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Surge in Lending In China Stokes Economic Worries

Spending, Investment Sprees Point To Overheating; Bad Debts Rise

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SHANGHAI -- Liu Yijun is 27 years old and works as a real-estate agent. He and his wife, a supermarket purchasing agent, together make about $8,000 a year. On that modest income, this year they've bought a new Mazda for more than $19,000 and a new apartment priced at almost $91,000.

How did they do it? "Bank loans changed our life," Mr. Liu says.

China is awash in easy credit these days, spurring a national spending and investment spree in everything from residential property to wine, cars, steel and shopping malls. Banks' liberal lending policies -- Mr. Liu and his wife, for instance, financed at rates between 5% and 6% -- have boosted lifestyles and helped fuel China's white-hot economic growth. Gross domestic product hit $1.236 trillion last year, up 50% from 1996, according to the International Monetary Fund. The average annual growth rate during that period was nearly 7%.

Warning Signs

However, there are signs that the world's fastest-growing economy may be in danger of overheating. Pessimists point to overproduction in steel and a possible asset bubble developing in property. They worry that economic growth can't be sustained at its current pace. What's more, economists estimate that of China's nearly $2 trillion in outstanding loans, between $500 billion and $750 billion aren't expected to be repaid. Those amounts are in line with Japan's bad-loan problem.

For now, there is little danger that the economy or even the antiquated, state-run banking system will collapse. China's banks remain government-owned and are backed by what amounts to a sovereign pledge to keep them afloat. Indeed, the banks have been carrying a huge load of bad loans for years, and have rarely experienced runs because of the country's closed banking system and China's traditionally trusting bank customers. In recent years, Beijing has been taking steps to overhaul the banks and reduce their bad debts, including setting up some companies to take over bad loans. Still, with many Chinese banks once again handing out loans rather indiscriminately, a new set of bad loans could emerge on their books, setting back China's financial reforms. And their problems could become harder to fix as the country prepares to open its doors to foreign competition.

EASY MONEY

Meanwhile, any major distress in this mammoth economy would hit hard abroad and at home. The global economy needs a healthy China, with all its export muscle and import appetite. Beijing needs economic growth and stability to help it fend off surges in unemployment and quell resentment over the widening wealth gap and rampant corruption. This year, record numbers of graduates are entering the job market, joining swarms of migrant laborers, demobilized soldiers and workers laid off from ailing state-run enterprises. Any slowdown in the economy could send the jobless hordes into the streets to protest.

Government Stimulus

The lending boom has roots in an economic-stimulus program that Beijing began in the late 1990s after the Asian financial crisis. It promotes government spending and easy credit to stimulate growth and generate jobs. The program has called for issuing large amounts of government debt, seriously widening the country's budget deficit -- $37.39 billion last year, compared with $2.5 billion in 1993.

The country's tightly controlled foreign-exchange regime also plays a big role in the flow of credit. The value of the yuan, or renminbi, is set at a fixed rate of about 8.28 yuan to the dollar. This spares the country's banking system from having to deal with exchange-rate complexities.

But maintaining this fixed exchange rate often puts China's central bank in a difficult position: For every dollar from exports and foreign investment that enters China -- a total of $378 billion last year -- the bank must supply an equivalent amount of yuan. Since there is more money entering China than leaving it, the supply of yuan keeps rising. China's money supply surged 21.6% as of the end of August over the same time last year.

The government has resisted revaluing the yuan or ending its policy of pegging it to the dollar, even after warnings earlier this year from Federal Reserve Chairman Alan Greenspan that the yuan's fixed exchange rate could make China's economy overheat. Last month's Group of Seven meeting, under pressure from the U.S. Treasury, called for greater flexibility in exchange rates, specifically targeting the yuan. Some in Washington believe the huge U.S. trade deficit with China is the result of Beijing's keeping the yuan artificially weak.

China's central bank tries to soak up some of the excess yuan with sales of short-term, yuan-denominated notes to banks, which must pay for them with yuan. But these notes absorb only a portion of the money. The rest ends up in the nation's banks, which are already flush with cash thanks to a domestic savings rate that ranks among the highest in the world. As the cash piles up, Beijing is pressuring bankers to put the money to use. By the end of August, total bank loans outstanding in yuan had risen 16% to $1.85 trillion. Real-estate and auto loans to people such as Mr. Liu and his wife led the way, with new loans in these areas totaling $60.4 billion for the first eight months of this year and accounting for 23.1% of total new lending.

Banks have become so eager to lend that they often conduct only minimal credit checks and impose minimal penalties for delinquencies. Mr. Liu's bank failed to learn that he and his wife have a combined monthly income of $664 to cover a monthly debt payment for their new car and apartment of $882. Mr. Liu, who dug into his savings to cover the two down payments, says he inflated his salary on his apartment-loan application and had his employer officially stamp it. Bank officers didn't check further. They also failed to discover that he had missed a payment on a previous mortgage.

"Credit checks at Chinese banks are still very poor," Mr. Liu says, smiling. He's counting on real-estate commissions to help him make his debt payments.

Beyond consumer lending, loans are bolstering industries large and small. Surging demand for steel and other construction materials has also drawn on the deep well of easy credit -- and raised concerns over a potential glut if demand tapers off. In the last boom-bust cycle, oversupply of steel dragged prices down to $229 a ton in 2000 from a high of about $483 a ton in the early 1990s. In the current boom, prices are creeping up to nearly $365 a ton.

"Everywhere there are steel plants going up," grumbles Dong Yizheng, a former policy director for the now-defunct metallurgy ministry who travels around the country as a consultant to companies and local governments. He blames the banks, for one. "Before banks were more cautious, but now that steel companies' profits are so high, banks are of course willing to lend," he says.

In the western province of Sichuan, cheap credit pouring into the dairy business has doubled output in the past five years and driven prices down to where milk now costs less than bottled water. Huaxi Dairy Co., among others, paid for expansion with bank loans. Then, just as the company was completing a newly imported production line, rising supply in the market depressed prices early last year.

Huaxi officials found a helpful investor in the New Hope Group, a private Chinese company that got its start in the animal-feed business. Earlier this year, it bought Huaxi for $12.1 million -- of which $5.3 million came from bank loans.

Wine, too, has seen boom and bust recently. In the late 1980s, a wine-producing craze caused volumes to soar, before oversupply sent prices spiraling downward. Yet officials in the impoverished western province of Gansu say they plan to double the amount of vineyards under cultivation there by 2010, despite signs already of a saturated market.

Gansu Qilian Wine Co., with the local forestry department's backing, easily secured a $2.2 million loan from the Agricultural Bank of China to help finance its startup in the mid-1990s. Although the loan came due last year, Gansu Qilian executives say the company has no intention of paying it back in the near term, opting instead to pay the bank a slightly higher monthly interest.

Now, with competition tough and the company racking up some losses earlier this year, Gansu Qilian is close to securing a $3.6 million loan through another bank to help pay for its marketing expenses, company executives say. "A reasonable amount of debt is good for the company's development," says Zhang Wenjie, a Gansu Qilian spokesman.

Nowhere is China's easy-money economy more clearly at work than in the property sector. Yao Zhen, a finance professor in the eastern province of Zhejiang, sold an apartment in the provincial capital of Hangzhou this spring for nearly three times the amount he paid for it in 1997. He then plowed the profit and a big chunk of his savings into a down payment of nearly $97,000 on a $170,000, three-bedroom house on the outskirts of the booming city.

Mr. Yao, who now lives with his family in a small apartment provided by his university for a pittance, took out a bank loan to cover the rest of the cost of the house. His mortgage payments now take up half of his monthly income, but he isn't worried. He says the resale value of the house "is already higher than when I bought it."

Property prices have shot up so fast in Hangzhou that the trend is now known around the country as "the Hangzhou phenomenon." During the past several years, developers, investors and city residents have all invested heavily in the city, betting on plentiful demand and rising prices.

"All the banks are doing property loans," says Jia Shenghua, head of Zhejiang University's Real Estate Research Center. "Everyone believes property prices will continue to rise, so no one feels any risks."

Deep in China's poor hinterland, farmers in Anhui province's Huanglu county are pooling their savings and securing bank loans to build rows of shiny, two-story buildings on what used to be wheat and cotton fields. Finished buildings sell for as much as three times the construction cost, potentially reaping a windfall for the investors, says Huang Shizhen, a former construction contractor in Huanglu.

The only problem: "Nobody could afford such an expensive house for residential use," he says. Many are converted to commercial use, but it's unlikely all will find buyers.

Some of the more extreme lending excesses turn up in places that wouldn't appear to justify any new funding. Shanghai, already saturated with shopping malls, saw another open a year ago. The 10-story Super Brand Mall, sitting on the waterfront of the Pudong financial district, required about $210 million in bank loans, according to news reports. The joint venture involves Thailand's Chia Tai Group and China's state-run Lujiazui Group; Chia Tai, which took out the loans, didn't respond to written questions.

The mall's claim to be Asia's largest shopping center was supposed to be a big draw for consumers. But on a recent afternoon, large portions of the mall lay deserted as two dozen shoppers stepped down from a bus and headed directly to a supermarket in the basement, ignoring the mostly empty clothes stores, audio shops and restaurants along the way.

At least 10 more large-scale shopping malls are set to open in Shanghai during the next few years, the vast majority financed with bank loans. "It's just like the rampant building of property projects across the city," says Zhu Hua, deputy director of the Shanghai Commercial Economy Research Institute, a government-run think tank.

Not everyone agrees that China's economy is headed for trouble. Even in the property market, there's little consensus among experts. While some warn of a growing bubble, others argue that individual home purchases are driving the current boom, unlike in the early 1990s, when speculation by financial institutions sent real-estate prices soaring. Home buying has stoked other businesses, boosting sales of furniture and other home furnishings and construction materials. Ikea and similar stores are enjoying booming sales.

Still, the combination of easy credit and heavy investment is clearly worrying Beijing officials. In August, China's cabinet suspended the approval of new development zones, launched an investigation into whether the property sector is overheating and issued new rules curbing investment in auto making. It's considering similar restrictions for mobile-phone manufacturers. Many Chinese insurance companies have stopped issuing policies for new-car buyers, amid signs that lax credit checks are leading to defaults.

Some banks fear they may be in danger of becoming overextended. For the first seven months of this year, Chinese banks lent more than they did in all of 2002.

"Commercial banks lent out too much money in the first half," says an executive at a Shanghai-based commercial bank, who declined to be named. She says her bank's loan-to-deposit ratio has exceeded the generally accepted upper limit of 75%, adding, "Now we have to attract more deposits, ... otherwise the financial risk is too high."

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