

FIVE PERSISTENT MYTHS ABOUT CHINA'S BANKING SYSTEM

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Of all the various topics and issues facing observers of the Chinese economy, it is safe to say that none arouses more spirited debate than the role of the financial system, and in particular the state of Chinese banks. Is the mainland on the verge of a financial crisis? Has the recent economic overheating created a new flood of bad loans? Do banks know how to allocate capital, or are they simply quasi-fiscal agencies acting at the mercy of the government? And does the rapidly opening financial system represent a gold mine or a “black hole” for foreign investors?

The answers to these questions are not always straightforward, but in our experience the truth lies very much away from the extremes so often presented in the financial press. Chinese banks are by no means “out of the woods,” first and foremost because they remain state-owned institutions, but they are now well advanced from their situation only a decade ago. This means that the economy is protected from the risk of a financial crisis—but, on the other hand, the banking sector is more a sunset industry than an exciting growth sector.

There are a number of myths about banks and the financial system in China but the following are the most important and most persistent: (1) China's cost of capital is far too low; (2) Mainland banks are unreconstructed quasi-fiscal agencies; (3) Bank recapitalization is a sham; (4) Banks are already “out of the woods”; and (5) The Chinese banking system is an exciting growth industry. Let us now examine these five myths.

Myth 1: China's Cost of Capital Is Far Too Low

Until 2004, bank lending and deposit interest rates were rigidly fixed in China, at roughly 6 percent on average for loans and 2

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percent for deposits. Even today, the regime for deposit rates has not changed, although banks have been given some leeway in raising lending rates. As a result, the common perception is that capital is “far too cheap,” and that low capital costs are the main explanation for China’s rapid growth over the past few decades.

In fact, the level of real lending and deposit rates are pretty much what we would expect from an economy with a gross domestic savings rate above 40 percent of GDP. The historical average for China over the past two decades is almost exactly the same as in the four Asian “tigers” during their high-growth period, and higher than that for Japan.

Indeed, a closer look at financial markets suggests that if anything, the capital cost to Chinese firms using the banking system is still too high, in the sense that full financial market liberalization would almost certainly result in lower lending rates. Market-determined long bond yields are currently only half the level of long-term bank loan rates, a reflection of the enormous amount of liquidity in the system. And although banks have taken advantage of the recent removal of the ceiling on lending rates to gradually bring the average up, the median lending rate is still firmly stuck at the mandated floor. Smaller financial institutions, in particular, are well known for their willingness to offer “under-the-table” incentives in order to bid effective deposit rates up—and effective loan rates down.

Myth 2: Mainland Banks Are Unreconstructed Quasi-Fiscal Agencies

The view that Chinese commercial banks are still little more than subsidy vehicles, propping up loss-making state-owned enterprises (SOEs) or blindly promoting government development goals, is so pervasive among outside observers as to be almost universal. However, this view turns out to be misguided on two counts. First, much has changed within the banking system itself, in terms of internal controls and incentives. And second, even more has changed among banks’ borrowers.

Looking at commercial banks’ internal structures, China has made significant progress in most areas. Whether state banks actually use these tools or not is a separate issue (and one that we take up further below), but over the past decade they have formally adopted modern risk controls, external auditors, centralized loan committees, and new corporate management structures. More important still, banks have seen enormous changes in the external regulatory environment,

including the creation of independent and aggressive supervisory agencies and a central government increasingly focused on improving commercial bank performance.

On the enterprise side of the balance sheet, the simple fact is that China does not have nearly as many loss-making SOEs as in the past. During the trough of the last “bust” cycle in the mid-1990s, a large swathe of the state (and, for that matter, private) economy was caught in the fallout. Aggregate industrial after-tax profitability fell fivefold to under 1 percent of revenues, and industrial losses alone exceeded 3 percent of GDP. However, rather than force banks to fund losses indefinitely, between 1996 and 2001 China embarked on the largest retrenchment program in recorded history. Nearly 40 million workers left the state sector, among which nearly 30 million lost their jobs outright as the authorities shut down tens of thousands of insolvent state firms. As a result, profitability indicators have rebounded to near record levels in recent years, and even after yet another round of excessive investment and subsequent macro tightening, gross state industrial losses are now less than 0.5 percent of GDP. This is a small number by both emerging and developed country standards, even accounting for the likely distortions in the official statistics.

A related banking system “myth” is that Chinese banks chronically ignore private companies and lend only to state borrowers. This is not to say that small private firms have ample access to funds in the mainland—by all accounts, they don’t. But most detailed surveys reveal that state commercial banks are more than happy to lend to large, established private players. Indeed, they compete aggressively for the business. By the same token, banks have proven themselves very reluctant to lend to smaller SOEs without visible cash flow. The point is that Chinese banks do not discriminate against private borrowers per se. Rather, they discriminate against small borrowers—into which category, unfortunately, most private companies fall.

How do we know? In part, because of the 2004 interest rate liberalization. One of the most cited reasons for banks’ unwillingness to lend to smaller firms has been the inability to price capital in a differentiated manner. Commercial banks may be quite willing to lend to large, established customers at a rate below the current 5.5 percent per annum floor, but have always maintained that they would charge higher rates to smaller companies. As mentioned earlier, once the ceiling on lending rates was lifted, banks continued to charge close to the floor rate for most loans—but the blended average rate has risen by more than 100bp, reflecting a new and growing “fat tail” of smaller corporate customers.

Myth 3: Bank Recapitalization Is a Sham

On the face of it, Chinese banks have made heroic efforts to throw off their accumulated bad debt burden. Best estimates show that since 1998, state commercial banks have written off roughly \$400 billion in nonperforming loans (NPLs) from their balance sheets, or some 30 percent of their average total loan portfolio over the period. And in the next year or two, banks are likely to remove another \$150–200 billion worth of NPLs, bringing the total to well over 40 percent of their historical loan book.

However, critics commonly retort that this apparent progress is nothing more than a facade. To begin with, most of the NPL write-downs have been funded by the government rather than by banks themselves—and moreover, very few of these loans have actually been resolved. Instead, they have simply been “parked” in state-owned asset management companies (AMCs) pending further collection. Second, it makes little difference how much debt banks take off their books if a flood of new NPLs is coming in from the other direction. As long as banks do not change their behavior, the government is effectively throwing good money after bad.

These criticisms are understandable, but ultimately misguided. Remember that market estimates from the late 1990s routinely put state commercial banks’ “true” NPL ratio at 50 percent or above—that is, so high as to make it literally out of the question for banks to write them off using their own resources. The state was going to have to pay for a recapitalization in any case; it was only a matter of when.

And this seems like a very good time to do it. For while outside observers still put new NPL creation at perhaps 10 percent of flow lending, in today’s terms it is impossible to argue that banks are generating anywhere near the 60–70 percent flow NPL rates we saw in the first half of the last decade. Back then, China did not have effective financial management. Indeed, it hardly had a functioning central bank at all. Money, credit, and investment growth reached 40–50 percent year-over-year, inflation was in the strong double digits, there was an enormous buildup in unwanted inventories and excess production across most industrial categories, and every asset market was rising at an unsustainable pace. None of this is true today, even after the overheating years 2002–03.

The surprise is how limited the impact has been on the broad economy. Outside of autos, steel and construction-related sectors, there are few signs of excess capacity or collapsing margins. Meanwhile, China has made visible progress on macroeconomic management and internal financial governance.

Finally, a few words on the debt workout strategy. If we were writing about Japan in the last decade, we would have good reason to disparage an approach that simply shifted bad loans from banks' ledgers to AMC balance sheets without any parallel efforts to restructure the corporate sector. But as noted, China has already carried out a draconian corporate restructuring in the state sector, shutting down factories and sending workers home. The sorry state of mainland bankruptcy legislation still prevents banks from formal foreclosure on many of the associated claims—but the real economic adjustment has already occurred, and disposing of these loans is for the most part a mere formality.

The same holds for state firms that survived the shakeout in the late 1990s. Most of them are profitable on a cash flow basis, but are still saddled with very high debt ratios after the credit binge during the past decade. Here the official strategy has been to convert loans to equity positions, and in the long run this will almost certainly prove to be the right tack.

Myth 4: Banks Are Already “Out of the Woods”

Given the preceding arguments, the reader would be forgiven for concluding that Chinese banks today are clean, strong, market-oriented institutions. Are we really trying to say that banks do not have any remaining problems whatsoever?

Not in the least. In fact, mainland banks are not inherently better at saying “no” to bad practices and poor projects. Quite the opposite. As 100 percent state-owned entities, financial institutions are still living very much at the government's whim. The simple reality is that in recent years, banks have gotten lucky. They are lucky that the central government has become a strong supporter of better lending policies, lucky that the authorities tend to shut down insolvent firms quickly, and lucky that the government has a stronger track record of macroeconomic management.

State ownership of banks also means, however, that when the central government is not paying particular attention to the financial system and not actively controlling the macroeconomy, it is very easy to fall into a pattern of overlending—especially with provincial and local governments who have every incentive to push growth at the expense of macroeconomic stability. We call this the “white elephant syndrome”: the tendency for the mainland to explode once a decade in a new round of overheated, redundant investment projects. Sure enough, by UBS figures China is the most volatile economy in Asia,

with very amplified boom-bust cycles even compared with its smaller neighbors.

The experience of the mainland steel sector over the past five years is a perfect case in point. At the beginning of the decade, steel companies were enjoying an unprecedented boom: housing construction had nearly quadrupled as a share of GDP over the previous decade, urban residents were buying cars at a frantic pace, and as a result steel profits skyrocketed. Needless to say, this climate provided a strong incentive for additional investment. Local governments all over the country were walking into bank offices with proposals for new steel plants—usually small-scale, wasteful projects aimed at making a quick return—and, looking at current profits, banks were all too happy to lay out the funds.

What happened? In retrospect, the result was inevitable. Government measures to stem excessive leverage in auto finance and property development throttled the growth of steel demand, exactly as the tidal wave of new production facilities hit the market. Suddenly, China had a large excess capacity problem in steel.

And now for the most interesting part: How did the financial system react to the problem? Were local governments able to convince banks to finance unneeded production? Did small, redundant plants get blank checks to prop up losses? The short answer is no. In fact, the smaller players dropped out of business relatively quickly. Despite a high theoretical capacity overhang, there was only a mild actual inventory buildup, and profits in the larger steel majors fell by much less than in neighboring industries such as autos or oil refining. The bottom line is that China's state-owned banks play a crucial role in chronic overheating in the economy, but capacity also exits as easily as it enters. In other words, the real problem is excessive "boom-bust" behavior, not endless subsidization of static loss-makers.

These points all lead to one conclusion: the authorities may be doing a much better job managing the financial system, but the fundamental problems will not be fully resolved until the state gets out of the business of running banks. In our view, privatization is the only long-term method of making structural reforms "stick" and ensuring macroeconomic stability.

Myth 5: The Chinese Banking System Is An Exciting Growth Industry

Which brings us to the final issue. As it happens, the single most revolutionary change in financial policy this decade has been the

launch of formal bank privatization. The real motivation for the massive government cleanup of the “big five” state-owned commercial banks is precisely to prepare them for equity listings and strategic sales. And foreign partners have responded in droves. From less than \$1 billion in investment over the past 50 years, overseas banks have made around \$20 billion in strategic commitments over the past 18 months alone, with a similar figure expected in new equity IPOs by the end of 2006. Indeed, by the opening of the 2008 Beijing Olympics foreign investors should own at least 25 percent of the urban banking system, and the share could rise sharply beyond that over time.

This development has raised howls of protest from two very different camps. The first are overseas pundits who claim that foreign banks are setting themselves up for disaster by throwing money into the moribund Chinese financial system. The second are mainland domestic interests, who complain that the government is selling off the “family jewels” far too cheaply in view of the future growth prospects.

From the preceding discussion, it should be clear that we have little sympathy for the first view. Banks today are cleaner and more well behaved than they once were, and foreign investors themselves should eventually emerge as a strong guarantee of future improvements in governance and management.

On the other hand, mainland banks are hardly the greatest growth story of the 21st century. The plain truth is that—glaringly alone among poor developing countries—China is already significantly overbanked. Just look at the numbers: Commercial bank deposits account for nearly 200 percent of GDP, and loans in the banking system currently stand at 130 percent of GDP. Only Taiwan and Hong Kong have higher banking ratios, and the average for the developed world is much, much lower.

What accounts for these huge numbers? The simple reason is that for two decades mainland firms have had no other source of outside financing, and mainland households have had no place else to put their savings. But this could change quickly. As China’s nascent equity, bond, and property markets mature, I expect a steady deleveraging on the part of companies, and a steady diversification on the part of Chinese savers. So while consumer banking is a promising development area, corporate lending is not. I am not saying that the banking system cannot grow, but rather that at some point it will begin to grow much slower than GDP.

Moreover, the profits earned by Chinese banks on that growth are far from impressive. In 2004, for example, global banking institutions recorded a 1.2 percent overall return on assets while the figure for

Chinese banks was only 0.4 percent. The rate of return on equity was closer (11 percent compared with 16 percent), but only because mainland institutions have lower capital adequacy. Of course Chinese banks will gradually learn to generate more fee-based income, but keep in mind that margins on regular lending operations are currently propped up at artificially high levels because of state-controlled deposit rates. Once these are decontrolled (which could happen fairly soon) deposit rates will rise, putting further pressure on profitability. At the end of the day, the only way for China's large banks to show high rates of earnings growth will be to cut costs aggressively, a fairly unlikely outcome for the foreseeable future.

In other words, while there are perfectly valid reasons for overseas banks to be investing in their Chinese counterparts, they had best not overpay for the assets. Indeed, the average price-to-book value ratio for the recent multibillion dollar Bank of China, China Construction Bank, and Industrial and Commercial Bank of China strategic investment transactions was a very moderate 1.2 times—well below the 1.9 ratio commanded by large global banks, not to mention ratios in excess of two for smaller, promising high-growth plays. So foreign strategic investors, at least, do not seem to be wearing rose-colored glasses; they paid pretty much what one would expect them to pay for a stable, low-growth, low-margin business.

Conclusion

This has necessarily been a brief summary of the main issues surrounding Chinese banks; a more complete treatment can be found in Anderson (2005). The main finding is that despite the often-breathless hype about the state of the mainland financial system, the actual situation is more prosaic. Banks are not on the verge of a crisis, and after government-led recapitalization they are no longer drowning in an unsustainable sea of bad debt. Chinese capital allocation is far from perfect, but has not led to an economy-wide calamity—and financial institutions are steadily improving their performance over time. As a result, foreign investors are warranted in their interest in buying into the banking system, as long as they don't treat commercial banks as an exciting growth sector.

Reference

Anderson, J. (2005) "How to Think about China (Part 3): Which Way Out for the Banking System?" *UBS Asian Economic Perspectives* (9 May).