What is ahead for China's financial system?

Tim Rühlig

Preface

- Political scientist “exploring” China’s political economy/financial sector
- Learning in ~70 interviews in China (central bankers, regulators, government advisors, think tanks, economic leaders, leading academics) in 2016

Main argument

- China faces two “worst-case scenarios”:
  - Financial crisis as a result of rapid economic reform
  - Lowering growth and efficiency, middle income trap
- Both worst case scenarios threaten CCP rule
- Explains economic and political course

Context

- Critical stage of China's economic development: the "new normal"
- Growth based on cheap labor and investment not sustainable any longer
- China's reform efforts

Context

- Macroeconomic challenges:
  - State-permeation despite all reforms
  - Demographics

Core challenges and the financial system

1. **Dysfunctional resource allocation and financial risks**
   - State-ownership and the financial system
   - Dysfunctional credit pricing
   - Rapid increase of debt
   - NPL ratio and non-transparency
   - Financial repression
2. **The role of the local party-state**
3. **Real-estate bubble**

1. Dysfunctional allocation of resources

- Financial system relies on state-ownership
  - Banks and non-bank financial institutions instead of capital markets
    - 700 million RMB (corporate bonds) vs. 5 trillion RMB (2016)
  - ~70-80% of state control
    - Big Four/Big Five
    - Local small and medium size banks
      - Heavily invested in non-bank financial institutions and risky products
      - Shadow banks estimated up to 50% of GDP

1. Dysfunctional allocation of resources

- Dysfunctional credit pricing:
  - Implicit guarantees

"When I receive guidance from a local party officials, I am not responsible; it is not my problem. The respective party official would be held accountable politically. Economically, the bank and we as bank managers have no problem: When lending to SOEs the state authorities bear ultimate liability."

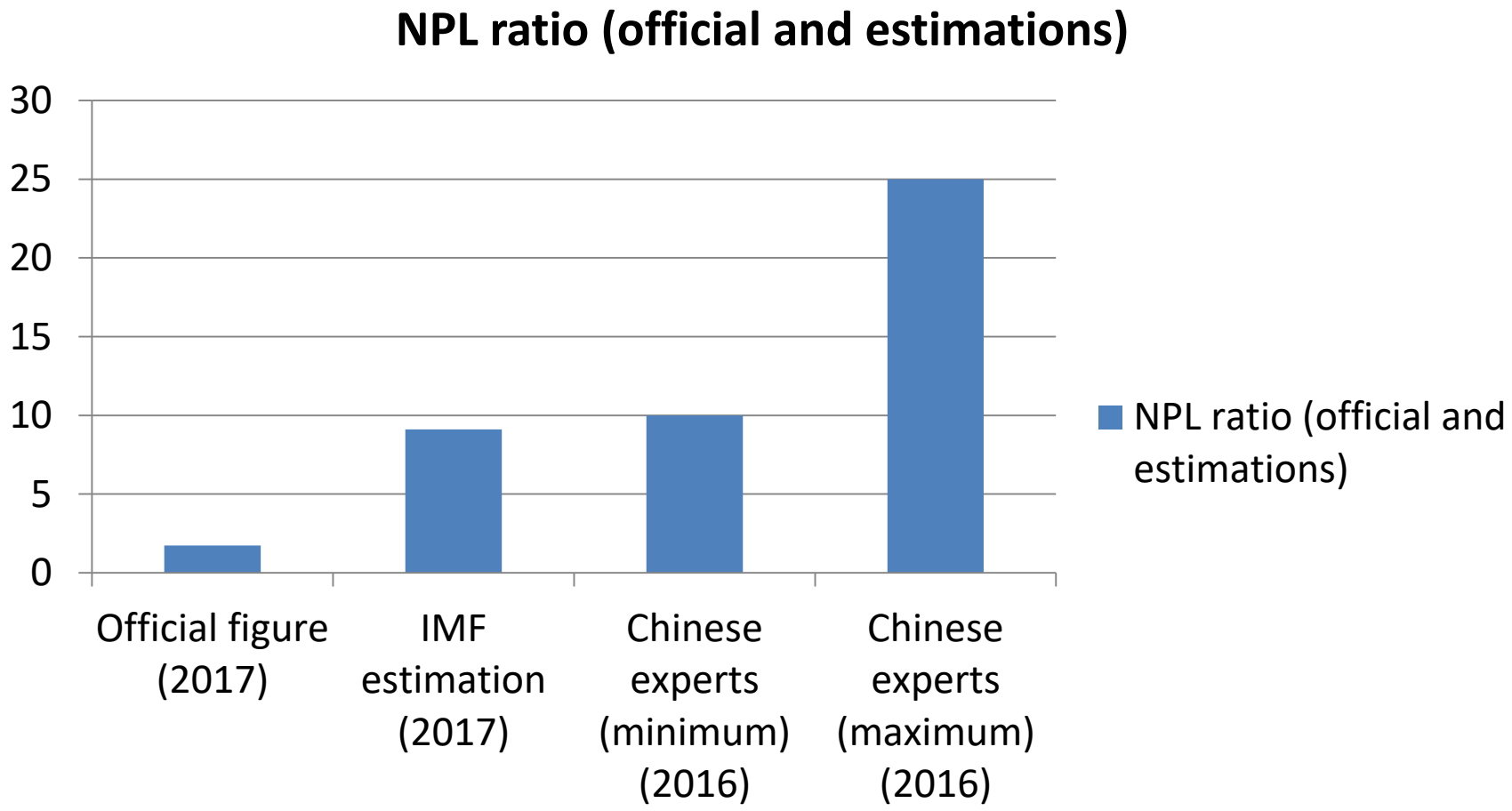
- Former manager of a leading state-owned bank

1. Dysfunctional allocation of resources

- Rapid increase of debt in times of lowering growth rates
  - IMF: Credit-to-debt ratio: 235% of GDP (2016), 290% of GDP (2022)
  - 80% rise of private debt since 2008

Result: Increase of bad debt

1. Dysfunctional allocation of resources



1. Dysfunctional allocation of resources

- How does China keep official figures so low?
  - On-lending through trusts, WMPs, banks and other SOEs
  - Securitization with very good ratings

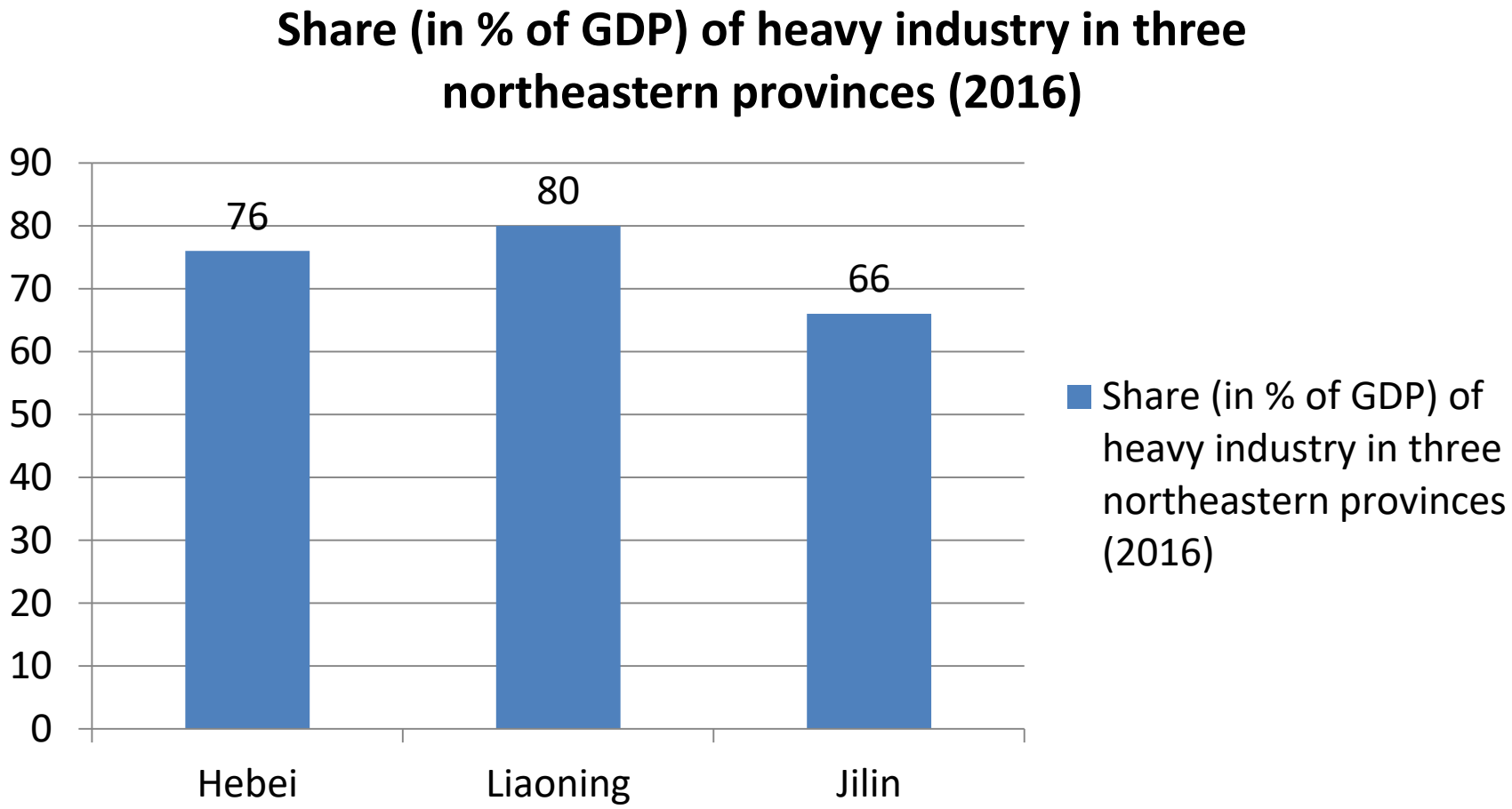
1. Dysfunctional allocation of resources

- Incentive of financial repression:
  - cap of deposit rates (enables cheap lending)
  - strict capital account controls (provides little alternatives)
  - dominance of state-owned banks (can be forced to buy government bonds to low interest rates)

2. The role of the local party-state

- Economic challenges geographically concentrated (particularly in the northeast after 2009 stimulus)
  - Local party-state instructs local state-owned banks to issue soft loans to ensure social stability

2. The role of the local party-state



2. The role of the local party-state

- Self-interest (corruption, coterie, cadre promotion)
- Fiscal interests
  - IMF: Chinese local state has highest share of national spending responsibility in the world
  - Rise of local state share of government expenditure: 1 trillion RMB = 69% (2000), 9.3 trillion RMB = 85% (2011)
  - Local authorities collect only 25% of value-added taxes (VAT)
  - 2003: “tax-for-free” reform: no local fees and taxes, no lending to local state
  - Alternative finance strategies:
    - LGFVs (incomplete clampdowns since 2015)
    - Sale of land use rights (1/3 of revenue in 2016)

3. Real-estate bubble threatening China

- Real estate bubble:
  - Local party-state's interest in high demand for land and real-estate development
  - Lack of investment alternatives
    - Capital account controls
    - Cap of deposit interest rates
    - 2015/16 stock market crash
  - First tier cities (BJ, Shanghai): annual rise by 30-40%
  - 20% of China's apartments are uninhabited
- Real-estate accounts for
  - ~8-9% of GDP growth
  - 30 million workers directly in real-estate sector

Chinese reforms

Xi: “financial security” = “national security” (April 2017)

Exemplary policies:

- Financial reforms
  - Abolishment of cap of deposit and credit interest rates
  - Partial/temporary ease of capital account controls
  - Internationalization of RMB
  - Deposit guarantee system
  - Implementation of Basel III requirements
  - More foreign bank involvement until 2020
- Financial regulation
  - non-bank financial institutions
  - risky financial products
  - Merge of CBRC and CIRC under the guidance of PBOC
- Governance reforms in banks
- Restrictions for real-estate purchase

Remaining hurdles

- Macro-economy
  - Strengthening of SOEs: number increases (since 2007); merge and acquisitions instead of privatization of SOEs
  - Lack of fiscal reform
  - Consumption ratio decreased recently, even more investment driven growth
- Financial sector
  - Informal regulations/vague regulation
    - Window guidance
    - Benchmark instead of cap for interest rates
    - Capital account controls (informal hurdles)

Remaining hurdles

"You must know that around 70% of all deposit rates are still congruent with the PBOC's benchmark. This clearly indicates the importance of informal regulation and window guidance. […] Yes, it is true that capital account controls have been formally liberalized. But this has hardly any effect because the regulators give the Chinese banks informal instructions. That's how it is."

- Banking regulator.

Remaining hurdles

"At the beginning of each year, we get a general plan from the respective party committee that details the volume of loans for each sector. Over the year, these plans are subject to readjustment from the Party. Usually, they just give us a phone call and inform us about changes. Very often they also indicate which companies should be granted the loans in the respective sector. […]"

TR: "I guess most of the time they instruct you to provide the loans to SOEs or companies closely allied with the party-state's authorities, right?"

Answer: "You nailed it."

- Former manager of a leading Chinese bank

The two “worst cases”

Scenario 1: no fundamental reform, preservation of state-permeated economy

- Financial crisis is unlikely because internal credit cycle keeps working
- lowering efficiency
- middle income trap
- growing discontent among the Chinese people

The two “worst cases”

Scenario 2: Rapid liberalization of financial sector and economy

- Increase of efficiency in the long-term
- Severe financial crisis: failing NPLs and burst of real-estate bubble
- Insolvencies and mass unemployment
- Growing discontent among the Chinese people

Conclusion

- Gradual reforms necessary, right timing the main challenge
- Risk for CCP rule

"By now, I think, the [housing] bubble has become as dangerous as it could lead to the collapse of the whole system and the end of the Party's rule in China."

- Advisor to the Shanghai government (finance).

Conclusion

- Understanding Xi Jinping: Not power-savvy authoritarian leader but rational and concerned:
  - Tame inefficiencies of local party state (centralization; corruption)
  - Gradual financial reforms vs. SOE policy
    - Gradual increase of competition (FinTech, foreign banks)
    - BRI to reduce overcapacities more socially acceptable
  - Increase control because of possible protests
  - Substitute output legitimacy (personalization; nationalism)