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The Party Line

High Financial Anxiety

By Arthur Kroeber

China's financial system has its troubles, but a large-scale crisis is unlikely. Localized problems among poorly run, small-scale city and rural banks are the bigger risk.

Financial risk has returned to center stage in China, thanks to a determined effort by regulators this year to clamp down on risky lending practices both by banks and by the plethora of non-bank financial institutions that have exploited a decade of deregulation to get into the lending game.

The crackdown was overdue. China's financial sector has undergone an extraordinary liberalization since 2005. This was largely beneficial: households and private companies gained access to credit markets, and depositors started to earn a positive real rate of return after years of being forced to accept regulated rates lower than inflation. But liberalization spawned loose practices, and the increasingly convoluted flows between banks and non-bank institutions like trusts and asset managers made it harder for regulators to know what was going on. Equally, though, talk of a financial meltdown in China is overblown. Financial risk exists, but is probably more localized than systemic.

Inferno, or slow burn?

Before we analyze the arguments for and against disaster, let us specify what disaster means. Bank crises come in two basic forms: inferno or slow burn. The inferno is a crisis that breaks out swiftly, precipitated by a balance of payments problem, asset-price collapse, or a sudden domestic liquidity crunch, and brings a sharp economic downturn in its wake. Prominent recent examples are the 1997-98 Asian financial crisis (balance

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of payments trigger), and the 2008 American crisis (domestic liquidity trigger).

A slow burn is one in which impaired assets in all or part of the financial system get so big that the banks need government assistance. Depending on its scale and scope, this workout may depress the economy, or it may proceed in the background. An example of the latter was the US savings-and-loan crisis, which played out over nine years (1986-95) and had little impact on national economic growth.

A less benign example was China's crisis of 1998-2001, when the government took extraordinary measures to bail out a banking system in which close to half of all loans had gone sour. Bank sclerosis during the restructuring period probably contributed to four years of sub-par growth and deflation. Japan's "lost decade" of the 1990s was an extreme case of slow burn—more like a coal-mine fire—which came about because the popping of a massive asset bubble set up an inferno, but the government had enough control of the system that it could stretch out resolution of the problem over a long period.

Our view has long been that China is unlikely to hit an inferno-type financial crisis

Our view has long been that China is unlikely to hit an inferno-type crisis, since liquidity is abundant and the state owns all the lenders as well as most of the problematic borrowers (local governments and state-owned enterprises). A descent into Japan-style stagnation seems more probable, because of chronic efficiency problems in state-owned enterprises and because the Communist Party might be unwilling to accept the erosion of its power that efficiency-oriented reforms would bring (see the April 2016 *CEQ*, "Avoiding The Japan Trap"). But even this outcome could be a long time in arriving.

The case for catastrophe

The argument for worry is straightforward. Credit has risen rapidly: after holding steady for many years at under 150% of GDP, since 2008 it has risen at a rate of 10-15 percentage points a year, to 262% of GDP. Such rapid debt build-ups, according to research by the IMF, the Bank for International Settlements and others paid to worry about financial risk, frequently end in crisis.

This rapid credit build-up spawns two problems. First, if credit rises substantially faster than GDP for a long time, it implies that credit is ever less productive, because each dollar of credit generates less and less economic growth. The corollary is that much of this unproductive credit will eventually turn into non-performing loans, since borrowers are not using the credit to generate revenues sufficient to service their debt. These losses may be hidden while economic growth is strong. But when growth inevitably slows, the losses will materialize.

The second problem is that when, as in China, fast credit growth is accompanied by a proliferation of new financial institutions and instruments, chains of lending get longer and risk is harder to regulate. So there is increased risk that a default somewhere in the system will set off a chain reaction of losses that moves faster than regulators can respond. This is what happened in the US in 2003-08 with the rise of poorly-understood securitized loans. And arguably something analogous has been going on in China over the past several years, with the rise of non-bank financial institutions as conduits for loans disguised as "investments" that require less capital backing and are exempt from loan-loss provisioning rules.

The case for the defense

These arguments contain some truth, which is why they get so much play in the financial media. But under close scrutiny their force dissipates.

First, take the excess-credit argument. It is simply not true that a sustained rise in the credit-to-GDP ratio proves that credit is becoming "less productive" and that huge efficiency losses are mounting. It could also be that the economy is going through "financial deepening," in which companies and households become more adept at using debt to finance their expenditures, and hold more financial assets in their investment portfolios.

This process is well known in the advanced economies of North America and Western Europe, where the ratio of private-sector credit to GDP rose from about 45% in 1960 to 100% in the early 1990s. At no point during that period did analysts proclaim (as they do about China today) that financial catastrophe was imminent because each dollar of debt was generating less and less GDP growth. Instead they celebrated the rise of consumer finance, which enabled families to buy bigger houses and boost their standard of living, and of corporate financial techniques that enabled companies to do more with less capital.

Financial deepening is obviously part of the China story. The knock on China's financial system a decade ago was that it only provided loans to state enterprises. Since then rapid deregulation has improved access to credit for households and private firms: definitional financial deepening.

The easiest way to see this is in the home mortgage market. In the space of a few years in the early 2000s, mortgage lending went from nothing to around 15% of banks' incremental new loans, and in the years since it has generally grown faster than nominal GDP, reflecting the rapid rise in urban land values from an artificially low starting point in the late 1990s. In 2012, annual mortgage issuance was around 15% of the annual value of housing sales; it rose to 42% in 2016 and neared 60% in the first half of 2017.

To the extent that the increase in mortgage debt is simply changing the debt/equity composition of housing purchases, and reflecting a rise in land prices, it is possible for debt to rise faster than the GDP growth associated with the property market. As long as households have enough income to service their debts, and house prices are not out of line with economic reality, this is not a problem. So far these conditions seem to be met: indices of housing affordability have generally improved since 2010, with the exception of the biggest cities such as Beijing and Shanghai.

Cracking down on the interbank channel

The deregulation of the past decade has created more ways for local governments and SOEs to finance schemes of dubious value; but it has also enabled private companies previously shut out from credit markets to get loans. To the extent that private firms shift their balance sheets from equity to debt, debt rises relative to economic value added (i.e. GDP). This does not mean that credit is becoming less productive—merely that firms have more options for how to finance investment

This is not to say that China doesn't have a lot of unproductive credit; clearly it does. But the rising credit-to-GDP ratio also contains a significant element of financial deepening. Assessments assuming all of the debt-to-GDP rise reflects a deterioration in underlying credit quality therefore overstate the risks.

Now consider the second major risk—lengthening chains of financial intermediation. This is a concern: as transactions get more complicated, the chance that something somewhere will go wrong rises. The good news in China's case is that there are obvious responses to this problem: curbing the use of the interbank funding market, and tightening regulations to make it harder for banks to squirrel away loans in their "investment" portfolios. These two measures have been at the core of this year's crackdown, and so far they have been effective. After growing for years, banks' aggregate "investment" portfolio shrank in the second quarter, and interbank funding has been squeezed.

The third and perhaps most important point is that financial crises rarely arise simply from imperfections within the financial sector. Rather they come about because of an interaction between the financial system and other macroeconomic factors. If macro management is soundly growth-oriented, a flawed financial system can go a long time without blowing up.

The last two years provide an example. In mid-2015 China's heavy industrial sector—and several of the provinces that rely on it—was effectively in recession, and banks' problem loans were rising sharply. Beijing boosted credit growth to stimulate demand, but also imposed supply restrictions in key industries like steel and coal. The result was a sharp increase in corporate profitability, as material prices soared. Corporate debt-servicing ratios improved, and problem loans stopped growing. Companies have largely used the extra cash to strengthen their balance sheets, rather than invest in new capacity. The underlying problem of excess industrial capacity has not been solved, but some time has been gained, and time is an important ingredient in resolving financial-system difficulties.

Chinese authorities seem to have studied closely the policy mistakes of Japan and Southeast Asia

Macroeconomic management matters

Taking a longer view, the Chinese authorities seem to have studied closely the policy mistakes of Japan and the Southeast Asian crisis countries, and done their best to avoid them. One rule is to avoid asset bubbles: collapses in property prices were a central feature of the Japanese, Thai and US financial crises. China's government intervenes incessantly in the property market precisely because it both needs property investment to underpin economic growth and wants to avoid a sustained price bubble. The data on housing affordability suggest they have done a good job striking this balance.

Similarly, they have been careful with exchange-rate and capital flow management, permitting neither the sort of rapid appreciation that wrought havoc with Japan's monetary policy in the late 1980s, nor the inflows of short-term capital that got Southeast Asia into trouble in the 1990s.

Another underappreciated factor is institutional: the strict division between financial and non-financial companies. An important contributor to the Japanese malaise was the "main bank" system, in which large banks were embedded within *keiretsu* groups via webs of cross-shareholding. When land and equity values collapsed between 1990 and 1993, ravaging corporate balance sheets, this hurt the banks both because of a rise in NPLs and because a lot of their net worth was tied up in the shares of related companies. This made the resolution of the problem especially thorny.

Finally, financial regulation itself, while imperfect, has been broadly adequate. Our survey of financial deregulation in this issue suggests that regulators catch up with and restrain financial innovations (such as wealth management products, or the various schemes banks use for disguising credit as "investments") after about two or three years of rapid growth. This is generally quick enough to prevent any given innovation from becoming systemically threatening.

Beware small, local banks

To conclude: China's financial system has its problems, but neither an inferno nor a slow-burn crisis is likely within the next few years. If something big does go wrong, it will probably feel more like the savings-and-loan (S&L) crisis in the United States than the more dramatic precedents from Southeast Asia, Japan or the US in 2008. There is no balance of payments problem, no large-scale domestic funding problem, no asset bubble, and generally sound macroeconomic management and financial regulation.

There are, however, significant localized problems that stem in part from rapid liberalization, and here the parallels between today's China and the US in the 1980s are noteworthy. The S&L problem arose because local savings banks were ill-equipped to handle the interest-rate deregulation of the late 1970s and early 1980s, which raised their cost of funds and caused them to chase high-yielding investments whose risks they could not accurately price. S&L failures were most common in regions in economic difficulty, such as Texas, which went through hard times after the sharp fall in oil prices in the mid-1980s.

Today, China's most problematic banks are the 169 city commercial banks, which rely most heavily on funding from the interbank market and have "investment" books larger than their loan books—meaning that their capital bases and loan-loss provisions are much weaker than their financial statements pretend. (The nearly 4,000 rural commercial banks, whose combined assets are a bit bigger than those of their city cousins, have similar problems.)

The most worrisome of these banks are concentrated in regions such as the northeast, which rely on "old economy" heavy industry and mining, and will be the hardest hit as the economy slows over the next year or two. If the government decides to let GDP growth settle at a lower—but more sustainable—rate, then it may have a local-bank cleanup on its hands. But the chances are that this cleanup can be done without creating national economic or financial disruption.

The Financial Labyrinth

Your Guide To The Maze

China's financial system has grown almost five-fold and seen a proliferation of players and products over the past decade. We try to impose order on chaos and explain how the system works.

Since the global economy was brought to its knees by the freezing up of the US financial system in 2008, China has become the market that financial analysts love to worry about. And no wonder: China's leaders responded to the slump in global demand by enabling a credit splurge of world-historic proportions. Total credit, stable at less than 150% of GDP in the years before the crisis, has surged to more than 260% of GDP. To create this boom, China deregulated its formerly stodgy financial system with alarming speed.

Once a simple arena where a handful of big state banks dispensed loans to state-owned enterprises, China's financial sector has become a labyrinth where a growing number of banks and non-banks (trust companies, brokerages and asset managers) keep inventing new financial gizmos (wealth management products, asset management programs, trust benificiary rights) that ultimately wind up in the hands of companies and households as loans.

Safer than it looks

The speed of credit growth, the proliferation of financial institutions and financial products, and the chaotic and fragmentary data, make it reasonable to fret that China is on the verge of a catastrophe like the one that sank the US in 2008. Close study has persuaded us that this is not so: the system remains securely funded by a huge pool of bank deposits, and the state competently controls enough of the main actors that the risk of

Financial system assets by institution, 2007

Institution type	Assets, RMB trn	Share of total, %
Banks	52.59	85.9
Policy	4.39	7.2
Big Five	28.00	45.7
Joint-stock	7.25	11.8
City commercial	3.34	5.5
Rural	5.61	9.2
Others	4.00	6.5
Asset managers	0.00	0.0
Trusts	0.96	1.6
Insurance companies	2.90	4.7
Mutual funds	3.03	5.0
Hedge funds	0.00	0.0
Securities	1.73	2.8
Total	**61.22**	**100.0**

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nationwide implosion in the next few years is modest. But the system's complexity and fragmentation mean that the chance of localized financial accidents is now uncomfortably high.

This issue of the *CEQ* is an attempt to bring clarity to this mystifying landscape. This article describes the financial system's current structure; subsequent pieces explain the deregulations of the past dozen years, analyze the ways banks turn ordinary loans into shadow finance, and argue that the condition of the major banks is not as dire as the pessimists proclaim.

No longer just a few big banks

We can analyze the transformation of China's financial system from two angles. One is the diversification of financial institutions. The first two tables show institutional holdings of financial system assets in 2007 and 2016. They show that China remains a bank-dominated system, but less so than a decade ago. The bank share of financial-system assets has dropped from 86% to 72%.

The position of the Big Five state-owned banks has eroded most dramatically. In 2007 they controlled nearly half of system assets; that share is now down to less than 30%. Conversely the smaller banks—and in particular the city commercial banks—have grown like topsy and enjoyed a significant market-share gain. The institutions that have gained at the banks' expense are asset managers, trusts and hedge funds. In 2007 asset

Financial system assets by institution, 2016

Institution type	Assets, RMB trn	Share of total, %	Market share change, 2007-16, pp
Banks	232.25	72.1	-13.8
Policy	22.94	7.1	-0.1
Big Five	86.60	26.9	-18.9
Joint-stock	43.50	13.5	1.7
City commercial	28.20	8.8	3.3
Rural	29.90	9.3	0.1
Others	21.11	6.6	0.0
Asset managers	34.48	10.7	10.7
Trusts	17.46	5.4	3.9
Insurance companies	15.12	4.7	0.0
Mutual funds	9.16	2.8	-2.1
Hedge funds	7.89	2.4	2.4
Securities	5.79	1.8	-1.0
Total	**322.14**	**100.0**	-

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managers and hedge funds were basically non-existent; and trusts (quasi-banks that are subject to less stringent prudential rules than regular banks and often finance riskier and higher-yielding projects) accounted for less than 2% of system assets. By 2016 these three types of institutions controlled RMB60trn in assets, an amount equal to the size of all financial system assets in 2007, and 19% of system assets today.

As the third article in this report explains, the spectacular growth of asset managers and trusts is largely the result of their role as conduits for shadow lending: loans that banks want to move off their balance sheets in order to comply with regulatory requirements such as capital-adequacy or loan-to-deposit ratios. Roughly half of trusts' and asset managers' activity is this kind of shadow lending. Much of the rest consists of investments in the bond, equity and money markets.

Smaller banks grow the fastest

Within this institutional framework, a closer look at the evolution of the banks is warranted, since despite all the changes of the last decade they remain the core of the system, and the ocean of deposits they control remains the principal source of funding for the system as a whole. Here the story is simple: the big banks have lost market share to the small ones.

In 2007, the Big Five state-owned banks (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China,

Banking system assets, 2007

Bank type	Number	Assets, RMB trn	Share of total, %
Policy	3	4.39	8.4
Big Five	5	28.00	53.2
Joint-stock	12	7.25	13.8
City commercial	124	3.34	6.4
Rural	8509	5.61	10.7
Others	224	4.00	7.6
Total	**8877**	**52.59**	**100.0**

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Bank of China, and Bank of Communications) accounted for 53% of bank assets; by 2016 that figure was down to under 37%. The next layer consists of the 12 "joint-stock" banks. These banks operate nationally or at least across several regions, have diversified shareholding, but are effectively state-controlled (one of them, Minsheng Bank, is sometimes described as private but the high proportion of state shareholders makes this debatable). The joint-stock banks were established in the 1990s as nimbler competitors to the Big Five. Their share of bank assets has increased from 14% to 19% since 2007.

But this understates their growth: they are the most enthusiastic issuers of non-capital guaranteed wealth management products (WMPs), which sit off balance sheet because the issuing bank does not have to refund buyers' capital if the product makes a loss. Joint-stock banks have issued non-guaranteed WMPs equal to a quarter of their combined balance-sheet assets.

The most explosive growth, however, has come at the 134 city commercial banks: their market share doubled to 12%, and in absolute terms their assets grew nearly seven-fold in 2007-16 to RMB28trn. Their astonishing balance-sheet growth has depended on especially aggressive use of two tactics: borrowing funds on the interbank market to supplement their meager deposit bases, and reclassifying loans as "investments," which allows them to skirt prudential rules and lend a lot with relatively little capital, while also making low provisions for bad loans.

This reliance on non-deposit funding and shadow lending channels to disguise their loan books means that the city banks are probably the riskiest banks in China. But it is hard to know for sure because only 15 are publicly listed, and aggregating financial data for the rest of them is a cumbersome chore. Even less visible are the thousands of rural commercial banks, many of which were assembled from the older rural credit cooperatives that once dotted China's countryside. Like the city commercial banks,

Banking system assets, 2016

Bank type	Number	Assets, RMB trn	Share of total, %	Market share change 2007-16, pp
Policy	3	22.94	9.9	1.5
Big Five	5	86.60	37.3	-16.0
Joint-stock	12	43.50	18.7	4.9
City commercial	134	28.20	12.1	5.8
Rural	3782	29.90	12.9	2.2
Others	471	21.11	9.1	1.5
Total	**4408**	**232.25**	**100**	-

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they command about 13% of banking assets and have grown rapidly over the past decade. But only five are publicly listed.

From really boring to rather less boring

The other way to look at financial diversification is to break down the system by type of asset, rather than by institution. Here again there is a straightforward story.

In 2007, China's credit universe was extremely boring: 63% of it consisted of bank loans, and virtually all of the rest consisted of the most vanilla sorts of bonds: Chinese government bonds (CGBs) issued by the central government, quasi-sovereign bonds issued by the three government-owned policy banks (China Development Bank, Export-Import Bank and Agricultural Development Bank) and corporate bonds issued mainly by large SOEs. About 8% of system assets were short-term bills issued by the central bank to withdraw cash from a system that otherwise would have faced huge inflationary pressure because of inflows from China's burgeoning trade surplus.

A decade later, it is not quite so boring. Bank loans are still the largest component, but "shadow lending" via non-bank intermediaries has emerged as an important channel of finance, almost as large as corporate bond issuance. Together, bank loans and shadow loans account for about two-thirds of all credit assets. (Note that in this analysis we consider only the final credit instruments that deliver funds to borrowers. Many instruments that are often discussed in media reports, such as wealth management products and trust products, are "wrappers" that bundle up depositor funds and then invest them in loans, bonds or the equity market. The third article will explain how these work. Also note that total

Financial assets by type, 2007

Asset type	RMB trn	Share of total, %
Bank loans	27.77	62.9
Shadow loans	-	
Bonds	12.70	28.8
China government (CGBs)	4.94	11.2
Local government	-	-
Policy bank	2.88	6.5
Other financial institutions	0.34	0.8
Corporate	4.54	10.3
PBOC bills	3.66	8.3
Total	**44.13**	**100.0**
Total non-equity financial assets, % of GDP	163	
Equities, RMB trn	*32.72*	
Equities as % of GDP	*121*	

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credit measured this way is a net figure, eliminating the double counting that arises when two or more institutions are involved in the creation of a single loan.)

In relative terms the bond market is about the same size (30% of total credit assets) but its composition has changed, mainly because of the rapid growth of local-government bonds, which were first allowed in 2015 and now account for nearly 6% of all credit assets and close to 20% of total bond issuance. In just two years, the stock of local government bonds went from zero to RMB11trn, almost as much as the stock of CGBs. The corporate bond market has also diversified beyond its original small group of SOE issuers and now accounts for about 11% of total credit.

In the rest of the fixed-income market, bills issued by the People's Bank of China have disappeared, as inflationary pressure moderated after the 2008 financial crisis and the authorities became more relaxed about letting trade surpluses be recycled via private-sector capital outflows. But a couple of new instruments have emerged. Negotiable certificates of deposit (large denomination certificates of deposit tradable on secondary markets), first permitted in 2015, have become a popular way for the joint-stock banks to raise short-term funds, and now comprise 3% of credit assets.

Asset-backed securities (ABS) have also begun to be issued, but their volumes so far are (in Chinese terms) negligible. Given the huge volume of assets that could potentially be securitized (mortgage loans, revenue streams from infrastructure projects, and so on), the bottomless desire of

Financial assets by type, 2016

Asset type	RMB trn	Share of total, %	Market share change 2007-16, pp
Bank loans	112.06	57.5%	-5.5
Shadow loans	17.20	8.8%	8.8
Bonds	58.77	30.1%	1.4
China government (CGBs)	12.10	6.2	-5.0
Local government	10.85	5.6	5.6
Policy bank	12.40	6.4	-0.2
Other financial institutions	1.86	1.0	0.2
Corporate	21.56	11.1	0.8
PBOC bills	0.01	0.0	-8.3
Negotiable certificates of deposit	6.28	3.2	3.2
Asset-backed securities	0.65	0.3	0.3
Total	**194.95**	**100.0**	-
Total non-equity financial assets, % of GDP		262	
Equities, RMB trn		*50.84*	
Equities as % of GDP		*68*	

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banks to move loans off their balance sheet to make way for new lending, and the need of local governments to find steady sources of income not dependent on land sales, ABS could well become a major source of growth in China's credit markets in the next few years.

The incredible shrinking stock market

A final observation relates to the stock market. Here our choice of comparison years is not quite fair: at the end of 2007 the equity market was just past the peak of an epic boom, so its value relative to the credit system was on the high side. Conversely at the end of 2016 the market had not fully recovered from its epic crash of mid-2015, so its relative value now may be on the low side.

Nonetheless, the general trend is clear: China's financial markets are dominated by debt, and becoming more so. In 2007 the stock market's capitalization of RMB33trn was nearly triple the size of the bond market, and about three-quarters of the combined value of all credit assets. By 2016 the RMB51trn equity market was smaller than the RMB59trn bond market, and was worth just over one-quarter of all credit assets.

It is possible that this trend has peaked. Since March 2017 the authorities have launched a fierce campaign to rein in the riskier forms of debt, with shadow lending and local-government borrowing the main targets. The government is also at least rhetorically committed to a policy of “deleveraging.”

Importantly, this does *not* imply an intent to reduce the aggregate debt-to-GDP ratio, which stood at 262% at the end of 2016, up more than 100 percentage points from a decade earlier. Rather the main focus is for heavily indebted state–owned enterprises to shore up their debt-to-equity ratios, mainly by raising new equity rather than paying down their debt. Yet if these initiatives are sustained, the breakneck growth of debt could slow down, the pace of equity issuance could rise, and the stock market might gain some ground on the credit behemoth.

A Short History Of Financial Deregulation

By Chen Long

Financial deregulation has seen a cartel of national state-owned banks give way to a bewildering array of local banks, non-bank lenders, wealth management products and loans disguised as investments. Regulators are tightening their grip, yet so long as Beijing demands high-speed growth, it will have to tolerate some financial misbehavior.

Over the past 10 years China's financial system underwent a massive transformation. The behemoth state-owned commercial banks lost market share to smaller joint-stock and city and rural commercial banks, which grew their balance sheets aggressively by disguising an ever greater share of their loans as trust products, asset management programs and wealth management products. Non-bank financial institutions such as trust companies and asset managers sprouted and became important links in a lengthening chain of financial intermediation.

Why did this happen? The answer is straightforward. First, liberalization was enabled by a decentralized regulatory system, in which authority was fragmented among the central bank and the insurance, securities and banking regulators. Second, the government's desire to maintain a high rate of economic growth (at least 8% during the Hu Jintao years; at least 6.5% in the Xi Jinping years) required fast credit growth.

Under these conditions, financial institutions had a strong incentive to create as much credit as they could by whatever means possible, and the fragmentation of regulations made it possible for banks to get around these barriers by regulatory arbitrage: masking loans (subject to the pru-

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dential rules of the banking regulator and central banks) as investment products to which the securities and insurance regulators might turn a blind eye. The lobbying power of financial institutions was also an important driver of deregulation.

The past decade has therefore been either a golden age of financial innovation or a lawless Wild West of risk-taking. Either way, this age may be nearing its end. In recent months financial regulation has tightened and become more centralized under a more powerful central bank. Opportunities for financial arbitrage are shrinking as government starts to worry more about containing financial risk than supporting economic growth. How the tradeoff between regulatory vigilance and GDP growth will play out during the next slowdown remains to be seen.

The "Glass-Steagall" wall crumbles

Until the early 2000s Chinese banks simply took deposits and made loans, and were subject to severe restrictions that also served as protections against financial risk. The banking regulator—the People's Bank of China (PBOC) until April 2003; the China Banking Regulatory Commission (CBRC) thereafter—set a hard limit on how much the banks could increase their loan books by every year, and the commercial banking law required banks to cap their loan books at 75% of their deposit base.

Banks were prohibited from owning any non-bank financial institutions—especially brokerages—in effect replicating the segregation of financial activity that the US imposed, under its Glass-Steagall Act, from the 1930s through the 1990s. Finally, banks enjoyed steady cash flows from the fat net interest margin guaranteed by the PBOC-set floor for loan interest rates and ceiling for deposit rates.

> With government worries about financial risk on the rise, opportunities for financial arbitrage are shrinking

This safe and static picture began to change in 2005, with new rules permitting banks to dabble in other lines of financial business and to raise funds other than traditional deposits. In February 2005 a joint regulation of the PBOC, CBRC and China Securities Regulatory Commission (CSRC) allowed commercial banks to set up mutual-fund subsidiaries—the first crack in China's "Glass-Steagall" separations. Subsequent rule changes allowed banks to own trust firms. In September, the CBRC issued guidelines on wealth management products. Banks could now start raising funds at rates higher than allowed for regulated deposits.

Major banking regulatory changes

1995	Commercial banking law sets loan-to-deposit ratio at 75%
2003	CBRC separated from PBOC
2004	First WMP
2005	CBRC officially approves WMP business
2007	CBRC issues trust product guidelines
2009	Big stimulus and expansion of WMPs and trusts
2011	PBOC scraps loan quota and publishes total social finance
2012	CSRC approves fund management subsidiaries
	CSRC approves broker asset management
2013	Interbank crunch; CBRC tackles FAPR
2015	Interest rates fully liberalized
	Revised banking law
	75% loan-to-deposit ratio removed
2016	PBOC introduces MPA
2017	Regulatory centralization

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Banks were quick to climb through the breach in the "Glass-Steagall" wall and load up on non-bank subsidiaries. ICBC, CCB and Bank of Communications set up mutual fund units in 2005. In June 2007, BoComm acquired 85% of the total shares of a Hubei trust firm, setting a precedent for bank ownership of trusts. From 2009, the CBRC permitted banks to own insurance companies.

And while the rules still formally prohibit banks from owning brokerage firms, many have found ways to do so, usually via their overseas subsidiaries. Moreover, three big financial conglomerates—CITIC, Ping An and Everbright—gradually gained approval to operate all types of financial businesses. By 2010, China's "Glass-Steagall" separations between different types of financial business were effectively dead.

The rise of wealth management products

Wealth management products (WMPs) got started even before the CBRC formally authorized them. Everbright Bank piloted the first local currency WMP in July 2004, offering a 2.18% annual return, slightly above the then 1-year benchmark deposit rate of 1.98%. After regulators gave the green light for all banks to issue WMPs, a frenzy began during the 2006-07 stock market boom. IPOs surged, and betting on stock debuts became a profitable trading strategy. Banks and trust companies collaborated to market WMPs whose proceeds were used to subscribe to IPOs. This particular strategy ended with the stock-market collapse of late 2007, but it laid the groundwork for the subsequent rapid expansion of trusts.

The easiest way for trusts to expand their reach was through banks, whose branch networks gave them a strong distribution channel. The CBRC's regulatory guidelines for trusts, issued in January 2007, put no limit on trusts raising funds through bank branches, and in that year alone trusts' assets under management nearly tripled, from RMB360bn to RMB960bn. After the stock-market bubble popped, banks and trusts shifted their attention to structuring credit for borrowers who had difficulty getting formal bank loans. Trust firms simply acted as intermediaries to channel funds from banks to borrowers, charging a small commission of 20-30 basis points (0.2-0.3%).

These trust loans, along with WMPs, became the key components of the first phase of shadow banking in China. WMPs and other trust products offered returns more than two percentage points higher than regulated deposits, so they became very popular among banks' corporate and household clients, who began to shift their money out of savings accounts and into WMPs. From the banks' point of view, the funding provided by WMPs is similar to time deposits. The only difference is that instead of being funneled into regular bank loans, some of this WMP cash was transferred to trusts and other non-bank channels which deployed them in higher-yield lending.

Regulatory Whac-a-Mole: Act I

The emergence of WMPs marked the start of interest-rate liberalization. At one level, financial regulators were content with these higher-yield alternatives to bank deposits, since they achieved the goals of rate liberalization (better pricing of risk, more options for savers) without the need for a politically tricky formal deregulation of deposit rates. But they were also shocked by the speed with which WMPs and trust loans exploded, so they decided to rein things in a bit.

In 2010 the CBRC put in new rules making it harder for banks simply to route funds directly to trusts. The next year, the PBOC began to publish data on "total social financing" (TSF), which included lending by trusts and other shadow banking activities, and quickly replaced the outdated bank-loan data as the main indicator of national credit conditions.

The restriction on bank funding of trusts worked for a few quarters, but by mid-2011 financiers found their way around this obstacle. Trusts developed their own distribution networks, and banks continued to funnel money to trusts, classifying their transfers as "financial assets purchased for resale," a type of investment. Regulators turned a blind eye, since by late 2011 the emphasis in macro policy had shifted from containing financial risk to supporting economic growth, and the authorities did not want to do anything that would constrict the supply of credit. Trust assets grew explosively, reaching RMB10trn by the end of 2013, a 30-fold increase in just seven years.

Asset managers get in on the act

Trusts were stars of the financial industry and other players wanted to get a slice of their business. In October 2012, the CSRC deregulated the asset management business of brokerage firms. And soon enough brokerages copied the trust model and started to take money from commercial banks to extend credit. They took market share from the trusts because they faced lighter regulation by the CSRC than the CBRC imposed on the trusts, and were willing to charge much lower fees to pick up business. Assets under management of brokerage firms sextupled from RMB282bn to RMB1.9trn in 2012, and kept growing rapidly in the following years.

The CSRC made another deregulatory move in late 2012, allowing mutual fund firms to set up special accounts and fund-management subsidiaries to manage money from third parties. The main difference between the two is that special accounts invest in the capital markets while fund-management subsidiaries mainly invest in credit claims. The first three fund-management subsidiaries were established in November 2012. Unsurprisingly, they adopted the same business model used by trusts and brokerage asset managers: channeling funds from the banks. Some fund managers have a natural advantage, because their parent companies are commercial banks.

Shortly after these deregulations, in April 2013, the new administration of Xi Jinping initiated another monetary policy tightening cycle to rein in credit growth, which had soared to 22% year-on-year in the final months of the Hu Jintao administration. In the beginning, the CBRC announced further restrictions on WMPs investing in "non-standardized" credit claims (credit instruments not traded on public markets—in essence, loans). This was a blow to trusts as they were the major channel for this type of WMP.

In June 2013, the interbank market suffered its first major squeeze. The PBOC withdrew liquidity and pushed up money-market rates in order to discourage banks from borrowing cheap short-term money to fund long-term high-yield credit assets. The interest rate on popular overnight repurchase agreements spiked to 13%. The high rate meant the money market basically froze up; and some worried that China had hit its

"Lehman moment," similar to the collapse of US money markets after the bankruptcy of Lehman Brothers in 2008.

The PBOC calmed things down by injecting fresh liquidity into the interbank market. The authorities shifted to the use of administrative tools, rather than monetary policy, to tighten the reins on shadow finance. In May 2014, the financial regulators issued a joint regulation that effectively prohibited banks from classifying loans to non-banks as "financial assets purchased for resale."

Regulatory Whac-a-Mole: Act II

But these restrictions did not end the growth of shadow lending; they merely changed the channel. Unable to push funds to trust firms, banks increased their dealings with the lightly regulated brokerage asset managers and fund-management subsidiaries, recording these transactions as "investment receivables." Credit creation via these channels was tolerated, especially after another monetary easing cycle began in late 2014 and the authorities were more concerned with propping up GDP growth than containing financial risk. By the end of 2016, total assets under management at brokerage asset management, fund special accounts and fund management subsidiaries reached RMB33trn, up five-fold from 2013. These institutions have become a much larger channel than trust firms in extending credit.

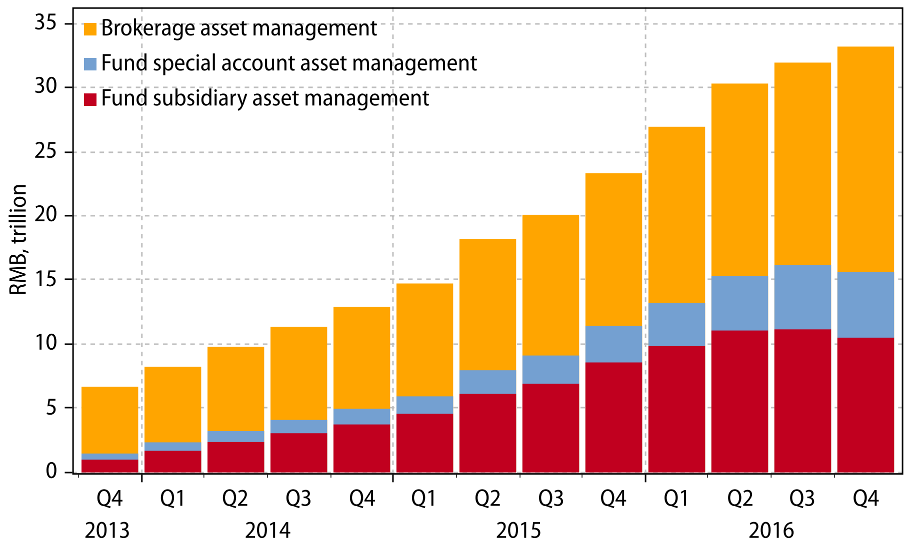
The final group to join the party were insurance companies, which had previously played a bit part in the financial explosion, thanks to a regulation that capped the guaranteed return on their investment products at 2.5%. But in 2015 the China Insurance Regulatory Commission (CIRC) scrapped that rule, igniting a frenzy of new insurance products—so-called "universal insurance products" that were in essence speculative WMPs, rather than traditional insurance policies. Insurance companies' sales of investment products soared from RMB30bn a month in 2014 to over RMB200bn a month in early 2016.

> In 2016, China's leaders decided that financial deregulation had gone far enough

Most of this increase came from little-known private insurance firms such as Anbang, Foresea Life and Evergrande Life, where investment product sales accounted for 75-95% of revenues at the peak of the insurance boom in the first quarter of 2016. (The big state-owned insurers such as China Life were far more restrained, relying on investment products for less than 20% of their revenues.) These private insurers went on gigantic

Asset managers are facing pressure to shrink

Assets under management, by type



Gavekal Data/Macrobond

acquisition sprees both at home and abroad, arousing the ire of regulators. CSRC chairman Liu Shiyu condemned them as "financial crocodiles" manipulating the stock market; foreign exchange regulators were alarmed by the huge sums Anbang shipped abroad to finance the purchase of trophy assets such as New York's Waldorf-Astoria hotel.

The end of the deregulatory era?

By late 2016, the Chinese leadership concluded that deregulation had gone far enough, and that the growth of non-loan credit books and other forms of shadow finance had to be brought under control. A series of steps indicated a determination to end regulatory fragmentation and curb risky lending funded by interbank borrowing. The first step was the PBOC's imposition of a periodic macro-prudential assessment on the banking system—effectively a checklist enabling the central bank to fully evaluate each bank's operations.

In March and April of 2017, the CBRC's new chairman Guo Shuqing (who, ironically, had deregulated the broker asset managements and fund businesses as head of the CSRC in 2012) launched a barrage of regulations against financial arbitrage and loans that go through two or more intermediaries. He also ordered banks to report whether they derive more than a third of their funding from other banks, implying that this is the new informal limit for non-deposit funding. Also in April, Xiang Junbo, the

CIRC head who had killed the limits on insurance companies' investment products, was removed in a corruption inquiry; he has yet to be replaced.

This regulatory blitz had an immediate impact. The assets under management of non-bank financial institutions posted their first ever quarterly decline, falling from RMB33.8trn in the first quarter of 2017 to RMB31.6trn in the second. Sales of universal insurance products collapsed.

Underscoring the fact that the authorities intend a systematic overhaul of financial regulation, not just a short-lived crackdown, the once-every-five-years National Financial Work Conference held in July 2017 announced plans to centralize regulation and impose tighter political controls. The conference established a high-level State Council Financial Stability and Development Committee, which will sit above all existing regulators and oversee financial regulatory policy. The PBOC will house the committee's secretariat, giving the central bank the strongest say in the direction of financial regulation.

This move stops short of the oft-discussed option of setting up a single super-regulator to oversee the financial sector, but it is the next best thing. If it works properly, the PBOC-led commission should bring to an end the regulatory competition and arbitrage that has made China's financial liberalization so chaotic.

This is surely a positive move, and will curb financial risk in the short term. The question is how tighter financial regulation will sit with the government's desire for rapid GDP growth, which in turn requires a loose rein on credit creation. For the moment this conflict is submerged, because economic growth accelerated through 2016 and the government's 6.5% economic growth target will easily be met in 2017 even if shadow lending is sharply cut back.

But the present economic boom is driven mainly by a property market supported by mortgage lending, which continues to grow at 30% even as regulators tighten the noose on shadow finance. This cannot last forever. By late 2018 the property market will soften and GDP growth will decelerate again. Will the government be content to let the economy slow to a lower but more sustainable rate, or will it once again ease up on credit controls to boost growth? My bet is that credit growth will accelerate again, through either conventional loans and bonds, or some new shadow channel. The long tug-of-war over financial deregulation is not yet over.

Three Sets Of Books

By Chen Long

China's financial system has grown dizzyingly complex, but at its heart sit the banks, which provide most of the funds for shadow lending by non-banks. To assess the system's risks, we need to understand the banks' three credit books: their loans, their "investments" routed through non-banks, and their off-balance-sheet wealth management products.

The Chinese financial system used to be simple. Banks took deposits and made loans or bought bonds. Non-bank financial institutions (NBFIs) were relatively small, managed money for clients, and either put their money in the banks or invested in the capital markets, which were also fairly small relative to the economy. This business model has changed a lot over the past decade. Chinese banks still lie at the heart of the system, since it is their enormous deposit base that provides the ultimate funding source for most of the credit in the system. But banks now run three distinct credit books, each of which is large enough to be systemically significant. The channels of credit creation have become more diverse, more complex (because two or more financial firms are now often involved in the creation of a single loan), and much harder to regulate.

The first of the three credit books is the traditional loan book, which is still growing steadily and remains the primary source of credit creation for the Big Five large state-owned commercial banks (Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, and Bank of Communications).

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Wang Ya'nan provided research assistance for this article.

The second is the investment book, which consists of funds routed to other banks or NBFIs. About half of these "investments" are disguised loans; their form changes periodically as regulators crack down on one channel, and banks and their NBFI partners scramble to open a new one. The investment book has grown much faster than the loan book in recent years and now takes up a large share of the balance sheets of the joint-stock banks and city and rural commercial banks.

The third credit book is the rapidly growing off-balance sheet activity, mainly in the form of wealth management products (WMPs) whose investor capital is not guaranteed. This activity is especially popular among the joint-stock banks: their off-balance sheet WMP book is nearly a quarter the size of their on-balance sheet assets.

Entering the labyrinth

To understand the evolution of banks' balance sheets over the past decade, we examined not only macro-level data from the People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC), but also compiled bottom-up data for all the publicly listed banks, of which there were 35 by the end of 2016. The sample of listed banks includes all five state-owned commercial banks as well as the postal bank, nine of the 12 national joint-stock banks, and a few large city commercial and rural commercial banks.

In aggregate this sample accounts for 88% of commercial bank assets in China. The only drawback is that while the big banks are almost fully included, the city commercial banks and rural commercial banks are still under-represented because many are not listed. City commercial banks are 16% of the total commercial banking system but only 8% of the sample, and the representation of rural commercial banks is even lower. From a system-risk standpoint this is not too troubling: all systemically important banks are included. But localized risk in small city and rural banks is harder to quantify with certainty. It is possible that shadow-lending activity is a bigger part of the balance sheet at these small banks, and is backed by more precarious capital resources, than at the listed banks.

The shift from traditional bank loans to investment products has mainly occurred in the smaller banks

The shift from traditional bank loans to investment products has mainly occurred in the smaller banks. The Big Five, which account for about 40% of system assets, run more conservative portfolios, because they are more tightly

Composition of public-listed bank assets by tier, % of total

Bank type	2007 Loans	2007 Investments	2007 Other	2016 Loans	2016 Investments	2016 Other
Big Five	48	19	33	52	11	37
Postal	N/A	N/A	N/A	35	33	33
Joint-stock	54	21	25	44	28	28
City commercial	47	19	36	34	37	29
Rural institutions	53	6	40	40	23	37
Subtotal: Joint-stock, city & rural banks	53	20	27	42	30	28
All listed banks	**49**	**19**	**32**	**47**	**19**	**33**

"Other" includes reserves, trading books, long-term bond holdings, loans to other banks, and fixed assets.

PBOC, CBRC, Gavekal Dragonomics research

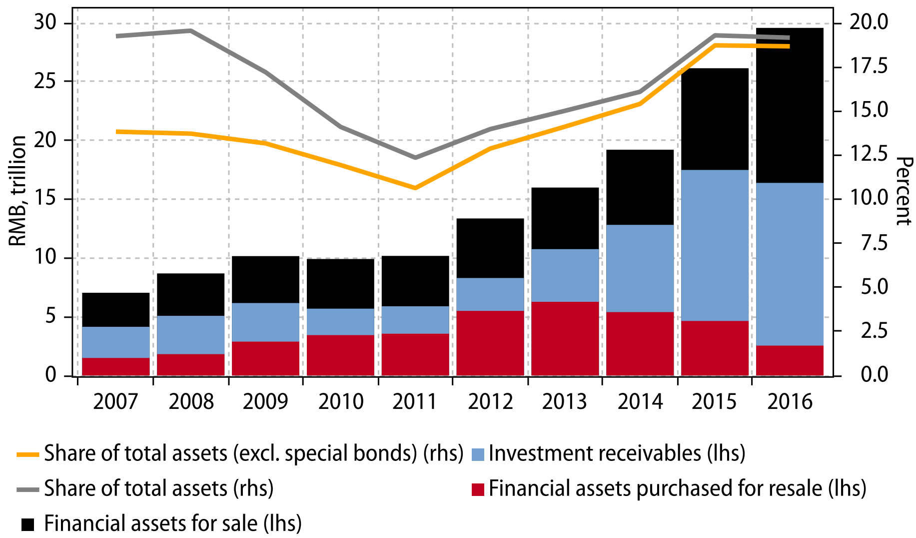
regulated: the liquidity they provide through the interbank market is the first line of defense against banking sector problems. Bank loans accounted for 52% of their assets in 2016, a slightly higher share than in 2007. For all other types of banks, the loan share has fallen by at least 10pp, to well under half.

Conversely, the share of investment assets at the Big Five has shrunk sharply since 2007, although this is slightly misleading. Starting in the early 2000s, the big banks held as "investment assets" a lot of special bonds issued by the state-run asset management companies and the Ministry of Finance (MOF) as a result of the bank system bailout and recapitalization process of 1998-2004. Many of these bonds were retired on maturity and so have dropped off the balance sheet, reducing the big banks' overall investment portfolios from 19% to 11% of their assets. If we exclude these special bonds, then the size of the big banks investment books fell only slightly to 10% from 12% of assets in 2007-16. Even so, it is clear that the big banks have not used their investment portfolios to bulk up their balance sheets.

At the smaller banks, though, investment portfolios have exploded, and now account for a quarter of the balance sheet at joint-stock and rural banks. At city commercial banks the investment portfolio is 38% of the combined balance sheets, bigger than the loan portfolio. For the three types of smaller banks in aggregate, investments rose from 20% of assets in 2007 to 30% in 2016. In absolute terms they soared more than tenfold, from RMB1.6trn to RMB16.5trn, during the same period. Loading up on investments has been the key mechanism by which city and rural banks have expanded their share of the banking-system pie. Some of these investments are actually equity or fixed income investments, but about half are really credit instruments—i.e. *de facto* bank loans that make up part of the shadow-banking universe.

Shadow lending tripled between 2011 and 2016

Bank investment portfolios, by type



Gavekal Data/Macrobond

Shadow channel #1: financial assets purchased for resale

Banks classify their investment portfolios under three anodyne headings: "Financial Assets Purchased for Resale (FAPR)," "Investment Receivables (IR)" and "Financial Assets for Sale (FAS)." Each has taken a turn as the preferred channel for shadow lending; and in each case after a heyday of two or three years they became the target of regulatory scrutiny and tightening. In aggregate they tripled between 2011 and 2016, to RMB30trn, and now make up 19% of the listed banks' balance sheet.

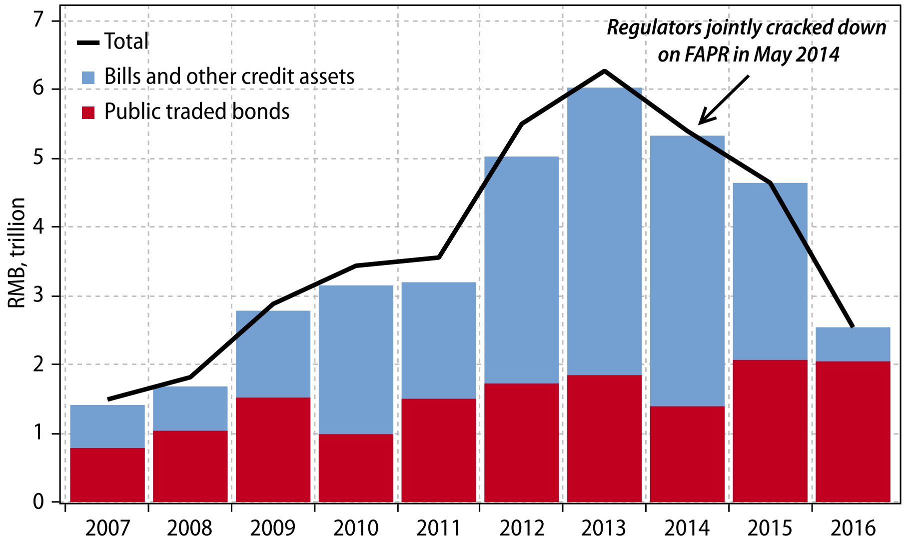
Until 2009, virtually all of the investment assets held by banks were simply bond holdings. Starting in about that year, however, banks began to use their investment portfolios to extend credit. The main reason to do so was to evade various regulations that limited banks' ability to grow their loan books. One such regulation was the statutory maximum loan-to-deposit ratio of 75%, which was only eliminated in 2015. Until 2011 banks were also subject to annual loan quotas set by the PBOC.

Even after banking rules were liberalized and these quantitative restrictions were removed, banks still could be crimped by capital-adequacy rules that compel them to maintain a capital base of at least 8% of their risk-weighted assets. Banks deemed "systemically important" faced even tougher capital requirements.

The way to get around this is to shift your assets into ones that carry a lower risk-weighting and hence a lighter capital charge. A corporate loan

Shadow investments bought for repurchase have collapsed

Financial assets purchased for resale, by type



Gavekal Data/Macrobond

has a risk-weighting of 100%, meaning that a bank must back each $100 in loans with $8 of capital. Investments often have risk-weights of 25% or below, meaning that the capital required to back $100 falls to $2 or less.

Banks first began to play this game of shifting costly loans into cheaper investments with FAPR—that is, assets bought under a repurchase agreement. FAPR includes short-term bills as well as various kinds of "non-standardized assets," meaning credit instruments that are not publicly traded. The best known of these are "trust beneficiary rights" (TBR), or a claim on the returns of an underlying asset arranged by a trust company.

A simple TBR example is as follows: Bank B tells Trust C to set up a trust product to provide credit to Company D. Bank B invests in this product, but immediately sells the claim on the returns on the trust asset to Bank A. In effect, money from Bank A is being used to finance a loan to Company D. But Bank A's balance sheet does not show a loan to Company D; it shows an "investment" (risk-weighted at 25%) in a TBR sold to it by Bank B. Bank A is usually an institution with a fast-growing loan book but a relatively small capital base. It has an incentive to disguise loans as TBRs or other kinds of investments so it can lend as much money as possible with as little capital as possible.

In 2007, total FAPR were around RMB1.5trn, or 4% of total bank assets; more than half of these holdings were bonds. Over the next six years, FAPR assets quadrupled to RMR6trn, of which nearly three-quarters were non-bond assets. Of these non-bond assets, a bit more than two-thirds were bills and the rest were credit assets such as trust beneficiary rights. In 2013, the peak of the FAPR craze, these assets accounted for 6% of the total banking system balance sheet, and 13% of the assets of joint-stock banks.

By 2014 the authorities fretted that these practices were getting out of control. In May that year, five regulators including the PBOC and CBRC jointly issued a regulation limiting the kinds of assets that could be counted as FAPR. Over the next two years FAPR holdings collapsed to RMB2.5trn, by which point they constituted less than 2% of total bank assets. The vast majority of these assets are bonds; bills and trust beneficiary rights are at their lowest level in over a decade.

Shadow channel #2: investment receivables

But by the time regulators started to crack down on FAPR, banks were already on to a new scheme: classifying loans as "investment receivables." Up through 2011, most of these assets were "special instruments" issued by the government, and sat on the balance sheets of the big state-owned commercial banks.

There were three main types of special instruments. The first was a set of bonds issued by the Ministry of Finance, used to inject new capital into the banks as they restructured and prepared for listing. They peaked at RMB2.6trn in 2008, when the MOF injected RMB665bn into the Agricultural Bank of China.

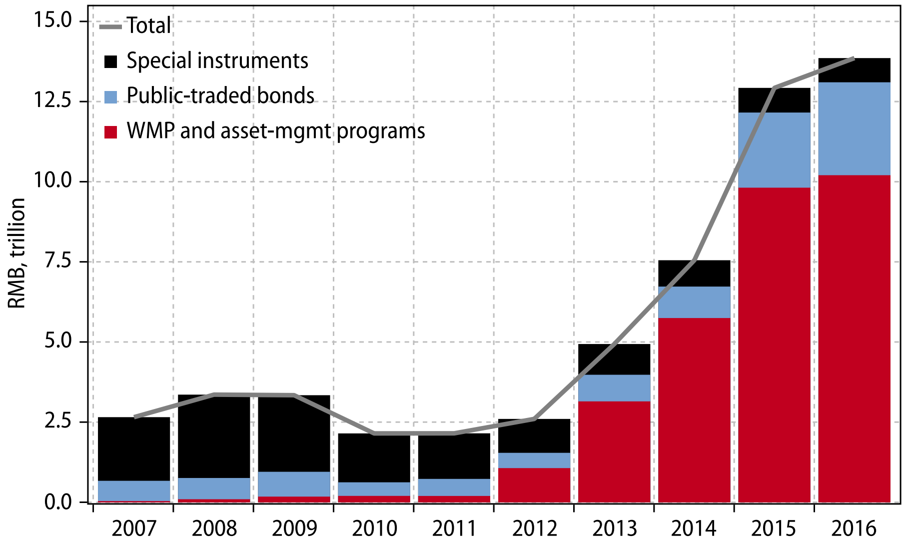
The second was a set of bonds issued by the four state-owned asset management companies (AMCs) set up in the late 1990s to take bad loans off the state banks' balance sheets. The banks transferred bad loans to the AMCs (at face value in the initial round, and at a discount in later rounds); in return they received bonds issued by the AMCs.

The third category were special central bank bills issued by the PBOC after 2005 to sterilize liquidity in the banking system as China's twin current-account and capital surpluses brought large inflows of foreign exchange. (If these inflows had simply gone into the domestic money supply, they would have driven up inflation. PBOC prevented this by forcing the big banks to buy its sterilization bills, thereby removing excess cash from the system.)

At their peak in 2008, investment receivables consisted almost entirely of these instruments, and 96% of them sat on the balance sheets of the big state-owned commercial banks, where they accounted for 9% of assets. At the smaller banks, they were less than 2% of assets and consisted mainly of holdings of publicly-traded bonds.

Asset-management programs boomed in 2014-16

Investment receivables, by type



Banks' annual reports, Gavekal Data/Macrobond

Over the next several years, investment receivables declined both in absolute terms and as a share of bank balance sheets, because the MOF and AMC bonds matured or were paid off by their issuers, and because the PBOC wound down its sterilization bill program. But in late 2012, regulatory changes prompted a boom in a new kind of investment receivables business, this time at the smaller banks.

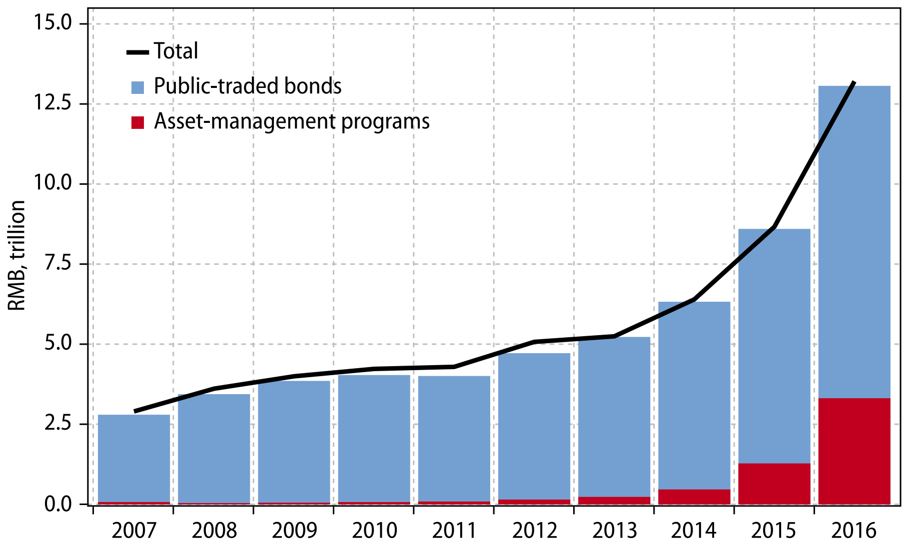
The brokers get into the act

At the end of 2012, regulators permitted fund management companies to set up subsidiaries and special accounts to make investments, and made it much easier for brokerages to set up asset-management accounts for their clients. The effect of these new rules was that banks could now pump money into fund managers and brokerages, ostensibly as "investments" in asset-management programs. They recorded these transactions on their balance sheets as "investment receivables." In many cases, however, the fund managers and brokerages used this money to extend loans to companies.

The use of investment receivables jumped from late 2012 on, thanks to this liberalization. But it really took off in 2014, when the regulatory crackdown made it much harder to use FAPR to disguise shadow loans. By the end of 2016, investment receivables totaled nearly RMB14trn, or 9% of the banking system balance sheet. About three-quarters were

Financial assets for sale are a new channel for shadow financing

Financial assets for sale, by type



Gavekal Data/Macrobond

in various asset-management programs (including wealth management products and asset-management programs of trust companies).

These instruments are overwhelmingly used by the joint-stock and city commercial banks, rather than by the big state-owned commercial banks. Investment receivables account for just 2% of the assets of the Big Five, but 18% and 21% of the balance sheets of the joint-stock and city commercial banks respectively. But after four years of explosive growth, asset management programs barely grew at all in 2016, and it is likely that tougher regulations by the CBRC will force banks to reduce their investment-receivables exposures in 2017.

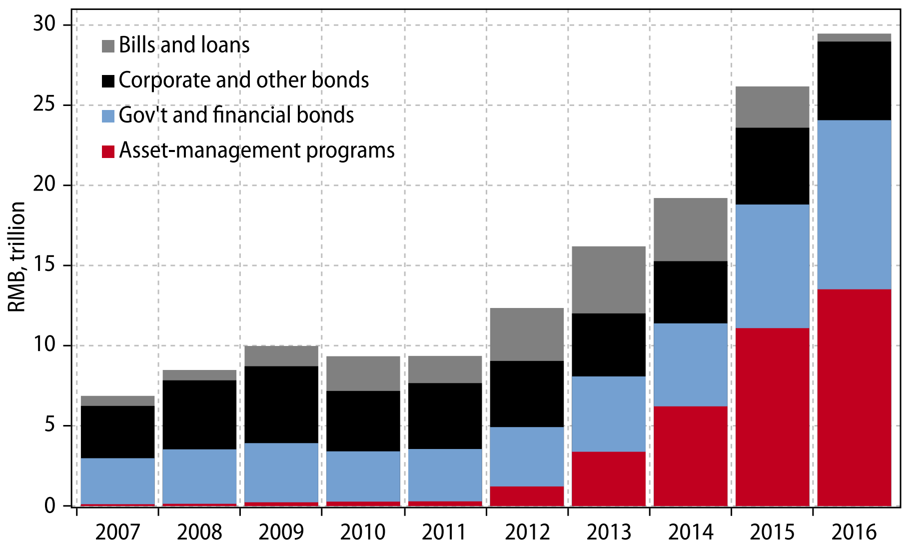
Shadow channel #3: financial assets for sale

Yet, once again, as regulators constrict one channel of shadow finance, another one opens up. As it becomes harder for banks to classify their holdings of WMPs and asset-management programs as investment receivables, they may start shoving them into the category "financial assets for sale" (FAS). Like investment receivables and FAPR, these count as investment holdings; they differ from FAPR in that there is no repurchase agreement, but they are considered "for sale" because they are bought for trading purposes rather than with the intention of being held to maturity.

As with the other two categories of investment holdings, FAS started out consisting mainly of publicly traded bonds, but since 2015 has mor-

Asset-management programs make up nearly half of total investments

Investment assets, by type



Gavekal Data/Macrobond

phed into a dumping-ground for "investment products" that disguise shadow loans. By the end of 2016, RMB3.3trn of banks' total RMB13trn in FAS were non-bond assets, of which more than a third are the WMPs, asset-management programs and trust products that have historically been classified as investment receivables. Another RMB2trn are investments classified as "equity products." But make no mistake: a lot of them are money market funds or asset management programs.

Once again, the smaller banks are the biggest users of this device: FAS account for 15% and 13% of the assets of city commercial and rural commercial banks respectively. As FAPR is no longer viable, and investment receivables are the target of tighter regulation, FAS will likely become the main channel for hiding shadow credit.

In summary, despite the periodic efforts of regulators to crack down on the use of "investment assets" to disguise loan activity, the practice continues to grow, with new channels opening up each time the authorities constrict an old one. The three types of investment assets of listed banks grew from RMB7trn in 2007 to nearly RMB30trn in 2016, and while their share of the total listed banks' balance sheet has remained steady at around 19%, the composition has shifted dramatically.

As late as 2011, most investment assets were publicly-traded bonds of government agencies or state-owned financial institutions. By 2016, though, asset management programs of various stripes accounted for 46%

of investment assets, and the bond share was down to 52% (short-term bills accounted for the rest). According to data from the Asset Management Association of China, about two-thirds of asset management programs ultimately feed into loans; the remaining one-third are invested in the domestic capital markets.

Going off the balance sheet

Apart from loans and investments, banks have a third credit book: their off-balance-sheet lending. There are two main types of off-balance-sheet credit. The first includes various items recorded under "commitments" and "contingent liabilities" in the footnotes of the audited annual reports, primarily bank acceptance bills and entrusted loans. A bank acceptance bill, also called a banker's acceptance, is an instrument issued by a bank which accepts the responsibility to make payment upon maturity, even if the customer for whom the acceptance was issued has not repaid the bank. An entrusted loan is a loan between two companies, for which the bank acts as an intermediary and makes a guarantee.

Both acceptance bills and entrusted loans are included in the PBOC's "total social finance" measure of aggregate credit, so we have a good sense of their system-wide volumes and don't have to estimate them via listed banks. By the end of 2016, the combined value of entrusted loans and acceptance bills combined was RMB19trn in the banking system. Letters of credit (similar to acceptance bills) are also sometimes considered as off-balance-sheet credit, but their volumes are too small to be important.

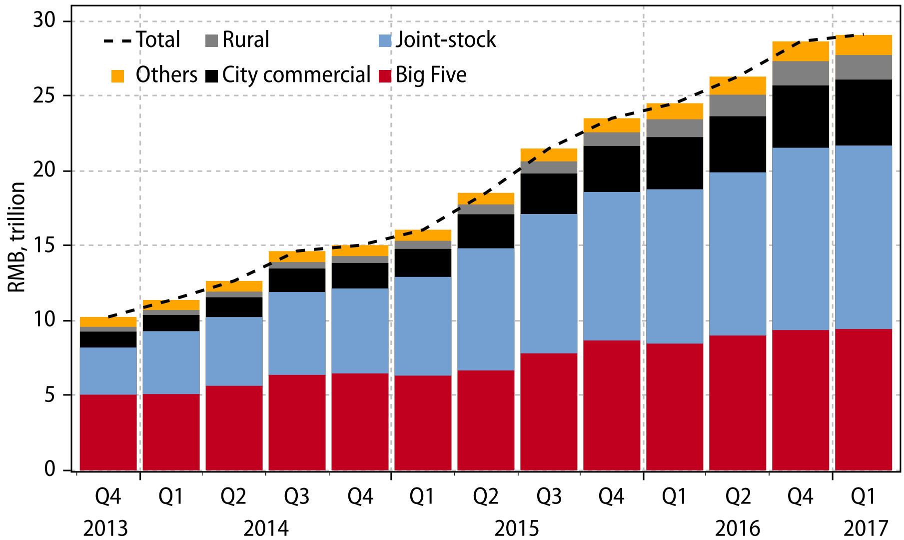
The second type of off-balance-sheet channel is non-guaranteed wealth management products. WMPs exist both on- and off-balance sheet. The difference is that on-balance-sheet WMPs guarantee the return of principle, making them a liability of the bank. WMPs for which principal is not guaranteed can be kept off the balance sheet.

The main reason to bulk up on off-balance-sheet instruments is to avoid regulations. They do not count in the calculation of loans for capital adequacy purposes. And the money that investors put in does not count as deposits either, so banks do not need to put aside required reserves to cover them. As with the various categories of investment products, off-balance-sheet WMPs are especially favored by smaller banks: they are equivalent to a quarter of on-balance-sheet assets at the joint-stock banks, and 15% at city commercial banks.

Our bottom-up calculation shows that total off-balance-sheet WMPs at the 35 listed Chinese banks amounted to RMB20.6trn at the end of 2016. For the system as a whole, the 2016 *Wealth Management Annual*

Off-balance-sheet WMPs have exploded

Lending via wealth management products, by bank type



Gavekal Data/Macrobond

Report issued by a subsidiary of the China Central Depository & Clearing Company and authorized by the CBRC, found that off-balance-sheet WMPs were RMB23.11trn—four times the amount of on-balance-sheet WMPs. Despite their lack of a principal guarantee, the default rate so far has been very low: just 0.05% of all WMPs recorded losses in 2016.

Off-balance-sheet WMPs fund a wide range of activities. Of their total value, about one-third recirculates within the financial system, going into bank deposits or money market funds. Of the remaining two-thirds, 44% goes into the bond market, 17% funds "non-standardized credit assets" or loans, and 6% goes into equity investments.

Beware the smaller banks

Summing up our tour through Chinese commercial banks' three credit books, we can make the following generalizations:

- The traditional loan book is still growing steadily and remains the primary source of credit creation for the Big Five state-owned commercial banks.
- The investment book—about half of which actually consists of disguised loans—was the main mechanism by which city and rural commercial banks expanded their share of banking assets over the past decade, and it was also used extensively by the joint-stock

banks. It now constitutes about 30% of the total assets of these smaller banks based on the listed banks' data.

- Off-balance-sheet exposures—mainly acceptance bills, entrusted loans and non-guaranteed WMPs—have risen from about RMB3trn a decade ago to RMB42trn, equivalent to 19% of the balance-sheet assets of the whole banking system.
- For the joint-stock and city commercial banks, the credit they create through their investment and off-balance-sheet portfolios is probably as great or greater than their traditional loan portfolio.
- The most obvious risk posed by this activity lies with the city commercial banks and joint-stock banks, which may not have enough capital to cover losses that might arise from their investment and off-balance-sheet exposures, and which increasingly rely on the interbank market, rather than deposits, for funding.
- The regulatory stance toward the rapid growth of the investment and off-balance-sheet portfolios has generally been one of tolerance, punctuated by occasional crackdowns on specific practices.

The big question now is whether the severe regulatory tightening against shadow lending launched in March 2017 is just another short-lived campaign, or signals a turn to more stringent regulation that will permanently curb banks' ability to hide loans in their investment books and build up off-balance-sheet activity willy-nilly.

China's Banks Are Better Than You Think

By James Stent

China's banks get a bad rap. But actually they are pretty well run, especially if one understands their twin roles as commercial actors and tools of state development policy.

Reading the incessant warnings of crisis in China's banking system, one can easily miss the fact that the big Chinese banks have become profitable, stable and well-managed organizations. Over the past two decades, China's top 17 national commercial banks, today comprising 60% of total bank assets, have evolved from bureaucratic cashiers into institutions that comply with most international standards of financial management.

They generally adhere to global accounting practices, and to capital adequacy and provisioning rules. They manage risk and reward to strike a balance between earning short-term profits and avoiding long-term losses. And they have reasonably effective corporate governance. In short, they look not much different from modern banks in other major economies.

One reason China's major banks do not get the credit they deserve for their remarkable transformation over the past 20 years is that they operate within the opaque political economy framework governed by the Communist Party and influenced by deep-rooted Chinese cultural and institutional patterns. Yet all banking systems are idiosyncratic, conditioned by national history and serving the interests of national elites.

Moreover, China's banking system is a hybrid, borrowing bits and pieces from Anglo-American, German and northeast Asian models. Financial regulators mixed these ingredients and adapted them to meet their vision

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of China's developmental needs. As a result, China's big banks are broadly modern in function and increasingly responsive to market forces, but not independent of government influence and guidance. They are tools to be used by the Party-state in the collective work of developing national wealth and power. To assess Chinese banks accurately, one needs a full understanding of Chinese banks' twin roles as commercial actors and tools of the state.

Boss Zhu cleans house

The transformation of China's banks from government cashiers to modern financial institutions began in 1998. At that time the financial system consisted basically of four big banks controlled by the Ministry of Finance. Their main job was to provide working-capital loans to state-owned enterprises (SOEs). Owing to China's economic reforms many of these SOEs were effectively bankrupt and unable to repay their debts. Non-performing loans were estimated at 40% of bank system assets.

Newly installed premier Zhu Rongji, who had spent most of the 1990s building a talented team of financial bureaucrats, drew up the blueprint for a modern financial system. The first step was a bailout and restructuring of the four big banks. Their bad loans were transferred, in exchange for bonds, to asset-management companies (AMCs) inspired by the Resolution Trust Corporation (RTC) that the US used to clean up its savings-and-loans mess in the 1980s. The Ministry of Finance injected fresh capital. And bank managers were instructed that their task was to clean up their operations so the banks could list on international stock exchanges. The first of the big four, China Construction Bank, listed in Hong Kong in 2005; the last and most troublesome, Agricultural Bank, finally listed in 2010.

The blueprint for China's modern financial system was drawn up in the late 1990s

Bank reform was not carried out in isolation. Zhu understood that the cleanup would work only if the economy grew rapidly and banks got profitable opportunities to lend. So urban housing was privatized, opening up a market for mortgage lending. SOEs were restructured, reformed and sometimes pushed into bankruptcy, so that banks faced less pressure to pump loans into non-functional companies. China's 2001 entry into the World Trade Organization ignited a phase of rapid growth powered by foreign direct investment and exports. Trade finance and loans to export manufacturers grew accordingly.

At the same time, banks were pressured to improve governance and build capital buffers. The government dispatched teams to study best practices in advanced banking systems. International investment banks and accounting firms worked intensively to improve Chinese banks' management and accounting practices so that they could list in Hong Kong. Perhaps most important, the 2003 establishment of the China Banking Regulatory Commission (CBRC)—headed for its first decade by a skilled banker from Zhu's stable, Liu Mingkang—created an institutional mechanism for forcing incremental improvements in bank management and capital adequacy.

Not accounting magic, just good policy

Zhu's bank cleanup attracted criticism as "accounting legerdemain." In the United States, savings-and-loans banks had transferred bad assets to the RTC at pennies on the dollar, reflecting likely liquidation values. China's banks, by contrast, transferred their bad loans to the AMCs at face value, resulting in massive overstatement of bank assets and net worth. Foreigners were then persuaded to invest in the banks at these inflated valuations.

Critics assumed the AMCs could never service the bonds, as receipts from liquidation of bad assets would be far below face value. Ultimately, therefore, the banks and the Chinese government would bear the costs of the bail-out, the banks would require another round of recapitalization, and foreign shareholders' holdings would be of little worth.

Like many critiques of China's banking system, this one proved wrong in most respects. Recovery values on the bad loans were indeed low, but the government orchestrated the AMCs' evolution into diversified financial conglomerates, several of which listed in Hong Kong. Thanks to income from other activities, they serviced their bonds. They accepted fresh transfers of bad loans from the banks—but at discounts that better reflected recovery values. The commercial banks built up their capital with the profits earned in the economic boom fostered by Zhu's structural reforms, and from a fat interest-rate spread guaranteed by government-regulated deposit and loan rates. Foreign strategic shareholders that bought big stakes in the banks in 2002-04 later sold their positions at hefty profits. So far, no additional capital from the government has been required.

Rather than accounting chicanery, the bank restructuring initiated by Zhu and completed by his successor, Wen Jiabao, reflected the skill of the Chinese system at pragmatically blending market and state mechanisms to achieve a positive result. It also benefited from a holistic, well-sequenced strategy, which acknowledged that bank restructuring could only occur in the context of other economic reforms. In my years as an independent director of Chinese banks, I saw the same skill at sequencing priorities play out at the micro level of bank management.

From transformation to evolution

The "transformational" era of bank restructuring ended in about 2010, when the big directly state-owned banks had all listed, and the dozen joint-stock banks (also state-owned but with more diverse shareholding) had restructured their operations along similar lines. Since then, many analysts have claimed that financial reform has stalled out. Once again, this dark view is wrong. Banking reform has indeed continued, just in a more evolutionary way. The focus shifted to incrementally improving banks' risk-management systems, increasing their exposure to the growing private sector, and adapting to interest-rate and financial-sector deregulation.

I had a front row seat during both the transformational and evolutionary phases, as an independent director of Minsheng Bank (2003-06) and of China Everbright Bank (2006-16). During this period I saw the quality of bank management steadily improve, and convergence with international standards substantially achieved. A few examples illustrate these gains in governance.

When I joined Everbright Bank Board's audit committee in 2006, the concept of internal audit was new to Chinese banks. The newly established internal audit department had little understanding of its job, an uneasy relationship with top management, and no ability to report its findings in ways that enabled directors to know whether internal controls were effective.

By 2010, internal audit had become powerful and effective, and had significantly enhanced the capacity of management and the board to control risk. This development was not unique to Everbright. In the early 2000s, high-profile defalcations, sometimes running to the tens of millions of dollars, were rife among China's banks. Since 2010 they have been rare, even though total lending activity is much higher and the involvement of non-bank financial institutions in "shadow finance" means loans have become more complex.

Strategic planning is another area of significant gains. Neither Minsheng nor Everbright, when I first joined their boards, had a strategy. This was understandable. Early in the reform process, banks could reap huge gains simply by absorbing global best practices as fast as they were able. But after the low-hanging fruit was seized, and market competition intensified, this was not enough. Everbright, like most of its competitors, beefed up its strategic planning function, empowering a committee that facilitated an intense and fruitful discussion between the board and management about the bank's direction. Formal strategic plans are now standard at China's major banks.

Finally, and contrary to a popular view in the financial press, bank boards have steadily improved and play an effective oversight role. Nominees for both shareholder and independent directors generally meet high standards; if they do not they are rejected. As a member of Everbright's nomination committee, I was involved in one such instance, when an institutional shareholder put forward a board candidate whose professional qualifications we judged inadequate. The candidate was rejected and the shareholder instructed to provide a better one. The CBRC also vetoes candidates who do not meet its standards of expertise.

Bank boards have steadily improved and play an effective oversight role

Three cheers for the CBRC

The under-appreciated role of the CBRC deserves special mention. The CBRC's supervision is much more intrusive and controlling than is common in the West. CBRC officials routinely sit in on bank board meetings as observers. When I visited the CBRC on bank business, I found the officers there extremely well informed not only about Everbright's activities but also about specific positions I had taken on various issues.

This interventionist approach may seem strange to foreigners, and at variance with global best practices about the separation between government regulation and company management. But in China it is accepted as routine, and it has produced largely positive results. With the help of the Communist Party's Organization Department, the CBRC took an active role in filling banks' management teams and boards with skilled professionals. The motive was pragmatic. The post-1998 bailout of the banks had been costly and time-consuming, and the government wanted to ensure that banks would be well enough managed that it need never be repeated. Over the past 15 years, the CBRC has steadily ratcheted up risk management, governance and capital adequacy standards. It deserves much credit for China's banking transformation.

Chinese bank regulation is effective; it is also relatively simple. Regulators focus on a handful of key financial measures, such as loan-to-deposit and leverage ratios, and compel banks to strengthen their capital bases at times of rapid balance-sheet expansion. This focus has enabled China's financial authorities to avoid the excessive and probably counter-productive complexity of US bank regulation, exemplified by the mind-numbingly arcane Dodd-Frank act.

The Augean stables aren't quite clean yet

China's banking system continues to evolve at a rapid rate. In 2010, when the "transformational" stage of bank reform concluded, interest rates were still tightly regulated and most corporate loans were made to state enterprises, despite the fact that private firms made up more than half of economic output. In the seven years since, interest rates have been deregulated and lending to private small and medium enterprises (SMEs) has soared. Lending to private-sector firms probably made up half or more of new corporate lending in 2010-13, although that figure has come down in recent years thanks to a renewed emphasis on economic stimulus via SOEs.

Much more needs to be done. In theory, interest-rate liberalization should mean that banks can price their loans on a risk-reward basis and accurately measure a risk-adjusted return on capital. In practice, their capacities in this regard are still developing. As a result, the central bank still maintains a benchmark rate for one-year loans, which serves as the basis for much loan pricing, rather than the floating money-market rates. The *de facto* state of interest-rate liberalization lags the *de jure* progress.

China's banking system continues to evolve at a rapid rate

Another important caveat is that the transformations I describe largely occurred at the 17 big nationwide banks, which account for about 60% of bank assets. Conditions at the smaller city commercial and rural commercial banks, with a handful of admirable exceptions, are more backward. These banks' share of system assets has tripled, from 9% to 26%, in the last decade. So clearly the CBRC has plenty of work to do to ensure that risks in this rapidly-expanding sector are contained, and that the transformation of the 17 large banks is replicated in the lower echelons of the system.

The expansion of "shadow lending" since 2010 means that some aspects of bank risk have leaked away from the CBRC's bailiwick. Joint-stock, city commercial and rural commercial banks have all enthusiastically moved much credit exposure off their loan books into "investment portfolios" at non-bank institutions such as trusts, asset managers and brokerages. The government has woken up to this risk and in early 2017 launched a tightening and centralization of regulation of shadow lending. Similarly, alarmed at the recent rise in dependence by smaller institutions on wholesale funding, it has cracked down on interbank lending, forcing small banks to return to more prudent reliance on deposit funding.

A final issue is that banks have increased lending to the private sector without a commensurate rise in their ability to assess private-sector risk. Credit officers have not gone through a recession in their working lives, and they lack training in cash flow analysis and in assessing management and shareholder strength. They lack the "gray hair" and "battle scars" of seasoned lending officers in other countries.

As a result, most future bad loans will likely emerge from private-sector lending—not from state-enterprise or local government debt as assumed by China skeptics. The debt of SOEs and local authorities is a problem, but precisely because these entities are directly controlled by the state, it is perfectly possible for the government to organize slow workouts that avoid the creation of non-performing loans: maturity extensions, debt-for-equity swaps, a shift to bond finance, and so on.

Doing just fine, thank you

The conclusion is that, thanks to nearly two decades of steady transformation, China's banks are pretty healthy. In the 1990s, a sclerotic banking system held back the growth of the real economy; since 2000, a flexible and rapidly evolving banking system has facilitated economic growth. Infrastructure, export manufacturing, industrial development, housing purchases and consumer spending have all been boosted by credit from the banks, provided under conditions of ever more rigorous market competition.

Relative to the most stable and well-regulated banking systems in the world—such as Canada, Australia, Hong Kong and Singapore—there is still much room for improvement. Compared to money-center banks in New York, London and Frankfurt, Chinese banks lack cutting-edge products, diversity of service offerings, sophisticated treasury operations, branding and international experience. And it remains to be seen how well Chinese banks will fare against robust non-bank players such as Alibaba and Tencent that have blazed trails in mobile payments and other areas of financial technology.

Yet China's big banks substantially comply with international standards on accounting, capitalization, provisioning and liquidity. They are global leaders in financial technology and consumer payments. In my early years on Chinese bank boards, Chinese banks were learning not just from Western banks but from their peers in countries like Thailand. Today, Chinese banks surpass the capabilities of banks in Thailand (where I have also served on bank boards). And, in the wake of the Great Recession, they find there is as much in Western banks to avoid as there is to emulate. The Chinese banking system remains a work in progress, but the progress so far has been impressive.

Rebooting China Inc.

By Yanmei Xie

Beijing is tightening controls on cross-border deals. The good old days of unhindered and lavish outward investment are over. Strategic ODI is back in fashion, with China's SOEs at the helm.

Over the past few months, pressure on the renminbi has eased and regulators have become more relaxed about capital outflows. After a crackdown beginning in late 2016, outward direct investment (ODI) began to pick up again in the summer. In July a senior official from the State Administration of Foreign Exchange (Safe) said the relaxation on ODI would continue if the balance of payments further stabilized. So is the Chinese global buying spree going to resume after a hiatus?

Not quite. The crackdown on capital flight may have eased, but the government has reasserted its role as a gatekeeper for outward investment. Officials want to have veto power over cross-border deals to ensure they are in line with national economic and strategic goals, and have partially reversed the deregulation of outbound investment that occurred over the past couple of years. This new environment is likely to prove easier for state-owned companies to navigate than private firms, and will also mean that Chinese money flows to a narrower range of industries more in line with government policy priorities.

The tightening of regulation is partly a reaction to the surge in ODI in 2016, which rocketed to US$170bn, up 44% from 2015—already a record year. This boom was driven by a significant regulatory liberalization starting in 2014 that removed pre-approval requirements for most deals, and only required companies to register their planned transactions with local

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authorities. The old regulatory regime had prioritized projects by state-owned enterprises (SOEs), many of which were in natural resources and infrastructure; but the liberalization unleashed pent-up private demand for diversification, foreign technologies and brands. Private companies thrived in the new environment, and were usually faster at identifying attractive assets and closing deals than SOEs.

The government has reasserted its role as a gatekeeper for outward investment

The frenetic pace of activity, though, made regulators uneasy. Their concerns intensified as the US dollar began to strengthen in the second half of 2016, capital outflows picked up, and downward pressure on the renminbi increased. Safe moved to stem outflows, reportedly ordering banks in November to stop processing outbound investments of more than US$50mn without approval by "relevant authorities."

Companies and M&A lawyers report that some banks flat-out refused to process foreign-exchange transactions, so the implementation of the rule seems to have been even harsher. The effect of the change was dramatic: outward investment flows reported by the Ministry of Commerce (Mofcom) collapsed in the fourth quarter of 2016, and in the first half of 2017 fell 46% YoY.

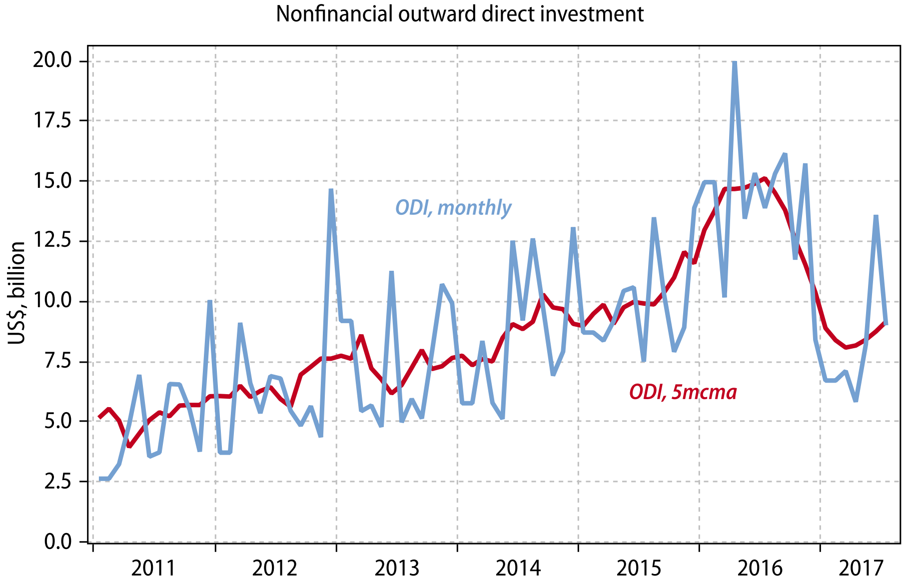
Avoiding another free-for-all

The government has made it clear the M&A free-for-all is over, and that it has objectives other than mitigating short-term capital flight risks. Its latest edict came in August in the form of "guiding opinions" jointly issued by the central bank, the National Development and Reform Commission, Mofcom and the foreign ministry. It divides overseas deals into three categories: encouraged, restricted and banned.

Investments that advance Xi Jinping's Belt and Road Initiative, facilitate industrial upgrades, and secure technology, energy, minerals and agricultural resources are encouraged. Government agencies will bless such deals with "enhanced services" on taxation, foreign exchanges, insurance and customs inspections. Restricted deals include purchases of real estate, hotels, theaters and sport clubs, as well as funds not tied to specific projects. Regulators will "verify" these deals and advise companies to use caution. Investments in gambling, pornography and sectors that undermine national security are banned.

The edict crystalizes the message that outbound capital, whether state owned or private, needs to prioritize national political and economic

Outward investment flows have started to pick up after the crackdown



Mofcom, Gavekal Data/Macrobond

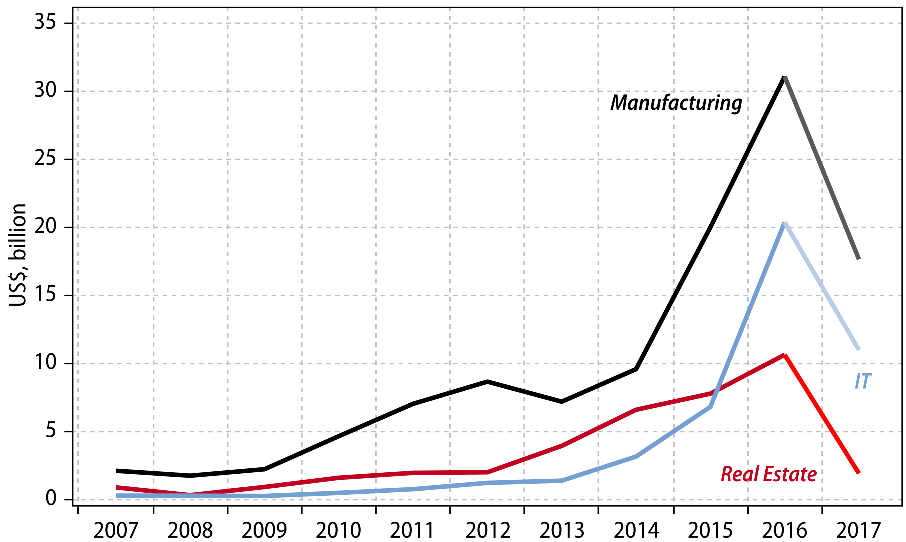
objectives. Beijing is clearly targeting some of the most high-profile recent examples of speculative excess, but also reasserting the principle that investment abroad should serve both national interests and industrial policy. The impact is already evident: in the first half of 2017, outward investment in real estate and entertainment both fell by over 80% YoY, whereas investments in Belt and Road countries dipped by a much smaller 4%.

It is fairly straightforward for the government to bring SOEs in line, and indeed scrutiny of overseas deals by state firms has been tighter in recent years after some high-profile failures. A tougher process was formalized in January, when the State-owned Assets Supervision and Administrative Commission issued new rules on overseas investments, in principle banning SOEs from venturing outside their core businesses. Asserting control over private-sector companies is a trickier task, however, as the pre-approval requirements for outward investment were removed in 2014-15 and have not been formally reinstated. Private buyers have often skirted capital controls by borrowing offshore, sometimes from the overseas branches of Chinese banks.

But the reach of the Chinese regulatory state is long, and there are many levers that officials can use to enforce their new priorities. In June, the China Banking Regulatory Commission ordered banks to examine their exposure to a group of acquisitive private firms, including property-to-entertainment giant Dalian Wanda, insurance-and-investment conglomerate Fosun Inter-

Less real estate, more high-tech

Outward foreign direct investment, selected sectors; 2017 forecast based on H1



Gavekal Data/Macrobond

national, travel group HNA, and insurer Anbang. The bank regulator was worried about "systemic risks" from these firms, which are both aggressive acquirers of overseas assets and not very financially transparent.

Dead chickens, terrified monkeys

Yet the selection of "risky" targets still seems somewhat arbitrary. Regulators may frown on purchases of flashy Hollywood properties, but Wanda's expansion into entertainment began years ago and is a well-established corporate strategy. On the other hand, regulators seem not to be troubled by state-owned coal miner Yankuang Group paying a hefty price (US$2.7bn) for some underperforming Australian coal mines. Yankuang is heavily indebted, has expanded into multiple unrelated industries, and already owns some Australian mines that hemorrhage money. Both Wanda and Yankuang are highly levered companies—so the lesson seems to be that high leverage can be tolerated in the pursuit of the national interest, but not for private commercial purposes.

The targeted companies have moved quickly to show they are complying with government priorities. Wanda has offloaded US$9.3bn in hotel and tourism properties to Sunac, another property developer, thereby reducing its debt load (though it is still facing restrictions on fundraising). HNA has told bankers it will not pursue new M&A deals until after the Communist Party Congress and leadership transition in October.

The campaign has also effected a more broad-based change in corporate behavior. By targeting some of the most visible high-flyers, the government sent a loud warning to everyone else—a tactic known as "killing the chicken to scare the monkeys." Chinese banks and companies now routinely "consult" with regulators before kicking off outbound deals, according to investment bankers and M&A lawyers. In other words, pre-approval for outward direct investment has returned, and the Chinese state has clawed back authority over where and how capital is deployed.

Chinese banks and companies now routinely "consult" with regulators before kicking off outbound deals

The priority now is for companies to demonstrate compliance with national economic and strategic objectives. Therefore deals in high-tech sectors like semiconductors and automation easily get a green light. It is also notable that recent large acquisitions by Chinese internet giants Tencent and Alibaba have not been questioned. Energy and resources deals are also rarely challenged, apparently reflecting the belief that it's good to buy when prices are low.

SOEs are the natural agents to carry out these policy goals, and the government is encouraging them—or "pressuring" them, according to some bankers and consultants—to invest abroad in order to advance the Belt and Road Initiative and "Made in China 2025" national plans. SOEs are accustomed to finding ways to blend political mandates with commercial interests, and also have better access to government officials than their private peers.

Many private buyers are even including state-owned investors as partners in recent outbound deals, according to investment bankers and M&A lawyers. Embattled Fosun has teamed up with state-owned Beijing Sanyuan Foods to buy French margarine maker St Hubert, reportedly to hedge against political and regulatory risks of doing it alone. The tighter regulation of outbound investment will probably lead to a greater role for SOEs, which already accounted for nearly 60% of announced M&A deals by Chinese firms in the first half of 2017, according to the Rhodium Group. While the rise in Chinese companies' investments abroad is far from over, the state wants to make sure the process serves its agenda.

This is unlikely to reassure recipient countries, many of whom are already concerned about state-led Chinese acquisitions undermining their leadership in key technologies. In the US, calls for closer scrutiny of Chinese investments enjoy bipartisan support. Germany has toughened its national-security review process for foreign investment and along with

France and Italy has proposed a rethink of European Union rules. The UK government plans to tighten screening of foreign ownership of British companies. But it will be difficult for recipient countries to formulate a recipe that both welcomes Chinese businesses and minimizes the influence of the Chinese state: the line between the two is getting blurrier.

Society

Dealing The Right Kind Of Opium

By Ian Johnson

Xi Jinping's embrace of traditional Chinese religions is a highly political move to build up popular support. But his hostility to Christianity, Islam and Tibetan Buddhism could cost him dearly in terms of social stability.

Halfway through his presumed 10-year term, Xi Jinping is already being hailed as China's most powerful leader in decades. Abroad he's best known for his muscular foreign policy and an anti-corruption crackdown that has snared thousands of officials and possibly stopped a dangerous rot in the Communist Party's governing apparatus.

But less obvious is a remarkable—and highly risky—embrace of religious and spiritual ideas from the past. This has helped Xi become personally popular across broad swaths of the population but could also be sowing future problems, including sectarian and ethnic divisions. In the long run, these issues could prove as troubling to China as more pragmatic and obvious challenges, such as the need to reform its slowing economy or rejuvenate its damaged environment.

To understand the significance and risks of Xi's approach we have to back up a century or two. In recent decades, religion has not played a big role in Chinese public life. Indeed, our images are overwhelmingly economic or political: China as the factory of the world, or China as a strong authoritarian state, locking up dissidents or projecting power across the seas. Unlike, say, India, religion and spiritualism seemed consigned to a distant past of monasteries and immortals dotting ink-brush landscapes. But, increasingly, these older images are returning to the present. China's

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imperial system, which lasted over 2,000 years until it collapsed in the early 20th century, was organized around a demi-god: the emperor. The most important Chinese philosopher of the past 2,500 years was Confucius and he offered a highly moralistic way of organizing society. Laws mattered, but what was most important was living a proper life, one governed by rules of property, etiquette and ritual. Almost all public space in China was religiously ordered, from the layout of cities to the centrality of temples in Chinese society, which were ubiquitous. A big city like Beijing had more than 1,000 places of worship.

This system began to be destroyed more than a century ago when Chinese elites doubted that traditional ideas and institutions could prevent their country's domination by the West. This predated the Communists, starting in the waning days of China's last dynasty, the Qing, and running through the Republic of China under Chiang Kai-shek from the 1920s to the 1940s. During this period, hundreds of thousands of temples were destroyed or repurposed. Most Chinese religion was rejected as superstitious nonsense that was holding the country back from a modern future of science and progress.

Xi is your shepherd

The Communists merely ramped up these attacks on religion when they took over. During the Mao era, the party was basically anti-religious, culminating in the Cultural Revolution from 1966 to 1976, when all places of worship were closed and all religions effectively banned.

This was followed by what is known as the reform era. Many people believe we are still in this era, but I would argue that it is more useful to think of this period as having run from the start of economic reforms in 1978 to sometime around the 2008 Olympics, by which time reforms had run out of steam. During this 30-year period, religions were tolerated: the Party wasn't fussy about any of them but left most of them alone.

Surprisingly—especially to the Party's apparatchiks—religion boomed. Far from being a dying relic of what in communist parlance was known as the "old society," religious groups reconnected to the past. Seminaries and academies reopened. Younger clergy were trained. Mosques, temples and churches were rebuilt. Rituals revived. Believers were increasingly young people wanting something more out of life than money. Mostly this went on without the Party's support. This was the era of China's economic miracle. Development, not politics or religion, was in control. In the apocryphal phrase of that era's paramount leader, Deng Xiaoping, to get rich was glorious.

Now, we are in a period—some might say stagnation, but let's stick with the more neutral term "consolidation"—of firming up accomplishments and control. During this period, legitimacy has to be derived from other sources. In the Mao era it was belief in the revolution and the great leader. In the reform era, it was belief in stability and prosperity—not an adequate basis for governing a society but enough in the short run to slake most people, especially after a century of turmoil and poverty. Xi Jinping has taken a page from the classic authoritarian playbook by dusting off traditions as tools for keeping legitimacy (see Anwar Sadat, Saddam Hussein or Vladimir Putin for other examples).

> After the upheavals of the past century, a return to traditional ideas is appealing

For a leader with a shaky basis of support, this has many advantages. Traditional ideas about filial piety—respect for one's elders, and by extension those higher in society than oneself—are deeply ingrained in Chinese society. After the upheavals of the past century, a return to seemingly stable ideas is appealing. Also, many of these ideas are infinitely more sophisticated than the vulgar Marxism that the Communist Party peddled in previous decades. Most traditional philosophies and concepts were refined and honed over centuries and have much more depth and appeal than the "ideology" (actually more like a series of random musings than a coherent body of thought) of Mao, Deng & Co.

State-sanctioned worship

The government came to this realization reluctantly. The first big outpouring of religiosity in the past half century was the *qigong* movement of the 1980s and 1990s. It ended in bloodshed. *Qigong* is a neologism that describes traditional practices of physical cultivation—something like yoga in the Indian religious tradition. A series of *qigong* groups rose up, especially in the 1990s, offering moral certainties at a time when the government was only offering its version of the prosperity gospel.

The most militant of these was Falun Gong, which in 1999 openly demanded recognition as a religious group. Since 1949, the government has only recognized five groups: Buddhism, Daoism, Islam, Catholicism and Protestantism. So it rejected Falun Gong's request, the group protested, and the government responded with its customary violence. Thousands of Falun Gong adherents were sent to labor camps. Human rights groups estimate that up to 100 died from police brutality.

This not only hurt China's image abroad, but domestically caused a rethink about how the party should address the country's obvious spiritual need. Although it is not possible to prove this with archival evidence, my long-term study of China's religious revival leads me to believe that in response to the Falun Gong debacle the government decided to unshackle, in part at least, the five legal religious groups. The idea was better to channel this spiritual yearning into groups the Party felt it could control rather than amorphous movements like Falun Gong.

At the very least, it's fair to say that a few years after the Falun Gong crackdown, the government allowed temples, churches and mosques to be built or expanded at a rapid pace. This was especially the case under the rule of Xi's predecessor, Hu Jintao, from 2002-12. It wasn't an era of religious freedom, but society was run with a comparatively light touch. Falun Gong was persecuted as during the previous administration, but the five official religious groups flourished: temples were expanded, mosques sprouted up across China, and churches—even illegal ones—were built with little government interference and sometimes even official support.

Chinese values, Chinese religions

Since Xi Jinping took over in 2012, control has tightened. We're used to thinking of this exclusively in terms of dissent and non-governmental organizations, but it's true, in a differentiated way, for religious groups too. Xi's embrace of traditional Chinese religions has turned them into instruments for political ends. Concretely it has meant the state's partial adoption of traditional China's religious-political ideology—Buddhism, Daoism and folk religions—with prejudicial policies against Islam and Christianity.

This can be seen in Xi's actions. In 2013, just after taking office, he visited Confucius's hometown and praised the sage. The next year, he explicitly praised Buddhism. Most remarkably, the government has done a complete about-face on folk religious practice: fortune telling, the worship of deified historical figures, physical cultivation practices, religious music and funeral practices. For over a century, these were denigrated as "feudal superstition" in government lingo.

Now the government subsidizes them, using a term it adopted from the United Nations Educational, Scientific and Cultural Organization (Unesco): "intangible cultural heritage," abbreviated as *feiyi* in Chinese. Across China, governments have been in a *feiyi* fever as they seek to identify these practices and support them financially. Earlier this year, Xi reaffirmed his support for this, with the government ordering all localities to make plans to bolster traditional culture.

Coming up short on the ledger are what are widely seen as foreign religions: Islam and Christianity, as well as Tibetan Buddhism. To some degree, these religions have always been viewed skeptically by the state thanks to their inherent foreign ties. But now they are coming under more sustained pressure. From 2013 to 2014, for example, one of Xi's political allies launched a campaign in one Chinese province to remove the crosses from the top of churches, including legal churches approved by the state. The government has also put increasing pressure on unregistered—sometimes called "house" or "underground"—Protestant and Catholic churches, requiring them to register with the government. These believers make up about half of China's estimated 60mn Christians.

Foreign religions—Islam, Christianity and Tibetan Buddhism—are coming under sustained pressure

As for Islam, the government has taken a series of outrageous steps, including efforts to ban fasting during Ramadan, or prevent women with the hijab from using public transportation. This mainly applies to one group of Muslims, an ethnic minority known as the Uyghurs, but it has also tolerated Islamophobic bloggers and activists who aim against the larger Muslim group, the Hui.

As for Tibetan Buddhism, the government has put temples under ever-tighter control. And earlier this year it began tearing down one of the world's biggest Tibetan academies, the Larung Gar Buddhist Academy in western Sichuan province.

The peril of Christian alienation

Forget human rights and dignity for a moment. From a Machiavellian point of view the problem with this approach is twofold. One, although ethnic Chinese make up nearly 92% of the population, China is a multi-ethnic state with 55 other officially recognized nationalities. Almost all have very small populations but several are important in China's border regions, especially in Tibet, Xinjiang, Inner Mongolia, Yunnan and Guangxi. Many of these groups will feel alienated if ethnic Chinese faiths are favored.

This is especially true of Muslims. In China, Islam is not a choice but an ethnic identity, with 10 of China's 55 minorities defined as Muslim, or about 2% of the population. Alienating this group by promoting Chinese culture could have serious consequences for long-term social stability, especially in Xinjiang. Indeed, the area is becoming increasingly a police state, with a draconian paramilitary presence and requirements for locals to use facial recognition software.

Less obvious but potentially equally troubling is the potential for divisions inside the Chinese majority itself. The reason is the Party's increasingly hostile view toward much of Chinese Christianity. This matters because Christianity—unlike Islam—is embedded in the ethnic Chinese majority. Although the presence of Christian belief in China is now taken for granted, it wasn't at all certain that it had survived the Mao period. That only became clear in the 1980s when Christianity emerged from the Mao era to become China's fastest-growing religion. That makes Christianity the first new religion to enter mainstream Chinese society since Buddhism pushed its way into China from South Asia about two millennia ago.

Many officials—and many ordinary Chinese, in fact—still have a hard time accepting this, an ignorance of reality that government policy will exacerbate. Protestants and Catholics make up only about 5% of the population, but many are increasingly part of the urban, well-educated, white-collar elite that the country needs for its modernization. Alienating these people could drive a wedge in the heart of Chinese society.

This isn't as improbable as it sounds. In 2011, the government closed one of China's most influential house churches, the Shouwang Church in Beijing, causing two years of Falun Gong-style protests. Hundreds of people were arrested and the pastor is still under house arrest. Until now, Shouwang has been an outlier, but last year the government announced that all churches had to "Sinicize"—code for registering with the government. Signs are that the biggest and best organized of them could be forced to do so or face Shouwang-style persecution.

How not to win hearts and minds

Chinese like to say that their country historically has not had the sectarian strife that is common in South Asia or Europe. This is not true. China's 19th century Taiping movement was at the root of what became the bloodiest civil war in world history. The smaller Boxer uprising around 1900 was another example—as arguably was Maoism itself, a messianic movement centered on a godlike ruling figure.

The government is not unaware of this history or these risks. But it feels tempted to do what authoritarian rulers have done through the ages: to see religion as a useful tool, one they think it can control. Given how this has played out across the globe and across the ages, one might be tempted to see this as a dangerous folly rather than simply the Party's latest effort at reinvention.

Companies

Beijing's Bid To Make US Rail Great Again

By Agatha Kratz

CRRC is winning contract after contract in the US light rail market, slowly squeezing out traditional competitors. Its secret? The promise of direct investment and job creation.

Since his election last year, Donald Trump has made clear that his plan for US economic rejuvenation would rely at least in part on the active contribution of overseas trade and investment partners. As a result, foreign heads of state and CEOs alike have developed a habit of coming to the US loaded with economic promises. Between the two of them, Japan's prime minster Shinzo Abe and Alibaba's CEO Jack Ma have already vowed to create 1.7mn jobs for the US economy.

But another, more discreet contender is also doing its bit to make American manufacturing great again. China Railway Rolling Stock Corporation (CRRC) is using the US's thirst for industrial investment and manufacturing jobs to enter the country's rail market. Thanks to its promises to open assembly plants in industrial wastelands, create employment where work is most needed, and re-train US engineers in the intricacies of the rail sector, the company is progressively ousting traditional competitors such as Bombardier (Canada), Siemens (Germany) and Kawasaki (Japan).

This strategy has already won CRRC a number of urban rail contracts, in Boston, Chicago, Los Angeles and Philadelphia. It is also positioning itself favorably within the wider rail market. One contract at a time, Beijing's rail giant might be fulfilling China's dream to provide the US with its rail network.

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Far from Beijing's high-profile-yet-low-return "high-speed rail diplomacy," which sees Chinese leaders tour global capitals to sell China's high-speed rail technology, CRRC's low-key and depoliticized strategy for the US urban rail market is already bearing fruit. In October 2014 one of CRRC's subsidiaries (CNR MA, now CRRC MA) won the company's first contract in the country, a US$567mn deal to supply 284 metro cars for Boston's subway system. Eighteen months later, in March 2016, CRRC (through its subsidiary CSR Sifang America) was awarded a US$1.3bn contract to build 400 new rail cars for the Chicago Transit Authority, with an option to provide 446 more.

In March this year, the Los Angeles County Metropolitan Transportation Authority confirmed a US$178mn contract for CRRC MA to build 64 new subway cars for Los Angeles' metro system, with an option for an additional 218 cars and a total value of US$647mn. Finally, the same month, CRRC MA was awarded a US$138mn contract to manufacture 45 bi-level railcars for Philadelphia's Regional Rail system, with an option for 10 more cars. In every one of these bids, CRRC's skillful strategy allowed them to beat numerous competitors that had historically dominated the US market. In Boston, CRRC snatched the contract from under the seasoned noses of Bombardier, Kawasaki Rail Car, CAF (Spain) and Hyundai Rotem (South Korea).

Why it's a winner

What made CRRC's offers so compelling? For one, CRRC's bids all relied on a great price tag. In Boston, CRRC's proposal stood more than 20% below that of the second lowest bidder, Hyundai Rotem, and almost 50% below Bombardier's. In Chicago, CRRC's bid came US$226mn below Bombardier's, the second cheapest. In Los Angeles, while bid values remain undisclosed, the city's metro authority said CRRC "had the highest-rated technical offer and lowest price." In Philadelphia, CRRC was once again the best bidder.

CRRC representatives say this low-ball pricing is a token of the company's commitment to the US market. But two more factors play in CRRC's favor. First is CRRC's domestic price advantage. Despite the requirements of most bids to source the majority of a contract's value in the US, CRRC can rely on securing the remaining parts for much lower production costs in China. Second and more importantly, CRRC, as a central Chinese state-owned enterprise, can capitalize on abundant state subsidies and a captive market at home. According to its listing announcement on the Shanghai Stock Exchange, CRRC received US$194mn and US$269mn in govern-

CRRC's American success story

Deals won by CRRC in the US

City	Date	CRRC subsidiary	Contract value	Contract scope
Boston	Oct 2014	CRRC MA	US$567mn	284 cars
Chicago	Mar 2016	CSR Sifang America	US$1.3bn	400 cars, option for 446 more
Los Angeles	Mar 2017	CRRC MA	US$178mn*	64 cars, option for 218 more
Philadelphia	Mar 2017	CRRC MA	US$138mn	45 cars, option for 10 more

*Could rise to US$647mn

Author research

ment subsidies in 2014 and 2015 respectively. Further up the value chain, CRRC's main client, China Railways, also benefits from the state's largesse. In 2016 China's rail operator saw its net profit increase by 58% despite a RMB5.6bn loss in the first nine months of the year, thanks to undisclosed but massive government subsidies. Part of this financial support finds its way into CRRC's pockets through lucrative public contracts, easily won in an almost undisputed domestic market.

Competition is also decreasing internationally. While China had two main rolling-stock manufacturers, CSR and CNR, up until a few years ago, Beijing decided to merge them into CRRC in June 2015—mostly to prevent harmful competition between them in overseas markets. Since then, CRRC has been bidding as a single entity, concentrating resources and support in its conquest of international markets, and securing higher margins on contracts while keeping prices low.

Made in the USA

Despite CRRC's unbeatable prices, and US officials' high consideration for their taxpayers' wallets, CRRC still had to sing a little more for its contracting supper. Despite decent technical ratings in all four bidding processes, the company also had to shake off a reputation for poor quality, and an overall negative bias due to its state-owned status. It did so in two ways. To appear as just another competitor, rather than a state-led and Beijing-backed conglomerate, CRRC developed strong local networks, hiring professionals with rich PR and public procurement experience. The company also followed to the letter each city's requirements in terms of employment and local opportunities, putting forward a number of "softer" conditions that competitors found hard to match.

In the case of Boston, CRRC fulfilled all "Make it in Massachusetts" requirements put forward by the state, which obliged bidders to assemble the metro cars locally, and asked for 60% of the contract value to be sourced in the US. CRRC thus readily agreed to build a US$95mn final assembly plant in the state, which upon completion would employ 150 people, and potentially more as the company wins other contracts in the country. The new factory will assemble cars for the LA and Philly contracts.

CRRC also responded to Chicago's demands for tangible local spillovers. As bidders were asked to advertise the type and number of new jobs their bids would create, CRRC's proposal to set up a US$40mn assembly factory, with 170 new jobs for high-skilled workers, likely played in its favor.

CRRC's willingness to build plants in the US has played a huge part in its success

In Los Angeles, major components for the subway cars, including air conditioning and propulsion, would be manufactured at a new CRRC facility to be purchased in the LA area. The plant, local officials say, could create 50 local jobs and generate up to US$38mn in local wages and benefits. What is more, CRRC promised that about one-tenth would go to disadvantaged workers.

CRRC's willingness to build these plants—when competitors, with existing factories in other parts of the country, were much more reluctant to do so—played a huge part in its success. So did its efforts to frame these as opportunities for the "revival" of areas deserted by other US or foreign manufacturers. CRRC's choice of locations for these plants—an old Westinghouse site in East Springfield, Massachusetts, and the economically depressed south side of Chicago—struck the right note. So did the fact that both Springfield and Chicago had, in a not so distant past, been rail-manufacturing hubs themselves. Local media, communities and politicians thus warmly welcomed both projects, with Chicago mayor Rahm Emanuel praising the deal as "a day that [would] go down in history."

If you can't beat 'em, join 'em

Months after these contracts were won, CRRC's seduction act continues. As of June 2017, CRRC's Springfield plant had already recruited about 90 of its 150 workforce, of whom 33 were flown to China in May 2017 for training at CRRC's manufacturing plant in Changchun. Their agenda included one month of theoretical classes, as well as two months of practical training, working alongside their Chinese counterparts in the assembly

CRRC is investing heavily in US rail manufacturing capacity

CRRC's US plants (existing and planned)

Contract	Plant location	Value	Employees
Boston, LA, Philadelphia	Springfield, MA	US$95mn	150
Chicago	Chicago (south side)	US$40mn	170
Los Angeles	n/a	US$38mn	50

Author research

section of the company's factory. In the US, CRRC is also partnering with local institutions in Massachusetts, including the Regional Employment Board of Hampden County, state colleges and universities, and local sheet metal and electrical unions, to (re)develop a local rail workforce.

CRRC is using the same strategy as it prepares for its next bid, a contract to manufacture 1,025 subway cars for New York City. The bid requirements are likely to involve local production and employment, and the company has already shown interest in a former GE plant in Fort Edward, New York. Once again CRRC is targeting a deserted facility with neighboring areas in dire need of jobs, thus building up an iron-strong sales pitch. CRRC would not only re-open the site, but also build a brand new 125,000-sq-ft plant, and a 2-mile test track. Upon completion, and if the contract is awarded to CRRC, the factory would employ 150 to 200 people.

Odds for the New York City contract seem once again to be in CRRC's favor, so much so that Bombardier, one of CRRC's fiercest competitors to date, has (momentarily at least) given up on its attempts to challenge CRRC's successes in court, and taken on a more cooperative approach. It has invited CRRC to join forces on the NYC metro bid and the Fort Edward plant, hoping to benefit from CRRC's strong positioning. The Sino-Canadian consortium is well placed in New York. So, too, is CRRC for upcoming US contracts, such as Atlanta's transit system, for which the company is already lobbying aggressively.

What next?

Other competitors are more worried. US manufacturing companies and industry associations in particular complain about the likelihood of unfair competition, given CRRC's strong state backing. In the absence of a level playing field, competing rail players could be forced out of the market. These also fear reverse engineering or, worse, plain intellectual property theft, were they to cooperate with the Chinese enterprise. Finally, they worry that CRRC could use the Springfield and Chicago factories to venture into markets other than subway cars. Already dominated by foreign players, the light rail market is less of a focus for US manufacturers, even though "Buy America" provisions mobilize domestic producers. Yet in the freight industry, where US companies have kept a competitive edge, CRRC's forays have raised eyebrows.

The picture is therefore a mixed one, as so often with Chinese outward investment. It involves significant potential economic benefits from CRRC's deep pockets and willingness to invest in concrete, productive projects in the US. But it also involves a serious, long-term threat for other rail players, both American and foreign. Yet no matter whether competitors decide to join CRRC, or to compete head-on in the market and in US courts, the state-owned behemoth is already a significant player in the US rail market.

Sectors

Hollywood Hoo-ha

By Jonathan Landreth

Chinese investors have developed a taste for Hollywood, but their buying spree has drawn more scrutiny than tangible benefits. With their wings clipped by new foreign investment rules, their focus will turn back to their home market.

Hollywood movies have long been the greatest calling card of the American Dream. As China rises, it stands to reason that its wealthy and powerful should wish to project a dream of their own, first at home and then around the world. They are spending billions of dollars on pushing China's soft power beyond its borders, but with decidedly mixed results. For a group of ambitious billionaires and media companies, the movie industry has become a lucrative, yet also troublesome, piece of the Chinese Dream.

The biggest problem for China's wannabe movie moguls is that movies work best as international dream-makers when state interference is light. Players in the Chinese film industry are fighting an uphill battle with regulators in Beijing to be allowed to make films that stand a chance of spreading Chinese cultural influence globally. Meanwhile, investors who built out the nation's movie theaters are clamoring for more popular American movies to screen in order to recoup their outlay.

To this end, they have engaged in a buying spree in Hollywood. So far, their venture has raised more eyebrows than tangible benefits. Chinese films fare poorly in the US, still the world's biggest market. And observers back home are questioning the viability of some of these high-profile investments, especially as Beijing tightens controls on outward invest-

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ment. Domestically, however, the market has grown quickly, offering a healthy fallback for China's large entertainment conglomerates, even as they begin to reconsider their international ambitions.

A tame but booming market

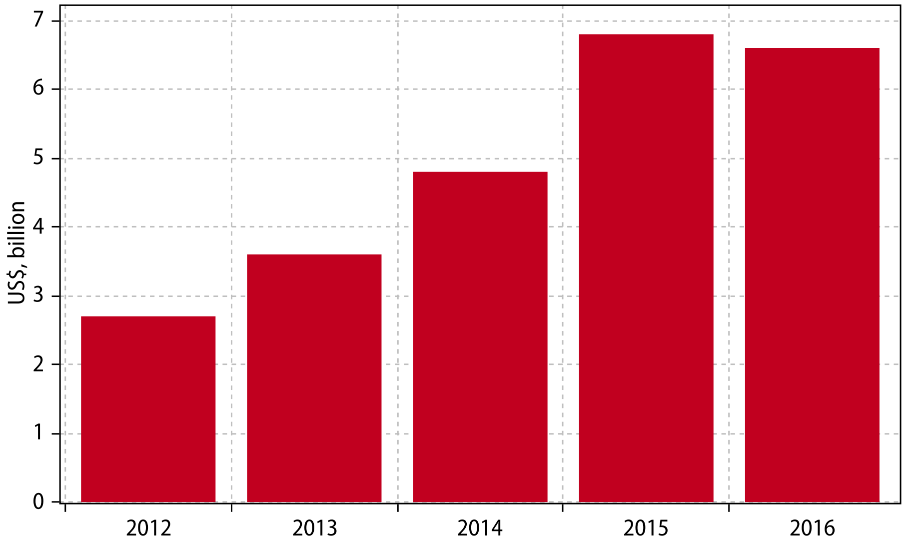
China's recent movie frenzy emerged in the wake of the Beijing Olympics in 2008, when the government encouraged media makers to promote a new image of China around the world. As the bull market in Chinese stocks crashed and fizzled, forward-looking investors turned instead to the movies. Chinese filmmakers knew that creativity and telling a good story, not Communist Party moralizing, were the key to attracting cinemagoers. They were skeptical about Beijing's "Going Out" propaganda, especially as so few movies from China had any track record of success abroad, least of all those that carried ham-fisted CCP messaging. But other players such as Wang Jianlin, CEO of real estate giant Dalian Wanda Group, spotted a business opportunity.

Listening to government concerns about overheated housing markets, Wang found that Wanda could acquire lengthy leases on land for shopping malls at affordable prices. Malls also fitted Beijing's plan to help China shift to a consumer economy. Their anchor tenants were multiplex theaters, which developers hoped would draw wealthy consumers to see 3-D IMAX Hollywood movies for RMB100 a pop. After the film they could buy shoes and a handbag next door, and celebrate with a meal in a mall restaurant. The strategy was a sound one, as gross cinema ticket sales almost doubled from US$3.6bn in 2013 to US$6.6bn in 2016. The number of China's movie screens also grew exponentially, from a mere 5,630 in 2007—just one screen for roughly a quarter of a million people—to 41,179 by the end of 2016.

In spite of tight controls on release dates and unofficial "blackout" periods that bar imports to protect domestic releases during holidays, Hollywood films averaged 40% of ticket sales from 2012 to 2016. This success came even though China's state-run distributors are limited to showing just 34 Hollywood films per year. These are imported on a revenue-sharing basis that, much to the dismay of the Motion Picture Association and the US Trade Representative's Office, pays Hollywood studios a paltry 25% of each film's revenue. While the roughly 280 movies made in China in 2016 grossed an average of US$14mn, the revenue-sharing films flown in from Los Angeles grossed about US$80mn each. China's box office should soon surpass North America's, making China the world's largest cinema market.

China's box office growth stalled in 2016

Box office receipts



EntGroup, MTime, Artisan Gateway, SAPPRFT

Heading to Hollywood

The billionaires backing the industry have long understood the potential of Hollywood in China. Five years ago they began directly funding the six major Hollywood studios to make big pictures for a domestic audience. Wanda's Wang was the most conspicuous of the Chinese moneymen arriving in Los Angeles. In 2012 he splashed out US$2.6bn on AMC, the US's largest theater chain, and plowed millions more into a string of movies made by US studios. Then, in 2016, he purchased the struggling mini-major Legendary for US$3.5bn.

Wanda was not alone in this venture. Hollywood films were also funded by Chinese e-commerce giant Alibaba, gaming-and-messaging behemoth Tencent, and mainland movie producer and distributor LeVision Pictures. Beijing-based production company Huayi Brothers opened offices in Beverly Hills, while its local counterpart Bona Films sold shares on Nasdaq and took investment from Rupert Murdoch. One of China's most active outward investing conglomerates, Shanghai's Fosun, backed a former Warner Brothers executive to form a brand new outfit called Studio8. All these Chinese companies and more signed deals to work with partners in California.

Hollywood quickly developed a taste for Chinese money. Studios expected big budget movies such as *Avatar* to sell well, if not better, in China than at home. As China put butts in seats, Hollywood salivated.

Big films from LA studios—such as *Arrival*, *Gravity* and *Transformers IV*, to name but a few—began boasting plots that seemed obviously adapted to please Chinese audiences. By adding Chinese stars and plot lines, such as *Gravity*'s favorable portrayal of China's space program, the studios hoped to gain a greater share of the Chinese box office.

Such developments raised eyebrows both among Chinese regulators and members of the US Congress. Democrats were concerned about a potential rise in Chinese-style censorship affecting Hollywood screenplays, while Republicans sounded off about the threat of Chinese investment to national security. A California congressman accused Wanda of shipping local jobs to China after *The Great Wall*, a bilingual war epic starring A-lister Matt Damon, was made largely in the Chinese port city of Qingdao. In September 2016, another congressman called for a crackdown against Wang and suggested putting China's Hollywood buying spree under a review by the Committee on Foreign Investment in the United States (CFIUS). Democrat Chuck Schumer, a long-term and notorious China basher, quickly joined in.

The CFIUS complaint has not yet come before the Senate. Nor has Peter Navarro, Trump's China economics czar, said what, if anything, he plans to do. Yet, despite this uncertainty, many Hollywood insiders believe the China dance is here to stay. They hope that Chinese players may, for the moment, shrewdly take two steps back for each step forward. They reason that Chinese moguls and studios have invested too much time and money simply to skip away.

Killing the golden geese

Such an assumption might be misguided. Even after a decade of double-digit box office growth ending in 2015, many of the loans from Chinese state banks to build the shopping malls and multiplexes still have not been paid off. China's economic slowdown threatens both developers' ability to pay for massive infrastructure and Hollywood studios' ability to make flashy, expensive films. As many Chinese movie fans opt instead for new subscription streaming services at home—or fall back on old habits such as pirated discs and illegal downloads—box office growth in China has stagnated since 2016.

What's more, the disappointment of *The Great Wall*—featuring one of Hollywood's biggest stars and directed by China's top director, Zhang Yimou—taught producers on both sides of the Pacific to exercise greater caution with movies touted to work in both markets. As Chinese ticket sales slow, and players on both sides learn from their mistakes, co-productions may begin to promote smaller, cheaper films. Besides, China has learned to make big splashy movies of its own. In July 2017 the neo-nationalist thriller *Wolf Warrior 2* opened to extraordinary success, grossing US$810mn in just over a month to become the most successful film ever in China (see "Finally, China learns to kick ass," p69).

Hollywood studios, meanwhile, will probably have to turn to new sources of funding for their largest productions. Beijing has begun clipping the wings of China's most fervent Hollywood investors, fearing that massive loans taken out by the likes of Wanda's Wang and Jia Yueting, CEO of the conglomerate LeEco that owns LeVision Pictures, will not be paid back. By the summer of 2017, rumors were circulating that Wang Jianlin—who this summer dropped a US$1bn bid for Dick Clark Productions, killing his image as the golden goose of China's entertainment industry and its outsized global ambitions—was barred from leaving China. Then Jia Yueting had his assets frozen by Chinese banks. Starved of cash flow, both Wanda and LeEco have since backed away from funding new Hollywood studio projects, and China's Recon Holdings was off-again-on-again with a proposed US$100mn acquisition of Millennium Films.

Hollywood studios will probably have to turn to new sources of funding for their largest productions

In August 2017, the crackdown became official when the government announced new outward investment restrictions making it harder to splash huge sums on foreign entertainment deals. Financial regulators ordered China's biggest banks to stop loaning money to fuel what they called "irrational" investments abroad. About one-quarter of Hollywood films currently in production are backed by Chinese money, which means that the funding will not dry up for the next three years or so. But the Chinse gold rush appears to be over.

Back to basics, back to China

Seen in a positive light, Beijing's crackdown on outbound investment represents a move to protect state banks from issuing risky loans that threaten to turn sour. It rightly wants to prevent Chinese depositors from overpaying for foreign assets, and to stop moguls from fleecing ordinary Chinese investors for funds to fuel speculative acquisitions. The upshot is that movie studios on both sides of the Pacific must get smarter and get back to basics. That means no more using film budgets to move dumb money out of China.

Initially, the focus in China could soon shift back to importing films. Rumors are circulating that the quota of 34 foreign films per year could soon double, while the 25% share of box-office revenue taken by US distributors could edge closer to the international average of 40%. This would allow Wang, Jia and other big investors to shore up their infrastructure investments at home by filling more cinema seats. Such a move may also encourage Hollywood to put more energy into producing genre films popular with Chinese audiences, or even making films in Chinese. The rise in the import cap is necessary to prevent movie theaters from closing as millions of consumers instead stream videos on demand.

Even then, competition from streamed internet content will be tough. The number of viewers watching films via the likes of Baidu's iQiYi, Alibaba's Youku Tudou and Tencent Video surged to 75mn in 2016, more than triple the 22mn in 2015. Although all of China's streaming services continue to lose money, in time they (like Netflix and Amazon) may learn how to turn a profit. One crucial advantage they have over movie theaters is that, despite regular crackdowns, the Chinese web is still more loosely regulated. Much of the content available online would never get anywhere near a movie theater.

In the long run, though, the popularity of streaming on demand may actually help rather than destroy the movie industry, by improving the quality of films shown in the cinema. Because most industry players now agree they must curtail their dependence on big imports with limited relevance to local audiences, Chinese writers and producers have begun to use the internet as a cheaper tool for experimenting with different types of content. If this eventually produces big-budget movies better suited to local audiences, the Chinese movie industry could yet find itself in rude health, even as the grand foreign ambitions of China's movie moguls fall by the wayside.

Finally, China Learns To Kick Ass

By Matthew Forney

Wolf Warrior 2
Directed by Wu Jing
(Produced by Dong Feng International Media, China Film Group, Bona Films, Beijing Culture, 2017)

When future historians seek the precise moment when China publicly celebrated its arrival as a world power, the example they will marshal is the newly crowned highest-grossing Chinese movie in history, *Wolf Warrior 2*. Most English-language reviews have presented the movie, which earned half a billion dollars in 12 days, as a cookie-cutter action flick that differentiates itself only through the nationality of its hero. To many Chinese viewers, however, it is much more: a long celluloid checklist repudiating every sick-man-of-Asia slight that China has suffered since the Opium Wars of the 19th century. And with each box that director and star Wu Jing checks off, he sends a new message: those days are over; China is powerful; get used to it.

The movie's attitude can be summed up in its tagline: "Whoever offends China, wherever they are, they must die." Pretty strong. Yet it would be wrong to suggest that the movie is fascist. The hero, Leng Feng, is a butt-kicking, liquor-swilling, flag-waving former special-ops soldier in the People's Liberation Army who must wade into a pitiless African civil war to save dozens of trapped Chinese workers before they are massacred by Western mercenaries. Leng is not a vigilante who runs around killing people just because they offend China. In fact, the main point of the movie is that China is now so strong, and the cost of offending it is so high, that the only prudent course of action is to consider China's interests first.

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The movie was born of a marriage between the profit motive and propaganda. It was written, directed and produced by its star, Wu Jing, also known as Jacky Wu, a former martial-arts champion and TV actor. Despite 13 other co-producers, including state-owned China Film Group, Wu reportedly mortgaged his house to cover production costs of US$23mn (although that sounds too low). He understood that a movie bursting with pride in all things Chinese would make money, all the more by hewing so closely to the Communist Party line that it could have been ordered by the Propaganda Department. Indeed, China's other summer-time big-budget film *was* ordered by the Propaganda Department—*The Founding of an Army*, an epic pegged to the birth of the People's Liberation Army. *Wolf Warrior 2* is far superior, almost certainly because to pay off his mortgage, Wu needed Chinese people to love his film.

All-Chinese hero

Before discussing the film's message, let me say that to my eyes, the movie works as a movie. That's saying something: Chinese films tend to veer off course with too many characters, subplots and melodrama. *Wolf Warrior 2* contains all the elements of a solid action thriller: character depth and motivation, a few laughs, thrilling chases, clever escapes, a workable love story, and a funny fat lady who breaks up the pace. Leng's mission to rescue trapped workers is fresher than usual plotlines like damsel-in-distress or one-last-job. About the only thing the movie lacks is a speech from the bad guy in which he justifies his actions. This Hollywood-style movie just wades too deep into Chinese politics, so it cannot present a contrarian view.

As befits an action film, the story's message shines through during the climactic one-on-one fight to the death. I'm going to spoil it for you because although what happened is predictable, the details are new. After Leng falls into the clutches of the sadistic American lead mercenary, who has dishonorably stabbed him with a concealed knife, Leng draws extra strength from a thus-far unexploited personal virtue. What virtue is that? As the American prepares to deliver the fatal thrust, he leans his sweaty face close to Leng's and says, "People like you will always be inferior to people like me. Get fucking used to it," and Leng responds with an angry burst of patriotism that reverses the peril. Before dispatching the American, Leng declares, "That is fucking history."

In case you missed it: "people like you" means Chinese people. They are not inferior anymore. In fact, they are probably superior. That is the point of the film.

Before the final credits roll, *Wolf Warrior 2* heals a number of other festering cultural sores. Some are perceived individual shortcomings; others are China's historical weakness. Among them: *Chinese are unathletic*: in a beach soccer game with Africans, Leng scores a last-second goal and is mobbed by teammates. *Chinese are uncool*: Leng is the life of the party when chilling with hip Africans in a bar. *Chinese can't hold their booze*: Leng vanquishes two enormous African men in back-to-back drinking contests, the second by drinking a whole bottle of iconic Kweichou Moutai. *Chinese cars are lemons*: Leng's ride is a red Beijing Jeep.

Wolf Warrior 2 heals a number of festering cultural sores

There's more. *China doesn't protect its own*: the Chinese embassy takes in war refugees when other diplomatic missions cut and run. *China's navy is for bozos*: Chinese warships steam into port to rescue Chinese workers as the US Navy sets sail and leaves Americans behind. *China's military technology is second-rate*: Chinese ships fire rockets with pinpoint accuracy—exactly what Chinese officers watched in wonder 25 years ago when the US fired precision missiles at Baghdad. *China is a useless ally*: the African rebel leader orders his mercenaries to avoid killing Chinese because "China is a permanent member of the UN Security Council, and I need them on my side." *China gets no respect*: China is so powerful that both sides in the African war stop fighting to allow a China-flagged convoy of civilians to pass. *A Chinese passport is a liability*: to the contrary, China's strength makes a Chinese passport a ticket to survival.

The motherland stands behind you

The message that the Chinese government protects its own is a big deal. In the early years of this century, when Chinese suddenly began traveling overseas in large numbers, Chinese embassies were unprepared to offer citizen services. The problem became acute during the Asian tsunami in 2004, when Chinese holidaymakers were stranded in Southeast Asian countries and their embassies were nearly useless. Chinese often admire services offered by US embassies—so much so that many Chinese mistakenly believe that the inside cover of US passports carries the words: "Wherever you go, you have the strength of the US government and military behind you." (In fact, it asks foreign governments "in case of need to give all lawful aid and protection.")

The final scene of *Wolf Warrior 2* creates a new vision for Chinese citizens. It depicts an open Chinese passport while an invisible typewriter taps out the words: “Citizens of the People’s Republic of China, when you encounter danger overseas, do not give up! Remember: behind you stands a powerful motherland!”

A few final points. The movie is careful to paint the US as cowardly but not evil. The bad guys are an international team of Western mercenaries led by an American, but since mercenaries are by definition unloyal and represent nothing, they are politically safe villains. The movie also depicts Chinese and African factory workers as one big and implausibly happy family. As for the Africans themselves, in true Hollywood style, they love nothing more than dancing around a fire to a tom-tom beat while waiting for someone to machine-gun them by the thousands. We can probably look forward to a future *Wolf Warrior 3* that does something similar with the Japanese.

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