China’s Financial Risks and Prospects
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1. Excessive debt in China’s non-government sector and financial risks

China’s non-government sector debt levels are quite high by international standards. Outstanding corporate and household debt has exceeded twice the nominal GDP since 2016. So far, China has been able to contain the emergence of major financial risks. However, in the way that Japan and Spain, having reached similar levels in the past, experienced bubble bursts and financial instability, it is impossible to definitely say that China will not experience a similar situation. In particular, the current economic downturn triggered by the Zero-COVID policy and the real estate slump are causing the fragility and faultline of China’s financial system to become apparent in some local cities, and the country has entered a phase that requires caution.

When looking at financial risk in China, it is not enough to assess risk in the banking system; in addition, we need to look at shadow banking risk, hidden local government debt risk, real estate risk, and their interconnectedness. Of these, the biggest key is real estate risk. The real estate recession has been going on for 18 months. If there is a major nationwide drop in real estate prices and a massive chain reaction of real estate developer failures, there would be a tremendous impact on the banking system, shadow banking, and local debt problems.

Below is an overview of the current status of each of the above risks, with the exception of shadow banking, whose balance continues to decline due to stricter regulations by the authorities.

2. Banking system risks

First, we look at risks to the banking system. The ratio of non-performing loans (NPLs) of commercial banks remained low at 1.66% at the end of September 2022. It should be noted that after the outbreak of the Novel Coronavirus pandemic, the reality of NPLs has been hidden by government guidance encouraging companies to defer repayment of their loans. Nevertheless, with banks carrying loan loss provisions twice as high as their NPLs, and with resilient profitability (commercial banks’ net income up 12% year-on-year in 2021 and up 1% year-on-year in January-September 2022), it is unlikely that systemic risk will materialize anytime soon.

However, the management of financial institutions located in some provinces where economic conditions are poor and the real estate recession is severe is a situation that is generally considered to be getting tougher. After the failure of Baoshang Bank in Inner Mongolia in 2019, the management crisis of Bank of Jinzhou Co., Ltd. in Liaoning province and Hengfeng Bank in Shandong province was revealed one after another. In 2022, there was a bank run on Henan province's rural banks, which had collected high interest deposits through fraud. Although the government-led handling and rescue of these cases and the protection of depositors have reduced the contagion of risk in each case, the emergence of management crises at small and medium-sized financial institutions at the local level is likely to continue to occur sporadically in the future.

The government has taken steps in the past, such as dispatching finance-savvy executives from central ministries and state-owned banks to the local areas and allocating part of the funds obtained from the municipal bonds it issues to recapitalize local banks, but this measure is still insufficient. To this end, the government plans to create a Financial Stability Law and establish a financial stability guarantee fund.

3. Risk of hidden local debt

Next, consider the risk of hidden local debt: even after the 2014 amendment to the Budget Law of the People's Republic of China allowing local governments to issue local bonds, the growth of hidden local debt through local government financing vehicle (LGFV) has not been halted. An IMF staff report released in February 2023[1] projects that the debt-to-GDP ratio of LGFV will reach 47% in 2022 and rise further to 66% in 2027. With the Ministry of Finance of the People's Republic of China controlling the issuance of local government bonds, local governments have no choice but to use LGFV under instructions to increase infrastructure investment as a stimulus measure.

With fiscal revenues falling due to the economic downturn and real estate recession, the financial condition of local governments has been deteriorating, and some local governments and LGFV have begun to reveal concerns about debt repayment: in December 2021, the fiscal restructuring plan of Hegang city, Heilongjiang province, was revealed, and in October 2022, the default of Lanzhou's LGFV on the Chengtou municipal bonds occurred. And in January 2023, a 20-year repayment deferral of the bank loan of Zunyi city, Guizhou province's LGFV was announced. The Central Economic Work Conference in December 2022 increased vigilance on the local debt problem, calling for "efforts to prevent and defuse local government debt risks, decisively curbing the increase and resolving the stock."

4. Real estate risks

Currently, real estate risk requires the most attention, primarily because a serious real estate recession has been going on for a year and a half. Prices for housing in China, especially in the major cities, have soared to levels that are considerably higher than those in the rest of the world in terms of annual income multiples. In addition, as much as 40% of the local government's gross fiscal revenue comes from the sale of land, and it is believed that in many cases, real estate development has been carried out in the countryside without reflecting actual demand.

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[1] International Monetary Fund, "2022 Article IV Consultation; Staff Report for the People's Republic of China," February 3, 2023.

Based on the policy that "housing is for living, not for speculation," the Xi Jinping regime imposed debt ratio regulatory requirements for real estate developers and property lending concentration rules for banks beginning in late 2020. The introduction of the rules and regulations led to a rapid cooling of the real estate market. However, the introduction of the rules and regulations was only a catalyst; what is more important is the structural change of declining actual demand. The population of the main group of first-time homebuyers (aged 25-34) has already begun to decline and is expected to drop by 70 million from its peak by 2030. In July 2022, cash-strapped real estate developers were forced to halt construction of homes that were sold before they were built in the presale model, and in response, homebuyers refused to pay their mortgages in various locations. When this trouble became news, buyers became increasingly reluctant to purchase homes due to concerns about the risk of halting home construction, further exacerbating the cooling of the housing market.

The government has been gradually easing regulations and providing support measures for real estate. Among these, the financial support measures announced in November 2022 were more in-depth than those announced in the past. Nevertheless, it cannot be denied that the government is still postponing the problem and waiting for demand to recover. This is because the government encourages the deferment of repayment of loans and bonds for real estate developers that are coming due. The IMF estimates that more than 20% of listed real estate developers in China are insolvent if actual real estate prices are taken into account.[2]

With the majority of homes in China transacted through the presale model, housing demand will be slow to recover unless real estate developers' business concerns are resolved. It appears necessary for the government to utilize the state-owned sector (state-owned banks, state-owned asset management companies, and state-owned developers) to promote fiscal restructuring and processing reorganization of real estate developers.

5. Prospects for financial risks in China

As we have seen above, management problems of local financial institutions, local debt problems, and management issues of real estate developers will continue to surface sporadically. The government is expected to respond to these problems so that they do not spill over into systemic risk. The Chinese government has strong control, including the use of the state-owned sector, and it is unlikely that a large-scale bubble burst and financial crisis will occur in the foreseeable future. Nevertheless, a prolonged slowdown in the economy and a protracted slump in the real estate market will certainly increase vulnerability to the financial system. China's financial risks require further attention.

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[2] International Monetary Fund, "Global Financial Stability Report October 2022," October 11, 2022 [https://www.imf.org/en/Publications/GFSR/Issues/2022/10/11/global-financial-stability-report-october-2022].