corridor

Source: PBOC, Bloomberg and Coface

CHART 4
FX Reserves and M2 growth



Source: PBOC, Bloomberg and Coface

debt[9] – might underestimate the real level of risk in China, as it does not take into account the external liabilities of Chinese companies with links to the state[10]. In addition to the official USD 2 trillion in liabilities to foreigners, Chinese firms have an extra USD 650 billion in debt tied to overseas subsidiaries, according to Bloomberg's calculations. Given that a large proportion of this debt (70%) is guaranteed by onshore parent companies, this brings the actual FX reserves to short-term debt to over 100%.

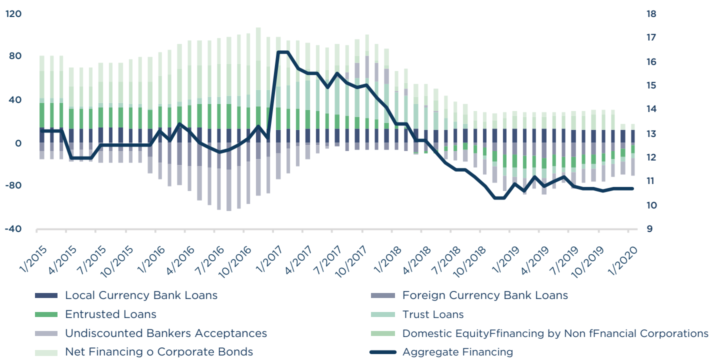
Case in point, following a 3% devaluation of the Chinese yuan (CNY) in 2016, the PBOC had to burn through almost USD 1 trillion in FX reserves to support the value of the CNY. Capital outflows were larger than estimated when observing unrecorded flows captured in the Balance of Payments' (BOP) errors and omissions. This amount was equivalent to roughly 4% of M2 in 2016. In case there is an episode of outflows similar to that of 2016, we believe that China would not have enough FX reserves to cover capital outflows by 2030, assuming that M2 continues to increase at around 10% between now and 2030 **(Chart 4).** The day of reckoning may in fact be sooner than expected, considering that FX reserves need to serve other goals, such as: supporting the value of CNY, bailing out Chinese banks and overseas subsidiaries, financing the huge network of infrastructure projects under the Belt and Road Initiative, etc.
Depreciation expectations are tightly linked to capital outflows. If the Chinese government faces a painful choice between selling-off its FX reserves or letting the CNY depreciate to reduce the level of domestic indebtedness and keep the economy running, it is almost certain that the CNY would depreciate. The PBOC would have to walk a tight rope between managing currency stability without exacerbating outflows, while simultaneously nudging companies to cut back their external liabilities. The longevity of such a situation remains unclear but one thing is certain: "something's gotta give".

Wider fiscal deficit and a less bang for your credit

Chinese authorities will also resort to fiscal stimulus and credit growth in order to spur activity. Outstanding total social financing growth declined from approximately 15% to 11% between 2017 and 2019, as the authorities remained committed to reduce financial fragilities. Not surprisingly, the contraction was steeper in the shadow banking components **(Chart 5)**. Coinciding with this slowdown, GDP growth also decelerated by one percentage point to 6.1%. Given that the Chinese economy remains exceptionally credit-oriented, it is likely that authorities will allow an uptick in the pace of outstanding credit growth in 2020, including controversial shadow banking components that are crucial to many SMEs' ability to access working capital[11]. The opportunity costs will be high: every marginal unit of additional credit will generate diminishing marginal increases in output.
According to figures by the Bank of International Settlements (BIS), China's credit-to-GDP ratio remained high at 205% in September 2019, but the credit-to-GDP gap[12] narrowed to -2.5% from a high of 20.6% in 2014, as a result of stricter credit controls. A high positive gap means that the corporate sector borrows at levels that are not justified by the current output-producing abilities of the economy and vice-versa. This is good, albeit futile news. By resorting to old tricks to reignite growth, China may well return to unsustainable levels of credit growth, resulting in an accumulation of NPLs and zombie companies.
Fiscal policy could also be constrained by weaker revenues. The latter rose by 3.8 %YOY in 2019, down from 6.2% YOY and the slowest pace since 1987. This decline can be traced back to a series of personal, consumption and corporate tax cuts enacted in 2018 and 2019, aimed at boosting consumption amid US-China trade war woes. On the other hand, fiscal spending increased by 8.0% YOY, exceeding GDP growth last year, as the authorities sought to buffer a slowdown in the economy. China hasn't officially exceeded a national deficit ratio of 3.0% of GDP since 2009. However, in the context of falling revenues and rising expenditure, we expect that the budget deficit will widen to at least -4.5% in 2020[13]. On February 21, the Political Bureau of the Communist Party of China revealed that 13 cities and provinces in China have announced major infrastructure projects worth CNY 33.83 trillion (USD 4.5 trillion or 31% of GDP). Expanding infrastructure investments may lead to a return of overcapacity concerns. Moreover, the fiscal health of local governments will also deteriorate because of additional fiscal stimulus - many provinces do not need additional infrastructure investments in rail, roads and airports. To get around this caveat, the Ministry of Finance stated that it would prioritize productive investments like ■■■

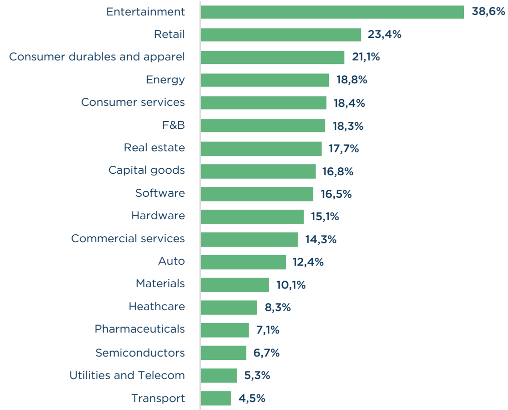
9 - External debt with maturities not exceeding one year.
10 - Bloomberg News (2019). 'China's Companies Have Unseen Foreign Debt That's Maturing Fast'. Bloomberg, 26 August 2019. Available at: https://www.bloomberg.com/news/articles/2019-08-25/china-s-companies-have-unseen-foreign-debt-that-s-maturing-fast
11 - Casanova (2018). 'SMEs in China: Monetary easing won't be sufficient to reduce credit pressure', Coface Economic Studies. Available at: https://www.coface.com/News-Publications/News/SMEs-in-China-Monetary-easing-won-t-be-sufficient-to-reduce-credit-pressure
12 - The BIS defines the credit-to-GDP gaps as the difference between the credit-to-GDP ratio and its long-term trend; in percentage points. Available at: https://stats.bis.org/statx/toc/CTG.html
13 - The official target will be announced at the National People's Congress, which has been postponed until further notice from original date of March 12.

CHART 5
Outstanding total social financing and GDP growth



Source: PBoC, Bloomberg and Coface

CHART 6
Percentage of Chinese listed companies with EBITDA / Interest Expense below 1



Source: Bloomberg and Coface

in 5G network infrastructure, high-tech and welfare[14]. Nevertheless, many local governments will be cautious about issuing bonds, as pressures have started to emerge regarding local government debt sustainability.

Officially, government debt is equivalent to 40% of GDP. However, it could be much larger if the vast amount of debt that is off balance sheet and tied to Local Government Financing Vehicles[15] (LGFVs), as well as other forms of shadow financing, are taken into account. While this amount is unknown, the IMF estimates that the actual level of government debt could be in the range of 60% of GDP[16]. Several LGFVs have defaulted on CNY denominated debt in the past years, but Qinghai Provincial Investment Group defaulted on USD denominated debt in February 2020, the first instance in 20 years.

Higher credit risks for some Chinese companies

Monetary and fiscal stimulus will exacerbate credit risks for Chinese companies. This is a problem in case the sector is already struggling with high levels of indebtedness and stress in debt service. To measure this, we consider the percentage of listed companies with EBITDA[17] to interest expense ratios below one. When a company's earnings are insufficient to cover interest payments on its debt, the company is considered to be dependent on external sources in order to secure access to working capital. According to the latest financials from listed companies compiled by Bloomberg[18], some sectors and sub-sectors may be more at risk than others **(see Chart 6)**. Sectors that are traditionally dominated by SOEs featured a smaller proportion of companies reporting cash flow risks. These include utilities, telecommunication providers and materials (including chemicals and metals). The role of SOEs in the market has strengthened under President Xi Jinping, so this is not entirely surprising. On the contrary, sectors with a predominance of private firms and SME's experienced cash flow risks last year, so might be more vulnerable to a sudden correction in funding conditions in 2020 (entertainment, retail, consumer durables – including consumer electronics and apparel – and consumer services). The transport sector was supported by a combination of state subsidies (a large proportion of SOEs in this sector) and a surge in passenger numbers in the last year. However, this trend is likely to reverse sharply given the steep decline in passenger trips in Q1 2020, with IATA reporting a -80% YOY decline in the aviation industry alone.
Cash flow risks are likely to intensify further in 2020. This trend is in line with an increase in bond defaults and a record surge in corporate insolvencies since 2014. Bond defaults reached USD 12 billion in 2019 and are expected to accelerate rapidly because of headwinds to growth in 2020. The same is true for insolvencies, which surpassed 8000 cases in 2019, from 6700 in 2018. Lastly, given the delicate balance that policymakers will have to maintain in 2020, the likelihood that a policy misstep could result in a systemic shock to the Chinese economy is higher than ever.

14 - The State Council of The People's Republic of China (2020).《习近平主持中共中央政治局会议 研究新冠肺炎疫情防控工作 部署统筹做好疫情防控和经济社会发展工作. *Available at: http://www.gov.cn/xinwen/2020-02/21/content_5481871.htm*
15 - LGFVs are special purpose vehicles (SPVs) set up by local governments to evade regulatory borrowing restrictions on raising capital for infrastructure projects.
16 - IMF (2019). 'People's Republic of China: 2019 Article IV Consultation'. International Monetary Fund. Available at: *https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Peoples-Republic-of-China-2019-Article-IV-Consultation-Press-Release-Staff-Report-Staff-48576*
17 - Earnings before interest, taxes, depreciation, and amortization.
18 - Bloomberg figures use GICS industrial classifications, which are different to Coface sector definitions.

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