

The debt, the stock market and the state-owned enterprises The sources of chaos on the Chinese financial markets

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The government's extensive programme for stimulating the economy has enabled China to maintain high economic growth after the global financial crisis in 2008. However, this success has come at the price of a number of negative economic phenomena and the consequences they have had are the major challenge for the government today. The vast programme of investments in infrastructure, construction and fixed assets, which has been the main source of economic growth over the past few years, has caused a rapid increase in China's debt from 158% of GDP in 2007 to 282% in 2014. Along with the local governments in charge of implementing the programme, the Chinese sector of state-owned enterprises (SOEs) has been heavily burdened by the stimulation policy. The sector's profitability has fallen, its indebtedness has increased and management problems have been revealed.

The 'mixed ownership reform' put forward by the new Xi Jinping government was expected to respond to these challenges, including by improving the financial condition of the SOEs sector through restructuring and the sale of minority stakes in companies. To implement this plan, with private investors playing a more active role, the Chinese leadership needed well-developed markets with sufficient depth. This is one of the reasons why the government launched the campaign promoting investments on the stock exchange which gave rise to the boom on the Chinese stock market in the middle of 2014 which ended one year later with a series of price falls and the imposition of strict administrative supervision over the Chinese stock exchanges.

The government's engagement along with the low level of development of the Chinese capital markets and the shortcomings in their regulations have made investor sentiment dependent on watching the government's moves and has led to short-term speculation strategies becoming predominant. At present, price fluctuation on the stock markets depends on the government's moves and not on the fundamental economic factors. One way out of this situation is to extend the reform of the capital markets – until that time the restructuring of the SOEs by means of the sale of minority stakes will remain restricted. Even the large financial reserves which give the Chinese government time to implement the reforms are limited – given this context, 2016 appears to be a key year from the point of view of the Chinese reform programme and of ensuring sustainable economic development.

The debt of state-owned enterprises

The brunt of the stimulation package launched by Beijing after 2008 has been borne by the Chinese provincial governments. Since GDP

growth was at that time the main local leaders' evaluation criterion for the evaluation of local leaders, they embarked upon an extensive programme to stimulate the economy, significantly increasing the expenditure on transport

infrastructure, construction and fixed assets. Since the official debt limits were imposed on local governments in 1994, extra-budgetary mechanisms have been employed to increase stimulus spending¹, in particular, investments in companies controlled by local governments and creating so-called 'local government financing vehicles' (LGFV)², to attract additional capital. Political reasons determined that the expenditure of SOEs managed by the central government have also been increased³.

China's economic growth after 2007 has been to a great extent based on a massive increase in credit made available to state-owned enterprises and local governments.

The Chinese SOE sector's extraordinary expenditure on stimulating the economy was financed massive credit growth. Shortly before the crisis, in 2007, the debt-to-equity ratio in SOEs was around 140%, while by 2013 this ratio rose to around 200%⁴. According to McKinsey Global Institute, between 2007 and 2014, China's debt-to-GDP ratio rose from 158% to 282%, and debts in the companies sector increased from around US\$3.4 trillion to US\$12 trillion, reaching 125% of the country's GDP. Experts from the Chinese Academy of Social Sciences point out that if the

present debt growth rate is maintained, in 2020 this ratio may reach as much as 200% of GDP. As a consequence of the government's pressure to stimulate short-term growth, funds obtained through increasing debts were often allocated to low-quality investment projects, sometimes disregarding economic feasibility. Investments in developing production capacity have led to significant overcapacity in some sectors, and the spending on infrastructure has also delayed returns on investments, thus undermining the financial stability of SOEs and adversely affecting their profitability⁵. Due to the fact that China's GDP growth is slowing down as a result of restructuring the economy and the slower development of the construction sector, some SOEs that have become less profitable (in particular those linked to the primary and construction sectors) are facing insolvency. As a consequence of the lack of political approval for the liquidation of unprofitable companies, a number of companies have turned into so-called 'zombie firms', surviving only owing to their growing debts.

The so-called 'mixed ownership reform' (混合所有制改革) announced in November 2013 by the main planning authority, the National Development and Reform Commission, was intended to serve as a remedy for the dramatic deterioration of the financial condition of Chinese SOEs. It was expected to enhance the role of market forces through the sale of part of their assets to private investors, while leaving the controlling stakes in these companies in the hands of the state. Mixed ownership is expected to improve the quality of corporate governance and management efficiency, without depriving the state of its role of key economic actor. Other essential elements include the concentration of state capital in strategic sectors and those

¹ According to the IMF, had this category of expenditure been taken into account in calculating the deficit in the Chinese central budget, it would have reached 15% in 2009 (officially, it was 2.8%), and 10% in 2012 (officially 1.5%).

² The LGFV are viewed as being the 'ticking time bomb' of the Chinese financial system, where high-interest debts are estimated to be around US\$3.8 trillion. In 2015, the central government began restructuring the debt by replacing the loans they had taken with long-term bonds, with state-owned banks being engaged in the task.

³ About one third of the approximately 150,000 Chinese state-owned companies are subsidiaries of around 100 conglomerates controlled by the central government (according to estimates from Deutsche Bank). The remainder are owned by local governments on the provincial and municipal level.

⁴ In the private sector this ratio fell within this timeframe from around 140% to around 115%.

⁵ In 2007, the profitability ratio of assets in the industrial sector remained on a similar level for both state-owned and private companies – 7% and 8% respectively. In 2013, the ratio for state-owned companies was only 4.5%, less than half the ratio for private firms.

which provide services to the population, as well as restructuring and ownership concentration in professionally managed holdings. Ultimately, the state intends to withdraw from the most competitive markets, such as the retail trade, the hospitality industry, and the construction and low-end manufacturing sectors.

Opening up to market incentives and offering a level of ownership to private investors is intended to improve management quality and the performance of state-owned enterprises.

Around 60% of SOEs operate in these sectors. The sale of part of the assets on the scale announced by the government was expected to bring significant funds to SOEs, offering the opportunity to improve the sector's financial situation and reduce its debts. This would also mean lifting a great deal of the burden off the local governments (which control the majority of SOEs)⁶. Towards the end of 2014, twenty Chinese provinces presented their plans to implement the reform⁷. It is estimated that local governments' assets in non-strategic sectors alone (these are scheduled to be sold off first) might be worth as much as US\$7 trillion⁸.

The government is playing with the market

The mixed ownership reform envisaged several methods of selling of the assets of SOEs, including sharing the infrastructure costs as part of a public-private partnership, selling shares to in-

stitutional investors and management buyouts. However, the existence of a deep and liquid stock market is key to ensuring sufficiently extensive financing for SOEs, and will simultaneously open up the way to slowing down the process of them falling into debt. Additional share issues or new initial public offerings (IPOs) of SOEs offer access to a large group of local and foreign institutional and individual investors, with controlling stakes remaining in the hands of state-owned holdings. The attractiveness of this model of financing is also affected by the unwillingness of some private entrepreneurs⁹ to acquire shares in SOEs without being offered any influence on their business decisions, and also due to the very high corruption potential in the case of management buyouts. The government's stance on the stock market was discussed in an article entitled 'Capital markets will be at the forefront of the mixed ownership reform'¹⁰ published in September 2014 in the main economic newspaper of the Communist Party of China, *Jingji Ribao*. The article stated that the stock exchange was an ideal platform for implementing the reform, and the prospect of a large number of SOEs being listed on the stock markets was presented as being a catalyst for it to develop.

In the middle of 2015, the public sector restructuring seemed to enter the decisive phase. Pilot projects allocated by the SASAC, the agency managing SOEs, were in the final phase. Large state-owned holdings, such as the oil company SINOPEC and the financial giant CITIC, began shifting part of their assets to companies listed on the Hong Kong stock exchange. In June 2015, the CNNC, one of the two giants on the nuclear energy sector, was floated on the Shanghai stock exchange. The state-owned Merchants Bank of China launched an additional issue of shares.

⁶ Even though local governments control most state-owned companies, the companies generate only around 40% of total public sector revenue (2015).

⁷ For example, the government of Guangdong Province has declared that 80% of state-owned companies would be open to private capital by 2020.

⁸ <http://www.bloomberg.com/news/articles/2014-05-05/china-provinces-eye-sales-from-7-trillion-asset-holdings>

⁹ For example, Wang Jianlin, the owner of Wanda Group, one of China's largest private conglomerates, has expressed a similar opinion.

¹⁰ <http://www.sasac.gov.cn/n86302/n86361/n86396/c1595595/content.html>

On 16 June 2015, the Shanghai stock exchange saw the largest initial public offering of shares (IPO) since 2010 – Guotai Junan Securities Co, China’s largest state-owned broker in terms of revenue, attracted the equivalent of US\$ 4.8 billion. According to some estimates, SOEs attracted around US\$100 billion during the boom¹¹.

Stimulating the stock market has opened up opportunities to reduce the debt of the SOEs sector, while allowing the government to retain control over the economy.

The key role played by the stock exchange in the SOE reform process needs to be viewed as the main reason¹² for the government’s media campaign launched in the middle of 2014, which was aimed at attracting more investors and improving the valuations of the companies listed on the Shenzhen and Shanghai stock exchanges. There were enthusiastic articles published in the government-controlled press, and the benefits of investing on the stock markets were praised. The regulations concerning both the limit of brokerage accounts per person and margin-lending were liberalised. All this led to a stock market fever across the country. What played the key role in the boom was the fact that the Chinese capital markets are still poorly developed – Chinese citizens’ investing opportunities are largely limited to bank accounts offering an undervalued interest rate due to administrative regulations – this, of course, makes the stock exchange even more appealing. The factors which coincided with the stock market boom included the ongoing cooling

of the property market and restrictions imposed on the operation of the shadow banking sector (both of which have previously been a popular tool to earn higher returns). In parallel to this, the People’s Bank of China on several occasions lowered the required reserve ratios for Chinese banks, thus ensuring high liquidity to the financial markets. As a result, the value of the Chinese stock market increased in under 12 months from June 2014 from US\$3.8 trillion to over US\$10.5 trillion¹³, i.e. to a value comparable to China’s annual GDP.

Neither the Shenzhen and Shanghai stock exchanges are particularly well developed and are still undergoing the modernisation process. In a year or so, they received a vast amount of capital, which exacerbated the negative phenomena seen there. The issues of the insufficient transparency of the companies listed on the Chinese stock exchanges and lower financial reporting standards than those used in developed countries, limiting the possibilities of analysing company value on the basis of their financial results, remain unresolved. The disconnect between share valuations and financial results is partly an effect of the predominance of SOEs on the largest stock exchanges in Shanghai and Shenzhen; these companies implementing the government’s political goals often disregard the interests of minority shareholders. The instability of the stock exchanges also deteriorated due to corruption among the stock market regulators, the common practice of insider trading and the unrestricted flow of personnel between the China Securities Regulatory Commission (CSRC) and the firms which trade in shares¹⁴, which led to conflicts of interest.

¹¹ <http://www.economonitor.com/blog/2015/11/china-stock-market-crash-part-1-communist-shares/>

¹² The Chinese government also hoped that the inflated share valuations would make small investors feel wealthy, and this would trigger consumption. The stock market also offers an alternative method of financing to the ‘new economy’ – innovative companies and start-ups which have very limited access to loans from state-controlled banks.

¹³ <http://www.bloomberg.com/news/articles/2015-06-14/china-s-stock-market-value-exceeds-10-trillion-for-first-time>

¹⁴ After the slump on the Chinese stock exchanges in the second half of 2015, the anticorruption campaign which had been launched in China a few years earlier was turned on the financial markets – investigations were launched against the senior officials of the main regulator, the CSRC, the largest state-owned brokerage firms and some private entrepreneurs.

The Chinese stock market bubble was to a great extent driven by the commonly shared belief that since the Chinese leadership were so keen to encourage investment on the stock market, this would guarantee that stock prices would continue rising. During the stock market boom,

The government's interventions on the stock market have made investors' sentiments dependent on the government's moves, limiting the possibilities of making a rapid reaction to the growing speculative bubble.

investors who were building their share portfolios on the basis of the companies' fundamental value were marginalised¹⁵ to make way for short-term and speculative strategies which had nothing to do with the economic foundations and which drastically increased the stock price volatility. This resulted in stock market sentiment being based on watching the government's decisions and meant that the regulators were trapped, with their hands tied to some extent while the bubble was growing¹⁶. The Chinese government decided to introduce strict controls of the stock market after a series of dramatic price falls in June 2015. This exacerbated the problem of speculation and the stock market acting apart from the economic foundations, where prices were the result of investors' attempts to guess the government's intentions. The regulations introduced in July and August 2015 halted new IPOs, prevented

¹⁵ Individual brokerage account holders, who have a relatively low level of financial education, account for around 80% of investors on the Chinese stock market.

¹⁶ The CSRC announced back in April 2015 that there will be restrictions on loans granted for the purchase of shares which pose a risk to the stock market. The value of these loans is now record-high, reaching US\$264 billion. Ultimately, the changes were not introduced, which in the opinion of some experts was linked to the stock market's nervous reaction to similar decisions – in January 2015 this caused the Shanghai Composite index to fall by 7.7% during the course of one day.

investors holding packages of less than 5% of shares from selling them and increased the liquidity in the margin-lending sector. Furthermore, a stock market stabilisation fund formed of state-controlled brokers was established and state-owned banks were prompted to invest – according to estimates from Goldman Sachs, the Chinese government pumped over US\$236 billion into the stock market within three months of the stock market slump in August 2015¹⁷. As a consequence of the interventions, stock exchanges have become dominated by institutions engaged in the government's stock market rescue operation and speculative investors capitalising on the government's intervention. As a result, any moves from the government linked to the stock market at present cause significant share price volatility¹⁸.

The future of reforms amid stagnation on the stock market

The reform of SOEs launched in 2013 has lost its initial momentum partly due to pressure from interest groups linked to SOEs and the conservative factions inside the Communist Party of China. In the present situation, the operation to sell off part of state-owned assets on the stock market has been limited to a significant extent, and this calls into question the main channel for the implementation of the mixed ownership reform. What is more, the volatility on the Chinese stock exchanges have brought about a partial regression of the reform – at a critical moment the government convinced part of the SOEs to buy back their own shares to save their prices from falling. The opportunities of

¹⁷ <http://www.bloomberg.com/news/articles/2015-09-08/china-s-stock-rescue-tab-surges-to-236-billion-goldman-says>

¹⁸ For example, the significant price falls at the beginning of January 2016 were mainly caused by the expected lifting of the ban on large investors selling shares, which had been planned for 8 January (and which was, as a result, postponed) and the inept introduction (and speedy cancellation) of the mechanism suspending trading in case CSI 300 index falls by more than 7%.

further restructuring and obtaining capital on the stock market are also limited. Although the introduction of new companies to the Shanghai and Shenzhen stock exchanges was resumed in late November/early December 2015, as compared to the beginning of last year, the number of IPOs has fallen, the valuations are much lower and decisions to issue larger quantities of shares by SOEs cause uncertainty among investors. This has left the Chinese government facing a dilemma – in their desire to return optimism to the stock market it has promised to further enhance the reforms of SOEs (for example by increasing their presence on the stock market) but on the other hand it has offered assurances that this process will take some time so as to avoid sudden share price fluctuation¹⁹.

The capital market reform is among the major challenges the Chinese leadership is facing – the Chinese financial system's stability depends on it.

Bringing back the reform to the initial track will thus depend on whether market mechanisms will be reinstated to the stock market and whether the confidence of investors searching for value, both domestic and foreign, will be regained. This requires a thorough reform on the Chinese stock market, cracking down on abuse, better protection of investors, and a long-term plan for educating individual investors.

Since investors' eyes are now turned towards the governmental financial market regulators, it is essential that the regulators provide the market with adequate communication of their intentions. The serious problems which currently exist include: the non-transparent distribution of competences, and the lack of

communication between financial market regulators. One result is that the institutions give contradictory messages. In effect, at the beginning of 2016, the Chinese leadership promised to establish a special commission for financial market reform whose members will include the central bank and the main regulator of the stock market. However, the situation remains somewhat opaque for the markets, especially given the fact that ever more competences are being vested in the informal group of advisors to President Xi Jinping.

In the opinion of most experts, the Chinese government still has the financial capacity to stabilise the capital markets – what may help it in this is the fact that the central government's debt to GDP ratio is relatively low (it 41% in 2014), and also the fact that the liquidity and profitability of state-owned banks is very high. The government is able to buy the time required to carry out the capital market reforms; however, these cannot be put off forever. Furthermore, there is a significantly increased risk in the financial system caused by the involvement of state-controlled banks in providing loans for unprofitable companies, restructuring the local governments' debt and supporting the stock market. On the other hand, the poorly developed capital market creates the risk that more speculative bubbles will emerge – the first symptoms of this have already been observed, for example, on the Chinese corporate bonds market²⁰, and on the real estate market in the largest cities. The key problem of companies' increasing indebtedness remains unresolved – according to Chinese statistics, the value of the loans granted to non-financial entities is growing by more than 14% annually, this is more than double that of the officially estimated GDP growth. Given the limited possibilities to reduce the debts of the SOEs sector, the scenario of liquidating some of the unprofitable

¹⁹ This is the tone of the official narrative accompanying the publication of the plan to enhance the mixed ownership reform of September 2015: <http://www.global-times.cn/content/942229.shtml>

²⁰ <http://www.bloomberg.com/news/articles/2015-10-08/if-you-thought-china-s-equity-bubble-was-scary-check-out-bonds>

entities seems ever more likely, even though the government has been trying to prevent this scenario due to the expected social costs. Proof that this process has begun include: the reduction of employment levels by 15% in the steel and coal industry announced in March

2016²¹; and the announcement in the annual report from Li Keqiang's government that 'zombie firms' and part of the centrally managed companies will be wound up.

²¹ More than 1.8 million jobs are at stake: <http://www.reuters.com/article/us-china-economy-employment-idUSKCN0W205X>

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