

# The Guaranteed Bubble

Ning Zhu

Shanghai Advanced Institute of Finance, SJTU

Yale University

University of California

# What would you do if

- You bought a shadow-banking product that promised to return 20 percent per year, WITHOUT RISKS, and the product eventually defaulted and caused you 60 percent of loss?

# What would you do if....

- You bought an apartment available next year at 10,000 \$/square meter three months ago and the developer slashed the price to 8,000 \$/square meter, and caused you 20 percent loss (more if accounting for the leverage)?

# What would you do if

- You bought the index future of Chinese stock market when the index traded at 5,000 and the market then crashed down to 3,000, and caused you 40 percent of investment loss?







萧内网







@我在全融街

t.163.com/8626373688



HOW IMPLICIT GOVERNMENT SUPPORT  
HAS PROPELLED CHINA'S ECONOMY  
WHILE CREATING SYSTEMIC RISK

CHINA'S  
GUARANTEED  
BUBBLE

PROFESSOR NING ZHU

WITH A PREFACE BY ROBERT SHILLER,  
NOBEL LAUREATE IN ECONOMICS



罗伯特·席勒  
诺贝尔经济学奖得主

托马斯·萨金特  
诺贝尔经济学奖得主

威廉·布伊特  
花旗集团全球首席经济学家

阿代尔·特纳  
原英国金融管理局局长

胡祖六  
春华资本集团主席

联袂推荐

中国将很难避免一场严重的金融危机，  
除非能解决经济中的隐性担保问题。

本书点到了中国经济的敏感之处，  
它会引发全世界的兴趣。

——罗伯特·席勒



中信出版集团 · CHINACITICPRESS

# Roadmap

- What is “Guaranteed Bubble”?
- Guaranteed bubble in Chinese financial sector
- Guaranteed bubble in Chinese economy
- Guaranteed bubble in global financial regulatory framework
- How to diffuse the guaranteed bubble?

# Roadmap

- What is “Guaranteed Bubble”?
- Guaranteed bubble in Chinese financial sector
- Guaranteed bubble in Chinese economy
- Guaranteed bubble in global financial regulatory framework
- How to diffuse the guaranteed bubble?

# What is Bubble?

- Sharp rise in price of an asset or range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers (Kindleberger, 1978)
  - Sharp asset price increase and decrease
  - Heterogeneous beliefs (about price expectation and existence of a bubble)
  - Unsound fundamentals and self-fulfilling prophecy
  - Hard to define ex-ante, or maybe even ex-post

# Historical bubbles

- Tulip mania (the Netherlands) : 1636-1638
- Mississippi bubble (France): 1717-1721
- South sea bubble (U.K.): 1719-1720
- Railway bubble (U.K.) : 1844-1846
- Stock market / land bubble (U.S.): 1920s
- Stock market / housing bubble (Japan): 1980s
- Global internet bubble: 1990s
- Global housing bubble: 2005-2007
- The skyscraper curse

# Necessary Conditions for Bubbles

- Excessive liquidity
- **New** technology/economy/business model
- Inexperienced investors
- Government support
- Historical shifts in global super power



# What is 'Guarantee'?

- To secure, as by giving or taking security;
  - to make oneself answerable for (something) on behalf of someone else primarily responsible;
  - to undertake to ensure for another, as rights or possessions;
  - to serve as a warrant or guaranty for;
  - to undertake to protect or indemnify;
  - to promise (followed by a clause as object):

# Different forms of Guarantees

- Guarantees in policy and mentality
- Guarantees in capital formation
- Guarantees in investment returns and risk hedging/insurance

# The Guaranteed Bubble

- To propel economic growth, policy makers encourage investment and speculations by providing explicit and implicit guarantees to investment, by enhancing returns or reducing risks
- Risky investments are considered risk-free with government guarantees
- Distorted risk preferences leads to over-investment, over-capacity, escalating debts, asset bubbles and bust, accumulating financial risks
- Moral hazard/ Too Big to Fail (TBTF)

# Roadmap

- What is “Guaranteed Bubble”?
- **Guaranteed bubble in Chinese financial sector**
- Guaranteed bubble in Chinese economy
- Guaranteed bubble in global financial regulatory framework
- How to diffuse the guaranteed bubble?

# Chinese stock market

- Regulatory objective and mandate
- Valuation
  - P/E, P/B,
  - International and historical comparison
  - A/H Premiums
  - CHINEXT / Strategic Emerging Industries Board / New Over-the-Counter Market

# Stock Market

- Listing / de-listing
- Trading mechanism
  - Margin trading and short sales
  - Index futures and options
  - Cross-border capital flow
- Reaction to sharp market drops
- ‘National Bull Market’ and investor expectation
- Market stabilization and investor protection

# Real Estate Market

- Exorbitant China Housing Price
  - Absolute price level
  - Price appreciation
  - Price to rental yield
  - Price to income ratio
  - Land value
  - Controlled land supply

# Real Estate Markets (II)

- Expectation, expectation, expectation
- Failed curb policy and successful investments
  - Protests after price cuts
- Land revenue bloodline for local fiscal sustainability
  - Property tax facing tremendous resistance
- ‘Steely’ demand, for speculation?
  - Lack of investment channels
  - Leverage and financial repression
  - Lack of renter protection



# Shadow Banking

- Different sizes and shapes
- Trust products and wealth management products (WMP)
  - Fastest growth spots in 2011-2015
  - Annualized returns of 10-15 percent
  - Guaranteed returns without any risks
  - Landscape started shifting

# Shadow Banking (II)

- Three major reasons behind shadow banking
  - Surging monetary supply and financial repression
  - Capital sufficiency requirement
  - Savings to loan ratio requirement
- Transformations of traditional banking
  - Entrusted loans
  - Collaborations between banks and trust, securities, and insurance companies
  - Alternative investment and financing channels

# Alternative Financing and Financial Innovation

- Internet financing
  - Third party payment
  - Yu E Bao and cohorts
  - Peer-to-peer financing
    - P2P with insurance
  - Crowd funding
- Trade financing
  - Copper, iron ore, and computer chips

# Roadmap

- What is “Guaranteed Bubble”?
- Guaranteed bubble in Chinese financial sector
- **Guaranteed bubble in Chinese economy**
- Guaranteed bubble in global financial regulatory framework
- How to diffuse the guaranteed bubble?

# Economic Growth Model Transition

- High speed to medium speed
- Investment driven to consumption driven
- Export to domestic demand
- Key: increasing labor productivity instead of increasing factor inputs

# Over-capacity

- Widespread over-capacity of 50-100 percent in many Chinese industries
  - Iron and steel
  - Cement
  - Solar panel and solar power equipment
  - Construction and construction equipment
  - Real estate

# Over-Capacity in Steel Production

- |  |                                  |
|--|----------------------------------|
| 1. China: 780 mil. (>50%)              | • China (ex. Hebei)              |
| 2. Japan: 110 mil.                     | • Hebei (ex. Tangshan)           |
| 3. U.S.A : 87 mil.                     | • Tangshan (ex. Hidden capacity) |
| 4. India: 81 mil.                      | • Japan                          |
| 5. Tangshan, Hebei: 80 mil.            | • U.S.A                          |
| 6. Russia:69 mil.                      | • India                          |
| 7. Korea: 66 mil.                      | • Russia                         |
| 8. Tianjin: 60 mil.                    | • Korea                          |
| 9. Qian'an, Hebei: 50 mil.             | • Tangshan ( hidden capacity)    |
| 10. South America Combined:<br>46 mil. |                                  |

# How did we get here

- Many once highly profitable industries quickly suffer from over-capacity
  - National strategic emerging industries
  - Perfect local investment projects
  - Easy fiscal appropriation and bank loans
- ‘Rational’ over-investment
  - Expansive monetary, fiscal, and industry policy
  - Asset appreciation
  - Pre-emptive strategy
  - Government subsidies and bailouts



# SOE reforms

- 100 Chinese companies on Fortune 500 list
  - Almost all SOEs
  - Ranked by total revenue
  - Results totally changed if ranked by profits
  - Mounting debt burdens
- Crowding out by SOEs
- SOE mergers: Further incentives to expand
- Competitiveness between public and private enterprises
- China: 2030

# Guarantees for SOEs

- Guarantees for debt/solvency
- Guarantees for favorable industry policy
- Guarantees for business
- Guarantees for financial stability
- Guarantees for legal positions
- Guarantees for project bidding

# Ballooning House of Debt

- Central government
- Local government
  - Local government financing vehicles (LGFV)
  - Local SOEs
  - Financing channels: shadow banking
- Central SOEs
- Debt level of listed companies
- Debt levels of Chinese households
- Leverage ratio highly dependent upon **asset prices**

# Fiscal Sustainability

- Central government
- Local government
- Social security
- Further reforms

# Roadmap

- What is “Guaranteed Bubble”?
- Guaranteed bubble in Chinese financial sector
- Guaranteed bubble in Chinese economy
- **Guaranteed bubble in global financial regulatory framework**
- How to diffuse the guaranteed bubble?

# 2007-2008 Global Financial

- Super easy monetary policy
- Financial innovation (CDO, CDS, etc.)
- Investors in the sub-prime markets
- Regulators' oversight
- Bankruptcy of Lehman Brothers and TARP
- Asset Purchases (Quantitative Easing) by the Fed

# Sovereign Debt Crisis

- European financial sector was severely impacted by the 2008 global financial crisis
- Transfer of debt and credit worthiness between private and public sector
- Worsening national credit and negative feedback into the economy

# The Internet Bubble

- The Fed unleashed unprecedented liquidity to save the 1987 stock market crisis and early 1990s savings and loans crisis
- The tides lift all boats, especially global emerging markets and risky assets
- The dual bull market in U.S. equity and bond market
- ‘irrational exuberance’
- The tightening cycle of the U.S. monetary policy caused the 1997-1998 emerging market turmoil and south east Asia crisis
- Collapse of the Internet bubble and the housing boom



# Global economy in 2016

- The New New Normal
  - Tapering off of quantitative easing
  - De-leveraging
  - Capital flow
  - Valuation adjustment

# Roadmap

- What is “Guaranteed Bubble”?
- Guaranteed bubble in Chinese financial sector
- Guaranteed bubble in Chinese economy
- Guaranteed bubble in global financial regulatory framework
- How to diffuse the guaranteed bubble?

# How to reform? (I)

- The institutional guarantee
- Rebalancing the tradeoff between
  - Growth and development
  - Speed and sustainability
  - Investment and consumption
  - Public and private sector
- Change of evaluation and incentive systems

# How to Reform? (II)

- The capital guarantee
  - Monetary supply
  - Total social financing (TSF)
  - Interest rate liberalization
  - Capital flow control
  - CNY exchange rate pricing mechanism

# How to Reform ? (III)

- The investment guarantee
- Let the market play a maximal role in allocating resources (and setting prices)
  - Real estate market
  - Re-valuation in capital markets
  - Shadow banking
  - Corporate and municipal bond markets

# Major Reforms

- Fiscal and taxation reforms
  - Government soft budgeting
  - One-off and on-going tax categories
  - SOE reforms
- Financial reforms
  - Information disclosure
  - Law of one price
- Legal reforms
  - Civil law system
  - Bankruptcy law

# Hayek Vs. Keynes?

Thank you!