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Circumscribing China's NPL "Puzzle"

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Abstract
The problem of the Chinese financial system with non performing loans is significant and murky. If China's non performing loan problem exists on a certain level of severity and is not trending toward a more manageable state, then China could be moving toward financial crisis. Empirical and theoretical studies in recent years have implied that this might be the case. It might be impossible to conclusively prove or disprove notions that non-performing loans will cause financial crisis in China. However, little academic inquiry has very recently been focused toward the holistic "puzzle" of China's NPL issue, and it could be considered worthwhile to simply attempt to trace a broad outline of the issue. The aim of this study is two-fold: first, it attempts to basically identify and circumscribe the different "puzzle pieces" that exist in trying to understand China's bad asset issue. Second, it aims to combine basic perspectives on the issue from multiple disciplines in a generalized way, and tentatively evaluate the inventoried "puzzle pieces" to propose a limited holistic interpretation of available facts and opinions.

Keywords
china, economics, finance

Comments
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Circumscribing China's NPL "Puzzle"

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April 28, 2008

The problem of the Chinese financial system with non-performing loans is significant and murky. If China's non-performing loan problem exists on a certain level of severity and is not trending toward a more manageable state, then China could be moving toward financial crisis. Empirical and theoretical studies in recent years have implied that this might be the case. It might be impossible to conclusively prove or disprove notions that non-performing loans will cause financial crisis in China. However, little academic inquiry has very recently been focused toward the holistic "puzzle" of China's NPL issue, and it could be considered worthwhile to simply attempt to trace a broad outline of the issue. The aim of this study is two-fold: first, it attempts to basically identify and circumscribe the different "puzzle pieces" that exist in trying to understand China's bad asset issue. Second, it aims to combine basic perspectives on the issue from multiple disciplines in a generalized way, and tentatively evaluate the inventoried "puzzle pieces" to propose a limited holistic interpretation of available facts and opinions.

The study is composed of three main parts: first, it attempts to characterize the nature of China's alleged developed NPL problem, and demonstrate the wide discrepancy in presentations of the extent of the problem. Second, it circumscribes an inventory of aggravating and mitigating factors which appear to influence the NPL problem, as gathered mainly from conducting a series of interviews with a set of experts who would have diverse, relevant perspectives to present on the topic. Finally, it collects input from interviewees into the outputs of a generalized survey and an analysis of the recent challenges posed to China's financial system health. In an almost purely qualitative tentative interpretation of the puzzle pieces provided in interviews, the study concludes that recent challenges posed, are to some degree, neutralized by other apparent factors.

I. CHARACTERIZING CHINA'S POTENTIAL NPL PROBLEM

This section briefly attempts to characterize China's financial system growth, and describes two separate perspectives which have been promulgated in recent years which have called into question the health of China's financial system.

China's Adventure Toward Economic and Financial "Normalcy"

One should view the issue of China's financial health as residing in the broader context of its economic development story. In its rapid development, China's financial system attempts to achieve "normalcy" at a breakneck pace of progress.

In *One Billion Customers*, James McGregor, a long-time Wall Street Journal reporter, conveys through a series of anecdotes the picture that he has obtained of China's growth through his years as a correspondent there. In the preface to the book, McGregor tells a story of a flight he took in China from Beijing to Fuzhou. McGregor, although a China veteran, describes being impressed by the government-owned airline and its new plane. Midway through his flight, though, he begins to notice the flight attendants' cheerful absentmindedness; the flight engineer's napping in the front row of the cabin; and the flapping back-and-forth of the open door to the cockpit. Finally, the plane begins its descent, only, about fifty feet before landing, to jerk abruptly back up, greatly startling its occupants. The pilot, expert enough to have guided a smooth flight through most of the entire journey, had nevertheless neglected to lower the landing gear on the first landing go-round, only compensating at the last moment to narrowly avert disaster. McGregor describes a realization he makes while exiting the Fuzhou airport:

> *I was thinking about how sensible it was to travel by train as I walked into the terminal. Then I saw a propaganda poster on the wall that has since remained firmly in my mind as the perfect description of the transformation China is undergoing: STRIVE TO FLY NORMAL. That is the essence of what China is trying to do: become a normal country, one that is integrated into the world economy, a place where citizens can concentrate on their prosperity and happiness instead of suffering from political power struggles.*[1]

McGregor captures the nature of China's unique economic growth story: speeding along awesomely, providing glimpses of abnormality here and there, and occasionally presenting serious, unprecedented, largely unforeseen problems that are just as startling.

McGregor's analogy is represented particularly poignantly in the case of China's financial system. China has attempted to build a modern-quality financial system in a very short period of time. As UBS's Jonathan Anderson states, China only really began to develop a banking system *per se* in the mid-1980s. During the Mao and early post-Mao eras, existing financial institutions more or less acted as treasury arms of the Ministry of Finance, allocating funds completely to politically-determined enterprises and holding deposits for "accounting purposes."[2] The most fundamental mechanic of a functioning market-based financial system is that financed enterprises are able to service their obligations to their financers. Transitioning from a socialist- to a market-based model, it has been these basic mechanisms of profit-motivated financial allocation that China has strove to "normalize." However, in China's normalization process, not only has there been a building awareness of the problem of China's bad assets, but it has been

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[1] McGregor, James. *One Billion Customers: Lessons from the Front Lines of Doing Business in China* (Free Press: New York, 2005).
[2] Anderson, Jonathan, et al. "How to Think About China: Part 3: The State of the Banking System." UBS Investment Research, February 21, 2008. For another, relatively concise description of the broad evolution of China's post-Mao financial system, see Liu, Henry C.K. "China: Banking on Bank Reform." Asia Times Online, June 1, 2002.

difficult to determine the nature of the problem. Rather than the vague experience and immediate realization that McGregor describes, with China's NPL issue, the problem has been somewhat homed in on, and general awareness of the situation can only gradually build. Therefore, a reasonable goal is to determine what levels and areas of the financial system might be causing the problem, and from what levels and areas the problem might currently be being successfully dealt with, or might be dealt with in the immediate future.

Calls of Concern: An Opaque View of Bad Assets

In recent years, the healthy functioning of China's financial allocation mechanism has been challenged in two distinct ways: empirically, in the accounting of non-performing loans which exist in China's financial system; and theoretically, in speculation on the incentive mechanisms which guide financial governance in China. The empirical challenge reached a climactic point when the global accounting firm Ernst & Young published a report in 2006 suggesting that China's NPL burden was much greater than was being officially stated. While the report was quickly retracted after being criticized by the Chinese government, its potential significance has, to date, not been primarily treated in an academic study. Particularly since an evaluator of China's financial system health might tend to intuitively assume that the E&Y report implicated China's financial system health even despite being retracted, it will be worthwhile to evaluate the contents of the report as they could actually influence China's financial system health.

As of December 31, 2005, the official non-performing loan amounts of China's Big Four Banks (the Bank of China; the Industrial and Commercial Bank of China; China Construction Bank, and the Agricultural Bank of China) were listed as summing to approximately US$133 billion. On May 3, 2006, Ernst & Young released its *2006 Global Nonperforming Loans Report*,[3] which became infamous. The report's author, Jack Rodman, claimed that in addition to the $133 billion of loans which were currently being attributed to the banks, $225 billion more of estimated NPLs should be summed to their total NPL amount, accounting for the results of a UBS study which estimated that that aggressive lending between 2002 and 2004 had led to the creation of that amount of new NPLs which were not being accounted for.

In addition to the new total of $358 billion of NPLs of Big Four banks, the report provided estimates for non-performing loans from two sources which had previously not been broadly factored. One source was the four state Asset Management Companies which the Chinese government established in 1999 to purchase and "digest" state banks' bad assets over time. About $170 billion of NPLs were transferred to the AMCs, at book value, at their establishment, and a total of $330 billion had been transferred to the AMCs by the end of 2005. The exact nature of the transaction by which the AMCs obtained the NPLs is not perfectly clear.[4] Stating that the AMCs had only successfully disposed of $100 billion of NPLs to date, the report added $230 billion to the $358 billion sum of estimated Big Four NPLs. Finally, the report added estimated NPLs from other financial

[3] Rodman, Jack, "China: Non-performing Loan Market Report." *Global Nonperforming Loans Report 2006.* Ernst & Young, May 3, 2006.

[4] Wang, Haijun, Powerpoint Presentation. "Banking Reform in China: Non-Performing Loans Control and Disposal." China Cinda Asset Management Corporation, PECC Finance Forum Conference, August 12-13, 2002. None of the study's interviewees who were directly asked about the AMC's payments to the banks were able to specify how exactly the banks were being compensated. The four AMCs are: Great Wall AMC for the Agricultural Bank of China; Orient AMC for the Bank of China; Huarong AMC for the Industrial and Commercial Bank of China; and Xinda for China Construction Bank.

institutions in China, including rural credit cooperatives and city commercial banks, totaling $323 billion. This produced a total estimate of $911 billion,[5] which equaled approximately 40% of China's 2005 GDP, [6] and approximately 2.5% of the official amount of assets in all financial institutions.[7]

On May 8, the *Financial Times* published an op-ed by Minxin Pei titled "How Rotten Politics Feeds a Bad Loan Crunch in China," in which Pei boasted of Ernst & Young's confirmation of his earlier forecasts of a broad NPL problem in China.[8] On May 12, Ernst & Young released an official apology for releasing a "factually erroneous" estimate.[9] Ernst & Young's retraction of the report followed a response by the Chinese government calling the report "ridiculous and barely understandable."[10]

Although Ernst & Young officially dismissed the report's accuracy, its contents are still worth addressing to the extent that they inform understanding of the nature of China's NPL problem. Certainly, the issue has not been resolved in the sense that a universal consensus has yet been reached on the general range of China and the Big

[5] The topic of how China's NPLs are actually classified is a rather difficult and contentious one. China originally published details of an official, three-tier system for classifying non-performing loans in 1995. Its current five-category rating system, putatively modeled on the US' system, was introduced in 2002. For discussion of some of the difficulties in classification, which tend to stem from weak incorporation of quantitative information (i.e., days overdue), see Standard & Poor's. "China Banks Face Decade of Problem Loans Unless More Equity Injected." June 20, 2002. http://www.gtnews.com/article/4565.cfm. Both Ron Thompson of Clearwater Capital Partners and Phil Groves of DAC Management, in their interviews, spoke to a general arbitrariness of loan classification. Original classification note from Studwell, Joe. *The China Dream: The Quest for the Last Great Untapped Market on Earth*. Grove Press, 2003. p. 207. 2002 classification from *China Daily*. "New Loan Rating System to be Enforced in China." December 25, 2001. http://china.org.cn/english/2001/Dec/24342.htm.

[6] Rough estimate derived from GDP obtained from Chinese National Bureau of Statistics via Chinability (http://www.chinability.com/GDP.htm) and approximate RMB/US$ rate from Yahoo! Finance (http://finance.yahoo.com/currency/convert?from=USD&to=CNY&amt=1&t=5y).

[7] Estimate derived from Q4 2005 listed assets on China Banking Regulatory Commission website. "Total Assets & Total Liabilities in 2005." http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=1330.

[8] Pei, Minxin. "How Rotten Politics Feeds a Bad Loan Crunch in China." *The Financial Times*, May 8, 2006.

[9] This apology could be found on Ernst & Young's website through April, 2008, but has recently been removed from the website.

[10] Lague, David. "Bank of China I.P.O. Raises $9.7 Billion." *International Herald Tribune*, May 24, 2006.

Four's NPL amounts: the report's author, former Managing Director Jack Rodman, maintains that the report was "conservative" in its estimate of NPLs both of the Big Four and of China's entire financial system.[11] The China Banking Regulatory Commission reports that the official amount of NPLs in all of China's commercial banks equaled approximately $177 billion as of the end of 2007.[12] In the only way that China's financial system health might be quantitatively measured—the amount of bad assets that currently exist within the system—there remains a large discrepancy of interpretations.

A Theoretical Basis for Crisis: Financial System Governance

In addition to perspectives regarding the actual amount of non-performing loans in China's financial system, another suggestion of danger to China's financial system has been presented in the form of a theoretical challenge to China's financial system governance model. In his recently-released book *Factions and Finance in China: Elite Conflict and Inflation*, Northwestern University Professor of Political Science Victor Shih promotes a theoretical framework for understanding China's financial system governance which could account for a large bout of non-performing loans, and put China on course for an inevitable financial crisis.[13]

[11] Interview with Jack Rodman, March 17, 2008.
[12] China Banking Regulatory Commission. "NPLs of Commercial Banks as of end-2007." http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2007051774830DBD1F20010BFFD7F4A6791F6F00.
[13] Shih, Victor. *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge University Press: Cambridge, 2008).

In describing China's elite political economy, Shih delivers a new twist to existent theory about state intervention in economic growth.[14] He describes the Chinese central government as a unique type of bureaucracy characterized by competition for political influence between and amongst two types of factions, "generalist" factions and "technocrat" factions, each faction led by a patron. "Generalist" factions are made up of politicians who have built up their careers through provincial government, and who have connected in a mutually-supporting network with other provincial government members. "Technocrat" factions are made up of officials in a given central government bureau, who tend to build their entire career in the same bureau and thus have connections confined to the bureau. It is asserted that the dynamic structure of the Chinese central government causes decision-making to be constantly motivated by power struggle between factions.[15]

In governing China's financial system, generalists are usually motivated primarily by the political "points" they gain by increasing GDP in the provinces which they advocate, and technocrats are motivated to gain "points" by becoming seen as broad "problem-solvers" within the government. Shih asserts that the arrangement of two types of factions with their respective incentives produces a mechanism that allows China to grow as fast as possible, while keeping inflation in check in small cycles: generalist factions vie for power to allocate as much direct funding and loans to their provinces as possible; when inflation (or even substantial fear of inflation) creeps up, the dominant generalist faction which controls the Chinese government recognizes that its only choice

[14] For his part, Shih references Gerschenkron, who argues that backward countries often need state intervention to concentrate capital and leap over the technological gap (*Economic Backwardness in Historical Perspective: A Book of Essays,* 1962, p. 20.)

[15] Shih: "The emphasis on factions stems from two fundamental assumptions about Chinese politics. First, top leaders in the Chinese political system value the retention and expansion of power above any ideological or policy preference. Second, because of the dearth of credible institutions and procedures to measure and transfer power at the elite level, top leaders face incessant threats to their authority." The formation of factions serves to "mitigate the fundamental uncertainty in the political system." p. 48.

to avoid universally harmful inflation is to centralize financial system control by delegating to "problem-solving" technocrats—who don't have a wide enough base of power to actually usurp the position of the dominant faction, but also are the only policymakers capable of wielding nation-wide influence in financial policy.[16]

The Chinese elite bureaucracy model as proposed by Shih is significant for two reasons: first, it sufficiently explains a "cooling mechanism" which has allowed China to manage a prolonged, multi-decade run of very fast economic growth without ever substantially overheating. Second, however, the Chinese government's unique model of bureaucratic control over its financial system also, in theory, completely fails to control some fundamentally important aspects of a healthy financial system. In a financial system governed by balanced power struggle, while inflation concern becomes optimally balanced with growth, no one in the bureaucracy particularly cares (much) about financial system performance. In terms of individual power seeking, it would, in fact, rarely make sense for a Chinese politician to treat the banking system as something other than a slush fund: using power to direct bank funds toward politically (rather than economically) profitable enterprises generally constitutes the most self-beneficial use of a politician's power. This means that, in addition to not caring about whether loan interest rates resemble anything close to normal market interest rates, politicians are not even incentivized to encourage the direction of loans toward organizations that are able (and willing) to pay back.

When central authorities are incentivized to make loans available to politically advantageous firms, they are then well able to transfer their incentives downwards to bank managers. In Kellee Tsai's *Back-Alley Banking*, a keystone academic work on the

[16] Ibid, pp. 47-63.

topic of informal finance in China, Tsai illustrates the directing down of policy orders through the chain of command: "When asked about the large portion of policy loans in their lending portfolios, state bank managers instinctually respond, 'It is our patriotic duty to support pillar industries.' When pressed about the definition of 'pillar industries,' however, most credit officers will concede that authorities pressure banks to subsidize politically important enterprises."[17]

In describing the thorough extent of the governance problem's roots, Shih concludes *Factions and Finance* gloomily:

> Although the Chinese leadership willingly liberalized other sectors of the economy, the enormous pool of savings in the banking sector made it an indispensable policy and political instrument. Despite some impetus to reform the banking sector, the political elite's need for a highly fungible policy and political resource – money – (has) led to a persistent reluctance to liberalize the banking sector beyond state control… This work propose no policy prescription… After all, Chinese policy makers have known all along how to commercialize the banking sector. They simply lacked the incentive to do so, and no amount of talk will change that fact.[18]

The necessary elite incentives to market-ize China's financial system are absent, and this "may well bring about the unraveling of the Chinese economic miracle."[19]

Just as the Ernst & Young report—and its author's ongoing insistence on its accuracy—suggest cause for concern in their empirical discrepancy with official estimates of the pure amount of bad assets currently plaguing China's financial system, the model of elite governance of China's financial system as described by Shih poses a challenge to China's financial system which renders it unable to react in a decisive

[17] Tsai, Kellee. *Back-Alley Banking: Private Entrepreneurs in China.* Ithaca/London: Cornell University Press, 2002. p. 8. Tsai calculated that as of the end of 2000, less than 1 percent of loans from China's entire national banking system had gone to the private sector, rather than to enterprises with state connections. The bias of lending to private businesses was such that a private business owner would exclaim, "A state bank wouldn't give me a loan if Chairman Mao himself rose from the dead and told them to give me one!" (Tsai, 2.)
[18] Shih, p. 191. Parenthetical (has) added by writer with assertion that in context, one can see that Shih is clearly extrapolating his model to the future.
[19] Ibid, p. 199.

enough way to a substantial challenge. If the true state of the balance sheet of China's financial system is nearly as NPL-ridden as suggested by Rodman, then China's financial system has a problem. If the financial system is as fundamentally organizationally flawed as is suggested by Shih, then it is developing toward crisis.

II. CIRCUMSCRIBING AGGRAVATING AND MITIGATING FACTORS IN THE NPL ISSUE

Little academic work has been published which broadly addresses current developments in China's NPL issue. Some good reasons for this are: data might not be conclusive, and, partly since China's economic growth story is so unprecedented, there is truly no theoretically obvious interpretation of the issue which presents itself. This section first attempts to identify the "puzzle pieces" of organizational factors which serve to aggravate or mitigate China's NPL issue, and then attempts to present the identified factors which are of general importance in a simple organizational chart describing the basic ways that the different factors relate to the issue. It utilizes fourteen interviews conducted via phone conversation, email, or in person,[20] with a range of professionals and academics with expertise relevant to the China NPL area, from perspectives including macroeconomics, political science, accounting, and investing.

Interviews were conducted with the loose format of asking interviewees to answer the questions:

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[20] The interview material includes Jonathan Anderson's February, 2008 research report, to which he directed the author.

1) Does China's NPL problem put it currently at risk of financial crisis?

2) Is the issue substantially improving?

While the answers to the two questions would certainly have some overlap (one might reason that if the issue is substantially improving, then China isn't really at risk of a financial crisis), they were so phrased partly in order to provide the interviewee with some range of expression of conclusion. Once respondents answered "yes," "no," or "maybe," they were asked to cite the primary factors informing their perspective. These factors are each briefly circumscribed below.

Aggravating Factors

First, features of China's political economy which can be seen to be aggravating factors are delineated. Each of the following factors was cited by at least one interviewee as a fundamental reason why China's financial system either does have a serious NPL problem, or is headed toward financial crisis (a full table describing interviewers' cited aggravating and mitigating factors is presented in the Appendix). A total of six distinct factors were identified:

Central Government Has Too Much Control: Banks Aren't Really Commercialized:

Two factors cited as aggravative of the NPL problem involved direct potential weaknesses of the central government in promoting a functioning financial system. The first factor would essentially represent a manifestation of Shih's theoretical description of

Chinese financial governance incentives. In a 45-minute phone interview, Jack Rodman (whose strongly pessimistic overall perspective will be discussed later) particularly emphasized a claim that the central government continued to possess too much indirect control over banks' portfolio allocation decision-making. This assertion was supported by both Wendy Dobson, Director of the Institute for International Business at the University of Toronto's Rotman School of Business, and Phil Groves, founder of DAC Management, which might currently be the largest foreign investor in China NPLs.[21]

"Princelings" Could Negatively Recast the Financial Governance Mechanism:

Victor Shih, in a phone interview, raised an argument which he had made in his book that the rise to power of a select few "princelings," sons of revolutionary veterans and senior Communist Party officials who have themselves been moving along tracks toward high ranking in technocrat positions, could pose a serious problem for China's financial system governance.[22] Shih suggests that despite rising to power in technocratic positions, "princelings" would unusually be tied to a wide network of close connections across China's government and corporate sector. "Princelings," with their own interests tied to economic growth, could destroy the generalist-technocrat balance in which technocrats can be trusted to implement restrictive measures when necessary, cutting out the governance breaks on bank lending.

[21] Little truly specific information regarding foreign assets devoted to NPLs was able to be obtained. It was listed as making seven separate purchases of NPLs from AMCs in 2006, more than any other foreign investor. Cheung, Brian, et al. "PricewaterhouseCoopers: NPL Asia." Issue 8, March, 2007.

[22] Shih, p. 198. For a more in-depth description of the "princelings," see Li, Datong. "China's Communist Princelings." openDemocracy.org, October 17, 2007. http://www.opendemocracy.net/article/democracy_power/china_inside/dynasty_reform.

Local Government Not Supportive of NPL Recovery:

An important stumbling block in fighting the bad-asset problem presents itself in the form of an occasionally uncooperative government. Both Jannie Wong of KPMG and Ted Osborn of PricewaterhouseCoopers brought up the difficulty that often remains in persuading local governments to buy into the importance of recovering loans made to delinquent companies. Osborn pointed out that, when faced with the choice between supporting an effort to threaten a struggling company with the prospect of seizing its assets, governments will often decline making the type of decision that would, for example, create the shutting-down of a factory that employs a few hundred workers.

Strategic Investors in Banks Are To No Effect:

In recent years, institutions including Goldman Sachs, Bank of America and HSBC[23] have made large investments in Chinese banks as "strategic investors" with the putative ability to influence management of the banks. It is unclear how much influence such strategic investors have to tighten banks' lending standards. In his interview, Rodman claimed that such investors "don't know how to find their way to the bathroom at a board meeting."

AMCs Refuse to Offer Attractive Rates to Distressed Asset Investors:

[23] See Wang, Zhi. "ICBC, Goldman Sachs embark on new journey." China Economic Net. February 20, 2006. http://en.ce.cn/Insight/200602/20/t20060220_6137659.shtml. Associated Press. Bank of America Buys Stake in China Bank: Move is Largest Investment in by Foreign Financial Firm." June 17, 2005. http://www.msnbc.msn.com/id/8253765/. Lee, Jane Lanhee. "INTERVIEW: China BoCom, HSBC Plan Credit Card JV In 06." Friday, March 10, 2005. Dow Jones Newswires. http://asia.news.yahoo.com/060310/5/2h4aa.html.

This argument was put forth not actually by either member of the two large distressed-asset investors which were interviewed, but instead by Mr. Rodman. He suggested that the most important factor contributing to NPL build-up was the government's unwillingness to allow foreign distressed-investment experts to make large profits on recovery. Rodman suggests that AMCs are compelled to sell assets at 30 cents-on-the-dollar which might take three years of work for an investor to recover.

Increasing Loans to Bubbling Real Estate Sector:

Yasheng Huang[24] of the Massachusetts Institute of Technology's Sloan School of Management stated that real estate loans will be the main cause of a financial crisis in China. He believes that the real estate sector's distinctive bubble/burst dynamics will cause an explosion of new bad assets, noting that real estate prices have already recently been falling in many of China's largest cities.

Mitigating Factors

Next are delineated aspects of China's developing political economy which can be seen as factors mitigating China's bad asset problem. Each was cited by at least one interviewee as a fundamental reason why China's financial system either does have a serious NPL problem, or is headed toward financial crisis. Some cited mitigating factors essentially compose refutations of some of the proposed aggravating factors. Ten factors were identified:

[24] Surname Huang.

An NPL Problem is "Affordable:" China's Foreign Currency Reserves Would Offset Potential Crisis:

A number of arguments provided as to why China does not truly have an NPL problem, or at least is not headed for financial crisis, rested on certain macroeconomic dynamics in China. One which is pointed to by Wharton Professor Franklin Allen, Peking University Professor of Finance Wang Shuguang, and which is even acknowledged by Shih, is that China's massive foreign currency reserves, of over $1.6 trillion,[25] comfortably outnumber even Rodman's 2006 estimate of China NPLs.

Broad, Consistent Economic Growth Supports the Financial System:

Another posited mitigating factor also composed of an economic trend simply consists of China's continuing economic improvement. When the economy grows, businesses do better, and can better pay back their loans. Additionally, the smaller percentage of the economy that is made up of non-profitable, loan-winning state-owned enterprises, the better. This was cited by Jonathan Anderson and Teng Tai, Research Director of Galaxy Securities, among others.

Government's Ability to Leverage High Savings Rate and Direct Citizens' Savings:

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[25] As of the beginning of April, 2008, they had surged to a value of $1.68 trillion. Piboontanasawat, Nipa. "China's Currency Reserves Climb 40% to $1.68 Trillion." April 11, 2008. http://www.bloomberg.com/apps/news?pid=20601068&refer=home&sid=a0k.nDyzhlAQ. The IMF's quarterly Currency Composition of Official Foreign Exchange Reserves data is published at http://www.imf.org/external/np/sta/cofer/eng/index.htm.

This other macroeconomics-based point was brought up by Professor Jacques deLisle of Penn Law School.

Non-Bank, Non-Risky Financial Businesses are Developing Rapidly:

Teng Tai of Galaxy Securities pointed out that a factor in lessening China's NPL problem will simply be composed of the decreasing exclusiveness of banks as the only places for Chinese savings to be directed. China's mutual fund industry, for example, has expanded to about $450 billion by the end of 2007, from only about $28 billion in 2004.[26]

Governance Incentive System Not Broken on A Large Scale:

A number of interviewees, including deLisle of Penn Law and Wang Shuguang of Peking University, denied that China's financial system governance operates at the mercy of such tenuous incentive structures as posed by Shih. Both believes that governance is sufficient for the successful development of banks into actual commercial entities.

Strategic Investors in Banks Are Not *To No Effect*:

The issue of strategic investors' influence will, of course, not be able to be conclusively resolved, but it should be noted that six interviewees mentioned a belief that strategic investors play meaningful positive roles in shaping banks' operations.

Public Listing:

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[26] Zhou, Xin. "China to relax laws on mutual funds –lawmaker." Reuters, January 10, 2008.

Many interviewees also suggested that public listing of three of China's Big Four Banks (Bank of China; the Industrial and Commercial Bank of China; China Construction Bank) has compelled them toward more efficient performance.

Banks Are *Learning To Act As Commercial Entities*:

Partly as a derivative of the two above cited factors, the argument was made, in different forms, by several interviewees that China's banks are learning to act as commercial entities. Teng Tai described that, because so many private-sector Chinese companies have previously been without access to loans, there exists a strong market for banks to provide loan services to, which tends to make the transition toward profit orientation somewhat easier. Ted Osborn mentioned that one of the Big Four Chinese bank recently hired PWC as a debtor auditor, which, since global accounting firms tend to charge appreciably higher rates for such services than local firms, had previously been "unheard of" as a measure taken by Chinese banks. Marshall Meyer recently pointed out that, overall, China's commercial banks appear to be trending toward more conservative operations, issuing loans less freely and lowering deposit interest rates.[27]

AMCs' Management is Not *Incompetent*:

Whether or not the ability of the state-owned AMCs to recover bad assets is improving is another factor in the NPL issue which is up to debate. Wang Yong, Director of Peking

[27] Personal correspondence, May 12, 2008.

University's Center for International Political Economy Research, has attested that the management of AMCs has, in fact, improved in recent years.

Foreign Investors Continue to Pursue NPL Purchases, Suggesting Some Recoverability:

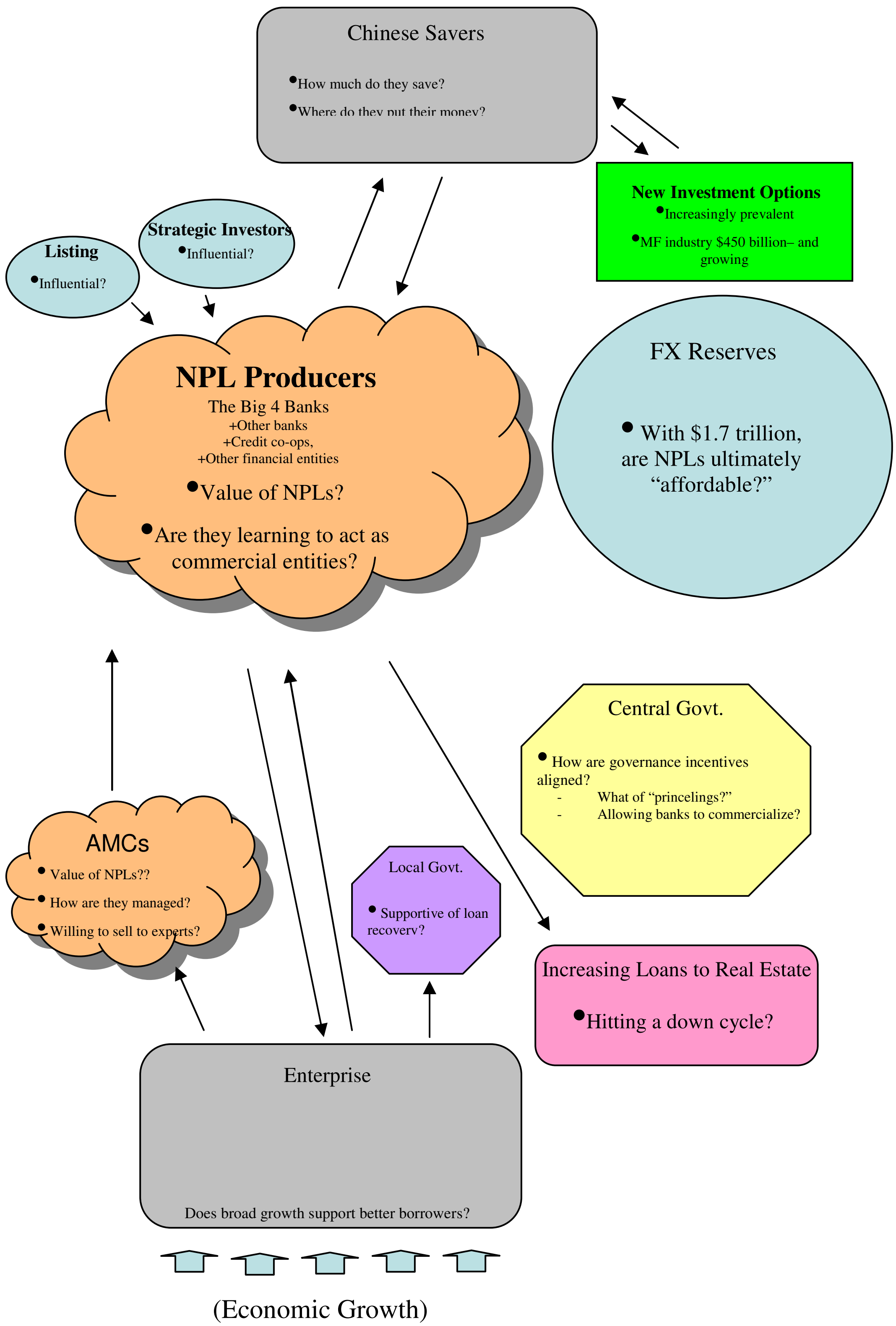
Clearwater Capital and DAC Management, two firms which were interviewed, are some of the larger firms investing in China NPLs.[28] Phil Groves boasted of DAC's ability to make strong profits by employing a large local workforce.

An Organizational Map of the NPL Issue

Before attempting to analyze the "puzzle pieces" of China's NPL problem, a useful step would involve simply mapping the pieces out. On the following page is presented an organizational diagram which attempts to basically depict factors influencing the NPL issue in China.

[28] Clearwater Capital Partners invests about $1.7 billion in assets under management, much of it in Chinese distressed assets. "Fact Sheet 2008." http://www.clearwatercp.com/media/Clearwater_Fact_Sheet_32808.pdf.

Sources of Funding in China



Uses of Funding in China

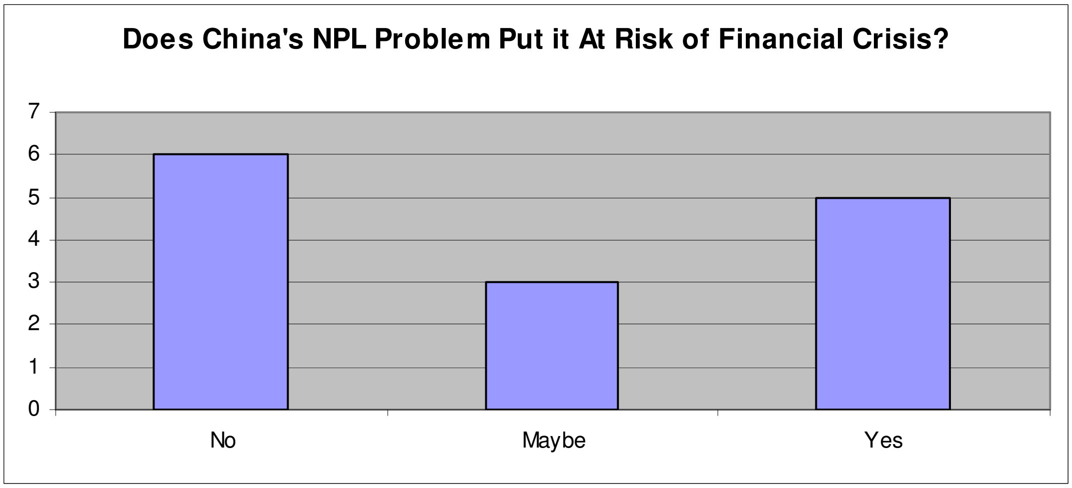
III. ORGANIZING A PERSPECTIVE FROM IDENTIFIED FACTORS

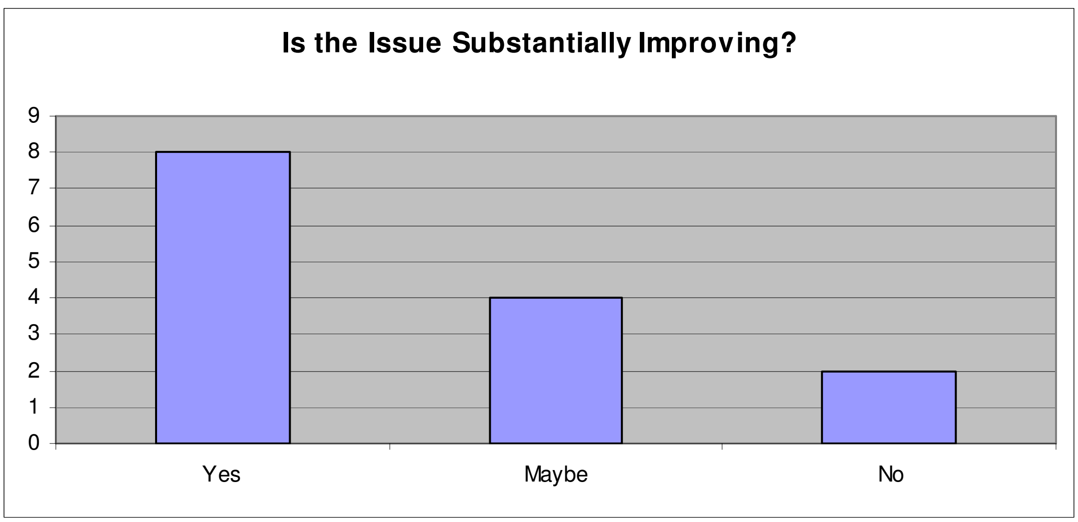
The previous section circumscribed the "puzzle pieces," the various main political economic factors which influence China's NPL issue. This section attempts to briefly, broadly address how the factors fit together as a political economic system. It first presents the "tallies" of interviewees' responses to the two main questions. It then briefly analyzes how the perspectives expressed in their respective interviews might be seen to importantly address the broad NPL issue. Finally, it applies the new holistic picture to speculate as to what some of the most important "puzzle pieces" might prove to be, and analyze Rodman and Shih's recent challenges to China's financial system health.

Although a sample size of fourteen interviewees is two small to be considered "data," one might consider the set of interviews conducted to be collectively indicatively useful in their own way. In particular, since the interviewees represent respected experts in a wide range of disciplines, their combined perspective could be seen as a sort of very rough proxy for a "multi-disciplinary view:" the set included 3 partners or former employees from among the Big Four accounting firms; 2 leaders of China NPL investing operations; 6 foremost experts in macroeconomics or finance; and 3 experts in China's political economy. While inconclusive, the interviewees do help to provide an ultimate indication of the validity of the described challenges.[29] Here are bar charts describing interviewees' responses to the two original questions posed, of whether China's NPL

[29] Of course, the quantitative drawback of the interviews—that there were not substantial repetitions to make statistically significant statements—would be distinct from the type which otherwise restricts the study—an absence of data which has not been challenged. The author hopes that the goals of the project, to provide an *outline* of the issue, and to propose a correspondingly tentative, limited-but-signifying qualitative interpretation of an admittedly-not-completely-qualitative topic, have been made sufficiently clear that information analysis can be taken for its non-conclusive nature.

problem puts its financial system at risk of crisis, and of whether the situation is currently substantially improving:





Immediately one can appreciate the general gist of interviewees' overall attitudes. Nearly as many interviewees believed that China's financial system was at risk of a financial crisis as did not. That is to say, a large proportion believed that bad assets compose a serious problem to China's overall financial system. However, only two respondents—Jack Rodman and MIT's Yasheng Huang—actually did not express a belief that China's

NPL problem was currently substantially improving. As a simple outline, this provides a tentative encouragement that the NPL problem is being dealt with. Indeed, even interviewees who responded “maybe” to either question tended more to emphasize reasons why a financial crisis is likely to be avoided, than why it is likely to occur.

Having catalogued the basic puzzle pieces, and where, roughly they fit into a large picture of China political economy system, was itself an end of the study. However, in addition to the NPL “map” produced to speak to China’s current issue, one can apply the elements themselves to come up with a basic meta-contextual analysis of the challenges presented by Rodman and Shih. Two identified elements of the NPL issue, along with a conclusion from the above “overall” outline of interviewees’ survey responses, can serve to relatively well address challenges of China’s financial system health in the realm of the bad asset issue.

In *Factions and Finance in China*, Shih came to the theoretical conclusion that China’s particular evolving financial system governance makeup “may well bring about the unraveling of the Chinese economic miracle.” Such a statement necessitates a response, if a response is possible. A particular mitigating factor which seems quite useful in refuting the conclusion which Shih arrived at through a lens of governance, is presented through a lens of macroeconomics: that is, China’s foreign currency reserves. Franklin Allen of Wharton, Teng Tai of Galaxy Securities and Wang Shuguang of Peking University’s Economics Department all suggested that China’s foreign exchange reserves are almost certainly too large for a financial crisis to occur in China (Allen had stated that the financial system was at risk, but “a small risk”). As a factor of profound theoretical impact which Shih does not touch on in his discussion of potential “unraveling,” the indisputable macroeconomic fact of China's foreign currency reserves could be seen as an important sort of companionate response to Shih's political-theoretical proposition. Perhaps most telling of all was Shih's own ultimate response to the interview questions: at the end of the interview, he, himself, stated that a financial crisis would be rendered relatively unlikely by the backstop of China's reserves.

The macroeconomic aspect of China's huge foreign exchange reserves appears to go a long way toward resolving what would be a substantial theoretical challenge to China's financial system stability with regard to NPLs, from the elite governance model proposed by Shih. However, Rodman's challenge to China's financial system health, presented from an empirical perspective, remains to be addressed. While in his 2006 E&Y report, Rodman, of course, most forcefully posed a limited quantitative argument that China had more bad assets than believed, in his interview, he expanded his realm of criticism to posit that China was at serious risk of a financial crisis, specifically because of failure in implementing operational reform in banks. Claiming that all "ultimate major decisions are (made) by the Chinese Communist Party" in China's banking operations, Rodman argued similarly to Shih that the base of coming problems would lie in the government's relationship to the banks, but adopted what could be seen as a more empirical angle,[30] describing the failure's being constituted in two main areas: first, in banks' inability to act more commercially, and second, in AMCs' unwillingness to act rationally and sell NPLs to expert distressed investors who could recover significantly more of loans. Despite Rodman's employing progressively extreme language throughout the interview to characterize what he posed to be a problem that most experts were afraid

[30] More empirical in the sense that it is based on putatively observable evidence of banks' failure at commercialization, rather than the theoretical assertion of what could only be banks' relation to the government.

to shoot straight about,[31] one might suggest that, while some of his claims could not be backed up in either an affirmative or negative, his main points could be somewhat addressed by input from other interviewees.

Interviewees did provide some compelling evidence against Rodman's assertion that banks' operations were not becoming more commercialized. For what their respective perspectives are worth, on the topic of strategic investors, a range of interviewees, from Jonathan Anderson of UBS to Jannie Wong of KPMG to Wang Yong of Peking University's Political Economy Research Center, flatly argued against the assertion that invested partners would not be able to "find their way to the bathroom at a board meeting." Similarly, Teng Tai of Galaxy and others also contradicted the assertion that public listing would not serve as an appreciable commercial-transformative factor. A somewhat minor, but intriguing piece of hard evidence was presented by PWC's Osborn, in his description of a Big Four bank's unprecedented decision to hire a Big Four accounting firm to audit a potential borrower. These inputs could be seen, as well, to challenge the theoretical assertions of Shih regarding financial governance dynamics, but they speak particularly directly to the purely empirical-based challenge of Rodman, by providing numerous contradicting perspectives which are empirical to varying degrees.

In addition to criticizing banks' operations, Rodman also described a fundamental impediment toward improvement of the NPL problem as being that the state Asset Management Companies were under directives not to sell loans at prices from which

[31] In terms of extreme language, Rodman used the phrase "fucking gigantic disaster" to sum up his overall view of the trending NPL situation. In terms of other asserted experts' unwillingness to frankly address the issue, it might be noted that Minxin Pei, who replied to an inquiry by puzzlingly stating that he "stopped following the NPL issue several years ago," is being listed in the Appendix with the Pessimist group, mainly as a means of providing recognition of a fact which one must admit could have possibly contributed to a lower rate of response to inquiry—many who might be critical of the issue, might be less willing to discuss it.

foreign investors could profit too much. This asserted unwillingness of AMCs to allow foreign investors to "take advantage of" distressed Chinese companies would result in drastic under-sale of loans to custodians whose expertise could actually make them less "bad." Rodman suggested that it was this factor that has resulted in the current relatively lower presence of foreign investors in the China NPL market, with many of the "original investors" in China NPLs in the early 2000s no longer participating in loan auctions. It should be noted that PWC's Ted Osborn presented a similar overall perspective to Rodman in interpreting that nationalistic considerations were causing AMCs to operate un-optimally.

However, like the denial that banks were substantially commercializing, Rodman's interpretation of the issue of AMC sell-off was also, effectively, directly challenged by inputs from several interviewees. Entirely different factors could be informing AMCs' recent conservativeness in selling NPLs. KPMG's Jannie Wong suggested that, with an improving overall set of credit risk management operations in banks, AMCs have been under less pressure recently to get rid of their NPLs to meet government-set recovery quotas, and so simply auction more conservatively. An additional, intuitively appealing alternative explanation to Rodman's, is presented by both of the American China NPL investment managers who were interviewed. Both Ron Thompson and Phil Groves posed the issue of AMCs' auctioning of loans as simply being a cyclical process. Banks will sell off large amounts of low-classified loans to their counterpart AMC, and resulting large auctions tend to offer better prices that attract more investors. In down cycles, only specialized investors such as Clearwater and DAC are able to make worthwhile profits. Thompson expressed that there was particular interest among investors in a new set of loans to be dumped by the Agricultural Bank in the coming months. Overall, the set of interviews conducted served to present many appreciable counterpoints to the challenges raised by Shih's book, and by Rodman's expressed perspective.

It would be heartening that, in light of much of interviewee input, the potency of the challenges provided by Shih and Rodman appear to be somewhat weakened. However, one aggravating factor which was briefly brought up in the set of interviews might be seen to be particularly concerning in the consideration of banking crisis potential in China. That factor is the one brought up by MIT's Yasheng Huang. In a brief email response, Huang stated a perspective that China's banking crisis potential lies most fundamentally in loans to an extremely cyclical real estate sector. Although Huang pointed to real estate prices' currently falling in Shanghai, Beijing, and Guangzhou, he did not cite specific statistics which would support the assertion of a danger of real-estate volatility (of course, this study has already resigned itself to a qualitative outline, anyway). However, Huang is also far from the first person to have brought up the possibility of a real estate bubble-burst combining with bad enterprise loans to create a financial crisis. Justin Lin, a Peking University economist, has also been quoted as early as 2003 expressing this concern.[32] The existence of a significant real estate bubble has been debated. A July, 2007 piece in *The Economist*, for example, claimed that an actual bubble "by most measures does not exist," arguing that while double-digit annual real-estate price gains would be cause for concern in a developed economy, in an economy

[32] Markus, Francis. "China's Property Bubble Risk." BBC News. January 3, 2003. http://news.bbc.co.uk/2/hi/business/2621907.stm. Also see Lin, Justin Yifu. "Is China's Growth Real and Sustainable?" China Center for Economic Research Working Paper Series. Peking University February 26, 2004.

which is expanding at as fast a nominal GDP growth rate as China, such price rises are within the realm of reasonable expectation.[33] However, currently-falling real estate prices as cited by Huang should be kept note of as an important potential causal factor in aggravating China's bad asset problem so that it might reach a more serious extent.

John Dewey said, "A problem clearly apprehended suggests its own solution." Recent challenges to a broad conception of China's financial system health, and the fact that little very recent academic work has been devoted to China's non-performing financial assets, have made the topic of NPLs in China, and their potential to cause financial crisis in China, worth attempting to broadly address through possible qualitative means. This study has not aimed to come to a full, clear conclusion in answer to the crucial questions of whether China is at risk of an NPL-driven financial crisis, and whether the risk is increasing or decreasing. It has aimed to provide an outline of the areas relevant to build a clear holistic understanding of the NPL problem, and provide tentative indications of the especial relevance of some factors. Interpreting this basic outline, one could suggest that a thusly-built apprehension somewhat neutralizes potent recently-posed theoretical and empirical challenges from Victor Shih and Jack Rodman, although, taking a full inventory of the basic political economic components, potential problem sources undoubtedly cannot be forgotten about. Hopefully this study has provided at least a starting point for a more clear apprehension.

[33] The Economist. "Home Truths: Talk of a housing bubble in China and other parts of East Asia is much exaggerated." July 5, 2007.