Weekly Report No. 16 Assessing China's sovereign risk 19/3/2022

The story for investors

The, temporary, collapse of the Chinese Tech sector during the week of 14 March 2022, and its recovery by the end of the week, dragged along the Chinese sovereign market. The latter can only be explained as a knee jerk reaction because Chinese sovereigns are backed by one of the largest net global creditor, the PRC. Creditors don't go bust, debtors do. There is, of course, the large non-sovereign debt market in China with the permanent question hanging over the likelihood of a state rescue rather than serial defaults, especially with the notorious property sector in China, led by near defaulting private companies. All these peripheral issues, once set aside and only the sovereign sector are focused on, the conclusions are clear . It is quite difficult to envisage a case of China defaulting on any of its sovereign debts. Hence sell offs at the back of unrelated equity crashes are unjustified. (Fig. 2 and the widening CDS)

Investment conclusions

The first conclusion is that investors should ignore analyses, which use the debt to GDP (D/GDP) ratios risk indicators, as they mean nothing. The correct ratio to use is the cost of servicing and amortizing the debt as percent of GDP, but these estimates are not easy to find on a consistent basis or at all. Next best indicator are macro data such as external balances, trends of forex reserves, dynamics of forex rate and more sophisticated indices such as CDS spreads (see Fig. 2) These indices point to resources which are more than adequate to service the sovereign debt. As for the corporate and personal debt, an issue of incessant obsession in the media, should the sector come to defaulting, the state has adequate fiscal resources to rescue should it chose to do so. China's fiscal deficit at 5.8% of GDP (2021) can easily double if necessary. See below, however, the caveat on the use of this type of ratios.

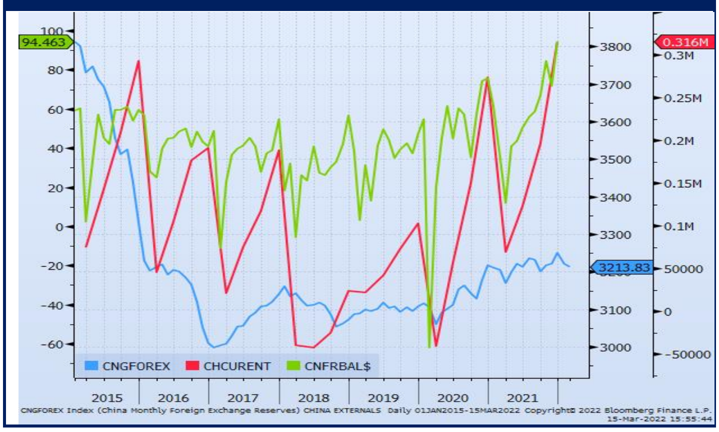
The sovereign debt position of China

First. The key point to start with is that China is a net creditor to the world. Net creditors don't go bust, debtors do. Its forex reserves in Feb.2022 stood at USD 3, 214 billion. The SAFE department of the PBOC had given the country's external debt, both state and private, in Sept. 2021 at USD 2,696,a net of reserves position of USD518 bl. China can pay off all its external debt with its reserves and still have plenty leftovers. (Fig. 1 the blue line). **Second.** China's net lending position is the outcome of the surplus in its trade and current account balances, (Fig. 1 green, red). **Third**. The USD/CNY a managed rate helped by some capital controls, but, be noted, no controls over the flows of the trade and current account. Under the combined circumstances of these three conditions, China cannot face the type of forex and flow of funds crises, which had faced, for example, Russia (pre Ukraine) and Argentina and which led to massive devaluations and collapse of their financial systems. **Fourth.** There is the issue of the forex reserves as a potential back up to a sovereign crisis. A rescue of the bond market will involve the central bank using its USD assets to buy the defaulting bonds and thus substituting a doubtful asset for a safe one. Should the purchased bonds default the central bank will need to raise more capital to balance its balance sheet. If the USD reserves were switched into local currency this would also imply a weakening of the USD and a drop in the price of the USD assets sold to raise USD.As it can be seen, using forex reserves to support the bond market is feasible but complex and could lead the central bank pushing the forex and bond market against its interests.

China's peripheral sovereign issues

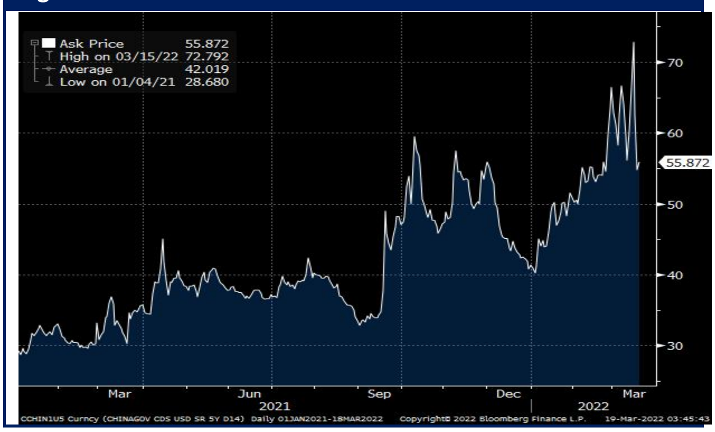
The overall size of Chinas debt is mired in definitional issues as well as speculation of "hidden" debt such as off-balance sheet items of the banking sector. The following figures are given very cautiously as different sources give widely different numbers. I believe these to be reasonably consistent (sources: Statista and CEIC). Invariably the numbers are given of Debt as percent of GDP: (D/GDP). These widely used ratios are worse than wrong, they totally misleading and totally useless as indicators of China's debt risk as we explain below**.** For 2021 China's total debt stood at 266.0% of GDP, which was roughly, apportioned as 62.0% by household, government 69.0% and corporate 135.0% (total 266%). Expressing debt levels as percent of GDP commits the cardinal error of dividing apples by bananas, something that in Economics or Accounting 101 would ensure a "Fail", but not when it comes from the IMF or major investment banks. Debt has no time dimension, it is a sum of money at a given date, GDP however is the national income, expressed per time period usually p.a. It is the sum of wages+rents+profits earned, or the value of the production of goods and services over a 12-month period. So dividing a statistical or accounting concept which has a time dimension (GDP) into something, which does, not (Debt) tells you that for every one banana there were 2.6 apples, whatever that means. The correct ratio would be the service plus amortization cost of debt p.a. as percent of annual income (GDP) but they're few, if any, of these data available.

Fig 1: China: Trade bal (gr) C/A bal (red), Forex res (bl) 2015-21



Source: Bloomberg

Fig 2: China: CDS USD 5Y 2021-22



Source: Bloomberg

Dr. Andrew Freris, Chief Strategist

UCAP Hong Kong Asset Management Limited
3rd Floor, 33 Garden Road, St John's Building
Central, Hong Kong
Direct: +852 3465 7464 Mobile: +852 97380944
Email: andrew.freris@ucap-am.hk

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