China

What lies behind the rise in corporate defaults?

Industrial enterprises were squeezed by tighter financing conditions in 2017 and early 2018, and then hit by a slowdown in production and revenue growth last year. These troubles have contributed to the deterioration of their payment capacity, resulting in a surge in defaults in the local bond market. The increase in defaults is an indicator of the financial fragility of corporates, and also seems to be going hand-in-hand with greater differentiation of credit risks by lenders and a certain clean-up of the financial sector. These trends are expected to continue in the short term as the authorities conduct a targeted easing of monetary policy. However, the persistence of the debt excess in the corporate sector will maintain high credit risks in the medium term.

Chinese corporates operated in a tough environment in 2018, squeezed first by tighter financing conditions and then by the slowdown in activity. As a result, their payment capacity has deteriorated while their debt burden has remained excessively high. In recent months, in response to the worsening economic growth slowdown, the authorities have introduced fiscal measures to stimulate demand and eased monetary policy. This accommodative policy stance is likely to be maintained in the short term, and economic growth is projected to slow only moderately in 2019. In this environment, how will corporate credit risks evolve?

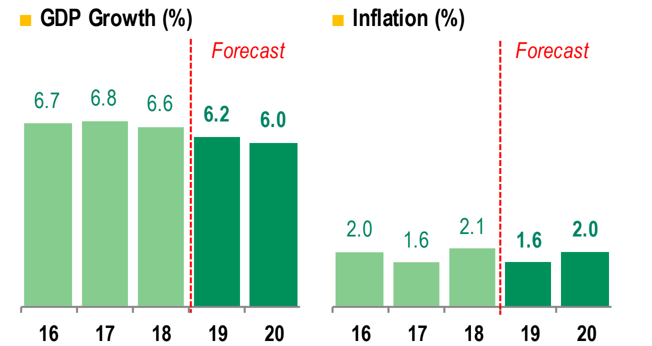
A complex environment for industrial enterprises

Since the end of 2016, corporates have found it harder to access credit. The authorities tightened monetary policy from late 2016 to early 2018 and then have only cautiously loosened it since Q2 2018. In the meantime, they have also considerably strengthened the financial sector's regulatory framework. As a result, growth in total credit to the economy (social financing) has slowed gradually, before picking up slightly again in Q1 2019 (see chart 2). The weighted average bank lending rate increased from 5.3% at year-end 2016 to 6% in mid-2018, before easing again to 5.6% at year-end 2018.

The deterioration in global economic conditions has only compounded the impact of tighter credit conditions on Chinese growth. Corporates in the industrial sector have been hit hardest by the slowdown in activity resulting from the weakening in both internal and external demand. Industrial production growth dropped to a low of 5.3% y/y in January-February 2019, compared to a monthly average of 5.7% in September-December 2018 and 6.5% in January–August 2018. While global demand has been cooling, China's export manufacturing sector has been hard hit by US tariff hikes. The latest round of tariff increases (10% in September) had a severe impact: total exports contracted by 0.1% y/y in November-December 2018 and by 5.2% in January-February 2019 (although they rebounded again in March).

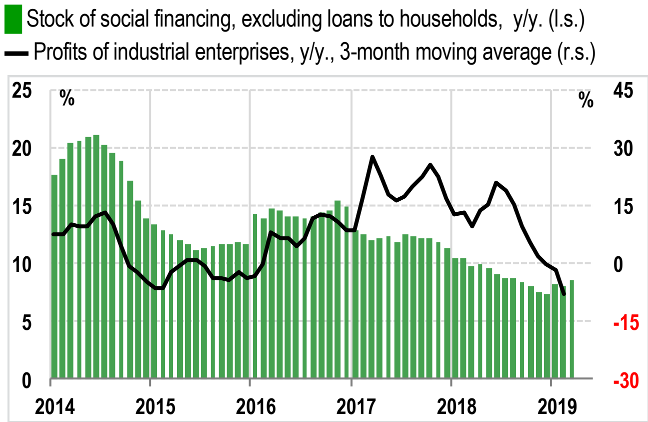
Industrial enterprises geared towards the domestic market have continued to be squeezed by the decline in real estate market transactions (which rose only 1.3% in 2018 and contracted 3.6% y/y in January-February 2019) and the slowdown in retail sales, especially in the durable goods and automobile sectors (vehicle purchases were down 3.1% in 2018 before plunging 15% in the first two months of 2019).

1- Growth and inflation



Sources: National accounts, BNP Paribas

2- Less credit, fewer profits



Sources : PBOC, NBS

Weaker demand, lower production capacity utilisation rates in 2018 (after two years of improvement) and the decline in energy prices in the year-end period triggered rapid disinflation in the producer price index (+0.2% y/y in Q1 2019 vs. 3.7% in Q1 2018). In the past, corporate revenues have been very closely correlated with this index. As a matter of fact, profits of industrial enterprises have slowed since mid-2018 and then fell by 14% y/y in the first two months of 2019.

Increasing number of defaults

In this environment, the payment capacity of corporates has deteriorated. Supplier payment periods have lengthened and the number of late payments has soared, which has helped spread these difficulties throughout the economy. According to Coface data, the average duration of late payments increased in the majority of sectors, with transport and construction reporting the longest durations, at more than 100 days. Worse, there has been an increase in the number of ultra-long late payments (80% of which are never repaid), which has eroded the cash position of many corporates, notably in construction, automobiles, textiles, information & communications technology and transport.

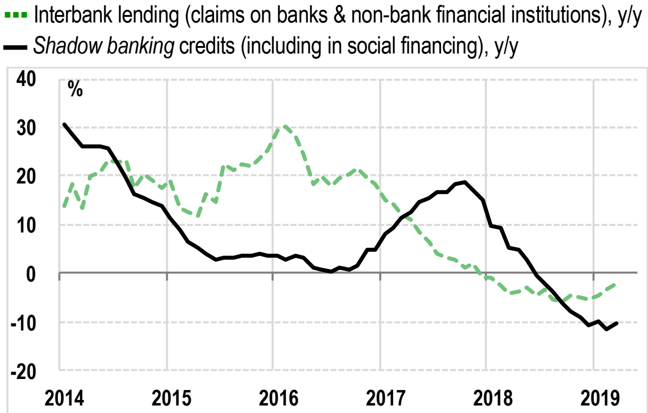
As to the repayment of debt, commercial banks reported a slight increase in non-performing loan ratios last year (to 1.83% from 1.74% at year-end 2017). The number of defaults in the local bond market increased more spectacularly, from less than 20 per year in 2015-2017 to about 40 in 2018 and 10 in Q1 2019. Several sectors were hit, and the energy sector in particular. The amount of defaulted debt is still limited (USD 16 bn in 2018, less than 0.5% of outstanding corporate bonds). Yet the surge in defaults indicates not only a deterioration in the corporate financial situation, but also a change in behaviour in the Chinese market (the first bond default did not occur until 2014). Moreover, not only private corporates are defaulting, but also a few state-owned enterprises, which signals that government support can no longer be taken completely for granted.

Therefore, while the rise in default risks is an alarming indicator of corporate fragility, it also seems to be accompanied by healthier lending practices. Moreover, other sources of vulnerability and risks of financial-sector instability have eased over the past two years, in response to the tightening of monetary policy and the strengthening of the regulatory framework. The decline in interbank financing has reduced the interconnections between financial institutions (banking and non-banking) and enabled them to deleverage. Shadow banking activities have also declined[1] (see chart 3). Meanwhile, the corporate sector began to report a slight decline in the debt-to-GDP ratio (estimated at 133% at year-end 2018, down from 137% at year-end 2017)[2]. However, this later trend is expected to be reversed in 2019.

An improvement in credit risk assessment?

Between economic growth and deleveraging, the Chinese authorities have switched priorities over the past few months: the current policy mix primarily aims to stimulate activity in the short term. Growth in bank loans and bond issuance has accelerated slightly again since Q4 2018, and investment in public infrastructure has also been picking up. Moreover, fiscal stimulus measures introduced since early 2019 should also help economic growth to recover slightly, after bottoming out in the first part of the year. The easing of credit conditions should also help improve the cash position of corporates. Even so, default risks are still high, simply because of the persistence of corporates' debt excess. The number of defaults on the local bond market is likely to increase even further since the amount of debt reaching maturity for non-financial corporates will hit a record high in 2019 (USD 459 bn according to the Institute of International Finance).

3- Attenuation of financial-sector instability risks



Sources : PBOC, NBS

At the same time, there should also be greater differentiation between different categories of borrowers. Firstly, the authorities are proceeding with a targeted easing of monetary policy: banks are notably encouraged (via directives or targeted financing facilities) to increase lending to private enterprises, SMEs and the healthiest companies. In addition, the increase in defaults seems to be prompting greater risk aversion and a better assessment of risks by creditors. As a result, financing conditions should continue to deteriorate for the most fragile companies. Lastly, reducing the risks of instability in the financial sector is still a key objective for Beijing, and the authorities are expected to maintain efforts to improve financial regulation and strengthen state-owned enterprises. The relative performances of financial institutions should continue to diverge as the big banks remain relatively solid and the others (small banks and non-banks) are hit by higher non-performing loans and the deterioration of their liquidity and capital adequacy ratios. Here too, even though the difficulties of certain institutions may well expose China to bouts of stress and volatility, they might also signal a move towards a healthier financing system.

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[1] The financing offered by shadow banking institutions is not monitored and supervised as closely as bank loans. Some of this financing is reported in official statistics of "social financing", for example trust funds and entrusted loans (intercompany loans intermediated by banks). Other shadow banking activities are excluded from these statistics (such as assets financed by wealth management products, loans by financing companies, microloans, online lending between individuals, etc.). All forms of shadow banking have contracted over the past two years.

[2] Debt of the corporate sector excluding local governments and their financing vehicles.