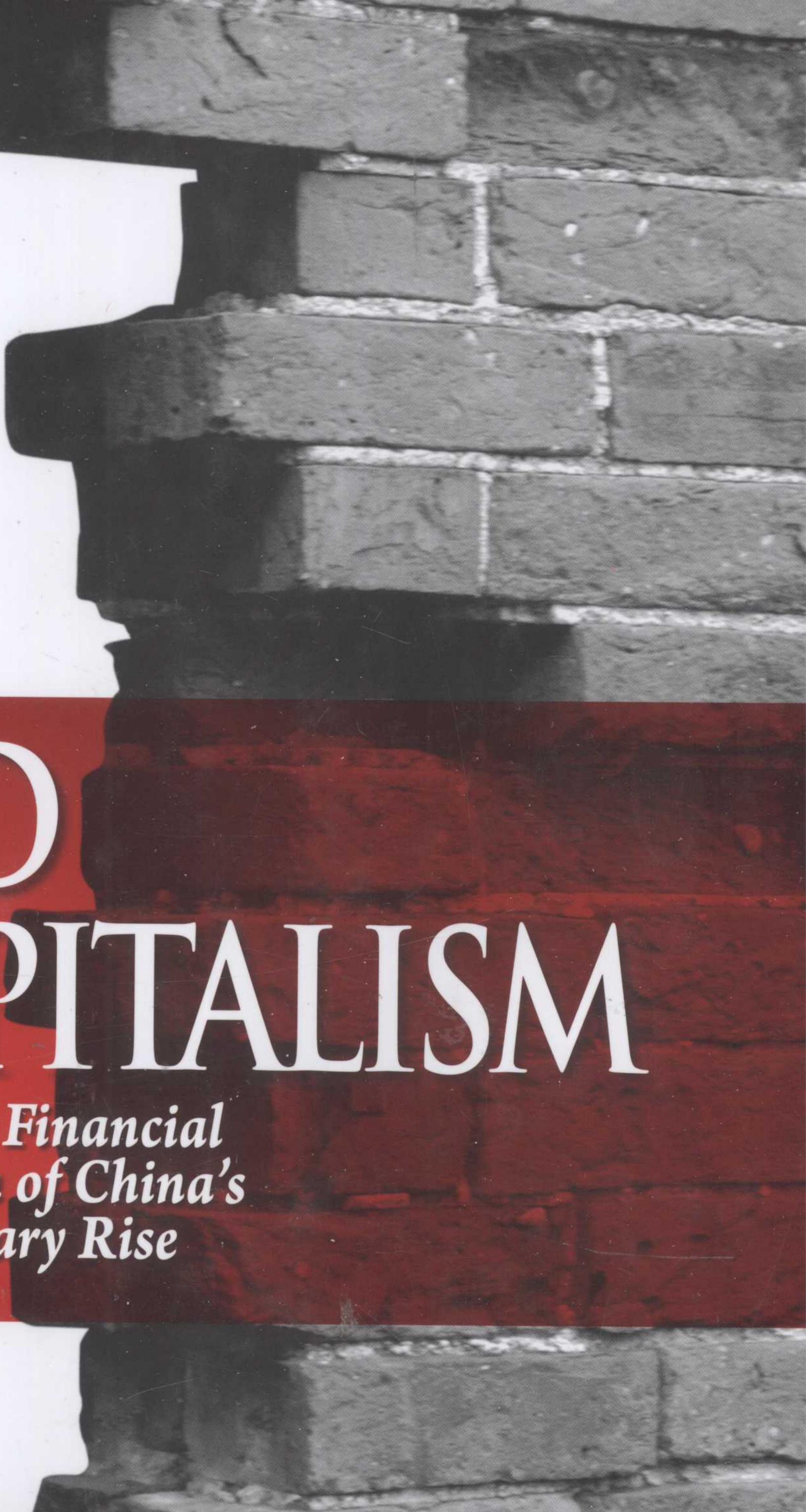

RED CAPITALISM

The Fragile Financial Foundation of China's Extraordinary Rise

CARL E. WALTER

FRASER J. T. HOWIE

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Preface

After three rounds of *Privatizing China*, our book about China's stock markets, we felt like we wanted to look into something new. Since we took our first look at the stock markets in 1999, we have been interested to note the lack of work on the financial side of China's miracle that gets beyond the macroeconomics of things. We are the first to agree that living and working in the country for 25 years may not qualify us as experts in economics. We do believe, however, that our experience has given us a feel for how China's political elite manages money and the country's economy. Having worked in banks for longer than we care to remember, we wanted to try to understand how China and its ruling class finance themselves and we knew we had to begin with the banks since, in truth, they are China's financial system. Those looking for tales of corruption and princelings with their hands in the till will be disappointed though. We think that the financial side of the story behind a 30-year boom that changed the lives of one billion people is much more interesting; so this is our effort at staking out modern China's political economy "inside the system."

We do not believe in Chinese exceptionalism. China's economy is no different from any other, in spite of the inevitable Chinese characteristics. If there are such things as economic laws, they work just as well in China and for Chinese businesses as they do in other markets. We also do not believe in the recent triumphalism of China's bankers and many of its leaders; this is only a diplomatic ploy. China's banks survived the global financial crisis, as one senior banker has publicly stated, simply because the financial system is closed off from the world. Having seriously studied the collapse of Mexico's peso in 1994, the Asian Financial Crisis of 1997 and those sovereign-debt crises that have followed, China's political elite has no intention of exposing itself to international capital markets. The domestic economy and markets are, and will continue to be, most deliberately closed off. With a non-convertible currency, minimal foreign participation and few overseas assets beyond US Treasuries and commodity investments that will neither be marked-to-market nor sold, why shouldn't the system survive a major international crisis better than open economies? China's financial system is designed so that no one is able to take a position opposite to that of the government.

Of course, the private export-oriented sector suffered massive losses in jobs, earnings and the closure of small companies in 2008 and 2009. But China's banks were not exposed in any material way to this sector. It is a simple fact that China's financial system and its stock, bond and loan markets cater only to the state sector, of which the "National Champions" represent the reddest of the Red. These corporations, the heart of China's state-owned economy, are "inside the system." The private economy, no matter how vibrant, is "outside the system" and, in fact, serves at the will of the system. If nothing else, the events of the fall of 2008 added an additional seal to the Party's determination to sustain a closed, tightly controlled, economy. "Don't show me any failed models," is the refrain of the Chinese officialdom these days. But is China's own financial system a model for the world to study? Can China be thought of as an economic superpower, either now or in the future, with such a system?

With this sort of question in mind, we began to look at the financial history of the People's Republic of China. We were fortunate that 2008 was the thirtieth anniversary of China's highly successful Reform and Opening Policy, so there were many excellent retrospectives prepared by the government agencies. The People's Bank of China, in particular, produced very useful material, some of which took one of us back 30 years to Beijing University where his study of Chinese banks began. We hasten to emphasize that all the information used in writing this book derives from purely public sources. In China, all of the important ministries, corporations and banks maintain excellent websites, so data is just out there in the wind waiting to be downloaded. In particular, China Bond and the National Association of Financial Market Institutional Investors (NAFMII), a sub-set of the People's Bank, have extensive websites providing access to information, in both Chinese and English, on China's fixed-income markets. Data for the stock markets have always been plentiful and, we believe, accurate. Again, Wind Information, China's Bloomberg equivalent, has been a rich source for us. Then, there are the audited financial statements of China's banks, all available online since the respective listings of each bank. Reading these statements has been highly educational. We strongly encourage others, including China's regulators, to do the same.

So the modern age of technology provided all the dots that, linked together, present a picture of the financial sector. How they are connected

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in this book is purely the authors' collective responsibility: the picture presented, we believe, is accurate to the best of our professional and personal experience. We hope that this book will, like *Privatizing China*, be seen as a constructive outsiders' view of how China's leadership over the years has put together what we believe to be a very fragile financial system.

For all the fragility of the current system, however, one of us is always reminded that his journey in China began in Beijing back in 1979 when the city looked a lot like Pyongyang. With North Korea in the headlines again for all the wrong reasons, it is worth remembering and acknowledging the tremendous benefits the great majority of Chinese have reaped as a result of the changes over the past 30 years. This can never be forgotten, but it should also not be used as an excuse to ignore or downplay the very real weaknesses lying at the heart of the financial system.

We would like to thank those who have helped us think about this big topic, including in no particular order Kjeld Erik Brosdgaard, Peter Nolan, Josh Cheung, Jean Oi, Michael Harris, Arthur Kroeber, Andrew Zhang, Alan Ho, Andy Walder, Sarah Eaton, Elaine La Roche and Victor Shih. What we have written here, however, remains our sole responsibility and reflects neither the views of our friends and colleagues, nor those of the organizations we work for.

We have dedicated the book to John Wilson Lewis, Professor Emeritus of Political Science at Stanford University. John was the catalyst for Carl's career in China and, indirectly, Fraser's as well. Without his support and encouragement, it is fair to say that this book and anything else we have done over the years in China might never have happened. We both continue to be very much in debt to our wives and families who have continued to at least tolerate our curious interest in Chinese financial matters. We promise to drop the topic for a while now, even though we are well aware that there remains much that needs to be looked at in the financial space, including trust companies and asset-transfer exchanges.May be next time.

Beijing and Singapore
October 2010

List of Abbreviations

ABC	Agricultural Bank of China
AMC	asset-management company
BOC	Bank of China
CBRC	China Banking Regulatory Commission
CDB	China Development Bank
CGB	Chinese government bond
CIC	China Investment Corporation
CP	commercial paper
CSRC	China Securities Regulatory Commission
ICBC	Industrial and Commercial Bank of China
MOF	Ministry of Finance
MOR	Ministry of Railways
MTN	medium-term notes
NAV	net asset value
NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	non-performing loan
PBOC	People's Bank of China
SAFE	State Administration for Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission

Contents

CHAPTER 1

Looking Back at the Policy of Reform and Opening

"One short nap took me all the way back to before 1949."

Unknown cadre, Communist Party of China
Summer 2008

It was the summer of 2008 and the great cities of eastern China sparkled in the sun. Visitors from the West had seen nothing like it outside of science fiction movies. In Beijing, the mad rush to put the finishing touches on the Olympic preparations was coming to an end—some 40 million pots of flowers had been laid out along the boulevards overnight. The city was filled with new subway and light-rail lines, an incomparable new airport terminal, the mind-boggling Bird's Nest stadium, glittering office buildings and the CCTV Tower! Superhighways reached out in every direction, and there was even orderly traffic. Bristling in Beijing's shadow, Shanghai appeared to have recovered the level of opulence it had reached in the 1930s and boasted a cafe society unsurpassed anywhere in Asia. Further south, Guangzhou, in the footsteps of Shanghai Pudong, was building a brand new city marked by two 100-storey office, hotel and television towers, a new library, an opera house and, of course, block after block of glass-clad buildings. Everyone, it seemed, was driving a Mercedes Benz or a BMW; the country was awash in cash.

In the summer of 2008, China was in the midst of the hottest growth spurt in its entire history. The people stirred with righteous nationalism as it seemed obvious to all that the twenty-first century did, in fact, belong to the Chinese: just look at the financial mess internationally! Did anyone even remember the Cultural Revolution, Tiananmen, or the Great Leap Forward? In a brief 30 years, China had rejected communism, created its own brand of capitalism and, as all agreed, seemed poised to surpass its great model, the United States of America, the Beautiful Country. Looking around at China's coastal cities bathed in the light of neon signs advertising multinational brands, their streets clogged with Buicks and Benzes, the wonder expressed by the confused Party cadre's comment—"One short nap took me all the way back to before 1949"—can be well understood. In many ways, the past 30 years in China have seen a big rewind of the historical tape-recording to the early twentieth century.

The West, its commentariat and investment-bank analysts all saw this as a miracle because they had never expected it. After all, 30 years ago China was barely able to pull itself off the floor where it had been knocked flat by the Cultural Revolution. Beijing in 1978 was a fully depreciated version of the city in 1949 minus the great city walls, which had all been torn down and turned into workers' shanties and bomb shelters. When the old *Quotations from Chairman Mao* billboards were painted over in 1979, one new one depicted a Chang An Avenue streaming with automobiles: cyclists glanced in passing and pedaled slowly on. Shanghai, the former Pearl of the Orient, was frozen in time and completely dilapidated, with no air-conditioning anywhere and people sleeping on the streets in the torrid summer heat. Shenzhen was a rice paddy and Guangzhou a moldering ruin. There was no beer, much less ice-cold beer, available anywhere; only thick glass bottles of warm orange pop stacked in wooden crates.

THIRTY YEARS OF OPENING UP: 1978–2008

As a counterpoint to the Olympics and 2008, Deng Xiaoping, during his first, brief, political resurrection in 1974, led a large Chinese delegation to a special session of the United Nations. This was a huge step for China in lifting the self-imposed isolation that prevailed during the Cultural Revolution. Just before departing for New York, the entire central

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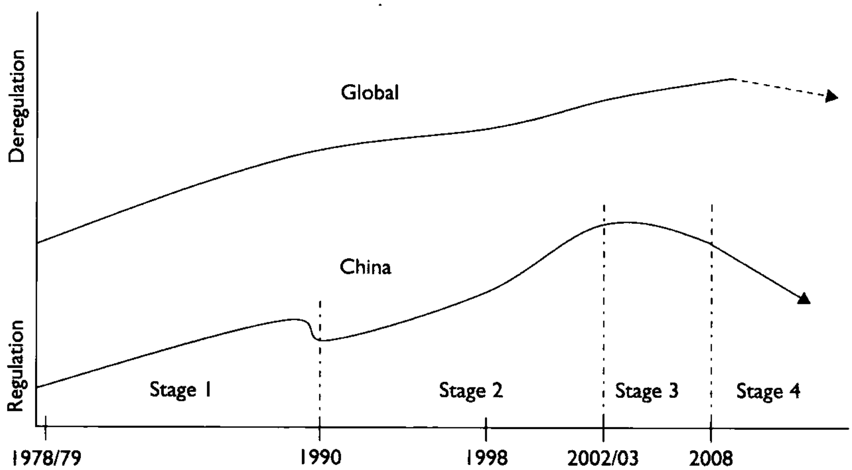
government, so the story goes, made a frantic search through all the banks in Beijing for funds to pay for the trip. The cupboard was bare: they could scrape together only US$38,000.[1] This was to be the first time a supreme leader of China, virtually the Last Emperor, had visited America; if he couldn't afford first-class international travel, just where was the money to support China's economic development to come from?

How did it all happen, because it most certainly has happened? How were these brilliant achievements of only one generation paid for? And the corollary to this: what was the price paid? Understanding how China and its Communist Party has built its own version of capitalism is fundamental to understanding the role China will play in the global economy in the next few years. The overall economics of China's current predicament is well understood by international economists, but the institutional arrangements underlying its politics and economics and their implications are far less understood. This book is about how institutions in China's financial sector—its banks, local-government "financing platforms," securities companies and corporations—affect the country's economic choices and development path. Of course, behind these entities lies the Communist Party of China and the book necessarily talks about its role as well.

Prior to the Lehman shock of September 2008, the trajectory China's financial development had been tracing generally followed a well-established path taken by more advanced economies elsewhere in the world. This approach was not easily adopted by a political elite that had been devastated by its own leaders for nearly 20 years and then suffered a further shock in 1989. The general story, however, has become the Great China Development Myth. It begins with the death of Mao in 1976 and the second restoration of Deng Xiaoping two years later. These events freed China to take part in the great financial liberalization that swept the world over the past quarter-century (see Figure 1.1). Looking back, there is no doubt that by the end of the 1980s, China saw the financial model embodied in the American Superhighway to Capital as its road to riches. It had seemed to work well for the Asian Tiger economies; why not for China as well? And so it has proven to be.

In the 1990s, China's domestic reforms followed a path of deregulation blazed by the United States. In Shenzhen, in 1992, Deng Xiaoping resolutely expressed the view that capitalism wasn't just for capitalists.

FIGURE 1.1 Thirty years of reform—trends in regulation



Source: Based on comments made by Peter Nolan, Copenhagen Business School, December 4, 2008

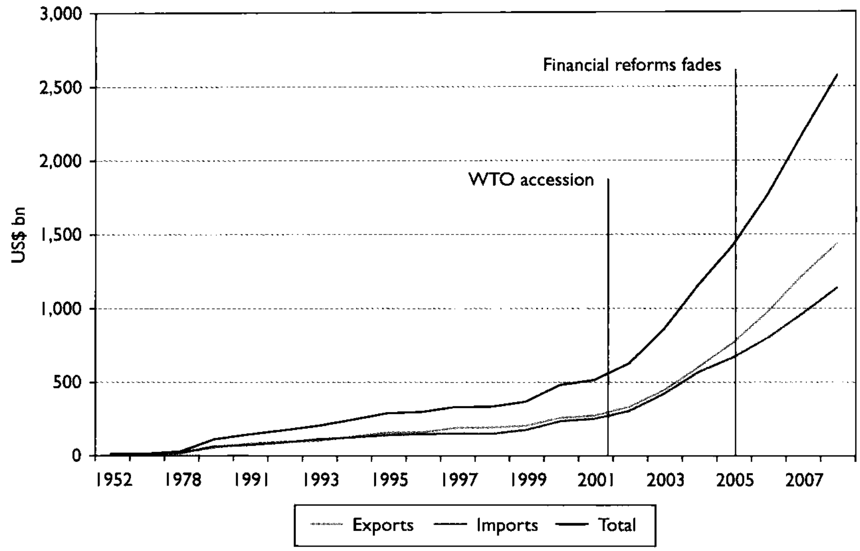
His confidence caused the pace of reform to immediately quicken. China's accession to the World Trade Organization in 2001 perhaps represented the crowning achievement in the unprecedented 13-year run of the Jiang Zemin/Zhu Rongji partnership. When had China's economy ever before been run by its internationalist elite from the great City of Shanghai? Then, in 2003, the new Fourth Generation leaders were ushered in and things began to change. There was a feeling that too few people had gotten too rich too fast. While this may be true, the policy adjustments made have begun to endanger the earlier achievements and have had a significant impact on the government itself. The new leadership's political predisposition, combined with a weak grasp of finance and economics, has led to change through incremental political compromise that has pushed economic reform far from its original path. This policy drift has been hidden by a booming economy and almost-continuous bread and circuses—the Olympics, the Big Parade, the Shanghai World Expo and Guangzhou's Asian Games.

The framework of China's current financial system was set in the early 1990s by Jiang and Zhu. The best symbols of its direction are the Shanghai and Shenzhen stock exchanges, both established in the last days of 1990. Who could ever have thought in the dark days of 1989 that China would roll out the entire panoply of capitalism over the ensuing 10 years? In 1994, various laws were passed that created the basis for an independent central bank and set the biggest state banks—Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC)—on a path to become fully commercialized or, at least, more independent in their risk judgments and with strengthened balance sheets that did not put the economic and political systems at risk.

Reform was strengthened as a result of the lessons learned from the Asian Financial Crisis (AFC) in late 1997. Zhu Rongji, then premier, seized the moment to push a thorough recapitalization and repositioning of banks that the world at the time rightly viewed as more than "technically" bankrupt. He and a team led by Zhou Xiaochuan, then Chairman and CEO of the China Construction Bank, adopted a well-used international technique to thoroughly restructure their balance sheets. Similar to the Resolution Trust Corporation of the US savings-and-loan experience, Zhou advocated the creation of four "bad" banks, one for each of the Big 4 state banks. In 2000 and again in 2003, the government stripped out a total of over US$400 billion in bad loans from bank balance sheets and transferred them to the bad banks. It then recapitalized each bank, and attracted premier global financial institutions as strategic partners. On this solid base, the banks then raised over US$40 billion in new capital by listing their shares in Hong Kong and Shanghai in 2005 and 2006. The process had taken years of determined effort. Without doubt, the triumphant listings of BOC, CCB, and ICBC marked the peak of financial reform, and it seemed for a brief moment that China's banks were on their way to becoming true banking powerhouses that, over time, would compete with the HSBCs and Citibanks of the world.

China at last acceded to the World Trade Organization (WTO) in late 2001 after 15 years of difficult negotiations. Zhu saw membership of the WTO as the guarantee of an unalterable international orientation for a China that in the past had too frequently been given to cycles of isolationism. He believed that the WTO would provide the transformational engine for economic and, to a certain extent, political modernization regardless of who controlled the government. His enthusiasm for engagement with the world paid off as trade with China turned white hot in the years that followed (see Figure 1.2).

FIGURE 1.2 Trends in imports, exports and total trade, 1999–2007

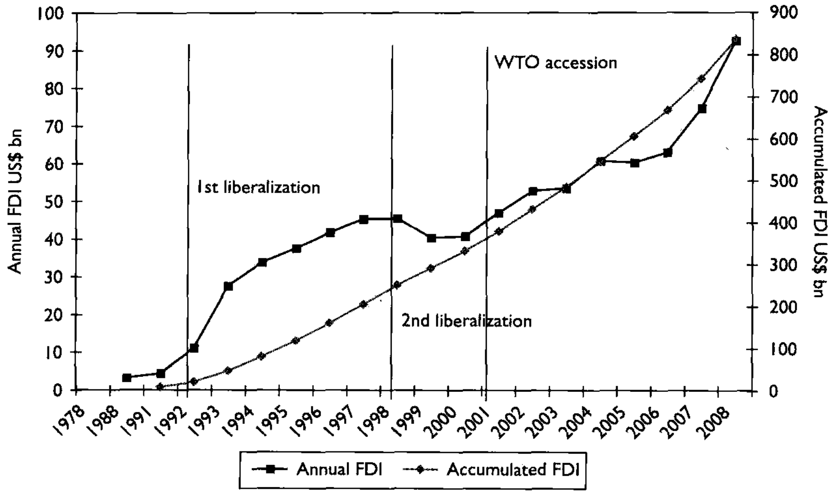


Source: China Statistical Yearbook 2008

It was not just trade; foreign direct investment also poured in, jumping to unheard-of levels of US$60 billion a year and peaking at over US$92 billion in 2008 as the world's corporations committed their manufacturing operations to the Chinese market (see Figure 1.3). Chairmen in boardrooms everywhere believed with Zhu Rongji that China was on a path of economic liberalization that was irreversible.

The commitment of these foreign businessmen was not simply a function of belief. In the early years of the twenty-first century, China's market opened up as it never had before. At the start of economic liberalization in the 1980s, foreign investors had been forced to contend with the practical consequences of the famous "Bird Cage" theory. Trapped in designated economic zones along the eastern seaboard, just as they had been in the Treaty Ports of the Qing Dynasty a hundred years earlier, foreign companies were forced into inefficient joint ventures with unwanted Chinese partners. Then every local government wanted its own zone and its own foreign birds, so that during the 1990s, economic zones proliferated across the country and were eventually no longer "special." Despite this, even as late as 2000, the joint-venture format accounted for over 50 percent of all foreign-invested

FIGURE 1.3 Committed foreign direct investment, 1979–2008



Source: China Statistical Yearbook 2009

TABLE 1.1 FDI by investment-vehicle structure, 2000–2008

	Equity JV (%)	Contractual JV (%)	Wholly-owned enterprise (%)	Shareholding (%)	Total FDI (US$ billion)
2000	36.2	16.1	47.4	0.2	40.3
2001	35.1	13.1	50.9	0.9	46.4
2002	28.4	9.7	60.5	1.3	52.4
2003	29.1	7.2	63.1	0.6	52.9
2004	27.1	5.1	66.4	1.3	60.5
2005	24.2	3.0	71.4	1.4	60.3
2006	22.5	4.0	73.4	0.01	65.8
2007	20.9	1.5	76.6	0.01	74.8
2008	18.0	2.0	78.2	0.01	95.3
2009	18.8	2.1	74.8	0.0	91.8

Source: US-China Business Council; as a percent of total utilized FDI

corporate structures. After China's accession to the WTO, this changed rapidly. It seemed that China was open for business after all: by 2008, nearly 80 percent of all foreign investment assumed a wholly-owned enterprise structure (see Table 1.1). At long last, the Treaty Port system seemed a thing of the past, as foreign companies had the choice of where and how to invest.

Over the past few years, they have undeniably committed their technologies and management techniques and learned how to work with China's talented workers to build a world-beating job-creation and export machine. But they have done this in only two areas of China: Guangdong and the Yangzi River Delta comprising Shanghai and southern Jiangsu Province (see Figure 1.4). The economies of these two regions are dominated by foreign-invested and private (*waizi* 外资 and *minying* 民营) companies; there is virtually no state sector remaining. These areas consistently attract 70 percent of total foreign direct investment and contribute over 70 percent of China's exports. They are the machine that has created the huge foreign-exchange reserves for Beijing and they have changed the face of these two regions. It is highly ironic that the old Treaty Ports, which once symbolized its weakness and subservience to foreign colonizers, are now the source of China's rise as a global manufacturing and trading power, becoming in the process the most vibrant and exciting parts of the country and, indeed, of all Asia.

China's economic geography is not simply based on geography. There is a parallel economy that is geographic as well as politically strategic. This is commonly referred to as the economy "inside the system" (*tizhinei* 体制内) and, from the Communist Party's viewpoint, it is the real political economy. All of the state's financial, material and human resources, including the policies that have opened the country to foreign investment, have been and continue to be directed at the "system." Improving and strengthening it has been the goal of every reform effort undertaken by the Party since 1978. It must be remembered that the efforts of Zhu Rongji, perhaps China's greatest reformer, were aimed at strengthening the economy "inside the system," not changing it. In this sense, he is China's Mikhail Gorbachev; he believed in the system's capacity for change as well as the dire need for its reform. Nothing Zhu undertook was ever intended to weaken the state or the Party.

Understood in this context, the foreign and non-state sectors will be supported only as long as they are critical as a source of jobs (and hence, the all-important household savings), technology and foreign exchange. The resemblance of today's commercial sector in China, both foreign and local, to that of merchants in traditional, Confucian China is marked: it

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