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Can China shield its economy from the impact of COVID-19?

EXECUTIVE SUMMARY

China will likely miss its 2020 growth target due to the impact of the coronavirus pandemic on the global economy. Although the government is taking proactive measures to limit the impact of this shock, an increase in corporate insolvencies and structural fragilities is unavoidable.

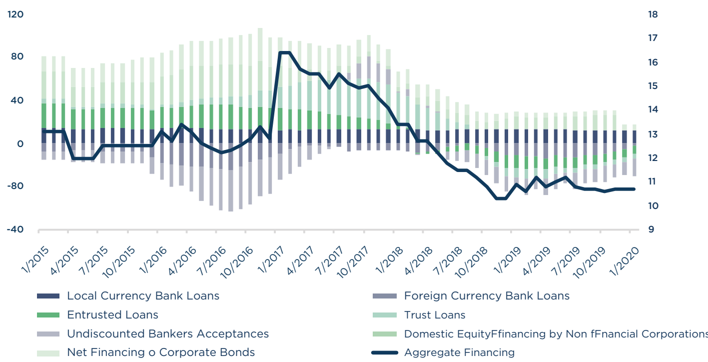
The Communist Party of China (CPC)'s government is hoping to achieve a moderately prosperous society before its 100th anniversary in 2021, requiring approximately a 5.6% growth rate in 2020. However, the coronavirus (COVID-19) pandemic will add significantly to existing growth headwinds, such as the US-China trade war, structural factors and demographics. While the government appears to remain confident regarding their 2020 targets, it is likely these will have to be postponed until July 2021: the spread of COVID-19 to key markets in Europe and North America (30% of total exports) will drag on activity throughout the second and third quarters of 2020. As a result, Coface expects China to achieve a growth of only 4.0% in 2020.

China will resort to aggressive monetary and fiscal easing to achieve stabilization, but these will come at a cost. For instance, foreign exchange (FX) reserves are not sufficient to cover outflows, and this may exert depreciatory pressures on the Chinese yuan. On the fiscal front, additional infrastructure investments will add to indebtedness at the local level, resulting in pressures on the banking sector and highly indebted corporations. Increases in bond defaults and corporate insolvencies are likely, as are restructuring efforts in the banking sector. Given the delicate balance that will be required, the chance of a policy misstep is higher than ever.

No "V-shaped" stabilization: China could miss growth targets

China's economy is expected to be hardly hit by the direct and indirect impacts of the COVID-19) pandemic and decelerate to the slowest pace in 30 years. Specifically, the large scale lockdowns and capacity closures that started in China the first quarter (Q1) of 2020 have escalated rapidly, spreading around the world. The Chinese Academy of Social Sciences estimates that the exogenous shock could have cost the Chinese economy up to USD 40 billion in February alone. However, this estimate does not price in indirect impacts or negative spill-over effects to other parts of the world. Activity indicators for the period of January-February 2020 point to a faster-than-expected contraction in Q1 **(Chart 1)**, with industrial production, retail sales and urban fixed asset investments (FAI) contracting for the first time in recorded history. Moreover, it will become harder for China to steer its economy out of this slump. First of all, the economy is structurally slower, a trend that is linked to the country's shift towards a more sustainable consumption-led growth model. This is imperative, as China also faces demographic headwinds (15% of the population over the age of 65). In addition, the trade war between China and the United States (US) will remain a drag on growth. Despite the optimism surrounding a "Phase-1" deal announced on 15 December 2019, average tariff levels on USD 250 billion worth of Chinese exports to the US remain at a record high of 19% compared

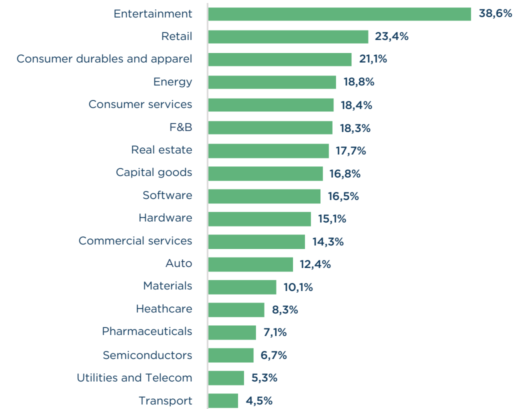
CHART 5
Outstanding total social financing and GDP growth



Source: PBoC, Bloomberg and Coface

CHART 6
Percentage of Chinese listed companies with EBITDA / Interest Expense below 1

Source: Bloomberg and Coface



in 5G network infrastructure, high-tech and welfare[14]. Nevertheless, many local governments will be cautious about issuing bonds, as pressures have started to emerge regarding local government debt sustainability.

Officially, government debt is equivalent to 40% of GDP. However, it could be much larger if the vast amount of debt that is off balance sheet and tied to Local Government Financing Vehicles[15] (LGFVs), as well as other forms of shadow financing, are taken into account. While this amount is unknown, the IMF estimates that the actual level of government debt could be in the range of 60% of GDP[16]. Several LGFVs have defaulted on CNY denominated debt in the past years, but Qinghai Provincial Investment Group defaulted on USD denominated debt in February 2020, the first instance in 20 years.

Higher credit risks for some Chinese companies

Monetary and fiscal stimulus will exacerbate credit risks for Chinese companies. This is a problem in case the sector is already struggling with high levels of indebtedness and stress in debt service. To measure this, we consider the percentage of listed companies with EBITDA[17] to interest expense ratios below one. When a company's earnings are insufficient to cover interest payments on its debt, the company is considered to be dependent on external sources in order to secure access to working capital. According to the latest financials from listed companies compiled by Bloomberg[18], some sectors and sub-sectors may be more at risk than others **(see Chart 6)**. Sectors that are traditionally dominated by SOEs featured a smaller proportion of companies reporting cash flow risks. These include utilities, telecommunication providers and materials (including chemicals and metals). The role of SOEs in the market has strengthened under President Xi Jinping, so this is not entirely surprising. On the contrary, sectors with a predominance of private firms and SME's experienced cash flow risks last year, so might be more vulnerable to a sudden correction in funding conditions in 2020 (entertainment, retail, consumer durables – including consumer electronics and apparel – and consumer services). The transport sector was supported by a combination of state subsidies (a large proportion of SOEs in this sector) and a surge in passenger numbers in the last year. However, this trend is likely to reverse sharply given the steep decline in passenger trips in Q1 2020, with IATA reporting a -80% YOY decline in the aviation industry alone.
Cash flow risks are likely to intensify further in 2020. This trend is in line with an increase in bond defaults and a record surge in corporate insolvencies since 2014. Bond defaults reached USD 12 billion in 2019 and are expected to accelerate rapidly because of headwinds to growth in 2020. The same is true for insolvencies, which surpassed 8000 cases in 2019, from 6700 in 2018. Lastly, given the delicate balance that policymakers will have to maintain in 2020, the likelihood that a policy misstep could result in a systemic shock to the Chinese economy is higher than ever.

14 - The State Council of The People's Republic of China (2020).《习近平主持中共中央政治局会议 研究新冠肺炎疫情防控工作 部署统筹做好疫情防控和经济社会发展工作. *Available at: http://www.gov.cn/xinwen/2020-02/21/content_5481871.htm*
15 - LGFVs are special purpose vehicles (SPVs) set up by local governments to evade regulatory borrowing restrictions on raising capital for infrastructure projects.
16 - IMF (2019). 'People's Republic of China: 2019 Article IV Consultation'. International Monetary Fund. Available at: *https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Peoples-Republic-of-China-2019-Article-IV-Consultation-Press-Release-Staff-Report-Staff-48576*
17 - Earnings before interest, taxes, depreciation, and amortization.
18 - Bloomberg figures use GICS industrial classifications, which are different to Coface sector definitions.

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