China

No rest for credit risks

■ **The slowdown in China's economic growth has paused since the second quarter of 2016 thanks to stimulus policy measures.**

■ **The stabilisation in industrial production growth, the upturn in the real estate market and monetary loosening could help reduce pressures on corporates and local governments by easing their liquidity constraints in the very short term.**

■ **However, their solvency is not improving, their debt levels have become even more excessive over the last year and their capacity to service their debt remains weak.**

■ **In this context, credit risks in the financial sector continue to increase and the performance of commercial banks deteriorates gradually.**

Corporates breathing a little easier

Signs of economic growth stabilisation that appeared in March 2016 have persisted. After bottoming out in January and February, industrial production growth has remained above 6% in year-on-year terms (see chart 1). Although this remains very low, the improvement has been accompanied by a slight upturn in the average performance of industrial enterprises. Their aggregate profits have started rising again (+8.4% y/y in the first nine months of 2016) after falling throughout 2015 (-2.3%). Demand for industrial goods has been boosted by monetary and fiscal stimulus measures (which have especially helped infrastructure projects, the real estate market and the auto sector). Commodity prices have rebounded since the start of the year and producer price deflation has eased gradually, eventually turning slightly positive in September (+0.1% y/y vs. -5.9% in December 2015).

However, the situation in the industry remains very fragile, and there are wide variations between different sectors and different types of corporates. In particular, state-owned enterprises are much less profitable than their private-sector peers (their profits rose by only 2.6% y/y in the first nine months of 2016, after they fell by 21.9% in 2015) because of their lower productivity, higher indebtedness and greater exposure to sectors suffering from large production excess capacities. These difficulties, along with the durable weakening in China's export prospects, have continued to constrain manufacturing investment growth (+3.1% y/y in nominal terms in the first nine months of 2016, after reaching an all-time low of 2.8% in January-August 2016).

In the real estate sector, similarly, the situation has improved but remains fragile. After the authorities loosened monetary policy and macroprudential rules on property transactions and lending, growth in sales volumes has accelerated (+26.9% y/y in the first nine months of 2016 vs. 6.5% in 2015) and house prices have rebounded in a growing number of cities.

Stabilisation in the industry

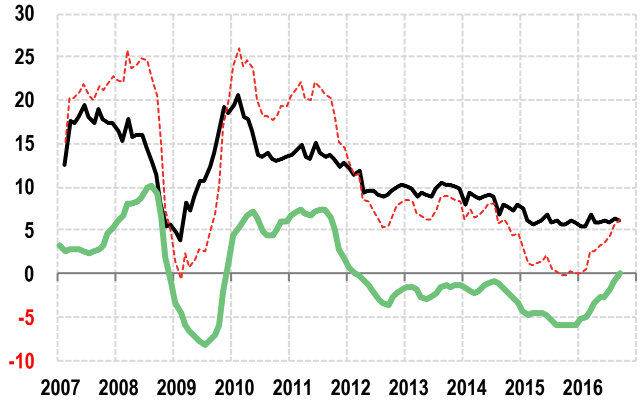

Chart 1 Sources: NBS, BNP Paribas

The average increase in house prices in China's 70 largest cities was 9% y/y in September 2016 vs. 0.2% in December 2015. Of those 70 cities, only six showed a year-on-year decline in September, vs. 48 in December 2015. In fact, major regional differences weigh on the sector's prospects. Signs of a property bubble have emerged in several large cities, prompting the authorities to tighten macroprudential rules, while smaller cities are seeing very moderate price growth and some still have a stockpile of unsold homes. In the short term, however, the upturn in activity and prices in the property market should give corporates operating in the sector some breathing space, and support real estate investment (+6.3% y/y in the first nine months of 2016 vs. +2.4% in 2015).

The market rebound has also benefited local government finances, as their proceeds from land sales increased by 14% y/y in the first eight months of 2016 after collapsing in 2015. The upturn in tax revenue from the real estate sector has also partly offset the weaker performance in other sources of tax receipts. In addition, local governments also continued their debt swap programs in 2016, increasing bond issues in the local market in order to refinance bank loans at lower interest rates and longer maturities.

However, credit risks continue to increase

The recent stabilisation in economic growth and the upturn in the real estate market, along with monetary loosening (with the weighted average interest rate on loans declining from 5.9% in 2015 to 5.3% in H1 2016), should give corporates and local governments some respite by reducing their liquidity constraints in the very short term. However, their solvency is not improving. Their debt levels have become even more excessive, with domestic credit growth accelerating again since mid-2015. This rebound has remained moderate, and credit growth has even slowed again since Q2 2016, showing that the monetary authorities and creditors are more cautious given the excess debt of borrowers and loan quality deterioration. However, total credit outstanding still grows much faster than nominal GDP (see chart 2). This means that the domestic debt-to-GDP ratio has continued to rise; it was estimated at 210% at the end of Q3 2016 vs. 202% at end-2015 (including the private sector, local governments and their financing vehicles, but excluding the central government). Within that total ratio, household debt accounts for only 40% of GDP.

In addition, the local government and corporate sectors still have deep-seated structural weaknesses (production excess capacity, distortions in the real estate market, inefficient SOEs, governance problems, for instance) while certain reforms that are vital to shift the economy to a more balanced and less credit-dependent growth model (such as the strengthening of governance or the effective implementation of fiscal reforms) have been delayed this year as the authorities have given priority to stimulus policy measures.

With debt levels worsening and profitability still hampered by structural weaknesses, corporates' capacity to service their debt remains weak (even though their cash positions could improve in the very short term). It has deteriorated sharply since 2010. On the basis of calculations made by the IMF on a sample of listed companies, the median debt/EBITDA (earnings before interest, taxes, depreciation and amortization) ratio more than doubled between 2010 and 2015. The real estate, mining and steel sectors are the most fragile, showing both the highest median debt/EBITDA ratios and the highest proportions of debt owed by loss-making companies. The IMF estimates that "debt at risk" (i.e. debt held by companies that lack sufficient revenues to cover debt interest payments, i.e. with an EBITDA/interest expense ratio of less than 1) accounted for 14% of total debt (for a sample of firms) in 2015, compared to 4% in 2010. Against this background, corporates have had growing difficulties to pay their suppliers, payables days have increased (transmitting stress across the economy), non-performing loans have grown in bank balance sheets and default risks have spread to non-bank financial institutions and to the bond markets. Equity markets are obviously also affected by the deterioration in listed companies' average solvency and the rise in credit risk (for example through the rise in share-collateralized lending).

The banking sector's performance is deteriorating

The official Non-Performing Loan (NPL) ratio for commercial banks was 1.75% in June 2016. It is still very low, but it has risen steadily since June 2012, and the total stock of NPLs has more than tripled since that date (increasing by 51% in 2015 and 32% in H1 2016). In addition, the official NPL ratio only partly reflects the true state of banks' asset quality. For example, the ratio rises to 5.5% if "special-mention loans" are included. Moreover, banks have taken a whole series of measures to prevent it from worsening further (refinancing, write-offs, transfers to asset management companies and, recently, NPL securitization). Finally, official NPL figures do not take into account the credit activities of shadow banking institutions, which equal at least a fifth of commercial banks' "formal" loans and post a lower quality on average.

Continued rise in debt ratios

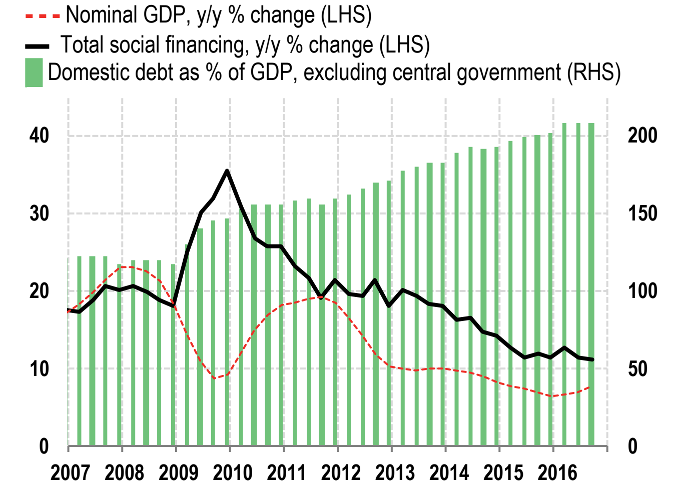

Chart 2 Sources: PBOC, BNP Paribas

The deterioration in asset quality and the rise in credit costs in the banking sector will continue. Banks' profitability is under pressure and their liquidity and solvency ratios are worsening gradually. However, these ratios remain solid. Although the risk of systemic problems spreading across the entire financial sector is higher today than it was five years ago, it is sharply mitigated by two key factors that still currently persist: firstly, the banking system still has a very comfortable liquidity position (large customer and deposit base, low loan/deposit ratios, little reliance on external financing), and secondly, the central government still provides very strong support to the main state-owned commercial banks (which account for around 60% of total bank assets).