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A View of China's Problems from a Top Official

Gao Xiqing used to head China Investment Corp., the country's sovereign fund. He's a lawyer trained at Duke University. He was on a panel at the Council on Foreign Relations on April 19 and his comments are the most insightful I've seen in some time from someone in the higher levels in China. And quite honest. At one point, when asked about conflict between the Central Committee and the State Council, he said "I understand this is open to the media?...so I personally do not have a comment." I interviewed him one-on-one a few years ago and he was quite straightforward. (<http://www.cfr.org/economics/china-impact-thirteenth-five-year-plan/p37772>).

Here are some excerpts with my comments:

SOE Reform

The biggest interest group, really, is the state-owned enterprises.

In fact, in the past two year(s) or so it's sort of a regressing, because in quite a few industries the oligopolies that were—you know, those were broken up, monopolies from the Zhu Rongji days. And in the past year also, several of those re-monopolized. They got together, and then formed, and they're—with the encouragement with SASAC.

Well, if you look at the numbers that was just out for last, you know, quarter, they—you know, on the surface it's more encouraging because, you know, the numbers are going up. But if you actually dissect them, you find that it's all old story of, you know, heavy investment in all these—you know. It's almost, you

know, 90 percent state enterprises going into it. So they are sort of encouraged to invest more. And the service industry is actually coming down a little bit. That's mostly private enterprises. So, in a way, many of these private enterprises are not being, you know, very much encouraged in doing that, because of various reasons.

Comment: Most interesting was his statement that SOEs are the biggest interest group....people talk about the strength of the military, or the princelings, but it's really the princelings *through* the SOEs. The Panama papers is the tip of the iceberg. Stock issuance, debt issuance, related party transactions — there are hundreds of ways to use the SOEs as a vehicle to steal funds. That's why SOE reform is going to be near impossible except in truly dire sectors in more impoverished areas.

Capital Flight

Central Bank people nod in agreement...."all these private enterprises are going out. Many of them, I ask them, and they say, well, it's not only because I want to—I think it's cheaper to buy things outside, but it's safer to hold things outside."

You know, so much, as we're saying, we try to control, you know—capital account, you know, we allowed the current account. But when you—when you actually look at the difference between these two accounts, the line between them becomes so blurred over the past 10, 20 years, it's no longer possible to, you know, take it apart.

And now, if you consider the number of Chinese, overseas Chinese, who deal, you know, substantially with the Chinese economy, it's 50 million—50 million Chinese outside of China, OK? Second number they gave me: last year 120 million Chinese traveled outside of China and, you know, did all these sightseeing tours, and all that sort of thing. And then, as of now, about 3 million Chinese students are studying, you know, mostly in this country and many in other countries. So the person told me—he said, look, if you think about these numbers, you know—you know, you can't actually—you know, it's very difficult for them to really put a wall somewhere and pull China back into the old days of total foreign exchange control.

So that's why the—I think that at least the present leaders should be—in the

Central Bank—you know, they are definitely—they are—you know, they are known to be illiberal on that side. But even with the pressure from—(inaudible)—they still—you know, there’s a lot of pushback there. Even with the people who are saying, no, you should close it down, *you stop the capital outflow, they can’t do it*. If they start doing that, things will be a lot worse. And right now it seems like, you know, things are much better for them with, you know, the recent change of the—of the trend.

Comment: Gao confirms what we all suspected. Overseas investments by private firms are mainly due to domestic fear mongering, not financial reasons. He also indicates that the officials he knows don’t believe China can stop it.

The Corruption Campaign and Decision Making at the Top

And my former employer, CIC, now is being very careful with whatever decision-making. Because in my days, when our typical length of decision on any particular investment would be, you know, within probably a month or two, now it’s, they say, average is six months. And most—many of my, you know, former colleagues on the lower ranks complain to me—they come to my office all the time and say, OK, well, I’ve been working on this for four months, and now, you know, we took it to the investment committee, within 10 minutes it was vetoed or it was, you know, turned down, simply because most people want to—want to see—want to be put on record that, OK, this is risky. They just want to say it so that, you know, whether or not it gets anything, we don’t care. But so long as I don’t—you know, I’m not getting criticized later if something goes wrong.

Comment: He confirms what we all suspected, decisions have come to a standstill.

Leadership Change in 2017

So now you can see, there’s probably going to be some pushback in that regard, and by fall of next year, by summer—late summer of next year, you’ll see a lot better in that regard. You were asking about indications. By that time you will see the change of heads of many industries, many major state enterprises, and many ministries, and possibly the Central Bank, possibly the Ministry of Finance, Ministry of Commerce. If you see people coming in, then by, you know, knowing who the person will be, then you know—you get a better indication as to whether

or not the government is staying forward or staying still.

Comment: He notes that there will be a complete change in many ministerial and SOE heads in 2017 and the nature of this group will tell us whether the government is “staying forward or staying still.” The party in 2017 will hold its 19th congress, when all of the seven Standing Committee members except Xi and Li are scheduled to retire, having reached the age of 68. Six out of the remaining 18 members in the Politburo, the second most powerful body in the hierarchy, are also due to step down by then.

Shadow Banking

I restarted my lawyering, but I usually—I only do the head arbitration. The one interesting thing I found is that, you know, over the past two and a half years I had all together about 15, 16 cases. Ninety percent of them were all about loan problems—someone, you know, go back on a loan. And the average contract of these loans for the—the rate of the loans, take a guess? You know, the Chinese—you know, Chinese banking loans are always regulated, and so you always have a number that’s stipulated by the Central Bank. And they always have—you have a very narrow tunnel, you know, where you can move. So it’s basically within 6, 7 percent.

But I was surprised. You know, I had more than a dozen of these cases. Every one of them has a loan rate much higher than that. And the lowest, guess—lowest loan rate for these contracts? Twenty-four percent is the lowest on these. And the highest, of course, is over a hundred percent.... You know, we always thought 6, 7 percent is all right. Maybe, you know, 8, 9 (percent). But 24 percent? And then you read on, the Court says: If it’s below 36 percent, we’re not going to overturn it. So basically what they’re saying is we’re going to say it’s illegal (sic I presume Gao means ‘legal’?). If it’s beyond 36 percent, that’s illegal....

So what happens is when you—so I dig harder into it and I said, why would anyone be willing to pay that much? Now you realize that most of the private enterprises do not have enough, you know, resources, and they can’t go to the banks to get loans. And the very inefficient state enterprises, and old people with power, with, you know, strings to pull, they get loans from the state banks, they turn around—you know, because steel mills and these people, they can get a loan.

But even putting in—as they say, for every thousand dollars I put in, I lose, you know, a hundred dollars, so why do I want to do it? So they turn around and they give the loan to someone else, with a markup. So now from 6 percent they get to 8 percent. Then you have all these people in the middle, eventually it gets to 24 percent. And the interesting thing is that the law—you know, at least the legal system now recognize(s) that.

Comment: The official data for non—bank lending puts interest rates at around 6-7%. He says what my research has noted....the actual rate is much, much higher — possibly as much as 24% or more. He knows this from adjudicating corporate disputes. That is a huge drain on the economy, an inefficient use of capital, and a tremendous transfer of wealth from the state sector to private individuals because the rich in China are the biggest source of Shadow Loans from the private sector. Basically, a combination of private lenders, local firms with state connections, and some SOEs are paying back high interest loans to keep the GDP wheels spinning and support the property bubble. 24% times some 24 trillion rmb in shadow banking in wealth management products is 6 trillion rmb a year going to, for argument's sake, 15 million rich people.

