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China extends loans to avoid mass default

By Simon Rabinovitch in Beijing

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A mountain of debt is coming due and the principal is unpayable, so governments have agreed to extend maturities.

This could be a description of a bail-out package for Greece. Instead, it is what China is doing to prevent scores of provinces and cities from defaulting on bank loans.

Does that mean China is another Greece? Far from it.

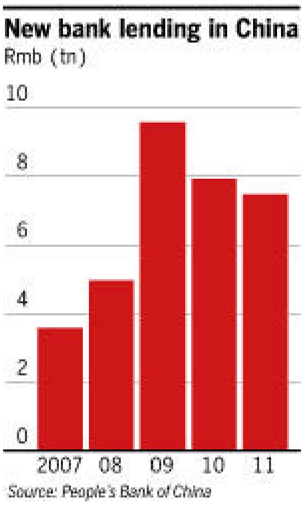
For starters, China's economy will expand more than 8 per cent this year, while the eurozone is confronting the likelihood of recession. And that sustained, high-speed growth will make it much easier for Chinese local governments to pay off debts over time.

More to the point, China's debt woes are very different from those of Europe or, for that matter, the US. In developed countries, the concern is the sheer amount of debt they have accumulated. The Chinese problem is less one of quantity and more one of structure: rather than issuing bonds, local governments have used opaque bank loans for funding.

"The problem is rooted in the national fiscal system," said Huang Haizhou, chief strategist at China International Capital Corp, the country's leading investment bank. "If a successful fiscal reform is implemented over the next three to five years by the new government, the problem will only be a temporary shock."

The flaws in China's fiscal system were savagely exposed during the global financial crisis when Beijing introduced a stimulus package that was largely implemented by local governments.

Lacking sufficient funding and prohibited from even borrowing money because of past excesses, provinces and cities created thousands of financing vehicles to get around the rules and raise capital in the quickest way possible. They tapped state-owned banks which, encouraged by Beijing, were happy to oblige with enormous loans.



From relatively little debt at the start of 2008, local governments finished 2010 owing Rmb10.7tn ($1.7tn). The national auditor has reported that more than a third of that debt will have matured by the end of this year.

"We are not talking about a cash flow problem. We are talking about a big cash shortfall problem," said Zhu Ning, deputy director of the Shanghai Advanced Institute of Finance. "Even though I think things will eventually work out, in this particular year it is very likely that a lot of the local government financing vehicles would default if something wasn't done."

The contours of what will be done are now apparent. The government has drawn up general guidelines for banks, instructing them to review maturing loans to see which are supporting viable investments and can thus have their maturities safely extended.

In the meantime, China has embarked on a landmark reform to avoid a repeat of the 2009-10 lending spree. Late last year a handful of provinces and cities were given permission to issue bonds, the first sold by local governments since the early 1990s. The amounts were small but the path is clear.

“Five or ten years from now, local governments will borrow very, very little from banks. Their debt structure will be almost entirely bonds,” said Fan Jianping, chief economist of the State Information Centre.

Critics have pointed to dangers in the loan rollover plan. Repayment delays will hinder banks’ lending abilities. Some bad loans will simply be prolonged instead of recognised. Problems will remain concealed.

Standard & Poor’s has warned the extension would be a “backward step” for the Chinese banking sector that could “shake investors’ confidence”.

But Mr Huang of CICC said such criticism missed the point. Calling in loans now for stimulus projects begun during the financial crisis would be the surest route to trouble. “A lot of the projects, if you just leave them 90 per cent finished, they are useless,” he said. “The profitability can only be captured if you go the last mile.”

? Wen Jiabao, China’s premier, said the nation should take pre-emptive measures and start “fine-tuning” economic policies as early as in the first quarter, Bloomberg reported on Sunday, citing China’s state-owned Xinhua News Agency.

Economic conditions in January and the first quarter deserved attention, Mr Wen told business executives last week in Beijing as he sought opinions on a government report. “We have to make a proper judgment as early as possible when things happen and take quick action,” Mr Wen was cited as saying by Xinhua.

But China would not waver on real estate curbs it had introduced, he said, as the government needed to maintain restrictions to ensure fairness and stability in the market.