

*China's banking system risks
after the 2008-10 stimulus package
and the housing boom*

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Outline

- 1 What has happened since China initiated banking reform in mid-2000s?
- 2 Déjà vu: what are the similarities with 1998?
- 3 How big the losses?
- 4 The housing boom and the banking system
- 5 Conclusions

What has happened?

- The world financial system is recovering from the ashes
- Meanwhile, China's banking system has blossomed from an “unsustainable” situation in the first half of 2000s
- Is it really true?
 - To some extent yes:
 - Banks are solvent and profitable
 - Bancarization proceeding rapidly
 - But roots of the problem not really addressed:
 - Misallocation of credit due to public interference
 - The jury is still out!

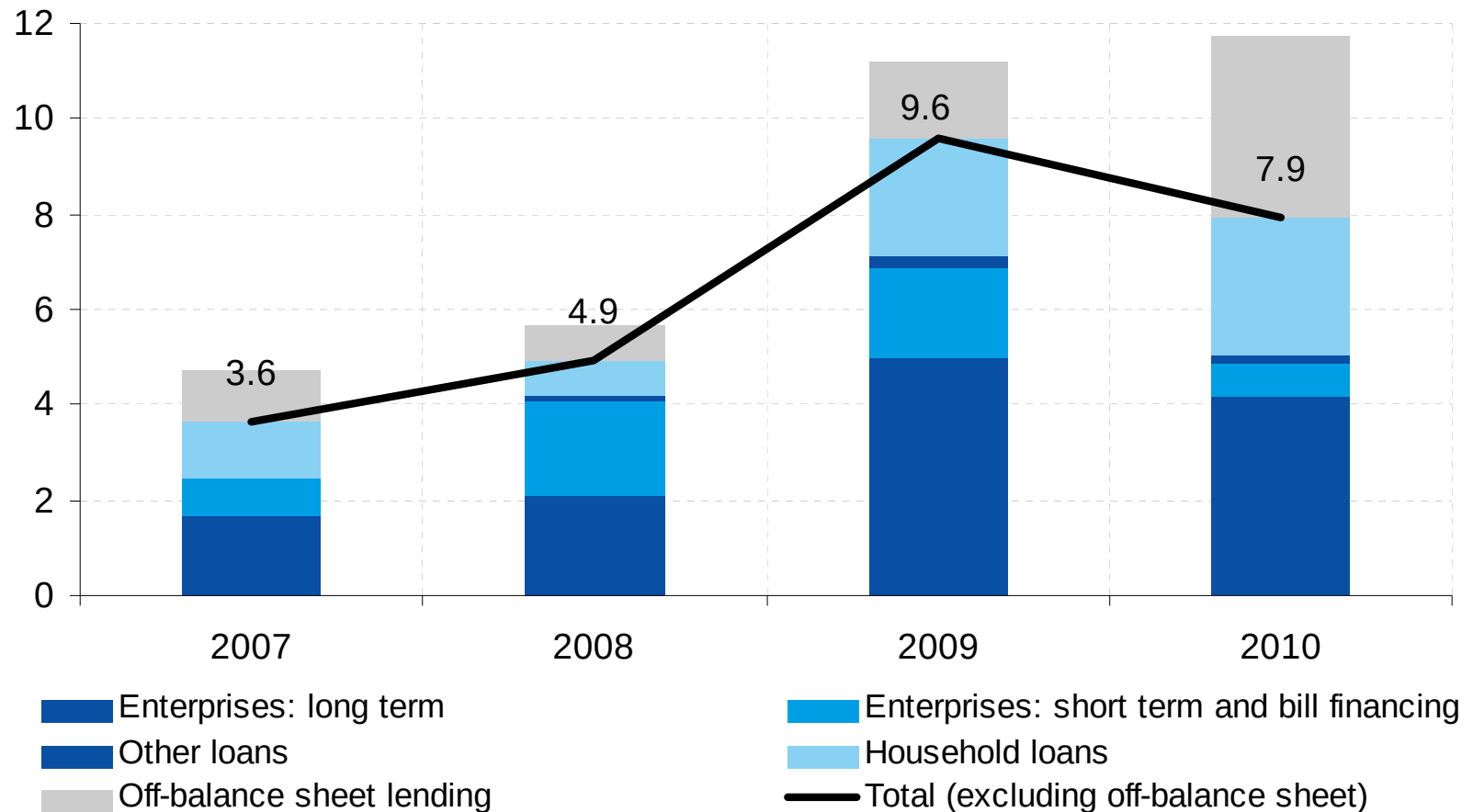
What happened: stimulus package

- RMB 4 trn stimulus package to be spent between 2009-10
- 1/3 would be born by the central government
- 2/3 by local governments and SOEs but financed through bank loans
- Credit growth points to a much bigger package
 - Nearly RMB 22 trn in new loans in 2009-10 when including off-balance sheet items (about 30% of GDP year by year)

Source: CEIC. Last observation Q1 2010.

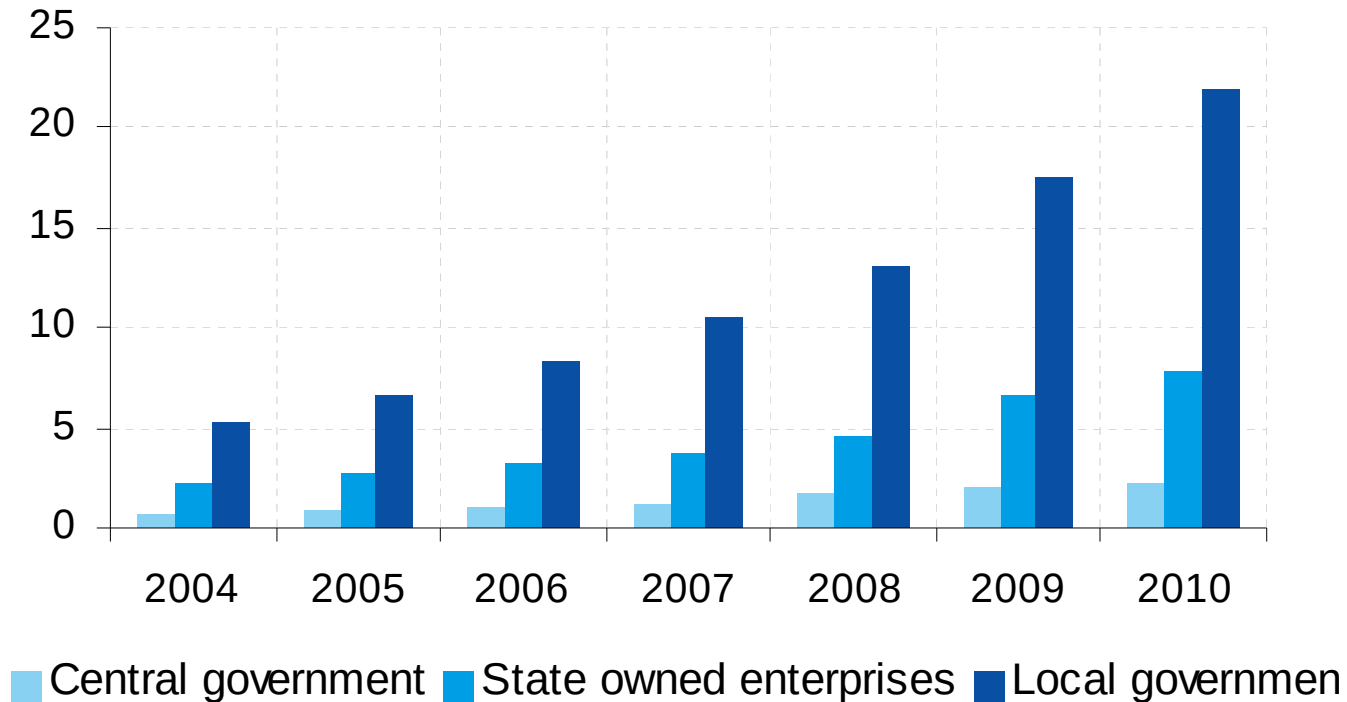
Changes in outstanding loans (RMB trn)

RMB Trillion



Investment driven by central & local governments and SOEs

RMB Trillion



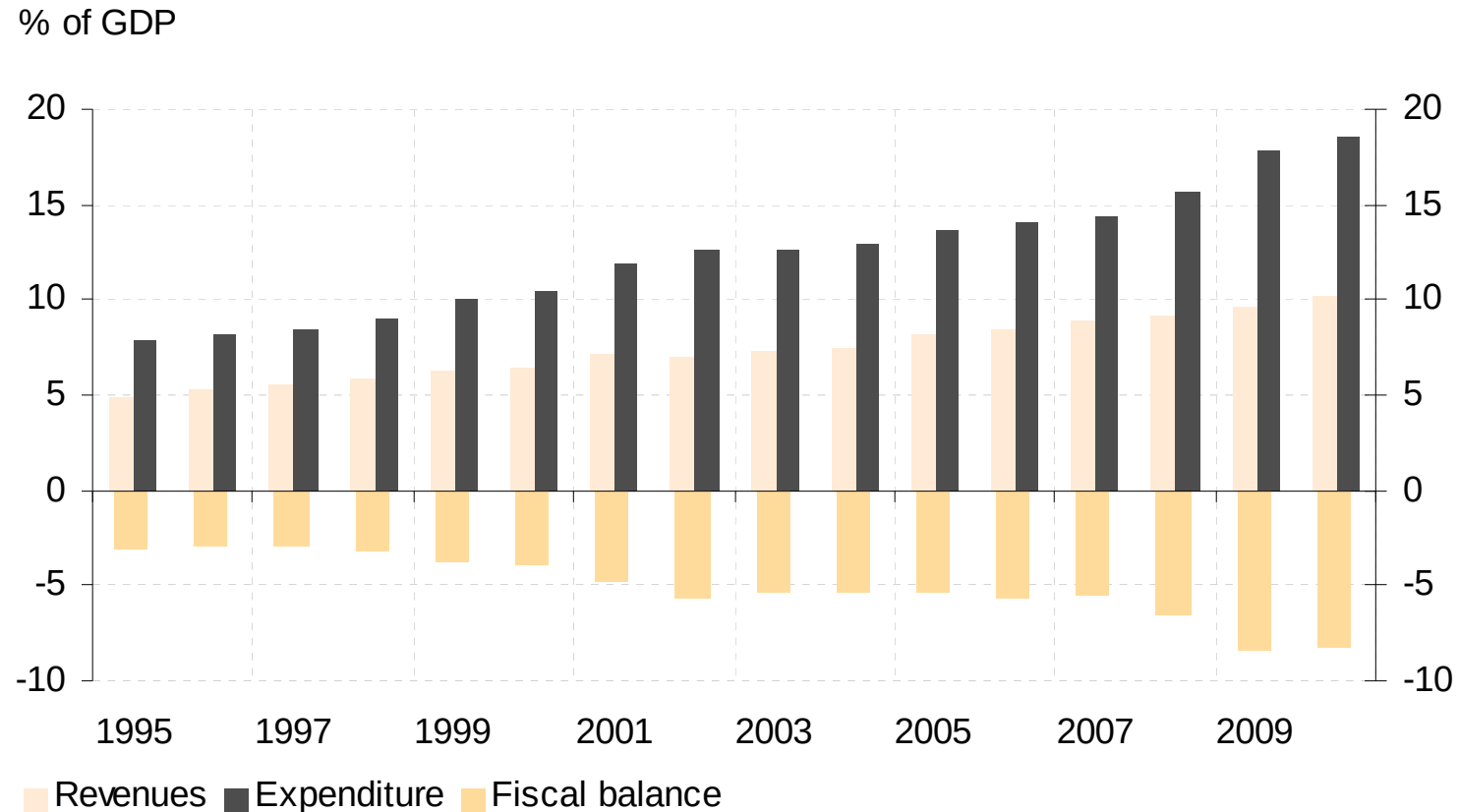
Is it worrisome?

- Rapid credit growth is a good predictor of crisis
- Local government finances worsening
 - More expenses
 - Increasing welfare state
 - Less revenue
 - Land for affordable housing to increase
 - 36 m in 5 years according to 12th Plan
 - Local governments' land sales at market price to be reduced (major source of income)

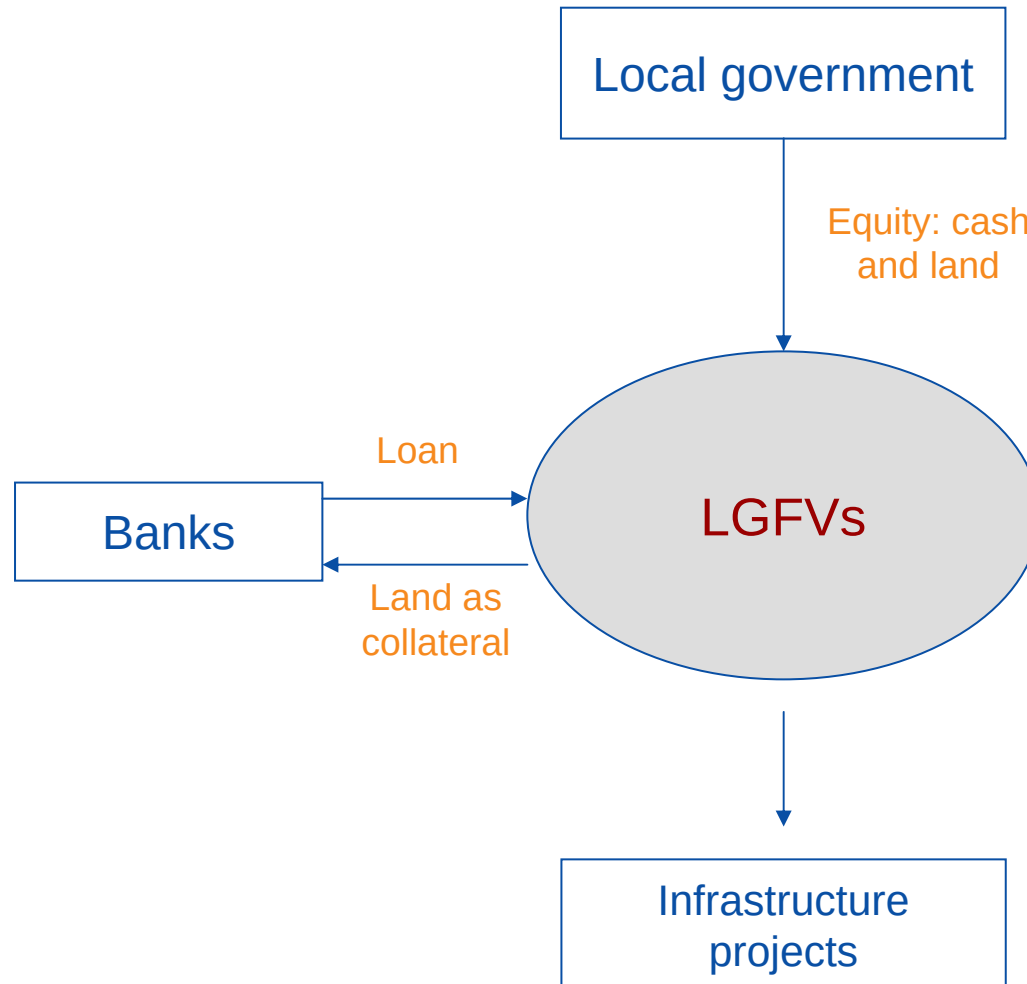
Is it worrisome?

- The vehicle used by local governments (LGFVs) only have implicit guarantee from local governments
- Land used as collateral by LGFVs so
 - Also direct impact of land prices other than local governments' ability to pay
- Most of borrowing by LGFVs into infrastructure projects
 - Very little cash from projects in short term
 - Marginal return of infrastructure projects doubtful after huge investment binge
 - ROE reported by LGFVs only 5%

Local government revenues and expenses



Relationship between Local governments, LGFVs and banks

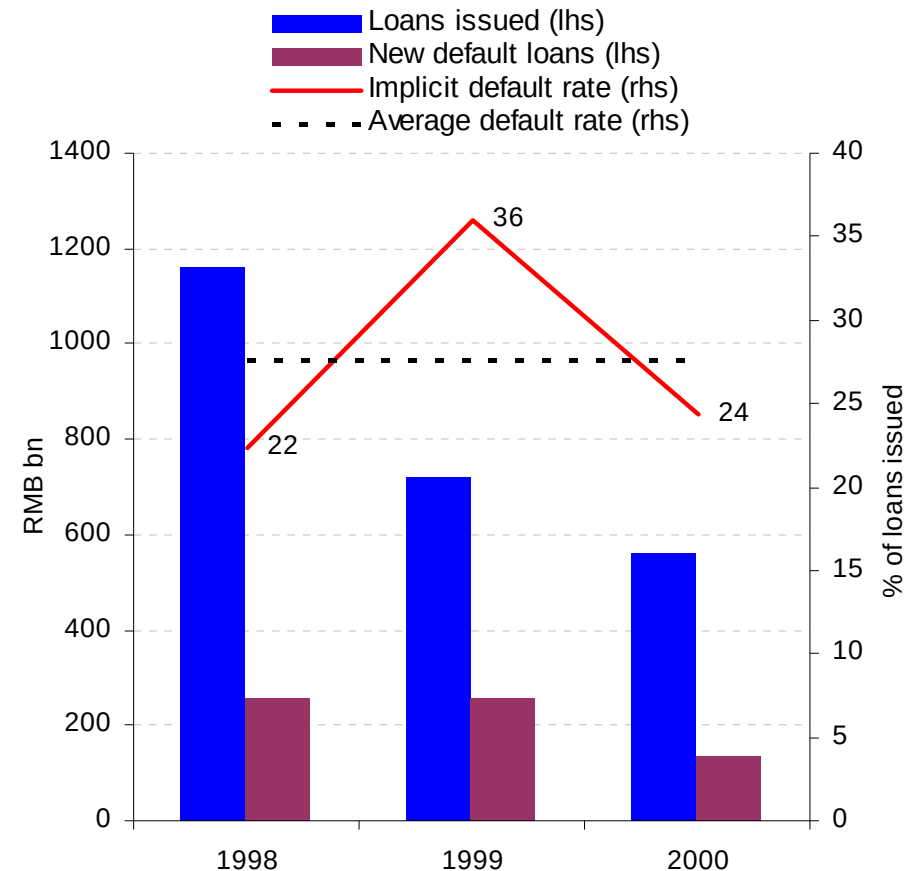


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Déjà vu?

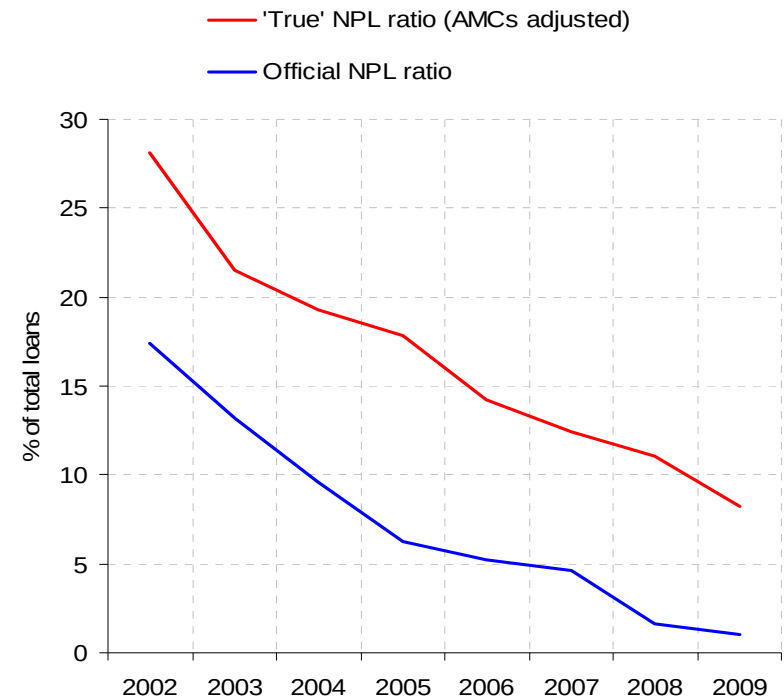
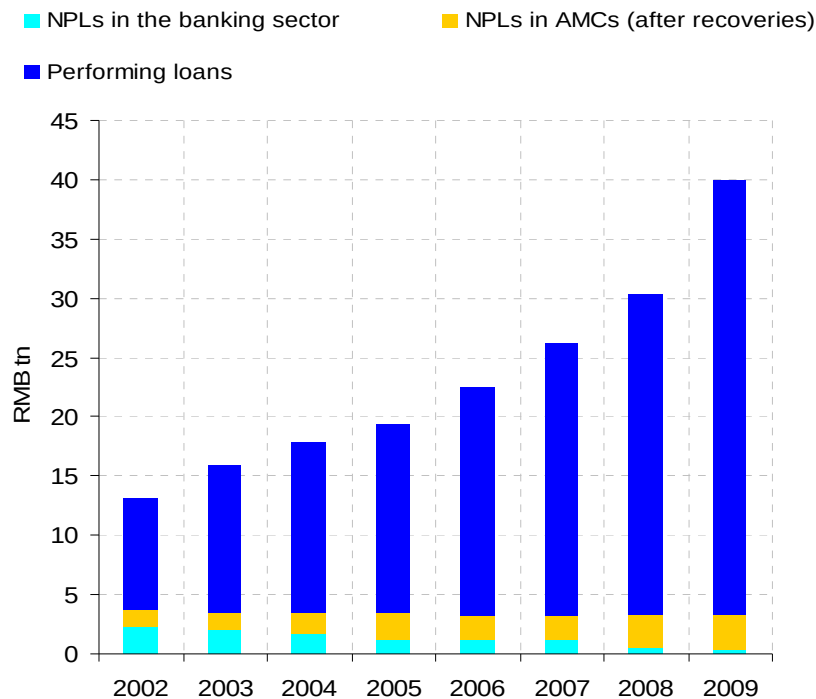
- In 1998, China put in practice a fiscal package that has in common characteristics with the one today.
 - Stimulus relied on bank lending to SOEs and Local Governments
 - About 28% of lending became NPL from 1998-2000
 - NPL ratio (already high due trust and investment corporation crisis) grew from 28% to 41% in 2000
 - However, sharply reduced thanks to restructuring process



Source: Bankscope. Estimates based on a sub-sample of banks with NPLs available. That sample was skewed towards the best performing institutions.

2008 experience with reducing NPLs

- Transfer of NPLs to AMCs in waves (except for last case of ABC)
- Low recovery ratio of AMCs (25%) but still NPL/total loan ratio vanishing thanks to growth



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How big the losses now?

- Assuming a default ratio between 7% (optimistic scenario) and 25% (pessimistic) of total loans granted between 2008-10,
- Upper bound default loss ratio would be 25%
- Assuming nominal growth at 14% (optimistic scenario) and 8% (pessimistic)
- We focus on optimistic scenario (more likely today)
 - Losses would be between 5-9% of 2008 GDP
 - But high growth will continue to reduce burden to 2-4% of GDP by 2020
 - That will imply an increase in the NPL ratio of 1-3 pp

Quite manageable!

- Even in pessimistic scenario no more than NPL ratio no more than 10%

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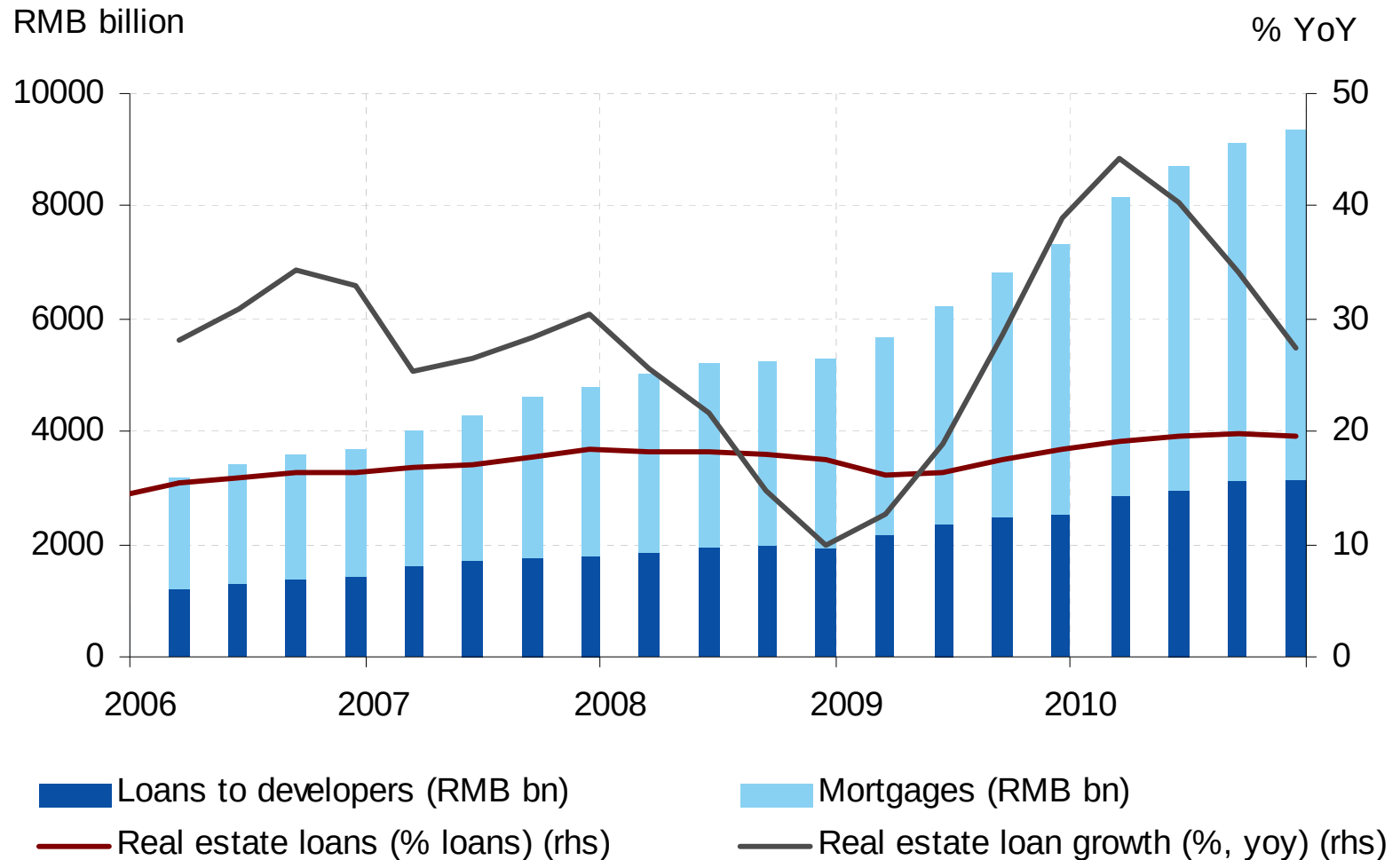
The housing channel

- Direct impact of fall in housing prices limited
- But indirect impact through collateral of LGFVs could be large
 - Still room for maneuver exists

Urban property prices (%)



Lending to real estate, (RMB bn, %)



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Conclusions

- Even this time it seems China can get away with a huge credit binge and even if housing prices are reduced
 - However LGFVs risk should not be underestimated if not because of direct impact on solvency at least as signal
- Functioning of the banking system should improve before growth is reduced
- Otherwise, the underlying NPLs will surface.
 - Need to reduce government interference in in banking system

QUESTIONS/COMMENTS

MOST WELCOME

THANK YOU!

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