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Guest post: can China bail itself out? (Quite possibly, no)

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What happens if China goes broke?

China's Rmb4tn stimulus package in 2008 – and its ballooning lending – has raised fears of a financial collapse. Certainly, debt has exploded. The China Academy of Social Sciences (CASS) estimates that total government debt is now Rmb 27tn, or 53%, of GDP. Throw in corporate and household debt, and CASS estimates the total at Rmb 111.6tn ($18.3tn) at the end of 2012, or 215 per cent GDP.

Chinese economists are quick to point out that the country has plenty of money to pay off its debts and could easily avert a financial collapse. The government, they say, could function as lender of last resort.

Fitch Ratings agrees. In April, Fitch reaffirmed China's Sovereign Debt Rating at A+ with a stable outlook. China's $3.8tn in foreign reserves is a "core sovereign credit strength." Although worried about China's growth model, due to leverage

and ability to absorb further investment, the agency praised China's "powerful levers for short-term demand management" due to its state ownership. Other good signs are the People's Bank of China's two year timeframe to free up interest rates and China's "ambitious reform agenda."

But what happens in a severe downturn may not conform to prior predictions. How does one confirm whether there are sufficient resources in China to provide adequate capital for a massive collapse in economic activity, including a popping of China's property bubble?

One useful way to test whether the Chinese have it right – that there is enough money to cover a collapse – is to look at China's sovereign balance sheet. Just as a company has assets and liabilities, so do countries. This analysis is not as easy to calculate as with a company, because the country covers a lot more ground, but with the right tools, it can be a useful exercise. It also lays bare China's economy.

We use a balance sheet compiled for the International Monetary Fund by economists Yang Li and Xiaojing Zhang. Their chart shows total assets of Rmb 142.3tn and liabilities of Rmb 72.7tn, for total net worth of Rmb 69.6tn.

China's Sovereign Balance Sheet (2010)

(RMB Trillion)

Assets		Liabilties
Deposits of Government at Central Bank	2.4	Domestic debts of central government
Reserve Assets	19.7	Sovereign external debts
Land Assets	44.3	Local government debts (excluding LG
State-owned assets in administrative institutions	7.8	LGFV debt
State-owned assets in nonfinancial sector	59.1	Nonfinancial state debts (excluding LG
State-owned assets in financial sector	8.2	Policy bank debt
State-owned assets in social security fund	0.8	Nonperforming Loans
		Contingent liablities due to NPLs
		Implicit pension debts
Total Assets	**142.3**	**Total Liabilities**
		Government Net Worth

Source: Orient Capital Research

Some items have changed since 2010. Local government debt, both direct and indirect, is closer to Rmb 17tn, according to the government's own estimates. And the non-performing loan (NPL) ratio for the banks by some measures is closer to

Rmb 1tn trillion than Rmb 400bn. But there's no doubt, at least on paper, China has a positive net worth.

China has the money – but can it use it in a crisis?

The real question is – can China use its capital in a time of crisis? If China suffers a financial meltdown can the government pay? Could China handle the so-called Minsky Moment when asset values collapse following a speculative bubble, a term coined by PIMCO's Paul McCulley about the 1998 Russian Financial Crisis?

On the asset side, clearly the easiest source of usable capital is China's $3.8tn of foreign reserves. However, pulling them out of western markets (mainly Europe and the U.S.) would send a strong negative signal and cause a decline in their value. Plus, importing foreign exchange would require massive sterilization by the People's Bank of China (PBoC) – a process dubbed "mopping up" – by selling bonds and thus avoiding an inflationary spiral. So the reserves are a doubtful source of easy money.

The next potential pool is China's Rmb 70tn in state assets. Many Chinese point to their bloated state firms as a source of ready capital. Why not sell them off? It worked for the four state banks when they went public in the earlier part of the last decade when China set up four asset management companies to dispose of non-performing loans.

Easier said than done. There are 117,000 state firms in China with assets of Rmb 85tn (more recent data than in our chart). Beijing controls 17,000 while the remaining 100,000 are owned by Provincial governments. China is unlikely to sell off its most attractive firms. These are the Beijing- controlled state champions like its oil, nuclear and electricity companies. That leaves the provincial state firms. But selling them is likely to be a difficult process.

Combined, they employ 64m people, a politically potent cohort. By investment, 30% of state firm investment is in manufacturing and 22% in real estate – two areas that are unlikely to be attractive to buyers. (Many of the manufacturing firms are in inefficient heavy industries like steel, for example.)

	China's State Firms - Fixed Asset Investment	Bln Yuan	% T
1	Manufacturing	5,871	
2	Real Estate	4,313	
3	Transport, Post	2,327	
4	Public Water	1,788	
5	Electricy, Gas and Water	1,355	
6	Mining	817	
7	Trades	449	
8	Public Management	403	
9	Agriculture and Fishery	336	
10	Education	324	

Source: Orient Capital Research

The other big asset on the country's balance sheet is Rmb 44.3tn in land (likely higher by now). On the face of it, this looks marketable. In 2013 alone, revenue from land sales rose 52.4% to more than Rmb 4tn yuan. But tapping into land sales to pay for systemic debts is problematic for two reasons. First, local governments are slowly running out of land; and second, if China is faced with a fiscal crisis it is highly likely that property values will collapse like a punctured bicycle tire, thus deflating land prices.

There are many scenarios for China's slowing economy, not all of them pointing to a "Minsky Moment." And there are other sources of capital, such as savings deposits in the banks that could be use to prop up the financial system. But we would argue that unalloyed faith in China's balance sheet is a bit like a circus acrobat who fails to test his safety net until it's too late.

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