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China’s Boom Threatened by Enron-Style Tricks: William Pesek
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Commentary by William Pesek

June 3 (Bloomberg) -- Credit downgrades can elicit fascinating reactions. Take a January move by Standard & Poor’s to cut Japan’s rating to the same level as China’s. I expected the backlash to come from Tokyo. Instead, it was the Chinese who were aghast.

Every Chinese official I’ve met since is bewildered that 10 percent growth and $3 trillion of currency reserves don’t buy a better grade than the AA- China shares with an overly indebted, aging nation that names a new prime minister every year. Many in China even think their economy deserves a higher score than the U.S., with its AAA rating.

These views are as tantalizing as they are wrong. Credit risks are rising before our eyes as China battles a worsening inflation threat, the result of which will be slower growth. The process poses bigger risks to China’s creditworthiness and the world economy than investors may realize.

In recent years, economists and credit raters voiced a similar refrain: Only when growth cools will we know the true cost of China’s efforts in 2008 to ride out the global crisis.
Somehow, the official price tag, 4 trillion yuan ($617 billion), never satisfied skeptics who didn’t think it possible for China to navigate the meltdown in credit markets with the ease it did.

Give China its due: It did a masterful job shrugging off recessions among key customers. Neither Wall Street’s meltdown nor Europe’s debt crisis nor Japan’s deflation knocked China off schedule in its quest to become No. 1.

China’s Secret

The secret to China’s success? A huge, unreported accumulation of debt. Scattered around China are 20 cities that want international airports, glistening skyscrapers, five-star hotels, six-lane highways, world-class universities and cultural centers, Prada stores, Mercedes-Benz showrooms and ample housing. It is the largest urbanization in modern history.

This building boom is taking place quietly, largely beyond the control of Beijing and financed with easy credit and local debt issuance. The surge of loans by banks to local authorities may spark a wave of bank failures that hobbles economic growth.
The jump in local debt, which is tough to measure, increases the risk of default around the nation and leaves Beijing with a touchy question: Must it bail out local governments that went too far?

Cities and provinces can’t borrow directly from banks, so they set up more than 8,000 investment companies to skirt regulations. Fitch Ratings predicts that, because of lending to these vehicles and to real estate developers, bad loans might reach 30 percent of the total at China’s banks.

Revival Plan

That’s not all. One of China’s post-crisis revival plans calls for building 36 million low-cost homes by 2015, an initiative that would add 2 trillion yuan to local government borrowing by 2012. Such plans will bump up against efforts to rein in property prices and inflation.

Expect a huge effort to push liabilities off balance sheets, Enron-style, as bankers scramble to mask the extent of their lending to local governments. It’s these kinds of financial shenanigans that have hedge fund managers like Jim Chanos of New York’s Kynikos Associates LP betting against China.

It’s hard to envision a full-blown crash. China has the world’s biggest pile of currency reserves at its disposal and a command-economy model that gets things done. The country also has been here before. In the late 1990s, years of state-directed credit left lenders saddled with bad loans. The government ended up spending more than $650 billion on bailouts.

Inflation Threat

This time, the stakes are higher. Inflation reached 5.4 percent in March, the fastest since July 2008, and analysts worry that it’s actually higher than that. The only answer is slower output. For a nation at China’s level of development, with a populace appeased by the promise of prosperity, 5 percent growth is a crisis.

Japan’s rise and fall during the past 25 years is a path China knows it must avoid. There is, of course, a very important difference between Tokyo and Beijing. While Japan suffers from political paralysis, China’s top-down system gives President Hu Jintao and Premier Wen Jiabao enormous latitude to steer the economy.

Bad debt is inevitable for China; most developing nations get in trouble with it at some point. The question is the dimension -- will it merely be a challenge for the national government or ruinous for the entire nation?

No economy grows in a straight line forever. As China applies the brakes it could trigger some chain reactions around the globe, and not necessarily for the better.

(William Pesek is a Bloomberg View columnist. The opinions expressed are his own.)

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To contact the writer of this column:
William Pesek in Tokyo at +81-3-3201-7570 or wpesek@bloomberg.net

To contact the editor responsible for this column:
James Greiff at +1-212-617-5801 or

jgreiff@bloomberg.net