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Ashmore

Worlds apart: Debt trajectories in China and the USA

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We review the latest debt numbers from China. We calculate the sustainability of China's debt stock going forward and we compare the results with US debt dynamics. We show that China and the US are worlds apart when it comes to debt. We conclude that the market continues to significantly under-estimate risks in developed economies and overstate them in Emerging Markets.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	972		-2.59%
MSCI FM	600		1.95%
GBI-GD	6.89%		-1.08%
ELMI+	4.61%		-0.43%
EMBI GD	5.87%	285 bps	0.14%
EMBI GD IG	5.02%	201 bps	-0.03%
EMBI GD HY	9.12%	633 bps	0.49%
CEMBI BD	5.69%	312 bps	0.12%
CEMBI BD HG	4.84%	227 bps	0.09%
CEMBI BD HY	7.45%	492 bps	0.00%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,831	-0.51%
VIX Index	13.76	10.43%
5 year UST	1.71%	1 bps
10 year UST	2.98%	1 bps
10 year Bund	1.91%	-2 bps
EURUSD	1.3607	-1.42%
USDJPY	104.55	-0.51%
Brent	$107	-3.52%
Copper	$340	-0.68%
Gold	$1,237	2.57%

Emerging Markets

China's National Audit Office (NAO) has completed its root and branch review of Chinese government debt and published its findings. The NAO's report shows that China's total government debt was 56% of GDP as at mid-2013; local currency debt comprised 33% of GDP and central government debt 23% of GDP. By any standards these are moderate levels of debt, especially taking into account China's high savings rate, high rates of real GDP growth, and strong asset position.

Much attention has been focused on the rapid rise in local government debt from 26.7% of GDP in 2010 to 33.2% of GDP in 2013. But the overall level of local government debt remains low both in absolute level terms and also in comparison with developed economies. Moreover, the Third Plenum recently introduced measures to control local government debt issuance, including:

- Measures to reduce local government spending
- Introducing more sources of tax and dividend income for local governments
- Increasing the role for bond markets
- Divesting activities to the private sector

The real significance of the low overall debt levels in China is that they are inconsistent with the commonly voiced thesis that China is financing over-investment with debt and therefore heading for collapse. The over-investment thesis derives mainly from a view that China consumes too little, but in fact China consumes a great deal more than official reported numbers suggest.

To see what the NAO's latest debt numbers imply for long-term debt sustainability we have updated our infinite horizon debt sustainability model for China using the IMF's 2014 forecasts for China's fiscal balances. As Fig 1 (overleaf) shows, China's debt profile is extremely benign with total government debt set to decline towards 35% of GDP over the next 35 years.

To put China's debt trajectory into context we have also updated our debt sustainability model for the United States using IMF's 2014 forecasts for the US fiscal position. We find that total US government debt is set to rise to more than 160% of GDP over the same period from just over 100% of GDP today. Fig. 2 shows the macroeconomic assumptions behind these projections. Note that we have used averages of the longest time series available as estimates of US growth rates and inflation rates going forward.

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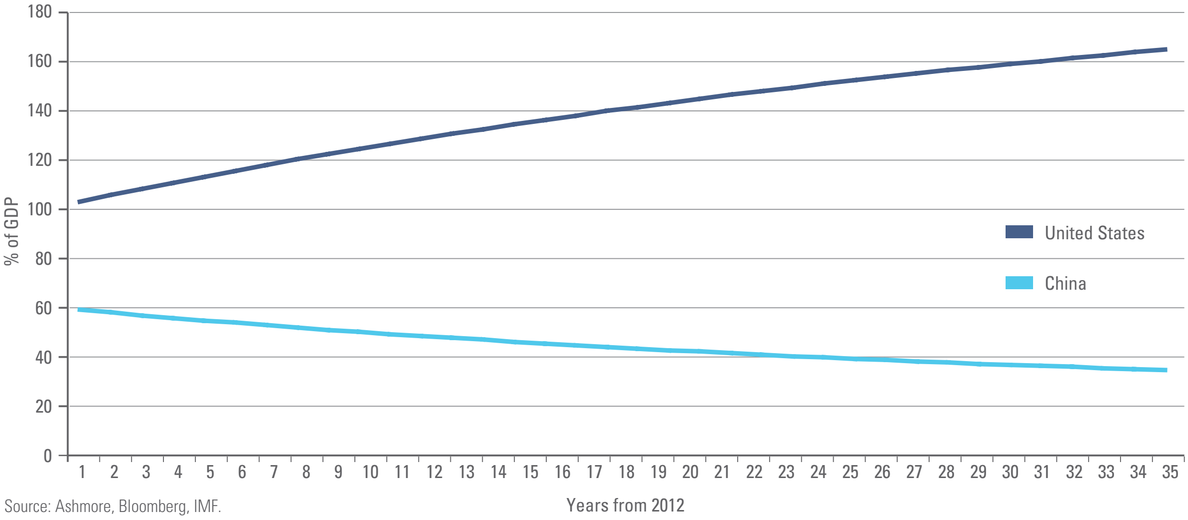
Emerging Markets

Fig 1: **China and United States general government debt profiles**



Source: Ashmore, Bloomberg, IMF.

Fig 2: **Macroeconomic assumptions**

China	Value	Source
Total government debt (RMB trn)	30.3	NAO Audit
Nominal GDP (RMB trn)	52.5	IMF Article IV
Revenue (% GDP)	23.4	IMF Article IV
Expenditure (% GDP)	24.0	IMF Article IV
Nominal borrowing cost (%)	7.3	UBS
Real GDP growth rate (%)	7.5	Ashmore
Inflation (%)	3.0	Ashmore
Real borrowing cost (%)	4.3	Calculated

United States	Value	Source
Total government debt (USD bn)	17,217	Bloomberg
Nominal GDP (USD bn)	16,913	Bloomberg
Revenue (% of GDP)	34.4	IMF Article IV
Expenditure (% of GDP)	39.6	IMF Article IV
Nominal borrowing cost (%)	4.0	Bloomberg
Real GDP growth rate (%)	3.3	Bloomberg
Inflation (%)	3.3	Bloomberg
Real borrowing cost (%)	0.7	Calculated

The above analysis is, of course, not a forecast. Governments change, policies change, and shocks occur. Besides, the world today is still in a state of extreme disequilibrium with very low rates, low inflation, and relatively weak growth following the housing and banking crises of 2008/2009. Going forward, it is likely that growth rates, inflation rates, and borrowing costs will all be very different from today's levels. Indeed, the cost of borrowing is already rising in China as the government pushes for interest rate liberalisation, while the commencement of monetary policy normalisation in the United States has also pushed real rates higher in the US treasury market.

So how sensitive are the debt trajectories in the two countries to changes in the fiscal position, growth rates, and real interest rates? In Fig 3 we show Chinese and US debt trajectories (expressed as percentages of GDP) for different macroeconomic shocks. China's debt situation is sound, sustainable, robust to rising interest rates, and can be improved dramatically with just a modest fiscal adjustment. The United States' debt situation is weak, unsustainable, is vulnerable to even modest rate increases, and cannot be fixed with just a modest fiscal adjustment.

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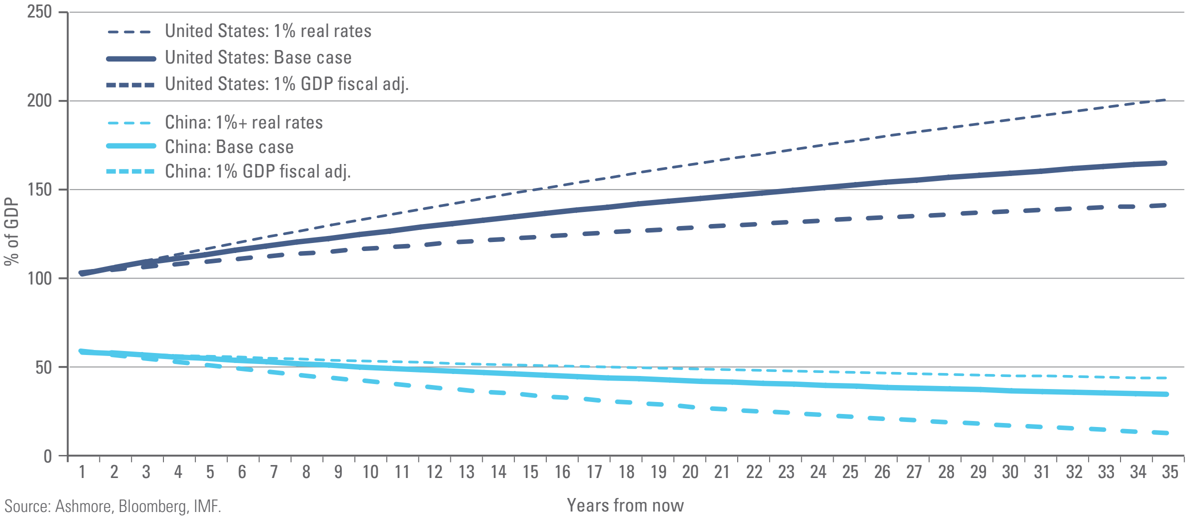
Fig 3: **Debt to GDP trajectories in China and the US under different macroeconomic shocks**[1]



Source: Ashmore, Bloomberg, IMF.

[1] Shocks to real rates and real GDP growth rates have similar effects on debt trajectories, so we only show the former.

In conclusion, China's latest debt numbers are reassuring. China's debt is sustainable and seen within the context of the reforms recently announced in the Third Plenum, the outlook for China continues to look bright. China and developed economies such as the United States, are worlds apart in terms of their debt profiles. When looking at the hard data it is difficult to escape the conclusion that risks are still massively under-estimated in developed economies, such as the United States, and significantly overstated in Emerging Markets, such as China.

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