INSTITUTE VIEW

BY TONG LI

By any standard, the Chinese economy has enjoyed a stellar run, growing at an average rate of 10 percent annually for three decades. However, the economy still relies heavily – too heavily in the view of many – on exports to sustain growth. And in the process of buffering the economy against falling demand from the United States during the recession, China exposed the weaknesses of a financial system that lags far behind the real economy in maturity.

With hundreds of millions of migrant workers floating around the economy, Beijing can hardly afford a pause in job-creating growth. So to sustain double-digit expansion in the teeth of the global recession in 2008, the government decreed a $580 billion economic stimulus package, mostly for financing locally managed infrastructure projects. The package did what it was supposed to do, substituting domestic demand for lagging export demand. But little of the resulting debt ended up on the balance sheet of the central government. Indeed, it had the unwelcome effect of increasing leverage for local governments and state-owned enterprises. And the resulting deterioration of credit quality came at an especially problematic time – one in which the emergence of shadow banks and informal credit markets is posing enormous challenges to China's financial regulators.

China has, in effect, outgrown a regulatory system that lacks the means to manage the complex, interconnected financial institutions that have popped up to serve the second largest economy in the world. As a result, the tools at regulators' disposal have all too often produced unintended consequences. Equally troublesome, regulators must often work in the dark; they lack the reliable statistical data needed to assess the risks associated with credit expansion.

A widely watched indicator for financial vulnerability is the nonperforming loan ratio (nonperforming loans to total loans) for Chinese banks. And here, the official numbers paint a rosy picture: nonperforming loans measured both in absolute terms and by the NPL ratio have been steadily on the decline since 2003. Currently, the ratio is under one percent – hardly a source of systemic risk. But the numbers do not capture the credit risks lurking just out of sight.

For one thing, the official data cover only commercial banks – and thus don't include bad loans on the balance sheets of the People's Bank of China (the central bank) or its affiliated asset management companies. They also exclude massive problem loans made by thousands of rural credit unions

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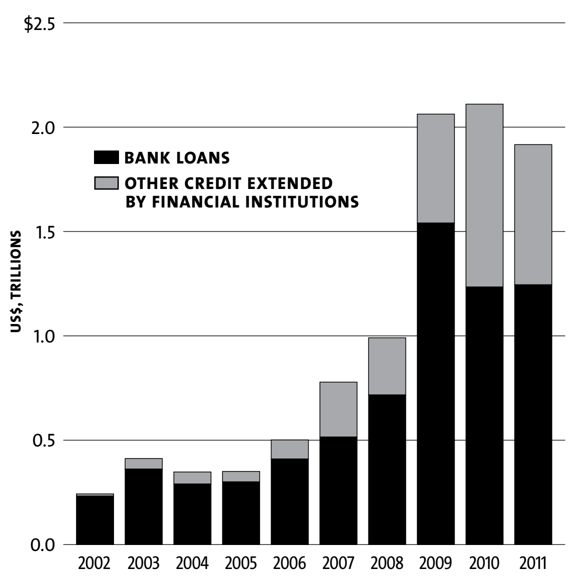
and cooperatives, where NPL ratios are estimated to be well above 10 percent.

To understand China's financial vulnerabilities, then, one needs to look beyond commercial banks' balance sheets. The real perils stem from off-balance-sheet activities. Or, to put it another way, China's real financial vulnerabilities lurk in the shadows.

VULNERABILITY NO. 1: LOANS TO LOCAL GOVERNMENTS

The true exposure of the financial system to local governments' liabilities is not known. When borrowing from banks for investment projects, a locality usually sets up a special investment vehicle (SIV) – or "investment platform company," as Chinese regulators call it. Credit extended to these SIVs is categorized as commercial and industrial loans; therefore, there is no straightforward way to distinguish these loans from the liabilities of business borrowers.

DECLINING ROLE OF BANK LOANS



SOURCES: People's Bank of China; author's calculation

In many cases, the investment projects financed this way cannot pay for themselves, and local governments are ultimately on the hook to cover the liabilities. Whether these loans ever become nonperforming thus depends on local governments' means – and will – to repay them.

The magnitude of these loans is in question. Official estimates vary from $1.3 trillion up to $2.2 trillion. No matter which number you believe, though, the import is clear: commercial banks are on the hook for loans to local governments equivalent to at least one-quarter of the annual GDP.

Regulators seem to be closely monitoring some 10,000 SIVs used by local governments. The banks are required to calculate discounted cash flows from these investment projects on a daily basis. There's a catch, though: the calculations are vulnerable to accounting gimmicks. Using lower discount rates for expected revenues from projects, for example, can drastically change conclusions about their fiscal viability. By the same token, the value of the collateral behind infrastructure loans is hard to pin down. The best guess now is that approximately 25 percent of these loans will eventually become nonperforming.

VULNERABILITY NO. 2: OFF-BALANCE-SHEET LENDING

So-called "shadow banks" account for an ever-larger share of credit provided to the real Chinese economy. These include trust companies, insurance companies, securities companies and microcredit companies. Entrusted loans (off-balance-sheet bank loans to trust companies that are classified as investments) and trust loans (credit extended by trust companies) account for most of it.

The People's Bank of China began publishing statistics in 2011 on "total social financing," which will also be used in formulating more comprehensive targets for monetary policy. This measure allows one to get a better sense of credit extension outside the banks' balance sheets. And the trend is disquieting, to say the least: from 2002 to 2011, the share of bank loans in total credit extension decreased from more than 95 percent to roughly 60 percent. Entrusted loans, trust loans and bank acceptance notes totaled $400 billion in 2011.

But the fact that the commercial banks' formal role in lending is declining doesn't make them less vulnerable to credit crises. Chinese shadow banks rely heavily on financing from the commercial banks. Take entrusted loans. By moving them off their own balance sheets, banks avoid capital requirements and the legal mandate to set aside adequate loan-loss reserves. Banks still service these loans, however, and will bear the losses if borrowers eventually default. Banks also have ultimate control on where entrusted loans go – usually to infrastructure and real estate projects.

Trust companies are thus really just bank surrogates. Yet some are reportedly leveraged at a ratio of up to 300 to 1 and certainly will not have sufficient capital to cover likely losses.

This is not the first time an end-run around regulation and capital requirements has put China's financial system at risk. Trust companies caused a banking crisis when an asset price bubble burst in Hainan province in the 1990s. The decline in housing prices, especially in large metropolitan areas, has the potential to trigger another, broader collapse in the housing market with grave consequences for the banks.

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VULNERABILITY NO. 3: INFORMAL LENDING

China's financial regulators do have regulatory power over trust companies and insurance companies. However, the vast and growing informal lending market operates below the government's radar. Indeed, even the country's umbrella financial regulator, the People's Bank of China, does not have adequate statistics on activities in the informal lending market.

Informal lending has a long history in China, thanks to the vacuum created by the absence of a modern banking system. Households and small businesses obtained credit from neighbors, relatives and friends – but also from affluent financial entrepreneurs who lent at very high interest rates. The tradition continues in today's China, where only 41 percent of bank credit goes to small- and medium-sized enterprises, which account for 77 percent of all employment and 65 percent of output. According to a 2011 survey by Peking University and the Alibaba Group (a Chinese e-commerce clearinghouse), although two-thirds of small businesses need credit, less than half reported activity in the formal credit market, and only 15 percent managed to obtain loans from banks.

In Wenzhou, a coastal city of two million best known for its thriving entrepreneurship, 89 percent of all households and 60 percent of businesses participate in informal lending activities. The local rich put 40 percent of their wealth into this market, where it generally fetches handsome returns. Very conservative estimates by the People's Bank of China and the Chinese Banking Regulatory Commission put the size of the informal lending market nationwide between $500 billion and $800 billion.

The fact that a market of this size is unregulated would be problematic in the best of times. But these aren't the best of times – and the informal credit market is showing signs of cracking. Weakened demand from the United States in 2008-9 severely dislocated the huge industrial base in China's coastal regions. Meanwhile, a tightened credit environment and a squeeze on profits led to a surge in small business bankruptcies and higher default rates on informal loans. Since many informal lenders borrow from banks, problems in the informal market are very likely to spill over to the banking sector.

A WORST-CASE SCENARIO

China's financial regulators are aware of these vulnerabilities and have considerable resources to defend the system. The central government is running a tolerable budget deficit and could certainly borrow more if needed without having to pay higher rates. The commercial banks' required reserve ratio is above 20 percent, which translates to a solid buffer against losses, should bank loan quality deteriorate. In addition, China now holds $3.2 trillion in foreign exchange reserves, which could certainly be used to recapitalize big financial institutions. (This is what happened in 2004 with two giants: the Bank of China and the China Construction Bank.)

But there is an unmanageable worst-case scenario in which the banks, shadow banks and informal lenders approach insolvency because local governments, the housing market and the business sector all buckle under stress in a credit crisis. The question, of course, is whether policymakers have the capacity to monitor the credit conditions adequately, as well as the authority – and cash – to prevent a liquidity-solvency crisis, or at least to contain the damage.

TWENTY-TWENTY HINDSIGHT

It's clear that China erred in failing to adopt policies that put the country's financial system on a more balanced track. Chinese regulators are fully aware that extraordinary growth of credit usually leads to deterioration in loan quality, especially when that growth is mandated by the central government. Indeed, to counter the impact, the People's Bank of China raised the commercial banks' reserve requirements 11 times in 2010 and 2011.

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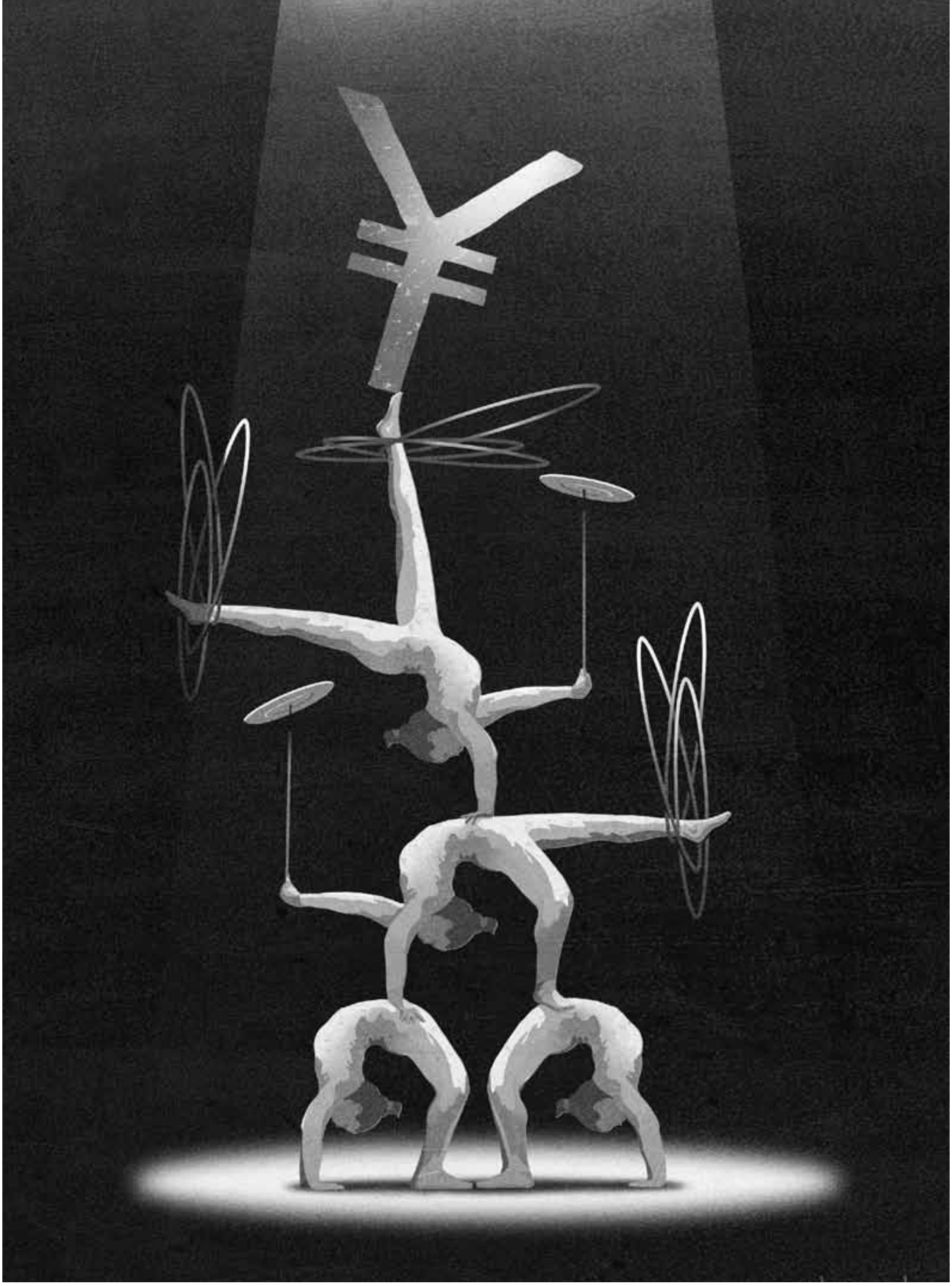
At last count, the minimum reserve ratio was 21 percent for large financial institutions.

Changes in the reserve requirement ratio (RRR) can effectively control the volume of bank loans. This tool is a problematic one, however, when used alone as a means of stabilizing growth and prices because, in the context of the hybrid Chinese economy, it is especially likely to distort credit allocation. Banks are inclined to respond to higher reserve re-



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quirements by rationing credit by nonmarket criteria. Usually this means that large state-owned enterprises with political clout are little affected, while small- and medium-size enterprises take a disproportionate hit.

At 6.5 percent (three percentage points higher than the deposit rate), lending rates at Chinese commercial banks are certainly low. But smaller enterprises, especially those lacking adequate collateral, are paying as much as 10 percent per month on the informal market. Thus, even after adjusting for risk, the returns to informal lenders far exceed those of the banks.

As a result, bank deposits have declined significantly in recent months, as those with savings find it far more lucrative to invest in the informal lending sector. Higher reserve requirements have only exacerbated this drain by reducing the portion of deposits that can be loaned by the banks.

The RRR, you'll remember, applies only to banks. It doesn't apply to off-balance sheet lending and shadow banks (let alone informal lenders), and therefore is not an effective tool to control excessive growth in total credit. Indeed, as the RRR takes its toll on the volume of bank lending, credit is increasingly extended by institutions that are the least regulated and monitored. Even the revised government policy target, "total social financing," fails to account for the vast informal lending market. In short, China's policymakers have been put in the impossible position of the proverbial drunk who loses his car keys at night, but confines his search for them to the areas around street lights because that's where the visibility is best.

LET THERE BE LIGHT

Plainly, an effective financial regulatory system would require a broader focus on the rest of the loan market and the tools to contain credit growth outside the formal banking system. Note, too, that monetary policy has borne too much of the burden for stabilizing growth and price levels, leaving local governments dangerously in debt and lenders overleveraged. Thus, fiscal policy, which would instead add to the liabilities of the central government, should be used more when further stimulus to the economy is needed. The development of bond markets should also be a priority, so that private businesses – especially midsize businesses – would be able to issue paper as an alternative to bank loans and informal lending.

A deep, liquid bond market would also give local governments an alternative means of borrowing without putting the banking system at risk. In the second half of 2011, several pilot programs were enacted to allow local governments to issue bonds. This was an important step that could eventually bring SIV lending out of the shadows and leverage private capital in more transparent ways. Regulators would, of course, need better data collection mechanisms as well as early warning indicators that cover both shadow banks and the informal lending market.

Equally important, regulators need an emergency funding mechanism to serve as an extra layer of protection in a full-fledged financial crisis. The last thing the world economy needs right now is a made-in-China financial crisis. If such a crisis occurred any time soon, the United States and Europe, which are preoccupied with their own debt problems, would be ill-prepared to help.

Much of what has been discussed here consists of near-term piecemeal fixes. The long-term goal of Chinese regulators should be reforms that toughen the economy and financial markets against the sorts of shocks faced by mature industrialized economies. This requires a gradual reduction in top-down control and increasing reliance on market incentives – credit allocation through markets, removal of international capital controls and a more flexible exchange rate regime.

Needless to say, such changes won't be easy. For one thing, there is no certain path to success – and the Chinese political system does not always reward policy innovators. For another, further deregulation and decentralization of the financial system are bound to be resisted by incumbent interests who would have less opportunity for what economists call "rent-seeking." But business-as-usual is not really an option any more. The risks in allowing the financial system to lag far behind the maturity of the economy are simply too great to ignore.