Ever Expanding Debt Bubbles in China and India*

C.P. Chandrasekhar and Jayati Ghosh

One of the more surprising features of the global economy since the shocks created by the Global Financial Crisis is the rapid re-emergence of debt, especially private sector debt. After all, excessive and unsustainable levels of private debt were critical in the build-up to the crisis in the United States as well as in some other countries like Ireland, Spain and the United Kingdom. But major players in the global economy appear to have learned few lessons from this.

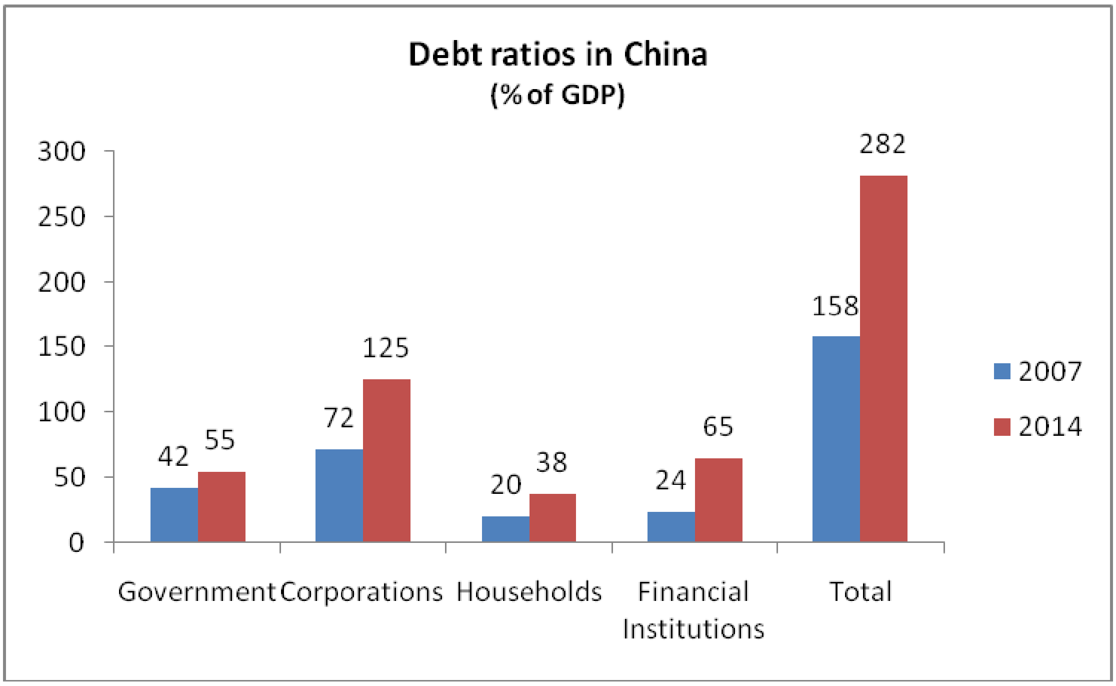
Remarkably, levels of debt in relation to GDP are now higher in many countries than they were before the Global Financial Crisis, and this is dominantly driven not by government debt but by increasing household and corporate debt. So boom-bust cycles and associated crises with potentially devastating effects on real economies and employment are likely to continue, and indeed even spread to other countries that were not so badly affected by the Great Recession.

One of the countries in which total debt has grown very rapidly in the six years since the Great Recession is China. Total debt in absolute terms went up four times, and the debt-GDP ratio in China nearly doubled between 2007 and 2014, as Chart 1 indicates. At around 282 per cent of GDP, this makes debt in China larger than in the United States in relative terms. The biggest increase was in corporate debt, which is now as much as 125 per cent of GDP, but debt held by households has also gone up nearly threefold to a hefty 65 per cent of GDP.

But there are other reasons – beyond the sheer size and the rapidity of its growth – that make the expansion of debt in China a source of concern. Fully half of the debt is oriented directly or indirectly towards the real estate market and housing finance, fuelling property bubbles in major Chinese cities that are just beginning to burst. Already sales of real estate in many urban areas are stagnant and in some places prices have also started to fall. When the value of the underlying asset falls, this affects the capacity to repay, as the experience of the United States housing market in 2006-08 vividly illustrated.

Further, a very large part of such debt in China – estimated to be as much as half or even more – comes from unregulated shadow banking institutions that are now also more linked to the formal commercial banks. Further, while government debt to GDP ratios are still relatively low, much of the increase has come from provincial governments eager to show higher GDP growth and therefore investing heavily in infrastructure through highly leveraged projects. As overcapacity becomes a more evident problem in China, many of these projects will find it hard to recoup their costs and repayment concerns are likely to surface.

Chart 1

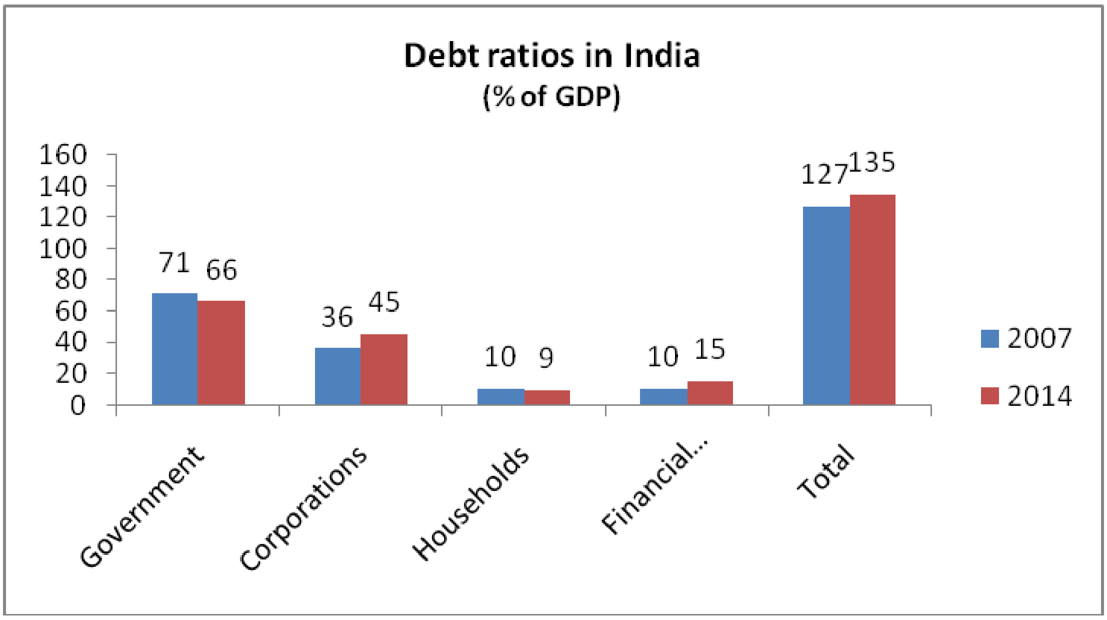


Source: McKinsey Global Institute Report: Debt and (Not Much) Deleveraging, February 2015

By contrast, levels of debt in India appear to be low and even comfortable in comparison (Chart 2). Government debt has actually fallen as a share of GDP, as has household debt. However, corporate debt has increased and is now as much as 45 per cent of GDP, while debt of financial institutions has also increased in the past seven years. As a result, total debt now accounts for as much as 135 per cent of GDP. This seems relatively low compared to the very high levels in some other Asian countries (not just China but South Korea and Singapore as well) but it is still quite high given historical patterns and the low financial intermediation in the economy. And the critical question is the extent to which the debt is sustainable in the medium term, such that corporations and financial institutions will not find repayment to be a problem.

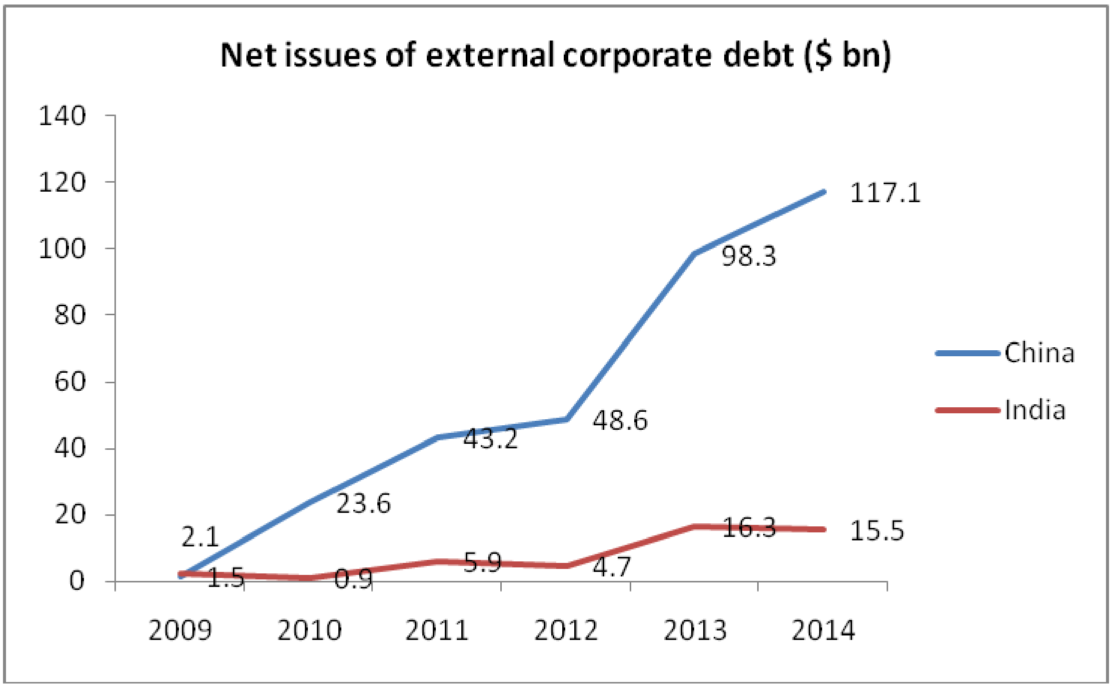
In addition, the macroeconomic context, and ability of the economy as a whole to withstand such financial shocks, are obviously important. Here the greater control of the Chinese state over the economy and its continued ability to direct credit through the commercial banking sector and to refinance institutions with liquidity problems is a major difference with India.

Chart 2



Source: McKinsey Global Institute Report: Debt and (Not Much) Deleveraging, February 2015

Chart 3



Source: BNP Paribas quoted in Financial Times, 15 February 2015

This is where the debt situation in India may in fact turn out to be more problematic than that in China, despite much lower aggregate levels of debt. Chart 3 indicates that net issues of external debt by corporations have been rising much more rapidly in China than in India over the past three years. But the overall balance of payments situation in China is far more comfortable. China holds nearly $4 trillion of external reserves that were accumulated on the basis of prolonged export surpluses and the Chinese economy continues to run a current account surplus. However, Indian reserves are not only much lower but are also (unlike China) based on debt-creating and short term inflows that can be reversed with any negative changes in investor perceptions. Indeed, the likely increase in US interest rates may well have an effect on such flows, possibly causing a rapid reduction in the level of foreign exchange reserves. In such a context the external debt held by Indian corporations contributes to the overall financial fragility of the economy and the vulnerability of the balance of payments.

The dominance of corporate debt within India's debt profile also matters because a highly leveraged corporate sector is less likely to invest, yet much of the current government's hopes for future growth in the Indian economy are pinned on corporate investment. The problem is intensified because much of the corporate debt is concentrated in a few infrastructure sectors (such as power generation and transport) and in the aviation industry, in which investments in the past decade were almost entirely leveraged. This was done through public sector commercial banks, which – in the absence of development banks proper – were forced to take on risky long-term loans that are now having to be restructured. The financial mess in these sectors is unlikely to go away soon, especially as the new government has not gone beyond rather general statements in resolving the problems in these sectors. Finally, if a widening current account deficit or capital flow reversals result in a large depreciation of the rupee, the increased debt-servicing burden in rupee terms on foreign debt can damage corporate balance sheets and have adverse spin-off effects on investment and growth.

Overall, therefore, both in terms of looming liquidity concerns and foreign exchange liabilities, debt in India is an emerging concern. China may appear to have a debt problem of larger size, but India's debt problem may well turn out to be the more lethal.

* This article was originally published in the Business Line on March 2, 2015.