INSIGHT

A crash in the making?

G. Bin Zhao says China's current economic difficulties, including the scale of its government debt, are not as severe as many fear, and are to some extent a temporary result of reforms. **Andrew Collier** is less sanguine, warning of worse to come if cash-strapped local governments fail to find alternative sources of revenue, as land sales dry up

Each time China's economy faces difficulties, talk of a collapse tends to surface. Some voices are driven by concerns about their investments; some are looking for speculative opportunities; others might just be following the trend, unable to draw their own conclusions. In any case, it's always necessary to think critically and deeply when absorbing new information, regardless of how authoritative the source may be.

So, what is the true picture of China's current economic situation? Will the country's stretched bank credit lead to a financial crisis? How severe are the debts accumulated by local governments and the shadow banking sector?

As I have said before in these columns, I expect China's economy to face a rough ride in the next few years as the new leadership introduces major changes. The current policy transitions, which are the root cause of the recent pain, combined with slower growth, have exposed major problems, such as the cash crunch in banks. But these short-term problems will neither hold up nor distort China's sustainable development, because at the core of these changes are reforms which are designed to facilitate a much healthier and better economic future.

China's top leadership has decided to follow a slower path; however, local officials, and even some ministries, as well as executives of the major banks and other state-owned enterprises, have demonstrated they are not yet ready to adapt. This is the root cause of the current tensions related to bank liquidity, shadow banking and local government debt.

Despite the slight increase in non-performing assets, Chinese banks are more healthy than many would believe

More specifically, gross domestic product growth averaged 10 per cent for the past three decades; now the official target is 7 per cent. A reduction of nearly one-third can mean a lot for many industries, not to mention provinces and municipalities.

As an example, during the recent bank liquidity shortage, there were many concerns raised, mostly from the international media and various foreign institutes, that this may lead to a financial crisis in China. But these doomsayers are too pessimistic.

Chinese banks might not be as efficient as their peers in the US and Europe, but, despite the slight increase in non-performing assets due to the economic decline over the past year, they are far more healthy and profitable than many would believe.

Though many banks are public companies, the state owns most of the major ones and government policy still steers their commercial activities. For instance, the senior executives of the big four are appointed by the government and they tend to bear more of the political responsibilities, while mid-level managers are more performance-driven.

Additionally, China faced a lack of liquidity in the inter-bank market, not a real credit crunch, as many said. One of the most important reasons for the crisis was that the People's Bank of China refused to provide more liquidity when the banks expected it. Bankers underestimated the determination of the top leaders to enact policy changes, which means there would be no stimulus for the real economy and the banking industry. Banks must be prepared for market adjustments.

Some argue that the surge in shadow banking in China is threatening its economy. According to estimates, the value of funding in the shadow banking sector reached approximately 20 trillion yuan in 2012 (HK$25 trillion), not inconsequential when compared to a 52 trillion yuan GDP and 130 trillion yuan in total bank assets.

Among all the banks directly engaged in the shadow banking sector (with more than 90 per cent of the shadow banking activities), wealth management products accounted for 7.5 trillion yuan, 5.7 trillion yuan were entrusted loans, and 6 trillion yuan were bank accepted bills. Due to its huge size, the shadow banking sector has indeed challenged China's financial stability and diluted the effectiveness of the central bank's monetary policies, but we cannot neglect the fact it is the result of market demand for diversified financial products. Shadow banking has generated a large amount of profit for the banks; in the meantime, it has also promoted the real economy. For instance, the majority of wealth management products are converted into loans, trust products and bonds, and flow back to businesses.

To minimise the potential hazards, Chinese regulators have strengthened the supervision and monitoring of shadow banking since the beginning of the year. As Dr Li Yang, vice-president of the Chinese Academy of Social Sciences, recently pointed out, shadow banking represents the emergence of innovation in the financial sector and will not draw China into a financial crisis; but the real challenge for regulatory authorities is how to provide effective and gentle management.

Finally, China's local government debt became a major concern after the downgrading by Fitch and Moody's. I wonder whether these rating agencies ever notice local debt risks in the US, especially since Detroit has recently filed for bankruptcy with debts of at least US$18 billion. Will these agencies downgrade the triple-A rating of US government bonds, which is much higher compared to China's? Chinese government debts, both centrally and at the local level, are much less than those in the US. Consequently, the credibility of these rating agencies must be doubted.

Nevertheless, Detroit's bankruptcy is an alarm call for all governments, including those in China. While there is no comprehensive updated official data for local government debt, according to the latest sample data collected in June by the National Audit Office, in 2012 there was a total debt of 3.85 trillion yuan owed by 15 provinces and their capitals, as well as the three municipalities of Shanghai, Tianjin (天津) and Chongqing (重慶), and three of their municipal districts.

Clearly, this figure might disappoint many analysts who believe local government debt is a major risk. Furthermore, 78 per cent of these debts are loans from the banks, and 12 per cent are bonds. So how bad can it be?

There are indeed many signs that China's economy is at a difficult point, but the country is still in much better shape than the US and Europe. The European economy is shrinking, and there are many hardships holding back the recovery in the US. Therefore, it is clear the global economy cannot afford a Chinese collapse. So, why do so many people want to see the dragon fall?

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President Xi Jinping (習近平) has ambitious plans to reform the economy. Ending the land grab among local governments should be top of his list.

For years, escalating land sales have been a valuable source of revenue for cash-strapped local governments. Each time Wenzhou (溫州), Fuzhou (福州) or other cities agree to a licence for a new high-rise apartment block, the local government earns a hefty chunk of cash for the land that is sold to the developer.

Land sales now account for an average of 40 per cent of local government revenue, up from 10 per cent just a decade ago. In some cities, the sale of land is the main source of income. That free income is beginning to decline as governments run out of land and the property bubble runs out of steam.

There is a reason for the giant land grab: local governments are desperate for new sources of revenue to pay for local social services and to keep the engines of the economy churning at high levels.

Local governments are responsible for everything from retirement income to health care for their citizens. Since fiscal reforms in 1994, local governments' share of the tax revenue has decreased to 40 to 50 per cent but they have been responsible for 70 to 80 per cent of expenditure. Outside fees – mainly from the sale of land – account for the difference.

Take Zen township in Zhejiang (浙江), studied by Lynette Ong of the University of Toronto. During one recent fiscal year, the town gave most of its 319 million yuan (HK$400 million) in revenue back to Beijing, keeping just 15 million yuan. To pay for the lion's share of its 88 million yuan budget, which included urban and rural development, education and health care, the town earned 71 million yuan selling land.

Another big incentive for local officials to sell land is to create glamorous projects to aid their chances of promotion. According to Victor Shih from Northwestern University and researchers at Peking University, drawing in revenue from outside the province boosts an official's chances of being promoted more than increasing gross domestic product. And what better way to show off leadership qualities than a new stadium or the proverbial "bridge to nowhere"?

More ominously, the revenue gap is increasingly being filled by China's growing shadow banking system

Now, though, many of the best pieces of land in the city centres have been sold. According to a study by the National University of Singapore, by 2007, the average tract of land sold was 50 per cent farther from the city centre than it had been just four years earlier. That trend has accelerated.

This year, according to local developers, Guangzhou is trying to double revenue from land sales to 48 billion yuan. Guangzhou is now offering three new central business districts, but they are located in less valuable areas on the outskirts of the city centre. Xian is asking developers to prepay tax on land the developers haven't even bid on. "The government is mortgaging against future land sales," the chief executive officer of one Xian developer told me in March. Also – and a bigger concern for China's economy – there are hints that the escalation of property values and thus land prices is easing. Home prices on the mainland rose for the 12th straight month in May, but the pace of growth continued to fall.

The average price of new residential properties in 100 cities rose just 0.81 per cent from April, to 10,180 yuan per square metre. That compared to a 1 per cent gain in April and March's 1.06 per cent rise.

No one can say for certain whether China is suffering from a property bubble or when it may collapse. But land is not an endless resource. That revenue must come to an end.

What can replace it? Beijing has been testing local property taxes. Apart from bringing much needed income, these taxes would impose a cost of ownership on property, crimping the use of flats as a cheap "bank account". Owners are baulking but these taxes would be a rational source of income for local governments.

More ominously, the revenue gap is increasingly being filled by China's growing shadow banking system, in which companies and individuals feed their excess savings into everything from residential buildings to white elephant projects, many backed by local governments through side companies called local government financing vehicles. While it's nice to see Chinese capital escape the claws of the state sector, the lack of regulation is a real concern.

The past decade's big land boom has been bad news for rural homeowners forcibly evicted from their ancestral villages. At a recent conference at Sun Yat-sen University, activists called for greater protection of the rights of homeowners.

"The effects of urban development, demolition and eviction on tens of millions of Chinese citizens have been profound," notes Eva Pils, a lawyer and expert on land rights at Chinese University of Hong Kong.

Until there is a new revenue system in place, the financial pressure on local governments is only likely to build. That means more dangerous financial games by local governments and more residents evicted from their homes.

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Our beloved film industry deserves a starring role in the Hong Kong story

Peter Kammerer says a promenade featuring celebrities' handprints and the odd tribute to notable artists do not do justice to the industry's reach

If, as a child, I had been asked what Hong Kong was famous for, I would have responded without hesitation: "toys". Spontaneity isn't so easy all these years later and there's a temptation to resort to the unexportable, "harbour views" and "skyscrapers". But with thought and perspective, the reaction is "movies". Which then leads to the question: why is there no museum dedicated to celebrating what the world knows us best for?

It's been a matter of curiosity to me since being asked a few years ago by an American tourist couple where the Bruce Lee museum was located.

I had to bring them down to earth by saying that all Hong Kong has to show for its most famous son beyond his movie output and a martial arts form he invented is a bronze statue on the Avenue of Stars in Tsim Sha Tsui. The 440-metre harbourside promenade on which it stands, marked by inscriptions and plaques, some bearing handprints and signatures, is the lone monument to our famed century-old film industry. On a typically humid summer's day, the rain pounding down and pollution hanging heavily, there's no less desirable place.

The plaques – some just bearing a name – tell us little about the celebrities. There are no video clips or stills, costumes and set props, or more than the vaguest of biographies. A photo can be snapped beside Lee's larger-than-life figure, but there's not much pleasure to be had staring down at director John Woo Yu-sen's handprint. The film industry has been immensely creative and given endless pleasure to people the world over, yet the art, passion and skill of those productions is missing in this barren place.

The film industry has given endless pleasure to people the world over

The list of those worthy of permanent exhibition space is long. Among picks beyond Lee and Woo are Linda Lin Dai, Maggie Cheung Man-yuk, Wong Kar-wai and Tony Leung Chiu-wai. Special mention goes to Chow Yun-fat, seen recently in Central by a friend. There is no more approachable celebrity: my friend asked for a photo and the star of *Crouching Tiger, Hidden Dragon* went one better, holding her camera with an outstretched arm and taking a cheek-to-cheek shot.

From time to time, the Heritage Museum at Sha Tin and the Hong Kong Film Archive in Sai Wan Ho make amends with a temporary display dedicated to a particular artist. The 40th anniversary of Lee's death on Saturday kick-started a year of remembrance with the launching of an exhibition at the museum and a trail marking landmarks in his life. But although the star was important to the action film genre and gaining Hong Kong cinema a wider audience, he is just one part of a diverse industry. A paved walkway, no matter how nice the views from it, and a one-off show don't do justice to what has been created.

A dedicated museum would, though – and what better place than the West Kowloon Cultural District? Alas, there is no such provision in the stage one plans, despite the minimum HK$21.6 billion price tag. The closest we would get could be an exhibition or two in M+, the visual culture museum, although its acquisition policy of having a "more recent and more global concept of art" does not auger well for representation of locally made films. So low a priority for an art form that has been so influential and given so much to so many is, to put it bluntly, criminal.

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Election victory will give Abenomics a needed boost

Nicholas Spiro says success, however, will hinge on crucial reforms

Japanese Prime Minister Shinzo Abe has a spring in his step. His Liberal Democratic Party's decisive victory in Sunday's election gives his government a solid majority in both houses of parliament and three election-free years to implement its radical policies aimed at reflating Japan's economy.

Abe is now Japan's strongest and most popular leader since Junichiro Koizumi. Politically speaking, this bodes well for Abenomics, the far-reaching economic reform agenda that has captivated financial markets since the LDP came to power in December.

The stage is set for the most important phase of Abenomics, and the one investors have been waiting for: the "third arrow" of structural reforms that are crucial to maintaining confidence in what is, for now, a huge stimulus programme.

The stakes are high for both Japan and the global economy, particularly at a time when the US Federal Reserve is about to scale back its asset purchases and there are concerns about China's economy.

Three big questions surround Abenomics. The first concerns Abe himself: is he a committed economic reformer or is his programme part of a nationalist political agenda aimed at restoring "greatness" to Japan? Abe is, after all, a cultural conservative. Having tightened his grip on parliament, the risk is that his right-wing instincts may become more pronounced, allowing politics to supplant economics.

This is unlikely, given that a strong economy is central to Abe's political objectives. The bigger concern is whether he is ready to take the tough decisions to maintain credibility in his bold economic project. A first big test is the long-awaited announcement on whether to approve a 3-percentage-point rise in Japan's sales tax next April, to 8 per cent. A decision must be made by October.

For a government seeking to aggressively stimulate growth, a consumption tax hike seems like a foolish policy. The last sales tax increase in Japan, in 1997, ended in disaster, contributing to a recession and forcing the prime minister who approved it to resign. Yet if Abe postpones the tax hike, doubts about Japan's fiscal credibility – long a concern given the country's staggering public debt burden that is approaching 240 per cent of gross domestic product – could undermine confidence in Abenomics.

The most important question, however, concerns the crucial supply-side measures aimed at boosting Japan's deplorable long-term growth rate. These include much-needed labour market reforms, aggressive deregulation of product markets as well as a host of other initiatives to promote trade and investment.

In order for the reforms to succeed, Abe has to face down the powerful interest groups within his own party that have long stymied structural change in Japan.

The challenges facing Japan's premier are enormous. Yet if the popular Abe can't grasp the nettle of reform, it's unlikely that anyone else in Japan can.

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