China Watch

A China Business Report prepared by David Mahon
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Autumn 2023

Excessive meanness is sure to lead to great expense;
Hoarding is sure to lead to great loss.
Know contentment and you will not suffer disgrace;
Know when to stop and you will avoid danger.
You can then endure.

Lao Zi, 5th century BCE

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Wounded colossus

China is entering a period of change as great as any since its economic and social reforms began. The economy's expansion over the last four decades has slowed due to the partial closure of the economy under COVID, the estimated USD 50 billion pandemic health cost, and longstanding structural and fiscal flaws. Washington's sanctions are also breaking China's economic stride. Citing largely spurious security concerns and in violation of WTO rules, the US is expanding its restrictions on American companies exporting advanced technology to China, and on some Chinese tech firms' ability to trade globally.

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This is not the end of China's economic rise, nor is it the beginning of a steep decline. The situation in certain sectors — particularly real estate — is dire, but they will recover, although not to heady pre-COVID growth rates. China cannot afford the wasteful real estate booms of the past. While urbanisation will continue to drive growth for at least another decade, the housing sector will no longer be left to the whims of corporate giants that grew accustomed to speculating with prospective home owners' deposits and gambling with easy bank loans.

Restraint

The Chinese Government has been trying to curtail profligate property giants for the last four years, instructing state banks to restrict credit, which drove Evergrande into bankruptcy and more recently sent Country Garden staggering toward insolvency. These policies have pitched the sector into its first decline in decades, which has in turn driven down growth in a range of related industries and dampened consumer confidence, slowing the wider economy with it. It has not taken much to destabilise some property companies, whose founders and managers had been misleading and looting shareholders for decades, abetted by sycophantic bank managers, hungry for the crumbs of corruption flicked their way.

The state has the means to both prevent the collapse of the wider property sector and lift it out of its stagnation, but has been cautious in intervening too heavily thus far. In April, the government lowered second mortgage deposit and general interest rates, sparking a brief recovery of confidence, and it will certainly undertake more measures before the end of the year, for the April rebound was shallow and short lived.

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There is already evidence of a revival of market activity in a few second and third tier cities. Property companies in Jiaxing, a city of 5.5 million people in Zhejiang Province, discounted apartment prices steeply in July, ignoring local government prohibitions on doing so for fear of alarming existing owners, in particular those who had signed contracts and paid deposits, only to see later buyers being offered discounts in the same unfinished projects. The practice of letting truer market values define prices has spread to Ningbo, Hangzhou and other cities in Zhejiang — a province with a history of being a harbinger of change, largely due to its mature, entrepreneurial private sector and business-savvy officials.

Slow lane

The Chinese automobile sector is a microcosm of the wider economy. As demand for private vehicles grew exponentially at the turn of the century, provinces, and cities within provinces, competed with each other to produce affordable cars and SUVs. Following the patterns of other key sectors, such as whiteware, electronics, and processed food, both SOEs and private automobile businesses expanded quickly, all

believing that they would prevail, even as supply threatened to exceed demand and prices fell.

This trend has seldom been as evident as in the electric vehicle sector. The government continues to support EV companies and subsidise consumers, while building battery charging infrastructure throughout China, well ahead of demand. It is paying off, despite a flat market today, in that of all vehicles in China 30% are either electric or hybrid, compared to 10% in Europe and 7% in the US. The once heavily polluted skies in major Chinese cities have cleared markedly, and non-fossil fuel sources account for 50% of national installed energy capacity. This rapid expansion has driven innovation to the point that out of the 150 or so major EV companies, winners such as BYD are exporting to Southeast Asian nations and Russia. BYD's total sales have surpassed those of BMW and Mercedes Benz.

The pace of development has been so swift that many earlier EV models have become unfashionable and technologically obsolete within a few years of being launched. Fields of unwanted EVs can be seen outside major cities. In time, these will be recycled, but a majority of smaller EV manufacturers will eventually go bankrupt, or be acquired by more advanced, successful competitors. China is already a clear world leader in the EV sector.

Consumers are waiting for apartment and auto price wars to abate before spending again. Once these sectors bottom out and prices begin to rise, consumers will hasten to buy while assets are still relatively cheap, creating a virtuous cycle of a recovery of confidence and economic growth. The question for investors is not so much whether or not the market will regain its lost momentum, but whether or not the Chinese Government will use the slowdown to correct structural weaknesses in the economy.

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Reckoning

If rising tides lift all boats, receding tides expose all hulks. The current economic downturn is exposing long-neglected fiscal flaws, particularly Beijing's practice of taking the bulk of provincial taxes into its coffers, forcing cities to sell land to private industrial and residential projects in order to raise municipal capital — thereby creating property

surpluses. Over the last three years Beijing restricted the freedom of local governments to redesignate rural land in order to boost agricultural output, resulting in many key provinces and municipalities struggling to raise funds and even facing insolvency. In many instances, the situation is so serious that local governments have cut salaries by as much as 50% and then delayed payments by as much as six months.

Beijing may deploy its considerable reserves to increase the pace of economic growth and help spur recovery, but if it does not allow provincial governments to retain more taxes and finance themselves, future economic crises will have the potential to stall the economy for longer and longer periods, leading to a patchwork of regional recessions across the country.

There are a number of obvious changes Beijing can make now to lift confidence and increase consumption while it takes more time to consider the deeper, structural problems of the economy.

Liberating the private sector

Beijing needs to empower the private sector more than it has to date to enjoy the economic benefits of lasting consumer and investor confidence. Apart from undertaking structural economic reforms, the government must continue to fight the corruption of officials and executives in companies of scale, whether private or state owned. Corruption sucks sorely needed cash out of circulation and often hidden skilfully. It also crushes the morale of ordinary working people and entrepreneurs, particularly those running small and medium-sized enterprises in less developed regions. If the government does not crack down on graft harder, it will face rising social unrest. President Xi's ten-year anti-corruption campaign has reduced corruption in first-tier coastal cities significantly, but it has yet to penetrate the rest of the country sufficiently.

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In the absence of an electoral process, the Party's survival depends on the tacit support of the people, which is now being sorely tested. It is not so much that Beijing's leaders fear that the mandate of heaven may be withdrawn suddenly, as ancient emperors once feared the consequences of losing the masses' support. But some in the Party

realise it has too often taken the people's uncommon endurance and patience for granted, and that these have already been sorely depleted in the last few years.

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If Beijing divested itself of some of its industrial and service sector interests, it could stoke an enduring period of economic growth and de-risk vital parts of the economy. It does not need to embark on a programme of full privatisation, but must mitigate the unfair advantages enjoyed by SOEs over private companies, and create a more level playing field. State-owned enterprises constitute 40% of China's USD 16 trillion GDP, yet they deliver poor returns. One dollar invested in the state sector yields less than half the return of the same dollar if invested in the private sector. Many SOEs would not survive were it not for preferential government policies, which allow them unfair competitive advantages, motivates them to create over-capacity, while often blindly expanding market share and deflating what would otherwise be healthy sectors. By indicators such as employment, profit and tax generation, and innovation, the private sector now constitutes 80% of the Chinese economy.

Blocked capital

If the government spent more on public health, pensions, and general welfare it would allow householders to feel freer to consume and invest, as opposed to save. This would be better than offering coupons to the Chinese middle class to buy more expensive consumer items and renovate their homes.

Chinese households save on average 40% of what they earn to cover the cost of health care, retirement, and increasingly, education (although education is supposed to be free). Household consumption, while increasing over the last decade, is still only 40% of GDP, compared to 60% in most developed countries. With so much development still needed in China, state investment will remain the major contributor to GDP growth for many years to come, but this should be counterbalanced more by consumption and private investment.

The developed Western world 'bounced' back after COVID due to significant stimulus, creating many of the inflationary forces with

which it now struggles. Beijing did not resort to widespread quantitative easing as it had in past economic downturns, with the intention of letting the economy pay its own way to recovery as much as possible. While tough, without facing election cycles as Western governments do, Beijing knows this is the surest way to ensure the economy recovers steadily without creating unmanageable clusters of bad loans.

Foreign critics miss the fact that China's unique flux of state and private endeavour over the last three decades have resulted in the greatest and most rapid creation of sovereign and individual wealth in human history. Over this period the efforts of the Chinese Government, the Party, and the masses striving to improve their lives lifted over half a billion people out of poverty. China cannot, and does not intend to now embrace full laissez-faire capitalism. It learned from the damage Western policymakers inflicted on their own societies by allowing unfettered business practices in pursuit of short-term profits. But China must now facilitate a better balance between state and non-state economic endeavours.

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The fundamentalists among Chinese policy makers have taken China's private sector for granted in their attempts to preserve state-owned interests and state power, but Western analysts too seldom consider the contradictions of their own systems before they judge China. As Washington and Brussels rail against Chinese imbalances and protectionism, they fail to acknowledge that their economies are fortresses crenelated with tariffs and swingeing regulatory requirements, denying global free trade.

External forces

US measures to contain Chinese competitiveness, particularly in technology, violate World Trade Organisation rules and threaten global prosperity and economic stability, but they have been effective. Between June 2022 and June 2023, US imports from China fell by an alarming 29%, having already dropped 19% in 2021.

In the early 1990s, Washington forced Tokyo to increase the value of the Yen to prevent Japanese technology firms competing with US companies. Japan languished in stagnation for 30 years, from which it has only just begun to recover. Unlike Japan, China does not depend on

the US for its regional security, and is seeking ardently to expand its Asian, South American and African markets. Once the war in Ukraine concludes or is suspended by a truce, Washington's leverage over Europe will weaken and Chinese-EU bilateral trade will recover. The Chinese people sense the existential threat of US containment, and this is contributing to their reticence to consume and invest. But their confidence will return as they see the acceleration of domestic technological innovation, particularly in computer chip production.

This year, China is likely to achieve just below or above 5% GDP growth, and many of the seeds of the country's economic revival have already been sown. Beijing policymakers know what they are doing, but only to an extent. Throughout China's reform era, the dynamism of the aspiring and originally relatively poor Chinese people has driven development, often superintended by slightly baffled officials. It is no different now. Foreign and domestic Chinese investors have for the most part overestimated the depth of China's economic problems, and many may miss the strength of the coming rally. ☯