Foreign capital pours into China's banks

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When China joined the World Trade Organisation (WTO) in 2001, Beijing agreed to open up its banking system to foreign investors by the end of 2006. A flood of foreign investment into China's largest state-owned commercial banks (SCBs) since last year has signalled the start of a process that will have major economic ramifications.

At the end of 2003, foreign equity stakes in Chinese banking institutions were just $500 million or 0.3 percent of total banking capital. Foreign banks held only about 1 percent of total banking assets. By contrast, China's five largest SCBs—the Industrial & Commercial Bank of China, the Agricultural Bank of China, the China Construction Bank, the Bank of China and the Bank of Communications—control over 60 percent of the country's loans and deposits.

International investors are rapidly changing this landscape. Last year, the British-based Hong Kong and Shanghai Banking Corporation (HSBC) bought 19.9 percent of the Bank of Communications for $2.25 billion. In June, the Bank of America invested $3 billion for a 10 percent stake in the China Construction Bank (CCB). In July, the Royal Bank of Scotland bought another 10 percent of the Bank of China for $3.1 billion, while Singapore's Temasek committed $2.5 billion to the CCB. In August, the US-investment house Goldman Sachs paid out $3 billion for a 10 percent stake in the Industrial & Commercial Bank of China.

The Chinese government has listed or is preparing to list major SCBs on overseas stock markets. When the Bank of Communications made an initial public offering (IPO) in Hong Kong in June, it was oversubscribed 200-fold by retail investors and 20-fold by financial institutions. The IPOs planned for another three major state banks next year will be worth a total of $20 billion. By 2007, it is estimated that foreign financial groups will control one sixth of China's banking system.

Paradoxically, the major Chinese SCBs are weighed down by huge bad debts and are technically insolvent. The capital adequacy ratio of the four largest SCBs was only 4.6 percent in 2003, compared to the 8 percent international standard. However, international financial institutions are pouring money into the SCBs in a bid to capture a key strategic sector of the Chinese economy and exploit the financial opportunities opening up.

Transnational corporations have invested tens of billions of dollars into the "workshop of the world" over the past two decades, spawning a rapid growth of private enterprises needing credit and financial support. Currently, private business accounts for only 40 of some 1,600 Chinese companies listed on home and overseas stock exchanges and receives less than 10 percent of total banking credit.

In addition, China's high domestic saving rate holds out the prospect of new sources of capital for the international financial markets. At the end of 2004, China's total bank deposits stood at 185.5 percent of GDP—far higher than most countries. The major Chinese SCBs, however, are not presently engaged in profitable activities such as investment banking, securities and insurance. Last year, the average rate of return for banking institutions internationally was 1.2 percent, three times higher than the 0.4 percent in China.

By partnering with the China Construction Bank, for example, which has 136 million deposit accounts and 14,500 branches across the country, the Bank of America will be able to engage in corporate lending as well as consumer banking activities such as mortgages and credit cards. Until now, foreign banks have had limited access to China's domestic banking business.

Opening up China's banks is bound up with broader economic "reforms". As Jonathan Anderson, chief Asian economist of the Swiss bank UBS, commented in the *Far Eastern Economic Review*: "The government has done everything it can for banks—except to privatise them. And as long as senior management is made up of civil servants with a mandate to support official policy, banks will never be fully market-oriented institutions. What China needs to make financial system reform and restructuring 'stick' is to get the state out of the business of running banks."

This restructuring involves a vast transformation in the role of the banking system. Under the new regime, banks will operate for the benefit of shareholders and foreign financial institutions. Their previous unprofitable functions of financing social services, pensions, the public sector, state-owned enterprises and rural subsidies, on which the lives of tens of millions of people depend, will be ended.

Before 1978, one institution—the People's Bank of China—controlled all financial resources within a closed, nationally-regulated economy based on state-owned industry and collective agriculture.

China's SCBs were created during the first wave of "market reform" in 1980s. Although these banks were "commercial," they continued to finance state-owned enterprises, social infrastructure and subsidies for the rural peasantry in the form of loans. As a consequence, the SCBs incurred huge bad debts, mostly unrecoverable.

While the Chinese government gave large tax breaks to foreign investors, state-owned enterprises were saddled with high tax rates and provided significant social benefits to tens of millions of employees. At the same time, the state banks started to look for profitable returns, entering the speculative real estate market and accumulating even more bad debts.

Non-performing loans (NPLs) rose sharply after the speculative investment bubbles burst in the mid-1990s. In 1994, Beijing intervened to stabilise the real estate and stock markets by tightening money supply and devalued the yuan from 5 to 8.3 to the US dollar to boost exports. As a result, yuan-denominate assets depreciated and deepened the crisis in state-owned economic sectors. By 1998, the ratio of NPLs to GDP ($960 billion) reached a staggering 20 percent.

Beijing reacted by slashing state spending. In 1995, the government formally established the People's Bank of China as the country's central bank, along the lines of the capitalist West. Its main objective was to prevent banks from providing direct subsidies to the state or making loans to government that did not meet commercial standards. Any subsidies had to come from a far smaller government budget.

Fears of financial instability effectively halted banking reform during the 1997-98 Asian economic crisis. Four asset management companies (AMCs) were established to liquidate tens of billions of yuan in bad debts owed by state-owned enterprises. Privatisation and closures took place on an unprecedented scale. According to official statistics, from 1998 to 2005, 60 percent of the workforce of state-owned enterprises, or 30 million workers, was thrown onto the unemployment queues.

The government's financial crisis continued, however, as it was forced to borrow to meet interest payments and pay off overdue debts. In 1998, Beijing issued 270 billion yuan ($33 billion) in bonds—equivalent to 3 percent of GDP—to shore up the capital bases of the four largest SCBs. The four AMCs issued 1.4 trillion yuan ($170 billion) in bonds in 1999 and 2000.

After joining the WTO in 2001, Beijing's policy has been that the state banks would "grow their way out of the problem". Their financial position, however, remains precarious. Pressure from the US and European powers to revalue the yuan has led to a wave of speculative lending to yuan-based real estate and industrial projects. Investors hoped to make a killing if the value of the yuan increased.

According to the September issue of the IMF's *Finance & Development* magazine, high saving rates and cheap credit has contributed to speculative investment in China amounting to 40-45 percent of GDP. The resultant excess capacity is likely to become a new source of bad debt, especially among less competitive state-owned enterprises.

"In short, one basic problem in China is that the high degree of thrift that fuels such rapid investment growth has a low payoff because of the fragile threads holding the economic picture together. Providing cheap capital to enterprises, especially state-owned firms, requires low interests rates. Sustaining bank profits then requires correspondingly lower rates of return on deposits. Thus, maintaining economically unviable state enterprises and supporting them through the banking system results in large implicit costs," the IMF magazine warned.

According to official statistics, for the first quarter of this year, non-performing loans (NPLs) in the four largest SCBs were 1,567.1 billion yuan ($193 billion) or 15 percent of total loans. Unofficial estimates, however, put the percentage much higher. The official ratio is down from 20 percent in 2003, but largely due to massive government bailouts.

In 2004, for example, Beijing injected $45 billion from foreign currency reserves—mostly dollar-based assets—into the Bank of China and the China Construction Bank. In April this year, the Industrial & Commercial Bank of China received $15 billion from the same source. Over the past 18 months, China's central bank had spent more than $100 billion to recapitalise or write off bad loans. None of these "cleansing" operations has changed the fact that the Chinese government is the ultimate debtor.

The more the Chinese economy is opened up to foreign investors and limited government controls are loosened, the greater the danger of severe financial instability. In July, Beijing announced a 2 percent appreciation of the yuan against the US dollar and changed the basis for the currency's peg from the dollar to a basket of international currencies. But the decision has not ended the inflow of speculative capital, or ended the risk of capital flight if the investment bubble collapses.

At present, Chinese authorities maintain tight restrictions on Chinese citizens investing abroad. Over the past two years, Beijing has used its control of state-owned banks to try to slow speculation by halting lending in some over-invested sectors such as steel. But as foreign capital flows into China's banks, the government's ability to use these financial institutions to control investment will end.

A financial crisis would have immediate consequences for the global economy, which increasingly relies on China as its main cheap labour platform. Last year, China received $61 billion in foreign direct investment. China's banks are now the second largest sources of finance, after Japan, to prop up the huge US budget and trade deficits. It is the world's third largest exporter after the US and Germany, and one of the biggest consumers of raw materials and energy. All this rests on increasingly unstable foundations.