Banking, Currency, and Consumer Spending in China

The following report was prepared by Valerie Klitzke, Wendy Miller, Deborah Stafslien, and Clif Tomasini as part of the requirement for Intl Bus 765. It was a preparatory document shared with the entire class two weeks prior to taking the entire class of 43 MBA students on a 7 day trip to Beijing, June 2007

Executive Summary

In addition to describing Chinese banking and currency valuation, we describe larger trends in consumer borrowing and investment in China as a whole.

I. Banking and Investment in China

Until 1978, the only banking option available in China was the People's Bank of China (PBC). The PBC was 100% owned by the Chinese government. By the early 1980's the choices had broadened to four government-owned commercial banks, called the "Big Four": Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC), and Agricultural Bank of China (ABC). The PBC then presided over these banks as the nation's central bank, and now has a role similar to that of the Federal Reserve in the United States.

Meanwhile, the number of commercial banks in China (excluding Hong Kong) grew to 128 by the year 2005.[1] With few exceptions, the Chinese government at various levels has owned these banks. Although private ownership is permitted, it is uncommon because even if the bank is privately owned, the Communist Party has had the power to appoint senior management. Further, foreign investment in banks is limited to 20% of total equity for a single foreign investor and to 25% for all foreign investors.[2]

Since 2005, three of the Big Four banks, BOC, ICBC, and CCB, have issued public offerings of stock (subject to the aforementioned limitations), and the performance of these stocks has been impressive. Further, since December 2006, China's participation in the World Trade Organization requires it to expand foreign access to China's markets.

Despite the opening of China's markets, the banking sector has been slow to emerge from government control. Despite the wildly successful public offerings of three of the Big Four banks, many doubt whether Chinese banks can stay afloat without rapid reform. The pervasive concern is that these banks are accustomed to putting the perceived needs of the State over the need to make a profit.

Historically, banks in China existed to be fiscal agents of state-owned enterprises (SOE's), which were the main sources of employment in the economy. Even when these SOE's were unprofitable, the government hesitated to scale them back because they wanted to avoid widespread unemployment. Thus, banks got used to lending to SOE's regardless of profitability.

Since 1995, the number of SOE's has dwindled. As of 2004 there were only 32,000 SOE's[3] (by contrast, currently 594,000 foreign enterprises are approved to operate in China[4]). However, serious questions remain about governmental influence over banks that are approached by SOE's

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[1] Special Report: A Great Big Banking Gamble – China's Banking Industry. *The Economist*: Oct 29, 2005, 377(8450):93.
[2] Dobson, Wendy and Anil Kashyap. The Contradiction in China's Gradualist Banking Reforms. Working Paper #4, *Initiative on Global Financial Markets*: 2006.
[3] Ibid.
[4] Tax Revenue to Shrink After Firms Face Equal Rate. *Shanghai Daily*: March 8, 2007.

for financing. Further, the government has a specific agenda of expenditures other than SOE's, such as infrastructure projects, for which it has persuaded the banks to lend indiscriminately.

Regardless of government influence, the numbers show that Chinese banks have done an abysmal job of managing credit risk. The banks' performance can be measured by the size of their nonperforming loans (NPL's). For example, officially disclosed data estimated China's NPL's at near $330 billion in 2000, which was 28% of China's GDP at that time. Substantial government efforts have reportedly reduced the NPL's to $160 billion in 2006, but some private market estimates are estimating the level of NPL's as high as $650 billion.[5]

In fact, some stock analysts suggest that even though the IPO's of three of the Big Four banks created a badly needed influx of capital, all three of those banks would be technically insolvent if the NPL's were valued correctly.[6] Moreover, a large part of the reduction in NPL's was merely a shifting of the losses from government-owned banks to government-funded asset management companies (AMC's).

This skepticism may reflect a lack of confidence in corporate governance, which is another challenge facing Chinese banks. The government continues to dominate the boards of directors and senior management of the Big Four banks. Historically, especially at the regional and local levels, governments have offered special favors to bank managers to lend for certain projects. Local governments set bank salaries, guaranteed loans and even played a role in what schools the children of bank employees attended.[7] In fact, one credit-rating agency (Fitch's) has estimated that local governments have illegally underwritten $100 billion in loans to bankroll favored investment projects.[8]

Further, most Chinese bankers, in the absence of these influences, may not know the difference between a good loan and a bad loan. Local managers' pay has traditionally depended on asset growth, and the only regulatory constraint has been a loan-to-deposit ratio of 75%. These managers have focused strictly on lending a lot and attracting more deposits, while they have largely ignored risk, return, and capital adequacy. In fact, until 2004, the central bank set a ceiling on commercial loan rates that prevented banks from charging customers based on their risk.[9]

These problems are compounded by the sheer volume of cash that flows through Chinese banks. Since the stock and bond markets have not fully developed, banks hold the majority of all financial assets in China. Bank assets comprise 77% of all financial assets in China, while in the U.S. they comprise 26% of all financial assets.[10] Chinese banks now hold approximately 210% of the Republic's GDP, more than any other developed economy in the world.[11]

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[5] Matthews International Capital Management. China: Setting the Pace, www.micm-asianow.com/issue2-2006/china-setting-the-pace-part1.php, accessed 14 Jun 2007.
[6] Ha, Thanh. Buying Into China's Volatility, http://ifinish.wordpress.com/2007/01/01/buying-into-chinas-volatility, accessed 13 Jun 2007.
[7] Sender, Henny. Chinese Banks Slowly Learn to Walk on Own. *The Wall Street Journal*: Jul 9, 2004, p. C1.
[8] Finance and Economics: Root and Branch; China's Banks. *The Economist*: Nov 6, 2004, 373(8400):88.
[9] Matthews International Capital Management.
[10] Ibid.
[11] Special Report: A Great Big Banking Gamble.

Fortunately, there are mitigating factors for these concerns. That is why the stock markets have embraced the three banks that had IPO's. For example, the Bank of China was priced just over three times its book value. The largest mitigating factor, at least in the short term, appears to be the continued economic boom.

A second mitigating factor is an increase in corporate governance. In 2003, the China Banking Regulatory Commission (CBRC) was carved out of the central bank. The CBRC serves as a central regulator of China's banks and has a workforce of 20,000 people. The CBRC has issued regulations that prevent local officials from guaranteeing loans or nominating the local bank head. Further, the CBRC has imposed a capital retention requirement of 8% of risk-weighted assets and is raising risk weightings for certain loans. The CBRC even has authority to shut down banks that fail to meet these requirements, although it has not yet exercised this authority.

The optimism surrounding corporate governance is muted by concerns that the agency can actually enforce its regulations. Further, there are concerns (some coming from the CBRC itself) that 90% of China's banks and regulators alike are unqualified to properly manage credit risk.[12] That is why an influx of intellectual and labor resources from foreign investment is another important mitigating factor. In fact, international investors have been able to negotiate rock-bottom prices for their shares because of the risk management skills and financial savvy they bring to the table. For example, Bank of America paid 1.15 times book value for its stake in China Construction Bank, which soon thereafter was valued at almost twice book value.[13]

However, U.S. financial services firms must be cautious in filling this need. The story of the China International Capital Corporation (CICC) [14] illustrates that this opportunity may not be as golden as it seems:

In 1995 Morgan Stanley and the China Construction Bank formed a joint venture, China International Capital Corporation (CICC). With over a billion people in China, many of whom are ambitious and eager to make money, the task was straightforward: penetrate the emerging Chinese market with much-needed capital and financial expertise. The marriage seemed like a match made in heaven. Morgan Stanley brought forth technology and expertise, while the China Construction Bank offered direction and strategy in the complex Chinese marketplace. In the words of many, this was the perfect "win-win."

Prior to forming the joint venture with Morgan Stanley, the China Construction Bank was responsible for funding the development of China's infrastructure. In need of financial reform, a stable exchange trading system and a general understanding of "best practices," the Chinese believed the best method was to import the knowledge. Who better to import that knowledge than the financial powerhouse, Morgan Stanley?

While on paper, CICC looked great, trouble began from day one. To start, neither side understood the other. Each CEO pitted himself against the other and struggled for control. One major issue from Morgan Stanley's perspective was the hiring of employees. First, the Director

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[12] Ibid.
[13] Ibid.
[14] McGregor, J. One Billion Customers. New York, N.Y. 2005: Chapter 2.

of Human Resources from the China Construction Bank was brought over to CICC without consulting Morgan Stanley. In the weeks and months to follow, many new faces were hired and almost none of them had been introduced or approved by anyone at Morgan Stanley. Morgan Stanley's people felt that they were ignored when it came to running the business and that the Chinese were doing things the Chinese way.

A second major issue involved compensation. Morgan Stanley's head, Jack Wadsworth, was paid millions while his Chinese counterpart, Wang Qishan, made a meager $20,000 USD a year. To make matters worse, Wadsworth and Wang could not discuss matters privately. Every conversation required translation and often consultation of staff members. With so many filters in the room, problems magnified and distrust grew between the two sides. The root of most problems was cross-cultural differences.

With only two years under their belt, troubles peaked for Morgan Stanley when Wang and CICC privately negotiated the biggest deal to ever come out of China (by a factor of ten) with Goldman Sachs. The deal gave Goldman access to the Chinese industry, crushed Morgan Stanley, and raised over $4 billion dollars during the IPO. In time it became more and more common to hear executives at Morgan Stanley describe themselves as the wife with responsibility and Goldman Sachs as the mistress with the jewelry. Several other deals between CICC and Goldman Sachs were reached, included a second mega-deal in 2000.

By 2002, Morgan Stanley had had enough. All remaining control of CICC was turned over to the Chinese. Moving forward, Morgan Stanley would keep stock in CICC and collect dividends, later they would co-underwrite many large deals for CICC. Notably, Wang Qishan was appointed mayor of Beijing in 2003. Currently he is organizing the 2008 Beijing Olympics. Wadsworth retired from CICC in 2001 and now resides in California. Despite the cultural failures and power struggles, Morgan Stanley emerged from the venture with a 50% market share of Chinese international IPO business.

Summary and Strategic Implications

- China's banking system presents risk of a financial crisis if economic growth slows.

- The Chinese government has made some effort toward better corporate governance, but still holds a substantial amount of influence among the country's banks.

- China's economy needs intellectual capital in the banking industry, both on the regulators' side and on the banks' side. U.S. firms with that intellectual capital have significant bargaining power and an opportunity to enter the market by filling that need.

- For U.S. companies, providing intellectual capital to China through joint banking ventures comes with significant risk. Much of this risk comes from cultural differences. To make such a venture successful, personal relationships may be more important than business contracts.

II. Currency Exchange Rates and Balance of Trade

The official unit of Chinese currency is the Renminbi (ISO 4217 code CNY), which means "people's currency." It is known colloquially as the yuan ("round") and was first issued in 1948 just prior to the Communist takeover. In 1978, the PBC introduced a dual track currency system in which Renminbi were used domestically, but foreign exchange certificates were required for foreigners. In 1994, the renminbi exchange rate was informally fixed at 8.28 per U.S. dollar.

While this policy was widely praised during the Asian Financial Crisis of 1998, China's trade partners were critical in the new millennium, claiming that the policy contributed to the mainland's massive trade surplus.[15]

In response to global pressure, China began pegging the renminbi to a basket of world currencies on July 21, 2005.[16] Figure 1 shows that the currency has steadily risen against the U.S. dollar since that time. Even so, businesses in Europe and the United States still complain that the Chinese are still keeping too tight a rein on the exchange rate.

Even U.S. Secretary of Treasury Henry Paulson, who has been accused of being too soft on China's currency policies in the past, recently stated that Beijing must revalue the yuan.[17]

Advocates of floating the yuan assert that domestic manufacturing jobs are eliminated by the artificially low price of goods from China. In fact, Ben Bernanke recently called the undervalued yuan an "effective subsidy" for China's exporters.[18] If that were true, the United States government could take the issue to the World Trade Organization. But according to the WTO, participating nations are allowed to choose their own exchange rate policies, so it would be difficult to prove that an unfair subsidy is in place.

Floyd Norris, chief financial correspondent for the New York Times, argues that it is labor rates, not exchange rates, that allow Chinese companies to offer cheaper goods than American and European ones. In that sense, China is competing more directly with other Asian companies than its Western rivals.[19]

Many U.S. critics point to the growing U.S. trade deficit with China as a sign that the currency is undervalued. Approximately one third of the total U.S. trade deficit is attributed to imbalanced trade with China.[20] However, it is also true that China only accounted for one third of the growth in the U.S. trade deficit from 2001 to 2006, so its share is not increasing disproportionately. In addition, increased imports from China have come as the United States has decreased imports from other parts of Asia.[21] These other factors demonstrate that the exchange rate is not the primary reason for China's massive trade surplus with the U.S.

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[15] http://en.wikipedia.org/wiki/Renminbi, accessed 09 June 2007.
[16] USA/China economy: Paulson's party EIU ViewsWire. New York: Dec 8, 2006.
[17] Somerville, Glenn, http://www.reuters.com/article/bondsNews/idUSN0726800920070607?pageNumber=1, accessed 09 Jun 07.
[18] Beattie, A. *et al.* Financial Times. London (UK): Dec 16, 2006, p. 6.
[19] Norris, Floyd. New York Times (Late edition (East Coast)). New York, N.Y. Aug 12, 2006, p. C3.
[20] http://money.cnn.com/2007/06/08/news/economy/trade_april/index.htm, accessed 09 Jun 07.
[21] Leaders: Yuan step from the edge; China's exchange rate. *The Economist*. London: Apr 1, 2006. 379(8471):11.

Nevertheless, a recent publication from the International Journal of Public Administration reports that the Renminbi is undervalued by 22% and that allowing the currency to appreciate would be beneficial to both the Chinese and the world economies.[22]

Unfortunately, the effects of a cheap yuan on the United States economy are not as simple as some claim. Domestic consumers benefit from the inexpensive goods currently available from China, so if the renminbi appreciates sharply, these goods will suddenly become less affordable.

In addition, United States companies running operations in China will see their expenses suddenly rise. In this case, the current policy of the Chinese government, which is to allow the currency to rise gradually, is better for firms doing business in China. It is also better for firms considering taking operations to China, since their business models are probably based on the current exchange rates, and may not take into account a sudden revaluation.

The central bank of China announced in May that it would create an investment fund to manage a portion of its massive reserve of U.S. dollars, which has swelled to over $1.2 trillion. The reserve currently holds hundreds of billions of these dollars in low-yield T-bills or other government-backed bonds. According to the Chinese press, the fund may be given control of up to $300 billion.[23] Movement in that volume of money will influence any market it enters.

Summary and Strategic Implications

- European and United States governments are concerned with the relatively slow rate that the PBC has allowed the renminbi to appreciate over the past several years.

- Economists and politicians agree that the renminbi is undervalued, but disagree about the magnitude of the problem and how to solve it.

- The U.S. trade deficit with China is growing as its trade deficit with other Asian countries is shrinking.

- United States consumers depend on cheap goods from China, so a significant rise in the exchange rate will have a far-reaching effect on the U.S. economy.

- China controls a large sum of United States currency, part of which will be placed in a new investment fund and, presumably, managed for higher yields.

III. Consumer Spending Trends China

Average net income in China has been growing for the last 10 years. However, there is a sharp disparity in growth rates between the urban areas and the rural areas (Figure 2). Less than 40% of

[22] Chang, Gene Hsin. *International Journal of Public Administration*, Feb 2007 30(2):137.
[23] Chandler, Clay. *Fortune*: May 14, 2007.
http://money.cnn.com/magazines/fortune/fortune_archive/2007/05/14/100024842/index.htm, accessed 09 Jun 07.

the country's population live in urban areas, which are seeing the fastest acceleration of net income.[24]

With the recent increases in income, it would be logical to think that the Chinese are spending their newfound wealth. However, this is not the case. Spurned by years of financial uncertainty, leery about having to cover health care costs and pensions out of their own pockets, determined to own their own homes, and concerned about securing educational needs for their children – Chinese consumers are saving rather than spending.[25]

Between 1997 and 2005, the Chinese consumer saved an average of 40.3% of his/her income. This dwarfs the U.S. consumer who only saved and average of 13.6% of his/her income during that time. Also, between 1997 and 2005, Chinese investments as a percentage of GDP were nearly twice that of the U.S. (Figure 3).[26]

Chinese consumers' restrained spending habits cause roadblocks for China's economy. For example, private investors tried infusing the economy by building the China Mall, the world's largest shopping center. Unfortunately, it has been unsuccessful so far. The mall, expected to attract over 100,000 shoppers/day, sees just a tenth that - about 10,000 shoppers/day. Even worse, the majority of these visitors use the mall as a place to meet and socialize rather than a place to shop for goods and services.[27]

The government has also been unsuccessful, overall, in its efforts to encourage more frivolity. In one effort, the government consolidated national holidays into week-long breaks to encourage more spending. Unfortunately, this had only minimal short-term effects.[28]

Other government policies, such as the valuation of the yuan, discussed earlier, play an important role in consumer spending. Because of the exchange rates, Chinese consumers find imported goods to be too expensive even with their increased income levels. This further hampers spending for desired goods.

One area where the Chinese government excels in its efforts to stimulate the economy is in real estate. Although the sector is incredibly strong in China overall, the government recently stipulated that up to 70% of total real estate developments should be in commodity houses with a floor area less than 90 square meters. This stipulation provides greater opportunity for low- and medium-income urban residents to afford their own homes.[29]

Meanwhile, although the current overwhelming trend for Chinese consumers is to save and invest their money, signs of change are starting to appear. In a recent door-to-door survey of Chinese consumers, McKinsey & Company discovered a strong, short-term desire for consumer goods.[30] Topping the list of desired goods were new cards, appliances, and flat-screen TVs. The

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[24] US-China Business Council, PRC Statistics, www.uschina.org/statistics/economy.html, accessed 15 Jun 07.
[25] Land and St-Maurice. The Chinese Consumer: To Spend or Save. *The McKinsey Quarterly*: 2006.
[26] Pitsilis, *et al*.. Checking China's Vital Signs. *The McKinsey Quarterly*, 2004 Special Edition.
[27] World's Largest Mall Nearly Empty as Chinese Save Cash. *International Herald Tribune*: April 18, 2007.
[28] Orr. Encouraging Consumer Spending in China. *The McKinsey Quarterly*, Web exclusive, December 2004.
[29] China's Real Estate Investment Picks Up. *SinoCast China Financial Watch*: April 17, 2007.
[30] Land and St-Maurice, The Chinese Consumer: To Spend or Save. *The McKinsey Quarterly*: 2006.

Gallup organization found similar results. It found that among those living in Beijing, Guanzhou, and Shanghai; mobile phones, digital cameras, computers, and TVs were in high demand.[31]

What's particularly notable about the desired consumer products in China is that they represent a spirit of self-satisfaction and self-expression. Last year, Harvard Business Review referred to this as an "emergence of a Chinese 'me' generation." Not only do Chinese consumers have a growing desire for luxurious and "fun" items, they also have a growing interest in European products.

The socio-economic situation in China is in transition, and will continue to be in transition for the next two decades. During this timeframe, there will be a steady and large migration from the rural areas to the more prosperous urban areas. As incomes continue to rise, the Chinese consumer will continue to gain more discretionary income, which will stimulate more consumer spending. However, it will be a slow change as the current Chinese consumer still has a lot to save for – health care, retirement, housing, and education for their children.

A large and powerful middle class concentrated in the urban areas will also emerge. The expected spending power of this middle class will outweigh that of the "affluent" Chinese and be equivalent to the total spending power of Japan.[32]

Summary and Strategic Implications

- The current economic situation in China offers some opportunities for businesses, but not to the extent of the future (potential) Chinese market. Entering the market at the right time will be critical for any business's success in China.

- Chinese consumers are becoming more consumed with self-satisfaction. As such, companies that poise their products as "fun" and use emotional appeal will fare better in the long run than their counterparts who sell products on functionality.

- The perception of quality is changing among Chinese consumers. The young, affluent, urban consumers, in particular, are growing a strong dislike for domestic goods and a particular interest for European goods. This poses an added challenge for all non-European companies.

- Manufacturers of consumer goods need to expand their current target market beyond the affluent Chinese consumer and into the emerging middle class market. The challenge with this is that the emerging middle class is still in development and likely to change over time.

- If the government wants to stimulate more spending, it will need to look beyond real estate and reconsider its policies regarding health care, education, and pension funding.

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[31] McEwen, *et al*, Inside the Mind of the Chinese Consumer. *Harvard Business Review*: 2006.
[32] Farrell, *et al*., The Value of China's Emerging Middle Class. *The McKinsey Quarterly*: 2006 Special Edition.

Appendix

Figure 1. Yuan-$ exchange rate

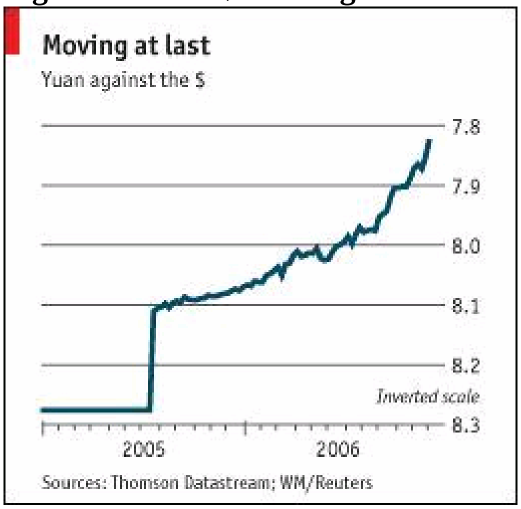

Figure 2. Average Net Income In China

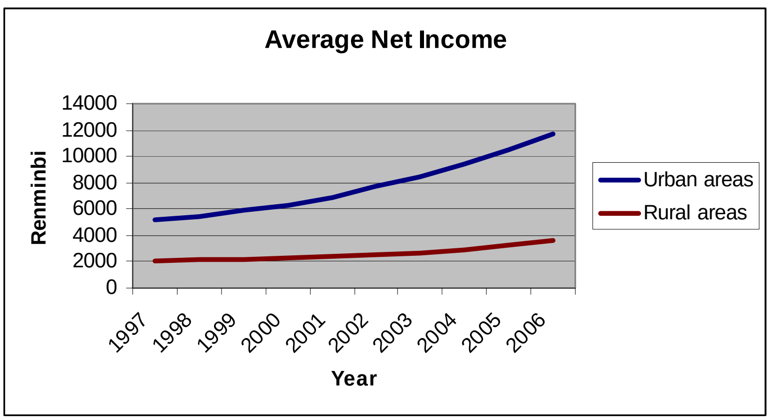

Figure 3. Savings Metrics; U.S. and China