# Is Debt China's Achilles Heel? The Belt and Road Initiative (BRI) and the Internal Debt Trap

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*China's credits to various countries along its much-discussed Belt and Road Initiative (BRI), the most ambitious infrastructure undertaking in history, have recently been criticized for drawing poor countries into a debt trap by extending huge credits. Myanmar is often cited, as well as Sri Lanka. Malaysia and Pakistan are renegotiating multi-billion-dollar projects of previous regimes.*

*What is not widely being examined however, is whether there is a danger that the China economy itself is vulnerable to a far larger debt trap, one that could spell trouble for the BRI project itself as well as for the unprecedented four decades of booming China economic growth. Could it be that debt is becoming China's Achilles Heel?*

The state of the Chinese economy is likely far graver than its leaders are admitting. The cause is not the effect of the US trade war. Rather it's the structure of a debt-driven growth that has defined the unprecedented rise of China to a world economic power second only to the USA. **What is called "socialism with Chinese characteristics" looks more and more like the Western debt-collapse model on steroids.**

At the heart of the current problem is **China's home real estate debt market.**

A debt trap is defined as a situation where a borrower takes on new debt to repay existing debt to a point where the terms of the original debt have drastically changed for the worse and default looms. During the Alan Greenspan US sub-prime debt bonanza more than a decade ago, millions of Americans took out loans, often with little bank checking, in a securitized mortgage market where home prices were rising so fast many believed they couldn't lose. Until the bubble burst in early 2007.

In China over the past decade or more, a rising middle class began to realize for the first time they could buy goods never before possible. The American and European cars their labor produced were the first big consumer purchase boom. Over the past decade and more, that consumption has shifted to buying a home or apartment in one of China's many growing cities. Much of the financial credit for the housing construction boom has come from unregulated local finance vehicles, a form of shadow banking, as the large state banks were tightly controlled.

By the beginning of 2018, after repeated efforts to rein in the exploding shadow banking, the size of shadow banking had risen to an alarming $15 trillion. At least $3.8 trillion of that was in the form of so-called trust funds that drew savings from ordinary Chinese citizens to invest in local government projects or in housing construction. Much of that was tied to the huge state-owned banks but in the form of investment vehicles that were off-balance sheet.

A 2015 World Bank report on China shadow banking attributed the explosion of shadow banking and a Chinese consumer real estate boom to the government's near panic reaction to the September 2008 global financial crisis. In a complex chain of events, State Owned Enterprises, awash with liquidity, began lending to local governments for real estate construction among other projects. The Chinese housing boom was on. Increasingly shadow banking was involved to conceal the extent of the local activity from regulators.

The housing bubble or boom really took off in 2015 when Beijing, for reasons not totally clear, initiated several steps to stimulate housing construction to try to revive its economic growth. Until then real estate prices had been somewhat stable. The new government measures led to rapid doubling of home prices in major cities or more. Added changes allowing monetization of the renewal of older shanty houses fed the post-2015 property boom.

By 2017 the internal shadow banking growth in China, much tied to this property boom, drew the increasing concern of the PBOC and the Beijing government. The World Bank estimated that all shadow banking had grown from 7% of GDP in 2005 to 31% in 2016. A 2018 report of the Basel Bank for International Settlements' Financial Stability Board estimated there were at least $7 trillion in risky shadow bank loans outstanding in China. If the economy slows significantly or goes into recession, that could become a huge problem.

**Mortgage Market Saturated**

In the course of a decade, from 2007 to 2017, China household debt grew tenfold, from around 5% of the total GDP to some 50% of GDP. The vast portion of that is home mortgage debt.

But the home buying boom could be near saturation. It has been estimated that some 61% of Chinese people live in homes less than 10 years old, an impressive figure. According to Chengdu's Southwestern University of Finance and Economics China's rate of private property ownership is 89.68 per cent. That's among the highest in the world. Two decades ago that figure was near zero.

Much of that real estate is financed via local governments and their so-called Local Government Financing Vehicles. In an October, 2018 report, S&P Global Ratings reported that the off-balance-sheet borrowings of local governments could be far higher than admitted, as much as $5.8 trillion, calling it "a debt iceberg with titanic credit risks," that could take a decade to resolve. A major share, no one knows precisely, is tied to the housing boom that is now decelerating as households feel the high debt burdens of their new homes and a slowing economy.

Complicating the problem and more or less insuring that housing will not lead the slowing Chinese economy to renewed growth, is the fact that while Chinese disposable income has grown at an average annual rate of 10 percent for the last six years, household debt — most tied to housing — has grown at an average rate of 20 percent a year.

Recent moves by Beijing authorities to try to control the further development of a US-style housing mortgage bubble and potential crisis, add to the huge problems facing the Beijing government of Xi Jinping. So long as home values were soaring, there was little cause for alarm. China's property market has been the "single largest driver" of the increase in Chinese wealth, with an estimated market rise in value to Chinese households of some $12 trillion since 2010.

Now, in recent months, however, the overall economy is slowing significantly. Some Chinese economists have recently suggested that rather than the official government GDP growth of 6.5%, reality might be less than 2% or even negative.

That is impacting the housing market where sales of existing homes in 10 major cities fell to a four-year low in October. Further, alarm over growth of a vulnerable housing bubble recently led Xi Jinping to warn that houses are for living not speculation.

China's total debt, government, corporate, household, almost doubled between 2008 and mid-2017, to 256% of GDP, while by official data the economy slowed down from double-digit growth to a mere 6%. This explains the growing concern in Beijing over how to bring China to become a world-class industrial power in such schemes as Made in China 2025. That, however, is precisely the issue that the Washington trade war is intent on changing.

For an economy the great size of China with growth slowing and overall debt rising, the trajectory is not good, barring a radical rethink. Recent proposals to stimulate economic growth via infrastructure investment are limited as already more miles internally of high-speed railways exist. So far projects for urban subway and tram lines are on line, along with prioritizing China's controversial 5G telecom rollout.

China has one advantage lacking in the West. **Its debt is mostly internal and its central bank and major banks are all state-owned.** That means they have the possibility of wiping all or some of the debt slate clear, in theory. The problem is that would make China a pariah for international capital investment, with huge impact on the ability of its Asia Infrastructure Investment Bank and the state banks to win the funds to finance the ambitious BRI or other projects.

If we include a dramatic ageing crisis developing as a result of decades of their one-child policies, China may have passed its peak growth period several years ago. How its leaders and economists, many of them educated in US or UK universities in flawed free market ideology, will deal with this, is a challenge that will exceed that of the rapid industrialization since China's entry into the WTO. For the stability of the world economy as well as China let's hope they are up to the challenge.

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