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CHINA

The Real Problem With China's Murky Markets

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China's epic ploy to convince the world its stock market is safe is no match for the Huang Guangyu caper.

Skepticism greeted news this week that the Chinese billionaire had somehow pulled off a deal to consolidate control of Gome, the electronics retailer he founded in 1987. Shares plunged as Huang boosted his stake to as high as 55.3 percent after Gome announced plans to buy another company he owns. The problem? Huang is in a Chinese prison until 2024 for bribery.

That the cost is too high and the logic murky are side issues. The real question is how a convict can seal a billion-dollar-plus corporate deal from behind bars without drawing the scrutiny of regulators. This bizarre tale speaks volumes about why investors are fast losing confidence in China's stock market. Shanghai shares fell 1.7 percent in volatile trading yesterday, extending the biggest one-day loss since 2007.

The world is fixated on China's macro story: Worsening fundamentals made the 68 percent surge in Shanghai over the last 12 months look completely unsustainable. Growth is slowing, debt risks are soaring and deflation is looming. As investors flee, Beijing has launched a series of measures to stem the rout -- cutting interest rates, ordering state companies to buy shares, banning short selling and letting punters put up their homes as collateral for margin trading. Yet President Xi Jinping is expending little energy strengthening the market itself or the unpredictable companies listed on it.

Huang's gambit highlights the cracks in China's microeconomy. Rather than pumping ever more air into China's asset bubble, Xi should be empowering regulators to clamp down on corporate malfeasance. China's corporate sector needs much greater transparency, random audits on even the biggest state-run enterprises, whistleblower hotlines, mandated compliance training, codes of conduct for due diligence among executives, a better credit-rating system, a freer press to police businesses, an independent enforcement team with subpoena powers and a legal framework to punish bad behavior.

So far, 2015 has instead been a dismal year for Chinese corporate governance. In May, Hanergy Thin Film Power Group lost a breathtaking $19 billion in 24 minutes after its CEO failed to attend a shareholder meeting. That same month, Pan Sutong's Goldin Financial and Goldin Properties lost a combined $21 billion, about half their market value, in a couple of days for no obvious reason.

Confusion also reigned at Kaisa, the first Chinese developer to default on dollar bonds, amid accusations of incomplete financial reports and weak governance (the Shenzhen company also was delisted). Back in April, as Kaisa's missed payments were rocking markets, analyst Raymond Chia of Schroder Investment Management crystallized the problem: "A recently successful company has defaulted. This can happen anywhere, anytime, when it comes to China."

The picture grows more ominous when one considers the record number of Chinese companies leaving U.S. exchanges to list on the mainland for higher valuations. As of early July, at least 25 significant names were eyeing a move, including Internet security provider Qihoo 360 Technology and data-center operator 21Vianet Group. Even Baidu, China's Google, says it's interested in returning to mainland bourses. These shifts will make it harder for investors to assess risks and proper valuations for Chinese companies. Executives would be free from filing quarterly financial results -- and even freer to fudge balance sheets or muddy their roles in companies. Gome's statement on Huang's jailhouse deal, for example, refers to him as "Mr. Wong" in Cantonese.

The stakes have never been higher in gauging risks in China, which fund manager Bill Gross dubbed the "mystery meat" of emerging markets. And yet Beijing is failing in its own fiduciary responsibility to create a more sustainable economy. "Improvements in corporate governance, the financial regulatory framework, and legal reforms that underpin a market-oriented system are all essential for productive investment," says Eswar Prasad, a senior fellow at the Brookings Institution in Washington.

Not one of these ingredients currently exists, making Beijing's aggressive attempts to support stocks futile, at best. The government may have the power to stabilize the market in the short run. But if Xi doesn't change the kind of corporate behavior so graphically on display this year -- even by those locked away in a prison cell -- he's courting even more uncertainty and selling pressure in the future.

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