Paramount leader Xi Jinping seems to have decided that now is the time to rein in China's unsustainable debt levels. The Chinese Government Work Report, delivered at March's National People's Congress, listed de-leveraging as one of Beijing's "five major tasks". It specifically pledged to keep the ratio of debt-to-GDP "relatively stable" and M2 (money supply) growth in line with GDP growth. While these targets appear modest, it is a marked change of direction – China's debt burden grew by 30% last year. Demonstrative measures, including the cancellation of high-speed rail projects in Shaanxi and Shandong, signal the seriousness of Beijing's intent.

The endgame of the series of de-leveraging measures introduced over the past six-months is to redirect capital towards more fiscally sustainable and consumption-orientated projects. Concurrently, Xi is doubling down on efforts to enhance the role of the state sector, whilst pursuing net zero carbon emissions by 2060. The combined result may ultimately be a slower-growth and greener economy dominated by what Xi describes as "stronger, bigger and better" SOEs. Concerted de-leveraging, consolidation (most recently in steelmaking) and greening processes will invariably see reduced demand for imported energy and resources.

Context

China's public investment-led growth model has resulted in a highly leveraged economy. According to the Institute of International Finance, China's debt has exceeded 300% of GDP since 2019. Recent stimulus efforts have exacerbated indebtedness. As the defaults of SOEs with AAA ratings last year showed, risk is underestimated because of opaque financial practices.

Factors that have until now prevented a financial crisis either have other downsides (i.e., strict capital controls) or are unlikely to persist, namely China's high savings rate which will shrink under demographic pressures. China's rising capital-to-output ratio is clear evidence of the current growth model's diminishing efficacy in promoting growth.

Reducing or moderating China's debt has been an overt concern of policymakers since the immediate post-GFC stimulus period. However, until now the fallout from the US-China trade war and COVID-19 slump led Chinese policymakers to prioritise short-term growth over financial discipline.

Provincial governments

Tackling local government debt was a key theme of China's annual Two Sessions meeting. Hidden local government debt, estimated by the Bank of China to be equivalent to half of China's GDP in 2019, was declared a "national security issue". Both the Ministry of Finance and powerful National Development and Reform Commission pledged to prevent and control local government debt increases. Concrete measures included the reduction in the issuance of quotas for special-purpose bonds – bonds that are meant to be repaid using project income – by US$15.4 billion. This was the first time since the introduction of the special-purpose bond debt instrument in 2015 that the quota was reduced.

Earlier in January, financial regulators also flagged linking the ability of local government financial vehicles (LGFVs) to sell bonds with the amount of debt on the books of local governments issuing the bonds. LGFVs are special off-the-books financing vehicles set up by local governments, often to bypass borrowing regulations. Under the proposed regulations, LGFVs with a red tag denoting a debt ratio in excess of 300% would be heavily restricted from bond sales.

In a circular released in April, China's State Council followed up with several further high-level policy prescriptions:

- Local government should not rely on LGFVs for their financing needs
- LGFVs should "implement bankruptcy proceedings or liquidation" if they lose their ability to pay. This is significant as there has previously been an understanding that LGFVs are more or less guaranteed by the government
- Investment projects funded with public money will have to go through a "fiscal endurance" test (the exact details of which remain unclear)
- To increase transparency and reduce risk, local authorities should make mid and long-term fiscal budget plans

Notably, local government officials will be held personally accountable for the rest of their lives for any debt raised during their terms that proves to be problematic, with negative implications for career progression. This mirrors environmental enforcement measures released earlier in Xi's tenure – backed by often high-profile inspection campaigns – ensuring that local officials carry "lifetime responsibility" for excessive pollution.

In a sign of how seriously the central government is about reducing debt, in March Beijing halted work on two high-speed railway projects in Shandong and Shaanxi provinces. The halting of the two projects, with total investment of US$20 billion, follows the release of a State Council document enacting an in-principle ban on construction projects with asset utilisation rates below 80%.

As the money tap is tightened, China is also imposing new climate policy pressures on provinces – notably in the north and west – which have lagged the strong growth of those in the south and east. Coal mining, power, steel and cement industries are clearly in focus for climate related reforms and will also be affected by the slowing of construction. The push for a less leveraged economy dovetails with a shift away from coal in particular. The low average utilisation rate of China's coal fleet is indicative of the pursuit of coal-fired power stations for economic stimulus as much as energy needs. So, China's domestic imperatives for new industry growth will clearly be high and may raise other contentious issues both at home and abroad.

SOEs

Despite notable examples to the contrary, it was often assumed by investors that SOEs would be bailed-out by the Chinese government in order to prevent defaults. However, a slew of high-profile SOE defaults occurring at the end of last year suggests that Beijing is deliberately trying to reduce moral hazard across the state sector. Examples of high-profile defaults include:

- Tsinghua Unigroup Co: Tsinghua is a government-backed company linked to Tsinghua University, Xi Jinping's alma matter. Tsinghua Unigroup had been considered pivotal to China's push for self-sufficiency in semiconductors and other strategic technologies. On 17 November 2020, Tsinghua was unable to repay a US$197 million privately issued onshore bond. On 10 December, it emerged that Tsinghua was set to default on US$2.5 billion of offshore bonds after failing to meet a deadline that day to repay a US$450 million Eurobond. It seems that Tsinghua Unigroup was able to use its status and connections to gain access to large amounts of finance without undergoing a proper credit-risk assessment.
- Also on 17 November, carmaker Brilliance Auto, the Chinese partner of BMW, revealed that it had again failed to make good on US$987 million in debt repayments. In late October, Brilliance's parent company, Shanghai-listed Huachen Automotive Group, defaulted on a US$149.6 million private placement corporate bond. Huachen,

which is backed by the Liaoning provincial government, had registered a AAA rating as recently as late September. It was expected that the Liaoning local government would financially back Huachen.

Like Brilliance Auto's parent company, many of the SOEs that defaulted had recently registered AAA ratings. This starkly called into the question the reliability of China's credit rating system. Practices such as "cross-guaranteeing" debts by allied SOEs and lending arrangements based on *guanxi* (connections) are common, if not publicly disclosed. In total last year, SOEs defaulted on 80 bonds worth US$15.17 billion – a record figure.

Political factors may also have been at play. Huachen Automotive Group Holdings and Yongcheng Coal (another SOE that defaulted on its debts in late 2020) both have indirect links to Chinese Premier Li Keqiang. Though Xi increasingly appears to have prevailed, the political rivalry between Xi and Li has fuelled speculation that the default of both companies was partly political.

One consequence of last year's spate of high-profile bond defaults has been to increase the cost of borrowing for SOEs. This and the clear political impetus for SOEs to practice greater credit discipline may ultimately drive consolidation in the state sector. Aside from paying economic efficiency dividends, consolidation has the added benefit of fulfilling the political objective of creating more dominant SOEs. SOE mergers have been common under Xi. For example, the recently approved merger between Sinochem Group and ChemChina will create the world's largest chemical player by some margin.

Consolidation is also one of the favoured ways for policymakers to help reduce China's industrial emissions, particularly in the steel sector where a range of inefficient players drive up total emissions. China's long-held plans to pursue consolidation in this area were given a boost in February this year when China Baowu Steel Group Corp. Ltd (China's largest steelmaker) acquired a 90% stake in state-owned Kunming Iron & Steel Holding Co. Ltd., based in the southwestern province of Yunnan. Baowu may now control up to 15% of China's annual steel production.

Several additional policy initiatives look set to further drive consolidation in the steel industry, as pressure on inefficient and indebted players mounts. Sources suggest that a draft plan was approved in March to peak emissions in the steel sector before 2025 and achieve a 30% reduction from peak levels by 2030. According to the draft plan, these objectives will be achieved by optimising the "spatial layout of the industry" as well as "energy conservation and consumption efficiencies".

Fintech

As well as bringing a flamboyant tech titan to heel, Beijing's very public chastening of Jack Ma's Ant Group was at its core, symptomatic of the desire to re-assert the role of the state in the economy and reduce financial risk.

Fintech players were initially welcomed by Beijing as a source of innovation and much needed credit for the private sector, which has often struggled to source funding from risk-averse banks who preferred lending to SOEs. However, party sentiment slowly soured towards peer-to-peer (P2P) lending based on the perception that it was fast becoming a source of systemic risk. Looser regulations for P2P lenders meant that before recent regulatory changes, they only had to hold a fraction – 2% in Ant Group's case – of the outstanding credit balance for loans originated. State-owned banks had to hold up to five times as much capital. With state-owned banks becoming increasingly uncompetitive, Beijing had clear political imperatives to act. By the end of 2019, outstanding P2P loans had already reduced 50% off 2018 levels to US$98 billion, whilst the number of P2P platforms had reduced from 1021 to just over 300 over the same period.

With economic recovery from the COVID19-induced slump now on track, Chinese policymakers have doubled down. New regulations released in March by the head of China Banking and Insurance Regulatory Commission, Guo Shuqing, will require fintech players to have the same capital adequacy ratio requirements as traditional financial institutions within the next two years. With digital payments expected to double by 2025, the government realises that it must step up its game in order to maintain control over the financial system. After having stymied private fintech players, Beijing, acting through the People's Bank of China (PBOC), is moving towards launching its own digital currency.

Although taming fintech makes sense from a political perspective, it is not without economic drawbacks. Lower volumes of P2P lending and increasing restrictions on shadow banking handicap the private sector, which is disadvantaged in access to finance despite accounting for roughly 80% of China's urban employment and 60% of economic output.

However, limiting the private sector's access to finance may actually be part of the plan. SOEs are being encouraged to invest in or purchase private companies – marking an inversion of the previous "mixed-ownership" model which pushed the private sector to invest in SOEs. In 2020, transactions involving SOEs buying into private companies exceeded US$20 billion, double the 2012 level. A high-level central government plan released late last year also implored SOEs to "play a leading role and important influence on the healthy development of private enterprises".

Property

Despite its contribution to economic growth (29% of economic output) and local government revenue, real estate has long been firming as a systemic risk for the Chinese economy. The property market has openly been acknowledged as a "bubble" by regulators. At the peak of the pre-GFC US property boom, US$900 billion was being invested annually in residential real estate. Despite the COVID19 pandemic, US$1.4 trillion was invested in Chinese housing across the June 2019-June 2020 period.

Banks have huge exposure to local property markets. Loans related to the property market comprise 39% of total bank loans in China, whilst many bonds, equities and trust investments also have exposure to the property market – not least being securities issued by local government financing vehicles. To bypass hefty deposit regulations often requiring up-front payments equivalent to one-third of total property value, investors have in the past lent heavily from P2P providers. More recently, the PBOC, China Banking and Insurance Regulatory Commission and the Ministry of Housing and Urban Rural Development, launched a crackdown targeting the practice of using business loans to fund mortgages.

In November last year, Guo Shuqing described the broader property market as the country's biggest "grey rhino [a probable, high impact, yet underappreciated risk] in terms of financial risks". Guo also criticised the fact that houses are seen more as an investment than a dwelling.

Towards the end of last year, regulators began taking concrete steps to cool the property market. Beijing's "three red lines" policy targeted hugely indebted property developers, China Evergrande Group being a notable example. The three red lines are essentially debt metrics which firms will be rated against: 70% ceiling on liabilities to assets, 100% cap on net debt to equity and cash to short-term borrowing ratio of at-least one. If all three-red lines are breached, companies will not be able to increase their debt this year. At least eight developers are currently in this category. Conversely, companies satisfying all three criteria will be able to increase their debt by a maximum of 15% this year.

In December, Beijing ordered banks to cap loans to homeowners. The largest banks now face a cap of 32.5% of all outstanding loans that can be held as home mortgages, while the cap is lower for medium and small-sized banks. Chinese policymakers have more broadly signalled their intention to ensure the mortgage loans for 2021 do not exceed last year's total. In March, a new policy described by one UBS Economist as the "final piece in the puzzle" will make it much harder for highly indebted developers to bid for land. Under the policy, land auctions will be synchronised by big cities to the effect of requiring developers to stump up large deposits – out of the reach of some of the most indebted players – to participate in any auction. Industry consolidation again appears to be a likely outcome. In mid-May, policymakers revealed that plans were underway to introduce property tax (no such tax is currently levied) in several cities.

Whilst a more financially sound property sector is an upside, the curbing of China's property bonanza has the clear potential to depress both economic growth and from Australia's perspective, demand for raw materials.

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