

Taming grey rhinoceros: China needs to release financial risks urgently

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Abstract: At present, the “grey rhinoceros” in China’s financial sector mainly exists in the real estate bubble and enterprise debt accumulation. In order to release the financial risks accumulated in the past, on the one hand, we should weaken the economic growth indicators, resolve to eliminate the zombie enterprises, neutralize the monetary policy and change the incentive mechanism of the officials’ assessment. On the other hand, we should also encourage the ideological emancipation to stabilize the expectation and further promote streamlining government and delegating authorities.

Key words: Real estate bubble, financial risk, debt risk.

The central authority keeps paying high attention to financial risks. After the end of the fifth national financial work conference in 2017, the commentator of the People’s Daily quoted a word “grey rhinoceros” in the article, which was proposed by Michel Walker, an American scholar. This word is very impressive and powerful to explain the current financial risks in China: First, it cannot be stopped once the rhinoceros rush over as whom are with very strong impact and explosive force. Second, why is it called the “grey rhinoceros”? Like a swan, it usually should be white and the black one is considered very abnormal. Thus, the normal grey rhino represents the risk that should have been able to see; if you could not see it, what you can only say is self-deceiving. Then, how to tame the “grey rhinoceros”? The key is to release financial risks. Generally, financial risk is still in the process of accumulating, which similar to blowing balloons with its air pressure constantly accumulating should be caused great concern.

1 The real estate bubble is a “grey rhino”

The volume of the real estate in China is large, however, the real estate is the mother of the financial crisis. Once the financial crisis exploded, its impact on real estate is many times greater than that of the stock market crash.

The Japanese financial crisis in 1990 and the American subprime mortgage crisis in 2008 were both triggered by the burst of the real estate bubble. Nonetheless, our understanding and discussion of the real estate bubble are still not sufficient. Real estate is not just a financial problem. At present, a prominent point of China’s economic transformation is to promote consumption, but the cruel reality is that the real estate has eliminated the middle class, which results in the consumption to be hard to grow constantly. In addition, more and more enterprises realize that working hard for a year may not be as good as selling a flat in Beijing to earn more profits. The self-accelerating process of the real estate bubble will inevitably lead to bubble burst. Enterprises which pursue profits do all the things that can make money. As the real estate speculation will benefit more than just the industry, but why are they engaged in industry and commerce? This leads China economy to transform from substantial to fictitious, which impedes the innovation.

In addition, we should also learn to be in awe of the market. Rethinking the stock market crash of 2015, at least one lesson that we should learn is: do not think we can control the market. We cannot control the stock market as the magnitude of the real estate is much larger than the stock market, and there is no broken bubble in the world, so we must have a very big fear of the real estate.

The price regulation policy of central housing is

numerous. Why has it not been effective? This is because the most fundamental problem still has not been solved. The real estate has the property of finance, and the real estate bubble is, in fact, the problem of excess money. Why does China's M2 account for a relatively high proportion of GDP? Some people explained that it is because China is an indirect financing country. However, this explanation is not convincing. Data shows that the currency excess is a phenomenon of rapid accumulation after the financial crisis in 2008. Is not China an indirect financial country before 2008? China's GDP is 60% of the US, but if China's M2 is converted into US dollars, it will be 1.7 times higher than that of the US. The basic fact that money is over issued is unavoidable. If we do not solve this problem, it will be impossible to suppress the real estate simply.

Given the excessive currency that causes the real estate bubble, why do we need to issue so much money? The reason is that: after the 2008 financial crisis, the increment of social financing is far more than the increment of GDP. In a simple way, the current GDP is accumulated by credit. The reason why money is excessive is due to more debt is needed to create GDP and without accumulating so many debts GDP will not be guaranteed. In essence, this is the problem of economic growth mode.

2 Enterprise debt accumulation is “grey rhinoceros”

On September 22, 2017, S & P lowered China's credit rating. China's corporate debt has achieved alarming stage no matter which standard it is in term of. The growth rate of non-financial enterprises in the proportion of GDP is very alarming and in explosive growth, which is close to the apex of Japan in 1990.

In addition, it is more worrying that, although the leverage is put forward to remove in 2015, in fact, it has not been realized. We are still increasing leverage, not limiting to the residents and government, but also the corporate sector.

What is the basic problem behind the corporate debt? It is also a question of growth mode as our growth mode is getting dependent on credit input. In 2009 to 2010, an abnormal phenomenon was that China's credit density (new debt / new GDP) had risen seriously, and after the regulation, it had fallen, but the credit intensity of the last two years has rebounded to a fairly high level.

Now, China's real financial risk is definitely not

financing itself, but a game like this: the goal of achieving GDP's steady growth depends on the state-owned enterprises. What the state-owned enterprises depend on to grow steadily? It is the state-owned banks that provide “ammunition” to the state-owned enterprises. Since the government requires the steady growth of the state-owned enterprises, they have to adopt a tacit attitude towards the bad assets of the state-owned enterprises and the state-owned banks, which is an undeclared “game”. Since January 2016, the growth rate of state-owned investment and private investment growth has suddenly separated. This is a very alarming data for central leaders. It can be seen that the growth since 2016 is highly dependent on the input of state-owned enterprises, and the data is very convincing.

The huge risk brought by the steady growth of the state-owned enterprises is the mismatch of financial resources. Why? This is because the profitability of the state-owned enterprises is much poorer than that of the private enterprises, but the debt ratio of the state-owned enterprises far exceeds that compared to the private enterprises. This is a very terrible mismatch. The state-owned enterprises have created about 25% of GDP, but it accounts for 55% of non-financial enterprise debt, which means that there may have a lot of bad debts and risks in the future.

Data from foreign research institutions shows that the number and proportion of Chinese zombie enterprises are increasing rapidly, however, increasing number of enterprises are unable to repay interest. Why does Chinese have no financial crisis like Minsky curve foretold so far? This is not to imply that China's debt level is not high, but China's state-owned banking system know how to avoid that by continuing to “transfuse blood” to many enterprises, thus the problem of large-scale debt has not been broken out. Despite that, this undertaken action does not mean that China's debt is not critical to be taken seriously and the financial crisis will come sooner or later.

3 Conclusions and Suggestions

Financial risk is not only a financial problem but also a financial risk. Financial risk cannot be solved from the financial level but to consider the root behind it. This root can be divided into two points: on the one hand, whether we want to maintain growth; on the other hand, what we need to maintain growth. We need to release many risks that we have been accumulated in the past, but how do we specifically release risks? After

the 19th National Congress, we must be determined to do the following aspects:

First, we should weaken the indicators of economic growth. The more emphasis is placed on the growth indicators, the greater the pressure of steady growth which will inevitably bring about the accumulation of debt risk.

Second, we should resolve to eliminate zombie enterprises. The central document has put the elimination of zombie enterprises in a very important position, but so far there are not too many cases. The northeast special steel, Chongqing iron and steel are small cases because there are many institutional problems behind the restriction and the elimination of zombie enterprises we have to face, including unemployment.

Third, we should neutralize the monetary policy. In August 2017, the M2 growth rate dropped to 8.9%, and it should be said that the gap with GDP has reduced a lot. But this reduction is not sustainable, and it needs to be further observed. The debt problem could be greatly alleviated if we insist on reducing the gap between the currency growth and the GDP growth in a relatively long time after the 19th National Congress.

Fourth, we must change the assessment and incentive mechanism of officials. Taking the zombie enterprise as an example, now many zombie enterprises cannot be eliminated, because firstly, the zombie enterprises elimination will affect the employment for a moment; secondly, it will affect the stability of the society; thirdly, it will affect the local economic growth. Therefore, if incentive mechanism of the local officials remains but just appeal to remove leverage and obsolete zombie enterprises, this appeal will not become a reality.

Furthermore, it is painful to rely solely on the “subtraction”. If we want to manage financial risks well, we need to do some “additions”. The so-called “addition”, in fact, is to bring new growth momentum. If there is a new growth momentum with high quality, not just rely on credit as the past to promote, the financial risk will slowly be diluted. Specifically, the following two aspects should be followed:

First, we should promote the ideological emancipation

to stabilize the expectation. We know that increasing speed of the private investment is much slower compared to the state-owned enterprises, whereby two factors of steady growth and the factors that are generally expected to be unstable in the private investment. It is unpredictable that what will happen in the future. More importantly, we should focus on the Third Plenary Session of the 18th CPC Central Committee reform and achieve breakthroughs. Only with these reforms, it is possible to change the way of growth and eliminate the growth model by bank debt. As Premier Li Keqiang said, reform is the biggest dividend for China’s economy. Therefore, the following aspects of reform are particularly important.

(1) The state-owned enterprises. The debt risk is mainly in the state-owned sector. (2) The IPO registration reform. IPO is equity financing, and the higher the proportion of equity financing, the lower the debt ratio. The direct financing of the US accounts for 78% of the whole society, while China has only 14%, so the potential is large. (3) The real supply-side reform should be promoted. At present, the concept of supply-side reform is very complicated. If we go back to the most classic Laffer Curve on the supply side, it is very simple, which is to reduce taxes on a large scale. Only in this way, the situation of the real economy can be improved and the risk can be reduced as well.

Second, we must further promote streamlining government and delegating authorities, and stimulate the vitality of enterprise innovation and entrepreneurship to have effective growth. According to the prediction of Blackrock, if we can achieve the reform promised in the Third Plenary Session of the 18th CPC Central Committee, the proportion of debt in GDP will basically remain stable. The deputy governor of the central bank, Yi Gang, also puts forward a “stable lever”. The top priority is not to remove leverage, because it cannot be realized. We need to keep it stable first. But the “stable lever” is not easy to be realized. “Stable leverage” must rely on reform and change the way of growth. If it cannot be done, the real debt risk, financial risk, and real estate bubble are probably difficult to get a fundamental control of risks.