

Can the Chinese Banking System be Sustainable under the Global Financial Crisis ?

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1. Introduction

A US subprime mortgage crisis triggered a global financial crisis that dragged the world economy into the worst recession since 1930s. Most of the governments adopted the old Keynes' method to survive and poured trillions of dollars into bank-rescue and fiscal stimulus.

The global financial crisis has also slowed down China's economic growth rate (Fig. 1). Both imports and exports suddenly dropped and the growth rates have turned to negative since November 2008, but exports have fallen further (Fig. 2). In order to stop the downward trend, China started the expansionary monetary and fiscal policies at the end of 2008. According to the People's Bank of China (PBC, the central bank), Chinese banks advanced 8.67 trillion yuan in fresh loans in the first nine months of the year, more than twice the amount they issued during the same period last year (Table 1). Also, the government

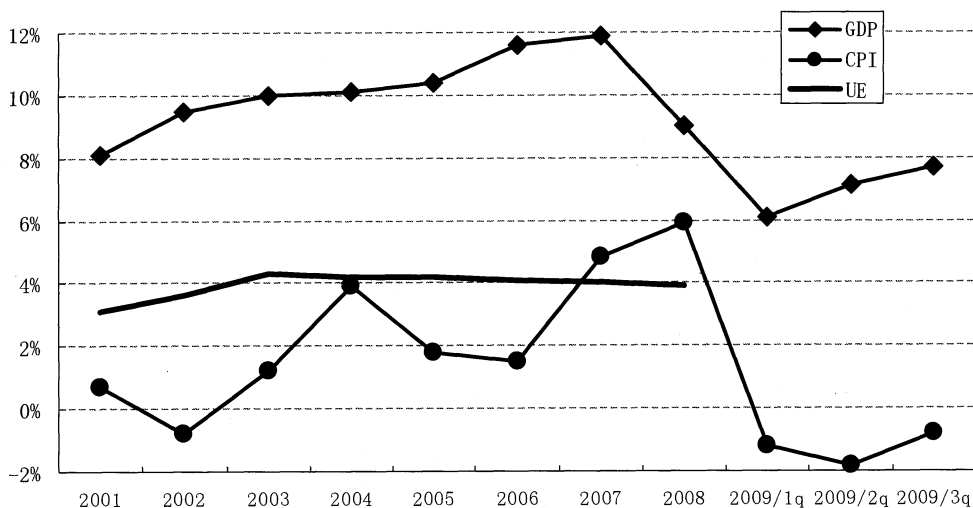


Figure 1 Increase rates of GDP, CPI and Unemployment rate

Source : Statistical Yearbook of China (various years), <http://www.stats.gov.cn/>.

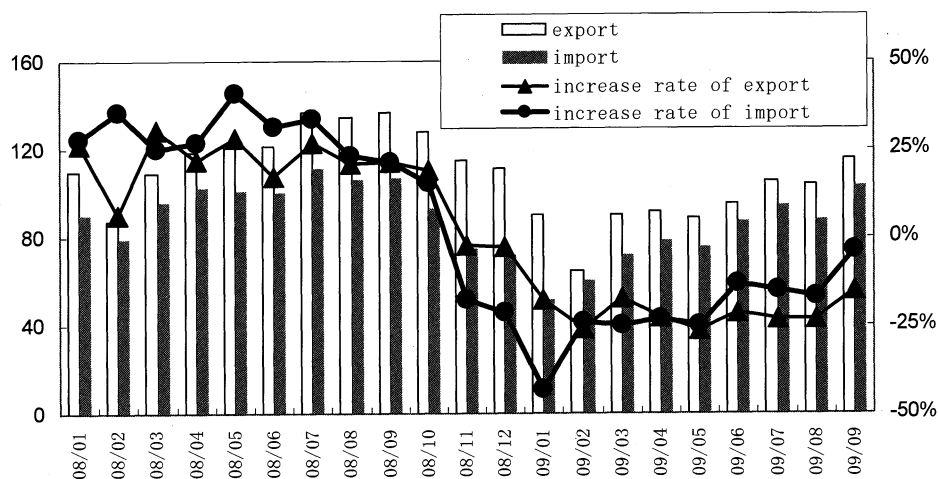


Figure 2 Export and import and the increase rates (Billion \$, %)

Source : Statistics, <http://data.eastmoney.com/>

introduced a 4 trillion yuan fiscal stimulus for 2009 and 2010, a sizable amount at 14 percent of the GDP in 2008.

Thanks to these huge stimulus packages, China's economy has shown clear signs of improving. Statistics show that the economy expanded 8.9 percent year on year in the third quarter, faster than the 7.9 percent in the second quarter and 6.1 percent in the first. There is no doubt China will achieve the goal of a GDP increase of 8% in 2009.

The data coming out from China suggest that the recovery is powerful with low unemployment rate and inflation rate (Fig. 1). However, the dramatic increases in new lending and fiscal funds this year, combined with rising property and equity markets, have raised fears that government policies are creating a series of bubbles and finally making a sudden collapse of the Chinese banking system a possibility.

This paper will answer the question of that if the Chinese banking system can be sustainable under the global financial crisis. Analyses and discussion are on basis of statistics, financial articles¹ and reports released by China Banking Regulatory Commission (CBRC).

Table 1 New loans and increase rates
(billion yuan, %)

	New loans	increase rate
08/01	804	42%
08/02	243	- 44%
08/03	283	- 35%
08/04	464	10%
08/05	318	28%
08/06	356	- 21%
08/07	382	65%
08/08	272	- 10%
08/09	375	32%
08/10	182	34%
08/11	477	446%
08/12	772	1489%
09/01	1,653	106%
09/02	1,072	340%
09/03	1,892	567%
09/04	592	28%
09/05	667	109%
09/06	1,530	330%
09/07	356	- 6%
09/08	410	51%
09/09	517	38%
09/10	253	39%

Source : Statistics, <http://data.eastmoney.com/>

2. Present Situation of the Chinese Banking System

2.1 A general view of the system of Chinese banking sector

Along with the gradual pace of macroeconomic transformation, the financial sector of China has been reformed by the way of slowly reducing the scope of planning and introducing a market-oriented system. The most important step of the reform was changing the four state-owned banks (ICBC : Industrial and Commercial Bank of China, ABC : Agricultural Bank of China, CCB : China Construction Bank, BC : Bank of China) into commercial banks in 1994, which meant to gradually reduce the policy-oriented loans and make them concentrate on generating profit without government subsidy. At that time, the total amount of assets in these four banks shares over 85% of that in all national banks.

At present, the Chinese banking system consists of 3 policy banks, 4 state-owned commercial banks (mentioned above), 13 share holding commercial banks (Communications Bank of China, *Minsheng* Bank, *Huaxia* Bank, etc.), various local and rural banks and credit cooperatives. At the end of 2008, the total amount of outstanding loans in the big four state-

owned lenders still shares 47.4% of that in all national banks.²

It is worth noting that the government's power more or less remains in both the state-owned and other commercial banks after the reform.

2.2 Solution of NPLs and listing boom of banks

After decades of government-directed lending to unprofitable state enterprises, the banking sector reached the brink of collapse in the wake of the 1997 Asian crisis. Well over a third of loans were not being repaid and virtually every lender was technically insolvent at that time.

In 1999 and 2000 the government transferred 1.4 trillion yuan of Non-performing loans (NPLs) from the big four state-owned banks to four newly established "asset management companies", namely Changcheng, Dongfang, Xinda and Huarong. The job of these four companies is to restructure and repackaging the NPLs to try to recover as much of the original outlay as possible, often through sales or auctions of assets held as collateral.

In 2003, another large chunk of NPLs in the big four amounted to 1 trillion yuan was transferred to the four asset management companies.

After the NPLs were transferred, and mostly in exchange for a variety of government-backed bonds, the four banks were allowed to turn bad debts in their balance sheets into interest-bearing assets and got a fresh start (Table 2).

Then the government utilized the surplus foreign currency reserves and injected \$ 225 billion, \$ 225 billion, \$ 150 billion, \$ 190 billion into CCB, BC, ICBC, ABC respectively for

Table 2 Some indicators of the four state-owned commercial banks

		(% , billion yuan)					
		2003	2004	2005	2006	2007	2008
ICBA	Owned-capital ratio	-8.81	-8.31	9.89	14.05	13.09	13.06
	NPLs ratio	21.24	18.99	4.69	3.79	2.74	2.29
	Pre-tax profit	2.66	21.05	59.35	71.52	115.11	145.30
BC	Owned-capital ratio	5.39	10.04	10.42	13.59	13.34	13.43
	NPLs ratio	16.28	5.12	5.41	4.04	3.12	2.65
	Pre-tax profit	38.57	34.58	55.14	67.63	89.96	86.25
CCBC	Owned-capital ratio	6.51	11.29	13.57	12.11	12.58	12.16
	NPLs ratio	4.27	3.92	3.84	3.29	2.60	2.21
	Pre-tax profit	37.47	50.22	55.36	65.72	100.82	119.74
ABC	Owned-capital ratio	7.41	9.72	9.72	10.83	14.44	13.47
	NPLs ratio	na	2.91	2.91	2.01	2.05	1.92
	Pre-tax profit	4.06	7.20	7.12	17.41	31.04	35.82

Source: PBC, "Report 2009 on Financial Stabilization", <http://www.pbc.gov.cn>.

Table 3 Ranking of Total current stock prices of the world banks (March 31, 2009)
(billion \$)

Ranking	Name of the bank	County	Total current stock price
1	Industrial and Commercial Bank of China	China	187.9
2	China Construction Bank Corporation	China	133.2
3	Bank of China	China	115.2
4	JP Morgan Chase	USA	99.9
8	Mitsubishi UFJ Financial Group	Japan	56.1

Source: *Financial Times*, "FT 500 Companies", <http://www.ft.com>.

Table 4 Ranking of pretax profits of the world banks (2008)
(billion \$)

Ranking	Name of the bank	County	Total pretax profits
1	Industrial and Commercial Bank of China	China	21.3
2	China Construction Bank Corporation	China	17.5
3	Banco Santander Central Hispano	Spain	15.8
4	Bank of China	China	12.6
8	Agricultural Bank of China	China	7.7

Source: *Financial Times*, "Top 1000 Banks, 2009", <http://www.ft.com>.

increasing their owned-capital. Eventually, the four banks became profitable; CCB, BC and ICBC were able to list on the Hong Kong and Shanghai Stock Exchanges (Table 2).

Furthermore, the four big banks became top level banks globally after the rescue by the government. The current market value of the listed ICBC, CCB and BC ranked top three banks of all the world banks (Table 3). All four banks were in the top ten in terms of pretax profits (Table 4).

Share-holding commercial banks and local banks with relatively low historic burdens show good performance along with rapid economic growth. Eleven banks of them have successfully been listed on the Shanghai Stock Exchange and four banks were able to be simultaneously listed on the Hong Kong Stock Exchange.

2.3 The structure of the loans

As mentioned above, the four state-owned commercial banks are the main force of credit distribution, delivering nearly half the amount of the total national loans. Most of the loans are lent to state-owned or state-controlled enterprises which are generally large. In addition, other banks also prefer lending to large scale enterprises.

Official data show that outstanding loans for the small and medium enterprises (SMEs) share 36.3% of that of all national banks at the end of 2008. But an inside official said that in fact no more than 8% were delivered to SMEs.³ There are two reasons that banks are reluctant to deliver loans to SMEs: one is higher transaction cost, it often costs much to allocate small and scattered fund; the other is higher risks, because of instability rooted in the SMEs, banks commonly suffer from arrears and defaults leading to risks. There is little incentive for banks to give credit to small, unknown entrepreneurs instead of large or established enterprises, if they wish to make more profit and avoid risks.

3. Potential crises of the Chinese Banking Sector

China has achieved preliminary progress in fighting the global economic downturn, but the foundation for economic recovery is still unstable yet. Some deep-seated problems in the Chinese real economy will damage the banking sector.

On the other hand, since the beginning of 2009, NPL rate and the amount of NPLs in the banking industry have both continued to drop. At the end of September, all commercial banks' remaining NPLs stood at 504.5 billion yuan, down 55.8 billion yuan from the beginning of 2009. NPL rate stood at 1.66%, down 0.76% points over the beginning of 2009. Although both NPL rate and the amount of remaining NPLs have dropped, potential risks from high credit growth are still accumulating.

3.1 Problems in real economy

3.1.1 Unbalance of the macro economic structure and overcapacity

Figure 3 shows the components of GDP by an expenditure approach. From 2001, the share of household consumption in GDP has been declining, while net exports and capital formation has been contributing more and more to the GDP growth. The trend shows that China's growth relies much on external demand. Among domestic demand, fixed asset investment has long been the most important driving force.

Booming fixed asset investment inevitably resulted in a huge capacity. After the sudden withdrawal of external demand at the end of 2008, the problem of overcapacity became much clearer. To maintain decent growth and avoid massive unemployment, the Chinese government was left with no option but to replace flagging external demand by domestic demand. But in the short run it is difficult to stimulate domestic consumption; investment demand became the only alternative. As a result of the stimulus packages, the growth rate of fixed asset investment has been soaring (Table 5), and yet worsened already severe

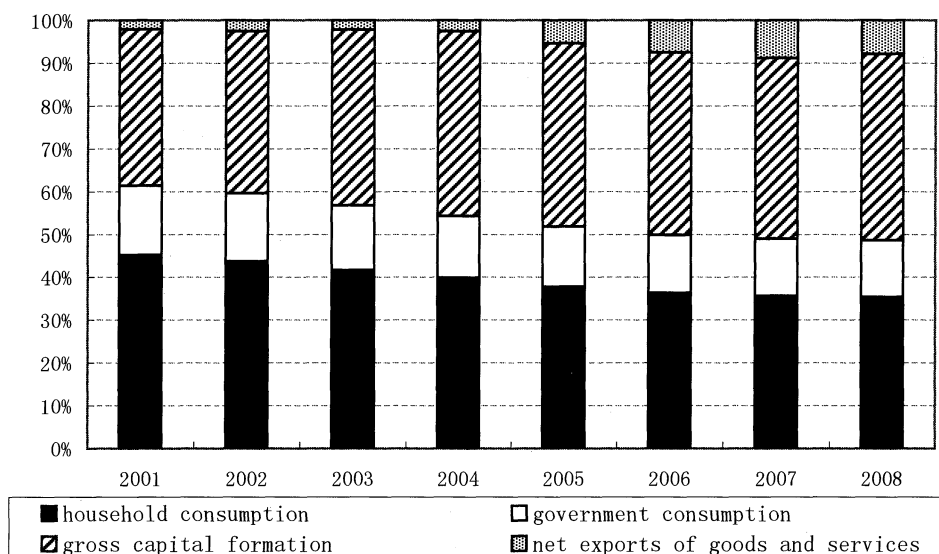


Figure 3 Components of GDP by expenditure approach

Source: Statistical Yearbook of China (various years), <http://www.stats.gov.cn/>.

Table 5 Amount of Investment in Fixed Assets in Urban Area and year-on-year increase rate

(billion yuan, %)					
	amount	increase rate		amount	increase rate
2001	3,000	14.4%	09/1-2	1,028	26.5%
2002	3,549	18.3%	09/03	1,328	30.3%
2003	4,581	29.1%	09/04	1,340	34.0%
2004	5,903	28.8%	09/05	1,644	38.7%
2005	7,510	27.2%	09/06	2,457	35.3%
2006	9,337	24.3%	09/07	1,729	23.9%
2007	11,746	25.8%	09/08	1,759	33.0%
2008	14,874	26.6%	09/09	2,019	26.0%

Source: Statistical Yearbook of China (various years), <http://www.stats.gov.cn/> and Statistics, <http://data.eastmoney.com/>

overcapacity.

According to annual fiscal reports released by 1,300-odd companies listed on the Shanghai and Shenzhen Stock Exchanges, although the profits of many companies increased substantially, those of many others dropped sharply. Overcapacity is thought to be the main reason for the decline in profits. For example, in the first half of 2009, the net profit attributable to shareholders in the outbound transportation sector dropped by 90 percent

year-on-year. The drop in overall performance was mainly due to a substantial decline in demand for the transportation of imported and exported cargo in the first half, significantly affecting the air freight service market and the air express business of cargo and passenger transportation enterprises. Aluminum Corporation of China Ltd. also faced the same problem. Weak demand and price drops resulted in a 27.98 billion yuan drop in turnover, down 29 percent from the previous year.

In October 2009, the National Development and Reform Commission (NDRC) warned of overcapacity in six sectors, which included steel, cement, plate glass, coal-chemical industry, polycrystalline silicon and wind power equipment, in order to avoid low level repetitive construction. NDRC also stressed that overcapacity might lead to bankruptcy, unemployment and bad bank loans. Furthermore adjustments, along with reducing costs and increasing efficiency, will become an important task for companies in overcapacity status.

3.1.2 Deficits of enterprises

Figure 4 shows the ratio of the deficit industrial enterprises above designated size⁴ and the total amount of their deficits. It is contradictory that enterprises in deficits have been increasing while the high growth rate of GDP continues. Logically, enterprises suffering losses in the business should withdraw from markets, but China is the exception. Because unemployment caused by bankruptcy might trigger a social riot, the government often takes some measures to maintain the running of enterprises in spite of inefficiency. It seems that mandating banks to provide credit fund is the most common way for rescuing.

On the other hand, the fiscal and monetary policy response to the crisis has mostly benefited the largest enterprises and biggest projects, most of them are government-

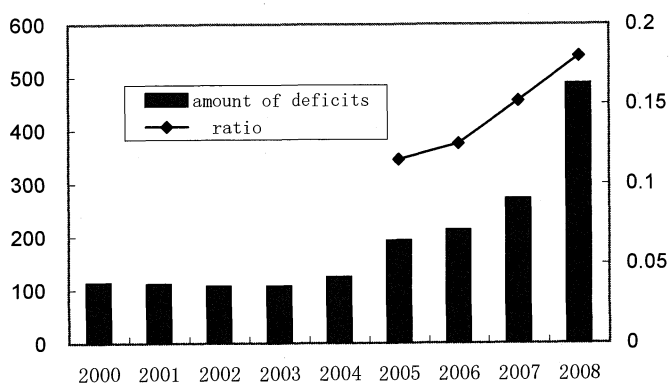


Figure 4 Ratio of the deficit industrial enterprises above designated size and the total amount of deficits

Source: Statistics, <http://news.cnfol.com/>

mandated. SMEs, which provide 75% of the jobs to China's urban workforce, are shrinking for the first time in 30 years of economic reforms.

3.1.3 Low energy efficiency

Table 6 shows the elasticity of energy consumption to GDP. Although the elasticity has turned down since 2004, the total amount of energy consumption has quickly increased causing the jump of the price of crude oil in the world market.

From 2008, low-carbon city pilots, an energy-saving and emission-reducing project, were initiated in China's major cities. A low-carbon city means, in the context of a city's rapid economic development, energy consumption and carbon dioxide emissions kept at low levels. With the goal of setting up low-carbon cities, and through establishment and implementation of policies promoting low-carbon economy, local governments are guiding enterprises to develop green industries, improve resource and energy efficiency to achieve a win-win situation of environmental protection and economic growth, while reducing resource consumption and pollutant emissions. But creating a low-carbon city is not easy, and it requires a long-term, continuous process of change, and faces huge challenges in the innovation of low-carbon technology.

Table 6 Elasticity of energy consumption to GDP

	energy increase rate (a)	GDP increase rate (b)	elasticity (a)/(b)
1999	1.2	7.6	0.2
2000	3.5	8.4	0.4
2001	3.4	8.3	0.4
2002	6.0	9.1	0.7
2003	15.3	10.0	1.5
2004	16.1	10.1	1.6
2005	10.6	10.4	1.0
2006	9.6	11.1	0.9
2007	7.8	11.9	0.7
2008	7.3	9.0	0.8

Source: Statistical Yearbook of China (various years), <http://www.stats.gov.cn/>.

3.2 Pressure of inflation

When entering 2009, China has been in deflation for successive months (See Fig 1). The deflation is caused by the overcapacity on the supply side. When aggregate supply exceeds aggregate demand, the price goes down.

It seems that we need not worry about inflation now, but things may change in the near future. As mentioned above, credit growth was surprisingly high, and the same was true for money supply, M1 and M2 (Fig 5), which grew at a record rate relative to GDP. As a result, the inter-bank money market has been inundated with liquidity.

CBRC stated that as of the end of September, banks' average liquidity ratio, or cash held by these banks as a proportion of deposits, was 41.7%, well above the industry requirement of 25%. The other indicator of loan-to-deposit ratio is also increasing. For example, China Minsheng Bank, the nation's first listed private lender, has seen its average net profit jump by 18.1% in the first three quarters from a year ago, driven by a galloping 42% lending growth during the period. But the rapid loan expansion also propelled the bank's loan-to-deposit ratio to a record 80%, exceeding the requirement of 75%.

With the liquidity issue becoming more and more pressing for Chinese banks, inflation will soon come.

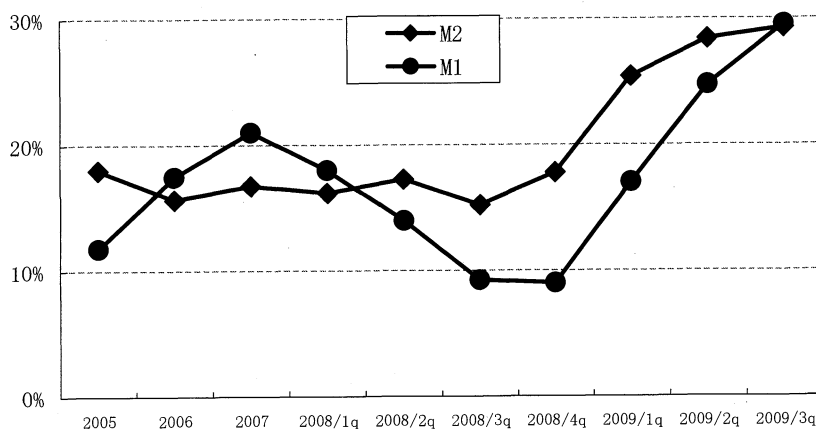


Figure 5 Increase rates of M2 and M1

Source : Statistics, <http://data.eastmoney.com/>

3.3 The bubble of equity and property

Both equity price and property price have been soaring since the beginning of 2009 (Table 7), driven by excess liquidity along with the jump of money supply.

Based on an inquiry conducted by CBRC, because the large amount of credit injection leads to overcapacity and low returns on capital, some enterprises who have been able to get loans from the state banks are speculating on the stock and property markets for higher profits, while not going into the real economy.⁵

When businesses make profits from, rather than for, the stock market, it becomes a negative sum game. With the PE (price/earning per share) of many stocks having jumped over 70, we have to say that China's stock market have already overvalued. It needs continuous liquidity inflows to sustain it or the stock market will burst.

Table 7 Equity and Property Price indexes

	Shanghai securities highest	composite index lowest	Shanghai real estate composite index
08/01	5797	4544	1959
08/02	4928	4326	1967
08/03	4692	3522	1982
08/04	3888	3138	2008
08/05	3973	3498	2034
08/06	3655	2825	2068
08/07	3097	2692	2069
08/08	2970	2398	2048
08/09	2499	1893	2025
08/10	2381	1749	2012
08/11	2154	1764	1987
08/12	2206	1905	1979
09/01	2206	1905	1956
09/02	2119	1936	1944
09/03	2523	2086	1943
09/04	2512	2138	1953
09/05	2707	2448	1972
09/06	2822	2610	2031
09/07	3147	2801	2127
09/08	3626	3094	2273
09/09	3651	2794	2359

Source : Statistics, <http://data.eastmoney.com> and <http://www.valuer.org.cn>

The property market is also full of liquidity and speculation. The situation is made worse by the revenue dependency of local governments on the property market. Local government officials, who change every five years or so, have strong incentives to juice up the property market to maximize their revenues. Speculation is encouraged, backed by the policies such as cutting transaction tax of real estate, and providing subsidies for housing purchase, discounting interest rate for mortgage loans and so on. This political incentive sows the seed for a great property bubble. As a result, China's land transactions and prices hit new highs in September 2009.

No one believes a bubble is happening until it bursts.

3.4 NPLs and shock to the banking sector

The old NPLs problem was just solved in the books. In the early years, four asset management companies reported recovery rates of 20-30% of the face value of the NPLs, but in the past three years they have not reported recovery rates. It suggests that the massive old NPLs are practically insolvent.

On the other hand, the present lending boom, carried out by the country's state-owned/controlled banks on the orders of the central government, has raised concerns that with declining returns on capital, much of the money has gone to borrowers who will not be able to pay it back. What is more, along with increasing deficits in enterprises, tremendous volume of loans might end up as new NPLs in the books of the banks.

Needless to say, if the bubble of equity and property bursts, the banking system will inevitably collapse.

What's happening now is similar to what happened in the US in 2001 — the government was flooding the economy with cash that just papers over the problems and left some significant asset quality and NPLs problems down the road until the U. S. subprime mortgage crisis happened.

4. Discussions and Conclusions

China has survived the global financial crisis. But its recovery is driven by a surge in credit and fiscal stimulus for fixed assets investment. In the longer term, China needs to rebalance its macro-economic and industrial restructure, expand employment for rural surplus labor force, regulate inflation prospects and promote energy efficiency so as to improve people's welfare and make a sustainable development.

Expanding household consumption must be set as a basic starting point. China is suffering

from extremely high saving rate. People save money for four big expenditures of education, housing, medical care and old-age security. More resources should be used in reforming the education system, old-age security system, medical and health system to build a decent social safety network, so household consumption can play a more important role in driving economic growth.

Cutting down the larger companies with overcapacity and fostering SMEs is an urgent subject in improving the quality and efficiency of the economic growth, and also pushing out more jobs for rural labor force and narrowing urban-rural income gap as well as boosting rural households' consumption.

History proofs that the money game cannot save any country, including China. Excess liquidity which has already raised inflation pressure and caused a series of bubbles must be under severe observation. In future global competition, technological strength will determine a country's future. So policies must give more emphasis on supply side instead of demand side. The concrete measures include strengthening China's scientific research and improving technological innovation, especially technologies on energy conservation and emission reduction.

The Chinese banking system is expected to play an important role in adjusting structure and making a stable growth. In the short term, it is necessary to effectively strengthen the risk management and ensure that loans flow into efficiency projects so as to prevent the accumulation of NPLs. The details include controlling of financing platforms and project loan risks, firmly adhering to the policies of strictly forbidding the issuance of bundling loans as well as limiting loans issued to the signing of large-amount credit cooperative contracts involving no specific projects. In the long term, the banking industry must closely trace macro-economic and industrial restructuring trends, scientifically control credit issuance and strengthen the construction of the risk management system and mechanism.

In China, the situation of the banking industry still depends largely on macro fiscal and financial policies and is controlled by government. The stable economic development is the prerequisite condition for the sustainable development of the Chinese banking system.

Notes

- 1 The financial articles source from *FTChinese* (<http://www.ftchinese.com>) and *People's Daily on Line* (<http://www.english.people.com.cn>). This paper depends on many articles and survey reports from these two websites. But the writers and titles are not shown one by one in the paper because of space limitation for publishing.
- 2 As of the end 2008, outstanding loans in all banks totaled 30.3 trillion yuan, in which the big four

amounted to 14.4 trillion yuan. (Data are from Statistical Yearbook of China 2009)

- 3 Because of the confusion of SME's definition, some enterprises are counted in SMEs although their scales are still large. For example, in the construction industry, all the enterprises less than 3,000 employees or with the annual turnover no more than 300 million yuan are defined as SMEs. (See the website <http://www.chinaplastic.net/news/detail.asp?ID=17922>)
- 4 Enterprises above designated size refer to relatively larger scale companies.
- 5 From one of the CBRC's internal materials which are named "Information on Supervision". Other materials in "Information on Supervision" are also cited, but concrete materials are not shown one by one in this paper for maintaining secrecy.

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