China’s Banking Sector
Old Problems Overcome – New Problems Ahead

Conference on European Economic Integration (CEEI) 2011
“European Integration in a Global Economic Setting – China, Russia and CESEE”
Vienna, 22 November 2011
Markus Taube
Storyline

I. State of the Chinese Economy
II. Banking Sector Development
III. Risk Assessment: The Real Estate „Bubble“
IV. Shadow Banking
V. The Way Ahead
## Storyline

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Slowing but still strong growth

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NBS 2011, IMF 2011

Contribution to GDP growth %, annual average

NBS 2011, IMF 2011
Private investors are back

Fixed Asset Investment, yoy growth

IMF 2011
Strong exports and increasingly dynamic import activity

Trade Development, monthly, US$ billion

IMF 2011
Inflation is coming down

Overall CPI y-o-y
Urban CPI y-o-y
Rural CPI y-o-y

NBS 2011
CCB Int'l 2011
Money supply and formal sector loans back to normal

M2, yoy

RMB loans of financial institutions

CBRC 2011
Bloomberg 2011
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China’s banking system

Increasing diversity, but still dominated by the big-4

IMF 2011
The ‘old’ problems are gone

The problem of NPLs appears to have been overcome – and it remains an SOCB issue.

CBRC 2011
Bloomberg 2011
Substantially strengthenend, impressive crisis resistance

Thanks to the substantial decline of their NPL burden as well as strengthenend equity capital positions all banks would withstand a NPL-quadrupling crisis upholding capital adequacy ratios of more than the required 8%.

IMF 2011
Post-crisis tightened monetary policy

With inflation coming down and GDP growth slowing down, China’s monetary policy may have reached a turning point allowing for a loosening of policies in the next months. – liquidity spillovers in the informal sector are to be prevented.
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A bubble?

Residential housing
100 = Dec 2006, sa

Housing affordability
Price-to-income ratio

IMF 2011

Note: Price of a 70 sq.m. home as a multiple of annual household disposable income.
Local bubbles

Property Prices
1000 Y RMB/s.qm., sa, 3mma

Commercial Real Estate
1000 Y RMB/s.qm.

IMF 2011
Hovering on a high plateau, formal sector real estate lending has recently leveled off. Informal inflows in the sector are understood to have remained high.
Fighting fire with fire – and more ...

Social housing in the 12th 5YP:
★ Construction respectively renovation of 35 million housing units
★ Provision of social housing for 20% of urban population from 7% end of 2010
★ 35% of all housing construction starts in 2011 based on government housing initiatives

Additional measures:
– Increased downpayment-requirements for mortgage loans
– Higher interest rates (in general and depending on type of investment)
– Restrictive authorization procedures for purchase of 2nd and 3rd apartments
– Restrictive authorization of purchase requests by non-locals
– Real estate tax (pilot project in Shanghai und Chongqing)
– Charging of business tax for real estate resold during first 5 years after purchase
– Binding commitment of local governments to enforce price targets (maximum price increases per year coupled to disposable income development)
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More than there seems to be

Global Financial System

Chinese Formal Financial System

Transaction-based

Chinese Informal Lending Channels

Additional dimension of financial interaction – May serve as back-up in case of formal dis-intermediation (liquidity crunch)

Better equipped to serve the specific finance requirements of the Chinese 'start-up economy' (!?)
Negative real interest rates on savings accounts in the formal sector continue to drive savers into the (informal) shadow banking sector, draining the formal financial system of resources.
The ‘formal’ shadow banking sector

“Social Finance”-Concept of NBS, * No shadow banking

PBOC 2011
China Economic Watch 2011
The informal dimension of Chinese banking

<table>
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<tr>
<th>hard information</th>
<th>soft information</th>
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<td>‘Transaction-based lending’. Standard object of analysis in the law, finance &amp; growth literature. <strong>Standardized information regime</strong> combined with highly formalized <strong>universalistic legal system</strong>. History (reputation) plays is – in principle – of no importance.</td>
<td>‘Relationship lending’ of the law, finance &amp; growth literature. The evaluation of potential financial transactions is primarily based on <strong>information gathered by informal institutional arrangements</strong> (-&gt; History rules!). Ensuing financial transaction are embedded in <strong>formal justiciable contractual relations</strong>.</td>
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<td>Requires close relationship between transaction partners in order to facilitate property rights enforcement inside a social network and without recourse to an external ‘umpire’. Given this close relationship hard information can be expected to be systemically less important than soft information for most financial transactions. -&gt; <strong>Low empirical value</strong>: hostage giving, pawnbroker</td>
<td><strong>Obstacles to co-operation like adverse selection and ex-post opportunism, i.e. property rights enforcement, are solved by informal mechanisms, first of all social networks based on particularistic ordering regimes. Information required to make financing decisions is gathered in non-standardized form in the context of the underlying social network by means of frequent and multiplex interaction. -&gt; History rules!</strong></td>
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### Specific forms of China’s ‘shadow banking sector’

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<td>– Off-balance-sheet lending</td>
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<td>– Special Purpose Vehicle lending</td>
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<td>– Direct company-to-company lending</td>
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<td>– Trust companies / Wealth management organizations</td>
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<td>– Leasing companies</td>
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<td>– Regulated pawnshops</td>
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<td>– Loan guarantee companies</td>
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<td>– Small loan companies / microfinance organizations</td>
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<td>– Offshore borrowing</td>
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<td>– Private equity organizations</td>
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<th>‘Informal’ Financial Intermediation</th>
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<td>– Underground banks</td>
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<td>– Private money houses</td>
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<td>– Associations for mutual assistance</td>
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<td>– Rotating savings and credit corporations (ROSCA)</td>
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<td>– Private peer-to-peer lending</td>
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<td>– Unregulated pawnshops</td>
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<td>– Unauthorized offshore borrowing</td>
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Total volume of ‘formal’ plus ‘informal’ shadow banking unknown, but probably in the range of a minimum 20 trillion annual flow.
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Three major issues to look at

Property bubble:
Are government policies adequate and can they be fast enough to deflate local bubbles?

Shadow banking:
Government must separately address two types of shadow banking.

Political economy:
Can the reform momentum be upheld in the run up to China’s leadership change in 2012/13?
University of Duisburg-Essen

Mercator School of Management
IN-EAST, Institute for East Asian Studies
Chair for the East Asian Economy / China

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