

**Statement of
Gordon G. Chang
U.S.-China Economic and Security Review Commission
Washington, D. C.
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Chairman Wortzel, Chairman Mulloy, and distinguished members of the Commission:

It is a privilege to appear before you today, and I thank you for this opportunity.

My name is Gordon Guthrie Chang. I am a writer and live in Bedminster, New Jersey. I worked as a lawyer in Hong Kong from 1981-1991 and Shanghai from 1996-2001. Between these two periods I frequently traveled to Hong Kong and China from California.

I am the author of *The Coming Collapse of China* (Random House, 2001) and *Nuclear Showdown: North Korea Takes On the World* (Random House, 2006).

Summary

China's financial system is much weaker than it appears because there is too much debt. Chinese localities and enterprises are burdened by excessive financial obligations. As a result, many lenders—and especially China's larger banks—are in a precarious position.

Furthermore, the central government is probably carrying more indebtedness than it admits to.

A debt crisis inside China will not have much effect on the American financial system, at least in the long run.

Amount of Chinese Debt

How much debt is there in China?¹

In short, no one knows. Those who try to total it up are reduced to making unacceptably imprecise estimates for two reasons. In some cases, Chinese officials do not know the amount of existing debt. In others, they try to hide indebtedness.

Central Government

Official figures claim that the central government had the equivalent of Rmb3.26 trillion (US\$408.80 billion at current exchange rates)² in debt at the end of last year. Of this amount, US\$281.05 billion was denominated in foreign currency. China's total sovereign debt amounted to about 18 percent of gross domestic product, well within the generally accepted alarm level of 60 percent.

Beijing estimates that national debt will total Rmb3.56 trillion at the end of this year,³ an increase of 9.1 percent over the amount at the end of 2005.

China's announced government debt is not only modest, but it is also well structured in that much of it is denominated in its own currency and is long term. If there were to be a financial crisis in China, the value of its renminbi debt, as expressed in foreign currency, would undoubtedly decline.

This is not the end of the story, however. There are substantial obligations that China does not include in its official figures such as central government debt incurred for municipal and other local projects, Ministry of Finance guarantees related to partial bank recapitalizations as described below, debt extended by multilateral institutions (such as the World Bank and the Asian Development Bank) and by other governments,⁴ borrowings by China Development Bank and the three other "policy banks,"⁵ and miscellaneous obligations such as grain subsidy payments. There is, unfortunately, a clear trend in Beijing's borrowing habits: the central government is increasingly relying on off-balance-sheet financing.⁶ In short, Beijing is becoming less transparent as time goes on.

We simply cannot say with any assurance just how much central government debt exists. For example, it is evident that annual budgets for the central government do not include the costs of acquisition of military hardware. The amount of the underreporting on this item alone could be as much as US\$70 billion this year.⁷ Although it is possible that this large amount is dispersed and hidden in the budgets for other government departments—the People's Liberation Army is, after all, involved in many aspects of civilian society—it is more likely that at least part of these expenditures is covered by off-budget financing. The PLA has close and nontransparent links with state-owned enterprises and receives off-budget revenues through them.⁸ It is thus reasonable to assume that the central government also is effectively responsible for the obligations of these revenue sources.

The Ministry of Finance is either working on or has just completed a study of China's indebtedness. Unfortunately, this document is not available for public inspection. This secrecy naturally raises concerns about the accuracy of the government's published figures.

Lower-Tier Governments

A half decade ago one report put the amount of local debt—debt of provincial and lower-tier governments—at US\$600 billion, but current estimates are considerably lower. For example, Beijing analysts, who labeled local debts a potential “minefield,” recently stated that such obligations could amount to a trillion yuan,⁹ a much lower figure. Cities' off-budget liabilities are, according to a January 2006 World Bank report, “sizable” but unknown in dimension.¹⁰

The Organization for Economic Co-operation and Development in February of this year issued a study stating that local debt probably ranged from 3.5 to 9.3 percent of 2002 GDP.¹¹ If we applied the same percentages to 2005 GDP, local debt would be between Rmb638.12 billion and Rmb1.70 trillion.

Should we extrapolate in this manner? If anything, local finances have deteriorated in the last few years. As discussed below, a large portion of GDP is attributable to fiscal stimulus. Much of this fiscal stimulus ends up as seed money for local government projects, and many of these projects are either explicitly or implicitly guaranteed by local authorities.¹² Moreover, rural governments are in a pinch because Beijing has ended the agricultural tax and other fees in order to relieve peasants of onerous financial burdens. Premier Wen Jiabao, however, has offered these governments little financial compensation for the loss of crucial revenues.¹³ Unfunded mandates from Beijing are also a continuing problem.¹⁴ Local governments already are accumulating debts without proper authorization, and it is virtually inevitable that they will continue to illicitly take on more obligations at more or less the pace of GDP growth.¹⁵

In view of all the circumstances, it appears that provinces and lower-tier governments have incurred recorded debt equal to roughly ten percent of GDP and unrecorded debt equal to another 10 percent.

Banks and Asset Management Companies

Official debt levels look manageable—even low by standards of developing countries—because obligations have been accumulating in state institutions, especially the country's commercial banking system.

Today, the commercial banks are burdened by the world's largest misallocation of capital. From the beginning of the reform era and continuing through today, central,

provincial, and local governments have forced these institutions to extend credit for a variety of public purposes—the banks are considered a “secondary budget” to, among other things, support ailing state enterprises and make uneconomic public investments. Beginning in 1998 the central government began partial bailouts of the “Big Four” state banks.

In the following year, Beijing created four asset management companies. These entities then acquired approximately Rmb1.3 trillion in doubtful loans. Since then, the AMCs, as these companies are known, have taken on about US\$173 billion of additional nonperforming loans and disposed of about US\$100 billion of their bad-debt holdings in auctions and sales.¹⁶ Because the AMCs bought debt at face value and have sold it for deep discounts to face, they too are insolvent. As Ernst & Young’s Jack Rodman has said, “China has not really resolved the issue—they have just moved it from one state enterprise to another.”¹⁷ Eventually, the Ministry of Finance will have to shell out cash to bail out the AMCs. A small amount of their financial obligations may have been effectively pushed onto the books of the People’s Bank of China, the central bank.¹⁸

How big is the pile of bad debt? This May Ernst & Young estimated nonperforming loans on the books of the Big Four to be US\$358 billion. It also stated that other state banks, rural credit cooperatives, and AMCs were carrying about US\$553 billion in bad debt.¹⁹ Fitch Ratings²⁰ and Standard & Poor’s²¹ subsequently came up with lower, but comparable, numbers and essentially confirmed E&Y’s views of the general magnitude of the bad-loan problem. Congress’s Joint Economic Committee last month essentially endorsed the Fitch estimate.²²

China’s own figures, not surprisingly, tell a much more hopeful story. The China Banking Association announced that at the end of this May 8.02 percent of loans held by major banking institutions—the Big Four and 15 smaller national banks—were nonperforming.²³ This translates into bad debt of approximately Rmb1.2 trillion (or about US\$150 billion).

In short, we have little idea how much bad debt is stuffed into various institutions around China. Yet we do know that analyses have almost always guessed on the low side and, even though there have been sporadic partial recapitalizations, estimates have consistently gone up over time. Therefore, even seemingly high assessments may actually understate the dimensions of the problem as it exists today.

There are reasons to believe that the real number is far in excess of published estimates. For one thing, economic growth has weakened the banks. Premier Zhu Rongji began his fiscal stimulus program in 1998 by flooding the economy with Beijing’s cash in order to jump start economic growth. To his credit, Wen Jiabao, Zhu’s successor, has tried to cut back the program, but state investment still plays an extraordinarily large role in powering the economy. In 2005 fixed asset investment increased by 25.7 percent over an already-high base. It then jumped by 29.8 percent in the first half of this year. Morgan Stanley’s Stephen Roach estimates that this year fixed asset investment will likely exceed

US\$1.3 trillion, more than half of expected GDP. About half of this stimulus will be attributable to the state.²⁴

State spending is ultimately unsustainable because no government, and especially China's, has been able to direct the use of capital efficiently over time. Beijing's fiscal stimulus has, in all probability, become progressively wasteful as more and more yuan chase fewer and fewer viable opportunities. As a result of the relentless building of underutilized infrastructure and the needless manufacture of unsalable inventory, China's GDP statistics undoubtedly overstate the real value of economic activity. At some point, borrowers will not be able to repay all the new loans, which are being created at a frenetic pace to finance economic—or should we say “uneconomic”—growth. The amount of bank loans increased by 9.7 percent in 2005. Bank lending then accelerated during the first six months of this year: the amount of outstanding loans as of June 30 was an astounding 10.38 percent higher than at the end of 2005.²⁵ Chinese banks are blowing up their balance sheets at unprecedented rates.

Quick loan growth has been followed by defaults in China's recent past, as events in Guangdong Province at the end of last decade illustrate. Beijing seems to have learned little from the failure of Guangdong International Trust and Investment Corporation, the other “itics,” and associated local government entities. In this decade, Beijing has pushed the banks to make commercial and residential real estate loans. Like the government-sponsored loans in Guangdong of the 1990s, many of this decade's building loans rest upon defective mortgages²⁶ and other imperfect security interests. A large portion of today's consumer loans, also made at Beijing's behest, also appear to be in trouble.²⁷

Although no one can know for sure, China's banks and instrumentalities are probably sitting on a trillion U.S. dollars of doubtful loans at this moment. Whatever the amount, it is essentially a contingent liability of the central government because the state is still the majority owner of these institutions. More important, the failure of the banks would almost certainly lead to a collapse of the economy. If the economy faltered, the country's political system would become even more fragile than it is today. Therefore, it is most unlikely that Beijing will let any major bank default.

Eventually, China will implement a deposit-insurance scheme, perhaps within a year. When it does, a least a portion of the banks' obligations to depositors will become explicit obligations of the state. Moreover, any unguaranteed portion will, in all probability, remain an implicit obligation because of the possibility of political instability following simultaneous bank runs.

Unfortunately for the central government, a bank failure in the next few years is possible, if not likely. The country's banks, almost without exception, are hopelessly insolvent from a balance sheet point of view. They remain in business only because they are liquid. Moreover, they suffer from the classic mismatch of possessing short-term obligations—deposits of individuals—and long-term assets—loans to enterprises. Any loss of confidence either in the banks or the central government would inevitably result in a crisis of historic proportions. The only thing that prevents the Chinese people from

withdrawing their savings from the banks is that they do not know the truth about the financial condition of these institutions. A system that depends on the continued ignorance of hundreds of millions of people is inherently unstable.

There have been scattered bank runs in the recent past when Chinese people, acting on the silliest of rumors, have panicked.²⁸ So what happens when they find out that the custodians of their funds are bankrupt and the economy is just one rumor away from disintegration? The problem for China is that history shows that in a debt crisis everything goes wrong at the same time.

The destructive cycle, seen in country after country, is by now well known, oft-repeated, and utterly predictable. First, banks, at the first sign of trouble, hoard liquidity. Hoarding liquidity then leads to economic contraction as large loans for expansion and small loans for consumption become scarce or even unavailable. The result, inevitably, is a quick cooling of the economy, which is followed in short order by failures of enterprises, waves of loan defaults, bank runs, flight of “hot money” to other nations,²⁹ and panic among fleeing foreign investors. The transition from “virtuous circle” to “downward spiral,” therefore, can take place in weeks and sometimes days. In China there is no room for an adverse shock. A system that depends on the continual absence of bad news is by definition vulnerable.

There is one other important point about bank obligations. Many analysts implicitly argue that China’s foreign exchange reserves³⁰—now the largest in the world³¹—can be used to prevent a bad debt crisis. Yet careful analysis shows that the reserves could only be used if the international community were to somehow lose confidence in the nation’s foreign currency debt. Because Beijing could use its reserves to buy back such debt more than three times over, the possibility of such a loss of confidence is, for all practical purposes, nonexistent.

Much less remote is the possibility of simultaneous banks runs. It is true that Beijing could use its reserves to buy renminbi that would be transferred to the banks so that they could pay off depositors. Yet this course of action would send the value of the local currency soaring and, therefore, quickly choke the critical export sector—and, eventually, the economy as a whole. The reserves would be useful in a bank crisis only if the government were to dollarize the economy, which for various reasons will not—because it cannot—happen.

There are also other reasons why Beijing cannot use reserves to stop bank runs. A bank crisis would undoubtedly unfold before a slow-moving central government could make the decision to use the reserves, the total of nonperforming loans probably exceeds the size of the reserves, Chinese officials have historically been reluctant to use their reserves for bank bailouts,³² and the use of reserves to help out banks partially owned by foreigners would be considered politically unacceptable. In sum, the possibility that the central government would use reserves in a banking crisis approaches zero. It is instructive to note that the United States suffered through a severe banking crisis in the early 1930s—not to mention the worst financial downturn in its history—even though

Washington then held the world's largest positions of gold, francs, and sterling. At the time it was also the world's largest creditor and had large current and capital account surpluses.

State-Owned Enterprises

China's state-owned enterprises carry substantial debt and other obligations, such as back-wage claims and vendor financing. The central government has selected, from more than two hundred thousand SOEs, 181 or so key ones, which are now supervised by the State-owned Assets Supervision and Administration Commission. The obligations of the key enterprises are, in a practical sense, obligations of the Chinese state.

Unfortunately, there are no publicly available official figures for the debt of the key enterprises. The latest public numbers from the National Bureau of Statistics indicate that the 2004 debt of state-owned and state-controlled enterprises, a category that includes 31,750 enterprises, was Rmb6.03 trillion. Assets for these large enterprises were valued at Rmb10.16 trillion.³³ The key enterprises are probably in better condition than the larger group. Nonetheless, official statistics undoubtedly paint a better picture than is warranted.

Key state enterprises could be balance-sheet insolvent. Nonetheless, they appear to be liquid. Larger enterprises have recently reported high profits, and there is no pressure to declare dividends.³⁴ It does not appear they are at risk of failure, in part because there are few parties willing to call their obligations, apart, of course, for unpaid workers.

Social Welfare Obligations

Localities and state-enterprises have accumulated substantial social welfare obligations—pensions, unemployment benefits, “baseline guaranteed” payments, and the like. Beijing sources put the maximum amount of these obligations at about a quarter trillion dollars.³⁵

The range of nonofficial estimates is wide, but there is nonetheless a consensus that the total liabilities are large. The most revealing assessment comes from Bank of China International, the investment banking operation of Bank of China, which a half decade ago put the figure at US\$850 billion.³⁶ Since that time estimates have gone up, especially as Beijing has expanded benefits. For example, Lehman Brothers noted in 2002 that the obligations could amount to as much as a trillion dollars.³⁷ In May of last year the World Bank estimated that implicit pension debt alone amounted to US\$1.6 trillion.³⁸ Provincial and local obligations will tend to go up as baseline guarantees are extended further into the countryside, as presently contemplated.³⁹

There are several factors that indicate the financial burden of these obligations is not as great as the numbers otherwise indicate. As an initial matter, some of these social welfare obligations will never be paid due to official malfeasance. Moreover, these

obligations are offset by the assets of China's National Social Security Fund, which was established in 2000 and now holds about Rmb190 billion.⁴⁰ Most important, many social welfare obligations will not mature for decades, so Beijing has time to figure out how to find necessary resources.

In sum, social welfare obligations, although enormous, probably do not endanger the finances of the central government.

Consequences of China's Debt Accumulation

China holds us in awe. We are endlessly enchanted by its history, its size, its beauty. Today, we marvel at, among other things, the ongoing transformation of the country's economy.

As we should. Beijing's leaders are engaged in what is undoubtedly the greatest ongoing experiment in the world. Many analysts say that the country's economic rise is unlike anything that has preceded it in history. That assessment is correct. Furthermore, some argue that China is unique.⁴¹ It most certainly is.

But so is Burkina Faso. China is unlike any other nation, but that is also true for every other nation. Observers go wrong when they argue that, because China is one of a kind, its economy is not subject to the same constraints that apply elsewhere. China's rise may be stunning and spectacular and without historical precedent, but the country's trajectory is nonetheless subject to universally applicable economic principles.

China only looks as if it can defy gravity. In reality, its growth appears much less magical when we take a closer look. As an initial matter, foreign parties have been constantly investing cash in large amounts in China and thus are continually adding fuel to its economy. As long as they continue to do so, the country will prosper regardless of the soundness of its policies. More important, state intervention in the economy is still significant. Despite what many believe, "socialism with Chinese characteristics" is not code for capitalism. If the phrase stands for anything, it means using market mechanisms to make a state-controlled system work better. As a result of continued governmental interference, Beijing has held the laws of economics in abeyance. In effect, Chinese leaders have been able to maintain a parallel economic universe.

Despite their ability to create an alternate reality, the imbalances that have been building up will, in one way or another, be corrected. The biggest and most important imbalance of all is the country's indebtedness,⁴² which, as noted above, has been accumulating at every level of government and inside almost all instrumentalities of the state. The longer Beijing delays the inevitable, the more painful the reckoning will be. Debt at some stage will no longer be manageable, even with the enormous resources at Beijing's command. The crucial question is how long can China escape its debt crisis.

There is no helpful answer because ultimately this is a question of confidence of hundreds of millions of people both inside and outside China. Market sentiment, of course, can be volatile and, at least in the short term, less than sensible.

There are four points that should be made when trying to gauge sentiment. First, the belief that China is truly unique will of course tend to postpone the operation of market forces. Every bubble creates millennial-type theories. China will continue to ascend as long as most people believe we are witnessing a “paradigm shift” or the “birth of a new economy.”

Last month Standard & Poor’s, reflecting the current optimism of the financial markets, upgraded China’s long-term sovereign credit rating. S&P primarily cited “continuing economic liberalization and reform,” which should “further entrench excellent growth prospects.”⁴³ If events continue as they have in the past, S&P’s view of the future is surely correct, but there have been indications that reform is slowing from even the gradual pace of the Jiang Zemin years.

Some analysts—most notably Minxin Pei of the Carnegie Endowment for International Peace—argue that the country is stuck in the middle of a “trapped transition.”⁴⁴ Others say that Pei is wrong. There is in fact no transition at this time, they argue, because central leaders think they have just about reached the *end* of the reform process.⁴⁵ In any event, the ruling Communist Party has never embraced full marketization, and its leaders are apparently happy to just tinker with the economic system as it is.⁴⁶

Chinese leaders from Hua Guofeng to Hu Jintao have wanted to make Mao’s socialism work better. They have not, as so many assume, tried to make China capitalist. Further reform would endanger the Party’s grip on power, so Party leaders are adverse to sponsoring further structural change. For example, a market economy requires institutional curbs on government. Because these limitations on power are incompatible with the Party’s ambitions to continue to dominate society, China may not be able to make much more progress toward them until there is a substantial change of the current political system.⁴⁷ Should this become evident in the years ahead, foreign investors, no longer mesmerized by the prospect of future growth, might shun China and thereby start a period of economic contraction there. The consequences could be severe for an economy that is dependent on foreign capital, especially if the withdrawal of support occurs during a period of global recession.

Second, if China continues to modernize, it will become less protected from the impersonal forces of the market. China’s economy, therefore, would become less Chinese. So Beijing’s maintenance of a parallel universe can only be a temporary phenomenon. How temporary? In less than five months foreign banks will be entitled to national treatment pursuant to the terms of China’s accession agreement with the World Trade Organization. That means foreign banks will be entitled to take local currency deposits from individuals and engage in all types of corporate transactions. Many analysts have scoffed at the notion that foreign banks will be able to compete with local ones across the breadth of the nation. Yet that’s not the point. The presence of foreign

banks is inherently destabilizing where virtually all of their competitors are insolvent. Just by attracting the best customers, for example, foreign banks could cause trouble by siphoning liquidity from local banking institutions, which survive only by attracting new cash. And in a crisis there will be a panicked flight to quality that will be evident most everywhere foreign institutions do business.

Third, economic conditions external to China, many of which will be beyond Beijing's control or even ability to influence, could be relevant to the debt issue. International investors, for example, withdrew their support from Argentina a half decade ago when financial shocks in Asia and South America affected global sentiment and when returns from American equities rose. As a result, Argentina—which also had taken on too much debt, created growth through fiscal means, deferred reforms by living on foreign capital, pegged its currency to America's, and stuffed its banks with government bonds—collapsed. Any number of general economic conditions, some foreseeable at this moment and others not, could spark a similar retreat from China.

Fourth, President Hu Jintao and Premier Wen Jiabao have yet to demonstrate their commitment to reducing China's indebtedness. They have not dealt with local debt or debt of state enterprises, and they have continued to gun the economy, which is only worsening the condition of the banks. Moreover, they have not freed these institutions to make their own lending decisions. If they were to do so, banks would cut off lending to many borrowers they are now forced to support. The political implications could be disastrous to the ruling Communist Party.⁴⁸ So it is not surprising that indebtedness in China, from all we can tell from the outside, is growing, not decreasing.

And, in all probability, debt will continue to increase for quite some time, at least through the 2008 Summer Olympics. The government will do everything within its power to keep economic growth on an upward track until then. The period after the games, however, will be a challenging time. As an initial matter, most countries have suffered post-Olympics slowdowns. China, which has not had a recession since the end of the Cultural Revolution according to official statistics, is certainly due for one. At some point, Chinese leaders will either run out of fiscal capacity to stimulate the economy or, more likely, fiscal stimulus will become ineffective. When the economy slows for whatever reason, China will probably suffer the inevitable, and undoubtedly calamitous, debt crisis.

In short, China's financial condition could deteriorate quickly if anything goes wrong. The country is already burdened by too much debt. To get some idea just how much China is burdened, we should calculate China's debt-to-GDP ratio, starting with its claim that it is only 18 percent. To this figure we need to add 1) three percent for its debt to the multilateral institutions and other governments, 2) ten percent for central government debt that is incurred for lower-tier governments, 3) ten percent for unrecorded debt of lower-tier governments, and 4) 40 percent for the uncollectible portion of nonperforming bank loans. China's ratio, calculated in this fashion, is 81 percent. To be conservative, I have not added the obligations of the four policy banks, grain subsidy payments and other miscellaneous obligations, obligations of enterprises controlled by the People's

Liberation Army, debt of state-owned enterprises, and social welfare payment obligations.⁴⁹

In any event, an 81 percent ratio puts China well into the danger zone. Argentina defaulted a half decade ago at a ratio of around 55 percent. Italy and Japan have ratios over 100 percent, but their modern economies are better able to withstand stress. As Morgan Stanley's Andy Xie, who in 2003 estimated China's ratio to be nearly 160 percent, says, "Without dramatic changes over the next five years, a major financial crisis may become inevitable."⁵⁰

Global Consequences

We used to talk about how the world affected China. Today, after almost three decades of stunning Chinese economic growth, we need to think about how China affects the world.⁵¹ Therefore, we should take a look at how a debt crisis there—whenever it comes and in whatever form it takes—could pose a risk for the international financial system.

As an initial matter, American and global markets are deep and flexible and can handle just about any foreign development, however unwelcome it may be. The real risk China poses is not so much the severity of a financial crisis as the unexpected nature of such an event. Today, the concern about China in the West is that the country will dominate the global economy. For many, if not most, people in the financial and business communities, the possibility of an economic crisis inside China is remote. For them, it is an "unknown unknown," to borrow Donald Rumsefeld's apt phrase. Yet all the underlying conditions necessary for such a crisis exist. When it occurs, market participants will probably be caught completely unaware. After all, how well have the markets predicted turmoil in other countries in the past?

There may be little we can do to avert a financial crisis in China, but public discussion of such a development would at least give market participants the opportunity to take that event into account, thereby making future market adjustments less painful.

In short, the more we discuss the possibility of financial turmoil inside China, the better off we will be. After all, we can handle any emergency we plan for. Michael Pettis, a director of the Galileo Global Horizons fund, says market participants don't talk about a problem until it is too late, at which time they talk about nothing else.⁵²

We should do better with regard to China.

¹ This testimony covers the People's Republic of China excluding Hong Kong and Macau. It does not cover Taiwan, which Beijing claims as its province.

² This amount was converted to U.S. dollars at the exchange rate of US\$1=Rmb7.9745, the prevailing rate on the first of this month.

³ See Ministry of Finance of the People's Republic of China, "Report on China's Central and Local Budgets in 2005 and 2006," March 5, 2006, http://www.mof.gov.cn/news/20060320_2115_13837.htm

⁴ These obligations currently amount to about US\$60 billion. For a general description of these financings, see Henry C. K. Liu, "China's Internal Debt Problem," Asia Times Online, May 27, 2006, http://www.atimes.com/atimes/China_Business/HE27Cb01.html.

⁵ China Development Bank is the largest issuer of Chinese bonds behind the Ministry of Finance. At the end of 2005 China Development Bank had total liabilities of Rmb1.77 trillion, according to its 2005 Annual Report, <http://www.cdb.com.cn/web/Column.asp?ColumnId=5>.

⁶ For general background of China's increasing use of this financing, see James T. Areddy, "Capital-Thirsty China Taps Fresh Sources," Dow Jones Newswires, March 4, 2004.

⁷ The announced budget for the PLA this year is approximately US\$35.1 billion. Actual expenses could be as high as US\$105 billion, however. See Department of Defense, "Military Power of the People's Republic of China 2006," p. 20.

⁸ See "Military Power of the People's Republic of China 2006," pp. 18, 21.

⁹ See William Hess, "Conference Presents Local Government Debt in China as a Potential 'Minefield,'" Global Insight, July 11, 2006.

¹⁰ See World Bank, "China: Building Institutions for Sustainable Urban Transport," (EASTR Working Paper No. 4), January 2006, p. 5, http://www.worldbank.org.cn/english/content/urban_transport.pdf.

¹¹ See *Challenges for China's Public Spending: Toward Greater Effectiveness and Equity* (Paris: OECD Publishing, 2006), pp. 34-35.

¹² For a general description of governments' implicit guarantees, see *Challenges for China's Public Spending: Toward Greater Effectiveness and Equity*, p. 34. A growing problem is municipal liability for the payment of wages of construction workers employed on government projects. See Jane Cai, "Back-Pay Claims Pile Up," *South China Morning Post*, March 8, 2006, p. 7; and Tim Johnson, "Millions of Workers in China Aren't Getting Paid," Knight Ridder/Tribune News Service, January 24, 2006.

¹³ Premier Wen, however, has given local governments strict guidelines about not adding to peasants' burdens. *See, e.g.*, "Provinces Told to Keep Rein on Debt," *South China Morning Post*, July 3, 2006, p. 6.

¹⁴ *See, e.g.*, "State Council Vows Rural Laborers to Be Paid On Time," Xinhua News Agency, July 9, 2006 (State Council makes provinces responsible for back wages within their jurisdiction).

¹⁵ Municipalities are also making illegal loans to enterprises. Many of these loans are uncollectible. The loans further weaken local governments and highlight the highly irregular nature of local finances. For a recent example of such a loan, see Wynne Wang and Linda Lin, "China Corporate Debt Raises Fears," *Wall Street Journal Online*, August 7, 2006, <http://online.wsj.com/article/SB115490413486128232.html>.

¹⁶ *See* Richard McGregor, "China Remains Vulnerable to Liquidity Shock Despite Launching War on Bad Debt," *Financial Times*, May 4, 2006, p. 11. It is not clear to what extent foreign parties that have "purchased" bad debt have actually taken ownership. Many of their purchase agreements are, in reality, contingent collection arrangements. *See* William B. Gamble, "Terminal Issues of the Chinese Banking System," International Assessment and Strategy Center, March 21, 2005, http://www.strategycenter.net/research/pubID.66/pub_detail.asp.

¹⁷ McGregor, "China Remains Vulnerable to Liquidity Shock Despite Launching War on Bad Debt."

¹⁸ The PBOC has recently held, and may still hold, doubtful loans. Stories about the PBOC's financial difficulties began to surface in the first years of this decade as a result of its extending initial financing to the AMCs. These reports were essentially confirmed last year when the PBOC established an asset management company to dispose of doubtful loans that it then held. *See* "The Setup of Hui Da AMC Clarifies PBOC's Route of Bailout Op," Xinhua Financial Network News, August 2, 2005. There is virtually no publicly available information on the size of the PBOC's bad-loan problem.

¹⁹ *See* Ernst & Young, "Global Nonperforming Loan Report 2006," May 2006, p. 14. Beijing subsequently pressured the accounting giant to withdraw its report and apologize to China. *See* James T. Areddy, "Ernst Illustrates Risk to Guessing China's Bad Debt," *Wall Street Journal Online*, May 16, 2006, <http://online.wsj.com/article/SB114774464092553774.html>.

²⁰ *See* Fitch Ratings, "China: Taking Stock of Banking System NPLs," May 30, 2006, <http://www.fitchratings.com/dtp/pdf2-06/bchi3005.pdf>.

²¹ *See* Standard & Poor's, "Rapid Rise in Interest Rates or Renminbi Could Stretch China's Embryonic Banking System," June 26, 2006. S&P estimates that bad loans at the end of 2005 amounted to US\$520 billion to US\$650 billion. A rapid increase in

either the value of the renminbi or interest rates would have a large impact on NPLs, according to the ratings agency.

²² See Joint Economic Committee of the United States Congress, “Five Challenges That China Must Overcome to Sustain Economic Growth,” July 2006, p. 21.

²³ “China’s Non-Performing Loans Fall Marginally in May,” *People’s Daily*, June 30, 2006, http://english.peopledaily.com.cn/200606/30/eng20060630_278783.html.

²⁴ See Stephen Roach, “Scale and the Chinese Policy Challenge,” Global Economic Forum, June 19, 2006, <http://www.morganstanley.com/GEFdata/digests/20060619-mon.html#anchor0>.

²⁵ These calculations are derived from figures found in statistical tables on the PBOC’s website, <http://www.pbc.gov.cn/diaochatongji/tongjishuju/>. Chinese banks, in the first six months of this year, lent 85.7 percent of the central government’s target for lending for the *entire* year. “China’s Investment Growth Expected to Slow in Second Half,” China View, August 3, 2006, http://news.xinhuanet.com/english/2006-08/03/content_4915043.htm.

²⁶ Based upon my experience of representing lenders in Shanghai in the 1990s and from conversations I have had with others since then, Chinese banks are particularly vulnerable in the real estate sector due to the failure to obtain valid security interests in land and improvements.

²⁷ For a discussion of recent consumer lending problems, see Peter S. Goodman, “China Discloses \$1.1 Billion Bank Fraud,” *Washington Post*, June 28, 2006, p. D1 (comments of Yi Xianrong of the Chinese Academy of Social Sciences); and Mark O’Neill, “Car Finance Slumps after Fraud,” *South China Morning Post*, May 6, 2006, Business Post, p. 1 (40 percent of car loans are nonperforming).

²⁸ See, e.g., Gordon G. Chang, *The Coming Collapse of China* (New York: Random House, 2001), pp. 128-30.

²⁹ In July, China’s National Bureau of Statistics reported that the country had an inflow of US\$12.5 billion in “hot money” in May of this year. See “China PBOC Shifts Focus to Yuan Defense from Interest Rates—Report,” Xinhua Financial Network News, August 2, 2006. If money can flow into China that quickly despite nominally strict currency controls, it can flow out just as fast.

³⁰ Contrary to popular belief, reserves do not represent the government’s wealth. Reserves reside on the asset side of the government’s balance sheet. They are accumulated by the central bank issuing debt (in China’s case about two-thirds of this debt is issued in the form of notes and bonds of the central government and the remaining third is in the form of printed currency).

³¹ China's State Administration of Foreign Exchange announced that the country's foreign exchange reserves at the end of June of this year totaled US\$941.11 billion. See http://www.safe.gov.cn/model_safe/tjsj/tjsj_detail.jsp?ID=110400000000000000,17&id=5.

³² Since January 2004 Beijing has used US\$60 billion from the reserves to partially recapitalize three of the Big Four banks. In view of the magnitude of the bad-loan problem, this amount shows the central government's reluctance to use its forex to meet a critical challenge.

³³ National Bureau of Statistics of the People's Republic of China, China Statistical Yearbook 2005, Main Indicators of State-owned and State-controlled Industrial Enterprises by Industrial Sector (2004), <http://www.stats.gov.cn/tjsj/ndsj/2005/html/N1407e.htm>.

³⁴ SOEs have used their large cash reserves to help fuel China's recent investment binge. They appear to have done so inefficiently and are wasting their resources. For a discussion of this matter, see Tom Holland, "Beijing Must Force Radical Reform of State-Owned Firms' Finances," *South China Morning Post*, July 24, 2006, Business Post, p. 2.

³⁵ See, e.g., Yushi Mao, "The Macroeconomic Implications of Pension Reform in China" (paper prepared for CCER-Cato Institute Conference on China's Pension System: Crisis and Challenge, Beijing, November 8-9, 2001).

³⁶ See Bei Hu, "Sick System 'Needs 850B Lifeline,'" *South China Morning Post*, February 23, 2001, Business Post, p. 6.

³⁷ See Alastair Newton and Robert Subbaraman, "China: Gigantic Possibilities, Present Realities," January 21, 2002, p. 69.

³⁸ See Yvonne Sin, "China: Pension Liabilities and Reform Options for Old Age Insurance," May 2005, p. 30 (Paper No. 2005-1), <http://siteresources.worldbank.org/INTPENSIONS/Resources/ChinaPensionLiabilities.pdf>.

³⁹ At present, the baseline guarantee covers about 22 million people in urban areas and eight million in rural locations. Ministry of Civil Affairs of the People's Republic of China, "Minister Li Xueju on Advance Education: Strengthening the Work of Alleviating Hardship Through Establishing a System," May 30, 2006, <http://www.mca.gov.cn/news/content/recent/2006530152510.html>. There is, not surprisingly, pressure to extend the guarantee to other needy Chinese.

⁴⁰ "China's National Social Security Fund Buys into State Bank," *People's Daily*, March 10, 2006, http://english.people.com.cn/200603/10/eng20060310_249585.html. Beijing can increase the size of the National Social Security Fund by selling more stock of state-owned enterprises. Over the past several years, however, this source of funds has

not been as promising as once hoped because Beijing has been unable to make substantial sales in the domestic stock markets without also generally depressing equity values.

⁴¹ Stephen Green, Standard Chartered's well-respected economist in Shanghai, was recently quoted as saying, "Maybe this is a new economy." See David Barboza, "China's Surge Raises Fears of Runaway Economy," *New York Times*, July 19, 2006, p. C3. Columnist Tom Plate recently wrote, "This Chinese economy is unique; there are no flight manuals that offer the guidance of precedents." Tom Plate, "Watch the Friendly Skies of China," *South China Morning Post*, July 31, 2006, p. 11.

⁴² Not every analyst agrees with this assessment. UBS economist Jonathan Anderson, for example, says the largest imbalance in the Chinese economy is the "ever-rising trade surplus." See Jonathan Anderson, "China's Economy Is Hot, Not Overheated," *Wall Street Journal Asia*, August 1, 2006, p. 13.

⁴³ Standard & Poor's, "People's Republic of China Ratings Raised to 'A' on Persistent Reform; Outlook Stable," July 27, 2006, https://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1145802355179&b=10&r=1&l=EN. Moody's quickly followed with an upgrade of its own. See Ditas Lopez, "Moody's Turns Favorable on China's Rating Outlook," *Wall Street Journal Online*, July 10, 2006, <http://online.wsj.com/article/SB115248268744901791.html>.

⁴⁴ See Minxin Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge: Harvard University Press, 2006).

⁴⁵ See, e.g., Andrew J. Nathan, "Present at the Stagnation," review of *China's Trapped Transition: The Limits of Developmental Autocracy* by Minxin Pei, *Foreign Affairs*, July/August 2006, p. 177.

⁴⁶ In July of this year a Commerce Department official said that reform in China was slowing and could even go into reverse. See "US Official Warns China Reform Slowing," Reuters, July 31, 2006 (comments of Undersecretary Franklin Lavin).

⁴⁷ See Pei, *China's Trapped Transition: The Limits of Developmental Autocracy*, p. 8.

⁴⁸ For one analysis making this case, see Joint Economic Committee, "Five Challenges That China Must Overcome to Sustain Economic Growth," p. 23.

⁴⁹ I have not subtracted a few percentage points to eliminate double counting that occurs because bank-bad-debt figures include doubtful obligations of local governments. This subtraction, however, would be dwarfed by the items I have not added to the ratio, as explained in the text accompanying this note.

⁵⁰ Karby Leggett and Kathy Chen, “For China, Question of Debt Is Crucial,” *Wall Street Journal*, January 20, 2003, p. A2.

⁵¹ See James Kyngé, *China Shakes the World: A Titan’s Rise and Troubled Future—and the Challenge for America* (Boston: Houghton Mifflin, September 2006), p. xii.

⁵² Michael Pettis, telephone interview by author, August 2, 2006. I thank Mr. Pettis for his assistance in the preparation of this testimony.