Paulson Policy Memorandum

Tackling Moral Hazard in China's Financial System

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Introduction

Because China's government has offered the country's economy and financial sector an implicit guarantee against insolvency, Chinese investors and enterprises have largely set aside their aversion to risk. That, in turn, has meant that they have poured large amounts of wealth into risky investments, including Chinese trust products, real estate, and the stock market, operating under the impression that Beijing will always guarantee investment returns, or that investors will not have to suffer losses.

This striking confidence in the presumed "security" of risky assets has led Chinese households and corporations to take more risks than they fully understand—and to exuberantly push forward the development of China's banking and shadow banking sectors, its real estate market, and its stock markets.

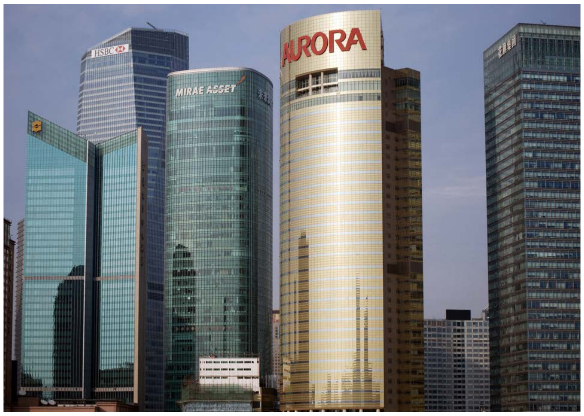
Just take China's housing market, which has reached one new high after another in recent years. Similarly, in the past decade, China has repeatedly witnessed its stock market moving through roller coaster-like rides, rising from nadir to zenith, before falling back again to another market bottom.

Excessive debt financed investments have led to overcapacity and the accumulation of corporate debt. Yet many imprudent investments will eventually turn out to be insolvent, which will yield even more bad debt problems and exacerbate the fragility of China's banking sector.

This short policy memo explores and explains why Beijing's affection for GDP growth targets will inevitably lead to excessive government support and guarantees for unsound investments. It elaborates why many of China's current economic problems, not least overcapacity and debt, have their roots in the moral hazard associated with the Chinese government's implicit guarantee against insolvency. The memo proposes six policy measures that could help to eliminate, or at least alleviate, this underlying moral hazard problem in China's financial system.

The Root Causes of Excessive Chinese Government Guarantees

Unlike the advanced economies in the Organization for Economic Cooperation and Development (OECD), China's unique political and economic institutional arrangements mean that the state is invariably more deeply involved in economic affairs. This plants the seed of the tendency of both central and local governments to support businesses, including by guaranteeing future returns on investment.



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One salient feature of China's political system is that the targeted economic growth rate has become an important factor for evaluating local government officials for promotion. Naturally, this incentivizes (or rather, *mis*-incentivizes) cadres to search for the most effective way to boost local growth. As a result, many local governments have pursued growth through borrowing, as this is the easiest and most effective way to boost local economic growth.

As I have argued in my book, *China's Guaranteed Bubble*, this is the nub of a major structural problem.[1] So long as local governments in China provide sufficient incentives and support for companies to invest, these companies, especially China's many local state-owned enterprises (SOEs), are more than happy to expand their own business while providing a favor to local government officials at the same time.

But this push for high-speed growth has come, ultimately, not just from China's local governments, but sometimes from the central government as well. Indeed, whenever China has faced an economic slowdown, the state has not just deployed conventional policy tools, such as fiscal and monetary policies, but also directed its massive SOE sector to increase investment, usually with funding provided by state banks. The fact is, no other major economy has an SOE sector as large as China's. Almost all of the big Chinese banks are also state-owned, and there are multiple Chinese policy banks that specialize in funding government initiatives.

Since Beijing has both the will and capacity to support growth, Chinese investors, both public and private, have formed a strongly optimistic belief in China's economic growth prospect. As a result, they tend to worry less about downside risks when making many business decisions.

This has introduced twin structural problems: first, official rates of economic growth are guaranteed in state plans; second, attendant financial support has stimulated investment by overly optimistic investors, helping borrowers to raise capital that they could not otherwise obtain.

Without this sizeable share of government guaranteed investments, China’s economic growth rate would surely not be as fast or impressive as it has appeared in recent years. However, even though short-term investment-driven growth may seem attractive, both to the state and to investors, it will inevitably reduce future investment and Chinese growth. Failed investments will not just deter future investments, but also hurt bank and investor balance sheets and confidence, further limiting China’s economic growth prospects.

To a certain extent, government support for economic growth and investment returns have been the engine behind China’s growth miracle of recent decades. But amid rapidly gathering debt and demographic challenges, this force, if not well harnessed, could eventually morph into headwinds that will plague the Chinese economy for years.

How Excessive Government Guarantees Undermine China's Economy

The Chinese economy currently suffers from a series of problems, including debt, excessive capacity, and an accumulation of financial vulnerabilities. In fact, many of China's current economic malaises have deep roots in the country's excessive government intervention and guarantees.

Debt

A first problem is the rapidly escalating problem of corporate and municipal debt. In a bank-dominated financial system, the majority of external financing is via debt, which takes the form of either bank loans or bonds. In recent years, Chinese bank executives, either because they are equally persuaded by the government's implicit guarantees or else because they simply face lending pressure from the government, have lent out an enormous sum. As a consequence, the size of China's banking sector has tripled since 2008.[2] China's SOEs alone have outstanding debt of more than 86 trillion yuan ($12 trillion).[3]

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If China's economic slowdown were simply temporary, such a large increase in debt would not necessarily be problematic; robust growth would eventually outpace debt accumulation. But it has become increasingly clear that the Chinese economy will more likely face a further slowdown rather than a quick turnaround. And that, in turn, means that debt levels will become an increasingly pressing issue.

Indeed, China's debt problems have become so dire that Zhou Xiaochuan, the governor of the People's Bank of China (PBOC), the country's central bank, has openly acknowledged that Chinese corporate leverage is "too high."[4] According to PBOC statistics, the average Chinese nonfinancial corporate debt to equity ratio was 106 percent in 2012. That ratio increased to 110 percent in 2013 and exceeded 160 percent in 2015. According to data from the Ministry of Finance, Chinese non-financial SOEs now have an average debt to equity ratio of 195 percent—significantly higher than that of China's private sector. And China's *overall* corporate debt figures are far higher than the 49 percent for Germany, 72 percent for the United States, 99 percent for Japan, and are also significantly higher than that of many other Asian countries at similar stages of development.

Overcapacity

One direct consequence of this excessive debt-financed investment is overcapacity. Based on official production capacity

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data, overcapacity is clearly evident across many industries in China, not just the steel industry that tends to get so many headlines. According to China's National Bureau of Statistics, the capacity utilization rate in China in 2014 was 72 percent (steel), 73.7 percent (concrete), 71.9 percent (electrolytic aluminum), 73.1 percent (flat panel glass), and 75 percent (shipbuilding, which translated into at least 30 percent overcapacity industry-wide), considerably lower than the international average.

And even with existing high capacity, many expect that continuing new investment will generate yet another round of Chinese capacity expansion in the next few years.[5] This underlying overcapacity problem in certain industries has become so acute that Beijing has now undertaken a national ban on new investments in the coal-chemical, steel, cement, polycrystalline silicon, wind turbine, flat-panel glass, shipbuilding, electrolytic aluminum, and soybean pressing industries.[6]

And such overcapacity, or capacity overhang, can certainly have a serious impact on the Chinese economy. With such sudden jumps in capacity across so many industries, competition will intensify even as corporate earnings rapidly drop. For instance, the Chinese solar panel industry reported a reasonable 30 percent gross margin in 2010. But with the massive industry capacity expansion and cutthroat price wars of subsequent years, gross margins in the solar panel industry dropped to 10 percent in 2011 and down to 1 percent among publicly listed Chinese solar manufacturers thereafter.[7]

Still, many Chinese companies, now well accustomed to asset appreciation and the expanding market potential of China over the past decade, have tasted highly leveraged growth. And the private sector is not immune either. Chinese entrepreneurial businesses, increasing in size and scope, find themselves benefitting not only from more government attention and support but also from greater bargaining power with banks when they face financial woes. Local governments, these entrepreneurs seem to believe, would be anxious to help them and thus help write down their non-performing loans to assure local growth and employment. But this has come at the expense of financial soundness and produced a highly risk tolerant approach to investing.

And that is not all. Distortions in China's state sector, in particular, have further amplified the incentives to expand. Unlike privately owned companies that have other reasons to care about a deteriorating balance sheet, the dual roles of SOEs—as enterprises but also as a tool for economic management by the government—induces SOEs to stick closely to the guidelines promulgated by China's state assets regulator to become "bigger and stronger." Li Rongrong, the former head of the State-Owned Assets Supervision and Administration

Commission, has bluntly told SOE executives that their choice is either to be among the top three firms in their sector or else be acquired by other SOEs through policy-led consolidation.

In the meantime, the downside to SOEs of further expansion is small. Even if expansion fails, the expectation remains that some other entity, usually the government, will foot the bill. Chinese SOEs understand just as well as state banks, their major creditors, that distressed debts, namely the state banks' non-performing loans, are implicitly guaranteed by the central government in Beijing.

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Ultimately, then, over-expectation persists throughout the Chinese economy that all SOE and state bank liabilities will be taken care of by Beijing in the end. Companies in overcapacity-laden industries may also simply borrow for a strategic purpose.

Deep-pocketed SOEs invariably wish to drive others out of their sectors, even if this means they will incur heavy financial losses themselves. The result is that too many Chinese firms seek new capital to sustain money-losing operations and fend off price wars from competitors.

Bubbles

Property and stock bubbles are not unique to China. One could argue that investors in every corner of the world frequently underestimate risks and overestimate investment skill. But one major difference in China is that the government has implicitly contributed to the making of these asset bubbles.

In recent years, for example, there have been repeated reports of Chinese property owners publicly protesting, sometimes violently.[8] These protestors tend to believe that their anger and direct action are legitimate because developers slashed prices significantly, shortly after they signed contracts with those that are now protesting.

Although China's property prices have been, on average, on an upward trend, there have also been repeated episodes of property cool-down. To expedite sales, some real estate developers have offered deep discounts, or more generous incentives, to attract buyers. Some new buyers do celebrate this opportunity to purchase property, but many of those who have bought property in China experience large paper losses.

In this volatile environment, home-buyers in China have not provided refunds to developers even after significant appreciation in apartment values. Developers, meanwhile,have often claimed that home-buyers have failed to offer to share the substantial gains made from rapidly rising housing prices.[9] Why, then, they ask, should developers be held liable for home buyers' losses?

Often, Chinese local governments step into the role of mediators in these situations. And in most cases, the local government will simply try to appease property buyers and forestall protest by asking developers to partially compensate buyers' losses or provide additional incentives to make home-buyers happy. What is more important, however, is that a market-wide expectation can form through these frequent and recurrent cycles of protest and concession. Yet the deeply-held belief among Chinese home-buyers that asset prices will only go up, fueled, once again, by implicit government guarantees, is a prime culprit for high housing prices in China and the bubble-like phenomena in many other areas of the Chinese economy.

The real estate market is just one such example. Chinese stock investors, similarly, have been known to pressure the China Securities Regulatory Commission (CSRC), the stock market regulator, to prop up the index whenever there has been a large drop in equity prices. And the CSRC's behavior in such cases, including in the recent past, clearly suggests that the regulator indeed feels obligated to prevent the market from dropping, even when this compromises the larger goal of undertaking critical capital market reforms.[10]

CSRC has an array of tools to influence the short-term movement of China's stock indexes. The most frequently deployed one is to temporarily ban the listing of new stocks. Distinctively from most capital markets around the world, the Chinese A-share market has an approval-based listing process. All companies interested in listing their shares are put through a lengthy, and sometimes cumbersome, approval process with the CSRC. CSRC has defended this approval-based listing system on grounds that the required background screening could, in theory, protect unsophisticated retail investors.

But, however benign the securities regulator's intentions may be, any attempt to further protect retail investors by artificially installing new requirements and price movement caps can only prolong the process of distortion and mispricing of stock prices.

Worse, once investors (and especially retail investors) sense that the government and regulators intend to support the market and their investments, they will begin to take on far more risk than they should or otherwise would, even though they have little market sophistication when it comes to highly risky investment.[11]

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Changing Policy

A crucial lesson of recent years is that it is essential for the Chinese government to withdraw the support embedded in such implicit guarantees. This will be critical to the long-term sustainable development of the Chinese economy.

Indeed, it will not only help Chinese companies and citizens make more prudent and efficient investment decision, but also properly incentivize them to refrain from speculative investments that yield asset bubbles, excessive leverage, and overcapacity.

Six specific policy prescriptions to tackle the moral hazard problem:

1. Look Beyond Targeting GDP

Beijing needs new evaluation criteria for cadres to reflect the more developed status of China's current economy and changing priorities. Competitive pressure to deliver on GDP targets has created many serious challenges for China.

One way to reform the system is to incorporate measures of *other* aspects of social wellbeing. These could include delivering on air quality, environmental protection, income distribution, and citizen satisfaction, all of which could be further added into the metrics for official performance evaluation. Cadre evaluation ultimately needs to focus not just on the speed of current economic growth, but also on its sustainability.

Beijing should consider introducing measures to control local debt and credit growth as part of how cadres are reviewed and evaluated. Some steps have been taken: for instance, a ceiling on local fiscal debt has already been introduced, and this is a step in precisely the right direction.Naturally, as more consideration is devoted to these other areas, the importance of growth for its own sake will be reduced. Some regions have already begun to downplay GDP growth targets, or to drop them outright. For example, the Shanghai municipal government has become the first to abandon its GDP target.[12]

2. Gradually Liberalize the Capital Account

Even after decades of reform and opening, the segregation of the Chinese economy and financial markets from the rest of the world remains significant. Capital account regulation forbids capital from flowing freely across Chinese borders. Such controls artificially shore up domestic Chinese asset prices by limiting domestic savings to chasing only domestic investment opportunities. These distortions spawn asset bubbles, of course, but they also artificially constrain Chinese households and corporate investment portfolios, limiting their returns.

Historically, appreciation in the value of the Chinese yuan has helped to cover up these disadvantageous asset allocations and make up for the foregone benefits of international diversification. But with the yuan gradually reaching its equilibrium exchange rate and now facing *depreciation* pressure, Chinese households and companies increasingly demand to diversify.

Discrepancies in valuation and quality of life have already led many Chinese to invest heavily in overseas properties or even to emigrate to developed economies such as the United States. This is putting greater pressure on the Chinese government to open up its capital account, since there could be an even bigger jump in Chinese demand to invest overseas and a diversion away from the Chinese stock and real estate markets.

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To a certain extent, constraining capital account flows any further in China may cause a time bomb: in other words, it could trigger even greater risks of asset bubbles, or perhaps a financial crisis. To forestall this, the Chinese government should steadily, gradually, and in an orderly fashion open up its capital account.

3. Introduce Asset-Backed Securities

After the 2008 global financial crisis, many came to regard mortgage-backed securities (MBS) and asset-backed securities (ABS) as double-edged swords in modern finance. During their early years, MBS and ABS increased asset liquidity for large stakeholders such as pension funds and insurance companies, while also improving market liquidity in the once dormant fixed income markets. But in time, derivatives on MBS and ABS came to be seen by many as the trigger, or direct cause, of the 2008 crisis.

MBS is of essential importance to China, not least because of the banking sector's dominance in the Chinese economy and financial sector. With an increase in the amount of bank loans for the real estate sector, any shock to property could bring severe shocks to Chinese banks in its wake. To address this problem, the Chinese government should encourage the development of the MBS/ABS market so that a broader group of investors, such as insurance companies, pension funds, private companies, and even foreign investors, could help share the risks in China's financial sector. Securitization likewise could help improve banks' liability turnover and diffuse their losses from nonperforming loans and illiquid capital.

4. Broaden Reform of China's Stock Markets

Chinese stock market reform needs to begin with the transition from an approval-based to a registration-based initial public offering (IPO) process. This would allow all qualified companies to choose the optimal timing and pricing to list their shares, without too much interference from regulators.

Another important reform would be to further legalize short selling. Short selling is known for having the power to help elicit negative information and balance the capital market. And precisely *because* of this effect, it is widely feared by investors and regulators alike as having the power to bring down a market by itself.

Even with the introduction of a series of futures products in China, most notably the CSI 300 Index futures, Treasury bond futures, and an index option, Chinese regulators are still reluctant to let these securities and trading mechanisms play greater roles. That is because they fear a negative impact on the market. Indeed, some of China's earlier reforms that aimed to legalize short selling were suspended after the 2015 stock crash. Thus, years after its introduction in China, the role of short selling remains limited, which has in turn hindered the functioning of Chinese stock markets.

One necessary condition of a well-functioning stock market is that news, both positive and negative, has to be reflected in prices. However, only when *both positive and negative news* are incorporated in a timely fashion into stock prices will information discovery functions operate efficiently in China's A-share market. Such an informationally efficient market could instill greater confidence in the sustainability and long-term value of the A-share market among investors from China and around the globe.

5. Alter the Mandate of the CSRC

The Chinese government needs to set a clearer mandate for the CSRC. Currently, the CSRC shoulders the responsibility for both implementing capital market reform and ensuring the orderly functioning of China's stock markets. Many investors have (mistakenly) interpreted this as equivalent to a mandate to support stock prices. And this explains why Chinese investors often pressure the CSRC whenever there is a big drop in Chinese stock markets, hoping to exert influence that leads the CSRC to launch more favorable policies.

Beijing needs to clarify the CSRC's mandate. The twin goals of ensuring market stability and developing China's financial markets may sometimes contradict each other. It needs to be made clear to investors that financial market development is (or *should be)* the CSRC's more important goal.

6. Enable Bankruptcies

Some argue that recent defaults on corporate bonds, especially corporate bonds issued by Chinese SOEs, are an encouraging sign that China is finally moving to tackle overcapacity and zombie companies by letting them fail. Yet many restructuring and bankruptcies are settled through government arbitration, instead of market mechanisms.

Such excessive government intervention is not limited to the handling of bankruptcies. In fact, recent debt-for-equity swaps in China—undergirded by a new policy mandate—also have worrying implications. Debt-for-equity, which means transferring bank loans for ownership in the debtor, runs against the spirit of letting the market play the "decisive role" in resource allocation, which was an explicit goal the Chinese Communist Party adopted at its Third Plenum in November 2013. Instead, these moves look more like a state sponsored bailout.

Some even argue that such a program has been intended to help distressed SOEs at the expense of state banks. But the fact is, such debt-for-equity programs and the local government debt swap programs, while instrumental in alleviating cash flow shortages for troubled companies and governments, also sent wrong signals to the market.

To some extent, these recent policy moves have reinforced the impression that Beijing will simply step-in and bail out debtors, whenever an important segment of the economy is in distress. To make sure Chinese companies and local governments stick to their financial and fiscal disciplines, clearer rules must to be set as to which entities will be salvaged, and under what conditions. In short, recent policies are not sufficient to persuade investors that the Chinese government's implicit guarantee has expired. The *only* credible way to convince the market of this would be through defaults and bankruptcies. For the debtors, there *will* be short-term pain, but this is ultimately the way a "real" market needs to operate.

At the end of the day, Beijing should realize that prolonged distortion of resource allocation and the pricing of risk will continue to yield bubbles and recession. Steve Jobs' famous statement that "death is very likely the single best invention of life" could be equally applied to the Chinese economy.[13] Only through market-driven destruction of inefficient firms can China's moral hazard problem be solved. Eventually, the restructuring of poorly utilized assets would revitalize the Chinese economy and the country's financial system.

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Endnotes

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