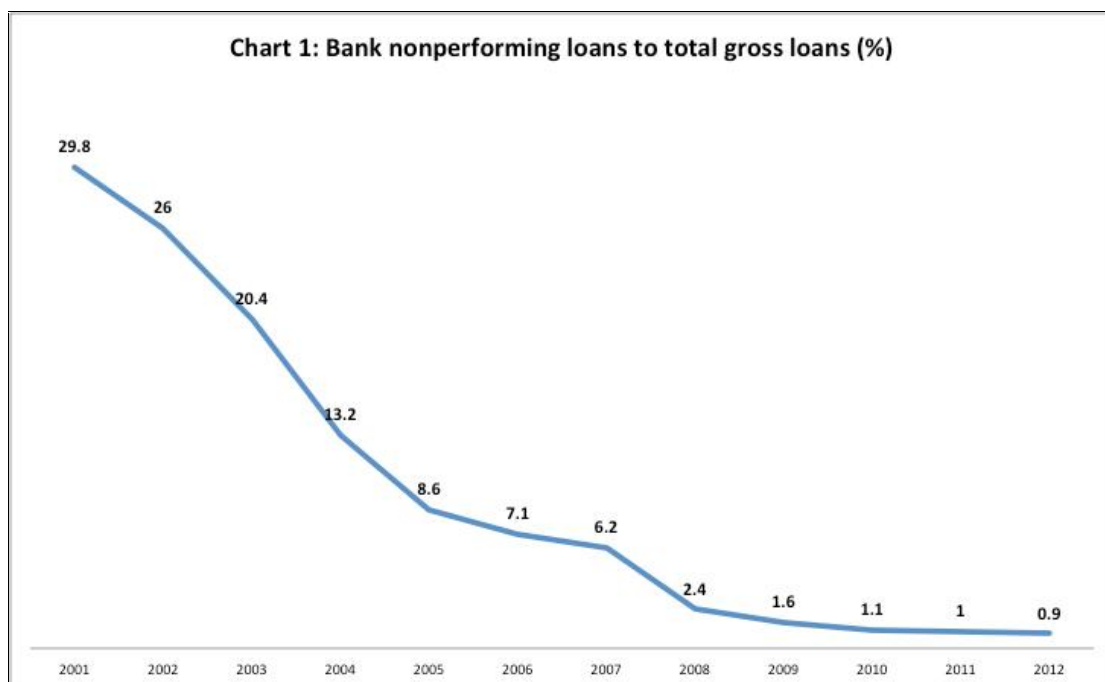


Those Chinese Fears

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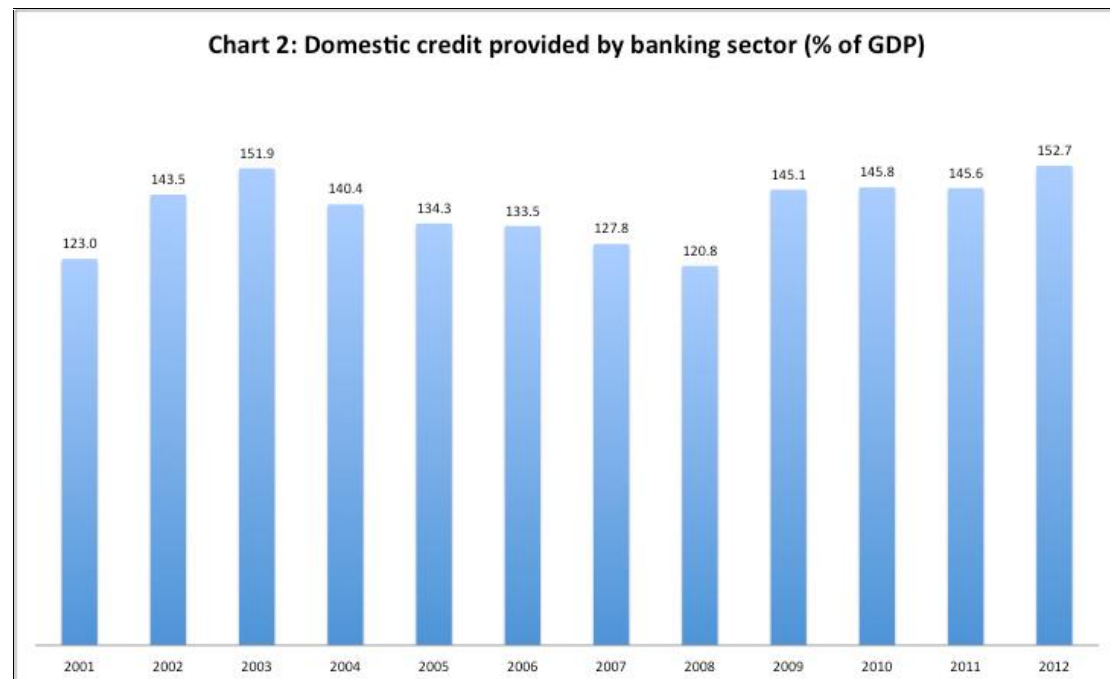
China's banks are among the biggest in the world. According to The Banker, the Industrial and Commercial Bank of China (ICBC) is the world's largest bank measured in terms of core capital, and the other three among China's Big Four banks— China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABC)—are among the top ten. But, if the international media are to be believed, these behemoths are a threat to global stability. Slowing growth in China, it is argued, is likely to result in a wave of defaults on interest and amortisation repayments by borrowers in China. As a consequence, predictions are that there is likely to be a sharp [increase in the volume of non-performing loans](#) in the Chinese banking sector, which could precipitate a banking [crisis](#) and worsen the growth downturn. And when [China slows](#) the world economy cannot but be affected.



The background to these fears need to be noted. First, they occur despite the fact that non-performing loans in China's banking sector have according to official figures fallen to comfortable lows (Chart 1). Second, however, they do reflect the fact that [credit provision in China has spiked](#), rising from 120.8 per cent in 2008 to 152.7 per cent four years later in 2012 (Chart 2). And third, much of this increase in credit is on account of an increase in credit to the 'private' sector (Chart 3).

There are three reasons why NPLs in China's banking sector are expected to rise. The first is the perceived fallout of the Chinese decision to adopt a 4 trillion yuan stimulus package in response to the global crisis. The package envisaged that a dominant share of the expenditures that constituted the total stimulus was to be undertaken by local governments, which were expected to launch projects to the tune of 2.8 trillion yuan. However, provincial governments in China are not permitted to issue bonds or otherwise borrow money to finance expenditures. This was because, in a drastic 1994 response to evidence that provincial governments had in a borrowing spree accumulated debts they were finding

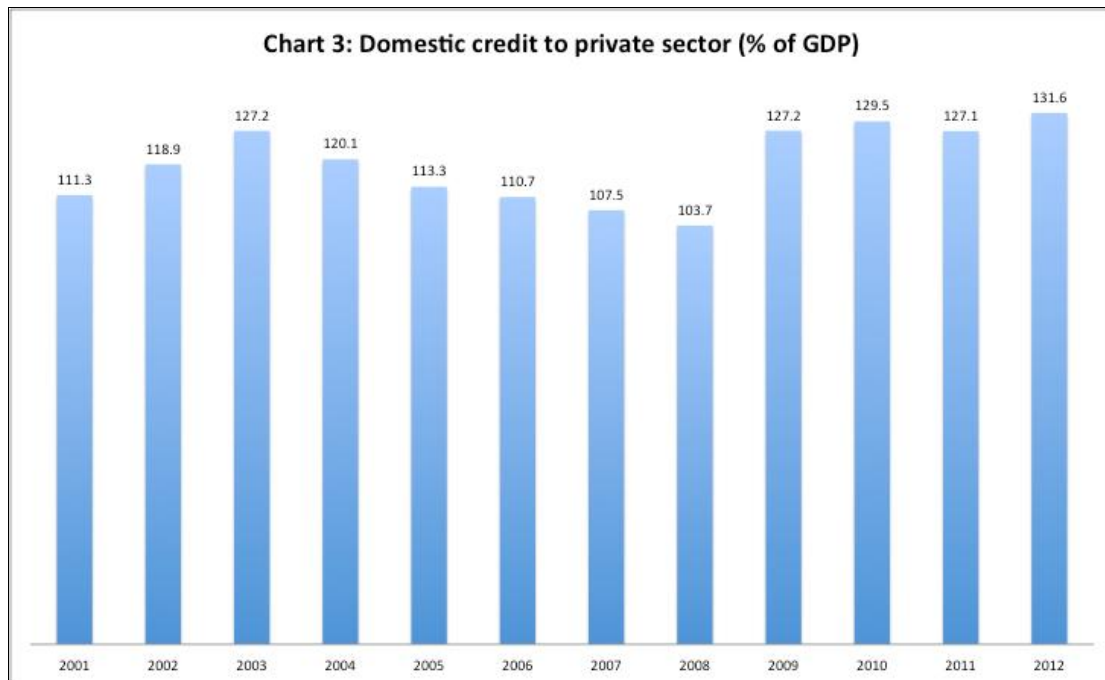
difficult to service, the central government imposed a ban on local governments running budget deficits and issuing bonds.



Hence, when called upon to spend as part of the stimulus effort, they adopted innovative schemes. One was the creation of financial vehicles—local investment corporations—superficially separated from the provincial government, which were made to borrow from the banks (or to which banks were persuaded to lend) to finance these projects. Most often these investment vehicles were given user or development rights over land that the government handed them. The land then served as the collateral to borrow from the banks or the basis for the issue of bonds to raise the capital needed to exploit or develop the land. This route proved popular. China's National Audit Office estimated that by June 2011, 6,576 local investment companies had been set up and they had acquired total debt of 4.97 trillion yuan.

A host of factors are making it difficult for the institutions, under the aegis of which these projects were being implemented, to meet their loan commitments. Slowing growth and inadequate demand has challenged the viability of some. The future cash flows associated with others such as toll-based roads, bridges and subways have proved to be much lower than estimated. And some are social sector projects with an implicit guarantee of a provincial investment holding corporation, but no explicit commitment to pay.

In the event, though the stimulus shored up China's remarkable growth rate even in the midst of the crisis, the way it was financed is now proving a problem. According to an audit conducted in the middle of 2011, stimulus spending had resulted in a rise in local government-associated debt to around 27 per cent of Chinese GDP. In comparison, central debt was estimated at around 20 per cent of GDP.



The probability that this would make it extremely difficult for provincial governments to meet their debt service commitments has risen, especially since much of it falls 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 second source of concern regarding China's banks comes from rising private and property-related debt. 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 could 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. One argument has been that the relatively low ceilings on interest rates paid to depositors in banks has been resulting in a slow process of disintermediation with individuals and businesses looking for opportunities to obtain higher returns and exploiting them when available. That has ostensibly combined with limited access to credit from banks for certain sectors (including real estate and stock markets) and certain borrowers (small firms) to create a parallel circuit. Trusts (that are not banks in themselves, but often created by banks) have created instruments identified broadly as "wealth management products" (WMPs), to mobilise deposits looking for higher yields and lent them to credit starved borrowers willing to pay much higher interest. Further, legitimate borrowers from banks, like eligible businesses, took on bank credit and lent it to credit starved private businesses and individuals. According to observers, a lot of these loans went to finance investments in real estate and the stock markets.

This does lead to a significant degree of maturity mismatch, with the deposits being mobilised of much shorter duration than the investments made. The expectation clearly is that there would be adequate inflows of these 'deposits' to more than cover any withdrawals. That may be misplaced. Moreover, the investments to which these funds are

being diverted are mostly opaque, though there are strong reasons to believe that the favoured destinations are the property or financial markets. When that bubble bursts creditors are bound to default. The net effect would be a rise in the NPL rates.

Finally, these difficulties are worsening an accumulated but concealed legacy of problem debt. In 1999, as part of its preparations to reduce regulation of banking in China and open up the sector to foreign banks, as required by China's WTO accession agreement, the government decided to clean up the balance sheets of the banks by taking out problem loans. Earlier, because of the backing involving unlimited access to liquidity from the government and the central bank, these non-performing loans did not matter. Now they did. As part of the clean up effort, as much as 1.4 trillion yuan worth of NPLs were transferred at face value to four specially created asset management companies (AMCs) in 1999-2000 and another 1.6 trillion yuan worth in 2004-05 at a discount. The plan was to keep these AMCs alive for around 10 years, during which they adopted a combination of policies of collection of dues, restructuring of loans, and/or repackaging and sale of debt to dispose of these assets. In the interim, the activity had to be financed. The government provided initial capital worth 10 billion yuan to each of the AMCs, the People's Bank of China (PBOC) provided loans to the AMCs of close to 650 billion yuan, while the AMCs themselves issued more than 858 billion yuan worth of bonds. Those bonds were largely bought by the big four banks.

Further, as it became clear that the success of the AMCs in recovering these assets was lower than expected, the AMCs themselves were restructured, partly through an expansion of their activities to earn profits and partly through the sale of equity holding in them. The Agricultural Bank of China was persuaded into acquiring a 49 per cent stake in China Great Wall AMC, the China Construction Bank a 48 per cent stake in China Cinda AMC, ICBC a 48 per cent stake in China Huarong AMC and the Bank of Communications a significant stake in China Orient AMC.

Thus, through the purchase of bonds and equity, the AMCs that had acquired the bad loans of the bank to reduce their NPLs, were made dependent on bank funding. The bad loans were partly brought back onto the books of the banks they were recapitalised, but disguised as a new asset. This too is now seen as threatening the viability of the banks.

This combination of factors is seen as creating a huge bad debt problem. That may be true. But what is unclear is why the state and the People's Bank of China cannot intervene once again to clean out bank balance sheets as they did in 1999 and 2004. Just as the US government and the Federal Reserve could resolve the banking crisis that set in in 2008 by injecting trillions of dollars into the system, the Chinese too could play the same game. All the more since, unlike the US banks that were pushed to the brink of failure by speculating for profit, China's big banks are where they are because being publicly owned they played the role set for them by the state.

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