Banks and the New Asian Tigers*

C.P. Chandrasekhar

In the immediate aftermath of the 2008 financial crisis and the Great Recession that followed, two countries that were seen as crucial to propping up global economic growth and even ensuring a recovery were China and India. Prior to the crisis these two countries were among those that had registered the highest growth rates in the world economy. Though they were both affected by the 2008 crisis, countercyclical measures adopted by their governments were seen as having returned them to growth. This strengthened the argument that these giants serve as the locomotives for the world economy.

Much has changed since then. Growth has slowed considerably in China fuelling fears that this would worsen the recession elsewhere in the world. In India too, though the GDP figures suggest it is the fastest growing country, direct information from the industrial and agricultural sectors indicates that growth in material production has slackened considerably. What is most noteworthy, however, is that in both countries as growth slackens, there are signs of a substantial accumulation of bad debt in the domestic banking systems of the two countries. Debt accumulated by firms, households and some public entities during the boom years seems to be proving too heavy a burden to bear when the good times are disappearing.

In China, non-performing loans (consisting of doubtful, substandard and loss loans) of the commercial banking system, which stood at RMB 1.3 trillion (close to $200 billion) in 2007, fell sharply to RMB 428 billion by 2011, as a result of provisioning and recapitalisation. But since then the figure has risen once again to return to the RMB 1.3 trillion figure by the end of 2015, with the loss loan figure alone placed at $154 billion. At the recently held annual parliament session in Beijing, senior officials including premier Li Keqiang, referred to a debt-for-equity swap scheme as a way of cleaning up bank balance sheets. However, since many of the companies that have accrued this debt are seen as ‘zombies’, this is seen as a temporary response aimed at taking potential non-performing assets off the books of banks.

In India too, the public sector banks that dominate the industry are sitting on more than Rs. 7 trillion of stressed assets, defined as the total of non-performing loans (NPLs) and restructured assets. Gross non-performing assets of the public sector banks have increased from 2 per cent of advances at the end of March 2009 to 7.3 per cent at the end of 2015. Between 2004 and 2015 banks had to write off Rs. 2.11 lakh crore, of which as much as Rs. 1.14 lakh crore was done between 2013 and 2015. Providing for loan losses has affected the profitability of banks. The 24 public sector banks reported an aggregate loss of Rs.10,911 crore in the last quarter of 2015 compared with a profit of Rs.6,970.8 crore in the corresponding quarter a year ago.

As a result the pressure on the government to recapitalize these banks has been rising over time. Over the four years ending 2014-15 Rs.65,600 crore of budgetary resources have been provided for purpose. In August 2015 the government declared that it would provide a total of Rs. 70,000 crore to public sector banks of which Rs.25,000 crore was to be provided in both 2015-16 and 2016-17, and Rs.10,000 crore each in 2017-18 and 2018-19.

Underlying this emergence of a serious bad debt problem in India and China was a debt spiral. In recent years both countries recorded a significant increase in the provision of credit provided by the financial sector. In China, the domestic credit provided by the financial sector rose from close to 120 per cent in 2008 to around 160 per cent or more by 2015. In India, the ratio of commercial bank credit outstanding to GDP, which had remained at around 22 per cent for a decade starting 1989-90, began to rise after 1999-2000, doubled (to 44.4 per cent) by 2005-06 and then rose further to almost 60 per cent by 2014-15.

Thus, the two countries that have seen the highest rates of growth in recent years are at the end of the boom saddled with large volumes of debt, a chunk of which is under- or non-performing. This suggests that credit mediated by the financial system was being used in both countries to drive demand and growth. The difference if any relates to the sectoral distribution of this credit.

In China's case, that credit has substantially financed its high, investment levels seems to be more important. This was particularly true after the global financial crisis of 2008, when credit financed investment was seen as the means to stimulate the economy. A dominant share of the expenditures that constituted the total stimulus was to be undertaken by local governments. When called upon to contribute to the stimulus effort, these governments adopted innovative schemes. One was the creation of financial vehicles—local investment corporations—superficially separated from the provincial government, which were made to borrow from the banks (or to which banks were persuaded to lend) to finance large projects.

A host of factors made it difficult for the institutions, under the aegis of which these projects were being implemented, to meet their loan commitments. Slowing growth and inadequate demand challenged the viability of some. The cash flows associated with others such as toll-based roads, bridges and subways proved to be much lower than originally estimated. And some were social sector projects with an implicit guarantee of a provincial investment holding corporation, but no explicit commitment to pay.

In the event, though the stimulus shored up China's remarkable growth rate even in the midst of the crisis, the way it was financed is now proving to be a problem. According to an audit conducted in the middle of 2011, stimulus spending had resulted in a rise in local government-associated debt to around 27 per cent of Chinese GDP. In comparison, central debt was estimated at around 20 per cent of GDP. Now, provincial governments are finding it difficult to meet their debt service commitments.

The second source of concern regarding China's banks comes from rising private and property-related debt. Large scale lending to real estate market and housing finance operators has created property bubbles in major Chinese cities that have begun to go bust.

The experience in India is more complex. The credit boom in India seems to have been triggered by the infusion of large volumes of liquidity into the system because of a surge in private capital inflows from abroad, especially after 2003. The liquidity overhang in an increasingly deregulated banking system has spurred lending and investment.

In earlier years a significant share of bank advances went to finance borrowing by the government, which was running up large fiscal deficits. But dependence on foreign financial inflows also meant that the government had to be sensitive to the fact that these foreign investors were critical of fiscal deficits. Rising fiscal deficits were seen as a potential cause for a loss of investor confidence that would result in an outflow of the previously invested and accumulated stock of legacy capital. Hence governments at both the central and state level were convinced into adopting fiscal responsibility legislation that set stringent ceilings on government borrowing.

If banks need to lend, but cannot lend to the government, they have to turn to the private sector. One area to which such lending went was the market for retail loans, or personal credit of various kinds: for housing, for purchasing automobiles and consumer durable, for borrowing for consumption in the form of deferred credit card payments and so on. The share of personal loans increased from slightly more than 9 per cent of total outstanding commercial bank credit in 1996 to almost a quarter of the total by the end of the 2000s. This did imply that banks were over-exposed to the retail credit market. Since that was possible only by relaxing loan conditions and expanding the universe of borrowers, fears that India may be faced with its own version of a sub-prime crisis were expressed in many quarters.

But since the pressure to lend continued, as capital inflows remained high after a short dip at the time of the 2008 crisis, banks needed to continue to lend. This saw them move to an extremely unusual area: infrastructure. The share of infrastructural lending in the total advances of scheduled commercial banks to the industrial sector rose sharply, from less than 4 per cent at the end of March 2000 to 16.4 per cent at the end of March 2004 and as much as 33.5 per cent at the end of March 2011. Under normal circumstances, commercial banks are not expected to lend much to infrastructure given the long gestation lags and high illiquidity associated with these projects. Banks after all mobilize capital from savers who are promised easy access to their savings. Not surprisingly, private banks have been unwilling to commit much to this risky business. So it is the public banking system (along with a few private banks) that has moved into this area, possibly with government encouragement and the belief that they had implicit sovereign backing for such lending.

However, as the exposure of the banks to these sectors has increased, the folly of “dragging” the private sector into infrastructure with concessions and cheap credit is becoming clear. The shakeout in civil aviation is the most discussed because of the Kingfisher experience. But returns have been low or negative in other infrastructure sectors like power generation, power distribution and ports and roads. The result is the default on loans provided to these ventures by the commercial banks, especially those in the public sector.

In sum, it appears that in recent times the growth pole in the world economy centred on China and India has been characterised by debt driven growth, that amounts to riding on a bubble. That explains why both countries are faced with the visible damage to their bank balance sheets, requiring large scale recapitalization. But that also means that the demand for credit would be lower because of the burden of past debt, and more importantly, that banks and other financial institutions would be reticent to lend to overstretched borrowers. The mechanism that served to stimulate growth is damaged. These countries cannot meet expectations that they can serve as locomotives for the recession-hit world economy.

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