Trends in China’s Financial Development: A Behavioral Finance Perspective

Harrison Hong

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Chinese Miracle Despite Under-Developed Credit Markets

- Grown from 10% of US economy in 1980 to 66% in 2010. Double US GDP by 2035 if average growth rate is double that of US.
- About half of employment due to state-owned enterprises (SOEs), and half to small-to-medium sized firms.
- Yet only SOEs have access to bank lending while small-to-mid sized firms financially constrained.
- Contrary to US experience where credit markets key to industrialization (e.g. bonds and railroads).
- Credit the more primitive instrument compared to equity in financial development but virtually non-existent credit markets in China.
Lack of Credit Markets for Storage of Wealth First Order Challenge Facing Chinese Financial System

- Non-competitive banking sector means negative to low real rates for deposits
- Cannot invest abroad due to capital restrictions
- Only two real options for Chinese households: stock market or real estate market
- A third for the brave is shadow bank (e.g. informal lending in Wenzhou) which is semi-legal
Chinese Stock Market Dangerous and Disappointing

- Cumulative performance by risk (beta) of assets
- Investors mostly want to speculate by trading high beta stocks
- High beta stocks massively under-perform low beta stocks
- Too speculative and not a good way to accumulate wealth over time
So what if there is a bubble: Real estate still only game in town

- Real estate has become the focal point for all savings, resulting in good performance but also fueling a bubble.
- Price-to-rent ratios in Beijing and seven other large markets across the country have increased from 30% to 70% since the beginning of 2007.
- Current price-to-rent ratios imply very low user costs of no more than 2%-3% of house value.
- Even modest declines in expected appreciation would lead to large price declines of over 40% in markets such as Beijing.
- Price-to-income ratios also are at their highest levels ever in Beijing and select other markets.
- Real, constant quality land values have increased by nearly 800% since the first quarter of 2003, with half that rise occurring over the past two years.
Apartments as Status Symbol

- Bachelor called Fei Cheng Wu Rao, or Don’t bother if you are not sincere, became a hit immediately after its launch.
- A man from Hangzhou described his qualifications:
  - My parents have their own place in Hangzhou, so they won’t come to live with us. The apartment is just for me, my future wife, and our baby.
- A man, vying for a date, asked a female contestant whether she would like to go for a bicycle ride.
- I’d rather sit and cry in a BMW. The girl responded instantly.
Apartments and Income Inequality

- Rising real estate values a major source of income inequality in China.
- Whether you bought an apartment has become the defacto decider of whether you are rich or not.
- An apartment has become a must have status symbol for young people to get married.
- This is not a good problem to have especially with an aging demographic
Reinforcing Processes
Chinese Savings Puzzle

Saving Rates, China versus Other Asian Miracles

Asian Miracle Countries
1960-2010 time series
Lack of Investment Opportunities and Domestic Consumption Linked

- Real estate forced to do too much of the work as the savings vehicle
- So much so that any stimulus by governments is channeled into housing rather than spent, resulting in the highest savings rate for a country of this size and economic development in history.
- Which means lack of domestic consumption, thereby making it harder for China to transition to a more balanced economy with consumption and investment
- Is it a surprise that the Chinese have to save so much when the rate of return on investments is so low in China?
At the same time, private enterprises lack funds as witnessed by the extremely high rates (18% overnight) in the informal shadow banking system, which is among the largest in the world.

According to the PBoCs Wenzhou branch office, the size of the underground banking in the city is estimated to have reached CNY 110bn, equivalent to 18% of Wenzhous CNY 602bn formal bank loans.

The central bank also estimates that close to 90% of households and 60% of local enterprises are participating in this credit boom.

There are various estimates of the size of this shadow banking sector nationally, which go as high as Rmb14,000bn 15,000bn.

Defacto legalized already
Securitization of Small Business Loans: Replacing the Eastern Shadown Bank with a Western Shadow Bank

- Why not then securitize these small banking loans in the same way that mortgages, student loans and credit card loans are securitized?
- Originators can be similar to the small mortgage players in the US who coordinate the loans but don’t take risks.
- Big banks do not care about making small loans but might like securitization business.
- Securitization of these loans and tranching into CDOs by credit quality would create a sizeable public credit market, where private households can invest.
- Lower rates of return but safer and tranching caters to different risk appetites.
- Some private households lending to small-to-mid size firms anyways.
Financial engineering and innovation getting a bad reputation because of financial crisis in the West.

Legitimate concern but shadow bank for student loans, credit card loans etc...extremely useful and helpful for society.

Chinese government running surpluses and large SOEs with access to bank loans are not a good supply source of credit. Big banks wouldn’t object with securitization business.

So these CDOs of small-to-mid sized companies could be a politically feasible solution to the lack of credit markets problem.