

HOW IMPLICIT GOVERNMENT SUPPORT
HAS PROPELLED CHINA'S ECONOMY
WHILE CREATING SYSTEMIC RISK

CHINA'S GUARANTEED BUBBLE

PROFESSOR NING ZHU

WITH A FOREWORD BY ROBERT SHILLER,
NOBEL LAUREATE IN ECONOMICS

A WAKE-UP CALL FOR CHINA, THE ECONOMY, AND THE WORLD

"The book is a call for action....Everyone interested in finance and human folly, in China and in global macroeconomic and financial prospects should read this book—but not just before going to sleep."
—**WILLEM H. BUTTER**, Global Chief Economist, Citi Group

"Professor Zhu Ning's book provides a lively depiction of the prevalent 'implicit guarantee' in Chinese financial sector and economy, and its impact on the Chinese economy.... This book is a great read for regulators, financial institutions, and investors around the globe."

—**FRED HU**, Chairman, Primavera Group Formerly,
Chairman, Goldman Sachs (Greater China)

"A fascinating description and analysis of credit systems in contemporary China.... Zhu analyzes challenges in constructing and administering a credit system that efficiently allocates resources to socially worthy investments in ways that protect savers."

—**THOMAS J. SARGENT**, Professor of Economics,
New York University; and Nobel Laureate in Economics, 2011



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Prior to coming back to Asia and founding SAIF, he was a tenured professor of finance at the University of California. During his time in the private sector, he has held leading positions at Lehman Brothers and Nomura Securities. He commands extensive experience as a consultant to regulators, government agencies, and financial institutions around the world.

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CHENNAI'S GUANTHEED BUBBLE

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China's Guaranteed Bubble

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For my family

Praise for *China's Guaranteed Bubble*

Professor Ning Zhu's book *China's Guaranteed Bubble* explains the drivers behind the massive excess capacity in China's traditional industries, the explosive growth of credit and of corporate and local government debt and the efforts (only partly successful) by the state to protect savers and investors—households as well as private and public corporates—as well as households against the consequences of unlucky, unwise and reckless investment decisions.

A culture of pervasive implicit state guarantees has led to state support of stock prices, house prices, and wealth management products. Insolvency, bankruptcy, debt restructuring, bail-ins of unsecured creditors and other laws, rules and procedures to limit moral hazard are applied reluctantly, rarely and late. “You break it, you own it,” is not part of the cognitive “acquis.”

The book is also a call for action. Unless the Chinese authorities clean up the current leverage and excess capacity mess and end the culture of implicit guarantees that created the boom, bubble and bust (and will ensure their recurrence), China faces the near-certainty of a serious financial crisis and a post-crisis zombified financial system.

Everyone interested in finance and human folly, in China and in global macroeconomic and financial prospects should read this book—but not just before going to sleep.

WILLEM H. BUTTER

Global Chief Economist, Citi Group

China cannot “let the market play a maximal role in allocating resources” without market discipline. Professor Zhu Ning's book provides a lively depiction of the prevalent “implicit guarantee” in the Chinese financial sector and economy, and its impact on the Chinese economy, culture of credit, debt crisis, and financial stability. This book is a great read for regulators, financial institutions, investors around the globe.

FRED HU

Chairman, Primavera Group

Formerly, Chairman, Goldman Sachs (Greater China)

Ning Zhu's *China's Guaranteed Bubble* is a fascinating description and analysis of credit systems in contemporary China—a network of private and state-owned businesses, banks, shadow banks, governments in various regions and

cities, and households borrowing and lending to one another, sometimes explicitly, sometimes implicitly. Zhu analyzes challenges in constructing and administering a credit system that efficiently allocates resources to socially worthy investments in ways that protect savers.

THOMAS J. SARGENT

Professor of Economics, New York University

Nobel Laureate in Economics, 2011

China's economy faces a huge transition challenge. Rapid growth has in the past been driven by a hybrid model which combines elements of competitive market discipline with a financial system shot through with implicit guarantees and rapidly rising leverage. But as Zhu Ning's book makes crystal clear, that model has reached its limit, and now threatens to produce inefficient resource allocation and increasing instability. The new growth model now required must combine a reformed financial system, hard budget disciplines in which default plays an appropriate role, and a still important but transparent role for the Chinese state. Zhu Ning's book is an excellent empirical and theoretical guide to the complex challenges which this reform programme must overcome.

LORD ADAIR TURNER

Senior Fellow, Institute for New Economic Thinking

Former Chairman, Financial Services Authority, Great Britain

Preface

Preventing the Guaranteed Bubble

The financial or speculative *bubble* has been arguably one of the most studied and yet least understood areas in economics.

China has been arguably the fastest growing and yet least understood economy in the world over the past several decades.

By utilizing a large army of cheap labor, unleashing labor productivity and entrepreneurship, and increasing capital inputs, China has accomplished astonishing economic miracles over the past three decades. Such economic growth has not only drastically improved the standard of living in China, but also jump started Chinese economic, political, and military influence around the globe.

After some fundamental restructuring in the world's economic and financial systems in the wake of the 2008 global financial crisis, and with increasing labor costs, diminishing investment return, worsening environmental conditions, and diminished natural resources, China's economy is currently facing unprecedentedly complicated and challenging situations.

Begun in early 2014, this book intends to examine economic growth in China from the perspective of the government providing implicit guarantees. Government guarantee, which has provided tremendous and highly valuable impetus to Chinese economic growth during the past three decades, is also largely responsible for the challenges China currently faces. By reviewing the potential risks involved in government guarantees in many different forms, the current book proposes potential solutions that will help China's sustainable, high-quality economic growth in the long run.

With slowing economic growth, diminishing corporate earnings, and as small- and medium-sized businesses find it increasingly difficult to access financing, China's government and its corporations and households have witnessed considerable increases in their respective leverage ratios in recent years. China's debt trouble has attracted more and more attention from governments, scholars, corporations, and investors from around the world.

In the short term, debt financing has the clear advantages of lower financing costs and easier financing procedures and has the potential to catapult the growth of enterprises and even countries.

However, the potential for default and bankruptcy and the substantial costs and reputational damage both involve should limit the debt capacity of any enterprise or country. In some sense, the lost decades of Japan's economy, which used to be the largest in the world some twenty years ago, and the bursting of the twin Japanese housing and stock market bubbles, were consequences of over-leveraging by Japanese corporations and households during Japan's booming '70s and '80s.

As in Japan, banks dominate the Chinese financial sector. Even though the Chinese bond market remains relatively underdeveloped compared to that of Japan or even to its own stock market, there has been a lot of development of "bond-like" investment products in China lately. The fast development of trust products, wealth management products (WMPs), and many products sold by the so-called internet finance platforms, all bear close resemblance to fixed income products in countries with more developed financial markets, such as the U.S.

Unlike the fixed income products offered in the West, many of these "bond-like" products in China carry implicit guarantees from their underwriters, the regulators, and, in the end, the Chinese government. Many investors believe that, as long as the financial institutions are concerned with their reputations, as long as the regulators are concerned with career advancement, and as long as the Chinese government is concerned with social stability, they will take care of the risks that investors themselves should bear when investing in such products.

The investors, on the other hand, need only concern themselves with the high returns offered by such products and to chase products with even higher returns. Such a "heads I win, tails you lose" mentality, is largely responsible for aggressive speculation throughout the Chinese investment arena, such as the housing market, the stock market, the shadow banking markets, and the newly developed "internet finance" field, and eventually will cause asset prices to rise far above their fundamental values and lead to a bubble.

What is more worrisome is that, during the recent past, the financing of local government and local government financing vehicles (LGFV) has heavily relied upon land sales and real estate development in the form of trust products and wealth management products (WMP) with implicit guarantees. Many products that originally were of high risk and had unpromising returns turned into "safe" and attractive investments with the help of financial structuring and in the guise of shadow banking products.

As Chinese investors see through to the implicit guarantee behind these products, they come to believe that the government will take responsibility for the risks that they themselves take when making these investments and therefore decide to actively invest in such products regardless of the risk.

If these products should lose their implicit guarantee from the government, or if one day the government cannot afford to provide such support any longer, the Chinese shadow banking sector, the high returns that investors have been enjoying, the cheap cost of capital many SOEs and LGFVs have been relying on, will all be seriously impacted, casting dark clouds over China's economic growth and its economic growth model transition.

Furthermore, the challenges currently facing China's economy, such as the slowing down of economic growth, serious overcapacity in many sectors, escalating debt at SOE and local governments, excessive volatility in many investment fields, may all be explained by the Chinese investor's willingness and audacity in taking excessive risks and speculating over the past few years. In some sense, the difficulties the Chinese economy is facing right now are indeed direct consequences of the bursting of certain previously created bubbles that were caused by implicit guarantees in the past few years.

The government's good will in seeking to grow the economy, highly effective in reaching the goal of high speed economic growth in the short term, nevertheless shifted the risk preference of investors and enterprises along with the social allocation of risk and capital, the tradeoff between return and risk, and the balance between short-term and long-term objectives. Many of the dilemmas in the Chinese financial sector, such as the difficulty SMEs face in obtaining capital, capital shying away from industry and flowing into investment and speculation, and many mini-bubbles that have burst and will eventually burst, are all merely the tip of the iceberg of the "guaranteed bubble" phenomenon prevalent in the whole country, and in some senses the entire world.

On the one hand, it is understandable that the speed of economic growth still matters dearly to further reform in China, to the improvement of Chinese well being, and to the enhancement of China's international status. On the other hand, the dictum "let the market play a decisive role in resource allocation," as mandated by the 3rd Plenum, means that investors have to (learn to) take responsibility for the risks entailed in their own investment decisions and that the government must gradually taper off its implicit guarantees to various enterprises and investments.

Only when investors are allowed (and required) to take responsibility for risks in their own investing, without the influence of various forms of implicit and explicit guarantee from the government, can investors set proper expectations for the rate of economic growth and for investment returns. It is not until that happens that the market can truly play its decisive role in screening and monitoring, and in efficiently allocating resources and capital.

Otherwise, once the expectation of "the guaranteed bubble" is formed and reinforced, investment speculation and mis-allocation of resources and capital will only become worse. In order to truly let the market play a "decisive" role

in allocating resources, it becomes imperative for the Chinese government, and governments around the world, to gradually wind down their guarantees.

As the borderline between the state and the market, the tradeoff between risk and return, and the balance between present and future become transparent and clearly defined, the overcapacity, worsening debt, deteriorating SOE performance, SME financing difficulties, and the resulting mounting systematic financial risks, will all gradually get resolved.

Professor Robert J. Shiller, my advisor, friend, and colleague at Yale University, has offered constant encouragement and assistance in the writing of the book. I have also benefited considerably from many discussions with Thomas J. Sargent (New York University), Eswar S. Prasad (Cornell University), William N. Goetzmann (Yale University), Adam Tooze (Columbia University), Harry Xiaoying Wu (Hitotsubashi University), Yiping Huang (Peking University), Sen Wei (Fudan University), Deborah J. Lucas (M.I.T.), Harrison Hong (Princeton), Wei Xiong (Princeton), Adrienne Cheasty (the IMF), David W. Wilcox (The U.S. Federal Reserve Board of Governors), Adam S. Posen (The Petersen Institute), and members of the Global Agenda Councils on the European Debt Crisis, on Fiscal Sustainability, and on Public and Private Investments, at the World Economic Forum.

My visits at the IMF, the Federal Reserve Board of Governors, Yale University, the University of California, Waseda University, and the Chinese University of Hong Kong during the past several years have been valuable in the writing of this book.

My colleagues at Shanghai Advanced Institute of Finance (SAIF), Shanghai Jiaotong University, in particular Min Zhuang, Yu Chun, Xuemei Wang, Guoxing Liu, Siyu Luo, have provided substantial administrative assistance to me during the writing of the book. Cathy Chenjun Fang provided some of the data collection and data analysis for the book.

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Last but certainly not least, I want to thank my family for their constant love, care and support!

Ning Zhu

November 2015, Beijing

Foreword

Ning Zhu has written a perspicacious, as well as fact-filled, account of the state of the Chinese financial markets and the Chinese economy. It is a real-world account, taking account of all the inconvenient facts that some would like to ignore. It is especially clear on the presence of false promises, faulty evaluations, and the long-run consequences of these. It offers such a sensitive account of China's economy that it should be of interest all over the world, as a case study of how financial markets can underpin the world's most spectacularly growing economy while at the same time involving serious financial defects.

People outside of China will find this book much better reading than the typical large international bank's country study or background paper on China, for this book connects the events in China with a broader and deeper perspective. The perspective is from scholarly research, including behavioral finance. At the same time, it pulls no punches; it is a candid account.

China has emerged from the privations of the Cultural Revolution into a period of renewed greatness and innovation. But it is not as if China had been sleeping during the Cultural Revolution. Indeed, during the very same Cultural Revolution we have examples of brilliance. Youyou Tu began research at the time on a cure for malaria, looking at a number of traditional Chinese medicines. She found one that really worked and then identified and extracted the biologically active component from it. She won the Nobel Prize in medicine in 2015. But the volume and intensity of Chinese innovation was not focused financially at that time and not focused on the international marketplace either. It is interesting to see how such a remarkable transformation has happened in China since then despite financial imperfections.

China after the Cultural Revolution discovered some of the power of modern financial institutions. At the same time, the new China has acquired new problems, the characteristic problems that go along with these institutions, especially as they are new and not as yet fully developed. The newly unleashed Chinese creativity has brought with it some of the same problems that were already well known in western economies even centuries ago.

Ning Zhu argues that it has brought with it errors, including the overconstruction of real estate and overcapacity in industry, encouraged by overly optimistic sales promotions for investments.

This new book in some sense parallels a book that I have recently written with George Akerlof, *Phishing for Phools: The Economics of Manipulation and Deception* (Princeton, 2015, China CITIC Press 2016). Our book covers mostly the United States, and barely even mentions China. It details many different facets of trickery, bribery and distorted influence that have been used to get ahead in America. We have encountered some anger here in the United States with our book, perhaps at least in part because some took our criticism personally.

People are basically the same in every country. Problems of corruption, manipulation and deception are basic human problems that are never completely solved, but the outcome can become better and better. There is a good side to all people too, and if the environment is right this side can become stronger.

It is significant that in the World Values Survey, the Chinese come across as particularly trusting of each other. The question in that survey, before translation into local languages and asked in many countries, is, “Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?” A trust index for each country is created, which is positively related to the fraction who answer that people can be trusted and negatively related to the fraction who answer that you need to be very careful. China has scored very high on this index, as recently as Wave 6 2010–2014, higher than the United States and just about any other country.

Studies have shown that if trust is strong and justified it facilitates economic success. But, as Ning Zhu warns, it is fundamental that this trust be honored, and those in positions of power not abuse it. We see today in China a sense that many people trust that the government will prevent any asset prices from falling, will make up for any financial losses, at least in the long run. So as not to find itself in the future where it cannot help but betray this trust, the government should make it clearer now that it will allow markets to fall in the future, will allow speculators to bet against markets to help prevent bubbles, and enforce a social safety net that only protects individuals from privation rather than trying to guarantee high investment returns.

Working against this need to maintain trust in markets and their independence from excessive government interference is the need to maintain confidence in the direction of the economy. A punishing market crash, if allowed to happen without interference, can cause people to curtail their spending and businesses to cancel plans for further hiring and expansion. Sometimes the dilemma that policy makers face has been compared to that of a president confronted with a military commander who is not performing well in his job, but who should perhaps still be kept in charge because the rank and file below him have come to believe in him, and to replace him

would harm morale. Wherever such a situation occurs, the dilemma is fundamental, and policy makers will find it difficult to find decisive opinion about the effects of their actions in maintaining confidence. The dilemma is not easily resolved by any economic theory since it operates in a mostly psychological, or rather social psychological, sphere, and works against the indisputable power of free markets in bringing economic efficiency.

Ning Zhu's book puts the Chinese dilemma at this time of overcapacity and slower economic growth into just such a perspective, and supports the view that the time has come for the Chinese government to be tilting toward pulling back on its implicit guarantee for financial assets and letting market forces have more rein in the economy. He shows significant evidence that the markets should be given more freedom to function on their own in China today.

Robert Shiller
New Haven, Connecticut

Contents

Preface	iv
Foreword by Robert Shiller, Ph.D.	viii
1. The Faultless Default	1
2. Failure is an Option (in China's Shadow Banking Problem)	31
3. Homebuyers Who Cannot Lose	55
4. Petition Against the CSRC	85
5. Alternative Financial Innovations	109
6. Behind the Growth Engine: The Great Slowdown	131
7. An Abundance of Overcapacity	151
8. From Fortune 500 to Truly Internationally Competitive Companies	175
9. The Mother of All Credit: The Government that Never Defaults	199
10. Voodoo Statistics	223
11. Guaranteed to Fail? International Lessons on Implicit Guarantees	245
12. When the Tide Goes Out: How to Reform	269
Index	301

The Faultless Default

The truth is incontrovertible, malice may attack it, ignorance may deride it, but in the end, there it is.

—WINSTON CHURCHILL

IN JANUARY 2014, IT HAD BECOME GRADUALLY CLEAR THAT ONE OF the trust products sold by the China Credit Trust Company faced the risk of default. The product, which was backed by assets from a once highly successful mining business, lacked not only the cash flow to repay its investment dividends but also the necessary assets to cover the product's principal, which were both due January 31, 2014.

Shanxi Zhenfu Energy Group, the coal company that had taken out 3 billion Yuan (about \$500 million) from the China Credit Trust Company and through the Industry and Commerce Bank of China (ICBC), faced a cash shortage in repaying its interest and principal obligations. Zhenfu Energy originally took out the 3 billion Yuan financing to expand its production capacity in hope of increasing coal prices. However, in light of the tapering off of quantitative easing by the U.S. Federal Reserve and plunging coal prices, it had to shut down its production, which resulted in its financial distress.¹

Adding to the drama of the event was the news that Mr. Xing Libin, owner of another regional energy company that had borrowed heavily through trust products and faced repayment pressure, had thrown a wedding for his daughter costing over 100 million Yuan, not long before the default.

Of particular interest to investors was the fact that the China Credit Trust Company claimed that it only serves as a distribution channel. The real holder and guarantor of the product is the Shanxi Branch of ICBC, China's largest bank and one of the largest banks in the world based on assets and revenue.

On the other hand, ICBC made it clear that it was not responsible and would not take any responsibility in repaying the principal or the interest on the products. The incident has attracted widespread attention, partly because such symbiosis between banks and trust companies, or the formal and shadow banking systems of China, had worked very well in the past, and nobody really knew what would happen if such a collaborative relationship broke.²

Surprisingly, unlike default events in the West (which attract considerable notice), the default in this case left Chinese investors and lawyers seemingly composed. This calm response cannot be attributed to Chinese Taoism or Confucianism. Understanding why the creditors and debtors remained calm is key to understanding not only this interesting case, but also many other phenomena in the economy and financial system of China.

Despite the details about the relative responsibilities of each party involved in the trust product prospectus and sales contract, the stance from both sides sets a very interesting precedent for the entire shadow banking industry in China. Shadow banking includes many high-yield-paying trust products and wealth management products that have mushroomed in the past few years. As a matter of fact, China's shadow banking system has shouldered an increasingly large fraction of financing for not only small- and medium-sized enterprises in China, but also investments in many industries with severe overcapacity, much local government debt, and local government financing vehicles.

For example, the China Credit Trust and the ICBC promised their wealthy clients returns ranging from 9.5 to 11.5 percent per year in selling the products related to the Zhenfu coal mine. Such products have become tremendously popular not only because they provide