Gnawing on bones

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Between mid January and late March, the Renminbi depreciated by 2.8%, before settling into a few days of small and shifting up-and-down movements. Following on the official explanation in China's state media, most press comments around the world interpreted this as an intentional move by regulators who are trying to reduce speculation in the currency by eroding investor belief that the RMB will always appreciate. Belief in regulator intentionality, however, relies on a conviction that China's policymakers want to stop the inbound flow of capital to support financial services.

Within China's banks, the view is quite different: “No one will take our calls or meet with us,” said one investment banker about the regulators. Government officials are too afraid of political reprisals to take responsibility for policy moves.

That depreciation should come on the heels of the first publicly acknowledged trust default and the first default of a bond traded in Shanghai is no coincidence: the easing of the currency is a last-ditch effort to address tumult in domestic markets. Among the bankers we talk to, astonishment and disquiet are the dominant reactions to the last three months in banking. Deposits are plummeting. Mortgage demand has fallen sharply in several cities that we have canvassed. Developers have halted projects, and several large property markets have either seen drastic price reductions or are hovering in an eerie calm without transactions. Unemployment seems to be rising.

At this time of rising stress on the system, it would serve everyone well to set aside the magical faith that attributes omnipotence to Chinese leaders. At a time of a low employment recovery in the U.S. and potential deflation in the Euro zone, global pundits are not telling us to feel reassured because the leaders in place will solve these problems. And yet this is the most persistent palliative in analyses of China's current challenges, both in China and globally. You will read very often in the analyses of the most respected China pundits that we are confident the leaders truly understand the problem; consider it solved.

Decades of intervention by China's government have trained us all to believe that a market is not a natural system but instead something that is merely an elective for a growing economy. China has elected not to leave much to markets. Instead, it has a set of rehearsed players garbed as regulators but actually allocators, writing the score, handing out the parts and waving a baton to set bow to string. It is arguably more efficient and agile than a market, and it reduces risk by avoiding the cacophony of a “market economy.” Gradually, regulators are trying to bring the few good parts of markets into play, what was once called "controlled competition" and "controlling competition," by turning State-owned monopolies into State-owned oligopolies, with the goal of addressing the defects of a socialist system with select tools of a capitalist one, letting the different parts work together with fewer impediments, risks, and abuses.

This process is called “reform.”

Wise leaders are challenged by unruly localities seeking narrow personal advantage. Such is the explanation of persistent imperfection in the development model. Li Keqiang’s comments last summer that reforming the banks would be like “disarming land mines” and would entail “wrist-cutting” pain were greeted with euphoria in the press. He might as well have used the ancient expression that the central dragon is no match for the local snake.

The subsequent Third Plenum of the 18th Party Congress was seen as embracing “big-bang reform” initiatives, and these were trumpeted loudly and persistently by the official media. The market was to play a “guiding role” in the economy; “outsiders” in the system, meaning new urbanites, were to have equal access to social services. Financial services were to be liberalized. Institutions would be strengthened. These Third Plenum campaign themes precisely echoed the *zhengqi fenkai* campaign, promoting separation of "enterprise" from "politics," celebrated a mere 20 years ago. As great as the economic challenges were then and are now, China is in good hands—hands that are ably piloting the economy and the people through treacherous waters.

If only the tsar knew

Our interviews suggest that shadow-market institutions are challenged to find good projects to invest in. They have capital to offer at reasonable rates, but the quality of borrowers, they say, is dismal. All banks, including the biggest at the top of the pyramid, meanwhile, continue to make a large portion of their loans off balance sheet. Recently there has evolved a strong preference for forming their own trust and private equity subsidiaries to manage to off-balance-sheet activities rather than hand their money to third-party institutions; they believe the risks are too great.

Over the last two years, loans to property and coal mining have been the principal focus of off-balance-sheet activity. This is because banks were restricted from lending to these sectors, and these assets were seen as extremely solid. Because, in most loan situations, neither property nor coal mines produced revenue to service debts, what would seem inevitable defaults have been consistently prevented. The unintended result is that the banks' formal lending restrictions push rates higher on one hand, even as risky borrowing is rewarded on the other.

We already know the plunge in coal asset values from the near collapse of "Credit Equals Gold #1." Suddenly, though, the formal news and blog sites are full of accounts of property price-cutting. Developers in Ningbo, Wuxi, and Suzhou have selectively announced cuts of up to 40%.[1] Developers in Qinhuangdao have announced 40% price cuts.[2] Agile and Wharf Holdings announced 40% price cuts in Changzhou, which one Chinese press outlet has pronounced China’s “new ghost city,” after Ordos and Wenzhou.[3] Overall, NBS numbers show continued strong pricing growth across China’s markets, and Chinese real estate experts counsel that property will continue appreciating for at least a decade to come. But when the

[1] http://money.sohu.com/20140330/n397439770.shtml

[2] http://esf.cd.soufun.com/newsecond/news/12418757.htm

[3] http://www.infzm.com/content/99331

country’s premier garden city, Hangzhou, saw a 30% drop in prices in March, markets reacted.

These warning signs make property developers much less attractive targets for financing. But if not property, what? It seems that the only growing sector left is finance itself, which must be a sign of the last days of a bubble.

The meme dominating economic analysis of China over the last year has been “cracking down on the shadow market” and “whack-a-mole,” pounding down on abusive practices and watching carefully for new "innovations" to defy regulators. The idea here is the old Russian saying, “if only the tsar knew,” and its Chinese corollary, meant to suggest how local officials find strategies to run amok, “the mountains are high and the emperor is far away.” The story goes that incorrigible local leaders have created a runaway shadow-banking sector that is loan sharking out money to sectors that the more rational center prefers to see stifled. This is dangerous and has created unpayable debts. As long as the center acts quickly, the tap can be turned off and the noxious spills gradually cleaned up.

The reality is simply that everyone is in this together. New and expanding investment is the only means available to China’s government for achieving growth, and investment has become so inefficient at this point that new NPLs are a necessary result of new investment. The old practices we got to know in the 1990s are alive as ever, of moving NPLs off balance sheet to other kinds of asset managers or simply evergreening loans by refinancing them when due. Given the need to attract capital into banks and other financial institutions, the political commitment to low NPLs in reality is a hard requirement, but getting the optics right is much easier, especially if core economic data is considered a state secret. Therefore, a shadow system is not only needed but is an integral and symbiotic portion of the functioning Chinese financial system.

Anti-corruption campaign

Xi Jinping has been lauded for his anti-corruption campaign, conducted with a degree of personal enthusiasm that makes Xi look very close to his enemy Bo Xilai, the imprisoned ex-Party secretary of Chongqing and, in the view of many, a princeling, who would be king, and with a pedigree arguably superior to Xi's.

Austerity reigns throughout government agencies. Premium spirits are no longer welcome at banquets. Luxury cars have been auctioned off. Sweeping, almost mass arrests for embezzlement have touched the very top of the system, with former security chief Zhou Yongkang living under a Damoclean sword of threatened reprisal. A top general in Jiang Zemin’s government, Xu Caihou, was dragged from his hospital bed, and his family members arrested, and brought to account for contract skimming.

Although the campaigns have been widely praised overseas, it seems unlikely that anyone in China rests easier knowing that corruption is on the retreat. Corruption is not a personal but a systemic issue, and when it is addressed with widespread arrests, the effect is to spread terror, not to reduce skimming. Xi is faced with a difficult balancing act, because he must be careful not to threaten senior party members in both the military and civilian sectors in a way that would undermine the consensus supporting his position.

As a result, economic bureaucracies appear cowed and dysfunctional; little is being done, as managers are rewarded for caution, not for effectiveness. This is especially true given the widespread belief in China that the corruption campaign is highly political. This belief is complemented with a fin de siècle feeling that it may end soon and it is no or never to cash in. The result throughout the system is a curtailment of political risk and a counter flowing increase in corruption.

Non-transparency and volatility

The omnipotence ascribed both within and outside China to its political leaders is pernicious not only for the passivity it tends to breed but because economic intervention heightens non-transparency and, in turn, volatility. In Xinjiang last week, an equipment-financing company said that sales of heavy machinery in the province had fallen by more than 75% since 2010. In Guizhou the previous week, liquor distributors said that 70% of the province's distilleries had shuttered. These are changes of a magnitude that is cataclysmic and would occur over many years in more rational, transparent economies. They are the inverse of the steep slope that characterized China's recovery of GDP growth from the collapse of export markets in 2008.

More than anything else, the speed and intensity of these changes are symptoms of two resolute features of the economy overall. First, senior executives of SOEs are still appointed by and serve at the pleasure of the top Party tier and personnel system. Secondly, the party remains in firm and direct control of the top three tiers allocating resources to the economy overall, the MOF and PBOC, then the major SOE banks, and then the big SOEs in all the key sectors. Is it any wonder that, faced with market shifts on this scale and Party involvement at this level, large Chinese companies wait for word from the government before they decide how much to manufacture?

When Xi Jinping said, before the opening of the Third Plenum, that "the good meat is all gone; all that is left are hard bones to chew," his remarks were interpreted to mean that the government now had to undertake the most difficult part of China's reform process. On some ears, the remark seemed to have another, simpler meaning: earlier generations of Party leaders robbed the best of the larder, and now, there is less fat to skim.

For the Party, that defines wrist-cutting pain.

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