Massive bad debt highlights China's financial instability

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China's financial system continues to be burdened by a mountain of non-performing loans (NPLs) in the state banking system, despite government promises to take action to reduce it. In its annual report on global debt released on May 3, the accounting firm Ernst & Young highlighted the dangers of China's bad debt, estimated at a staggering $US911 billion.

According to the report, China's current NPL level was equal to 40 percent of gross domestic product (GDP). It was almost twice the 2002 figure of $480 billion, and larger than the country's foreign currency reserves of $875 billion—the world's biggest. The four major state-owned commercial banks accounted for $358 billion of bad loans—almost three times the officially reported figures. "With the exception of China, every market covered in 2004 report has witnessed a reduction in its levels of NPLs written before 1997," it stated.

The alarming report came just before an initial public offering (IPO) of shares worth $9.9 billion by the Bank of China in Hong Kong. China's central bank—the People's Bank of China—posted an angry statement on its website attacking the report as "ridiculous and barely understandable" and damaging to the "image" of China's banking assets.

Ernst & Young prepared the report as part of its efforts to explore new potential in the trading of NPLs in the international financial markets. The firm claimed that its higher estimation of Chinese bad debt was based on access to broader information, including the rapid growth of loans in recent years and details of distressed debt companies (such as rural credit cooperatives) attached to major banks. These had been excluded from previous reports.

Under pressure from Beijing, Ernst & Young withdrew its report last weekend, declaring it had been in error and promised that "such an embarrassing situation will not happen again". The firm now accepts the official figure of $133 billion for the bad debt of the Big Four state banks, saying the estimate is "based on objective evidence of impairment". Ernst & Young currently has a lucrative contract to audit the Industrial & Commercial Bank, one of the Big Four and China's largest lender, ahead of its overseas share listing in September.

The incident revealed Beijing's extreme sensitivity to any comment critical of its financial system. Even if the official estimate of the bad debts of the four leading state banks is correct, which is unlikely, other issues raised in the Ernst & Young report—including surging lending, investment bubbles and the transfer of bad assets to other state companies—remain unanswered.

According to the *Financial Times* on May 4, the Ernst & Young report is line with a number of recent studies, including by the corporate consultancy firm, McKinsey, released in the same week. "While there have been improvements in the banking sectors, and the government has sought to address NPLs, the core causes for the build-up have not been fully dealt with," the McKinsey report stated. "Until these problems are addressed, the problem is likely to persist, and the banking system will remain vulnerable to potential liquidity shocks."

Prior to his firm's retraction, Jack Rodman, managing director of Ernst & Young, commented: "I think the numbers will be a big surprise because China has been giving the impression [with its banks listing overseas] that the problem is behind us. China has not really resolved the issue—they have just moved it from one state enterprise to another."

International investors are concerned because China is due to open up its banking system at end of this year under the terms of its entry into the World Trade Organisation (WTO). Since 2005, major global banks and financial institutions have invested billions of dollars in the large Chinese state banks.

More broadly, China is one of the main growth engines for the world economy. Its central bank is playing a leading role along with its Asian counterparts in purchasing the US dollar-dominated assets and financing the huge US deficits. China's continuing expansion of around 9 percent a year has stimulated the Asia-Pacific economies and lifted the world's commodities prices to unprecedented levels.

The growth of massive bad debts in China's banking system has exposed the fact that this apparently strong economic performance is resting on shaky financial foundations.

The Beijing government claims to have cleared $560 billion in bad debts since 1999 and injected fresh capital into the major state banks from the central bank's foreign currency reserves. Now it is clear that much of this "reduction" has been through transfers to other state-owned disposal agencies, and nullified by surges in new lending.

Up to last December, the Chinese government had placed more than $330 billion of bad debts from the four major state banks in asset management firms. The four largest firms—Cinda, Orient, Great Wall and Huarong—still have $230 billion in bad debts to dispose of. China's finance ministry continues to guarantee bonds valuing hundreds of billions of dollars issued to the state banks when the bad assets were transferred.

In other words, bad assets have been transferred from one state sector to another, but the financial system as a whole continues to be weighed down by huge levels of bad debt, with the Chinese government as the ultimate debtor.

Moreover, from 2002 to 2004, the Big Four also contributed more to the country's investment bubble by making $225 billion in new risky loans—one-third in real estate. Chinese banking authorities attempted to obscure the nature of these loans by classifying them as of "special mention".

For instance, the China Construction Bank, which was listed on the Hong Kong share market last year, reported an acceptable bad loan ratio of just 3.8 percent. But it had to admit that its ratio of "special mention" loans to overall loans was a high 8 percent.

Beijing managed to pressure Ernst & Young into modifying its estimate of bad debts. On April 27, however, the Chinese central bank suddenly lifted its benchmark one-year lending rate by 0.27 percent to 5.85 percent in a tacit admission of concern about the rising tide of bank lending.

The IMF has warned that China needs further interest rate increases in order to slow down the "over-invested" sectors, especially property. At the same time, the IMF, in line with Washington's demands, called on China to use its current account surplus, which is likely to remain at about 7 percent of GDP this year, to implement a "flexible" exchange rate with the dollar.

The Chinese government is walking a fine line. Further interest rates rises could also result in higher levels of bad debt. Most Chinese enterprises, particularly small and medium manufacturing firms, operate on thin profit margins and are already under pressure due to the rising costs of raw materials and even labour. Overcapacities in industries like steel, cement and textile are already threatening to undermine profits.

The most serious speculative bubble is in real estate, where prices had been driven up by the prospects of yuan revaluation and the 2008 Beijing Olympic Games. Chinese central bank statistics at the end of 2005 show that property lending reached 3.07 trillion yuan (about $379 billion) or nearly 17 percent of the GDP. The National Bureau of Statistics recently warned that unsold residential space across the country had risen by 23.8 percent to 123 million square metres by the end of March, as compared to last year. Any collapse of the property bubble could have catastrophic consequences for the country's fragile banking system.

China's economic expansion cannot go on indefinitely. Speculative investment and mounting levels of bad debts are the inevitable result of the Chinese government's policies designed to maintain huge inflows of foreign investment and high economic growth rates.

The December issue of the *Far East Economic Review* pointed out that China's ability to attract 10 times more foreign capital than rival India, was based not on cheaper labour, but on more efficient infrastructure. China has invested $24 billion a year to upgrade highways, compared to India's major $16 billion road project over eight years. Electricity prices for industrial users in China are half those in India. In 2003, 61 percent of Indian factories had to buy their own power generator, compared to just 27 percent in China. Chinese exports to the US take 3-4 weeks on average to reach their destination, compared to 7-12 weeks from India.

China's state-directed investment in infrastructure has been vital to attracting foreign investment, but is fraught with difficulties. Provinces and cities compete with each other for investment by building their own ports or industrial parks. The process has led to widespread duplication and overcapacity. The local branches of state banks function as sources of cheap credit and inevitably bear the burden of failed infrastructure projects. According to the World Bank, about one-third of China's fixed asset investment in infrastructure in the 1990s was wasted. Few bank officials have been held accountable.

At the same time, the anarchic economic growth has led to growing social inequalities. In order to prevent unemployment from rising, the government maintains inefficient state-owned enterprises, which account for more than 70 percent of the mainly state bank loans. Their output has fallen to just a quarter of the GDP in the past decade. Beijing fears any fire-sale style privatisation of the state sector, which has already laid off over 30 million workers, would threaten social stability. The Chinese central bank admitted in 2000-2001 that "politically-directed" bank lending accounted for 60 percent of bad loans.

Nor can Beijing afford politically to rein in foreign investment and economic growth. An Asian Development Bank (ADB) study last month demonstrated that China has needed higher and higher rates of growth to generate jobs. In the 1980s, a 3 percent economic growth rate generated 1 percent increase in employment. Because of higher productivity, however, China needed nearly 8 percent in annual growth in the 1990s to create the same job growth rate. This year it is estimated that 25 million people will enter the labour market, but only 11 million will find a job.

One result of these economic policies is a systemic build-up of huge levels of bad debt that threatens to trigger a major financial crisis with reverberations around the world. Far from being a demonstration of the viability of pro-market policies, China could well prove to be an Achilles heel of global capitalism.