Capital market reform

Market? What market?

by Carl Walter and Fraser Howie

Everyone knows that capital is mispriced in China. In the long run, capital and risk need to be priced better if China is ever to generate economic growth out of efficiency improvements rather than the brute accumulation of capital and labor. For this pricing to occur, the banks must be reformed to become commercial allocators of capital, and true capital markets have to be developed. What is the likelihood of this happening any time soon? Very low.

China must price capital better to generate growth from efficiency improvements instead of brute accumulation of capital and labor

Banks have no incentive to allocate capital because the administered interest rates set by the Peoples' Bank of China (PBC) guarantee them a comfortable profit margin on loans. They therefore lend almost exclusively to borrowers who offer the most reliable security (state enterprises and, more recently, home mortgage borrowers) and make no effort to chase potentially more profitable, but also more risky, lending to private-sector firms.

Bond markets – the most effective mechanisms for pricing capital – have expanded greatly in the last two years. But China's bond markets are illusory and play no role in pricing capital. Bond prices are set not off a market-determined yield curve, but off the administered bank loan rates set by PBC. While the primary market is substantial, the secondary market (which is where, in a real bond market, prices are set on a daily basis) is trivial. The only debt market with any depth is a short-term money market whose main purpose is to enable speculators to raise funds to punt on initial offerings in China's casino-like stock market.

The root cause of China's stunted capital markets is political. The bond markets, like the banks, are part of a closed system entirely controlled by the party-state. Prices are set by the party-state for the principal purpose of minimizing the financing cost of the central government budget deficit. So long as the financial system remains a tool of fiscal policy, and the price of capital is determined by the fiat of the party-state to satisfy its budgetary needs, China's capital markets and financial system more generally will remain deformed, and will not be true markets.

Politics underlies the stunted development of China's capital markets

Alpha and omega: the banks and administered interest rates

The basis of the entire Chinese financial system is the state-owned banks that control 76% of corporate finance. And the basis of pricing in the capital markets is the set of benchmark bank lending rates determined by the PBC. These are the central facts of the Chinese financial system

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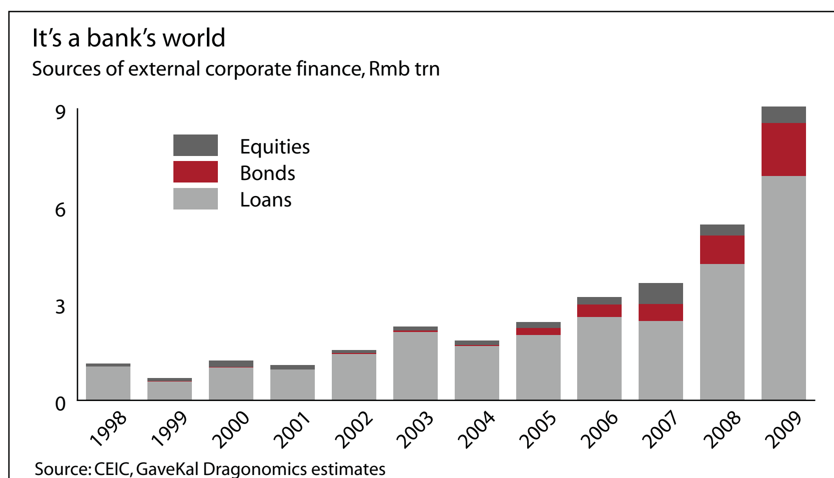


and, until they change, the development of mature capital markets is all but impossible.

The PBC sets benchmark loan and deposit interest rates for every maturity from one month to five years. The loan benchmark is a floor rate and the deposit benchmark is a ceiling rate. The most widely used benchmark is the one-year loan rate, which applies to working capital loans. Since June 1999 the spread between the one-year loan rate and the one-year deposit rate has been virtually constant at between 300 and 360 basis points. This guaranteed spread assures bankers substantial profits just for waking up in the morning, and eliminates any incentive to price risk. In theory, loan interest rates were deregulated in 2004, enabling banks to lend at any rate above the benchmark and down to a 10% discount to benchmark. But banks have made no use of this ability to price risk: actual market lending rates follow the benchmarks in lockstep, and the proportion of loans made at or below benchmark rates rose from a low of 40% in mid-2005 to over 60% today.

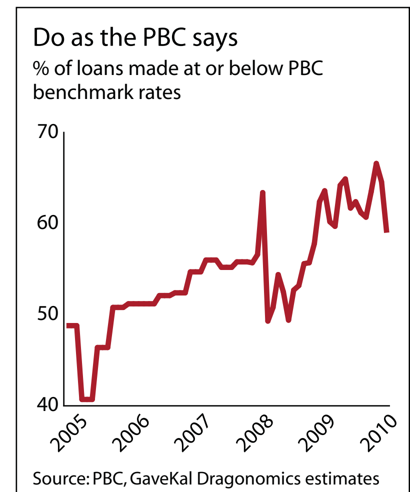
Adjustment of interest rates plays almost no role in monetary policy

For most of the past 15 years adjustment of interest rates has played no significant role in monetary policy. PBC sets policy mainly with an eye to deposit rates: the idea is to ensure that retail depositors get just enough of a return to leave their money in the banks and keep the banks flush with liquidity. Banks fund themselves overwhelmingly from this captive market of retail depositors. There is a wholesale interbank funding market, and a benchmark interest rate in that market, the Shanghai Interbank Offered Rate (Shibor) which was introduced in 2007. Modeled on the London Libor quote, Shibor is calculated daily across eight maturities. But in reality, China's money markets are thinly traded and play no role in the pricing of capital.

The only Chinese money market with any depth is the seven-day repurchase (repo) market, in which Chinese government bonds (CGBs) are used as collateral for short-term fund raising. The interest rate on this contract is quite volatile, showing that the demand for capital is being driven by supply and demand. Is this the basis of real capital pricing?

Unfortunately, no: the main function of the seven-day repo is simply to finance stock-market speculation.

The wildly speculative bidding on initial public offerings (IPOs) on the Shanghai stock exchange forces investors to put together the largest amount of funding possible to secure an allotment in the share lottery. In IPO subscription lotteries, massive amounts of capital – often in the tens of billions of dollars – are frozen to secure allocations of shares. Much of this capital is raised by repo transactions. The peaks in the seven-day repo rate correspond exactly to the peaks in IPO frenzy, when demand for money to put into share lotteries is highest.



The stock market: more fun than Lotto

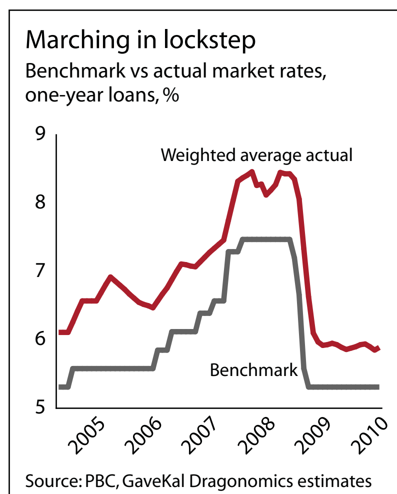
So the short-term money market is not a mechanism for capital pricing but simply a way for speculators to gamble on stock-market IPOs. What about the stock market itself – does it perform any capital pricing function? Again, the answer is no. From the government's point of view, the purpose of the stock market is to enable state-owned companies to raise low-cost capital. Any market in which state and private companies freely compete for capital, and are valued based on their ability to provide a return on investment, is not desirable.

From the investor's point of view, the stock market is a vehicle for speculation in quest of quick (untaxed) capital gains. As is obvious even to infrequent observers, speculation is a central fact of China's economy. The artificially fixed returns on bank deposits, loans and bonds mean that the only available investment alternatives are real estate and shares. Since the stock market is run deliberately to avoid valuing companies on fundamentals, stock investors must be purely speculative. And the main speculative game is to get into IPOs early, via the lottery; reap big gains on the first day of trading; and get out. From 2000 to 2008, the average first-day price jump for IPO stocks was never less than 45%, and was frequently well above 100%. It is not uncommon for as many as 70% of the shares allocated in an IPO to be flipped on the first trading day.

CSRC appears to see its role as managing the share index – not creating a better-functioning market

Before 2006 these first-day jumps were virtually guaranteed by the fact that IPO prices were set administratively (and consistently too low) by the China Securities Regulatory Commission (CSRC) when it approved listings. And for years, CSRC has effectively promoted the first-day jump mentality by slowing down or suspending IPO approvals in order to reduce the supply of new shares when stock prices are low. CSRC appears to think its role is not to create a better-functioning market, but to manage the stock-price index through control of the supply and demand for shares.

But even after the switch to an apparently more market-driven IPO pricing system, the first-day jumps continue, because ultimately the allocation of IPO shares comes down to a lottery, with no mechanism to allocate all investors some token minimum amount. The result is vast oversubscriptions, sometimes running into thousands of times the



number of shares available, as speculators all hope to strike it rich in the lottery. The fact that the widely trumpeted change to a "market-driven" IPO pricing system had zero impact on market behavior is a sobering reminder that apparently bold capital market reforms often lead nowhere in China, because the deep structures and incentives remain unaffected.

Not surprisingly, this market is dominated by big-time speculators with access to money-market funding; the mom-and-pop Chinese retail investor is largely a myth. It is true that China now has 124m stock-market trading accounts, 99% of them in the name of individuals. But half of those accounts simply reflect the fact that investors must open separate accounts to trade in the Shanghai and Shenzhen markets. And clearing house data show that 55% of all accounts hold no shares and have not traded for over one year. At most, China may have 10-20m active retail investors, and the real number may be even less. The recently launched index futures market already trades more than the equity market and has become one of the most liquid contracts in the world – yet it has fewer than 30,000 open accounts.

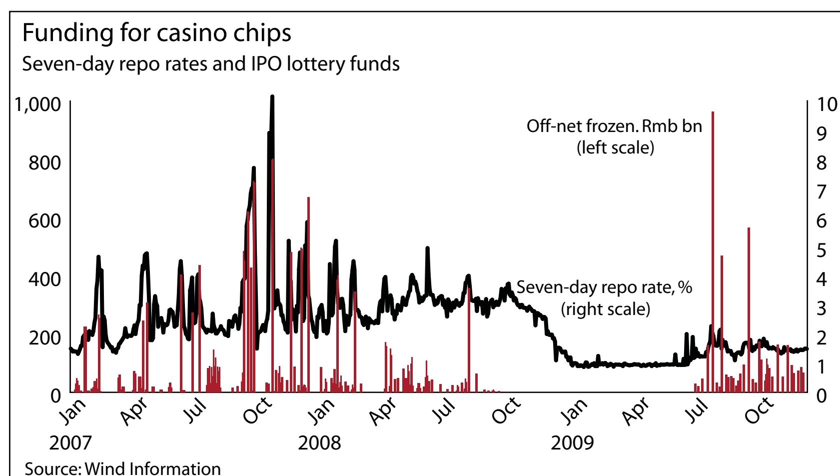
The captive bond market

At the end of the day, however, it is the bond market where the price of capital is really set in mature economies. And here, on the surface, the news seems better. Since 2005, vibrant bond markets have been created by the same group of reformers who promoted bank reform, led by PBC governor Zhou Xiaochuan. Aiming to reduce excessive risk concentration in the banks, they took over the moribund interbank market for government debt and introduced products modeled after those available to corporations internationally. But huge issuance volumes, thousands of market participants and a growing product range disguise the fact that China's debt markets remain captives of two unchanging realities: that interest rates are controlled by the party-state, and the buyers of bonds are all ultimately banks.

China's bond market has no means for measuring and pricing risk

All the trappings are there: like highways, new airport terminals or CCTV's ultra-modern office building in Beijing, China has bond markets because the party-state believes such markets are a necessary symbol of economic modernity. So there are ratings agencies (five), regulators (at least seven) and industry associations (at least two) with overlapping authority and little respect for one another. China also has many of the same debt instruments one might see elsewhere: government bonds, commercial paper, medium-term notes, corporate bonds, subordinated debt, asset-backed securities, and so on. These products are traded for cash, repoed out, sold forward and hedged through swaps.

What is lacking is the engine of true bond markets: risk and an ability to measure and price different levels of it. In China the party-state has made sure that it, and not a market-driven yield curve, provides the definitive measure of a risk-free cost of capital, and this measure is based ultimately on the funding cost for bank loans. Consequently, in the primary market (that is, the original issuance of bonds) it is common



practice that underwriting fees and bond prices are set with reference to PBC benchmark loan rates, and not to true demand. And while China's primary bond market is now fairly large, the *secondary* market – where informed investors buy and sell bonds based on changing perceptions of the riskiness of the borrower – is virtually non-existent. As a result, bond prices wind up being nothing more than a pale reflection of PBC benchmark interest rates. And since more than 70% of bonds are bought by banks which hold them to maturity, there is little difference in practice between bonds and bank loans.

Nice market you've got. Pity no one trades in it

So why does China have a bond market at all? The answer is that bond markets evolved because the national budget needs to be financed. Starting in the 1980s, the Ministry of Finance started to issue CGBs to cover its budget deficits. Initially, these bonds were sold on a compulsory basis to companies and individuals. In 1994, MoF stumbled on a market pricing formula that combined underwriting by large institutions (mainly banks) with just enough of a secondary market to enable investors to exit their positions. Since then, MoF has issued an ever-increasing flow of CGBs in what superficially appears to be a market.

China's bond market was set up to finance the national budget

But the reality is that the CGB market – and the more recent corporate bond markets built on top of it – are thinly disguised loan markets. There are 24 primary dealers, of whom all but two are commercial banks (the others are CITIC Securities and China International Capital Corporation). Bond interest rates are set lower than the rate that would reflect actual demand. Thus, anyone who buys a bond when it is issued would take a loss in a secondary market trade. So the primary buyers – mainly banks – simply hold the bonds until maturity, like loans. The result is a bond "market" without trading. And what is a market without trading?

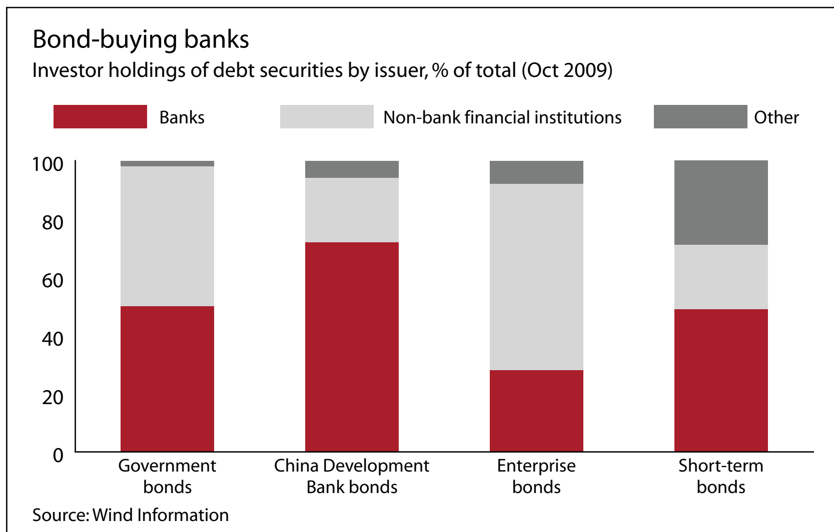
It turns out that that a market without trading is a market without meaningful prices. In theory, bond interest rates are subject to PBC-determined mandatory minimum spreads (depending on credit rating) above the CGB rates for each tenor. In practice, bond issuers and buyers

usually ignore these spreads. The issuer tries to get an interest rate on its bond lower than what it would have to pay for a bank loan of the same maturity. The bank, meanwhile, will compare the price of a corporate bond to the rate it would charge the same company for a loan. Generally, issuers entice banks to buy their bonds at lower rates than would be charged for a loan, in return for guaranteeing the banks other bits of lucrative business. In any case, the reference for bond pricing is not the supposed spreads over the CGB yield curve, but PBC's benchmark loan interest rates.

China's bond market has no meaningful yield curve

The whole idea of a "yield curve" is fictional in China anyway. Yield curves are determined by high-volume trading, which enables clear price levels to be set for different types of issuers at various maturities. Snapshots of a day's trading in the Chinese corporate bond market look like something created by random machine gun bursts against a wall. In one arbitrarily selected trading day last December, two five-year AAA-rate bonds traded at lows of less than 2% and highs of close to 5%. How could this possibly occur? The answer is that there was barely any trading. On that December day, the entire China interbank bond market recorded only 1,550 trades – this in a market with 9,000 members and Rmb1.3 trn in underlying bond value. The CGB market was even more comatose: it recorded only 52 trades that day, and days when no CGBs trade at all are not uncommon. In contrast, in the US Treasury market there are on average 600,000 trades each day, comprising US$565 bn in trading volume – more than 20 times the typical day's trading volume in China's interbank bond market.

In short, China's bond markets enable a lot of bonds to be issued, but they do nothing to price risk. Bond prices in the primary market are set in relation to the PBC's benchmark loan rates, not in relation to "risk-free" CGBs – whose yield curve is purely imaginary in any case, because the bonds trade so infrequently. Prices in the thinly-traded secondary market simply reflect the liquidity premium investors must pay on a given day to sell their bonds into a saturated market.



Don't hold your breath

To summarize: China's capital markets produce enormous issuance of stocks and bonds, but very little in the way of valuation of companies, bond trading or pricing of risk. This suits the party-state fine, since it gets lots of cheap finance for the government deficit and for the state companies it controls. As long as the name of the Chinese economic game is simply mobilizing lots of capital to build infrastructure, housing and basic infrastructure, this primitive financial system can persist. But at some point economic growth will have to start coming from efficiency gains, and it will be necessary to have a financial system that prices risk. The way to do this is conceptually easy but politically hard: deregulate interest rates, force the banks to earn a living instead of feeding off their guaranteed spread, and allow more private-sector and international participation in stock and bond markets so that trading volumes increase and the accuracy of capital pricing rises.

The party-state will not like this because it views control of financing channels, and of the price it pays to finance its own government deficits, as central pillars of its regime. The single lesson that the party-state has learned from the whole series of sovereign debt crises from the 1994 Mexico peso crisis to the 2008 financial meltdown and today's problems in Europe is that open financial systems create vulnerability. Therefore we are unlikely to see substantive capital-markets reform any time soon – only incremental measures that lead nowhere, like the reform of IPO pricing and the creation of the interbank bond market in recent years.

The government sees open financial systems as a major source of economic vulnerability

In the meantime, substantial risk is building up in the big state-owned banks, about 30% of whose balance sheets now comprise securities investments (mainly bonds) whose prices in a true market would be much lower than the prices at which they were bought; this should occasion the need for provisioning against market losses. Total securities investments by the biggest four state banks comprised Rmb9.2 trn at the end of 2008, more than four times the banks' combined capital. In addi-

tion to a buildup of non-performing loans from last year's lending spree, potential losses on these mispriced securities investments pose a threat to the long-term health of China's banks. Let the buyer beware.