Is China's Debt Load the Locus of the Next Crisis?

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A reader of this blog recently noted the magnitude of the debt problem in China and argued it will be the locus of the next debt-financial crisis–not Europe. Making good points in support of his view, my reply follows arguing it is not the magnitude of the debt load that is, by itself, key. True, the quantity of debt–and the quality of that debt–are important. But the ability to 'service' that debt (paying interest and principal when due) is just as critical. And that ability to 'service' in turn depends on the assured cash/near cash assets available, which depends on maintaining price levels and sales levels (i.e. revenue) and returns on near cash assets in order to make the payments. The various terms and conditions associated with the servicing may also be critical (i.e. can the borrower roll over the debt, what's the interest rate and term structure of rates, can it legally suspend payments, are the covenants that relieve payments generous or not, etc.

Here's the reader's notable comments and my reply:

The Reader's Comments on China debt:

> I came across some of your writings and been reading for a few hours… I am curious to know why you seem to be thinking the financial crisis isn't coming from collateral shortage in Eurodollar Markets? Since baoshang 30 % haircuts, AA bonds no longer accepted, AAA 2 to 1 value only sovereign bonds accepted at face value in china repo. Eurodollar markets seem to want Sovereign Bonds and stopped accepting HY Bonds, Gold furious bid indicates Collateral problems, Gold collateral of last resort in money markets.
>
> European banks are the starting crisis point, due to Trillions in USD loans to EM's and china china has 3.5-4 Trillion US bond issuance, on paper borrowing 100 Bil USD + a Quarter… Then add 250 Trillion + of derivatives between Big 9 of New York and EU, the biggest financial collapse the world will ever see. China is the catalyst by far right now, they make Wall St look noble. Their 10 year isn't being bid much which indicates serious cash flow problems in their banks, while every other sovereign bond in the world is being full blown bought, money dealers and banks running towards liquid and accepted collateral, credit cycle is done… Baoshang sealed it, no way European banks are making it out, Chinese collateral is bunk, not worth much and big haircuts, PBOC isn't gonna cover much on foreign debt… Hengfeng bank failing now, 16 more to go.
>
> I think you are hell bent on America and the " Establishment " but give credit where it's due… China was the biggest cause to Inflation in this cycle, they will be the biggest cause to deflation, gravity Jack… What goes up, always comes down
>
> Please let me know your thought process behind China not being the catalyst given they accumulated close to 80 % of world's debt in this cycle (Corporate,

Local Gov, Household and Central Gov)… Price Per Income is 45-50 in Tier 1's, their income to mortgage average in the country is 330 %, it doesn't make sense the amount of leverage, everybody is indebted to their eyeballs with over 100 Trillion Yuan in shadow banking loans to consumer, their Consumption GDP is the lowest in the world in net terms, highest investment GDP in the world… I don't get how you think they are even growing at 4 %, with debt servicing they are negative growth, M1 growth is horrendous in China

My Reply:

Indeed, China debt is extremely high, in all sectors, government, household, etc. But debt magnitudes are not the entire picture when it comes to an asset crash. Servicing of the debt is key, and in turn price levels and revenue from sales of output which generate the income with which to service the debt. When debt servicing reaches a point where income is insufficient and then defaults occur, that's the threshold to watch. China has shown its willingness, and has the resources, to absorb defaults. Also, it can respond quickly before the expectations of creditors deteriorate too far, and they precipitate a general asset price collapse that begins to snowball. The US, EU, Japan-S.Korea can't respond as quickly as China might. Also, China is still growing, although far more slowly than reported. That growth generates income for debt servicing. In contrast, Europe is not growing at all, hasn't really since 2009, and has never really recovered from the 2008-09 and 2011-13 crises. Its bank lending is still mostly flat. Money capital keeps flowing offshore. Central banks' QE has not gone into real investment in Europe but has been diverted elsewhere. Negative rates have not proven effective in stimulating bank lending in Europe. Non-performing loans totals are very large. QE has failed miserably and it will again when they try it again soon. In contrast, China can turn to boosting government investment quickly in lieu of revenue from exports now slowing because of the global trade slowdown and US trade war. Europe cannot or will not seek to offset its exports slowdown with government direct investment as an alternative. Its bankers driving policy and the Euro system have structured austerity systemically. It's therefore far more dependent on export revenue but the global slowing of manufacturing and exports means less 'income' from revenue with which to service debt.

In short, my point is that magnitude of debt is not the only determining variable of financial fragility and instability and eventual financial crashes. Excessive debt levels and leverage are necessary conditions for a crisis, but the quality of that debt, the ability to service it, the means and willingness of government to avoid or cut short defaults preventing contagion, etc., are all important.

Read my equation in the appendix of the Systemic Fragility in the Global Economy book written in 2016. It considers the role of debt in relation to ability to service the debt and the numerous terms and conditions and covenants that may be associated with debt servicing.

I'm currently developing these equations further, using neural network data analysis to determine the actual multiple causal relations between government, household, corporate, bank debt as well as, within each of these sectors of the economy (government, household, business), the degree of causality between debt levels, quality of debt, income available to service the debt, and terms and conditions of debt financing.

But you're right, the situation in China is worse than it appears. But so is Europe even worse. China debt may be higher in absolute terms, but Europe's debt servicing ability, after eight years of double dip recession and near stagnant growth (what I call an 'epic' recession that still continues), is weaker than China's ability to ensure debt servicing and thus avoid defaults contagion that sets off a general financial asset price crash. And let's not forget EMEs like Argentina, Turkey, Pakistan, as well as India which has a very serious problem with its shadow banks. Their debt servicing ability may be even weaker than Europe's.

I think the crisis will involve feedback effects between Asia (China, India, Japan) and Europe and EMEs. Where it first erupts is important. I'm leaning toward Europe as the initial focal point, although I could be wrong.

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Dr. Jack Rasmus is a frequent contributor to Global Research.

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