



Global Strategy Weekly

If UK Chancellor George Osborne is a moron, Fitch's Charlene Chu is a heroine

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Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

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I wanted to focus on all things Japanese this week. But a seething anger has been bubbling within me since UK Chancellor George Osborne's March budget. I cannot suppress my thoughts any longer. We say what we see. By contrast Fitch's Charlene Chu deserves a medal of honour for her stark warnings about the Chinese credit bubble. But when will the bubble burst? Our own Wei Yao thinks we may have reached that "Minsky moment".

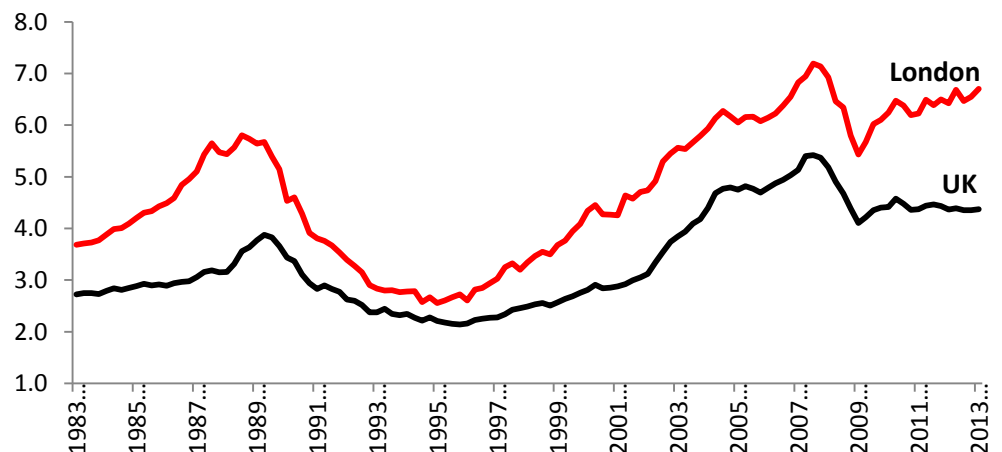
■ We say what we see. We stress that we are not being party political. If we felt that Jilted John's 1978 Hit "Gordon is a moron" applied to our then Chancellor Gordon Brown for his 2006 decision to hire Alan Greenspan as a UK Treasury advisor, then for consistency's sake we feel it should equally apply to George Osborne in this case.

■ George Osborne in his March budget proposed an unusually misguided piece of government interference in the housing market. The measures will see government provide lenders with a guarantee of up to 20 per cent of a mortgage in an attempt to encourage lending to borrowers with small deposits. This means that if a borrower defaults on a loan, the taxpayer will be liable for a proportion of the losses. Numerous critics of George Osborne's scheme range from the IMF to the outgoing Bank of England Governor Mervyn King, who said "We do not want what the US has, which is a government-guaranteed mortgage market, and they are desperately trying to find a way out of that position."

■ My favourite quote though is from Andrew Bridgen, senior economist for Fathom Consulting, a forecasting firm run by former Bank of England economists. Bridgen said: "Help to Buy is a reckless scheme that uses public money to incentivise the banks to lend precisely to those individuals who should not be offered credit. Had we been asked to design a policy that would guarantee maximum damage to the UK's long-term growth prospects and its fragile credit rating, this would be it."

■ But what really makes me angry is that UK house prices, and London most especially, have never been allowed to correct to 'affordable' levels. First time buyers need *cheaper* homes not greater availability of debt to inflate house prices even further. This is madness.

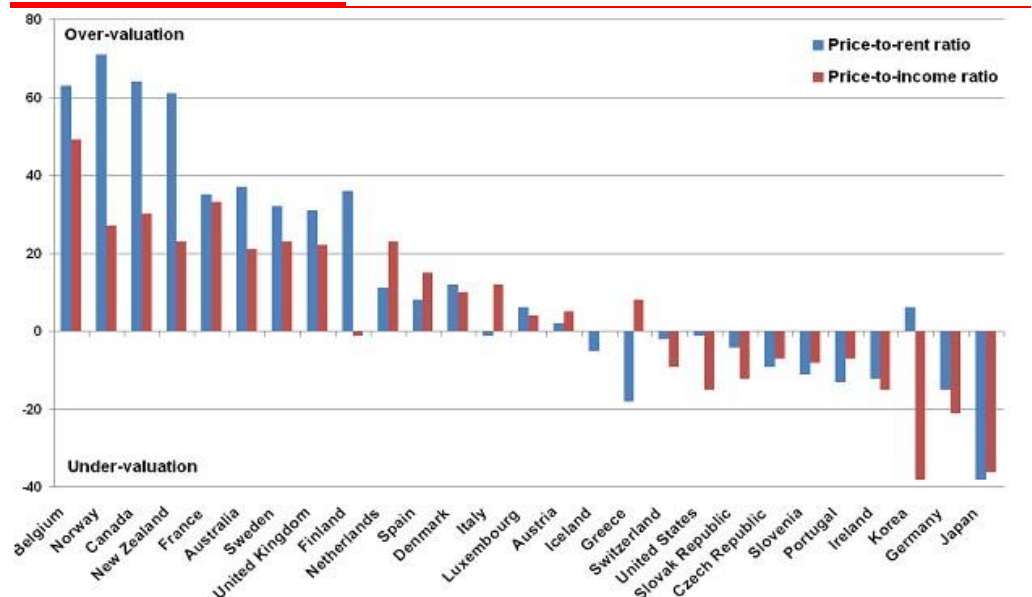
UK first time buyer house price/ earnings ratio: UK housing simply too expensive



Source: Nationwide

The OECD has recently identified UK house prices as between 20-30% too high (depending on whether you compare prices with rents or incomes - [link](#)). To be sure the UK is nowhere near the most expensive, with some of the usual suspects such as Canada, Australia and New Zealand even worse. But what is surprising to me about the UK is that house prices are still extremely overvalued despite the country having been at the epicentre of the global credit bust and remaining in the icy grip of private sector debt deleveraging. For it is also notable that in other countries which have also found themselves in the eye of the credit storm, such as Portugal, Ireland and most importantly the US, house prices are now unambiguously cheap.

House prices across the OECD (% over or under valuation relative to long term averages)



Source: OECD

The UK authorities have gone out of their way to prop up house prices and prevent a proper correction taking place. I was lucky. I managed to buy my first house in London when I was only 22 in 1983, which as you can see from the front page chart, was a time when property was very affordable for first time buyers. Young people today haven't got a chance of buying a house at a reasonable price, even with rock bottom interest rates. The Nationwide Building Society data shows that the average first time buyer in London is paying over 50% of their take home pay in mortgage payments - and that is when interest rates are close to zero!

What makes me genuinely *really* angry is that burdening our children with more debt (on top of their student loans) to buy ridiculously expensive houses is seen as a solution to the problem of excessively expensive housing. I would have thought the lack of purchasing power *should* contribute to house prices declining or stagnating (relative to incomes), hence becoming affordable once again. You would have thought that George Osborne would be ideologically predisposed to a market solution, wouldn't you? But apparently not.

Why are houses too expensive in the UK? Too much debt. So what is George Osborne's solution for first time buyers unable to afford housing? Why, arrange for a government guaranteed scheme to burden our young people with even more debt! **Why don't we call this policy by the name it really is, namely the indentured servitude of our young people.**

I don't think Andrew Bridgen at Fathom Consulting was strong enough when he described George Osborne's scheme as "reckless". I believe it truly is a moronic policy that stands head and shoulders above most of the stupid economic policies I have seen implemented during my 30 years in this business. It ranks above some of Alan Greenspan's very worst blunders. And when so many highly regarded commentators speak out against it, only to be totally ignored by George '*I know better*' Osborne, he may really deserve to be called a moron.

Another country that is still hooked on debt as the solution to its problems is China. And when it comes to analysis of China, **Charlene Chu deserves a very special mention for standing out among the crowd. Who is she? She is Senior Director in the Financial Institutions Group at Fitch Ratings**, based in Beijing, and oversees the credit ratings of Chinese banks and other financial institutions.

Credit ratings agencies came in for a lot of criticism in the aftermath of the financial crisis but Chu stands aside from the conspiracy of complacency on China warning loud and clear that China is nearing the abyss. The well known China commentator Michael Pettis calls Chu "the only analyst who actually understands what is happening in the (Chinese) banking system."

I was reminded of Chu's thoughts in a 29 May Bloomberg interview and I think it is worth repeating some of the key points (full interview [here](#)):

Chinese banks are adding assets at the rate of an entire U.S. banking system in five years. To Charlene Chu of Fitch Ratings, that signals a crisis is brewing. Total lending from banks and other financial institutions in China was 198 percent of gross domestic product last year, compared with 125 percent four years earlier, according to calculations by Chu, the company's Beijing-based head of China financial institutions. Fitch cut the nation's long-term local-currency debt rating last month, in the first downgrade by one of the top three rating companies in 14 years.

"There is just no way to grow out of a debt problem when credit is already twice as large as GDP and growing nearly twice as fast," Chu said in an interview. Chu says companies' ability to pay back what they owe is wearing away, as China gets less economic growth for every yuan of lending.

Chu calculated China's total credit at 198 percent of GDP last year by adding off-balance-sheet assets such as letters of credit, financing by non-bank institutions and offshore loans by foreign banks to figures for all forms of financing in the economy published by the central bank. The Chinese government doesn't provide an estimate for total credit to GDP.

A jump in the ratio of credit to GDP preceded banking crises in Japan, where the measure surged 45 percentage points from 1985 to 1990, and South Korea, where it gained 47 percentage points from 1994 to 1998, Fitch said in July 2011. In China, it has increased 73 percentage points in four years, according to Fitch's estimates.

"You just don't see that magnitude of increase" in the ratio of credit to GDP, Chu said. "It's usually one of the most reliable predictors for a financial crisis."

"Companies are taking on a lot of debt but not getting comparable returns," Chu said. "If they're not getting sufficient returns, at some point they will have problems repaying the debt."

Now my own experience of writing bearish comments on China is that your inbox quickly fills up with abusive emails. Indeed nothing gives me more entertainment than reading a cautious article on China in The Economist or Financial Times and scrolling down to the comments section where China supporters will throw abuse by the bucketful. Many claim this online defence of China is orchestrated by the state. I don't care. It makes for great entertainment.

But it's not great entertainment if you are personally on the receiving end of abuse and death threats for giving an honest professional opinion that does not concur with the prevailing bullish rhetoric and group-think. Charlene Chu might wish to confer with Meredith Whitney, who if you remember back in October 2007 savaged Citigroup in a report and predicted that they would have to slash their dividend. The subsequent collapse in the stock price resulted in

Whitney receiving a number of death threats. In her shoes I would have been reassured that I was married to a former professional football player and wrestler standing 6 foot 6 inches, weighing in at 300 pounds (21.5 stone or 136kg). I don't expect my wife has quite the same physical deterrence value, although we do have a very snappy Jack Russell Terrier.

Anyway back to China. What particularly struck me about Charlene Chu's interview is that it resonated closely to something I had read by our very own China economist Wei Yao. I have mentioned Wei many times on these pages. She does some excellent work and certainly doesn't pull her punches. **She wrote just a few days ago that China may be on the verge of a "Minsky moment."** Despite Wei being much more cautious relative to the China consensus, that certainly is the most bearish thing I have seen her write and it is worth exploring.

Wikipedia defines a Minsky moment as well as anybody: "A Minsky moment is a sudden major collapse of asset values which is part of the credit cycle or business cycle. Such moments occur because long periods of prosperity and increasing value of investments lead to increasing speculation using borrowed money. The spiralling debt incurred in financing speculative investments leads to cash flow problems for investors. The cash generated by their assets is no longer sufficient to pay off the debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. This is likely to lead to a collapse of asset values. Meanwhile, the over-indebted investors are forced to sell even their less-speculative positions to make good on their loans. However, at this point no counterparty can be found to bid at the high asking prices previously quoted. This starts a major sell-off, leading to a sudden and precipitous collapse in market-clearing asset prices, a sharp drop in market liquidity, and a severe demand for cash. The term was coined by Paul McCulley of PIMCO in 1998, to describe the 1998 Russian financial crisis, and was named after economist Hyman Minsky. Some, such as McCulley, have dated the start of the financial crisis of 2007–2010 to a Minsky moment, and called the following crisis a "reverse Minsky journey"; McCulley dates the moment to August 2007"

So clearly if Wei thinks China is approaching a Minsky moment akin to the US situation in August 2007, I'm sitting bolt upright and taking notice. In her piece, which is so important I reproduce it in full below, she explains why rapid credit growth is not being utilised by the real economy (i.e. why the credit multiplier has declined so much). She writes **"At the macro level, we estimate that China's debt servicing costs have significantly exceeded underlying economic growth. As a result, the debt snowball is getting bigger and bigger, without contributing to real activity."** Forgot Minsky moment, this is classic Ponzi pyramid!

She calculates "a shockingly high (corporate) debt service ratio of 30% of GDP, of which 11% goes on interest payments. At such a level, no wonder that credit growth is accelerating without contributing much to real growth. The BIS estimate a number of economies had similar or moderately lower debt service ratios when they were headed towards serious financial and economic crises. Examples include Finland (early 1990s), Korea (1997), the UK (2009), and the US (2009). This is one more data point in China that evokes the troubling thought of a hard landing."

And Wei's conclusion: **"the logical conclusion has to be that a non-negligible share of the corporate sector is not able to repay either principal or interest, which qualifies as Ponzi financing in a Minsky framework."**

And you thought I was bearish?

Read Wei Yao's wise words below. All hate mail can be sent directly to me.

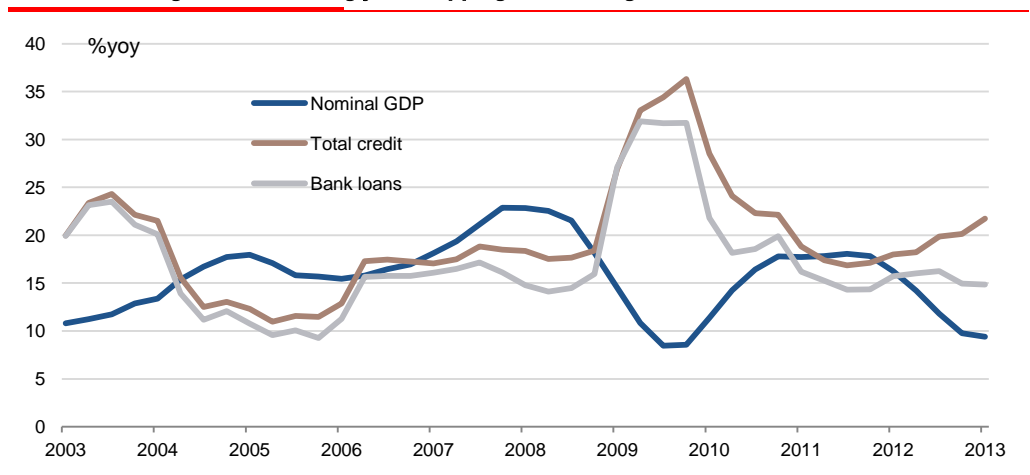
China's missing money and the Minsky moment

China's credit growth has been outstripping economic growth for five quarters. This raises one key question: where has the money gone? Although such divergence is not unprecedented, it potentially suggests a trend that gives greater cause for concern – China is approaching a Minsky moment. At the micro level, we notice that a non-negligible share of the corporate sector and local government financial vehicles are struggling to cover their financial expense. At the macro level, we estimate that China's debt servicing costs have significantly exceeded underlying economic growth. As a result, the debt snowball is getting bigger and bigger, without contributing to real activity. This is probably where most of China's missing money went.

The missing money

In the first quarter, China's total credit growth – bank loans, shadow banking credit and corporate bond together – accelerated to the north of 20% yoy, more than twice the pace of nominal GDP growth. This gap has been widening since early 2012.

Chinese credit growth increasingly outstripping economic growth



Source: PBoC, NBS, CEIC, SG Cross Asset Research/Economics

True, the gap was once close to 30ppt in 2009 and credit growth looked like leading economic growth most of the time in the past ten years. However, we still think the recent divergence is particularly worrying.

Since 2009, China's credit growth has outpaced nominal GDP growth in every quarter except one (Q4 11), whereas, in previous years, economic growth managed to better credit growth more than half of the time. The excess borrowing that occurred in 2009 has never been absorbed by the real economy and now more borrowing is being piled on top of this.

In addition, the credit binge in 2009 was a result of the exogenous policy shock engineered by Beijing. Authorities were quick to boost credit supply within months of the breakout of the Great Recession, long before generic credit demand from corporates picked up. However, this time, the economic slowdown as well as the credit pick-up is largely endogenous. The increase in credit demand is disproportionately larger compared to the recovery in investment appetite so far. This raises the question whether activity growth will really follow and if so by how much?

The role of shadow banking

Another big difference between the current situation and that which occurred in 2009 is the greater and increasing presence of non-bank credit. Bank loans accounted for most of the credit surge in 2009, but it is the shadow banking system and the bond market that have

supported the upturn since 2012. Loan growth barely accelerated beyond 15% last year, and actually dipped somewhat entering 2013. In contrast, trust loans more than doubled in the past 12 months and corporate bonds increased by nearly 50%.

Borrowing from shadow channels like trusts are hardly a voluntary choice, as costs are often stiflingly high and duration unpleasantly short. Hence, there is an issue of adverse selection. It is those who are unable to roll over bank loans that have to tap the shadow banking system and refinance at more demanding terms. Local government financing vehicles (LGFVs) have joined this league since 2012, as the banking regulator put more and more restrictions on formal banks' lending to them (Cf. "[On our minds: Recalculating China's government debt risk](#)," 22 March).

The ever-greater role non-bank financing has played in this credit cycle has clearly increased the vulnerability of China's already burdened financial system.

Debt snowball

A fast rising debt load of an economy suggests either deteriorating growth efficiency or high and rising debt service cost, or in many cases both. There is clear evidence that China is suffering from both of these. We have written extensively on the point of declining growth and summarised the causes as: 1) excess capacity resulting from inefficient investment in the past and 2) increasingly marginalised private sector.

Here, we focus on the debt problem. Adopting the methodology from a 2012 BIS paper¹, we manage to estimate China's debt service ratio (DSR) at the macro level, and the result is very alarming.

First, taking bond, formal and shadow banking credit together, we see the debt burden of non-financial corporates and LGFVs at 145-150% of GDP as of end-2012. We consider LGFVs with other corporates because they are in pursuit of the same financing sources and increasingly face similar borrowing costs.

Second, the average interest rate and maturity are estimated at 7.8% and 6.3 years (see table below). Bear in mind that this is a fairly rough estimate, as detailed loan-level data are not easy to obtain, especially for shadow banking credit. As a general rule, we choose to adopt more lenient assumptions when information is scarcer. Therefore, maturities used in the calculation for each segment are probably longer than in reality and actual prevailing interest rates in the shadow banking system may be higher.

Estimating China's debt servicing costs

	Debt load (% of GDP)	Average interest rate	Average maturity (yr)
Total corporate debt	145	7.8%	6.3
bank loans: short-term	45	3.0%	1
bank loans: medium/long term	55	7.0%	8
corporate bills/commercial papers	3.8	3.0%	1
corporate bond	10.2	6.5%	8
shadow credit: short-term	11.2	3.0%	1
shadow credit: medium/long term	16.8	9.0%	3
Interest payment (% of GDP)	11.3		
Principal payment, no roll-over	18.6		
Total debt service cost	29.9		

Source: PBoC, CBRC, CEIC, SG Cross Asset Research/Economics

Note: The estimate for the shadow credit stock covers trust loans, entrust loans, credit supplied by Hong Kong banks and underground banking, but underground credit is not considered when estimating the corresponding interest rate or maturity. Otherwise, the rate should have been higher and the duration shorter.

Third, assuming the repayment schedule of an instalment loan (i.e., a regular mortgage, for example), we then arrive at a shockingly high debt service ratio of 29.9% of GDP, of which

¹ Drehmann, M. & Juselius M., "Do debt service costs affect macroeconomic and financial stability?" BIS Quarterly Review, September 2012.

11.1% goes to interest payment ($=7.8\% \times 145\%$ of GDP) and the rest principal. At such a level, no wonder that credit growth is accelerating without contributing much to real growth!

A Minsky moment?

As a reference, the BIS paper estimated that a number of economies had similar or moderately lower debt service ratios (DSRs) when they were headed towards serious financial and economic crises. Examples include Finland (early 1990s), Korea (1997), the UK (2009), and the US (2009). This is one more data point in China that evokes the troubling thought of a hard landing.

However, we also agree that the actual DSR is probably lower. The assumption of an instalment-loan schedule implies that roll-over is not an option and all debt is fully repaid at maturity. This is clearly not the case in China. Otherwise, the 1% non-performing loan (NPL) ratio of the formal banking system would be simply impossible to explain - not to mention the zero default record kept by China's domestic bond market or by the vast numbers of low-return infrastructure LGFVs.

Apparently, debt roll-over is not a good thing either; and, it cannot explain the increase in the debt burden. Hence, the logical conclusion has to be that a non-negligible share of the corporate sector is not able to repay either principal or interest, which qualifies as Ponzi financing in a Minsky framework.

The mechanism that still holds the situation together is the state-backed formal banking system and its unspoken commitment to supporting local governments. **We think this precarious equilibrium could last a bit longer but not much longer**, particularly if the central government does nothing.

It is encouraging that the new leadership has so far tolerated slowing growth and largely resisted the temptation to resort to the 2009 approach. This at least has the merit of not making the problem any bigger than it already is. Furthermore, the set of new financial regulations targeting the shadow banking system and the bond market reflects the awareness of authorities of the level of financial risk. Nevertheless, we think more corporate defaults, rising NPLs, and some degree of credit crunch will still be unavoidable in the next three years, which lends weight to our below-consensus medium-term growth forecast.

(Any questions or comments on the above you are very welcome to contact my esteemed colleague Wei Yao on wei.yao@sgcib.com. And as I mentioned previously all hate mail can be sent to me. I'm well used to it by now!)

APPENDIX

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