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The China Bears' Feeble Growl

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BEIJING – In recent months, bearish sentiment about the Chinese economy has surged, owing largely to three conjectures. First, China's housing market is on the brink of collapse. Second, China's fiscal position will worsen rapidly because of massive local government debt. And, third, the collapse of underground credit networks in bustling cities such as Wenzhou will lead to a broad financial crisis across the country.

In fact, despite its problems, China's economy remains in good condition – at least so far. Indeed, it is not yet near to hitting the rocks.

Since the twenty-first century began, skyrocketing housing prices in China, except for a short respite during the global financial crisis, have caused serious social discontent. After years of half-hearted effort, China's government has finally clamped down on housing speculation. As a result, prices fell in October for the first time this year, while real-estate investment growth fell as well.

But the fall in housing prices is unlikely to turn into a rout, because real demand for houses will remain strong after speculative demand is driven from the market. As soon as housing prices fall to an affordable level, buyers will enter the market and set a floor under the decline.

Moreover, because there are no subprime mortgages in China and down payments are as high as 50-60%, even a significant fall in housing prices will not seriously damage China's mega-banks.

Over the past decade, real-estate investment in China has been the single most important contributor to fixed-asset investment growth and therefore, to the economy. Indeed, since the late 1990's, the real estate investment-to-GDP ratio has been far higher than it was in countries like Japan and Korea during their high-growth periods.

It is simply wrong for a developing country with *per capita* income of $5,000 to concentrate its resources on producing concrete and cement. Although a significant decline in real-estate investment will have a very serious negative impact on China's growth – which can and should be prevented – as long as the fall is not too drastic, it is a welcome development.

Meanwhile, local government debts are a relatively new phenomenon. In 2009, local governments were encouraged to create Special Purpose Vehicles, specifically “local finance platforms” (LFPs), to supplement China’s RMB4 trillion ($628.7 billion) stimulus package. The LFPs would borrow from banks using future government revenue as collateral to finance packaged-investment projects in Chinese localities. By 2010, some 6,576 LFPs had been created.

There is no denying that local-government debt is a ticking time bomb for the Chinese economy. According to China’s National Audit Office (NAO), these LFPs’ total borrowing amounts to RMB10.7 trillion, of which 79.1% is bank loans. But it is equally true that China’s local-government debt has so far been manageable, and there is no reason to believe that all of it is bad. In fact, for the majority of the LFPs, the cash flow generated by investment so far has been enough to meet repayment of principal and interest. According to the Industrial and Commercial Bank of China (ICBC) – the largest of China’s “big four” banks – 93% of its loans to LFPs are being repaid regularly.

Indeed, the ICBC’s non-performing loan (NPL) ratio for LFP loans is as low as 0.3%, while the corresponding coverage ratio – the bank’s ability to absorb losses from NPLs – is 1,066%. According to the NAO, the NPL ratio for the RMB10.7 trillion in local-government debt is roughly 2.3%.

A significant proportion of total local-government debt either has no direct relation to local governments, or cannot be guaranteed by them. Therefore, in legal terms, it is not government debt at all. In addition, given that local-government debt comprises 27% of China’s 2010 GDP, while central government debt and policy loans stand at 20% and 6% of GDP, respectively, the total public debt-to-GDP ratio is approximately 53% – lower than Germany’s. So, while China should not be complacent about local-government debt, panic is unwarranted.

Finally, there is a long history of underground lending and borrowing in some of China’s east coast region, especially in Wenzhou. Whenever monetary tightening causes bank credit to shrink, small and medium-size private enterprises are prepared to borrow at suicidally high interest rates from relatives or loan sharks.

In recent years, real-estate speculation has become another important source of demand for underground loans. When real asset prices fall and cause local credit networks to collapse, not only are hundreds of families left financially shattered and enterprises bankrupted, but banks suffer collateral damage, as occurred recently in the Wenzhou region.

But the severity of Wenzhou’s underground credit crisis has been exaggerated. In fact, Wenzhou’s underground credit accounts for less than 20% of total credit in the region, while the region accounts for less than 1% of China’s GDP. The total volume of affected bank credit in the crisis was just above RMB3 billion – roughly 0.5% of bank loans in the Wenzhou region. So, the damage that the breakdown of Wenzhou’s underground credit networks has inflicted on the regional banking system is limited, with scant national impact.

Thus, despite the high likelihood that China’s economic growth will slow significantly in 2012, a hard landing is unlikely. Nevertheless, while there is no need to be overly bearish about China’s short-term economic prospects, because of the slow progress in fundamental adjustment and further reform, even Chinese Premier Wen Jiabao has noted that China’s growth is ultimately unsustainable. The real test has yet to come.

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