Excessive Concerns Ease while Slowing Investment Continues to Weigh on Economy

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China's economic deceleration, which was triggered by a slowdown in investment activity, has persisted, but recent economic indicators appear to be improving and over-concerns have been easing. The monthly economic indicators—for August—shows that the Manufacturers' PMI stood at 50.4, the first time above 50 in three months, and industrial production accelerated slightly to +6.3% YoY (versus +6.0% YoY in July). Fixed asset investment (year-to-date, for urban areas) also continued to rise, by +8.1% YoY (Table 1). Fixed asset investment was also weighed down overall by slowing investment in mining and heavy industries, while investment in infrastructure including railroad and road supported overall spending.

Looking ahead, increased infrastructure investment and private consumption are expected to support China's economy, but there is still considerable room for surplus capital stock and debt to correct, and slowing investment—particularly in heavy industries—is likely to continue to weigh on the economy. The Government has indicated it will focus more on cutting excess production capacity by monitoring progress at the local level and stiffening penalties in 2H as part of its economic policy management strategy. President Xi Jinping showed his resolve to cut excess production capacity in the steel and coal sectors at the G20 meeting in early September in Hangzhou.

Non-performing loans held by commercial banks continue to rise, but official figures are still low, at just RMB1.4 trillion (1.75% NPL rate, as of end-June). The figure would stand at RMB4.8 trillion (5.8% NPL rate) if loans classified as Special-mention Loan are included. However, financial data of listed companies shows that companies with negative after-tax cashflow hold approximately 10% of total debt (Table 2). Based on this 10% calculation, we estimate that debt that could possibly be irrecoverable actually stands at RMB12 trillion. This estimate includes only listed companies that are believed to be in relatively good financial condition, and on a macro scale (including unlisted companies), debt in danger of non-collection could balloon even more. Banks have been addressing NPLs by using profits to build up reserves and selling non-performing assets to asset management companies, as well as through securitization of loans. However, once companies start reducing excess capacity and debt faster, the downward pressure on the economy could weigh even more.

Table 1: Main Economic Indicators (China)

	2016					
	Mar	Apr	May	Jun	Jul	Aug
Exports (YoY, %)	9.3	-3.5	-5.5	-5.3	-5.4	-2.8
Imports (YoY, %)	-7.9	-11.1	-0.4	-8.4	-12.5	1.5
Fixed Assets Investment (YTD, YoY, %)	10.7	10.5	9.6	9.0	8.1	8.1
Retail Sales (YoY, %)	10.5	10.1	10.0	10.6	10.2	10.6
Industrial Production (YoY, %)	6.8	6.0	6.0	6.2	6.0	6.3
Manufacturing PMI	50.2	50.1	50.1	50.0	49.9	50.4
Non-manufacturing PMI	53.8	53.5	53.1	53.7	53.9	53.5

Note: 1) Manufacturing PMI and Non-manufacturing PMI are from China National Bureau of Statistics.
2) Shadowed portion indicates lower growth rates or decline in indicators from previous months.
Source: China National Bureau of Statistics, BTMU

Table 2: Potentially Risky Debts(as of end-2015)

Industry	Number of Entities	Debt (RMB billions)	Number of Potentially Risky Entities	Potentially Risky Debts (RMB billions)	Potentially Risky Debts (%)
All entities	2,893	8,831	205	913	10.3
Mining	76	1,105	16	63	5.7
Coal mining	27	363	7	38	10.4
Manufacturing	1,881	2,806	170	506	18.0
Non-manufacturing	936	4,920	n.a.	343	7.0

Note:1) *Potentially Risky Entities* refers to the ones which run a deficit in after-tax profits in 2015.
2) *Potentially Risky Debts* refers to the debts held by potentially risky entities.
Source: Financial statements of each company

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