ECONOMIC ANALYSIS

Taking stock of China's external debt: low indebtedness, but rapid growth is a concern

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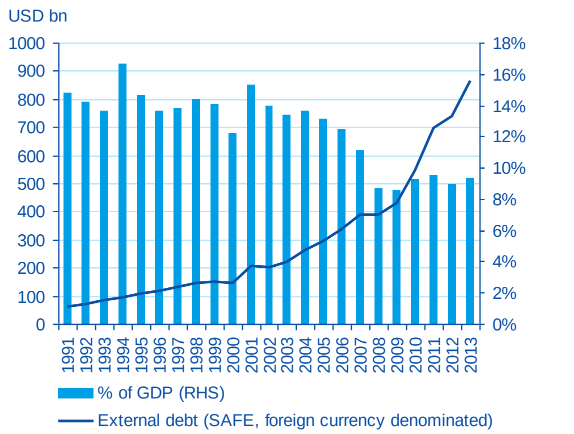
Summary

- China's external debt has risen rapidly over the past few years according to officially reported data. The main reasons behind such surge are how cheap international funding has become compared to domestic sources and a gradual opening-up of the capital account.
- Although the rapid increase is worrisome, the overall external indebtedness is still contained and should pose no risk as long as the economy continues to grow and the RMB appreciates.
- The combination of a sharp deceleration of the economy and currency depreciation would, of course, be very bad news for China's external debt developments.
- Looking ahead, growth in external debt may moderate somewhat as QE tapering dampens global funding supply but this also means that the funding cost will increase
- However, given that China's nominal growth is also slowing down (both real growth and inflation), external indebtedness as a percentage of GDP may continue to trend up steadily.

Official gauge of external debt is rather low

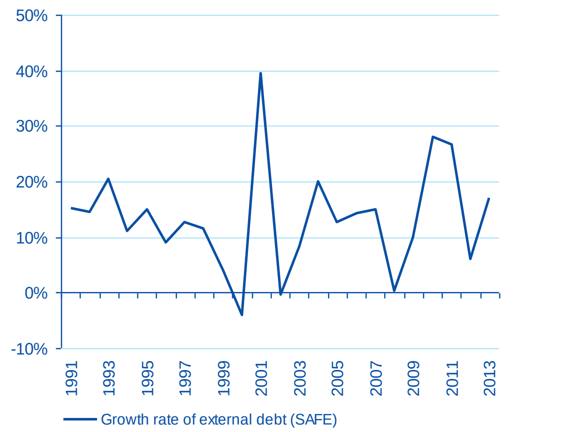
According to the official data from the SAFE (State Administration of Foreign Exchange), China's external debt recorded 863.2 billion USD at the end of 2013, or 9.3% of GDP (Figure 1). External indebtedness according to these official sources has stayed flat at about 9% of GDP since the 2008 financial crisis, despite a rapid rise in external debt (doubled in five years from 390.2 billion USD in 2008). Rapid GDP growth, inflation, and RMB's appreciation (respectively 8.9%, 2.6%, and 2.4% against the USD per year on average from 2009-2013) has helped to contain the debt's ratio to GDP (Figure 2) below the average of emerging markets estimated to be around 20% and, possibly, a good threshold for China.

Figure 1
China's official external debt is low



Source: SAFE, CEIC and BBVA Research

Figure 2
…but growing at a rapid pace



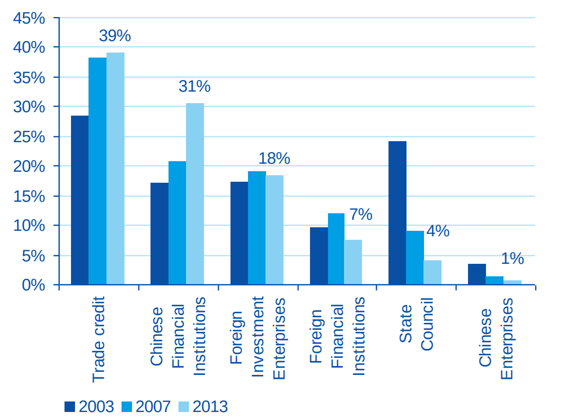
Source: SAFE and BBVA Research

… and mainly origins from trade credit and financing

When looking at the composition of external debt, trade credit accounts for a large share (about 40% of total external debt in 2013), followed by Chinese financial institutions (about 30%), and foreign investment enterprises and financial institutions (about 25%). In contrast, the central government and Chinese (non-financial) enterprises only account for 4% and 1% of the total, respectively. Low external debt by Chinese (non-financial) enterprises may be due to strict regulations in the capital account (Figure 3).

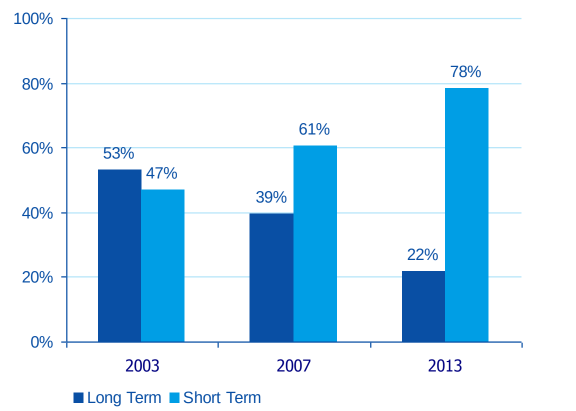
Meanwhile, China's external debt consists of mainly short-term debt (78% of total in 2013) but most of it is, actually 70%, is trade credit and financing accounts (Figure 4). This reduces the risk of the relatively large share of short-term debt.

Figure 3
External debt by debtors



Source: SAFE, CEIC and BBVA Research

Figure 4
External debt by maturities

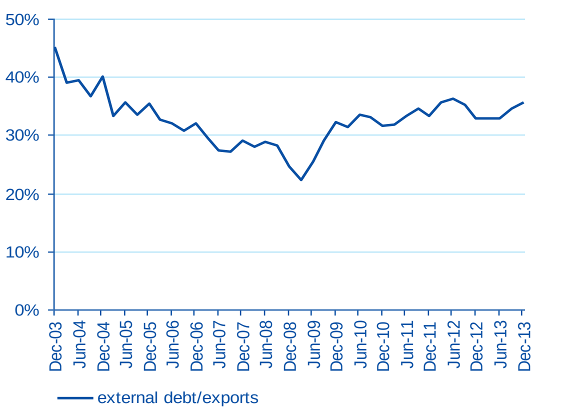


Source: SAFE and BBVA Research

China has the capacity to repay external debt

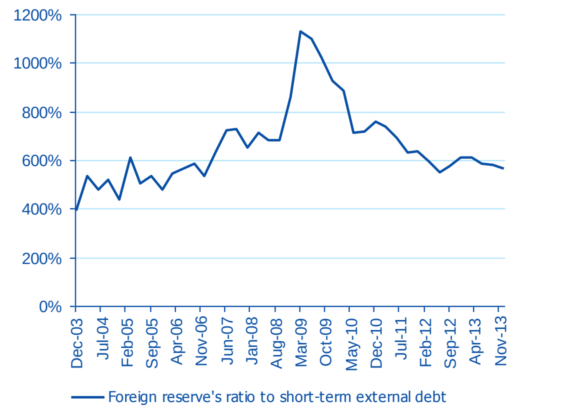
Two indicators are widely used to measure the capacity to repay external debt. The first one is the ratio of external debt to exports, and the second one is the ratio of foreign reserves to short term external debt. Both indicators show China's ample capacity to repay its external debt. In fact, the ratio of external debt to exports has stabilized at 30-40% (Figure 5), which is quite low compared to international standard (a threshold of 100% is generally acknowledged). In the same vein, the ratio of foreign reserves to short-term external debt, namely 6 times or 600% (Figure 6), is extremely ample (with the international threshold lying around 100%)

Figure 5
External debt/exports ratio is quite low



Source: SAFE, CEIC and BBVA Research

Figure 6
…and foreign reserve provides further buffer



Source: SAFE, CEIC and BBVA Research

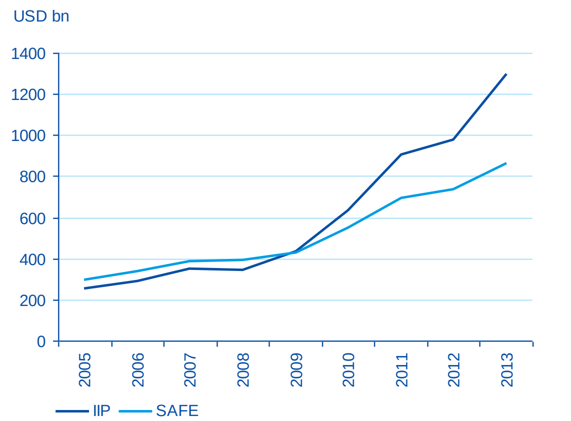
Moving to other sources of data, external debt looks bigger but still manageable

Besides the data provided by SAFE, the official International Investment Positions (IIP) also provides a helpful glimpse at external debt. The IIP is constructed based on the Balance of Payment (BoP), while the SAFE's external debt is reported directly to the SAFE from domestic debtors.

The IIP estimate may provides a slightly wider gauge for external debt, as it includes the following items which SAFE's data does not, namely: (i) letters of credit with maturities shorter or equal 90 days; and (ii) foreign exchange deposits smaller than 500 thousand USD in a domestic bank by a single foreign entity.

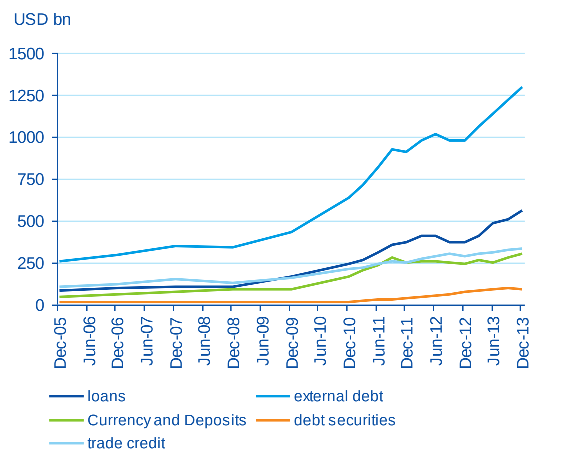
As of 2013, the IIP's external debt estimate is about 50% more than the SAFE's, which amounts to 14% of GDP (Figure 7). As for the composition, China's external debt mainly consists of loans (44%), trade credit (26%), currency and deposit (24%), and debt securities (7%) as of 2013 (Figure 8).

Figure 7
IIP's external debt outpaces the SAFE's



Source: SAFE, CEIC and BBVA Research

Figure 8
External debt by types (IIP)



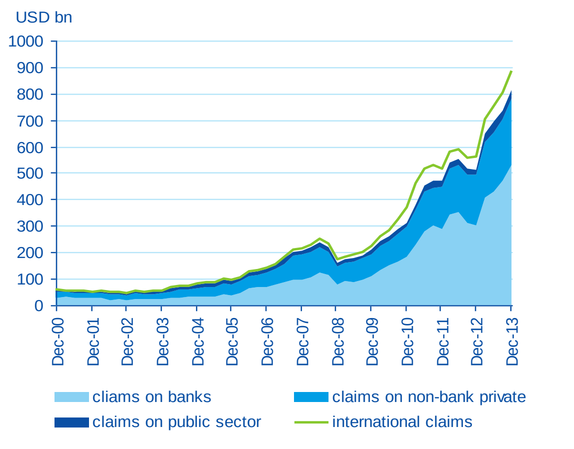
Source: SAFE, CEIC and BBVA Research

Although the IIP seems more accurate than the SAFE numbers, it may still underestimate the total amount of external debt for a few of reasons. First, both statistics do not include RMB-denominated external debt, which has become increasingly relevant with the internationalization of the RMB (especially in Hong Kong's dim sum bond market but not only). Second, some overseas borrowing may be disguised under FDI inflows or over-invoicing exports. Third, domestic entities (especially banks) may hide their overseas debts by setting up subsidiaries abroad and borrowing from debt as such subsidiaries do not consolidated with the parent company.

Therefore, we try to further examine external indebtedness from data provided by overseas creditors. We can only focus on one part of the creditors, namely international banks, but we believe that they are probably the bulk of it. We use the BIS consolidated banking statistics, which reports international claims (or cross-border claims) by 27 reporting countries (mainly European US and Japanese) on China. In addition, given that Hong Kong is a main funding source for China but is not included in the 27 reporting countries to the BIS consolidated banking statistics, we further look into claims from Hong Kong's banks on mainland China from the banking statistics provided by the Hong Kong Monetary Authority (HKMA).

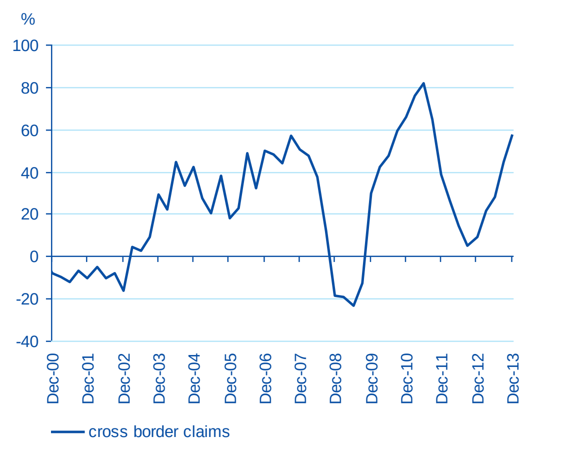
BIS data covering the lending of major banks overseas shows a similar trend, namely a rapidly increasing accumulation of liabilities by Chinese entities with the rest of the world (namely international banks in this case). In fact, such liabilities have moved from less than 200 billion USD before the 2008-09 crisis to close to 900 billion USD in 2013 (Figure 9 and 10). Meanwhile, the structure of the claims is similar to the SAFE's official external debt: about 60% of cross border claims have been extended to domestic banks and the rest of 40% to non-bank private sectors. The rapid growth in international claims on China is likely due to the same reasons: relatively rapid GDP growth in China, cheap global funding, and a gradual opening-up in the capital account.

Figure 9
Rapid rise in international claims was led by claims on the banking sector



Source: BIS and BBVA Research

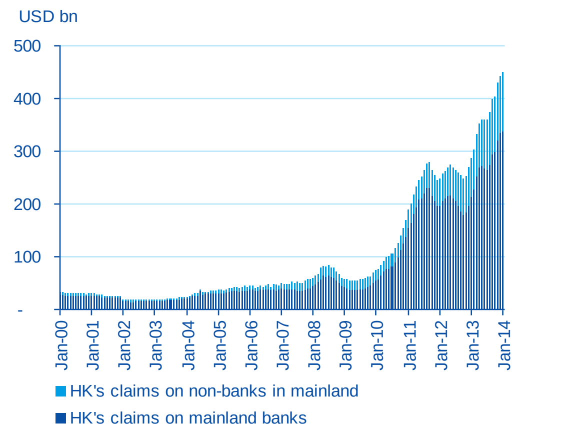
Figure 10
… international claims have grown rapidly



Source: BIS and BBVA Research

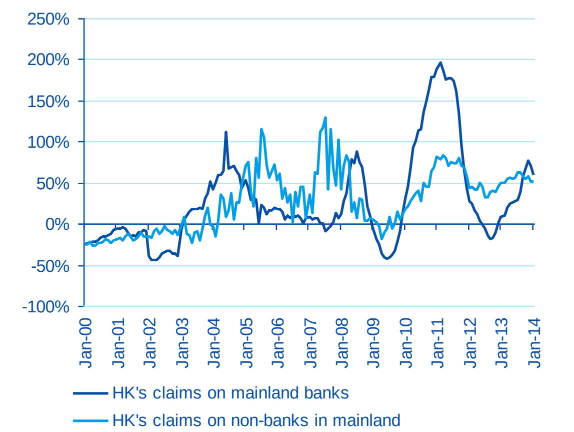
Over and above those figures, Hong Kong, the international offshore financial center in closest proximity to the mainland, has played a critical role in financing domestic banks and firms. The HKMA data show that mainland banks and corporations have been borrowing at a rapid pace from Hong Kong's banks after the crisis. In fact, as of 2013, Hong Kong's banks have about 440 billion USD claims on the mainland, of which three quarters were on banks and one quarter on other sectors (Figure 11 and 12). Adding up claims on China from the BIS reporting countries and Hong Kong would account to over 1,3 trillion USD. As international banks are major creditors for most of non-trade credit debts (loans, debt securities, currency and deposits), our best estimate of external debt may be lifted to about 1,6 trillion USD, or about 18% of GDP in 2013. The ratio is approaching but still below the average external debt of emerging markets hovering 20% of GDP.

Figure 11
Hong Kong plays a critical role in financing mainland banks and firms



Source: CEIC and BBVA Research

Figure 12
Hong Kong's claims on mainland banks have grown rapidly after the crisis



Source: CEIC and BBVA Research

Overall, external debt still looks low but subject to risks given its fast growing pace

From the official external debt figure by SAFE of 9% of GDP to our more comprehensive estimate of external debt of 18% of GDP in 2013, there is obviously a big difference but it still looks manageable based on an international comparison. This is all the more true when we look at the usual indicators of capacity to repay external debt, namely the ratio of external debt to exports and that of foreign reserves to exports, which look very comfortable for China.

However, rapid growth in external debt remains a concern specially if growth sharply decelerates and the RMB depreciates substantially. Looking ahead, external debt may not grow as fast as the US QE tapering dampens global funding supply and thereby pushes up the cost of funding internationally. However, external indebtedness as a percentage of GDP will probably continue to trend up as China's nominal growth decelerates (both real growth and inflation).

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