

Capital Markets: China's Achilles Heel?
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During the session "Capital Markets: China's Achilles Heel?" panelists discussed the state of the Chinese capital markets and their ability to provide sufficient funding to maintain the country's economic growth.

Professor Charles Calomiris of Columbia Business School began the panel by stressing the importance of the role capital market institutions play in encouraging continuing productivity growth. In early stages of development, mobilizing a large amount of savings can create great success since there is so much "low-hanging fruit." But as economies begin to develop, the efficiency of the capital allocation process becomes a crucial factor in avoiding diminishing returns and maintaining high productivity growth. Referring to the role of poor financial institutions in East Asia in contributing to its slowdown in the 1990s and the financial crises in Thailand, Indonesia, and Korea, Calomiris posed the question "Will China repeat that history of initial success running into diminishing returns because of an inefficient capital market?" While an increase in competition and legal reform in China has paved the way for progress in China's capital market reform, Calomiris said that the dominance of state-owned enterprises and problems with China's banking system could crimp growth of the economy going forward.

Columbia Business School Professor Lee Branstetter reviewed the challenges of China's equity markets, stating that despite high GDP growth during the past decade, China's equity market performance has been lackluster.

"In 2003 and 2004, China's stock markets were the worst performing equity markets of significant size anywhere in the world," Branstetter said. "The collapse has been so pronounced that the total market value of China's public companies has fallen since 2000, even though 513 new listings came into existence during that period."

Branstetter pointed to several reasons why China's equity markets have declined in the midst of booming economic growth. First, he noted that equity markets are generally limited to state-owned enterprises, which are widely acknowledged as being less productive than the economy as a whole. Less than 10 percent of listed companies on the exchange are truly private. Second, the state only sells a minority of the shares in listed firms and holds the remaining shares. That majority interest also implies continuing state control, which breeds inefficiency.

“The government not only regulates the equity market, but is the dominant share holder by far, and this creates some interesting conflicts of interest,” Branstetter said. Branstetter noted that since the state enterprises have majority control, they also have the ability to appoint senior executives and that these managers are often “guided by objectives other than pure economic efficiency.”

Mary Darby, senior research scholar at the Chazen Institute of International Business, agreed with Branstetter’s assertions about China’s equity markets and said that increasing institutional ownership is critical to stabilizing China’s equity markets.

Darby said that retail ownership has historically dominated China’s securities markets. Banks were not permitted to own equity or manage equity funds and the markets have been “chaotic, highly volatile, and fraught with irregularities,” Darby said.

The five prospective institutional participants in the stock market include securities companies, fund management firms, insurance companies, commercial banks, and pension funds. Increasingly institutional participants will be allowed to participate more openly in the equity markets, Darby said, and China has also encouraged foreign institutions to become joint venture participants, owning up to 40% of fund management companies.

“Through the building of institutional ownership they will improve corporate governance, disclosure, and transparency, and institutions will demand better quality investment products and will use better risk management tools,” Darby asserted. “The end result will be better pricing of securities and less volatility.”

Michael DeStefano, managing director covering financial institutions at Standard and Poor’s Rating Group, said the banking system is the cause of most of the weaknesses associated with China’s macroeconomy.

China’s high savings rate of 35 to 40 percent has been one of the contributors to China’s large asset base. DeStefano said that domestic credit relative to GDP in China stands at approximately 140 percent, which mirrors that of the US and Europe, “fully developed economies, very rich societies in which the credit is a sort of normal part of life.”

However, because of China’s fledgling fixed income market and anemic equity markets, its banks control credit flows. DeStefano said that historically most of the lending decisions taken by banks have been policy lending, not commercial lending.

“On a commercial basis, you make a loan with the expectation that you’ll have a return on that loan,” DeStefano said. “Policy lending you do because it’s ‘good,’ – it’s good for the economy, it’s good for the nation, it’s good for whatever social purpose you’re lending for, but it’s not made with the expectation you’ll have a commercial return.”

This has resulted in a large number of bad loans. These loans, in aggregate, have an enormous cost to the economy, DeStefano said, and a full cleanup and recapitalization of the banking system in China will cost on the order of \$600 billion.

China's state-owned banks are not just a source of financial instability but also a potential source of social and political instability, Professor of International Management Yasheng Huang of Massachusetts Institute of Technology said.

“(Banks have) squandered depositors’ money and they have lent to wasteful projects,” Huang said. “The domestic sector has been starved of credit when all this massive amount of capital has been poured into inefficient, value-destroying state-owned enterprises.”

Employment in private sector firms, which Huang believes to be a good indicator of the development of the private sector, has hardly increased since the 1980s. Huang said Chinese banks’ lending policies have led to this result. For example, in the 1990s, the Chinese government began a financing policy that favored the cities, leaving the early entrepreneurial firms in the rural areas to be starved of credit.

Huang said this policy led to the development of the informal financing sector, networks made up of loan sharks and relatives, at a huge cost to private firms because private firms could not get financing from the formal sector.

To reduce financing constraints, private firms in the 1990s turned to foreign direct investment. Forming alliances with foreign firms allowed these private enterprises to tap into resources. However, Huang said that a large number of private firms, those which are located in the interior parts of China, are not able to tap into FDI. “There is nothing that FDI can do to help the growth of those firms, and this is exactly where you need the most domestic entrepreneurship,” Huang said.

Shang-Jin Wei, head of Trade Unit at the International Monetary Fund, and a senior fellow at the Brookings Institution, agreed that the Chinese banking system is a problem for continuing growth. His research shows not only that Chinese banks have failed to resolve existing bad loans, but that they are making additional bad loans, and failing to provide credit where it is needed most. By his calculations, the inefficiency of financial markets (measured by the inability of the banks to channel investments to the highest and best use) is worsening over time.

Overall, the panelists seemed to agree that the weaknesses in the Chinese financial sector are an Achilles Heel for China today. If China can resolve its bank insolvency problems and establish the basis for efficient allocation of savings by banks and securities markets, it can avoid the problems of slowing growth and financial vulnerability that plagued other Asian economies in the 1990s. Without such reform, however, China may be in for a rough ride over the next few years.

Although the panel mainly focused on the challenges that remain for continuing growth from capital market shortcomings, Professor Bernd Schmitt, the Robert D. Calkins Professor of International Business at the Columbia Business School and executive director of the Center on Global Brand Leadership, was invited to comment on the development of the Chinese consumer market.

Schmitt briefly presented his own research as well as other research (e.g., the Gallup polls), arguing that Chinese consumers are becoming increasingly knowledgeable about brands. They prefer Chinese products but view many Chinese products as lacking in quality. This presents opportunities for foreign brands, especially in primary cities like Beijing and Shanghai. Chinese companies, on the other hand, are only in the early stages of brand development, and at this point are not as sophisticated as companies in other Asian markets (e.g., South Korea).