

“Developing the bond market in China would not only diversify the risk in the financial system,” writes sovereign wealth asset adviser Dag Detter, “but would also act as a catalyst for reform of state-owned enterprises”



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China could be the world's leading financial and industrial power if it successfully develops a more effective financial sector. An important milestone would be the advent of a vibrant bond market. In contrast to other major economies, China's bond market is currently underdeveloped when compared with its gross domestic product and the size of its corporate sector. Such a development would radically reduce the near total dependency of the country's corporations on bank financing.

History offers numerous examples of economies punching above their weight in global economic influence as a result of their well functioning and efficient domestic financial markets. The small city states of Venice and Genoa establishing themselves as leading international financial centres in the Middle Ages are but two examples. Developing the bond market in China would not only diversify the risk in the financial system, but would also act as a catalyst for reform of state-owned enterprises.

Some of China's largest industrial corporations and commercial banks are government-owned. Many of these institutions have the inclination and potential to become fiercely competitive on the international stage. To achieve this goal, the government wants to adopt state-of-the-art corporate governance practices without ceding ownership control of its giant corporations or causing an adverse impact on China's social cohesion. However, it is currently

unable to impose commercially sound, market-based investment returns on its portfolio or deliver meaningful transparency in monitoring the efficiency and performance of its assets.

Private companies in China, accounting for half of GDP, are generating the majority of new jobs and growing faster than GDP, and are struggling to find external financing. Conversely, government-owned companies, which account for barely 25% of GDP, continue to absorb most of the funding from the banks. With banks supplying more than 80% of the capital in the corporate sector, this leads to crowding out of valuable private sector investments.

Development of the bond market is crucial for China to 'open up' to globalisation as it delivers better risk management for its corporations. By shifting the funding of companies from bank financing towards corporate bonds, the government would be using market forces to achieve greater checks and balances, and efficiency, without losing any ownership control of its commercial institutions.

With credible ratings, international markets and higher standards of disclosure in place, the bond market can deliver considerable advantages to the Chinese economy. However, key infrastructure, laws relating to the bond markets, rules on insolvency and important market makers are all vital to the development of a successful bond market. A number of these conditions are not yet in place, but are no doubt very high up on

the government's agenda.

The process of securing a rating would not only instil some much needed financial discipline in government-owned commercial assets, but would also introduce an additional layer of political insulation, which is essential in addressing the inherent conflict of interest between the demands of political expediency and purely commercial imperatives. Political insulation is not only beneficial at the corporate level, but also the holding vehicles of state-owned commercial assets would benefit from having a debt rating. Temasek, the holding vehicle of the Singaporean government, received a debt rating in 2005, which was seen as a significant step towards further independence and increased transparency of the state ownership function. The result has been that Temasek now enjoys a status akin to that of a private sector holding company. This has ultimately meant that Temasek has freed itself from accusations of benefitting from subsidies and political involvement as it continues its international acquisition spree.

Holding vehicles for Chinese state-owned corporations and financial institutions could be the ultimate provider of capital for Chinese state-owned commercial assets, allocating capital efficiently within its portfolio in a commercially expedient way for acquisitions or recapitalisations. In return, the government would receive a proper annual dividend from its holding companies that could be used for public spending to mitigate the social consequences of structural change. Such an approach would relieve China's state-owned holding vehicles of responsibility for managing domestic policy issues, leaving them free to focus on their commercial functions.

Locking into a professional system of checks and balances designed for the commercial sector will help the government to manage its commercial assets through its holding vehicles in a more productive way. By harnessing market forces in this fashion, the Chinese government could turn its holding vehicles into useful instruments for achieving economic reforms, such as when New York City used bond credits of the New York City Water Finance Authority to fund capital improvements to its water and sewer system.

By shifting the funding of its companies from bank financing towards bonds the government would achieve greater economic efficiency – without losing ownership control of its corporations – and receive more funds to finance its social reforms.

Dag Detter advises governments on their sovereign wealth assets and has been contributor to the OECD guidelines.