

China Watch

A China Business Report prepared by David Mahon,
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S P R I N G 2 0 1 6

*The Sage has no hard and fast ideas,
but he shares the ideas of the people
and makes them his own.*

Laozi, fifth century BC

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The mask of state

China's National People's Congress (NPC) meets in Beijing each spring in the Great Hall of the People. The few token, non-Han Chinese in ethnic clothing stand out among the thousands of dark-suited delegates. The meetings are long and stilted and, despite the red communist livery, reminiscent of the rituals of the imperial Chinese court. Leaders propose preagreed policies and objectives which are confirmed with delegates' hands raised in unison. Foreign diplomats and correspondents watch from a remote balcony, trying to detect signs of new trends in the stoical speeches, and senior officials give contained press conferences after each session, answering the preapproved questions of vetted journalists. It is understandable that Western observers dub the forum a 'rubber stamp' parliament, convened by the Chinese Communist Party to create the illusion of a participatory political system.

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the People's Bank of China. The People's Liberation Army, while operationally obedient to the Party, lobbies hard each year for more resources and for the tools of its modernisation. The four state-owned banks respond to the government's instructions to meet these diverse demands by making available loans and policy-related allocations of capital that often do not appear to make much economic sense, but these are sometimes social and political necessities. The unity and stability of

China depends to a degree on the centre meeting the demands of the key interest groups in the country, whether they be industrial sectors or powerful cities and provinces. Over the last 12 months, this political contract has been one reason that noncorporate debt — which includes local governments' direct borrowing and indirect exposure through pseudo-commercial vehicles — has ballooned on the balance sheets of the banks, much to the alarm of key managers and strategists in the Chinese banking system. It is an expression of the present limits of the Party's power.

In order to implement political control across the country as the economy has expanded, the government has had to become increasingly flexible in implementing its economic policy. The Party and government structures are strong, but the constant tug of war, as each part of China haggles for its

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share of the national budget and seeks to secure exceptions and leniency in respect of national policies and regulations, keeps the centre under considerable pressure. The importance of recognising economic interests while balancing the need to maintain relative obedience means that, despite the lack of formal opposition in China's one-party state, no leader or coterie of leaders has ultimate power.

The NPC used to be little more than a ritual, but it has changed due to the complex nature of today's economy and more open society. In my father's day, ideology was the focus but now it is about managing the market and dealing with public expectations. A great deal of negotiation goes on before the congress, and delegates petition the leadership and then air their views through social media during the meeting. The leadership must listen to the delegates, and if something important and popular cannot be dealt with at the time, chances are it will be on the next meeting's agenda. Social media means that each year the NPC is a more public forum.

NPC delegate

The fetters of office

The popular, relentless anticorruption campaign demonstrates the breadth of Xi Jinping's political power, unparalleled in China's reform era. Xi is attacking the conspicuous wealth and flaunted privilege of officials that corroded public morale for decades. This respected but deeply conservative leader has also tightened social policy, partly controlling China's public narrative by urging patriotism and reviving communist political ritual and ceremony, while censoring and blocking undesirable internet sites and influencing traditional and social media. The perception outside China is that the Party is managing the thinking of ordinary

Chinese citizens and their access to information to a totalitarian degree. But with hundreds of millions of Chinese people accessing the messaging and social network app WeChat, Chinese Twitter-equivalent Weibo and other social media platforms predominantly on their smartphones, there is a broad subculture of dissemination of information and debate that China's censors cannot control. In this environment of greater grassroots transparency, as the power of Xi's political administration has grown, so too has the power of the Chinese people to supervise their government.

In an article published in January, Minister of Finance Lou Jiwei suggested that the state reduce medical subsidies to retirees in order to improve the sustainability of the state pension system. Via WeChat, an ensuing storm of tens of millions of people decrying the idea forced the Ministry of Finance to rescind the proposal.

The government is conflicted between wanting to prevent people from organising politically online and wanting the conversations to continue so that they can be aware of what the people are thinking. I think the fact that people can vent their frustrations in this virtual fashion lowers the chances of their taking to the streets.

Chinese security official

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In February Xi visited key state media outlets in Beijing and demanded greater patriotism and obedience from China's journalists. The media may have been bowed and many journalists will think more carefully about content in the future, but a growing liberal spirit was not broken: within hours, key journalists were deriding this direct influence through articles posted anonymously on social media. The extent to which Xi appears to be trying to guide social issues and attitudes could be

considered not so much an expression of his power, but the expression of a leader confronting the limits of his power. Social management is in some respects an easier task in China than dealing with the compromises and demands of interest groups while maintaining balanced economic growth.

Pampering the provinces

While the government is increasing China's domestic debt to placate strong interest groups and to maintain political stability, it appears that the primary motive behind the current stimulus is an attempt to lift growth. Xi Jinping is allowing the banking system to resume funding infrastructure and real estate projects. The increase in new property construction of 27% year-on-year in March, combined with the relaxing of deposit and credit standards of purchasers, has had a marked effect, but the government is taking hollow, short-term economic gains at the price of

medium-term rationalisation in a vital sector. The surge in new starts in the property sector will add significantly to top-line GDP growth in 2016, but it is likely to abate toward the end of the year as investors question the quality of their returns. As slow as the development of private sector banking may be, the banks are at last offering an increasing selection of wealth-management products that are attracting some investors away from real estate speculation.

Banks often bend to the wishes of local party bosses and administrators and make poor loan decisions. The continuation of the current trend for another three years could have potentially catastrophic effects on the domestic financial sector. Nevertheless, it is unlikely that the government would allow noncommercial debt to grow to the point where the banks would run out of cash. Global analysts who misunderstand the potential for swift policy shifts in China are now issuing forecasts on the assumption that the trend is irreversible.

The problem in creating economic forecasts for China is that analysts tend to measure the economy against free market principles they consider immutable. Exceptionalism is a poor excuse for the management blunders and policy mistakes that Beijing frequently makes, but it is equally unreasonable to underestimate the extent to which China differs from other developing markets of scale and to discount China's proven potential to derive growth from the dynamic economic and social transition that continues to take place within its huge population. The majority (60%) of China's 1.4 billion people still live in relative poverty, and their struggle to better themselves continues to drive urbanisation and ultimately the

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expansion of the middle class. Any assessment of the direction of the economy must also take into account the fact that in China, policy may change suddenly. Financial sector policy has been and remains an ongoing experiment, and over the past two decades few harmful major trends have continued for longer than a year or 18 months before policies were amended.

President Xi knows that the Party will only survive if the economy is strong and so will be doing all he can to implement sensible policies. He is more powerful than his last two predecessors, and we need him to be. Perhaps those around him want to flatter him and so you see him frequently in the media and his face on posters, but few of my friends think that he is trying to develop a personality cult as Mao did. As a teenager in the Cultural Revolution, Xi's family was purged and he lived in poverty, working alongside farmers and living in a cave. Despite the fact he is the son of a powerful leader himself, he understands the struggle of ordinary people. He and his wife are popular and appear to live plainly compared to some other leaders.

As long as he fights corruption and we can earn and save in safety, most people will support Xi. I don't mind too much that the Internet is restricted and social media may be monitored. I am focused on my family and running my business.

Beijing restaurant owner

A number of Western politicians share a vested interest in seeing the system built by the Chinese Communist Party replaced by a more Western political and economic system. As the fall of communism in the Soviet Union proved the sustainability of capitalism and Western democracy over a command nonmarket system, many in the West are now looking for China's one-party authoritarian state to falter in order to boost flagging Western confidence. Accusations that Xi Jinping is accumulating too much power will become common as Western observers watch through the cracked lenses of their own increasingly distorted democratic, social, and economic systems.

Xi is unlikely to overstep the pre-established bounds of his role to the point that he destabilises China's political culture. In the name of social stability, the Party has always over-reacted to criticism, jailing dissidents and critics on often the slimmest of pretexts, often out of instinctive insecurity. Xi does not seem insecure, but the price of expressing dissent publicly in China today is still high, as some journalists and lawyers, many of whom have simply pointed out obvious faults in the administration, have found to their cost.

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The rule of law in China has nevertheless evolved at an extraordinary rate over the last decade. As many as 90% of copyright cases that foreign companies have brought to Chinese courts in the past year have resulted in judgements in favour of the plaintiffs. The process is faster than those in the United Kingdom and the United States. Civil law lags behind, but the public injustices that come to

the attention of the Western media obscure the fact that arrests are usually only made after solid evidence has been gathered. The judiciary, while not independent of the Party, has been emboldened by the anticorruption campaign, and is increasingly resistant to political coercion.

Xi is genuinely intent on taking on some of the deepest flaws in the Chinese system and standing up to regional coercion of China from abroad. Some of his strategies, such as building military bases on the rocks and reefs of the South China Sea, can be perceived as too polarising, driving countries in the region to spend inordinately on defence. But China's argument is that it is simply responding to a continued American military presence in the region that is bent on containing China's influence, and to the militarisation of Japan. Xi Jinping is playing a traditional authoritarian

role in an inherently hierarchical society. In such a diverse, populous country, many of his citizens expect him to be a strong political father-figure, confronting those in local government that abuse the system and challenging those nations that exploited China in the past.

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At a meeting of the Party Congress earlier this year, the announcement that the government would focus on restructuring nonperforming industries was puzzling, for industrial underperformance and corporate debt do not pose serious short- or even medium-term risks. Only a handful of the 170 or so

sectors that make up the Chinese economy are in trouble. Shipbuilding, steel, nonferrous metals, coal mining, heat generation, and plate glass manufacturing are enduring the inevitable consequences of an economy moving away from heavy industrial production to services and consumption. Although large employers, these weaker industrial sectors make up less than 14% of the economy. The rest of the industrial and service sectors are largely profitable with manageable debt levels. The state owns many companies in the underperforming industrial sectors and so it is relatively easier to intervene and show results in this area than to challenge provincial leaders who continue to borrow money to beautify their cities and build grand airports and railway stations.

We have few businesses facing bankruptcy here. We have encouraged the banks to help some that employ large numbers of workers in sectors such as low-end manufacturing of iron and steel components to keep their doors open until deals may be arranged for stronger companies to acquire the assets and integrate the businesses. Or the weaker businesses can be closed over time.

Provincial Commercial and Industrial Bureau official
in Jiangsu Province

Generation gap

If the Chinese Government faced tighter financial circumstances, as it did in the 1990s, it would be taking on the harder task of reducing wasteful infrastructure and real estate projects out of necessity. The coffers are full. Foreign exchange reserves of USD 3.2 trillion, combined with an aggregate personal savings rate of 50%, will take years to deplete, and it would be better to use these riches as a base for more radical financial reform now rather than a resource to repair flaws later. The Chinese economy is presently not as exposed to defaults and credit crises as most other emerging and even developed markets. China does not have the obligations to foreign creditors that Asian countries did during the Asian Financial Crisis in 1997. China is indebted, uniquely, to its own financial system, with total exposure to foreign creditors of no more than 15% of GDP. Too accustomed to the economics of endurance and gradual social

development, the Chinese Government has a tendency to squander valuable resources on maintaining the status quo rather than facilitating urgently needed change.

The Chinese Government struggles with the consequences of deep income disparity, but it also wrestles with a significant generation gap. Many of today's citizens born after the 1980s, having lived in an era of material improvement and social stability, are making decisions as businesspeople, entrepreneurs, and consumers with more confidence than their parents' generation. They do not share the conservative values of those who grew up in the 1970s and 1980s in a climate of anxiety and insecurity.

I have wondered at what point social change in China will reach such a pace that the Party will be unable to adapt. They probably thought they would not face the present challenges until the middle class was large enough to demand more political participation, in 10 or 20 years' time. Now anyone with a phone and an opinion or a grievance may be a source of pressure as they congregate in cyberspace to share their frustration and criticise the government. The new generation of workers expect to improve their lives as their parents have over the last 20 years.

Retired official

Xi Jinping will lead China for six more years. He is not trying to take China back to the days of communist political and economic orthodoxy. Xi has demonstrated throughout his career that he believes in market forces, particularly as Party Secretary of Zhejiang Province. It is 50 years since Mao launched the destructive Cultural Revolution in an attempt to avoid a backlash from the Great Leap Forward, in which tens of millions of people died in man-made famines. There is no evidence that the political madness of those campaigns could happen today. Xi is no Mao, and China remains in a progressive phase. The collective social aspirations that have driven the development of China have created an environment of high expectations and frustration. Each new generation of officials must take more progressive approaches to managing society and the increasingly difficult task of preserving the one-party state. Today's leaders would do well to acknowledge and harness change rather than resist it. ☺