WHO IS GOING TO BAIL-OUT CHINA

China is suffering a brutal economic "hard landing" as the pay-back for their massive Keynesian stimulus spending to revive economy growth after the 2008 credit crisis. China's stimulus bought two years of economic boom, but the cost of this instant gratification was unleashing venomous run-away inflation that forced the central government to hammer the economy this year. Touted by most Wall Street analysts as the world's engine of growth, we now learn that regional Chinese governments are so cash-strapped they are refusing to make interest and principal payments on their bond debt. Given the state integration of banks and the economy, if Chinese local governments are unable to pay their debts, who will bail-out China's economy?

China Daily reported this morning: "China's biggest provincial borrowers are deferring payment on loans just two months after the country's regulator said some local government companies would be allowed to do so." After the economy shrank by 8% during the 2008 worldwide credit crunch; Chinese authorities responded with epic spending of borrowed money. Adjusted for the differences in size of economies, the China stimulus was twice the size and happened in half the time for the U.S. stimulus programs. But now that the world's economies have again stalled and the European sovereign debt crisis is about to spark a deflationary spiral, the cash-flow of China heavily indebted provincial governments has evaporated.

China's Zhou Mubing, Vice-Chairman of the China Banking Regulatory Commission, announced in October the first Chinese national audit determined local governments had $1.7 trillion dollars in debt. Given China has 1/3 of the GDP as the United States, Chinese provincial government debt is twice the debt load of U.S. state and local governments. More than half this debt was issued in the last three years and Chinese state-owned-banks hold 79% of the debt.

Given the severity provincial government cash-flow deficits; "Mubing announced so-called local financing vehicles that meet collateral requirements can have a one-time extension on their loans." According to public disclosure documents, Hunan Provincial Expressway Construction Group, China's largest provincial debtor, delayed payments of $490.5 million in interest; Guangdong Provincial Communications Group, Gansu Provincial Highway Aviation Tourism Investment Group Co and Sichuan Railway Investment Group Co that owe $31.7 billion, plan to "defer" $5.4 billion in interest payments this year; and bond prospectuses from 55 local authorities that raised money in capital markets since the November state they too do not intend to pay $4.8 billion in interest on newly issued bonds. In the U.S., such across the board action would be called defaults! American borrowers claiming negative cash-flow always have the right to try to negotiate "amend, extend, and pretend" with creditors; but this normally results in lenders gaining more collateral and operational control over the borrowers. But for China's state-owned-banks, it would be hard to take more control from China's state-owned-enterprises.

Prior to this morning's news, the outlook for the China banking sector seemed bright. Standard & Poors (S&P) on November 30th upgraded the credit ratings on Bank of China and China Construction Bank Corporation; while downgrading the U.S. banks, including Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, Bank of New York Mellon and Wells Fargo. The payment freeze may be legal under Chinese law, but it will seriously curb future bank lending. As Patrick Chovanec, a professor at Tsinghua University in Beijing stated; "When companies start to roll over debt they're not retiring debt, and banks aren't retrieving their capital, so you're crowding out new lending"…"This is a problem that's going to start to bite next year."

Most Americans have no clue that China had one of history's worst banking crises in the mid-1990s. After relaxing banking regulations in 1992 and 1993, China state-owned-banks diverted funds earmarked for agriculture and other development projects into real estate and the stock market speculation. According to the Asia Times, between 1985 and 1993 the number of state-owned-bank branches jumped from 60,785 to 143,796; total deposits expanded from $51.6 billion to $277.7 billion; and total loans vaulted from $67.9 billion to $298.9 billion. Ultimately, 2/3 of China bank loans became non-performing and between one-third (by Chinese bank officials count) and one-half (by rating agencies' count) of the loans were written off.

Once again China's banks have financed massive real estate and stock market bubbles that are imploding. The Shanghai Stock Index is down 36.5% this year and Beijing home prices dropped by 35% in November. Speculative lending shenanigans cost China's state-owned-banks hundreds of billions of dollars in the 1990s. It took world record growth and ten years to pay for the losses. China's bank loans are ten times larger today and the speculative losses could be in the trillions of dollars. Where will China find the growth and the time to bail-out these losses?