



China Crisis?

Aside from a poor play on words, (for those who remember the eponymous short-lived pop band from the 1980s), what exactly is the intention behind the title of this article?

-Some of our investors have over the last 12-18 months queried why we have not recommended investment specifically in China. Many pundits (i.e. the Financial Press) are saying that China will be the next economic superpower and have pointed out that the economic growth over the last few years has been astounding.

There are several reasons why we do not encourage investment in China, particularly for our more conservative or 'balanced' investors. Of all these reasons the most predominant is the corruption and instability that still plagues the country from the grass roots upwards.



As we have said before, we do not just expect our investors to take our word for it – if nothing else such an expectation would lead to an extremely short and uninteresting article.

In 1998 the Guangdong International Trust and Investment Corporation (ITIC), a specialist investment company owned by the Guangdong regional government, collapsed with a total debt of \$4.5 billion. The government's initial solution was to leave foreign bankers with the losses. These bankers had become enthusiastic investors in China following the explosion of economic growth and the announcement of various liberal reforms. The ITICs (of which there were 240) were also controlled by the Central Bank of China, which led to the foreign bankers assuming that they represented a relatively low risk.

Naturally, the foreign bankers cried foul and immediately started withdrawing investment and loans. China, then as now, needs massive foreign investment, credit and expertise. The leadership therefore decided to bail out not only the Guangdong ITIC, but also all other ITICs with a similar problem – total bad loans of around \$170 billion were transferred from the ITICs to various Chinese state banks.

Whilst the Chinese government renewed attempts to attract foreign investment, these bad loans grew rapidly in size. Through bad lending practices, for example propping up local businesses by lending money to pay the interest on outstanding debt, the value of non-performing loans had risen to \$750 billion by the end of 2000. Nearly 40% of all loans at that time were deemed to be 'bad'. For comparison purposes, no banking system in the history of the world has survived for long with bad debts of more than 10%. The latest data would suggest that roughly 20% of these loans remain non-performing.

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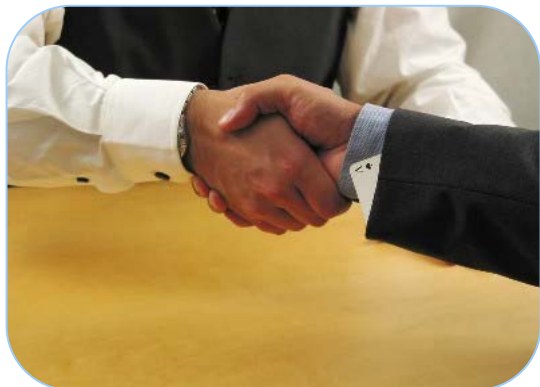
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Some attempts have been made to reform the system, including one-off rescue packages involving over \$75 billion dollars, huge numbers by anyone's standards (the Barings scandal involved less than a \$1 billion). Without exception these measures have failed.



One of the core problems is the Guanxi system. Guanxi means connections and has been at the heart of the Chinese banking system for over 1,000 years. It is the old boy network with bells on. It includes relatives, clans, people from the same locale, and revolves around favours. It has its strengths, but is extremely resistant to change and embeds corruption at the deepest level.

Western banks seem to have swallowed the line that China's banking system has been cleaned up. Large stakes have been purchased in China's leading financial institutions by several household names, because 'it makes sense if you are looking to tap into economic growth'.

All claim to be investing for the long term, hoping that their expertise will effectively break the Guanxi system. Although they believe that they know the true balance sheets of the banks that they are buying, to the best of our knowledge none to date have had a return on capital above its cost.

Back in the mists of time the Chinese not only invented accounting, but also quadruple accounting (one set for each of the government, investors and wives as well as the true internal set). It remains to be seen whether Western banks with their eyes fixed on the 1.3 billion consumers and short-term executive bonuses, rather than on the \$750 billion of bad debt in the system, can see through these fictions.

Our view, and the view of large institutional fund manager DFA, is that China has many issues to resolve satisfactorily before we are willing to commit our clients to direct investment. In the meantime indirect investment does occur through the FTSE All Share Index tracking funds and also Pacific Basin funds that inevitably invest in Hong Kong.

Thanks to Bedlam Asset Management for the main substance of this article. Other sources used for verification purposes include the William J Casey Institute, BBC News and the American Enterprise Institute for Public Policy Research.

Whilst this article will hopefully give some insight into the reasons why we are nervous about explicit investment in China, as with all investment commentaries it should not be read in isolation. Please speak to us before taking any investment decisions.

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For more information on any of the issues raised your current Hillier Hopkins contact will be happy to assist you. Alternatively, please call us on 01442 220788 to speak to one of our advisers.

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