An Inflection Point In China's Banking Problem

By George Friedman

The month of May witnessed an interesting phenomenon: a spate of reports on China's nonperforming-loan problem. What is most intriguing is that these reports did not come from organizations like Stratfor — minor outfits that have been talking about this for a couple of years. It came from real, solid, serious mainstream organizations that were, and continue to be in some cases, quite positive about China on the whole. What is important here is not that China has a serious problem with bad loans in its banking system. That's old news. What is important is that mainstream analysts in the West now are taking official notice of it. The wide divergence between the Western perception of Chinese economic health and the realities of China's economy is beginning to close. There will be consequences to that.

The first report came from Ernst & Young, which released a study saying that China had a substantial problem with nonperforming loans (NPLs). We have to confess to not having seen that report, because the accounting firm withdrew it a few days later. The Chinese government blasted the report, using words like "ridiculous" and "distorted." Ernst & Young, which has a substantial practice in China, denied having retracted the report because of pressure from the government. Whatever their reasons for doing so, we wish we had been faster in asking for a copy.

No matter, because May also brought studies on the same subject from P ricewaterhouseCoopers (PWC), McKinsey Global Institute, and Fitch. Each said the same basic thing: that Chinese banks have enormous NPL numbers on their books. The PWC report was issued by a group within the company that specializes in making markets in NPLs. Their news was that the water in China was fine and everyone should come in. McKinsey focused on inefficiencies in the Chinese banking system that should be cleared up, so that NPLs could decline and the Chinese gross domestic product could surge. Fitch was the harshest of the three, but that firm also argued that the Chinese had the tools in place to handle the problem. The bottom line was that all three acknowledged that NPLs were a big issue for China, but they took different approaches in trying to put the problem in perspective. In other words, they gave a warning without yelling "Fire!" Some of the reports were criticized by the Chinese, but none were blasted. Meanwhile, Moody's Investors Service has told us that they will be releasing a report in a couple of weeks. It will be interesting to see what their take is.

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Let's begin this analysis by looking at a couple of quotes from these reports. McKinsey, for example, writes:

"Underlying these reforms, however, is capital misallocation by the system. Nonperforming loans are the most conspicuous outcome of this misallocation, but our research shows that the much larger volume of loans to underperforming ventures that don't go bad but yield only negligible returns are potentially more costly to China's economy."

Fitch's report states:

"Summing all of these figures, we come up with total official nonperforming loans of US$206 bn and other estimated problem loans of over US$270 bn in the banking system. *We would reiterate, however, that a large portion of this latter figure is comprised of estimated Special Mention loans or loans that currently are <u>not</u> classified as nonperforming* [emphasis Fitch's]. At the same time, there is an additional US$197 bn in NPL carveouts still remaining on the balance sheets of China's asset management companies, which no longer represent direct losses for banks but are a future liability for the government."

Fitch also states:

"Beyond this, estimating a rate of flow of new nonperforming loans is not an easy exercise given Chinese banks' extremely weak historical data and ongoing deficiencies in accounting and disclosure. Few banks report data on NPL flows, and those that do show recent flow rates in the extremely low single digits. We believe these numbers understate the likely level of ultimate credit losses, given what we know to be the slow evolution of a strong credit culture and risk management practices and our suspicion that China's over-reliance on investment-led growth comes at a cost to bank credit quality."

Fitch is estimating China's bad-loan situation (our term, lumping all these categories together) at $673 billion, but it warns that — given Chinese accounting and reporting, and the fact that what reporting exists is not credible — $673 billion is a low number. That's important. If $673 billion was the final number, then measures that are put in place could limit the ultimate losses to a level below that figure. If, however, the total number of bad loans is substantially higher than $673 billion — which is our view of the situation — then the system would be lucky to have to write off only this amount.

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There are numerous ways to measure the magnitude of the problem, but one of the simplest is this. China is said to hold nearly $819 billion in foreign reserves. Fitch's conservative estimate of the bad loan situation comes close to matching that number, and a more liberal calculation would swallow those reserves up and then some. Put very simply, the Chinese banking system is in deep trouble — and with it, so is the Chinese economy.

It has become an article of faith that China's economy is booming. The economy certainly is growing rapidly. But growth and size alone don't tell you how healthy an economic entity is. During the Great Depression, the U.S. economy was enormous, but it was crippled. Japan's economy was growing at a phenomenal rate in the 1980s, all the while heading for its disaster. Size and growth are but two measures of an economy — or of a business. They do not tell you how well it is doing.

The basic problem of the Chinese economy, as in many Asian nations, is that the banks have not made loans with business considerations in mind. They made loans for political reasons and to maintain social stability. In many cases, loans were seen as being more like grants. As a result, they were invested in enterprises that did not make enough money to repay (or even attempt to repay) the loans. Frequently, rather than bankrupting the business or writing off the loan, the banks lent more money to the business — so that it could repay old debts, and there was an appearance that the loans were viable. Loans went into land speculation or to investments in areas that were already overbuilt. (And this does not attempt to take into account ancillary problems, such as corruption and embezzlement, which also have been significant issues for the Chinese government.)

In the first part of 2006, there has been a huge surge in lending in China. With the economy already growing at rates of more than 9 percent, it would seem structurally impossible to grow it any faster. Shortages in skilled workers, management, buildings — all these limit the rate of growth. The truth is that a substantial portion of the loans that went out were issued to keep bad loans floating, like using one credit card to pay the monthly payment on another. You can do that for a while, but you can't do it forever.

What keeps the Chinese system alive is not domestic consumption, which is not rising in tandem with overall growth. What keeps China afloat is exports — exports in ever greater numbers, and with ever-smaller profit margins. Surging exports are critical to China, as they were to Japan before it. They generate the cash that allows the financial system to continue operating.

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This is also the Achilles' heel of the Chinese economy, as Fitch points out:

"Given the weaknesses already discussed, we believe Chinese banks remain acutely vulnerable to an economic slowdown, although the analysis above recognizes that much work has been done to tackle these weaknesses and at a minimum suggests that Chinese banks and the government are more equipped today than in the past to deal with problems that may arise."

Here is the problem. The official policy of the Chinese government is to cool off the economy. In fact, the Chinese are attempting to cool growth only in certain sectors, where they perceive particularly dangerous bubbles starting to form. For the most part, however, they are doing everything they can to keep the economy hot, in order to try to manage the financial problem. Now, Fitch argues in its report that the Chinese banks are better equipped than in the past to deal with their problems. We agree with that assessment; they were completely unprepared in the past and now are abysmally prepared. You cannot prepare to deal with a loan situation as bad as that in China. You simply keep cycling as fast as possible and hope that something turns up.

In our view, this spate of reports on China's financial situation marks a turning point.

One of the things that has kept the Chinese economy booming was cheap exports. But another was the perception in the West that, underneath it all, China was sound. This perception induced foreign banks to invest in Chinese banks. There have, of course, been studies detailing the Chinese debt problem for some time: Standard & Poor's, for example, estimated the bad debt in 2002 at $600 million. That part isn't new.

However, when "irrational exuberance" (to quote Alan Greenspan) is at its peak, it is hard to break through the noise. Markets continue to rise, even as bad news comes out. Last week, for example, we saw the Bank of China make its initial public offering and shares soar, just as these financial reports were emerging. That doesn't mean these reports are wrong or that the Chinese have things under control. It simply means the market is ignoring news and rising on its own giddiness.

Nevertheless, a turning point has been reached that will be difficult to ignore. Reports from Stratfor are, of course, one thing. Reports from a single credit agency are another. But when a series of reports from highly

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respected, mainstream analysts all come out within a few days of each other — with each, in their own way, telling the same basic story, it becomes hard for the system to dismiss that. Western companies moving into China have CEOs and CFOs who must exercise due diligence. There are now too many reports out there to be simply ignored. All of them are caveated. None of them write China off. But a critical mass is forming that will cut through the froth in due course.

Obviously, this does not mean that China will implode, disappear or anything like that. It will remain an enormous economy and an important one. But this does mean that the dynamics of the Chinese economy are shifting. The debt issue represents a deep structural problem that China will either deal with — as South Korea did — or not, as Japan did not. (Japan reaped more than a decade of economic stagnation as a consequence. It is significant that China lacks the degree of insulation that Japan built up; the economy has more external exposures and would not weather a similar crisis as well.) The point is that, ultimately, the books have to balance everywhere. That means that the huge structural imbalance of China, which these debts represent, must be rectified. And that process, as in all such matters, will be painful.

It is not clear how much pain Chinese society can withstand before it fractures. This is clearly a concern for Beijing as it tries, simultaneously, to reform the economy and to crack down on dissent. The Chinese, like anyone in this fix, try to put the best possible face on the situation. Which is why they exploded at Ernst & Young. But even the government in Beijing couldn't shout down the ensuing tidal wave of financial reports; instead, they grumbled and pointed to the passages that said it could all be managed.

Perhaps it can. But if it can, it won't be easy — and we doubt that it is possible. We have been writing about this problem for several years now, and people keep asking when the crisis will come. Our answer is simple: If this isn't a crisis, what would a crisis look like? The Chinese financial system is sinking under nonperforming and underperforming loans. Mainstream Western analysts are all writing about the problem and calling for reforms that the Chinese cannot possibly implement in time to make a difference. At some point, the weight of evidence will shift the behavior of the Western financial community, and that will be that.

In the meantime, let the exports flow — for they surely will, and in breathtaking quantities.

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