Will Problems in China's Financial Sector Be the Trigger for Total Collapse?

"Revolution is impossible until it is inevitable." At the very beginning of his book, Gordon Chang quotes this phrase from Leon Trotsky in order to catch the flavor of surprise yet inevitability of the collapse that he predicts for the Chinese communist regime. Indeed, since the fall of the Berlin Wall in 1989, many apparently strong regimes have collapsed. From East Germany in 1989, to Indonesia in 1998, and then to present-day Argentina, these transformations came about so suddenly and unexpectedly that the top political leaders did not know how to respond. The sudden confusion and inaction of the top rulers, in turn, sent out a signal to the citizenry that the rulers were no longer able to rule. Therefore, hundreds of thousands of people took to the street to pull down the regime.

As demonstrated in the cases of Indonesia and Argentina, a systemic bank or currency run is a perfect candidate for triggering such a crisis. The relevant question here is thus: Are China's financial problems so serious that the country may experience a systemic bank or currency run? Gordon Chang dedicates one chapter in his book (chapter 6) to addressing this question. He begins by arguing that Chinese banks are "the most vulnerable link in China's economy today.... It is here, in the banking system, that the end of the modern Chinese state might well begin" (p. 122). However, at the end of that chapter, he concludes that "Beijing will do everything in its power to keep the state banks alive.... [Of] all segments of the economy, banking will be the last to fall" (p. 143). Chang's answer to the question seems to once again confirm the perception, generally shared among observers of China's banking system, that although seriously insolvent, Chi-

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nese banks are above all sovereign; the government will use every means possible to bail out frail state banks. Thus, the "dying" banks will not really die, at least not over the next several years.

This widely-shared perception is exactly why the Chinese as individual savers continue to deposit their money into bankrupt state banks. Chinese banks continue accumulating nonperforming loans (NPLs) with little risk of liquidity problems. The Chinese government, after so many years of dumping its fiscal burdens on to the banking system, can in turn still maintain strong confidence in its currency; note that the *renminbi* (**人民幣** RMB) managed to be the most stable force in the region during the Asian financial crisis. Nonetheless, as the government deficit continues to rise dramatically and as WTO accession brings foreign competition to the banking system, the Chinese government will find maintaining this perception to be increasingly difficult.

First of all, the NPL problem will continue to deteriorate, posing a time bomb for government finance. Since the late 1990s, Western rating agencies have estimated that China's "Big Four" banks have NPL problems equivalent to about 50 percent of total assets, or a staggering 50 percent of China's gross domestic product (GDP).[1] Even the People's Bank of China (**中國人民銀行**), China's central bank, has long admitted that the banks' combined NPLs are more than 25 percent of their total assets, much higher than the corresponding figures for Thailand and Indonesia during the Asian financial crisis. In 1998, the Chinese government first issued RMB 270 billion in bonds to inject capital into the Big Four, and later established four asset management companies (AMCs) to digest the Big Four's bad loans. In 1999 and 2000, the four AMCs together issued RMB 1,400 billion in bonds. All these moves are implicitly guaranteed by the government. According to Nicholas Lardy, these efforts would make the outstanding debts of the Chinese government jump to more than 40 percent of the country's

[1]The Big Four, the four largest state-owned banks, include the Industrial and Commercial Bank of China (**中國工商銀行**), Agricultural Bank of China (**中國農業銀行**), Bank of Construction (**建設銀行**), and Bank of China (**中國銀行**). They used to be part of the People's Bank of China during the Mao era. In terms of assets, they together hold about 70 percent of the market share in China today.

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GDP, rather than the 15 percent that the government would admit.[2] Despite these efforts, there is no sign of improvement in the Big Four's NPLs. As China continues to employ proactive fiscal policy to alleviate the pains of economic transition, Chinese government finances will be in deep trouble if the NPL problem continues to worsen.

Secondly, the growing foreign competition following the WTO accession will increase the chance that Chinese banks will run into liquidity problems. Despite the five-year grace period, the WTO accession will allow foreign financial institutions to gradually enter the RMB markets to compete with the natives. At present, most Chinese and Western economists agree that the foreign banks will not expand aggressively in geographic terms. Nonetheless, by offering more attractive financial commodities and services, these foreign financial institutions will compete with the Chinese state banks for the most valuable customers—such as foreign companies, profitable state-owned enterprises, private enterprises, and affluent individuals—in China's major coastal cities. As the profits of Chinese state banks further drop and their deposits are diverted to foreign competitors, bankrupt banks will find avoiding liquidity problem to be increasingly difficult.[3] Liquidity problems can, moreover, cause a run even on the healthiest bank, not to mention the Chinese moribund banking zombies.

Finally, the WTO accession will make attacking the RMB much easier for international financial speculators. Today, the RMB is the most stable currency in East Asia. The stability of the currency, together with China's holding of high levels of foreign reserves and its handsome foreign debt structure, is highly related to China's tight capital control. The WTO accords do not require China to make its currency convertible on the capital account any time soon, and the Chinese government, moreover, currently has no timetable for lifting this control. However, the WTO accession

[2]Nicholas R. Lardy, "China's Worsening Debts," *The Financial Times*, June 22, 2001.

[3]See John D. Langlois, Jr., "The WTO and China's Financial System," *The China Quarterly*, no. 167 (2001): 625, and Xu Dianqing, "The Impact of Accession to the WTO on China's Economy" (Working paper presented at the Symposium on the Political Economic Reform of Mainland China in a Changing Global Society, April 25-27, 2002, National Taiwan University, Taipei), 10-11.

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will surely increase the already heavy engagement of foreign investors in China, whose need to hedge their exposure will grow explosively. Thus, the pressure for convertibility on capital account will increase sharply in the coming years. Even if the Chinese government still holds the capital account inconvertible, the foreign investors will be strongly tempted to try other means to manage their risks. In fact, many researchers have found that China experienced constant capital flight throughout the 1990s. The abnormally high "net errors and omissions" in China's balance of payments accounts is the evidence.[4] As long as China's capital account is held inconvertible, the abnormal capital flight will continue. The "underground" capital flight will increasingly provide chances for speculation. Some pessimists even contend that, once foreign banks are allowed to conduct RMB business after the WTO accession, the financial firewall built by China's tight capital control against international speculators will diminish soon.[5] In sum, no matter whether China's capital account is convertible or not, the WTO accession will definitely increase capital flows in and out of China. This will in turn create more channels for international speculation.

Therefore, in the short run, the problems in China's financial sector are unlikely to be the trigger for total collapse, as Mr. Chang has himself argued. The book title, however, would seem to be overly gloomy. Nonetheless, the perception that the dying Chinese banks will not really die as long as they are sovereign cannot sustain forever. The Chinese authorities must immediately make up their mind to finish the "unfinished revolution" in the financial system.[6]

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[4]Langlois, "The WTO and China's Financial System," 622.

[5]Xu, "The Impact of Accession to the WTO on China's Economy," 13.

[6]Borrowing from Nicholas Lardy's book title *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998).