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Energy Beat

China's banking system still in need of reform, experts say

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The question of whether China's financial and economic structure is headed for collapse continues to be hotly debated. (See Energy Beat, "Stratfor's scenario: Economic woes in China will deflate oil prices," Feb. 18.)

Several Houston attorneys doing business in and with China are cautiously optimistic that the country will likely dodge that bullet. But they agree that the bullet is there.

"China's banking system is rotten," says Greg Burch, a partner with Houston law firm Locke Liddell & Sapp.

Locke Liddell currently represents Sinopec, one of China's four big oil and gas companies, and has done work for all four.

"That China's formal bank lending sector has a big problem, there is no question," Burch says.

Locke Liddell associate Tom Tong, who is from China, agrees that China's banking system is "very broken. It leaks like a sieve."

The Chinese banking structure is a lot like the one that existed in Japan before collapsing in the 1990s, says Burch. Both ran on the basis of "friendly" lending with low -- or no -- credit standards, making it difficult for a borrower to fail and therefore difficult to foreclose on a bad loan.

The problem in China stems from the fact that both the banks and the companies borrowing from them were state-owned a decade ago, explains Tong. And that meant banks were unlikely to collect on bad loans because there was "no incentive to be tough." Lending decisions were usually based on government policy or budget decisions.

But most of these entities have since been severed from the government through privatization, and the financial sector now must treat these deals as commercial lending.

"It's a difficult transition," says Burch.

The Chinese government has mandated that the four largest formerly state-owned banks be listed on the New York Stock Exchange. So the era of "easy lending" is over, says Tong.

In trying to get their houses in order, the Chinese banks have borrowed the same mechanism used by the U.S. government in dealing with the savings and loan crisis in the 1980s. The banks have created a state-owned asset management company modeled after the U.S. Resolution Trust Corp. to handle the bad loans.

Burch is optimistic about China weathering these challenges.

"The Chinese are really good at coming up with all kinds of alternatives. Their formal banking sector could rot and fall and not bring about an overall economic collapse because Chinese entrepreneurs find ways around it," Burch says.

The biggest detour, which is funding much of the development of China's cities, is foreign private equity investment.

"There are thousands of ways foreign investors could take up the slack of a failed commercial lender," Burch says.

And there is compelling motivation for that to happen.

Unlike Russia, whose economic struggles and failures haven't affected the rest of the world, Burch says China is "too hooked into the entire fabric of the world economy" for it to fail -- or be allowed to fail.

Nevertheless, there is a huge real estate bubble now in China that is a house of cards built on speculation, says Tong.

China's coastal cities are awash with high-rise luxury condos that are "sold out" but have no lights in them because the units are owned by overseas investors, Tong says. And lately, China's prospering middle class is jumping on the real estate investment bandwagon, too, fueling an even bigger bubble, he says.

Tong worries about that bubble bursting.

"It would be terrible. It would affect a lot of people, and it would erode credibility and confidence in the banks," he says.

What is going on in China's real estate sector reminds a lot of Houstonians in China of the real estate bubble that fueled Houston's boom in the 1980s and then brought Houston to its knees when it burst, says Jeff Blount, a Fulbright & Jaworski partner who practices in the firm's Hong Kong office .

"There is a huge real estate bubble in Shanghai, where a big middle class is speculating and borrowing money to buy their first apartments," he says. "A lot of people are predicting a collapse."

But Blount thinks this phenomenon is confined to a few areas in China. And he thinks China's economy overall is maturing and becoming much more diverse. As a result, he thinks that even if several large state-owned enterprises or banks fail, it would not have a disproportionately negative impact on the national economy but rather would be "muted."

China's privatization of its state-owned entities is the "biggest source of economic instability" in the country, Blount says, but the reform is being carried out gradually and successfully.

He agrees with Burch and Tong about the historic problems with China's banking system. But the government, he says, has "taken strong measures" to correct those issues.

Burch doesn't foresee any repetition of the 1997-1998 economic meltdown that occurred in Southeast Asia. The countries and economies that were affected at that time were much smaller and much different than China, he says.

Burch thinks China's economic growth will moderate and be characterized by more predictable ups and downs rather than huge, catastrophic swings.

Still, Jeffrey Garten, dean of the Yale School of Management, voiced some warnings to an international gathering of energy executives in Houston last week.

China still doesn't have a truly market economy, he pointed out. And if China does stumble economically, "it would reverberate everywhere," Garten said.

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