

China's asset market

Economic note

11^h July 2011

[China's under-developed capital markets represent the largest risk to China's growth story.](#)

Part of my confidence in China's economy is the strength of competition in most industries. This aids capital allocation in these industries because returns are quickly competed away. Generally, owners are under no illusion that super normal returns exist. Rather than buy existing assets, the Chinese strategy, given large markets and abundant capital, is often to replicate assets to compete away excessive profit margins. This lowers asset prices and should create stable asset markets; perhaps it's no surprise that the Shanghai Composite has range traded since mid-2009.

Elsewhere, however, the story is not as rosy. There remains a scarcity of properly priced financial assets, representing a serious risk to the economy. This situation has been made worse by the monetary tightening that has come at the expense of households and small and medium sized enterprises (SMEs).

Households, prodigious savers, have lost out through negative real deposit rates and this has led to more risky behaviour. Given the legislated gap between bank lending (6.56%) and deposit rates (3.50%) households have sought alternative savings vehicles that are often more aggressive strategies with the aim of allowing assets to keep pace with inflation.

Housing has long been a favourite. But increasingly this avenue is out of reach as authorities limit second and third time purchases. One commentator on China recently remarked that these regulations are creating political unrest – those without large property portfolios are envious of those who established large portfolios prior to the regulation change.

With bank deposits, the stock market and housing either failing to meet return expectations or effectively outlawed, households are looking elsewhere to the benefit of wealth management businesses.

SMEs have suffered through significantly worse terms than the larger and better connected state owned enterprises (SOEs). SMEs are borrowing at rates of up to 30% while SOEs can access funds at less than 10%. Such has been the restriction on funds for SMEs that they have taken to the copper market to fund working capital. Credit strapped companies, unable to afford market rates for credits have taken to using trade credit to buy copper internationally and then sell it on the domestic market. The trade costs have tended to be better than rates charged by commercial banks.

This combination of poorly rewarded savers and hard-pressed borrowers has led to stunning growth in the shadow banking system.

Chinese SMEs have always tended to be funded through informal networks of lenders. This is particularly the case on the Eastern Seaboard, around towns such as Wenzhou made famous for their entrepreneurs, where businesses access capital outside the formal banking sector. Often this will come from a family network. Such networks exist throughout the emerging world. A broker in India told me he lent capital to people of a similar ethnic background.

But as the demand for savings products grows, banks are starting to form their own networks of lenders, through the Term Deposit market or off-balance sheet style vehicles, and making the system more prevalent and important.

These networks are providing liquidity to firms that otherwise would be going to the wall and allowing households to keep pace with inflation. But there are obvious risks. A downturn, particularly in exports, would hit this sector hard, and as we saw with sub-prime, an unregulated banking sector can cause havoc to an entire economy.

The solution for China is further reform of its banking sector. In particular, households need to be properly rewarded for their savings through positive real returns on deposits. But this seems a long way off and in the meantime, as inflation remains above a comfortable level, the size of the potential problem can only grow.

For further information

Investment Markets Research team

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Senior Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Senior Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

Regional Managing Director, Australia and New Zealand

Joanna Davison	+61 2 9303 7007
----------------	-----------------

Institutional Business Development and Consultant Relationships

Matt Russell	+61 2 9303 7024
Ali Karmali	+61 2 9303 6070
Tracey McNaughton	+61 2 9303 2695
Trent Koch	+ 61 2 9303 7653

Institutional Relationship Management

Liz Krajewski	+61 2 9303 2927
Dan Bristow	+61 2 9303 6311
Helen Squadrito	+61 2 9303 6142
Hugh O'Neill	+61 2 9303 6116
Simon Good	+61 3 8628 5681
Harry Moore	+613 8618 5532
Nadene Moore	+61 3 8628 5615

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of Colonial First State Asset Management (Australia) Limited ABN 89 114 194 311 (CFSAMAL). This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy, none of CFS or CFSAMAL offers any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS and CFSAMAL. You should not rely on the contents. To the fullest extent allowed by law, CFS and CFSAMAL exclude all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by any of CFS or CFSAMAL. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © Colonial First State Group Limited 2011

All rights reserved.