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## Report from China: Impressive industrial growth but sickly capital markets

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- **Growth performance is impressive. A hard landing seems improbable.**
- **But capital markets are inefficient. Modernization will take a long time.**
- **A revaluation of the yuan is approaching. It could be larger than expected, and a managed float may not be too far away.**
- **The present quarrel with Japan will not cause any economic damage.**

Having spent one week in China (Beijing & Shanghai) with a delegation of financial institutions, my main impression is one of a **dual economy**. The impressive Industrial growth performance continues, at ever higher GDP levels. China is now the second largest economy in the world (PPP-based) and the third largest exporter. The Chinese dragon will consequently continue to conquer market shares, suck up commodities and grab an increasingly important role in world politics.

On the other hand, the previous euphoria has waned on financial markets; officials are more willing to admit huge inefficiencies on capital markets and in banks as well as difficult challenges in building a social

insurance net. Even though the industrial growth success has become even more obvious, the overall picture is therefore less triumphalist and more nuanced – which, in my view, is a good thing. This short report will concentrate on problematic challenges such as capital markets, banks and currency reform. But the reader should keep in mind that the dominant trend is one of huge successes in production and trade.

### Short-term outlook

The over-heating obvious in 2003 and early 2004 was met by interventionist credit rationing, energy taxes and a small interest rate hike. These policies initially seemed successful as inflation fell back somewhat during H2 2004, the pace of lending decreased, and the pace of investments slowed down. But GDP growth in 2004 nonetheless ended up at 9½ per cent, same as in 2003, as consumption surged.

In early 2005, clear signs indicate that the economy is gathering steam again. Inflation has edged up once more – it is currently running at 4 per cent, year-on-year – and

investments are picking up speed, once again. Producer prices are increasing more rapidly, and there are signs of speculation in local real estate markets. The government has stated that it wants to reign in GDP growth this year at around 8 per cent (which is the sustainable growth rate). To do that, they would need to tighten credit policies again via administrative measures, or to move on further with a market-conform monetary policy, including new small interest rate hikes and ideally also a revaluation of the currency.

I believe this is feasible. The tightening of economic policy this time started earlier than in previous boom-bust cycles. Thus, the amount of tightening necessary probably is not enough to cause a hard landing.

Higher interest rates would be the right way forward. Nominal lending rates are at 5 per cent, just slightly above inflation. But many companies can borrow at special, lower rates – meaning that they can actually borrow at negative real interest rates. Such low capital costs imply that many investments are inefficient.

### **The currency**

The Chinese authorities keep repeating that their long-term goal is a convertible and flexible currency, but that they are in no hurry; the banking system is too frail to allow full convertibility (which could imply huge flows of “hot money”). As regards possible moves towards a floating exchange rate they have also stated that these will be taken gradually and in ways which will not be dictated by markets or foreign pressure.

It should be underlined that this long-term task – flexibility and convertibility – at least theoretically is separate from the much-debated possible revaluation of the yuan. A

revaluation followed by a repegging could be undertaken any minute, and has no far-reaching implications for the long-term strategy. Nor would it affect banks. Nonetheless, the Chinese authorities may want to advance both issues at the same time, e.g. by widening the trading band (which would allow more flexibility and at the same time make it possible for the yuan to gradually become stronger). Alternatively, they could move to a currency basket (which makes a revaluation vs the USD possible at the switch, while permitting flexibility towards the individual currencies in that basket).

Although everybody expects a revaluation, few of the people we talked to have a firm prediction of when or by which method this would come; the government and the Central Bank are still debating the sequencing and timing of measures.

Still, if I were to bet, I’d place my money on a one-step revaluation rather than a basket, possibly followed by a wider band after repegging vs the USD. The band could then gradually be widened and a managed float introduced – with currency controls still in place.

As regards the size of the initial revaluation, I’ve previously forecasted a rather small one – 5-10 per cent – but after listening to some of the economists we met, I wouldn’t be surprised if the revaluation turned out to be 15-20 per cent. This would be beneficial against the risks of over-heating but not enough to trigger a sharp downturn. As regards timing, the only clue we have is that the Prime Minister has stated that he wants to “surprise” the markets – which I interpret as a wish to strike at a point in time when political pressure is low and markets focus on other issues.

Huge indirect bets on revaluation are taken in the markets. Real estate developers often finance their investments by borrowing in HKD, expecting repayments becoming cheaper the day the CNY is being revalued.

### **The banking system**

The non-performing loans ratio is coming down. According to official statistics the NPLs now amount to around 20 per cent of GDP. However, to this should be added the NPLs which were taken off the banks' balance sheets a couple of years ago and transferred to the "asset management companies", i.e. the bad banks. They still sit on another 10 per cent at least; so far, they have not been very successful in the work-out process, mainly because their assets consist of decrepit old factories without natural buyers. Furthermore, the fall of the NPL ratio in the banks have partly been the effect of a rapid increase of new lending, increasing the denominator of the ratio. Fears are ripe that a lot of this lending – though sound-looking now, in times of rapid growth – may turn out sour in a future downturn of the economy. As a result, S&P claims that the "true" NPL ratio in the economy as a whole probably is above 40 per cent.

One should remember that the Chinese banking system is state-owned, and that most of the bad loans are the result of political lending to state-owned enterprises (SOE), often under the influence of local governments. In that respect all these problems are still within the same, governmental balance sheet – in a country where the public debt still is rather low. The government, however, does not want to clean the slate since that would increase the moral hazard problems already rampant in the banking system.

The credit culture is still very weak, despite frantic efforts to improve governance. Local government (regional and provincial levels) push hard on local bank branches to continue political lending to projects which are deemed politically important. The four big commercial banks are trying to clean up their act by centralising credit policy, naming independent directors, imposing international accounting standards etc. But this is a long, long process, which so far has been slower than expected. As a result the recapitalisation and IPOs of the four big banks have been delayed. Some USD 45 bn have been taken from Central bank's FX reserves and injected into the two leading banks. Hopes are that they may be listed (probably in Hong Kong) within a year. But the weaker two in this quartet have a very long way to go.

### **Capital markets**

Capital markets are still very immature. The Chinese save much – the household savings ratio is 40 per cent of disposable income – but almost all of this becomes bank deposits (at 1 per cent interest rate). Companies fund themselves almost exclusively by bank borrowing; the corporate bond market is still more or less non-existing.

The lack of normal capital markets constitutes a huge problem. As stated above, bank lending goes primarily to the SOEs and interest rates are abnormally low. This has led to enormous over-capacity in several sectors as investments are subsidized. It also leads to SOEs using excessive inputs and wasting resources. When credit controls are pursued, this process goes into reverse, and SOEs are squeezed hard. Thus, administrative credit controls and cheap bank lending cause policy-driven busts and booms.

The Chinese stock market is illiquid and non-transparent – and has fallen for five straight years. The woes largely stem from the fact that no less than 70 per cent of the market cap on the Shanghai Stock exchange is non-tradable; these are state-owned enterprises where the government does not allow any change of ownership. Furthermore, transparency for most of the tradable shares is poor. The public's trust in the stock market is weak, after a number of scandals, where securities firms have squandered their clients' money. There are no firewalls between client money on the one hand and trading in your own book on the other. If/when investors lose their savings because of poor governance, the government usually bails them out – which is a signal to securities firm that there's no hurry in raising those firewalls. So all in all, this is still a wild, non-transparent and illiquid market, rife with poor governance and moral hazard.

There are detailed and serious plans on how to improve governance of capital markets but it will take many years before they are anywhere near the standards of Western markets. Thus, investors who want to invest in the Chinese markets directly must realize that risks are great.

### **Capital flight**

The legal system is gradually being strengthened. The number of lawyers is rapidly increasing and the rule of law is advancing – not least as a result of the WTO entry. But on regional and provincial levels, corruption is still rampant. Some of the most talked-about cases are local SOE managers more or less stealing their companies, buying out assets at fixed prices or using (overvalued) acquired assets as collateral to secure loans. During the last couple of years, some 4,000 managers or party offi-

cial fled the country, taking with them tens of billions of USD!

A large amount is assumed to have moved to the British Virgin Islands, from which much foreign direct investments into China originate. As much as 25-50 per cent of FDI inflows is, consequently, “round-tripping”, i.e. capital flight money being laundered and then invested back into China again.

### **Politics**

The “fourth generation” of Chinese communist leadership (Mao was the first, Deng second and Jiang Zemin the third) is now in full control. The slogan dominating their work is Ziao Kang – “to create a moderately well-off society in a rounded-off way”. This means quadrupling GDP between 2000 and 2020, as well as spreading income more evenly than in the past years.

The Communist part is in absolute control and shows great determination in promoting growth. People in general are largely non-political, but accept the party's rule as long as it delivers rising standards and China continues to strengthen its global position. There is a very strong feeling of national pride – China is once again emerging as a global power, thus ending a 200-year long parenthesis of weakness.

One symbolic aspect of China's ascent is the reunification. China's leaders can accept the status quo with Taiwan for a protracted period, assuming that convergence and reunification eventually will occur. But they will never allow Taiwan to break loose. Two signals are now sent out: 1) A new “non-secession law” tells Taiwan's leaders: Go no further. 2) At the same time China is courting the Kuomintang (presently in opposition in Taiwan). Thus, they assure the Taiwanese that peace is possible – if Taiwan

accepts a gradual, long-term reunification, the terms of which are negotiable. My own view is that war is unlikely – but the probability is not zero...

During our stay, anti-Japanese demonstrations rocked the streets of several cities. The authorities not only implicitly allowed these demonstrations but actually egged them on (e.g. by permitting anti-Japanese cartoons in newspapers). Superficially, this is about atrocities committed during the Japanese occupation in the 1930s. But although the anti-Japanese sentiments among the population no doubt run deep for historical reasons, the real aim – from the government's side – is to block Japan's entry into the UN's Security Council. This, in turn, is a card in the negotiating game to establish China as *the* super power in Asia, demoting Japan. It is also an ingredient in the negotiations going on about disputed off-shore oil wells. Stock markets have fallen, as a result of increasing tensions, but my best guess is that these will not have any important repercussions on trade or investment flows.

### Concluding impressions

Once again, a trip to China leaves me awed and dazed. The pace of growth in cities like Beijing and Shanghai is palpable. There is a difference, however, compared to previous years. The grandest projects are now outside the city centres. And at least in Shang-

hai, new parks, greenery, pavements etc are putting more human touches to the city; it is now rapidly becoming a chic, rounded-off, modern city rather than a gigantic and brutal construction site. Traffic, however, is becoming more and more obnoxious in both cities, meaning that it is impossible to predict travel and commuting time by car. My own conclusion is that road or congestion tolls will be introduced; it is only a question of time.

This trip showed me that the Chinese are getting ever more assertive – no wonder, given the rising economic and political strength. But this strength is also allowing a more open discussion about weaknesses of the Chinese economy. I have never encountered such frank revelations about the deplorable state of the Chinese capital markets – inefficiencies, corruption and inertia – as during this visit. To a large extent we knew this already – but the mere fact that it is openly admitted can actually be seen as something positive.

Coming back to Sweden, I feel very small, more convinced than ever that old Europe is facing a challenge on a scale that none of our politicians has realized.

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