CHINA'S FINANCIAL SYSTEM: DANCING FASTER THAN THE MUSIC?

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When asked to select the first topic for this special series of T.notes – produced as part of the ChinaMed Business Program currently under way at Peking University – China's financial system was the inevitable choice. Not only because of the unparalleled attention it has received in the past months by the general press and the academic community, but because it is a paradigmatic example of the distortions, contradictions and conflicts which lie at the heart of China's economy – and of this CMBP T.note series.

Virtually no segment of China's financial system is insulated from a variety of notorious and deep-seated problems: the rapid and constant rise of corporate debt (which in the past 5 years skyrocketed from 100% to around 170% of GDP, and continues to rise) and the structurally unsolvable and cyclically reappearing problem of non-performing loans (according to official figures currently at a 11-year high at 1.7% of total loans, with unofficial estimates putting the figure much higher) have been widely covered by the economic press in recent months. The bond market is also going through rocky waters, with a long series of defaults in repayment by Chinese firms, some of which state-owned or state-backed – an event that was not even contemplated until a few years ago.

The condition of local governments debt, whose total size ranges between USD 2.5 and 3 trillion, is slightly better, with some progress made by the central government to keep the situation under control. Local governments, however, continue to come up with creative solutions to issue debt and boost growth numbers, in a seemingly never-ending cat-and-mouse game. Last but not least are equity capital markets. After the *annus horribilis* of 2015, when an impressive growth in the first half of the year (+120% for Shanghai's composite index and +60% for Shenzhen's) was followed by a sudden crash around June and a return, by the end of the year, to the pre-boom levels, the situation has slightly improved. After the ban on new IPOs adopted in the wake of the June/July 2015 meltdown was finally lifted in December 2015, Chinese equity markets have remained weak and unstable.

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The distortions, contradictions and conflicts appear even more tangible when moving from the systemic level to that of empirical observations on the ground. This realm is best known to professionals actively engaged in long-term business practice in and with China, who are often among the most alert to the inventive countermeasures developed by Chinese companies (as well as, to a lesser extent, foreign firms operating in China) to react to restrictive (and sometimes anachronistic) policies.

This approach, a trademark of CMBP T.notes, allows now to emphasize how these countermeasures have escalated to a degree previously unseen: specific instances witnessed by the author include a number of Chinese medium-sized and privately owned enterprises deciding to shift their holding company or assets abroad to benefit from more competitive markets and access to finance; unsophisticated coal producers of a remote inland province renegotiating their loans with the Japanese or European branches of Chinese banks to take advantage of lower interest rates; a renaissance of a number of illegal or semi-legal financing structures from what are popularly called "shadow banks"; local government openly authorizing investors not to comply with national regulations in order to attract them; and others. Overall, the feeling is that the divergence between the regulatory and political structure of China's financial system and the needs it is called to satisfy is continuing to increase, putting additional pressure on an already critical situation.

Where is this rising divergence leading? Observers have fixed their views around two possible outcomes: on the one side are the doomsday-callers, prophesying a hard landing of the economy and financial turmoil. On the other, those seeing China and its financial system as unique and therefore capable of absorbing all the stress they are subject to and continue to develop, synthesizing the apparent contradiction between capitalism and socialism. Such contradiction, however, has become more and more difficult to navigate. One example in particular gives an immediate sense of the dynamics at play: on June 14th MSCI Inc. (one of the leading providers of equity, fixed income and stock market indexes, whose emerging-market index is tracked by investors globally) denied China's domestic equities entry into its benchmark indexes for the third time in a row, thereby denying them the possibility of receiving investments by the USD 1.5 trillion-worth investors following the index. A great contribution to such negative decision must have come from the distortions still existing in China's financial system and the brutal measures taken by the Chinese government in the wake of the June/July 2015 stock market crisis, including (but not limited to) the use of public funds to invest in listed firms and keep the market afloat, the ban on short-selling and on the sale of shares by State-owned firms, and detention and criminal prosecution of bank executives.

Such decision is a major blow to the efforts by the Chinese leadership to make the *renminbi* an international currency and integrate China in global markets. The reality, however, is that such intention must be implemented with decisive and permanent measures that so far have been lacking. The impression of most people "on the ground" (executives of multinational firms and SOEs, consultants, bankers etc.) is that China has been advancing by making three steps forward and two steps back each time, and such a pace is now insufficient. The inevitable conclusion is that major changes have now become unavoidable. This view was summarized in a comment made by the CEO of a Chinese private equity fund at a recent closed-door conference:

> *"Everybody knows that the situation has to change and all segments of China's financial system have to modernize and open up to the rest of the world completely, once and for all: you know it, I know it, the government knows it. The only uncertainty is as to how, how fast and starting from where."*

The next months are likely to see much turbulence affecting global financial markets and China, although partially protected, will not be immune. This may slow down the opening up and modernization of China's financial system but it may also be a great opportunity for the authorities to put in place the long awaited reforms. China is likely to do so in its own way and with the typical inventive and experimental approach that has characterized its development path over the last 30 years. It is however predictable that this will bring benefits to firms and individuals, both Chinese and international, to different degrees and in different forms, with the main loser being the government and its reduced ability to control the economy.

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