Orient Capital Research

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# Xi's Corruption Drive

## Will the New Campaign Hurt the Banks?

**The Financial System Under Attack**

President Xi Jinping in his continuing corruption campaign has turned his sites from the oil sector to the banks. The president of one of China's larger banks, Minsheng, has resigned, due to a corruption scandal, and a relatively new board member of the Bank of Beijing is under investigation. Is this part of a broader attack on the financial sector? What does it mean for the banks at a time when they are facing the potential for massive write-downs to due to a declining property market and 18 trillion yuan in local debt?

**A New Push for Xi Jinping**

The probe against the banks has taken most China watchers by surprise. So far, the targets in the financial sector have been lower on the totem poll than the earlier campaign. The highest target thus far has been Zhou Yongkang, former member of the Party's Standing Committee and the head of one of the oil giants, CNPC.The president of Minsheng and the Beijing Bank board member do not have the stature of Zhou Yongkang. Sill, it's an alarming turn into a new economic area, one that is particularly sensitive given the importance of the banks and the financial sector in general to the power of the Party.

Xi has steered clear thus far from anyone in the key areas of the state controlled banks, the regulating body of the China Banking Regulatory Commission (CBRC), or the heart of the whole system, the People's Bank of China (PBOC). That may yet come. Ten years ago, Beijing forced out several top executives of the state banks, including Wang Xuebing, head of the China Construction Bank, along with Zhang Enzhao, former CCB chairman. But those ousters came just before the banks were cleaned up, bad debts sold off to the Asset Management Companies, and the banks were listed. There was a catalyst for the political crackdown that is missing here.

**It's All About Control**
Why now? One theory is that Xi Jinping is moving sector by sector. He started with someone related to the fallen Chongqing leader Bo Xilai (Zhou Yongkang), who happened to be in the oil sector. Now he's looking at the banks.

The theory I prefer to subscribe to is that the banks are at the heart of the financial system. At a time of slowing GDP, and a potential debt crisis, Xi has to maintain tight control over the banks. One academic theory, from Jiangnan Zhu of Hong Kong University,  states that anti-corruption campaigns in general are a way for a leader to "signal" a leader's power — particularly when the leader is relatively weak. Xi came into leadership without the widespread support within the system, and with many competitors, and is now establishing his position. When he entered power, he forced the top generals in the Army to sign published documents in the press stating their allegiance to the Party. More signaling. Arguably, this time it's the banks he is trying to assert his control over.

**Impact on the Banking System**
What does Xi's corruption campaign mean for the financial system?  I believe there are two themes to China's economic system in 2015, both interrelated. One is capital flight, which I plan to address at a later time. The second is a crisis in local government financing. Xi's emerging power comes at a difficult time for fiscal finance.

The tighter control over the banks will be increasingly necessary as capital becomes more scarce and local government struggle to pay basic bills. There have been essentially four periods of economic policy in China that have buffeted companies and governments  alike. The first, from 1949 to 1979, consisted of Soviet style planning. The second was instigated by Deng Xiaoping and allowed local businesses to flourish, peasants to sell grain privately, and local banks and shadow banks to begin to wrest control of money away from the state. The third occurred under Premier Zhu Rongji in the 1990s and essentially re-centralized the banking and economic system at a time when tax revenues were falling. Local branches of the PBOC no longer reported to local officials— an important step for control of monetary policy. And local governments gave up control of most taxation in exchange for intergovernmental fiscal transfers from Beijing. As a result of these changes, the central government's share of national revenue soared from 22% in 1993 to 56% in 1994.This was a great deal — for a while. However, because of these changes 40,000 local township governments became responsible for 70% of social service spending but directly controlled only 30% of revenue.

They became increasingly dependent on Beijing and other sources of funds. Rising social service payments partly caused by collapsing state firms gradually put them in a fiscal bind.

**Land Became the Coin of the Local Realm**

To overcome this rising fiscal deficit, they relied primarily on land sales. According to a report by economists at the IMF, from 1998 to 2012, the 18 trillion yuan gap in local fiscal revenue was filled by 13 trillion in land sales and 5 trillion in Shadow Banking. Unfortunately, with the end of the property bubble, that game is over. Land sales for 300 cities fell 7% in 1H 2014, 55% in Q3 and 54% in Q4. This year it is likely to down again. Even worse, the property developers are backing away from the auctions and are being replaced by the government-backed highly unstable Local Government Financing Vehicles (LGFVs), which now account for an estimated one-third of all land purchases.

Why is this risky? The LGFVs are borrowing money from banks to buy land for property developments that will end up in government hands when they fail, as is likely. Thus, local governments in 2015 are facing a triple whammy: declining revenue from land sales, rising implicit debt from their off-balance sheet holdings, and lower tax revenues from the property market. What's going to happen? This means, combined, the estimated 18 trillion yuan ($3 trillion) in local debt is likely to balloon in 2015 — just when local governments are suffering from a shortfall in cashflow as the sale of land plummets.

**Beijing to the Rescue**

It's inevitable that Beijing will have to step in to clean up this mess. So far, Xi Jinping has been relying on a combination of monetary stimulus and targeted intervention through key Beijing-based institutions to keep the economy from a rapid downward spiral. The China Development Bank is busy injecting 1 trillion yuan into the housing market, courtesy of funds from the Ministry of Finance. State firms have been asked to purchase housing. While there has been a crackdown in shadow banking loans, according to the PBOC's Q3 2014 monetary report, total social financing (which includes equity and debt fund raising along with shadow and formal loans) rose 8% to 12.84 trillion yuan. Nonetheless, local revenue will be flat to down in 2015. It is highly unlikely Beijing will be willing to increase the intergovernmental transfers to local governments. Beijing now spends about 24% of total national revenue (local and central). More than three-quarters of that is for defense alone, with the rest going to capital investment and interest on debt. There's not a lot of wriggle room.

Beijing cut the Reserve Requirement Ratio by 50 basis points on Feb 4 and there's likely to be more. But that lending is increasingly ineffective, as we have seen by declining productivity.

**How Much Debt Can the Banks Handle?**

Eventually, the banks will have to absorb local debt. Can they afford it? The state banks have 73 trillion yuan in assets. Bank profits in 2013 were 1.7 trillion yuan and the banks have 6.13 trillion in equity. A default of 50 percent of 17 trillion in local debt would require 11 percent of state banking assets and would eliminate equity and profits. A smaller number would leave the banks financially solvent but would cause a drastic drop in lending. No doubt this is fiscally possible. However, a default of this scale would significantly reduce overall lending, further slowing the economy. Property and infrastructure investment will slow over time, along with GDP. National leverage will continue to rise but local governments will be forced to deleverage. This could cause local friction — something Beijing would avoid at all costs. This could explain the corruption crackdown. Xi needs to maintain a disciplined Party or else local protests could escalate and challenge the hegemony of the Party.

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