The Chinese Way

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Among the many inadequately understood facets of China's post-reform economy is the role of its banking system. Before the reform, the country's banking assets were concentrated in a few banks, especially the top four. The system itself was a secondary instrument in macroeconomic policy, implementing the overall cash and credit plans of the state, besides providing working capital support to state owned enterprises.

The consensus is that the role played by these institutions has changed dramatically in recent years, with their involvement in credit provision for investment purposes having increased substantially. That transformation came to the fore after 2008 when the Chinese government decided to launch a huge stimulus package to address the effects of the global crisis on the Chinese economy. The resort to the stimulus was in itself not surprising. Ramping up domestic spending in order to neutralise the effects of a global slowdown on an economy that was an export powerhouse made sense. It also served the rest of the world well by keeping Chinese growth going at close to 9 per cent.

There were, however, two features unusual about the Chinese stimulus. To start with the stimulus package was not designed to rely largely on an increase in direct government spending financed with its own receipts. Rather, the increase in spending was to be financed by the banks that were encouraged to offer huge volumes of debt to finance spending by government-sponsored, but off-balance sheet, entities. Second, in a reflection of the decentralisation of decision-making and implementation, a substantial part of the additional spending was undertaken at the provincial level by entities associated with provincial governments.

One problem was that provincial governments in China have not been permitted to issue bonds to borrow money to finance expenditures. In a drastic 1994 response to evidence that provincial governments had in a borrowing spree accumulated debts they were finding difficult to service, the central government imposed a ban on local governments running budget deficits and issuing bonds. Hence, when called upon to spend as part of the stimulus effort, and happy to do so to launch big, "prestige projects" backed by provincial leaders, they adopted innovative schemes. Principally, these involved the creation of financial vehicles-like the Urban Development Investment Corporations-superficially separated from the provincial government, which were made to borrow from the banks to finance these projects.

The problem now is the inability of such institutions, under the aegis of which these projects were being implemented, to meet their loan commitments. Many of the projects were financed with non-recourse loans backed by collateral of uncertain or little commercial value that could not be easily cashed in case of default. The future cash flows associated with others such as toll-based roads, bridges and subways are difficult to estimate. And some are social sector projects with an implicit guarantee of a provincial investment holding corporation, but no explicit commitment to pay.

Though the stimulus shored up China's remarkable growth rate even in the midst of the crisis, doubts were soon being expressed about the way it was financed. According to an audit conducted in the middle of last year, in the aftermath of stimulus spending, local government-associated debt had risen to $1.65 trillion or around 27 per cent of Chinese GDP. In comparison, central debt was estimated at around 20 per cent of GDP. The audit showed that outstanding local government debt rose by 62 per cent in 2009 alone, when Rmb 9600 billion was pumped into the system as part of the stimulus.

The inability of provincial governments to meet their implicit commitments seems to be dawning on the centre with about a third of the loans set to mature by the end of this year and around a half falling due over the coming three years. Sensing repayment problems, the government has reportedly initiated a huge programme to rollover debts owed to the banks by these borrowers. The argument seems to be that in time, these projects would on completion yield adequate revenues, so that an extension of maturity is the way to go.

With the economy still strong and the government in command, there is little fear that the problem would lead to a crisis of the kind that the over-indebtedness of households and the high debt to GDP ratios of governments in the West has precipitated. The centre would in all probability recapitalize these banks as and when required to keep them solvent. Even early critics of the policy of restructuring debt by extending maturities, like the China Banking Regulatory Commission, now admit that there is no immediate option.

But the wisdom of concealing a proactive fiscal policy, by making state-owned banks lend to state-sponsored financing vehicles, which in turn lend to state-backed projects is now in question. The problem is that though these are infrastructure projects with an uncertain future revenue stream, those revenues have to meet the acquired interest and amortization commitments. That is at the moment clearly not feasible, necessitating the restructuring. If the governments had directly financed the projects, they could, in case of a revenue shortfall, use other receipts they are eligible to receive or new revenue sources to cover the difference.

Thus, the experience seems to signal the need for a change in the policy of financing the large investment undertaken directly or indirectly by the state in China. Over the last year, governments in a few provinces and cities starting with Shanghai have been given permission to issue bonds for the first time after close to two decades. The Shanghai issue was hugely successful reflecting the hunger for government bonds. But that once again raises the possibility that provincial government in pursuit of the special interests of their leaders would resort to excessive borrowing inadequately backed with revenue generation. The problem is that, though constrained by the ban on borrowing imposed by the central government, most provincial governments in China rely on transfers from the centre and the sale of lands they control or commandeer to finance their expenditures. They are yet to establish any degree of financial independence based on taxation despite the increase in incomes and inequality in the system.

There is cause for concern elsewhere as well. Encouraged by easy liquidity, the credit-financed spending boom has affected other sectors. Chinese financial institutions have overextended themselves in the property market in particular. The exposure of Chinese banks to the property market is placed at more than a fifth of their advances. Since the escalated lending has resulted in a spiral in housing and real estate prices, fears of a speculative bubble that can go bust have increased. This would impact on bank balance sheets and solvency.

This problem has been exacerbated by structural changes induced by liberalisation. Besides the state banks, especially the top four, that dominated the financial system as a whole in China, the Chinese financial structure now includes a host of private banks and a significant shadow banking system consisting of trusts and other investment companies. In the initial flush of the transition that saw banks becoming important lenders, the big state controlled banks lent to state owned enterprises and the private banks lent locally especially to the small and medium enterprises that have been an essential part of China's success story.

But recent developments appear to have taken the system in three directions. First, as noted above the state-owned banks have hugely increased their exposure to projects launched by provincial government-sponsored entities that have yet to show adequate returns. Second, the private banks and trust funds have moved on from financing small and medium enterprises to financing and fuelling a real estate bubble. And finally, through their engagement with the shadow banking system, the larger commercial banks too are exposed indirectly to the property market bubble.

These are all the result of the government choosing to use the banking system as a development instrumentality, even while relaxing controls on and supervision of financial firms as part of a "Chinese way" of restructuring the financial sector. In the event, while growth promoted by the huge stimulus was a beneficial outcome, there are a host of new problems surfacing. This would possibly encourage the government to retrace its steps and strike a new path. Unless membership of the WTO and the conditions that the government accepted at the time of entry prove to be obstacles.

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