

# Perilous path

## *Economic rebalancing while stamping out corruption poses challenges for China*

by Jack Rodman

Anyone who reads the newspaper (Western papers or *China Daily*) knows a key programme of Chinese President Xi Jinping is to eliminate the fraud and corruption that has plagued the government for decades. From lowly local government officials (who own 10–20 residences) to the highest echelon of the Central Committee of the Communist Party of China elite, no-one seems to be exempt from investigation. Average Chinese citizens enthusiastically support the president's efforts to stamp out, or at least reign in, corrupt officials; however, like most things in China, one must be careful of what one wishes for.



***China must navigate a perilous path between the goals of stamping out corruption and speculation, and engineering a soft landing as it rebalances its economy.***

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Most Chinese economists would acknowledge that for the past two decades, one of the foundations of Chinese economic growth was fixed-asset investment — real estate and infrastructure — fuelled by expansive bank credit policies and government stimulus. But what many fail to recognise is the significant impact “corruption” has had in fuelling China's economic miracle. “Guanzi” — Chinese “relations” — allowed a privileged group to amass tremendous wealth, skimming off the top of enterprise and economic growth. In a recent *Financial Times* article, Jonathan Anderson, former global emerging market economist at UBS Investment Bank and now founder of Emerging Advisors Group, “estimates that US\$11 trillion has gone missing in China in the past half-decade as a result of weak oversight and enormous opportunity provided by the

investment boom”. Anderson notes this “skimming off the top” equates to roughly 5 percent of GDP per year.

### **Mainstream skim**

Here is my view of how the profit or “skim”, as I call it, from this rent-seeking, relationship model has made its way into the mainstream economy, its path from asset class to asset class, and what President Xi's drive to stamp out corruption may mean for China's markets.

First and foremost, the majority of skim found its way into the residential real estate markets. The meteoric rise in Chinese residential property has been well documented, and China has acknowledged the market was driven to record highs by speculation and greed. Recognising the lack of affordable housing could affect “social harmony”, the government took steps to reign-in residential real estate prices through a number of reforms affecting land sales, down payments and interest rate policies and restricting the number of properties that an individual can own.

As speculators with ill-gotten gains were forced out of residential property markets in first- and second-tier cities, they focused their attention on third- and fourth-tier cities where most of the overhang exists. Today, everyone acknowledges the bloom is off the rose in terms of housing as a favoured “gold bar” the Chinese can invest in to supplement their retirement incomes and lack of universal healthcare, both of which are social-safety-net issues. As a result, residential real estate values continue to decline month-to-month in China's 70 major cities.

As it became more difficult and less profitable for investors to continue buying real estate, speculative investors (fuelled by ill-gotten gains) discovered they could get double-digit returns by investing in wealth-management products and trust products sold by the largest and strongest Chinese banks. These products grew from nothing to more than US\$2 trillion in less than

five years. Much of this money went to property developers and small businesses that were no longer able to obtain low-cost bank financing. Maturities for these products were quite short term, from a few weeks or months to less than one year, and interest rates were very high. As WMPs and trusts matured, new funds were raised to pay off maturing funds, causing many analysts to question if these were “Ponzi scheme” products. In January 2015, Kaisa Group Holdings, one of Shenzhen’s major property developers, missed an interest payment of US\$23 million on an approximately US\$500 million bond due in 2020. While a third party (presumably the government) has come forward to make creditors whole, this has triggered concern over the ability of large Chinese developers listed in Hong Kong to meet growing debt obligations.

### The local angle

Compounding concern over shadow banking products, many WMPs and trust products were used to finance Local Government Finance Vehicles, which skyrocketed in recent years to as much as US\$4 trillion. Local governments borrowed to invest in questionable infrastructure projects (as part of government-led stimulus) and, more recently, to purchase land to prop up local real estate values to halt a feared spiraling decline in property values. Recent initiatives have authorised select local governments to



Chinese President Xi Jinping

issue “local bonds”, similar to a municipal bond in the United States, with maturities of five to seven years to keep critical infrastructure projects from failing. While the central government states it does not stand behind local government debt, its actions to date say otherwise.

While this well-told saga continues to unfold, the central government and People’s Bank of China continue to provide banks with more liquidity to attempt to kick-start the economy and keep economic growth above 7 percent. Simultaneously, the PBoC has assisted banks in increasing their capital bases to allow banks to be more aggressive in writing off and managing a growing portfolio of nonperforming loans. We have yet to see banks act aggressively on nonperforming debt, however, and when large debtors have failed recently, the banks provided funds to their relatives, the Big Four asset

management companies — China Cinda Asset Management Co, China Huarong Asset Management Co, China Orient Asset Management Corp and China Great Wall Asset Management Corp — to buy up bad loans at prices close to 100 cents on the dollar and avoid incurring a reportable loss. It is no surprise most Chinese banks are trading below their book values, and the effort to list AMC’s (following Cinda’s successful IPO) may be more challenging. At the end of 2014, Cinda was trading below its IPO listing price.

### Systemic strategies

China never seems to run out of strategies to put off losses at any cost. In the latter half of 2014, concerns about LGFV defaults as well as WMP and trust defaults, which could affect local government finances and public confidence, led the Chinese government to announce the creation of a series of “provincial” AMC’s. These regional AMC’s are tasked with taking over bad debts at the local level that are deemed “potentially systemic” to local government, banks and businesses. So far we have seen little action by provincial AMC’s, although they claim they are economically driven and not an arm of local government. From the other side of their mouths, however, they publicly acknowledge their primary mission is to prevent systemic losses at the provincial-government level. Similarly, the Big Four AMC’s are charged with the same task for large state-owned enterprises and the Big Four Chinese banks.

### The saga continues

So where does this leave the Chinese economy? China is in the process of fighting corruption at all levels of government while simultaneously trying to reinvigorate the economy with concentrated doses of government stimulus, prevent a property market meltdown, and shore up its banking system with liquidity injections. All the while, the Shanghai Stock Exchange soared in 2014 (from about 1900 to 3300) despite an overall slowdown in the economy and the aforementioned dark clouds on the horizon.

I do not see any reason for this rapid turnaround in the stock market other than all other channels to “wash” ill-gotten gains have been squeezed out or regulated away. Money is no longer flowing into the property market, it is harder to get money offshore to Hong Kong and Macau, and everyone is waiting for the next WMP and trust to fail. I believe most of the market exuberance is based neither on China’s GDP growth nor on government efforts to rebalance the economy away from fixed-asset investment, real estate and export growth to a more balanced consumer-driven economy. (Good luck with that rebalancing; noticeable positive changes



People's Bank of China

in ageing demographics, family formations and birth rates — despite recent efforts to relax the one-child policy — seem a long way off.)

So what is driving Shanghai's stock market to record levels as the economy slows and problems continue to emerge that could have systemic risks to the financial system, apart from having no other place to put money? The skim and government-injected liquidity are running out of asset classes in China to invest in as regulators have cut off other avenues. China's stock market has become the next (only?) destination for this capital, but its foundations seem anything but secure.

It appears the banks have succeeded in channelling liquidity to the stock market by loaning money to brokerage firms, providing funding for speculators to leverage their stock purchases. A recent report from Bank of America Merrill Lynch shows the amount of margin trading in China is among the highest in the world, already up 9 percent in 2015, putting the balance at US\$177 billion as at 16 January 2015. Simultaneously, the PBoC is trying to stem the rapid rise of "Entrusted Loans" (a rapidly growing part of the shadow banking industry), in which one company lends to another using a bank as an intermediary. These loans grew by 458 billion yuan (US\$58 billion) in December 2014, and regulators fear much of this lending is finding its way into the stock market. In mid-January 2015, the government recognised the risk the stock market

posed to the overall economy and implemented controls on the amount of leverage or "margin requirements" that securities firms and brokerages could offer to their customers. The immediate effect was a 7.7 percent, one-day drop in the Shanghai exchange.

### Competing goals

China must navigate a perilous path between its two (at times) competing goals of stamping out corruption and speculation, and engineering a soft landing as it rebalances its economy. Achieving the first goal may endanger the second one. Historically, China has dealt with systemic risks by putting off losses (parking bad debts at the AMC's) and via government stimulus. Following the 2007 market collapse, the Chinese government used the Big Four AMC's to consolidate and rehabilitate brokerage and securities firms to prevent systemic losses in China's Big Four banks. China may encounter difficulties with this preferred strategy of dealing with bad debts, as it is currently attempting to list the AMC's, and the magnitude of the problems are so much greater than those encountered in the past. The great feat is at some point China will run out of road for its can kicking.

As always in China, stay tuned for the next bubble. ❖

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