

Walter, Carl E. & Howie, Fraser J.T. – Value – Red Capitalism

John Wiley & Sons, 2011, [Business] Grade ★★★★★

Very few westerners have worked in the Chinese financial sector for twenty years. The two writers of Red Capitalism both have. Being residents of Beijing and Hong Kong they have managed Chinese investment banks, worked in investment firms and played roles in the early IPOs of state owned companies. When two persons with the background of Carl Walter and Frasier Howie write a book about “the fragile financial foundations of China’s extraordinary rise” we should listen. The writers are not “bears on China” (to talk with Jim Rogers). However, they point to the unbalanced state of local governments, state owned banks and the property market. The picture of a power house flush with cash might not be the only one.

After a brief recap of the economic reforms after the death of Chairman Mao the rest of the book describes the current state of the economic and financial system. Most of us have read about the risk of a property bubble. In my view the combination of state owned banks with close to free access to peoples deposited money and corrupt local government business entities is the really scary picture. China, to some extent, is still a commando economy. The communist party officials state an economic growth target and then it is the task of those “inside the system”, i.e. state owned companies and local government entities to carry out the investments in infrastructure that create the growth and the state owned banks to fund the party with low interest rates that’s politically decided. Need I say that credit control and making sure the return on invested capital is higher than the cost of capital is not really prioritized in this process?

It’s like a mystery by Agatha Christie. One piece of the puzzle after the other is presented: the banking system, the handling of historical credit losses (they

were hidden), the shadow banking system, the equity and bond markets, the local governments, the property market and the risk for coming credit losses. In the end a picture emerges that reveals a public debt of the Chinese state close to 80 percent of GDP. Not far from the Rogoff and Reinhart danger line of 90 percent. Yes. China has huge foreign currency reserves but as long as the currency is not exchangeable these funds are of very little use inside the country. It’s a story well told and it certainly changed my perception of the Worlds second largest economy.

I still think the future of China is bright but it might be a rockier ride on the way to the future than most people believe. As China is a large part of global GDP, of global trade and the country practically IS the commodity demand in the world, the imbalances the authors point to should be on every investors radar screen. Most western investors have a surprising faith in that a few elderly communist officials can steer this huge economy through any trouble and this often without really understanding the troubled waters they have to navigate through.

Not wanting to bring anything that might annoy a customs official I read the book prior to going to China a few months ago. It greatly increased the benefit of the trip. On site you mainly get the bull picture. However, most people you meet are fully prepared to discuss any worry the pessimistic foreigners might have regarding the property market or the risk of credit losses, always with the conclusion that there is little to worry about. The Chinese optimism today is very much how I imagine the western optimism in the 1950’s. The future is bright and shiny.

Read this book. You will understand the world economy better and many of your competitors will not have read it.

Mats Larsson, August 18, 2011