COMMERZBANK

EM Briefing

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China's external debt: More pain to come?

China's external debt surged after the global financial crisis. As CNY is under pressure to weaken, Chinese corporates have started to reduce borrowing in offshore markets. This will not only add weakening pressure on CNY, but could also retard the development of CNH market.

CNY depreciated by 4.7% for the whole year of 2015, the biggest annual drop in the past decade. Entering the New Year, CNY made losses of 1% against the USD in the first week of 2016. Against this backdrop, the concerns of China's external debt resurfaced.

How big is China's external debt?

First of all, we need to investigate the overall profile of China's external debt. Data compiled by State Authorities of Foreign Exchange (SAFE) suggest that China's external debt rose by 130% from end-2007 to end-2014, and reached USD 895 bn at end-2014. While growing rapidly, the pace of external debt accumulation is actually slower than that of China's overall corporate debt, which illustrated a 330% increase between end-2007 and end-2014.

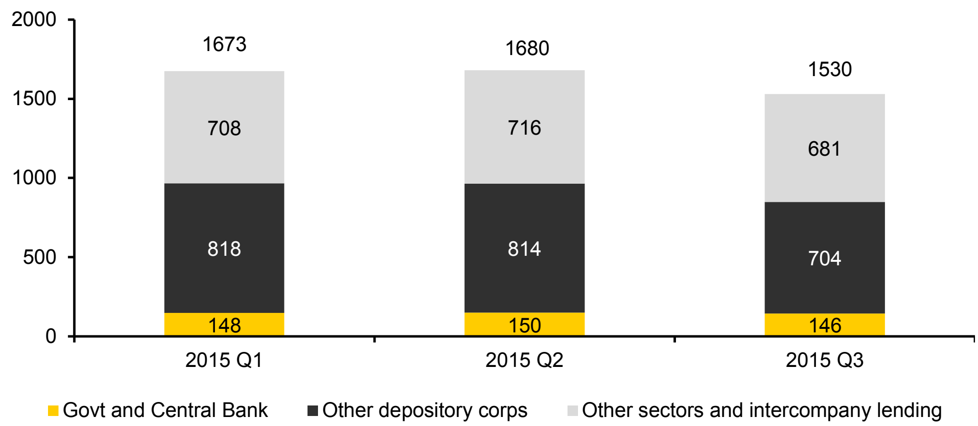
However, the official statistics before 2014 do not tell the whole story. SAFE stated earlier last year that external debt in China refers to the debt owed by a domestic institution to a non-resident, which are denominated in a foreign currency and exclude external debt in RMB, indicating the definition of China's external debt is narrower than the international standard definition. As such, starting from 2015, official statistics started to report a new data series which includes offshore CNH borrowing as part of external debt. After adding CNH debt into the pool, China's gross external debt picked up sharply to USD 1.67 trn by the end of Q1 2015, from USD896 bn at the end of 2014.

Who is exposed to these risks?

The next question is who is exposed to these risks? The data breakdown illustrates that the borrowing of the government and central bank remained stable and only account for less than 10% of the total debt, while the borrowing of financial institutions and corporates take up roughly 50% and 40%. Notably, the financial institutions actually act as a "bridge" as the money will be eventually lent to corporates. Ultimately, Chinese corporates are exposed to the risks of the external debt.

CHART 1: **Chinese corporates are exposed to the risk of external debt**

Gross external debt by sector, in USD bn



Source: SAFE, Commerzbank Research

For important disclosure information please see page 3.

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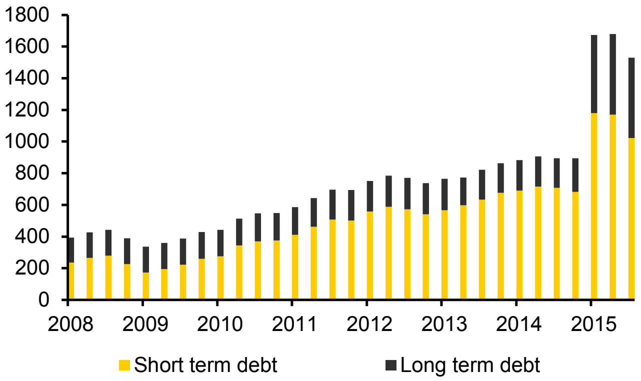
Deleveraging has started, at a slow pace

By the end of Q3 2015, China's total external debt declined by 11.4% from Q1 2015, to USD 1.53trn, or 14% of China's GDP. Moreover, 47% of China's external debt is CNH-denominated, while others are in foreign currencies.

CHART 2: **China's external debt "surged" when CNH borrowing is included**

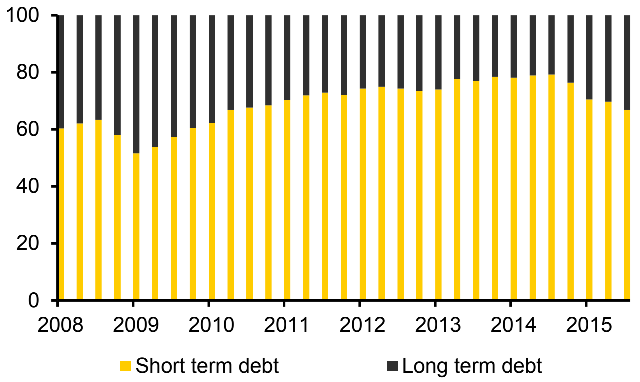
Gross external debt in USD bn



Source: SAFE, Commerzbank Research

CHART 3: **The share of long-term debt is rising**

China's external debt, % short term vs long term



Source: SAFE, Commerzbank Research

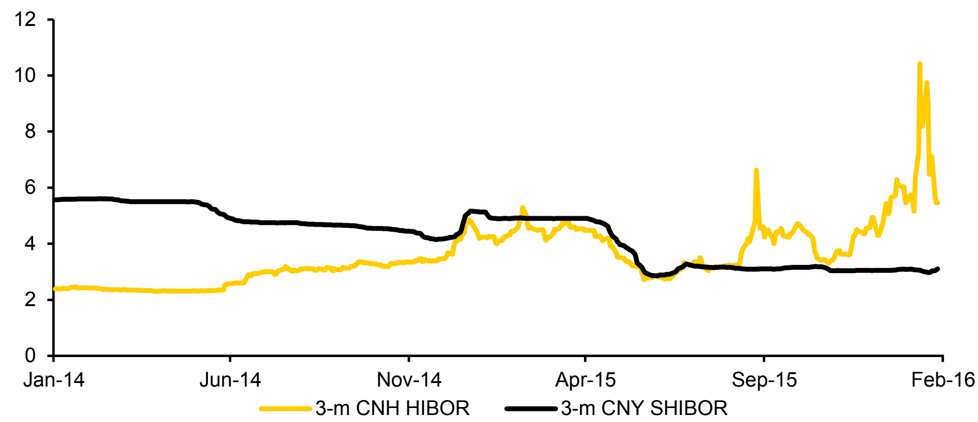
The decline in total external debt suggests that Chinese corporates started to reduce offshore borrowing. In the meantime, the proportion of long-term debt (longer than one year) is rising, suggesting that Chinese corporates are reluctant to roll over short-term debt when it matures. The moderate decline in China's external debt implies that there will be more pain to come as long as CNY is under pressure to weaken. Assuming that CNY sees another 5% depreciation versus the USD this year, Chinese corporates will suffer another USD 40 bn loss.

In the meantime, the risk embedded in CNH borrowing is the rising cost of funds. On average, the cost of 3-month CNH funding has picked up more than 200bps since Q3 2015, and right now is significantly higher than onshore CNY funding. If this persists, Chinese corporates will turn to the onshore market for funding. The development of the CNH market could also slow down, if the offshore banks' CNH asset books shrink.

In our opinion, there is little chance that the external debt will bring in a balance of payments crisis, as the foreign currency debt only accounts for 24% of China's foreign reserves. However, as China's foreign reserves are dropping sharply due to capital outflows, the deleveraging in China's external debt could add further weakening pressure on CNY in the coming quarters.

CHART 4: **CNH funding cost has risen significantly**

3-month CNH HIBOR vs 3-month CNY SHIBOR, in %



Source: Bloomberg, Commerzbank Research

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