Confidence game

Growing pessimism in China could spark a dangerous flight of capital

"China has been the world's strongest economy in recent years. It should be full of hope," Hu Zuliu, the founder and chairman of Primavera Capital Group, wrote on his microblog in August. "The rich in particular, China's most successful people and its biggest beneficiaries, should be the most confident in China's future. So why are they using every conceivable means to immigrate?"

A new wave of pessimism seems to be inundating China. A survey earlier this year by the Committee of 100, a non-profit organization that advocates Chinese-American cultural exchange, shows the percentage of Chinese who expect their country to be the world's largest consumer society in 20 years fell to 39% this year from 71% in 2007. Attitudes towards China's prospects have worsened in recent months as economic data provide stronger evidence that the country may yet fall victim to the global crisis.

This perception inevitably affects investment, and recent data show that less cash is coming into China and more is leaving. In the second quarter, China recorded its first quarterly balance of payments deficit since 1998, dragged down by a capital account deficit of US$71.4 billion.

Much of this decrease was due to an increased preference for Chinese to hold their cash in US dollars instead of renminbi, as renminbi appreciation no longer seems certain. The yuan's appreciation against the US dollar effectively ended at the beginning of the year, and since late April it has depreciated by roughly 1% as the economy worsened.

But these outflows are not just about returns; they are also about protecting wealth. Corruption and income inequality are in sharp focus because

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of the leadership transition, and China's rich may have reason to be scared about the selective application of China's laws (see the pg 24 op-ed by UniRule's Yang Junfeng on the persecution of entrepreneurs).

The slowing economy and the risk of inflation returning later this year are encouraging those who can get some money out of the country to do so. Chinese have become the second largest group of foreign buyers of real estate in the US behind Canadians. A survey by the Hurun Report and consultancy Bain & Co last year showed that 60% of the 960,000 Chinese with assets of more than RMB10 million (US$1.6 million) are considering emigrating or have already begun the process.

China's super-rich own a huge proportion of the country's wealth; the top 1% in China controls 70% of the country's financial assets, according to a 2008 report by Boston Consulting Group. They are also best positioned to find means to circum-

The B team: International financial centers don't have foreign equity ghettos

China's exchanges for Class-B shares – equities that can be freely bought by foreigners and are denominated in US or Hong Kong dollars – are sleepy places. The market capitalization of Shanghai's B shares is roughly 0.5% of A-share brethren, with similarly low trading volumes.

But this summer B-share markets got a wake-up call. Under new rules on delisting, electronics maker Tsann Kuen (China) Enterprise was dangerously close to being booted from the Shenzhen Stock Exchange, after its shares traded below HK$1 for 18 consecutive sessions. Trading in its shares was ultimately suspended before it was forced to delist, but the incident raised fears the rules could jeopardize other B-share listings.

Then on August 15, China International Marine Containers Group, the world's largest shipping container maker by volume, put forth a plan to delist from the Shenzhen B-share exchange and relist in Hong Kong. Although not yet approved as this issue went to press, the exit of such a large company could prompt a major exodus from the board.

These events drew attention to B-share markets that have long flirted with irrelevance. Few companies have carried out B-shares listings in the last decade. Now that China's expanding Qualified Foreign Institutional Investor (QFII) program and the similar renminbi-denominated RQFII program are allowing some foreigners access to A shares, shutting down B shares has become a painful, but necessary, step.

B shares may soon be gone, but they shouldn't be forgotten. Regulators should learn a lesson from those markets as they work toward the stated goal of turning Shanghai into an international financial center by 2020. It's not enough to create an equities ghetto for foreigners; the entire

vent the country's tight controls on the export of capital. This presents a small but significant economic risk: If the economy worsens and China's elite move more of their wealth abroad, that could drain liquidity from the country at a time when it needs it most.

Too much of a good thing

As Patrick Chovanec, an economist and professor at Tsinghua University, pointed out at a recent event in Shanghai, the flow of money out of China is not inherently a bad thing. Instead, it could be good for China and the globe.

China has run a persistent capital and current account surplus for nearly a decade, and these massive capital inflows have contributed to the formation of asset bubbles and inflation. By investing in other countries, China can help foster economic growth that allows foreign consumers to buy Chinese products again. It could also help reverse the pernicious trade imbalances that have led the US and the EU to take on more debt than their economies can sustain.

But a sharp decrease in capital, or capital flight, is almost always very destabilizing. These dramatic outflows played an essential part in the crashes of Asian and Latin American markets in the 1990s and threaten to destabilize heavily indebted European nations today. The difference between growth-promoting investment and destabilizing capital flight is just a matter of degree.

How does one quantify the degree in China? Official data on capital flows is available only on a quarterly basis, but a monthly model by RBC Capital Markets showed in August that capital outflows had been recorded in eight of the previous 10 months. Total capital outflows reached US$168 billion in the past year, a much deeper and more persistent deficit than during the 2008-2009 global financial crisis.

This may seem small compared to China's US$3.24 trillion foreign exchange stockpile, but there is reason to be cautious. Well-known academic Victor Shih estimates that the wealthiest 1% of households in China command wealth that is at least as large as two-thirds of forex reserves and is possibly twice its size. Moving even a portion of this wealth abroad could have a noticeable effect on the banking system.

This is because forex reserves are closely tied to bank liquidity in China. In order to keep the value of its currency stable, China's central bank must use newly minted renminbi to buy dollars from China's exporters. After nearly one decade of surplus in the balance of payments, the Chinese system has been flooded with liquidity. China's M2, the broadest measure of money, is twice the size of the country's economic output and more than four times as large as its forex reserves.

As capital inflows subside, so will the ready supply of cash that the banking system has grown used to. Data already shows growth in China's forex reserves slowing; they expanded only US$63.6 billion in the first six months of the year, down 77% from the first half of 2011.

If this situation persists, liquidity will be siphoned out of the system just as other demands on bank capital are growing. As banks choose to roll over existing loans rather than classify them as non-performing loans, they are required to spend a greater proportion of their capital on servicing debt. Meanwhile, Beijing is calling on banks to increase their lending to stimulate the economy.

In the shorter term, these trends would likely prompt the central bank to reduce the required reserve ratios for banks, allowing more liquidity into the economy. In the longer run, however, they could cause economic growth to contract as banks see their ability to make new loans reduced. This does not necessarily mean China's banking industry is headed for a crash, but it is no cause for confidence in China's future. ◆

system must be reformed to suit foreigners and Chinese alike.

B is for board

The next step regulators are taking to open equity markets is the proposed, though long delayed, launch of an international board in Shanghai, part of the State Council's goal of making Shanghai an "international financial center" by 2020. While Shanghai will also need to attract more professionals and improve its financial infrastructure, reaching this goal essentially hinges on one thing: making the city a place where international companies want to raise funds.

That's why regulators should take note of woe-begotten B-share markets. The international board – which would allow foreign companies to sell shares to domestic investors – would serve a different role than B shares but could fall prey to the same problems as those foreign equity ghettos.

Companies need only look to established financial centers such as New York, London and Frankfurt to see that plans for an international board will not make Shanghai an international financial center. Those mature centers do not cordon off foreign equities or investors, and foreign companies list on the New York Stock Exchange and Nasdaq on the same terms as their domestic counterparts.

To become truly international, China needs a uniform platform with the same rules and standards for all companies. Shanghai's major hurdle is its opaque listing and securities rules, under which regulators could take months or years to approve an IPO with little explanation.

Chinese regulators might consider a disclosure-based system for approving IPOs and overseeing listed companies, as is standard in the US. The regulatory requirements and company disclosures for listing are available to the public, and any firm meeting them can list.

Regardless of whether Shanghai mimics the US system, it can only become a mature financial market by achieving full transparency. Regulators must open a window into their opaque machinations for Chinese stock markets to have any hope of fully opening the door to global investment. ◆