



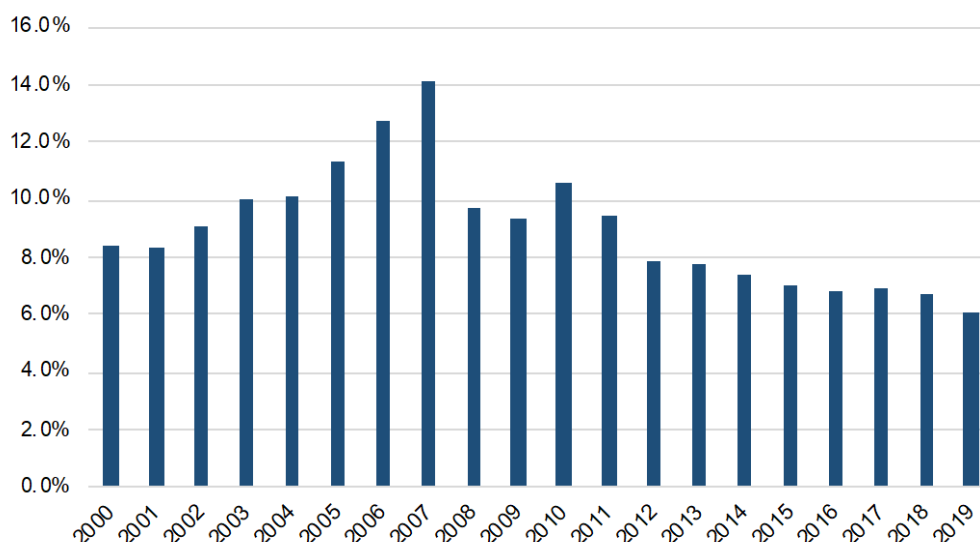
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The importance of growing wealth

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Countries, much like listed companies, aim to grow through time. However, instead of assessing their margin expansion or sales growth, a country's growth is often measured in gross domestic product (GDP). GDP represents the total value of all goods and services produced in a country over a one-year period. China has been one of the fastest-growing countries in the world, with their latest annual GDP print at 6.1% for 2019. What we don't know, given that GDP is effectively a revenue number, is whether it has translated into creating wealth.

Figure 1: China Real GDP Growth (YoY) %



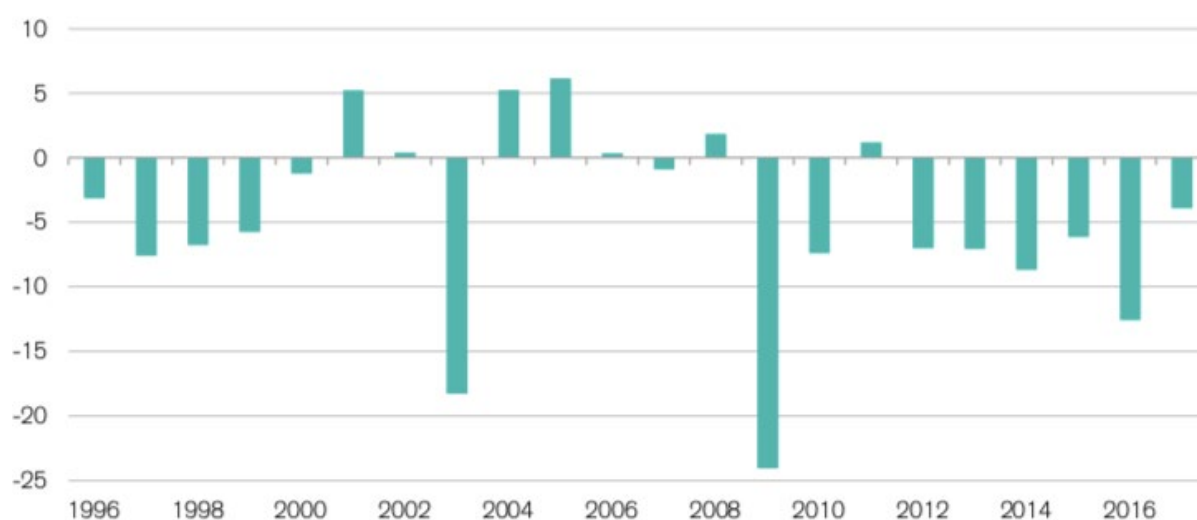
Source: Bloomberg

Again, like many listed companies, countries can take on debt to fuel expansion. However, it is often difficult in the case of a country, to know whether aggressive debt expansion is in fact creating net wealth. Conceptually, this is the same as an industrial company building a new plant. The return generated from the plant, once built, needs to be greater than the cost of building it. If this is indeed the case, then building the plant would create economic value (wealth generation) for the company.

The credit crunch

A hint at what is perhaps going on, is to look at the credit gap. In the case of China, the credit gap – or the difference between the growth in overall debt (credit) and GDP, in percentage points (as seen in Figure 2) – widened sharply since the Global Financial Crisis of 2008. A widening and negative credit gap implies that credit expansion has exceeded GDP growth, meaning increasing debt has potentially destroyed wealth.

Figure 2: Inefficient Debt Expansion in China



Source: Credit Suisse

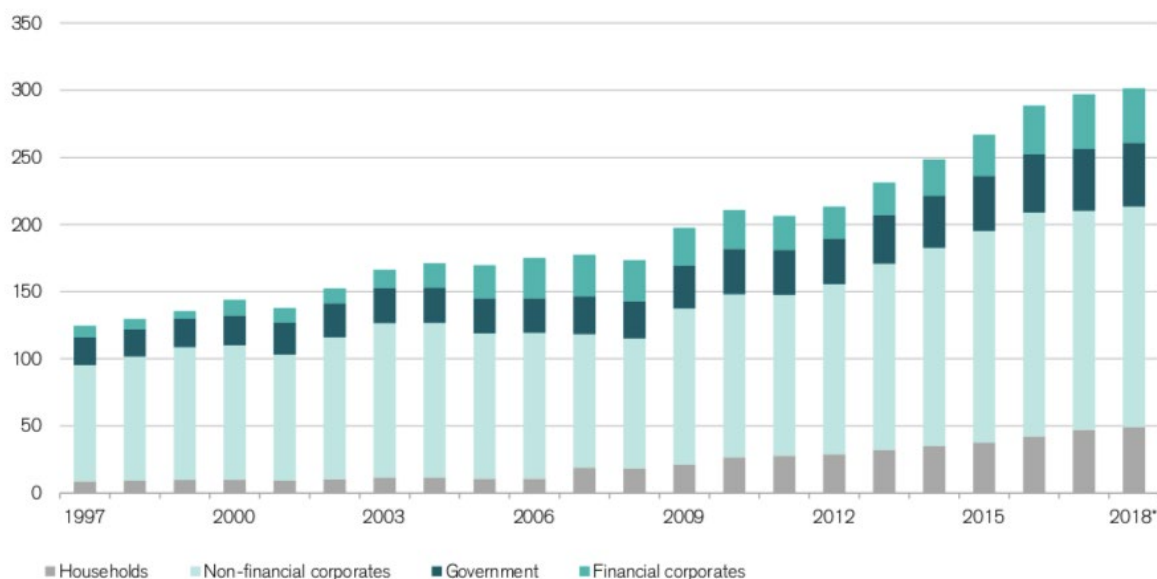
Assessing the breakdown of growing credit is also instructive in understanding how it has fuelled growth. Household debt in China, previously a small component of overall credit extension, has been growing, and currently is at around 50% of GDP. Non-financial corporate debt is the largest chunk of the total, at around 150% of GDP. While not displayed in official figures, we estimate social financing, which would form part of government debt, to be another 50% of GDP, which would need to be added to the total displayed in Figure 3. This means that the total Chinese debt would actually be around 350% of GDP in 2018. To put these staggering numbers into perspective, the table below summarises the comparisons between China and the US (we have removed financial corporates for ease of comparison). As the US is home to the largest corporates in the world, this might imply excessive Chinese corporate debt expansion.

Debt to GDP 2018	China	USA
Household Debt	50%	76%
Non-Financial Corporate Debt	150%	75%
Government Debt	100%*	106%
Total (ex-Financial Corporates)	300%	257%

*includes social financing estimate mentioned above

Source: Credit Suisse, IMF

Figure 3: China's Debt to GDP Ratio



*Q2 2018 | Source: Credit Suisse

Some companies can expand their businesses without generating much actual income. Similarly, countries can also grow in this way, by increasing leverage. However, we don't know if that growth results in real wealth creation. In the case of China, debt expansion outpaces growth in GDP, suggesting that the leverage they've taken on to drive expansion, may actually be destroying wealth over time.

Glacier Research would like to thank Nicola Jordaan for her contribution to this week's Funds on Friday.



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Nicola joined the BlueAlpha team in February 2016 as a research analyst. She has eight years of experience in financial markets and is part of the investment team involved in company analysis, as well as performance and quantitative research.

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