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Debt and Financial Crisis: The Case of China

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Abstract: In recent years, the economy of all the countries in the world has been developing rapidly, and the economy has been affected for some reasons. Using China as a case study, the swift advancement of its economy has led to a myriad of challenges. One of the serious problems is that the debt-to-GDP ratio is rising year by year, which has raised concerns about whether China will fall into a financial crisis as a result. This paper analyzes the relationship between debt and financial crisis, and analyzes and thinks about the current debt situation in China. Combining past studies and analyzing China's debt situation, we can make a judgment on China's future. Using China as a case study, alongside the circumstances of other nations like Japan and the United States, the author assesses the prospective trajectory of global developments.

Keywords: China's economy, Debt situation, Financial crisis.

1. Introduction

In recent years, the swift expansion and advancement of China's economy have garnered significant global attention. Nevertheless, an escalating concern lurks beneath this remarkable narrative of growth. China's rising debt-to-GDP ratio. This worrying trend raises questions about the sustainability of China's economic model and whether it has the potential to trigger a financial crisis in the future. An important concern is that the rapid build-up of debt could pose a significant risk to China's financial stability. China has experienced a significant increase in corporate borrowing, local government liabilities, and shadow banking operations, all of which have led to escalating debt levels. Furthermore, a rise in non-performing loans within China's financial sector, particularly among smaller banking institutions, has intensified apprehensions. At the same time, China's closed policy during the COVID-19 epidemic has also had a huge impact on the Chinese economy.

Under the influence of various factors, China's debt problem is becoming increasingly serious. And this problem is not only the existence of China, looking at the world, Japan, the United States, and other developed countries also have relevant problems. This study will focus on China as the primary subject of analysis, integrating insights from prior research in finance and economics alongside China's debt statistics. The objective is to examine the correlation between debt levels and financial crises, while also making forecasts. Additionally, the analysis will consider the global context to assess the severity of the current issues at hand.

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2. Literature Review

2.1. Debt and the Financial Crisis

Before discussing whether China's debt will cause a financial crisis in the future, people should first understand how debt affects financial crises. The relationship between high and rising debt levels and potential financial crises, while complex, has been documented by historical events. While debt can be an important tool to finance growth and investment, it can also become a significant risk when it reaches unsustainable levels. When debt levels surpass economic growth and borrowers face difficulties in fulfilling their obligations, it can trigger issues that may culminate in a financial crisis. These challenges encompass loan defaults, diminished consumer and business expenditure, declining asset values, and instability within the banking sector.

[1] In the article Debt and Financial Crises by Koh et al., the authors study debt accumulation episodes in 100 emerging markets and developing economies since 1970. Since 1970, there have been over 500 instances of debt accumulation, with approximately half linked to financial crises. Typically, eight years post-crisis, per capita output has been observed to be 6-10% lower during these crises and 15-22% lower in terms of investment.[2] It can be seen that debt significantly impacts the entire market and economy, and it is possible to cause a financial crisis.

2.2. Regulatory and Policy Frameworks

Document No. 35 has played a key role in the management of local government debt in China, and its introduction marks a strict regulatory measure on the growth of local government debt. The policy framework categorizes local government financing entities and constrains their funding capabilities based on their economic circumstances and operational characteristics, aiming to foster a more sustainable financial ecosystem within each province.[3] Document 35 aims to prevent excessive borrowing and fiscal imprudence by local governments by setting clear borrowing limits and financial management requirements, which have often led to significant financial stress and the risk of default in the past. This targeted management strategy not only limits unnecessary financial risks, but also encourages local governments to adopt more efficient and effective financial management practices. Furthermore, the document enhances fiscal transparency and accountability by mandating local governments to implement more stringent reporting and oversight of their debt levels and financial operations. This approach aims to elevate management quality and avert the buildup of unreported debts, thereby safeguarding the stability of the overall financial system.

3. Global and China

3.1. The Global Economy and the Debt Situation

Globally, governments increasingly rely on debt financing to stimulate economic growth, manage crises such as COVID-19 pandemics, and fund public services. This trend has led to a rise in debt-to-GDP ratios in many countries, much like China’s.

Debt levels have risen sharply in developed countries such as Japan and the United States. Despite high debt levels in these countries, borrowing costs remain low because they have strong institutional frameworks and monetary policy tools to manage economic impacts. In the case of nations like Brazil and India, they have also amassed significant levels of public debt. Nevertheless, the associated risks are heightened due to fluctuations in exchange rates and the potential for capital flight, which could exacerbate their debt-servicing obligations and worsen economic conditions.

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3.2. The Current Situation of China's Debt Growth

In recent years, the external debt situation of low- and middle-income countries has not been optimistic, especially in China. The recently published International Debt Report by the World Bank indicates that debt service obligations (comprising both principal and interest) for developing nations rose by 5% relative to the prior year. Approximately 60% of low-income countries are confronted with significantly elevated debt risks or are currently experiencing debt distress[4] Under the premise that the overall debt situation of developing countries is not optimistic, China, as the largest developing country, has an even more worrying debt situation. "Aggregate financial flows to China turned negative in 2022 for the first time since 2015, resulting in an outflow of US$103 billion, a marked contrast to the decade-high inflow of US$728 billion in 2021", In 2022, China's gross national income experienced a growth of less than 1 percent, marking one of its most significant downturns in decades. This decline can be attributed to prolonged COVID-19 lockdowns, severe weather events, and a notable contraction in the real estate sector. Additionally, the pace of China's external debt accumulation saw a marked deceleration during the same year[5] This is the World Bank's original text on China's recent foreign debt situation. It can be seen that China has a huge and historic problem with its foreign debt.

Furthermore, as indicated by the Global Debt Monitor published by the Institute of International Finance (IIF), the debts of China's households, non-financial corporations, government, and financial sector collectively represent four distinct categories in relation to GDP[6] All are above the global average. In non-financial corporations, the ratio of debt to GDP is as high as 166.9, second only to Hong Kong. If Hong Kong is not counted separately, China's Non-financial corporates' debt to GDP ratio is the first in the world, and Government debt to gdp ratio is among the top five in the world. From this point of view, China's debt problem is very serious, and cannot be ignored.

3.3. Local Government Debt - Banking and Real Estate Markets

Local government debt has emerged as a critical source of systemic risk, with its impacts rippling through both the banking sector and real estate markets. This interdependence is particularly pronounced in China, where local authorities heavily rely on land concessions and real estate-driven revenue streams as core components of their fiscal strategy. The foundation of this dependence lies in China's decentralized fiscal framework, which imposes significant spending responsibilities on local governments while simultaneously limiting their ability to generate revenue [7] Consequently, local administrations frequently resort to land sales and real estate-related taxes to sustain public financing needs, entrenching a dependency that embeds real estate market dynamics deeply within the financial stability of local governance. The structural reliance on these volatile revenue sources elevates the risk of fiscal fragility, exposing local government debt to external economic shocks with systemic repercussions.

This unstable financial balance makes local governments, and consequently the banking sector, especially susceptible to declines in the real estate market. A notable drop in property values can initiate a series of financial disruptions, jeopardizing the ability of local governments to service their debts and reducing the asset values in banks' loan portfolios, considering their substantial investments in real estate projects and land financing. Furthermore, the interlocked nature of these sectors amplifies the risk, as banking institutions, heavily vested in real estate-backed securities, face increased exposure to defaults and liquidity constraints. Such circumstances present extensive systemic threats, as the intersection of public debt dependence on real estate and the banking sector's vulnerability to land-based assets generates a feedback mechanism that could undermine regional economic frameworks and diminish national financial stability.

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3.4. Inferences about the Financial Crisis of China

Through the above analyses and data surveys, it is easy to see that China already has major problems with its published manifest debt. The Growth and Stability Pact, introduced by the European Union in 1997, established that a debt-to-GDP ratio exceeding 60 percent is considered a critical threshold. However, in 2020, the EU revised this limit from 60 percent to 100 percent[8] Nevertheless, China's stated debt-to-GDP ratio exceeds 140 percent. While this figure aligns closely with that of the United States and remains below Japan's staggering 260 percent, the concerns surrounding China's concealed debt are far more alarming. Incomplete data suggests that the hidden debt of local governments in China could be twofold or even greater than the officially recognized debt[9] This indicates that China's debt-to-GDP ratio could surpass 400% when accounting for concealed liabilities. This statistic is quite concerning and poses significant risks. Debt cycles that transition into a contraction phase are susceptible to economic crises or prolonged periods of deleveraging. [10] Therefore, China's current debt problem will likely lead to a financial crisis within five years.

4. Experience and Recommendations from China

China's approach to managing its burgeoning local government debt involves multiple strategies, primarily focused on debt restructuring and refinancing. Historical practices have evolved from direct bond issuances to replace old debts to more comprehensive measures addressing hidden debts. This includes financial maneuvers such as the sale of government assets, the use of fiscal funds for direct debt payments, and restructuring debts through bankruptcy procedures when necessary. The juxtaposition with global occurrences, such as the U.S. subprime mortgage crisis, serves as a cautionary narrative highlighting the repercussions of inadequate regulatory supervision, which can result in extensive financial turmoil. [10]

China's strategies for managing and reducing the risks associated with high levels of local government debt-such as regulatory measures, debt restructuring, and a shift toward sustainable economic growth-provide lessons for other countries grappling with similar issues.

Regarding regulatory oversight, tighter supervision of lending practices, as in China, may help prevent excessive debt accumulation. Countries could implement stricter standards for debt issuance, especially at the local government level. In the area of debt transparency and management, improving the transparency of debt and the health of financial institutions can contribute to the early detection of risks and better management, a strategy that could draw on China's approach to dealing with hidden debt. In the realm of fiscal decentralization and local accountability, fostering local fiscal responsibility—akin to China's customized approach for different provinces—can efficiently align debt levels with the economic capabilities and needs of each region.

5. Conclusion

Debt plays a critical role in the dynamics of financial crises, and a high debt ratio is often a precursor to financial instability. China's current debt issues are particularly concerning, not only because of the visible public and corporate debt but also due to the substantial levels of hidden debt that are less apparent yet potentially more perilous. This article argues that in the absence of strategic governance and proactive measures, the current debt levels could trigger a financial crisis in China in the near future. Comparable issues are evident worldwide, as many nations contend with substantial debt loads. Nevertheless, the effects and management of these debts differ markedly, influenced by varying monetary frameworks and distinct strategies in fiscal policy and regulation.

Globally, whereas certain nations have effectively established comprehensive frameworks for debt management, others face entrenched inefficiencies that intensify their financial vulnerabilities. As the

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primary focus of this research, China's financial management systems exhibit certain deficiencies but also offer valuable lessons that other nations might consider.

Despite the insights offered, this analysis is constrained by publicly available data, which may not fully capture the depth and nuance of the debt situation in China or globally. Additionally, the limited scope of this paper primarily concentrates on China's context and offers only a broad comparison with other global situations. This approach inevitably overlooks each country's specific economic conditions and debt management strategies.

Future investigations ought to focus on integrating a more extensive dataset that facilitates an in-depth, country-specific examination of the debt management strategies employed by each nation. Such studies could provide a richer, more comparative perspective that highlights effective debt management strategies and identifies common pitfalls to avoid, thereby contributing to a more nuanced understanding of global financial stability challenges.

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