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China's financial system

Red mist

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Who matters in the world's second-largest financial system is barely understood

Illustration by S. Kambayashi

FROM being a rounding error a decade ago, the financial clout of China now trails only that of America. By market capitalisation, it has three of the four largest banks, the two largest insurance companies, the second-largest stockmarket and a lengthening list of investment funds. Yet who makes the decisions in China is barely understood. The government and the Communist Party are intimately entwined with the managers of China's financial institutions. Working out who is really in charge is almost impossible.

Even attempting to do so takes you into sensitive territory. Disclosing information about how the Chinese government works risks violating nebulous secrecy laws or sacrificing business opportunities. Many China-watchers will only speak face to face, concerned about using e-mails or phone calls to discuss what, in the West, would be standard chatter about the status of bankers and their supervisors.

Almost all of the credit for Chinese companies is raised through its commercial banks. The country's bank chiefs are powerful men whose careers have been meticulously managed. But none has the freedom of their peers in the West, not even those managing state-infested firms like Citigroup and RBS. Perhaps the only Western equivalents of a Chinese bank are the two American housing agencies, Fannie Mae and Freddie Mac—vast institutions with political mandates to expand credit, and protection from the consequences of their role in fostering bad debt.

Big credit decisions in China are not advanced by any one bank, nor any one banker. Credit is infused and withdrawn by central diktat. That process has extraordinary appeal to state planners but is horribly inefficient for individual institutions. In recent weeks, for example, as the screws on lending have tightened, favoured industrial companies have been getting urgent calls from their bankers demanding that they immediately scoop up their credit needs for months to come, or be subject to a freeze of uncertain duration. Firms that manage to load up on credit still suffer because they bear interest costs long before the money is actually needed.

"The Chinese banks are pure utilities," says one banker. "The State Council [the government's chief administrative arm] tells them to lend, and they lend." Overt controls increase in line with the amount of credit. Loans above $500m are said to be directly vetted by the State Council.

Something like four-fifths of the assets in the banking system are controlled by 17 institutions. In many ways, China Development Bank is easiest for an outsider to understand. It is vast, run by a powerful government official, **Chen Yuan** (son of Chen Yun, one of the "eight immortals" who created modern China), and supports projects that the government favours. Most of the other big banks are not explicitly run by the government, but regulators attend board meetings and senior management often includes a person with the title "head of discipline", who represents the Communist Party.

Executives are rotated between institutions by government decree. HSBC was stunned in 2006 when **Zhang Jianguo**, the president of Bank of Communications, in which it had taken a 20% stake, turned up as president of a key competitor, China Construction Bank, the country's second-largest financial institution. There was no consultation, nor even notification of the move. China Construction Bank's chairman, **Guo Shuqing**, is rumoured to be in the running for a top political position: the move could have been succession planning. Shifts of this kind have gone into high gear since the start of the year.

Some China-watchers reckon that those bankers who stay in their posts have more chance of developing their institutions into world-class businesses. This group includes **Jiang Jianqing**, chairman of ICBC, the world's largest bank by assets and valuation, and possibly **Ma Weihua**, president of China Merchants Bank, often cited as the most dynamic of the mainland's big financial institutions (despite a ratings downgrade by Fitch this week). Both institutions have been permitted to undertake non-mainland acquisitions. The bidding process, however, remains tightly controlled. ICBC abruptly dropped out of a competition with Merchants to buy Hong Kong's Wing Lung Bank in 2008. The suspected reason? The government's reluctance to bid, in effect, against itself.

Other parts of the financial system are no more transparent. Take the China Investment Corporation (CIC), China's sovereign-wealth fund, which was founded in 2007. For fund managers and companies in search of money, CIC's chief investment officer, **Gao Xiqing**, has become highly sought-after. But just how much autonomy Mr Gao has is uncertain. CIC's chief executive, **Lou Jiwei**, told a conference in Hong Kong on January 20th that two things would improve his organisation: more freedom from foreign authorities to make investments, which would doubtless be fostered by his second wish, more freedom to manage itself.

AP

Ring Wang

For many firms, ties to government are considered their greatest asset. The seed capital for China International Capital Corporation (CICC), which dominates domestic underwriting activity, was provided by Morgan Stanley back in 1995. But Morgan has since been squeezed out of a hands-on role. CICC is now run by **Levin Zhu**, son of Zhu Rongji, a former prime minister. Two CICC alumni, **Wu Shangzhi** and **Fang Fenglei**, run what are described as the most important private-equity firms in China—CDH Investments and Hopu Investment Management, respectively.

In this kind of system, big decisions are funnelled upwards to a very small group of people. Technically, the banks fall under the auspices of **Liu Mingkang**, chairman of the China Banking Regulatory Commission. Interest-rate and exchange-rate decisions come under **Zhou Xiaochuan**, head of the People's Bank of China, and a former director of the State Administration of Foreign Exchange, now run by **Yi Gang**. But their official titles both overrate and underrate their authority. Mr Liu and Mr Zhou are likely to be involved in innumerable decisions that would be considered private matters outside China. It is unlikely that lending rates or credit policies could be shifted without their input. Both provide an intellectual foundation, through papers and speeches, for China's actions.

Even so, in the shifting currents of power, many believe the critical hand is played by **Wang Qishan**, the vice-premier responsible for the financial sector, a former mayor of Beijing and former head of China Construction Bank. Unlike Mr Zhou and Mr Liu, Mr Wang rarely comments publicly. But he is a critical conduit for bankers inside and outside China, directly oversees the People's Bank and is a member of the Politburo, the government's chief political arm. He also serves on three big regulatory commissions covering insurance, banking and securities.

When the government is pondering a new policy—expanding China's financial ties to Africa, say, or the creation of a futures market—Mr Wang is the one who calls in foreign bankers for consultations. They do not say no. During the depths of the financial crisis, when money was being sought for Morgan Stanley from CIC, Hank Paulson, then America's treasury secretary, called Mr Wang for his blessing (and got a lukewarm reception).

Technically, only **Wen Jiabao**, the prime minister, sits above Mr Wang in economic matters. But when it comes to financial decisions that China perceives to be particularly sensitive, such as exchange-rate movements, stimulus spending or even large financial transactions, the standing committee of the Politburo—the nine most senior leaders of China, including President **Hu Jintao**—can take up the matter. At some point the sheer complexity of China's economy will preclude China's top leaders from serving, in effect, as an elevated credit committee. But that time has yet to come.

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Chinese banks

Rot in the vaults

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Problems loom for China's newly refurbished banks

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THE mainland's banks have never looked in better shape. On April 6th China Construction Bank, the country's third-largest lender, reported its results for 2005. Although net income dipped a bit, operating profit (a better reflection of its underlying business) rose by 17%, boosted by robust loan growth in a booming economy. The bank's shares have risen in price by more than half since it listed in Hong Kong last October, the first of the "Big Four" state banks to do so. Meanwhile, the share price of the smaller Bank of Communications (BoCom) has doubled since listing last year. No wonder that Industrial and Commercial Bank of China and Bank of China (BoC), another two of the Big Four, are as eager to sell shares this year as foreign investors are to buy them.

Reality, though, is less rosy than it appears. The banks look healthy largely because of repeated capital infusions, initially from the Chinese government but latterly also from foreign strategic partners and the capital markets. Moreover, the bad loans sluiced overboard in past bail-outs look as if they are being replaced by a new wave. China's rapid growth may be producing good-looking profits today, but it is storing up problems for tomorrow.

The biggest threat is overcapacity in almost every industry. Take steel, a big client of the state banks. China's rapacious demand drove steelmakers' profits from 5 billion yuan ($600m) in 1999 to more than 125 billion yuan last year. This triggered a surge of investment in new plants—worth 650 billion yuan in the past five years, two-thirds of it financed by the state banks. Today China has excess steelmaking capacity of 120m tonnes, or a third of its output. "No other country even produces 100m tonnes of steel—and that's China's excess," marvels Nicholas Lardy, a senior fellow at the Institute for International Economics in Washington, who put the numbers together. The result is plunging returns. In the first two months of 2006, the steel industry's profits were 75% lower than a year before. On March 30th Baosteel, China's biggest producer, reported its first quarterly drop in net profits in more than three years. Stocks of steel are expanding and cashflow is drying up. Despite signs that global steel prices may be picking up, many steelmakers will find it hard to pay back the loans they took out to finance their expansion.

This overcapacity—and declining profits—is repeated in many industries, from power generation to cement, coke, aluminium, car parts and luxury property. All told, the banks face a fresh burst of bad loans, says Mr Lardy: "This could erase some of the very hard-won progress in bank reform in the last eight years." The concerns go right to the top. At the annual meeting of China's parliament in March, Wen Jiabao, China's prime minister, pointed to a growing risk to the banks from a build-up of inventories.

Yet while the government has tried to curb investment in some industries, in others its foot remains firmly on the accelerator. It plans to splurge 2 trillion yuan on railways, including several new subway lines in Shanghai, in the next five years; to build 24,000 km (15,000 miles) of expressways by 2010; and to have 30 nuclear power stations by 2020, against nine now. Much of this will be financed by the banks, and not all with state guarantees. Dong Tao, chief Asia economist at Credit Suisse, thinks a lot of it will not be commercially viable: "The returns will not be high. There will be a lot of new pressure on the banks."

Nor can the banks rely on new consumer spending to bail them out. Although pundits have been hailing the emergence of the Chinese consumer for years, net new household borrowing declined in 2005, estimates Mr Lardy, and accounted for less than 15% of net bank lending. Last year, for the first time in nine years, the share of bank loans to households failed to grow.

These threats would be worrying enough if the banks had learnt how to lend properly. But they haven't. A new working paper by economists at the IMF finds that the big state banks still do not price their loans according to either the riskiness or the profitability of the borrower. An embarrassing tale last month of five officials at a remote branch of BoC, who embezzled 430m yuan, is further evidence that old, bad habits remain. Behind their newly burnished facades, China's banks still carry rot within.