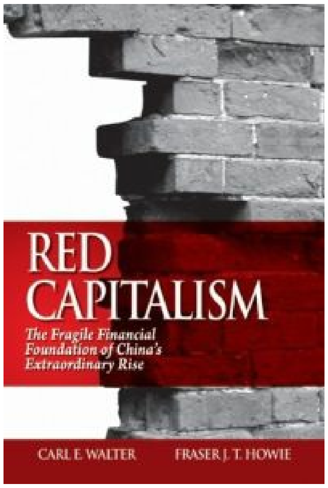

Book Red Capitalism

The Fragile Financial Foundation of China's Extraordinary Rise

Carl E. Walter and Fraser J.T. Howie
Wiley, 2011

Recommendation

This insider's report on China's version of capitalism tells a revealing story about an economy that is poised to become the world's largest. Asia banking experts Carl E. Walter and Fraser J.T. Howie expose the interconnections of a financial system dominated by the Communist Party; the conflicts among ruling families, corporate executives and technocrats – each vying for political and personal gain; and the challenges opaque, state-run companies present to Western investors. The authors delve into the byzantine, often clandestine machinations behind the modern and sophisticated screen China presents to the rest of the world. The book provides a detailed account of major players, agencies and policies, as well as an advanced-level financial analysis of the banking and capital market sectors. The book's most interesting points sometimes bog down in historical details, but patient readers reap rewards. *BooksInShort* recommends this extraordinary behind-the-scenes look to those who want to know what's really driving China's dazzling growth. Surprisingly, this is a story most people do not know.

Take-Aways

- China's economic development dazzles outsiders, but in the 1970s, the country was on the verge of bankruptcy.
- When then-premier Deng Xiaoping went to the United Nations in 1974, his delegation could only find $38,000 in state funds to pay for the trip.
- Communist Party cadres, not market forces, rule China's financial markets.
- China relies on its major banks to fund state-owned firms and government interests.
- Despite their size, China's banks are neither innovative nor internationally competitive.
- China's "Bird Cage" approach once restricted foreign investment to certain regions.
- China's bond market trades thinly, with only a few hundred transactions daily.
- Chinese banks own 70% of all Chinese bonds, which they hold to maturity, like loans.
- The party runs Chinese stock exchanges, which are the largest in Asia, through its ownership control of all listed companies.
- China's future pension obligations will cost from 10% to 40% of its annual GDP.

Summary

"The Great China Development Myth"

The 2008 Olympics put China in the world spotlight. In preparation for the competition, the nation built highways, stadiums, apartments and hotels. Overnight, workers placed 40 million flowerpots along main streets to welcome visitors. China's spectacular reintroduction to the West was even more remarkable considering that the nation was effectively bankrupt just 30 years earlier. In 1978, Beijing resembled a devastated city, while Shanghai, once considered the most cosmopolitan city in the East, was run-down, its residents sleeping in the streets for lack of air conditioning. The nation was so broke that when Premier Deng Xiaoping went to the United Nations in 1974, his delegation could find only $38,000 in state funds to pay for the trip.

> "Understanding how China...has built its own version of capitalism is fundamental to understanding the role China will play in the global economy in the next few years."

While many in the West have lent credence to the Great China Development Myth, China's rapid economic transformation from the 1970s to the present has not been linear nor without mistakes. The changes began when long-time leader Mao Zedong died in 1976 and Deng acceded to power in 1978. China's journey coincided with a wave of financial deregulation that swept the world. Seeking to follow the US capitalist model, China's new leaders, Jiang Zemin and Zhu Rongji, deregulated its markets in the 1990s and founded stock exchanges in Shanghai and Shenzhen. In 1992, Deng publicly acknowledged that capitalism could play a role in China's economy.

> "If Deng had not said that capitalist tools would work in socialist hands, who knows where China would be today?"

After the Asian financial crisis of 1997, China restructured and recapitalized its bankrupt state banks. With this financial makeover, the banks listed some of their shares on global exchanges, allowing them to raise new money and attract international partners. Another breakthrough occurred in 2001 when – after 15 years of discussions – the World Trade Organization admitted China as a member. Attaining membership paved the way for a massive influx of foreign investment, as corporations from around the world lined up to build businesses in China.

> "China's state-owned economy is a family business, and the loyalties of these families are conflicted, stretched tight between the need to preserve political power and the urge to do business."

Up to that point, China had kept foreign investment regionalized and restricted to designated eastern seaboard special economic zones (SEZs). This "Bird Cage" approach forced foreign corporations into joint ventures with often unqualified Chinese partners. In an effort to attract jobs and investment, China relaxed its controls and allowed more local governments to set up their own SEZs. By 2008, almost three-quarters of all foreign investment had shifted to "wholly owned enterprises" expanding into new locations.

Still a "Family Business"

Since the late 1970s, economic reforms have allowed China's state-owned enterprises (SOEs) to expand and thrive. Chinese leaders used US investment bank expertise to help the country's SOEs go public. By 2009, China boasted 44 companies on the *Fortune* Global 500, all of them newly restructured SOEs. While their shares trade publicly, their majority owner remains the state. Thus the companies' management and future development are tied to the political system. These "superficially internationalized corporations" represent "the inside economy" that is nominally independent but actually under state control. However, foreign direct investment, exemplified by the factories and plants of multinationals, operates in an entirely different sphere. This private, nonstate sector has helped advance a growing Chinese entrepreneurial class.

> "China's banks look strong but are fragile; in this, they are emblematic of the country itself."

Despite reform, the economy still operates within a complicated web of personal and political relationships. China's dominant Communist Party sits at the top of a seemingly monolithic but essentially fragmented political system; regional and local level governments wield great power, while the connected families of politicians and special interests – including SOE executives and ministerial bureaucrats – contribute to Chinese "crony capitalism." These leading Communist Party cadres guide China's economy according to a patronage system. While political shifts may occur among the ruling groups, they all adhere to a common goal of political stability, which allows them to pursue their own economic interests.

The Importance of Banking

China's financial system depends on its state banks; the four largest – Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial and Commercial Bank of China – monopolize 43% of the nation's financial assets. These banks have massive loan portfolios, funded by the prodigious savings of Chinese citizens. The banking sector is firmly centralized in party hands. China admits foreign banks, but they account for less than 2% of banking assets.

> "Party leaders believe they are better positioned than any market to value and price risk."

Bank lending fuels the inside economy. The major banks hold 70% of all bonds outstanding, including those that the Ministry of Finance (MOF) issues. The banks are largely undisciplined lenders, with untrained party loyalists in their employ. Banks lend at the direction of the state, without regard to credit risk or return potential. Though the banks are compelled to lend, their borrowers – also state-controlled companies and other government interests – are under no constraint to repay their loans. As a result, Chinese banks have repeatedly faced bankruptcy, and the state has continually come to their rescue.

Restoring Confidence

After the 1997 Asian financial crisis, China's financial authorities resuscitated its moribund banks through substantial capital injections and transfers of nonperforming loans to a series of asset management companies (AMCs). Following America's Resolution Trust Company model – which rescued failed US savings and loan institutions in the 1980s – AMCs assumed the delinquent portfolios and took on losses from corporations, securities and leasing firms, finance and insurance companies, and commodities brokers. By 2000, Goldman Sachs and Bank of America had invested in seemingly pristine banks and provided Western management expertise.

> "Rolling outstanding debt when it matures – that is, reissuing new debt to repay the old – is a principal characteristic of China's financial system."

The restructuring worked, and major Chinese banks have since raised large amounts of capital in international markets. But troubling items classified as "receivables" remain on bank balance sheets, some dating back to the early 1990s. These are IOUs issued by the Ministry of Finance. Despite their name, these debts are outstanding, and it is unlikely the debtors will ever extinguish them, given the government's grip on the banks. These assets confound any Western accounting analysis, because it is unclear who approved the debt and how to collect it. In addition, the nonperforming loans ostensibly transferred to the AMCs in reality remain liabilities of the major banks, through a circuitous funneling of bonds and funds among what are all essentially government organs.

> "One cannot simply assume that words such as 'stocks' or 'bonds' or 'capital' or 'yield curves' or 'markets' have the same meaning in China's economic and political context."

Under the current structure, the People's Bank of China (PBOC) – acting as a central bank – is the guarantor of China's AMCs and responsible for resolving all bank failures. Yet banks are still lax in their loan valuations, credit issuance and risk controls. Additionally, the PBOC has been lending at a furious pace to stimulate the economy in the wake of the 2008 global recession that hammered China's manufacturing and export sector. Undoubtedly, 2009's $1.4 trillion spending spree will lead to another wave of future nonperforming assets. At the behest of the state, the PBOC "write[s] the check for the party's profligate management of the country's finances."

"The Fragile Fortress"

Actual financial reform in China remains elusive; bureaucrats at the PBOC and MOF jostle for dominance in a conflicting and confusing administrative setup. The banking scheme is intentionally opaque, which is why few outsiders know that the Chinese financial system has been on the verge of collapse several times in 30 years. Chinese banks remain instruments of the party's politically driven lending policies. As a result, bad debt gets recycled to new government entities, so financial institutions never have to realize losses. And banks depend on the party for their profitability: The government stipulates the interest rate spreads between deposit and lending rates. With these assured profits, the banks invest in cheap government securities. A lack of competition maintains the spreads, and banks rely on a dedicated customer base for deposits.

> "China's capital markets, including Hong Kong, are now home to the largest IPOs and are the envy of investment bankers and issuers the world over."

Since the party controls them, China's banks have not proven that they can create value without government direction and protection. This is why no Chinese banks made offers for the distressed US financial institutions like Washington Mutual, Citigroup and Merrill Lynch that were for sale in 2008. It also explains why other nations have not adopted China's banking model and why its very large banks are not internationally competitive.

China's Bond Market

Despite China's huge economy, its bond market is still developing. Because the party controls interest rates, bank loan rates determine bond prices and risk assessments, not market demand. Only a few hundred bonds trade daily – with prices largely determined by how quickly an investor must sell. In such an illiquid system, market participants have no objective way to measure and price risk. Almost all bond primary dealers are banks, which hold the bonds they buy in their own portfolios until maturity, just like loans. As a result, the Chinese bond market is a mechanism for making loans, not a competitive way of raising new capital.

> "The Chinese are masters of the surface and excel at burying the telling detail in the passage of time."

In a 2009 report, the MOF reported that the majority of China's thousands of local municipalities run fiscal deficits; the main duty of mayors and provincial governors is to finance local job-creating projects. China's larger, more sophisticated coastal provinces can raise funds by attracting foreign investment. Interior provinces don't have this option, so they often rely on land auctions and cash flows from infrastructure projects. Cities and regions also have created a municipal bond market by issuing bonds and commercial paper through limited liability companies. In 2009, provincial and local governments had created 8,221 of these "fund-raising platforms" totaling $95 billion in new debt; by year-end, the total cumulative municipal debt was $1.14 trillion, equivalent to 23% of the nation's yearly gross domestic product.

Stocks: Form over Substance

Party authorities encourage citizens to invest in shares for two main reasons: First, entities that issue stock don't have to repay their investors, an event that government officials have termed as "inconvenient" in referring to bonds. Second, the party recognizes the value of symbols, and it considers a Chinese company's public listing on a stock exchange as projecting a more modern image for the nation. As a result, the state encourages stock ownership as a means of building individual wealth and conveying China's sophistication.

> "An inherently conservative political class, whose natural instinct is to control, will not easily invite those it cannot easily control to participate actively in its domestic debt markets."

China's stock exchanges are Asia's largest in daily trading volume, new IPOs and brokerage fees. The party runs the stock exchanges through their ownership of all listed companies. When the Shanghai exchange started in 1990, a year after the Tiananmen Square protests, the party looked to the opening to quell social unrest. Since then, wild IPO speculations, driven by lottery subscriptions, boost stock market activity. In the listing process, issuers intentionally set their share prices low, so that they will surge on opening day. This eliminates underwriting risk for bankers, but it attracts investors looking for a quick score. It also means people don't analyze and understand a company's performance or prospects. Government policy changes affect the stock market more than the performance of individual, listed companies. Unless and until privatization occurs, a remote possibility, China's stock markets will not operate like their Western counterparts.

> "If...China seeks to replace the US at the center of the global economy...one would expect it to export not just capital, but also intellectual property."

China's economy is impressively large, but it is subject to serious problems that could arise from changes in household savings rates, interest rates and rising pension costs. Unequal income distribution among China's vast population keeps authorities primed to address any incipient social unrest. The country faces a demographic shift as its population ages: As more individuals divert their savings to health care, domestic consumption will decrease and bank deposits will fall. The state also must fund pensions for its graying population. The World Bank estimates China's future retirement obligations represent between 10% and 40% of its GDP, a massive liability that is even more foreboding due to China's poorly structured capital markets.

About the Authors

Carl E. Walter worked in China's financial sector for 20 years; he held a senior position in China's first joint venture investment bank. **Fraser J.T. Howie** is managing director of a brokerage firm in Singapore.