“China’s Quest for Capital: Motivation, Methods, and Implications”
Testimony before the U.S.-China Economic and Security Review Commission
Brian W. McCarthy, Managing Principal, Macrolens llc
January 23, 2020

Today’s testimony will cover various aspects of China’s evolving system of corporate finance.

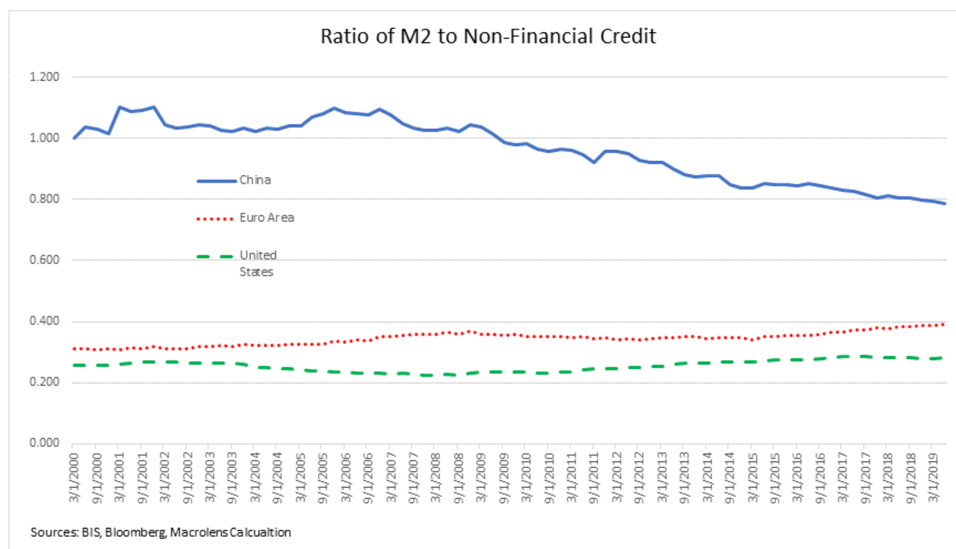
While on the surface the system appears to be undergoing a period of rapid transformation, an underlying reality of China’s system of economic management remains the driving force for “change:” **the Chinese Communist Party has no intention of surrendering its control over the allocation of capital to market forces**.

- Credit markets remain bank-dominated and State-entity focused
- The recent push to increase lending to SME’s is just a pivot in the central plan
- Increasingly vibrant equity markets provide a bastion for market-based capital allocation, but within strict confines
- Increased openness to foreign investment is driven not by a desire to marketize, but by China’s macroeconomic and geopolitical predicaments

China’s Credit Markets are Bank-Dominated

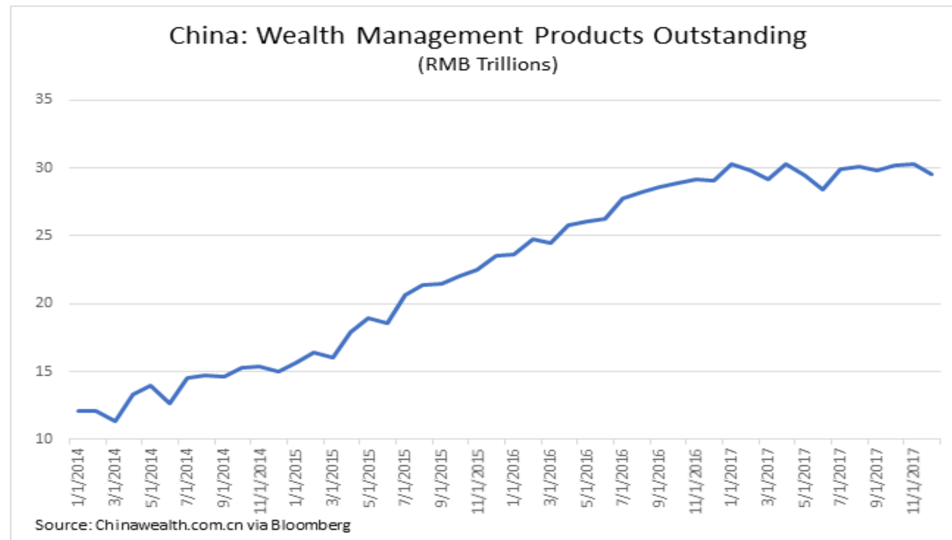
Aside from the centrality of bank lending in Chinese corporate finance, **banks are also predominant buyers of all form of bond issue** – central government, local government and corporate

- As a result, some 80% of credit extended is financed through the creation of bank deposits:



Shadow Banking is in Dry Dock

China's credit markets are unlikely to continue the trend towards increased non-bank intermediation, as regulators have put the brakes on expansion of so-called "shadow banking."



- Overt and implied linkages to banks rendered most non-bank financial products subject to the public's belief in implicit guarantees.

- This left the state ultimately responsible for losses on such products, but without the degree of oversight they wield over on-balance sheet activities.

- The combination of implicit guarantee with limited oversight rendered continued expansion of non-bank credit untenable from a systemic risk standpoint. The government was writing black checks to fund risky behavior.

- Regulators are in the process of rolling out new regulations by end-2020 to transform Wealth Management Products from off-balance sheet slush funds into genuine stand-alone asset management products. Proposed changes include:

    - Restrictions on investments in "non-standard assets" (ie. loans)
    - Restrictions on "pooling of assets," by which WMPs would finance a portion of an amorphous pool of assets rather than a list of specific assets
    - A firm pledge that funds will "stand alone" with no form of explicit or implicit guarantee

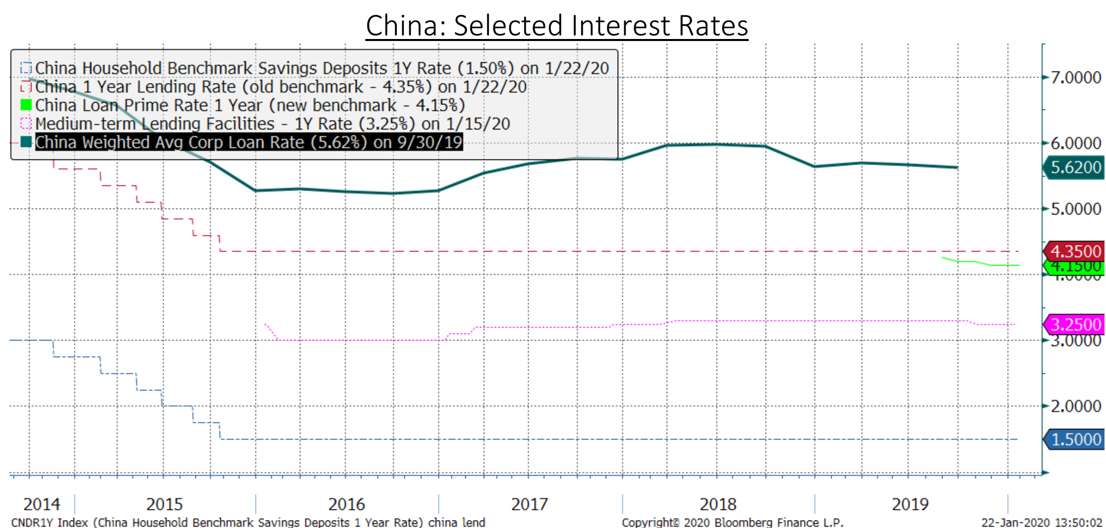
- "No battle plan survives contact with the enemy." **Extreme skepticism is warranted towards the pledge to eliminate moral hazard from this sector**.

- Until the existence of credit risk is firmly established, Chinese policymakers are **unlikely to**

sanction renewed expansion of Wealth Management Products and other "shadow banking" channels of credit provision.

Is the New Benchmark Lending Rate a Significant Reform?

Late last year, the PBoC began a phase-out of the administered "benchmark lending rate" in favor of a purportedly market-based Loan Prime Rate, based on fixing submissions from 18 Chinese banks specifying their lending rate to prime borrowers, expressed as a spread to the rate on the PBoC's "Medium Term Lending Facility" – a primary PBoC funding facility.



- As with the PBoC's purportedly market-based daily fixing for the USDCNY rate, it should be anticipated that **PBoC will either window-guide or simply jury rig the fixing** to its liking.

- The objective seems to be to squeeze net interest margins under the guise of "market competition." Yet, the **room for a reduction in lending rates is limited**:

    - With M2 at 201% of GDP and 925% of FX reserves, further cuts in administered deposit rates **risk exacerbating capital flight** pressures.
    - Aggressive reduction in lending rates absent deposit rate cuts would compress net interest margins and **further stress a banking system** struggling to remain adequately capitalized, amidst a gathering NPL problem and the need to continually increase lending by double-digit rates.

Private Sector Borrowing Squeezed from All Sides

In late 2018, Authorities became seriously concerned about the plight of non-state corporate borrowers who were being squeezed from all sides:

- **Loan supply**: "shadow banking" – now constrained - had served as a key conduit for credit to non-state borrowers, largely crowded out of official channels by politically connected and implicitly guaranteed State-owned Enterprises.
- **Loan demand**: unlike state actors, private sector actors must be cognizant of repayment ability. With the nominal GDP growth rate slowing towards (and in many cases through) the nominal borrowing rates available to private borrowers, loan demand shriveled.
- **Growing accounts receivable**: payment delays (frequently from SoE to private company) extended significantly throughout 2017 and 2018.

In response, PBoC took several measures in late 2018 to spur lending to private small and medium-sizes enterprises:

- Introduction of the TLMF – Targeted Medium-Term Lending Facility – to provide term funding at the MLF rate less 15 basis points to banks meeting targets for the growth in loans to SME's and private businesses
- Targeted reduction in the Required Reserve Ratio (RRR) for banks meeting SME lending targets
- With carrots failing to do the trick, Prime Minister Li Keqiang wielded a stick in his 2019 work report delivered in March of 2019, announcing a **central target of 30% growth in loans to SMEs** (defined as firms with credit lines of less than RMB 10m). This implied some RMB 2.8bn in new financing to SME's in 2019.

As it turns out, the PBoC can declare victory in having generated a 41% increase in "inclusive financing" to SME's in 2019 (although some analysts allege that they moved the goal posts by redefining the SME lending metric).

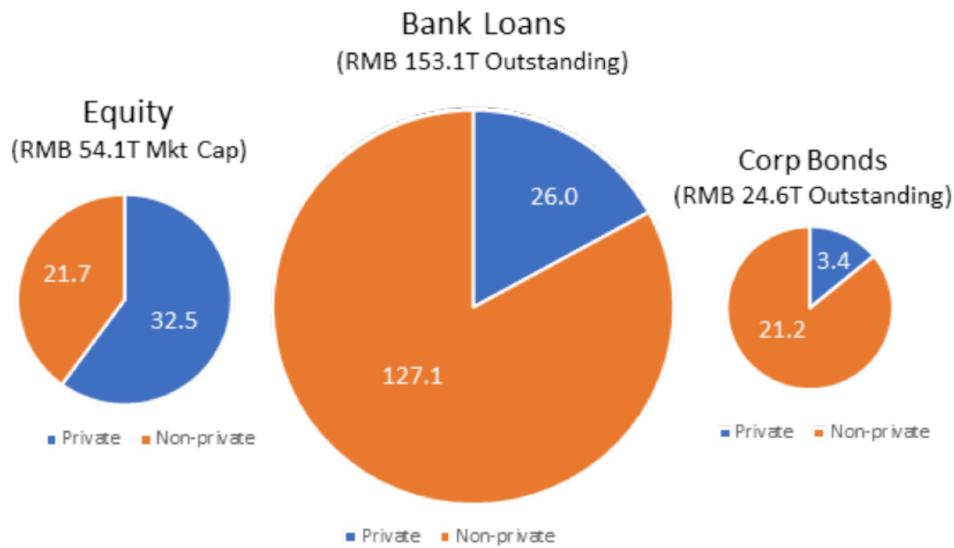
The jury is out as to whether this centrally-commanded push into private sector lending will rekindle entrepreneurial activity or simply cause further distortions which emerge as problems elsewhere in the ongoing game of systemic whack-a-mole. Anecdotally, reports are not positive, with a rash of private firms bailed out from failed share-pledging schemes in late 2018 already relapsing into default, and a sharp increase in the number of private firms being sold to SOEs.

In sum, China's push to increase lending to private companies, whether well-intentioned or simply an imperative of systemic risk-control, is **unlikely to rekindle animal spirits in a way that might improve capital allocation efficiency**.

Equity Markets: Vibrant and Growing, but a Systemic Pip Squeak

Chinese equity markets provide a bastion of market-based financing to entrepreneurial China. While these markets are large in absolute terms, they remain dwarfed by China's massive (and rapidly expanding) credit markets as a source of funds for Chinese enterprises. Also, doubts remain as to the degree to which Chinese policymakers will sanction market movements that run counter to policy objectives, as well as to the level of capital-allocation efficiency Chinese equity markets can achieve in the absence of a free press and rigid accounting standards.

- Equity markets (by market cap) are the least State-dominated asset market in China:



Source: Pensions & Investments, *The Value in China's SoE's*, 3/7/19, PBoC, Fitch Estimates, Macrolens Calculations

- But volumes of funds raised remain a fraction of that sourced through bond issue and bank borrowings:

China recently enacted long-awaited amendments to its Securities Law (with effect March 1), intended to modernize the IPO approval process and improve accessibility of equity financing. Changes include:

- **Shift to a "registration-based" IPO process** intended to simply and shorten the onerous approval process currently in place
- **Stricter disclosure requirements** and heavier punishment for breaches of such rules
- **Removal of the "sustainable profitability" requirement** seen as a critical hurdle to the financing of newer businesses

On balance, these reforms should increase the attractiveness of onshore listings relative to listing in the U.S, Hong Kong or elsewhere.

Despite the improvements in market access and infrastructure, questions remain about the compatibility of Communist Authoritarianism with an efficiently functioning equity market.

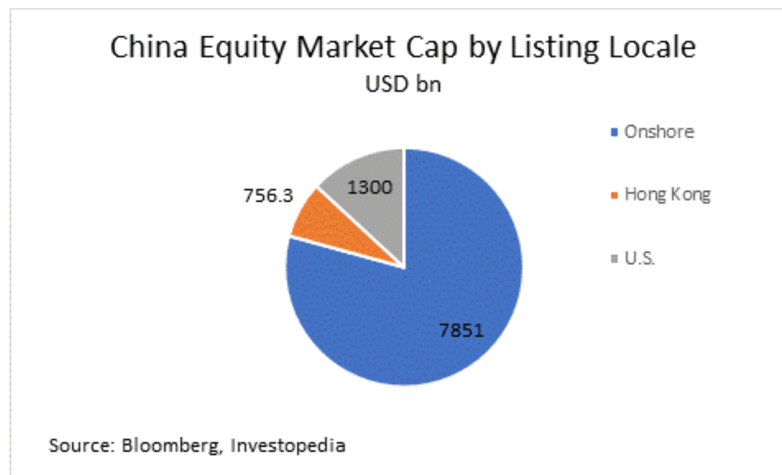
- **More than 1,500 onshore-listed stocks – over half of the universe - were suspended** at some point during 2015's market tumble. Regulators have made vague pledges of having tightened requirements for suspension and shortened (to three months) the allowed timeframe. But **investors remain wary** as to whether any pledged improvements will survive the next market downturn
- **Speculative investors dominate** onshore equity markets for various reasons (some of which were highlighted by Peking University's Michael Pettis in a recent Financial Times piece):
    - unreliability of both financial statements and macroeconomic economic data
    - The prevalence of domestic propaganda and a heavily restricted internet
    - Government intervention in the economy is dominant yet unpredictable
    - Signals from offshore are repressed by capital controls

Evidence of market inefficiency can be found in the **wide valuation premium of A-shares** to their dual-listed equivalents in Hong Kong, which has persisted despite the 2014 opening of the HK-Shanghai Connect, which provides easy access to arbitraging this valuation discrepancy.

Access to Foreign Capital both Onshore and Offshore

China's access to and integration with pools of global capital remains limited, but is experiencing rapid growth. Offshore capital raising by Chinese entities is generally driven by restricted access to domestic capital or a desire to source U.S. Dollars, while foreign investor participation in China's markets is being driven by macroeconomic prerogatives of the Chinese government. In neither case is the evaluation of relative risk and reward by market participants the driving force.

Listing on U.S. equity exchanges has been a significant source of financing for Chinese companies historically, but is likely to shrink in importance.



- As noted above, accessibility to onshore equity capital should improve, particularly for companies yet to achieve consistently positive earnings – historically an important factor driving Chinese companies overseas
- U.S. markets are becoming less hospitable to Chinese listings, with the Nasdaq already tightening listing standards and slowing approvals and legislation such as the Equitable Act likely to tighten standards for Chinese listings, in particular by forcing Chinese companies to allow the Public Company Accounting Oversight Board access to audited financials.
- One motivation for U.S. listings should remain strong – the desire of Chinese entrepreneurs to cash out in U.S. Dollars, access to which is becoming increasingly restricted

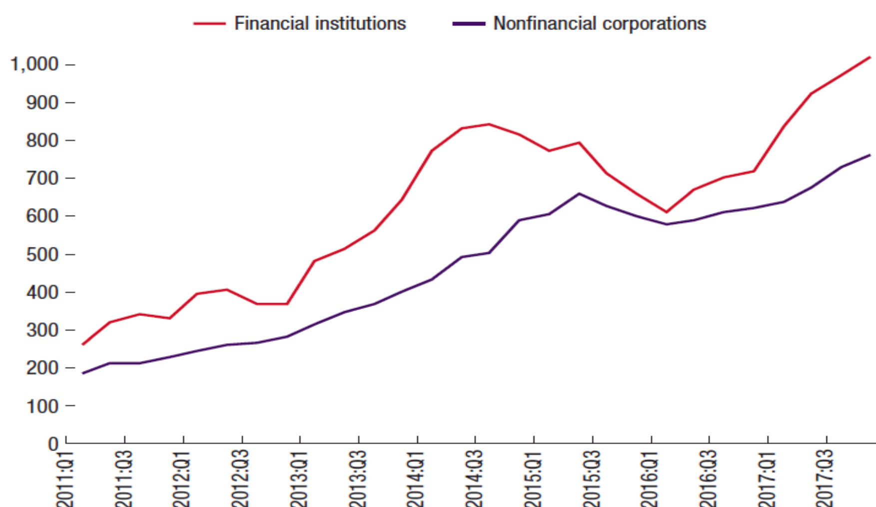
Chinese banks and corporates have also been active participants in offshore Dollar-denominated bond markets in recent years. Motivations for Dollar-borrowing include:

- Access to finance for Chinese property companies who are frequently restricted in onshore borrowing in the attempt to curtail speculative real estate activity. Property companies were also heavy users of onshore Trust Products and other means of "shadow financing" that has been curtailed in recent years. Chinese policymakers benefit in

driving property borrowing offshore in two ways: Dollars sourced are repatriated, helping to support the deteriorating balance of payments, and a prevalence of Dollar financing will “outsource” some measure of the financial disturbance when domestic property markets inevitably cool

- Chinese banks are heavy borrowers of Dollars, presumably to fund the acquisition of Dollar assets. Financing of the Belt and Road Initiative is a likely driver of demand for Dollars by Chinese banks.

Figure 16.1. Offshore Bonds Outstanding, First Quarter 2011 to Third Quarter 2017
(Billions of US dollars)



Source: Bank for International Settlements.
From: The Future of China’s Bond Market, IMF, March 2019

China’s borrowing of U.S. Dollars is a **growing source of systemic risk transmission** from China to the rest of the world.

- Currency mis-matched Dollar borrowing by Chinese property developers is the epitome of “wrong way risk,” as an eventual bust in Chinese property markets will undoubtedly be accompanied by RMB devaluation
- Chinese banks are likely currency-matched but badly duration-mismatched. Borrowings are generally short term (including, by my estimate, some $500bn in borrowing via FX swap contracts, not included in the chart above) while the Dollar-denominated assets are likely of extremely long (if not infinite) duration – i.e. loans to Emerging markets with questionable ability to pay collateralized by immovable infrastructure.

Another rapidly growing source of systemic risk transmission is foreign investor participation in Chinese onshore bond and equity markets which is being aggressively encouraged by the Chinese government, providers of stocks and bond indexes, and global banks.

From: Bloomberg News

The glaring problem with China's capital market opening is that it is **one-way** in nature. That China must continually tighten restrictions on the outflow of capital is **ipso facto evidence of a disequilibrium condition** in China's asset markets and/or its currency. In layman's terms, if Chinese asset were not overvalued in common currency terms the Chinese government would not have to outlaw the sale of domestic assets for foreign currency.

While index providers might rightfully claim that it is not in their remit to judge the valuation of any respective asset market, investors who are benchmarking to indexes which are increasing their weightings towards China should be fully aware that they are being piled into China asset markets **on top of domestic investors that are effectively prohibited from selling**. Caveat emptor.

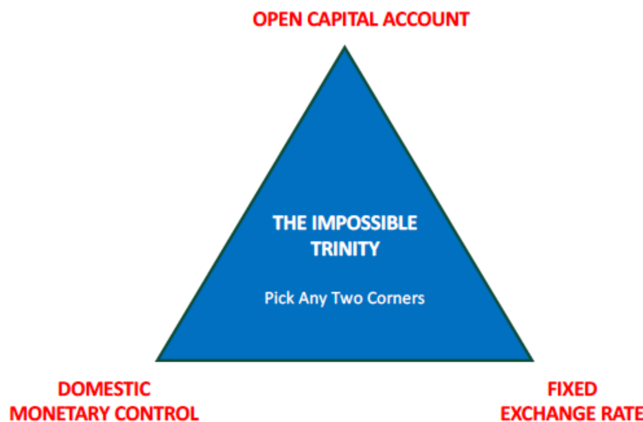
China's objective in welcoming foreign capital is twofold

- Alleviate the Dollar shortage resulting from a policy of "FX rationing"
- Expose the rest of the world to China's risky financial system so as to render it globally "too big to fail"

While a deeper analysis is beyond the scope of today's testimony, I'd like to briefly outline the source of China's increasing "Dollar shortage," to illustrate how the opening to foreign capital fits the overall macroeconomic objectives of the CCP.

The Impossible Trinity and China's "Dollar Shortage" Problem

The "Impossible Trinity" is a basic arbitrage model of global capital flows and exchange rate determination that encapsulates China macroeconomic dilemma.



- In the presence of an open capital account, arbitrage flows dictate that domestic monetary policy and the level of the exchange rate must remain market-compatible
- Policymakers must choose two of the three variables

Growing tension between the **domestic requirement for easy liquidity** in support of the credit bubble and the official desire to maintain **control of the exchange rate** is the force behind China's increasingly **tight control over capital flows**.

However, contrary to the popular impression, **China does not actually have effective controls on capital**. With over one million domestic firms licensed to trade foreign exchange for purposes of trade settlement, and gross trade flows exceeding $4T per year, it is simply **impossible for China to disentangle elicit capital flows** from the massive volume of FX trading that is necessary to accommodate China's foreign trade.

This was in evidence in 2015-16, when China lost $1T in FX reserves in defense of the currency **despite de jure capital controls**.

Defending the RMB through sterilized intervention rapidly became untenable (and was ineffective to boot). While it's commonly said that China has subsequently "tightened capital controls," this is technically inaccurate. As noted, the capital controls don't really work.

No, leadership's solution to was approach common to its form of top-down authoritarianism: command that the desired end result be obtained and worked backwards from there.

Chinese authorities deiged to make "impossible trinity" possible. With domestic monetary conditions remaining incompatible with the RMB's soft peg to the Dollar, and capital controls proving ineffective, authorities simply **commanded that foreign exchange flows be balanced**. Access to foreign currency from within China would be limited by the volume of foreign currency coming into China, and doled out by prerogative of the domestic banks. **What goes out is limited to what comes in**. Voila: balance.

The logical outcome of this policy constellation – easy domestic liquidity, a fixed exchange rate, and forced balance in FX trading – is that **China's policy disequilibrium is now manifest in a shortage of availability of foreign exchange** – i.e a "Dollar shortage." Yes, the FX flows may balance, but since that is not a market-determined outcome, it does not necessarily indicate that the economy's needs for FX liquidity – for imports, for financing BRI and other foreign investment, for satisfying the "diversification" demands of the moneyed elite – are being sufficiently met.

In this light, the objectives of China's "one-way capital account opening" become obvious. Far from desiring to foster a more efficient market-based allocation of capital, **China's welcome mat to foreign investors is meant to forestall a reconciliation of the contradictions in China's macroeconomic policy settings,** by alleviating the growing shortage of FX liquidity.

Lastly, it would be my contention that China's efforts to increase foreign investor exposure to Chinese debt and equity assets are also intended to foster greater integration in order to **reduce the risk of "decoupling"** in trade and finance. China's moves to open its domestic financial markets to greater participation by global banks and non-bank finance companies works in a similar direction. (As an aside, so does a policy of coerced Chinese purchases of U.S. farm product and manufactured goods).

Five years ago I was arguing that while China's credit bubble was gargantuan, it was largely self-financed, and the fallout from a Chinese financial crisis would prove eminently containable. Save for the inevitable market adjustment resulting from an RMB depreciation, direct financial linkages at that time remain limited.

I am no longer so sanguine. With each passing day we are increasing the vulnerability of the global financial system, and the exposure of U.S. investors, to a Chinese financial system that **at its core is not market-based**.

Markets inevitably tend towards equilibrium. Like water building behind a faltering damn, market pressures in China have been long resisted by increasingly heavy-handed policies. The pressures continue to build, only temporarily relieved by the index-driven flow of foreign capital into China.

Policy Recommendations and a "Silver Bullet"

We should not counter Chinese policy missteps in finance by emulating them, as we seem to be doing in trade, with the "Phase One" formulation of centrally-directed purchases of U.S. goods. While it would be tempting to consider restricting U.S. portfolio investment to defend the market-based system of global finance from the distortions inevitably to arise from integration with China, that would be anathema to the market-based system itself. **We cannot abandon market-based capitalism in order to save it**.

There are of course some common-sense actions that can be taken:

- Pass the Equitable Act to bring the listing standards for Chinese companies into line with that applied to domestic companies
- Assure that index-inclusion decisions are made behind "Chinese walls," so that Chinese authorities cannot either dangle carrots or wield sticks over associated business lines as coercion
- Encourage index providers to offer ex-China versions of all benchmark indices under the rubric of sound Environmental, Social and Governance (ESG) policies

These are of course but palliatives. Today I propose a "silver bullet" solution to the imbalances and distortions fostered by China's non-market practices.

The United States should reduce its "Phase Two" demands on China to one: allow the free movement of capital.

Restricting the ability of the Chinese citizenry to "vote with its wallet" is the **cornerstone market distortion** that enables all others. The "forced savings" which has financed all manner of Chinese subsidy and market-distorting practice becomes impossible to marshal in the existence of a liberalized capital account.

Of course, opening China's capital account is not costless! A large RMB devaluation would result, necessitating a period of long-overdue global adjustment. That this immediately strikes one as entailing a near-impossible to endure level of global financial instability illustrates how **badly corrupted the system of global trade and finance has already become** as a result of China's persistent prevention of economic equilibrium via brute force policies unsanctioned by democratic consensus.

In allowing a large, centrally-planned Chinese economy to become increasingly integrated into the global system, we resign ourselves to persistent macroeconomic disequilibria, which we seem increasingly tempted to offset with market distortions and central plans of our own.

Removing this linchpin of Chinese central planning is the key to restoring a market-based system of global trade and finance - one that will tend towards equilibrium as designed, and perhaps save the system from having to defend itself from China by emulating it.