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“China and the Global Capital Markets”

Executive Summary.

Introduction.
My name is Donald Straszheim. I am the CEO of Straszheim Global Advisors, LLC, an independent economics and financial markets research firm which focuses on China and how China affects the U.S. and global economy and financial markets. We have offices in Los Angeles and Beijing. Prior to founding my own firm, I was global Chief Economist for Merrill Lynch, the securities firm, and President of the Milken Institute, a not-for-profit economic and public policy think tank. I have been a regular visitor to China since the mid-1980s and a student of her economy and financial markets for many years.

This statement briefly addresses the current economic situation in China followed by some thoughts on the banking system and China’s equity markets. A brief comment on the debt and the currency markets is at the end.

China’s Economic Ascent Since 1978.

A brief review of China’s current condition is necessary to understand the role, condition and prospects of China’s capital markets and financial system.

Careening toward a market economy. China is careening down the path toward a market economy, with a long way to go, but with, in my view, no turning back. China remains a mixed, dare I say jumbled, economy of the modern and the archaic. China has elements of the old command-and-control system established by the Communists in 1949 alongside, and co-mingled with, entrepreneurial enthusiasm and market forces of great strength. Applying our perspectives and background to China’s different setup is dangerous. Beijing is enthusiastic to embrace the market economy and let the “invisible hand’ take over in some sectors. But she is also as yet utterly unwilling to let go in other portions, still insistent on decision making by committees and bureaucrats in secrecy and without account to others.

Threat or opportunity or both. Every company in the world now that is not totally asleep sees China as a threat or an opportunity, or, usually, as both. Since 1978, when China launched the "reforms and opening up", real GDP growth has averaged 9.4% annually, 3 times the U.S. record. Our analysis suggests these figures are realistic, not exaggerated. With intermittent interruptions, we also believe 9% growth is sustainable for many years – 1% labor force growth and productivity. However, China needs to modernize her capital markets, precisely the focus of these hearings, if these growth figures are to be attained. China, America and the world will be better off if China attends to these matters promptly. In a phrase, China has gone from interesting to important over the last 5-10 years.

Economy unbalanced, not overheated. It has been entirely inaccurate over the last year to describe China's economy as overheated, as has been the general description of the business press. Unbalanced, yes; overheated, no. Overheated suggests a general condition of "too much money chasing too few goods." That is not China. Rather, China is awash in goods, produced for both domestic consumption and export. There are sectors which are overheated, and they are largely the result of decisions made in the command and control portion of the economy. China's mass of economic managers in the still-dominant public sector remain more comfortable with decisions made by the governing committee around the conference table rather than leaving such decisions to the consensus judgment of the marketplace – the "iron fist" rather than the "invisible hand."

1% labor force and 8% productivity is sustainable. China is an under-developed country still in many ways, and is long on labor and short on capital. Give China a continuing flow of new capital to combine with her quite well educated labor force and entrepreneurial inclination and a stable government and society and China will become ever more powerful and significant. China's populace has come to enjoy the economic gains of the last quarter century. They associate these gains with economic and social reform. Beijing will be in trouble if and when the advances stop. It is no exaggeration to say that the reform process in China is being lead by the people. Beijing has figured out that there is a parade of economic reform going on and that they need to get in front of that parade. The people are pushing the reforms; Beijing is not. The government's claim to legitimacy rides on a continuation of these gains. Accordingly, China's leadership is very much interested in making the requisite reforms. All of the market economies of the world, most of all the US, need to foster this reform movement in any way possible.

Finance is China's weakest link. There is a solid consensus view that the financial system is China's weakest link. If destabilizing economic trouble erupts in the next decade, it likely will start in the financial sector. Manufacturing in China has made great strides in the last decade as we all can see. Retailing and trade have also developed quite well and more is to come. But the only way to describe the state of finance in China is both primitive and weak. If any sector in

China is likely to create troubles that will hold China's economic progress back, and might spill over into causing trouble for the global economy it is finance. China's banks are not banks; they are lending arms of the government. China's two domestic equity markets, Shanghai and Shenzhen, are simply not equity markets in the conventional sense. China's debt markets are even less developed. Their currency remains, for all practical purposes, still pegged to the dollar despite the recent small 2.1% revaluation of the Yuan and the announcement of a narrow band and reference to a basket of currencies. Capital still does not flow freely into and out of China. Until China's financial structure is modernized, China will remain a country of incomplete development. China wants to be regarded as a full fledged member of the global economic and financial community. They are not there yet, but are highly susceptible to outside help and suggestions.

Demonstrate and coax. As outside observers, we are often impatient with the pace of reform that we see. We would be better off to demonstrate best practices and appropriate next steps by our actions and coax gently with examples and encouragement rather than push without limit the pace of these reforms. No one in 1978, just after the end of the 1966-76 "Cultural Revolution, easily the most damaging social experiment in the history of the world, could have imagined the strides China would make by 2005. Even the financial system is being modernized and making progress. To push too hard encourages a push back. We need to do all that we can to get China ever more engaged in the global economy. As that occurs, she will have no choice but to adopt something like global standards.

China's "Commercial" Banking System

China's banking system remains primitive and weak fully 27 years into the process of "reforms and opening up."

China's Big-4 commercial banks. China's "big-4 commercial banks" are not banks in the American sense of the word. They are lending arms of the government. These four banks – the Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agricultural Bank of China – are state-owned, and have a dominating 65% market share in China. They are in some ways reminiscent of the so-called "keiretsu" banks in Japan and the "chaebol" banks in Korea. The big-4 primarily provide lending services to the other state-owned enterprises in China in manufacturing, mining, retail, trade, services, agriculture and more. They still lack many operational tools and technologies essential to good banking practices as we understand them. They lack the managerial and strategic talent and expertise that is commonplace in global market-oriented banks. They serve the lending function for the other SOEs in China quite adequately, but do not allocate capital as a scarce resource to the best returning alternative in any meaningful market-tested sense. This is an ultimately fatal flaw. The result is that capital is not treated as a scarce resource in a way that is familiar to us. The banks don't really support the best projects and starve the worst ones. Record keeping remains hamstrung by lack of technology. They lack a sufficient pool of talent with real banking experience. They do not have experience in rationing credit, or in matching assets and liabilities on their balance sheets. Loan committees do not generally function in a judgmental and capital allocating way. Private sector companies are not supported in the way we are accustomed. These characteristics represent both the threat and the opportunity. Capital is allocated in a very haphazard way. Imagine what China's economic growth record might have been -- or might become – if this were corrected.

Non-performing loans (NPLs) and government bailouts. Not surprisingly, China's big-4 banks have massive bad loan problems. The estimates vary widely. In December 2003, Beijing provided a cash infusion (bailout) of $22.5 billion to Bank of China and $22.5 billion to China Construction Bank to remove bad loans from the books and repair their balance sheets. This bailout was hailed, incorrectly, as a positive step. Until banking practices are changed and loans are written according to market principles, these $45 billion of bad loans will simply be replaced by $45 billion of new loans that are not yet bad simply because they are still new. Until China learns modern banking practices, the process of writing loans, the loans becoming bad, a bailout is provided and new loans that ultimately turn bad will be repeated. A $30 billion bailout was provided in early 2005 to the Industrial and Commercial Bank of China. The Agricultural Bank of China is so widely regarded as beyond redemption, even in China, that no bailout has even been attempted that might set this bank on a positive course.

The Asset Management Companies (AMCs). A few years ago, China set up four AMCs, each to receive the bad loans of the big-4 banks in the effort to clean up the big-4 banks balance sheets. This is China's version of the standard "good bank-bad bank" strategy that has been used to salvage struggling lending institutions. The AMCs have not lived up to the expectations for two principal reasons. First, China remains skeptical that the outside buyers (largely westerners) are trying to unfairly gain control of valuable properties at too-low prices. Second, western bids remain low because the potential buyers have no confidence that once they buy a property that they will be able to ultimately get free-and-clear title to the asset they bought. In principle the AMCs are potentially a useful tool. But in practice, to date China has not yet established the underlying conditions for them to work.

The future of the big-4. In the long run, we see the big-4 banks as dinosaurs bound for either extinction or a role limited to some kind of development role for the government. The investments being made in the big-4 banks by western banks are unlikely to provide any real returns. Likely they are being made in order to establish relations rather than on any expectation of a real return.

The smaller municipal banks. The future of banking in China is more likely with the smaller municipal banks in China which are also government-owned, but which do not have the baggage of the big-4. We expect western banks to establish joint relationships in one form or another – ownership or operational – with all of these banks, bringing technology, talent and perhaps capital to them. Anything we can do to support the modernization of China's banks will be a plus.

No good monetary policy transmission mechanism. The lack of a well structured and operational banking system in China means that China lacks the transmission mechanism that is essential for monetary policy to be an effective modulator of the economy. If interest rates flexed up and down in a coherent and regular basis, the opportunity to manage growth and inflation would be much more straightforward. This is even more fundamental than the lack of a monetary policy that is independent of the executive branch of the government.

China Banking and Regulatory "Commission. This body performs the basic regulatory functions in banking in China. Discussions with this body quickly reveal that they do not see banking in the way that we see it and that the legacy of the origins (and even present operations) of banking in China have their banks in a different position from ours. More interaction between the relevant regulatory bodies in China and in America would be constructive. China is willing and eager to work with us. We need a healthy exchange of staff – in both directions -- in order to accelerate the learning process.

WTO Opening as of December 11, 2006. China's entry into the WTO on December 11, 2001 established a schedule of dates in which China was obligated to open up various industries to foreign competition. The date for banking was 5 years after entry -- or December 11, 2006. It is clear at present that China's banking sector is in no condition to compete head-to-head with a global quality commercial bank from the west. They simply do not have the talent, technology or experience to do so. As a consequence, it is in neither side's best interest for foreign banks to enter China's banking sector in December 2006 with an aggressive plan to take market share in the short run. No one wants a financial crisis. Rather, we expect the foreign competition coming in to adopt a relatively go-slow approach. And we expect China to establish conditions and rules which will effectively slow the process and act as speed limits upon entry.

Next steps for China's banking system. In summary, banking in China remains primitive, undeveloped and unsophisticated. But China is making progress. China needs to accelerate its reform process in anticipation of the December 2006 WTO mandated opening up of the banking system. We see the following steps as most important: expertise from the west; real lending standards; loan reviews that are operational; a functioning and independent monetary policy; more vigorous action from the CBRC; and the adoption of internationally accepted banking standards. China's economy continues to grow. If China can just adopt new standards and practices, the burden of non-performing loans can be absorbed over time.

China's Equity Markets.

China's equity markets, like China's banking system, remain under developed and not an effective mechanism to match sources of capital with uses of capital. They have been the worst performing markets in the world for the last 18 months. And just like the banks, a well oiled equity market would be a major plus to China's economy.

The Shanghai and Shenzhen stock exchanges. China's domestic equity markets were started in 1990. There are about 1400 companies listed for a total market capitalization of about US$425 billion. China's markets are the third largest in Asia, behind Japan and Hong Kong. Over 90% of the listings are state-owned enterprises rather than privately owned.

The purpose of equity markets in China. China's equity markets were launched when China was far less developed than today. They were established to be policy-driven rather than market driven. China wanted to raise the value of the state-owned assets that it already had. Beijing also wanted to keep control of these assets. Accordingly they established the practice of issuing a majority interest of non-tradable shares for each of the stock issues. That legacy remains to this day. Unlike the basic function of the equity markets in America, the Chinese markets were not established in order to match capital needs with capital sources.

Reforms needed in China's domestic equity markets. It is no accident that China's equity markets have been the worst performing in the last few years while China's economy has been the best performing. Global and domestic players have become increasingly aware that the domestic markets lack the features that are essential to fair investing. And until these markets are reformed investors will continue to stay away. A short list of the reforms China must make would include: better protection against insider trading; improved corporate governance; more transparency and openness; outside directors that are truly independent; more and more timely reporting of results and material events ; adoption of internationally accepted accounting standards; elimination of the overhang of non-tradable shares owned or controlled by the state; more policing of practices in the brokerage community and generally a more market-based mentality. This list might seem straightforward enough, but when juxtaposed against the origin and purpose of the Shanghai and Shenzhen exchanges, these items represent a 179 degree turn from past practices.

China Securities Regulatory Commission. The CSRC is China's equivalent of the SEC. While working hard to upgrade their capabilities, the CSRDC still lacks adequate staff with the requisite background and experience to reform, modernize and regulate these markets in a way that will install confidence in global or even domestic investors. The QFII (Qualified Foreign Institutional Investors) program, to allow foreign investors into Shanghai and Shenzhen, has been a disappointment. As with banking, any increased interaction between China and America that involves training and an exchange of views will be highly constructive.

IPOs on NASDAQ since 2000. There are 23 high-tech companies from China that have done IPOs on NASDAQ since 2000. These are young companies with young managements, largely educated in the west. Some will succeed and some will fail – with good and bad plans, technology, management and execution. These companies represent the heart of China's most promising young companies. These firms choose to list on NASDAQ instead of on the domestic Chinese exchanges because they are well aware of the shortcomings of the domestic markets. This fact is gradually being absorbed and accepted in China, and will become an ever more powerful incentive for reform in Shanghai and Shenzhen. We can't imagine a quality young Chinese company listing domestically under anything that remotely resembles the current environment. To use a baseball analogy, why play in the minor leagues (Shanghai, Shenzhen) when you can play in the majors (NASDAQ, NYSE)?

Recent and future IPOs. Last week a small Chinese internet search company, Baidu, completed an IPO on NASDAQ to great fanfare and publicity. At present, there are discussions between a highly respected and rapidly growing private Chinese company, Alibaba (the Chinese Ebay), and Yahoo about a major transaction. That these most attractive companies in China are forsaking their domestic markets and looking to list in America speaks volumes about the need for reform in China's securities markets.

Debt Markets, Foreign Exchange and Other Matters

Leaving the debt markets to later. China's debt markets remain even more undeveloped than the equity markets. With SOEs still dominating the production side of China's economy, banking as noted above remains the dominant form of finance. Yet around the world, the record is clear – a well functioning debt market serves the private sector of the economy and serves the financing needs of the government as well. China is making some progress here, but it is slow, and in our view, of secondary importance to developing the equity markets and making the banking system modern and functional. With western talent still scarce in the finance arena, to focus on the debt markets at a later date is both understandable and appropriate.

The Currency and foreign exchange markets. Without getting into the core of this contentious debate on the pegged currency, revaluation and trade, it is I believe appropriate to consider them briefly.

Revaluation on July 21, 2001. The revaluation of the Yuan by 2.1% on July 21, 2001 from the long-standing peg of 8.28 to 8.11 was small step forward. The announcement that China was adopting a "managed floating exchange rate regime" with reference to a basket of currencies and to supply and demand conditions was especially heartening. China further indicated they might revalue (up or down) the currency by up to 0.3% on a daily basis. But at this point the focus seems to be more on managed and less on floating. And the reference to a basket of currencies seems almost entirely misdirection. Our calculations indicate that the daily movements in the currency bear no resemblance to what would seemingly have been implied by the currency basket movements. We hasten to add that China is a sovereign nation and can handle their currency in any manner they choose. It is their currency. However, China adopted the language of the currency markets in announcing their revaluation and new exchange rate regime changes on July 21. To then act differently from what any reading of their statement would mean has been distinctly unhelpful. We expect that in the coming weeks more unhappiness on how this matter was announced and is being executed will become widespread, to China's damage, not to her benefit.

China's long run goal. We believe that China wants to be regarded as a full fledged member of the global economic and financial community. To achieve this standing by the time of the Beijing 2008 Olympics would be most desirable from Beijing's perspective. To be so regarded, a necessary but not sufficient condition is that China has a currency that is freely floating and freely convertible – not fixed to the dollar. Much has to be done in reforming China's capital markets and financial system before they are ready for the rough-and-tumble of these markets. And for China to act before they have the requisite reforms and the knowledge base would be dangerous. But this is a date peg that suggests China will work hard to meet and should be susceptible to ideas for reform and modernization coming from any source.