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The Next Great Pyramid Game

BY CHRISTOPHER WHALEN

A disturbing inside peek at China's financial mania.

One of the great ironies of 2005 has been to watch the spectacle of cash-flush China push former state-owned companies out into the market to raise even more paper dollars, part of a ritual whereby this very old, corrupt society seeks economic validation. Few of the credulous gringos who today buy shares in Chinese banks and companies know that they follow in a long tradition of western investment in dubious eastern opportunities. Just as foreign investors have made and lost great sums in markets like Russia, Argentina, and our beloved Mexico, the financial bubble in Chinese stocks is the next great paper pyramid game waiting to fall.

China spent more than two centuries under foreign colonial rule, but since the end of World War II it has sought to regain independence and prosperity even as Japan, Korea, and Taiwan became the industrial leaders of the world. Mainland China wants a piece of the pie and it is in a hurry. What makes the situation even more ominous in terms of potential financial market system risk is the fact that even very senior gringos have such a hard time telling our brash, always certain friends from China when they are off course. Indeed, the speed at which China is pressing the world for recognition is reminiscent of a young child reading about an exciting subject for the very first time.

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China's Veneer

"Everything in China today is louder and more gaudy than ever before," notes one western banker who spent part of his childhood in that nation. "The entire population of China seems both tone deaf and color blind. Nothing else could explain the volume at which Chinese must be spoken and the hideous taste in clothes on display. Material wellbeing has, on the surface, improved over the past decade, but much of what foreigners see is a garish veneer, the image of how China thinks it should look in 2005," notes one western banker.

While modern glass buildings grace the main thoroughfares of China's largest cities, they fail to hide the crammed, dreadful, and repulsive living quarters in which the majority of the population continues to dwell. Try as the Chinese government may to project an image of progress and modernity, cracks are apparent (for those who venture from the two immediate blocks surrounding their hotel or the various tourist attractions). Homeless people, cripples, and beggars—groups which were never before allowed to be visible—are ever-present in the major urban areas. Prostitution, which was unthinkable a few years ago, is now common.

—C. Whalen

AP PHOTO/NG HAN GUAN

In September, China Construction Bank (CCB) ran a quarter-page advertisement in the *Financial Times* seeking a chief risk officer. The ad was like those published by other global banks announcing an opening for a senior executive, but the CCB ad was several times larger than normal and placed conspicuously near the front of the paper—as though to announce the mere fact that CCB was hiring its first real CRO. Generally speaking, large financial institutions do not find members of the C-suite in such an ostentatious fashion, but then again, CCB and its peers among China's banks are not your usual financial institutions.

The size and placement of the CCB ad typifies the style of China's approach to its growing economic importance. "Everything in China today is louder and more gaudy than ever before," notes one western banker who spent part of his childhood in that nation. "The entire population of China seems both tone deaf and color blind. Nothing else could explain the volume at which Chinese must be spoken and the hideous taste in clothes on display. Material wellbeing has, on the surface, improved over the past decade, but much of what foreigners see is a garish veneer, the image of how China thinks it should look in 2005."

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China's economic opening is an almost manic event, a source of overwhelming pride and exhilaration for a nation that spent nearly half a century enduring political purges and communist indoctrination, a bru-

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tal period that left millions dead and many millions more scarred personally and economically. The economic rise of China is almost a relief for people accustomed to being tightly controlled, both by the Chinese Communist Party and by aggressive Western colonial interests. As the fourth-century Chinese parable states: "In the grass, the trees, everything seems a soldier," but that soldier may be either Chinese or foreign.

Because of the importance of China's economic opening to the collective self image of this nation of more than a billion souls, any criticism directed at Chinese companies or policies is greeted with tremendous hostility—whether the criticism is justified or not. When Christopher Cox, chairman of the Securities and Exchange Commission, said in mid-October 2005 that CCB did not list in the United States because it could not meet New York's regulatory requirements, an obvious statement of the facts, the reaction from Beijing was chilly indeed. When Cox also suggested that CCB's financial health would deteriorate after the share offering in Hong Kong the following week, he was castigated by members of the financial media who make a living writing about "opportunities" like CCB.

Just as many Chinese cities have become reflections of what China's communist leaders believe offshore investors want to see, CCB and other Chinese financial institutions are likewise facsimiles of western financial institutions, according to foreign bankers and lawyers involved. The formerly state-owned Chinese banks do not yet have the inner workings or functions of a bank as defined in the industrial nations, in part because virtually all credit and commercial transactions in China are controlled by the Communist Party. Indeed, if CCB were to actually hire a new CRO who is not familiar with China's financial and political system (which are one and the same), that lucky person might be very surprised by their actual job responsibilities—but not as surprised as some of the foreign banks who are currently shoveling money into the furnace by "investing" in China.

Sol Sanders, who has covered Asia as a journalist for three decades, confirms the full dimensions of the ongoing financial mania in China, a kleptocratic free-for-all which makes the asset grab by communist officials after the fall of the Soviet Union seem polite by comparison. Sanders writes that "No sooner had the Royal Bank of Scotland taken its $1.6 billion plunge into the Bank of China than a deputy chairman received a lengthy prison term. In March, the Bank chairman was removed for alleged bribery. Shortly before, fifty staff members were accused of embezzling $85 million. Earlier this year a branch manager fled the country with $120 million."

A western banker reports to *TIE* that Chinese Communist Party officials are busily stealing much of the dollar inflow raised by direct investment, a repeat of the classical method refined by the Latin American debtor countries in the 1980s to deprive credulous gringos of their hard currency. Senior officials, aided and abetted by western bankers, reportedly spirit these funds

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away to the safety of banks in Asia, the United States, or the European Union, even as the Chinese economy heads for one of its periodic "adjustments." These Chinese officials seemingly know that while the country's foreign reserves amount to some $769 billion as of September 2005, the country's financial liabilities are far greater.

The IPO for CCB and other Chinese banks seemingly should be cause for alarm among western regulators and bankers, but in fact the opposite is the case. With various foreign banks "invited" to invest in CCB, this to provide further validation of the economic reform efforts of China's Communist Party, CCB has already been blessed by the New York banking community, regardless of what the head of the SEC may think. Of note, the reason CCB did not seek a U.S. listing is the same reason why it is not permitted to operate a branch in the United States, because of its links to China's communist government.

Citigroup reportedly was coerced into making an investment in CCB after it was threatened with being "shut out" of China's financial services market. If you believe that there are really 300 million bankable consumers in China, perhaps investing billions of dollars in CCB or other Chinese banks makes sense. This logic certainly seems to have convinced the management of Bank of America, which paid $3 billion for a 9 percent stake in CCB. But with little details—such as a lack of property rights or legal due process, and fraudulent financial information—still unresolved in China, we wonder how foreign banks can justify investing or lending, at least without treating such commitments as 100 percent reserved for loss.

The fact is, CCB and the other "banks" in China are not really financial intermediaries and do not generally extend credit to private companies, according to local bankers who work with these entities. As arms of the Chinese government, banks reportedly are used primarily to support state-run enterprises (SREs) and provide a slush fund for Communist Party officials and corrupt managers. None of the classical credit or even financial functions of a western bank are to be found inside a Chinese state-owned bank, say our sources in the region, nor do they have any of the most basic internal controls or reporting systems necessary for a transparent, prudential operation.

"China's economy is like the old burlesque comedian with a loose string that when pulled disintegrates his suit."

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Indeed, according to one western banker based in Beijing, CCB and the other large Chinese banks lend primarily to SREs, which in turn make small, usurious loans to private companies—with the requisite bribes to the Communist Party officials involved. All of the knowledge, credit information, and lending experience that you would expect to find inside Chinese banks is instead ensconced inside the SREs, which remain under firm Communist Party control. When you hear the glib reports in the western media about 10 percent of China's loan market being non-performing, says our observer, multiply that number by five, seven, or even nine times and you'll be closer to the economic reality.

"For state-owned banks, lending to private companies isn't worth the risk since should something go wrong lending to a private concern, the bank official would get the blame without adequate compensation for the risk, whereas if they lend to an SRE, they have recourse through the authorities should things go bad," says the banker. "As a result, large state-owned banks don't lend to the private sector. They don't have authority to price risk and they really don't know how."

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"Capital, however, is like water," continues the banker. "Barriers do not stop it, it simple flows around them. So, SREs have become the conduit to private enterprise. SREs borrow money from the banks and turn around and 'lend' money to private enterprises on a short-term basis at rates two to five times greater than the official rates, often times by creating dummy invoices." Of interest, this practice is not a state secret. The Bank of China has spoken about this issue earlier this year, but cannot address the underlying causes of this strange arrangement without a head-long confrontation with the Chinese Communist Party.

Part of the reason that Chinese banks are restricted from lending to private business is the question of political control and corruption. By channeling funds through the SREs, local Communist Party officials can select which borrowers gain access to credit on what terms, and extract their share of the vigorish, but the effect on the financial soundness of Chinese banks is horrendous. Actual credit risk is pooled and collecting outside of the official banking system, inside the SREs which are, for an practical purposes, affiliates of the banks. Officials turn a blind eye because the usurious interest rates charged for loans are needed to help prop up the SREs and the entire bankrupt state-owned economy.

More important, Chinese banks really don't know how to lend or price risk and implementation of international banking accords such as Basel II will do nothing to strengthen the weak links in China's financial system. And if American manufacturers think they are having a tough time competing against Chinese manufacturers now, just wait until the day Chinese manufacturers have access to capital at market rates!

Even though the shortcomings of the Chinese "banking system" are manifest, the western media happily applauded for the CCB offering. The *Financial Times* called the IPO "a pioneering listing that is crucial for Chinese bank reform." But reform of what?

Until the Communist Party deigns to allow truly independent private economic activity, which is a contradiction in terms, reforms are meaningless. No amount of foreign investment is going to change the basic fact that China's leaders do not recognize or even understand what it means to operate private banks with private borrowers and private property in a market economy where corruption is not the dominant factor in everyday life.

Sanders summarizes China's economic outlook: "China's economy is like the old burlesque comedian with a loose string that when pulled disintegrates his suit. That a crash is coming is gospel for many China watchers. At dispute is when, which trigger, how big, the political fallout, and how and when economic growth recommences." ◆