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CHINA'S MASSIVE DEBT v1

China has a $28 trillion problem. That's the country's total government, corporate and household debt load as of mid-2014, according to McKinsey & Co. It's equal to 282 percent of the country's total annual economic output.

President Xi Jinping's government aims to wind down that burden to more manageable levels by recapitalizing banks, overhauling local finances and removing implicit guarantees for corporate borrowing that once helped struggling companies. Those like Baoding Tianwei Group Co., a power-equipment maker that Tuesday became China's first state-owned enterprise to default on domestic debt.
Now hold that thought, and consider this: China's also trying to prop up a $10.4 trillion economy that's decelerating and probably will continue to do so through 2016, or so says the International Monetary Fund.

The economy expanded 7 percent -- the leadership's growth target for this year -- in the first quarter, the weakest since 2009 and a far cry from the 10 percent average China managed from 1980 through 2012. Against this backdrop, a barrage of recent policy moves out of China in recent days comes into sharper focus. It also helps explain why various parts of the government don't always seem to be working from the same playbook.

"There's obviously a contradiction between attempts to deleverage the economy and attempts to boost growth," said Dariusz Kowalczyk, a senior economist at Credit Agricole SA in Hong Kong who's covered emerging Asia for a decade and used to work at the Chicago Mercantile Exchange. "There's a trade-off. China will focus on deleveraging as long as growth meets its target but if growth slows excessively then they will refocus."

Mixed Messages
On April 17, securities regulators clamped down on margin lending that has helped fuel epic stock market rallies in Shenzhen and Shanghai over the last year.
Three days later, officials unleashed about 1.2 trillion yuan ($194 billion) into the economy -- and stock markets -- by cutting the level of deposits that banks need to hold in reserve with the central bank. For large lenders, the reserve requirement was lowered a full percentage point, to 18.5 percent, the PBOC's most aggressive such step since 2008.

In a separate move, the People's Bank of China injected a combined $62 billion worth of capital into two state-owned lenders that are referred to as policy banks, as they carry out government objectives, a Caixin magazine report showed.

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Roll Over

Also in recent weeks, China's Premier Li Keqiang has urged banks to support economic growth and roll over loans when needed to key borrowers.

That call didn't apply to Baoding Tianwei, which suffered losses last year amid a glut of investment in the solar-energy industry. Nor to Kaisa Group Holdings Ltd., which on Monday became the first Chinese property developer to default on dollar debt. Kaisa's delinquency on $1 billion of bonds served as a reminder of the risks for overseas investors -- Chinese companies have $275 billion in dollar-denominated bonds outstanding, according to data compiled by Bloomberg.

Ying Wang, a credit analyst with Fitch Ratings in Shanghai, sees more defaults ahead for "non-strategic, commercially unviable SOEs." Such events may help "instill greater market discipline and reallocate capital more efficiently within the economy," she wrote in a statement published Wednesday.

Market Calm

For many observers, the defaults are the logical outcome of companies piling on excessive debt year after year. Financial markets, lubricated by the PBOC's actions, took the incidents in their stride: the main Shanghai stock index touched a seven-year high Wednesday and the benchmark money-market rate dropped.

The question is whether the calm remains as a weakening economy makes it harder for borrowers to service interest payments and the government gets more tolerant of some companies going under in crowded sectors such as real estate, steel and cement production.

"China is moving to a new model where the check is not blank anymore," said Chi Lo, a senior strategist on China at BNP Paribas Investment Partners in Hong Kong. "It will be controlled and measured -- large companies won't be allowed to fail. Small private and state companies in sectors with excess capacity will fail."

More Coming

Another source of coming failures may be banks themselves, at least smaller ones. Among regulatory overhauls in train is a deposit-insurance program and ending a cap on deposit rates that effectively subsidized credit and punished savers. The deposit-rate ceiling may be abandoned this year and deposit insurance, a vital prerequisite, is scheduled to start May 1.

Putting depositor safeguards in place would allow for bank failures without stoking the kind of panic that spurred almost 1,000 customers to rush to outlets of Jiangsu Sheyang Rural Commercial Bank last year amid rumors the lender might go bust.

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Moving toward a financial system where risk is more accurately priced and defaults tolerated is also crucial to the government's fiscal overhaul of debt-besotted local governments.
In March, China's Finance Minister Lou Jiwei unveiled a plan letting local governments swap 1 trillion yuan of existing high-interest borrowing for lower-cost municipal bonds. In future, local authorities will also issue bonds directly rather than relying on off-balance sheet financing vehicles.
Local authorities will issue at least 1.6 trillion yuan of notes this year, four times as much as in 2014, according to Ministry of Finance estimates.

Fair Pricing
Getting investors to soak up that supply will be easier if bond prices are viewed as fairly priced, with less credit-worthy local issuers paying a higher interest rate than sound ones.

"The biggest hurdle doing the debt swap is moral hazard," said David Cui, head of China equity strategy at Bank of America Corp. "Without significant pain suffered by the local government and lenders, it is hard to instill discipline into local-government borrowing and lenders' risk assessments."
As policy makers in Beijing complete the strategy, regional governments are struggling to find cash to keep building roads, metro systems and water works. A slump in investment is a big reason behind the economy's slowdown.

All this explains why cleaning up the debt mess matters. With $3.73 trillion in foreign currency reserves, China has the financial resources to handle any future bank bailout or economic stimulus if need be.
Even so, if borrowing levels keep rising, at some point the country's ability to both roll over existing credit and fund new projects will get tapped out. That's not a good place to be for a one-party state with huge inequality and still-considerable development needs.

"The only hope of deleveraging the economy successfully is to redirect lending away from inefficient SOEs towards private firms," said Michael Spencer, chief Asia Pacific economist at Deutsche Bank AG in Hong Kong.