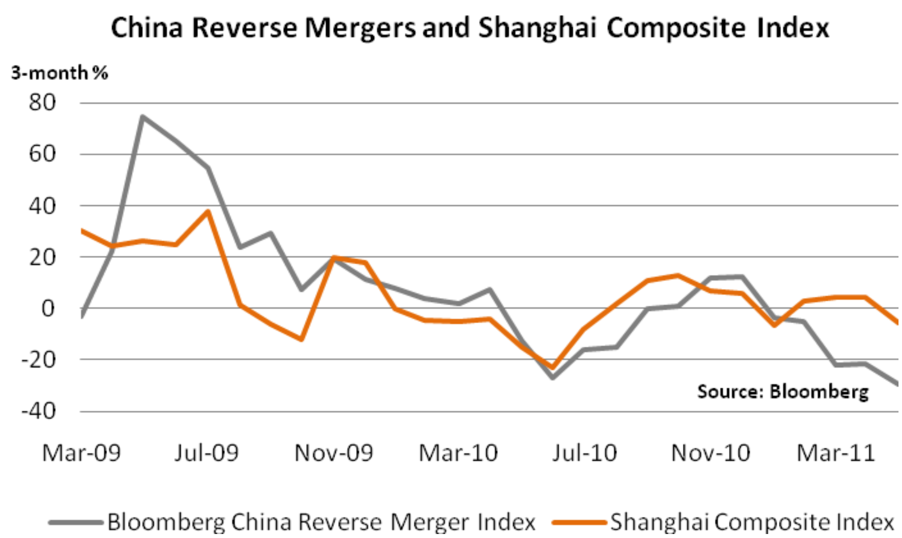
China Update: Strong and Fragile

Many seasoned observers exaggerate China. Some do it to demonize it; others to celebrate it. After all, they speak of China as the factory of the world when it is really an assembler rather than producer. Recognizing, as such, its $3 trillion of reserves (and growing), we are told that China is the banker of the world, yet its financial system is fragile. This fragility, in fact, appears to have begun to hamper the projection of China's financial power in recent weeks.

Reverse Mergers

One of the most dramatic developments has been the collapse in the share price of a number of Chinese companies listed in the United States. The shares are accessible not as American Depository Receipts, the way, say, Petrobras trades. Instead, these companies bought small marginal businesses in the US that were already listed.

This allows a company to become listed quickly and with much less regulatory scrutiny. The Bloomberg Reverse Merger Index, for instance, composed of almost 80 Chinese companies (which achieved their listing through reverse mergers) has fallen nearly 30% since mid-May. The decline, therefore, is largely a function of allegations of fraud and short selling, while at the same time the Shanghai Composite Index was off about 9%.



The Securities Exchange Commission, meanwhile, has recently revoked the registrations of eight Chinese based companies since December. Reports indicate that auditors resigned at another two dozen China based companies for accounting problems since March. Furthermore, in early June the SEC warned investors from buying stakes in Chinese companies listed through reverse mergers.

Knock on Dim Sum

Questioning the credibility and integrity of many Chinese reverse mergers opens a proverbial can of worms. Its contagion appears to be a factor behind the apparent slowing of the Dim Sum bond market, which you will recall is the yuan denominated bond market in Hong Kong. Chinese officials themselves are also doing a fair job, even if unintended to cool off the Dim Sum market.

Yuan deposits in Hong Kong (CNY511 bln, ~$49 bln end of April) are six times greater than they were a year ago. The source of the yuan is largely a function of trade settlement. Estimates suggest about 7% of China merchandise trade is settled in yuan and often in Hong Kong accounts.

The yuan in Hong Kong (CNH) cannot be easily brought back on shore (to the mainland). It is tightly regulated and the process is not particularly transparent. All told that suggests there is not yet a standardized repatriation mechanism or process.

There are limited places to invest the CNH outside of deposit accounts. Hence the rapid growth of the Dim Sum bond market. However, the Dim Sum market remains small, with about CNY130 bln outstanding at the end of April.

The greater supply of CNH looking for better yielding investments helps explain why Dim Sum yields are significantly lower than mainland rates. That gap (and perhaps other considerations) is sufficient enough for the Chinese government to raise funds in the Dim Sum market.

The Dim Sum market is not very diversified either. Chinese banks, the Chinese government, financial service firms and supra-nationals (like the World Bank) account for about three quarters of the outstanding bonds. A handful of multinational companies, like Volkswagon, Unilever, Caterpillar and McDonalds have issued Dim Sum bonds, but they account for less than 10% of the market.

Whose rules?

Some Dim Sum bond holders want to be able to hedge their exposures. This must be a completely expected evolution of the market. The commonly used financial instruments to hedge such exposure are swaps, but there isn’t really a swap market for CNH, though two non-Chinese banks reported did conduct a swap among themselves in Q4 10.

Chinese officials want to regard Hong Kong as separate from China for currency purposes (CNH-CNY), in other respects they want to treat Hong Kong like it is a Special Administrative Region. If a swaps market is to develop in Hong Kong, they want it to be under Chinese rules not the international standards.

Chinese officials from the National Association of Financial Market Institutional Investors (NAFMII) are reportedly encouraging foreign banks in Hong Kong to use the mainland's legal documentation. The international standard is the International Swaps and Derivatives Association, master agreement.

Acquiescing to Chinese requests may carry with it the possibility of more business. For example, the NAFMII can also grant licenses for lucrative mainland business, such as underwriting corporate bonds. On the other hand, the needless fragmentation of the market could make it more expensive and more cumbersome to transact.

Banks

China appears to have granted the Bank of China Hong Kong a monopoly on clearing CNH. However, some investors are concerned about such concentrated counter-party risk. In the beginning of Q2, officials allowed banks to set up special fiduciary accounts with the PBOC, for which the Bank of China Hong Kong is the custodian.

However, investors are concerned about how China is doing this. Reports indicate that the PBOC places all the yuan deposits from foreign banks into one pool of liquidity. By not keeping the deposits separate, investors are concerned that they are exposed in case of a credit crunch. This appears to have discouraged its use as reports indicate that only a few of the more than 120 potential banks are using these special accounts.

On the mainland, the rating agencies have warned recently of increasing bad-loan problems. One of the ways in which China avoided the sharper slow down over the past couple of years was through fiscal and monetary stimulus, which helped fuel a dramatic growth of bank lending. Overall loans stood near CNY50 trillion ($7.67 trillion) at the end of April.

Local governments in China have borrowed about CNY10 trillion, through some 8000 special purpose vehicles (SPV). Another 2 trillion is likely to be added as the government pushes for the construction of 36 mln low cost homes by 2015. Often seen as late to recognize a problem, the three major rating agencies have weighed-in. Moody's, for example, says that its stress tests for Chinese banks are ('show a') 10% bad –loan ratio. S&P has warned that Chinese bank bad loans may rise next year to as high as 10% from a little over 1% now.

In Fitch's worst case, the combination of the local government SPVs that are used to circumvent restrictions on direct borrowing, and real estate exposures, suffer 30% losses. It cited these SPVs, which are the conduit for fiscal stimulus provided during the crisis among its biggest export markets (US and Europe), when it cut the outlook China's long-term local currency debt rating of AA- in mid-April.

On the Treadmill

To avoid a build-up of bad loans, some, such as Li Yang, former PBOC advisor and vice president of the prestigious Chinese Academy of Social Sciences, estimate that the Chinese economy needs to grow 8-9% a year. The implication of the current five-year (2011-2015) plan's 7% per annum growth target is clear.

Chinese officials are becoming more cognizant of the issue. The PBOC itself sees the increasing risk of losses from the SPVs. There have been reports in recent weeks that Chinese officials are working on a plan to shift some CNY3 trillion of loans away from the local governments. It may be effectively nationalized. Ironically this is what Alexander Hamilton did for the United States (Assumption) and what many have suggested would be a solution for Europe's crisis.

This is not to be alarmist. China is struggling to maintain control of its financial experiment in Hong Kong SAR. As it has in other facets of its re-emergence on the world's stage, China wants to challenge the status quo. This contributes to and spurs on the disruption that would likely to have occurred in any event, given China's economic heft. It causes friction.

Domestically, like Oedipus trying to avoid his Fate and running right into it, so too is China risking a banking/lending problem, in a large part fueled by those policies precisely aimed at minimizing the impact of the US-European crisis. Investors should monitor the financial system and property markets, which may be particularly vulnerable to even a modest slowdown in growth.

Marc Chandler
Global Head of Currency Strategy