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China has its eye set on both economic recovery and structural reforms

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China is recovering nicely from the COVID-19 pandemic compared with major developed countries. According to the monthly indicators for November, retail sales continued their recovery, rising 5.0% YoY, and growth of investment in fixed assets (total since January) accelerated from the previous month to 2.6% YoY.

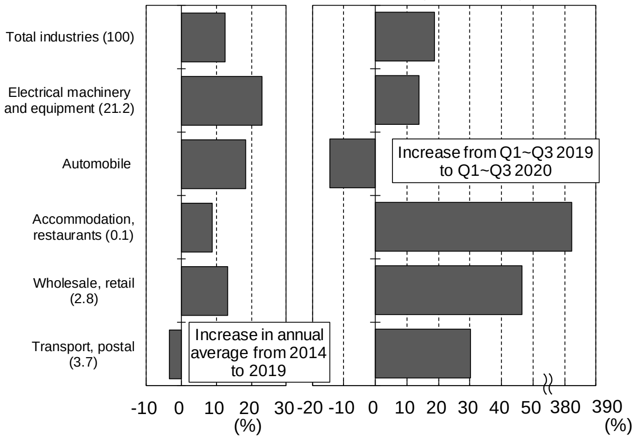
The reason for this recovery is the success China has had in curbing the spread of COVID-19 domestically as well as economic policies enacted by the government. There were many industries where the amount of subsidies received between January and September increased year on year; subsidies to the accommodation and restaurant industries, which had been heavily affected by the COVID-19 pandemic, increased by close to five times from the previous year and it appears the subsidies have supported funding and the continuation of businesses (Chart 1).

The Chinese economy has achieved a recovery whereby it could be described as the “sole winner” globally due to its success in curbing the spread of infection and the government’s policies; however, the current rise in defaults on corporate bonds is concerning. The number and value of defaults on corporate bonds was low before 2017, but they rose in 2018 owing to deleveraging and the growing conflict between the US and China and, in 2020, there was a marked increase in corporate defaults among state-owned enterprises, which up until that point had been relatively low (Chart 2). Previously, it is said state-owned enterprises could receive financing from banks and stave off defaulting thanks to an “implicit government guarantee”, namely the expectation that they can get support from the government even when they found themselves in a difficult situation. However, it appears this also led to problems – the financial discipline of state-owned enterprises has declined, and it is easy for enterprises to overextend themselves. The Chinese government has been working to correct this as part of its structural reforms since around 2014, but with the emergence of the unprecedented crisis caused by the COVID-19 pandemic, it is possible that there will be a sharp rise in the number of defaults among state-owned enterprises.

Correcting “implicit government guarantees” is necessary to curb excessive borrowing and investment, and the government’s tolerance for defaults by state-owned enterprises could be optimistically interpreted as a demonstration of the government’s strong will to carry out structural reforms which also take into account a prolonged conflict between itself and the US.

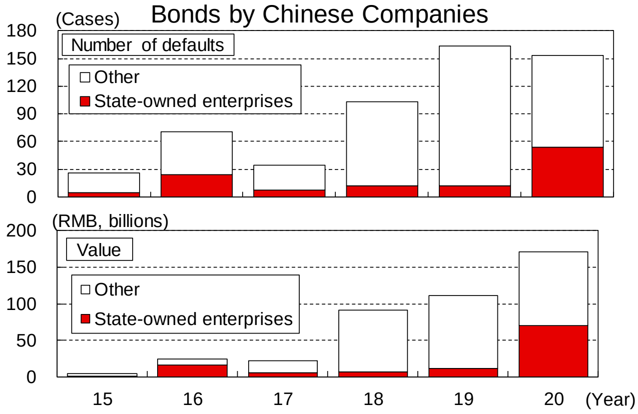
That being said, there is an undeniable possibility this will put downward pressure on investment as defaults by state-owned enterprises will dampen investors' appetite for investing in bonds, which will make it difficult for companies to raise funds. Although the Chinese economy is recovering from the COVID-19 pandemic at a relatively quick pace, it will be important to keep an eye on whether this rise in defaults acts as a weight on the Chinese economy.

Chart 1: China's Subsidies by Industry



Note: Sum in brackets () denotes percentage of total
Source: WIND, MUFG Bank Economic Research Office

Chart 2: Number and Value of Defaults on Corporate Bonds by Chinese Companies



Note: 1. Reflects data as of 23rd November
2. There are cases where multiple items are recorded for one company
Source: WIND, MUFG Bank Economic Research Office

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