

# China Watch

A China Business Report prepared by David Mahon  
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S p r i n g 2 0 2 3

*A certain military commander used to say:  
'I dare not act the host; I prefer to play the guest.  
I dare not advance an inch; I prefer to retreat a foot.'*

Lao Zi, 5th century BCE

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## China returns to work

The Chinese economy is recovering and will continue to expand this year, probably exceeding the government's annual GDP growth target of 5%. Public scepticism of the leadership's motives and management capabilities over the last 12 months seem to have abated somewhat as

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the day-to-day demands of work and family preoccupy households. Yet few will forget the debacles of Beijing's stringent zero-COVID policies, and the surprise reversal of all restrictions last December.

One week the government demanded complete obedience to zero-COVID on the basis that Omicron was lethal, and the next, entreated people to return to 'normal', saying Omicron was simply an unusually contagious but mild flu. There were two reasons for this.

*The protests shocked the government, not because they were seen as an immediate threat to public order, but because officials knew what measures would be needed to suppress them. And the protests were spontaneous: the most dangerous kind, without a head or centre. The risk was they could pop up anywhere, or everywhere. Then came the bad news on the economy. The leadership had no choice.*

Senior Beijing trade official

The countryside appears to have fared better than the cities, confounding public health authorities' and the World Health Organisation's anxious forecasts. Perhaps rural people's immune systems were more robust than those of their city-dwelling relatives.

*We visited 15 counties in Hunan and across Yunnan province during the peak of Omicron infections and in the weeks afterwards, and saw less impact than we expected. Farmers told us there had been little serious illness and few deaths. The thing that struck us most was how much people had returned to work in general, not just in the fields but in the factories we passed.*

Chinese horticultural manager

The Chinese economy will recover this year to the extent that it will regain a measure of multinational investor and domestic consumer confidence, but this short-term recovery risks masking the medium to long-term economic challenges Beijing faces. The Chinese Government will have to show it can manage hard times better than it did during the end of the pandemic. It would be wise to improve its communication with citizens and acknowledge its mistakes, in order to regain a degree of public trust and win deeper consumer confidence.

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This would help people to spend and invest without fear. But contrition is hard for any government to express, let alone an authoritarian one that would rather rewrite the narratives of the immediate past to avoid facing them.

China must maintain strong domestic consumption and investment if it is to weather the exterior pressures of global inflation and US attempts to sever economic ties and contain it. Some in Washington and Brussels quietly believe they can affect regime change in Beijing through sanctions and technological containment, despite recent historical evidence that these measures seldom work, and usually backfire. China can maintain relative prosperity over the next three-to-five years despite Western disdain and distrust, but it needs to be inwardly strong, and this requires the confidence of its citizens. There are acute economic problems that the government must face, which will either demonstrate it can recover the public's trust, or dissipate it further.

## Solvency

The Chinese Government will need to be firm with municipalities and counties that borrowed heavily over the last two years to mitigate their tax losses during COVID and pay for the costs of complying with public health requirements. Ten years ago, local governments would have borrowed cash relatively easily from one of the four state-owned banks, or converted agricultural land to industrial and residential purposes, generating considerable revenues. Beijing has been reluctant to allow regional administrations to borrow as liberally as they once did, and so an explosion of bank debt in poorer jurisdictions this year is

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unlikely. Local governments are also now forbidden to convert good agricultural land to other purposes, as China needs to maximise yields and remain as self-sufficient in food production as it can. Local governments will instead issue new bonds in the coming months, adding to the RMB 4

trillion accrued value of bonds by the end of 2022. China is the world's largest bond market.

While this attempt to rebuild beleaguered local balance sheets makes sense, the bonds may not be met with great enthusiasm by foreign investors, especially when compared with returns from similar financial instruments in other recovering economies. Foreign investors may prefer equities as recent reforms make it easier for Chinese (particularly private) companies to list and China's bourses become more attractive.

## Tax

As private-sector manufacturing recovers profitability throughout the year, local tax revenues will increase. China still taxes its companies excessively, for as with many developing countries it struggles to implement an efficient, broad personal tax system. Arbitrarily imposed taxes and fee increases pose a risk to the profitability of all types of enterprises in China, as strained local administrations grasp for ways to improve their finances. The government will need to manage, and at times curtail these more subtle excesses if it is to win back public and business confidence.

*I have just returned from my first business trip outside China for three years. I was surprised how negative people were about China. I don't know the country they are talking about. I have no doubt the economy will recover this year. We are already seeing it in strong consumer demand. Be careful not to link domestic politics with the economy too much. Our economy is its own force.*

Leading Chinese food importer

## Diplomacy

The United States may face deep divisions in its domestic politics, but it is unified in fearing China and taking measures to confront and slow its imaginary enemy's economic rise. Whether it is Secretary of State Blinken announcing that China will soon sell arms to Russia (against clear evidence that it has not and would fail to benefit from doing so), or FBI Director Christopher Wray announcing the COVID-19 pandemic was likely the result of a lab leak (without producing new evidence against scientific consensus that it was more likely zoonotic), it is clear that propaganda has replaced most diplomatic dialogue between Washington and Beijing. China is not blameless, for most prime-time Chinese TV news bulletins end with negative stories about the US, often factual, but usually out of any context.

*There are no optimists in the American Embassy and few among Washington based China watchers. It has never been so bad.*

US businessman in Shanghai

***Although China and the US are not facing imminent military conflict... statements from Washington are being heard around the world as the drums of war...***

Although China and the US are not facing imminent military conflict, such statements from Washington are being heard around the world as the drums of war, and the intervals between the beats seem to be getting shorter. Unhelpfully, China seldom responds to these taunts in a measured manner, but rather

reacts with such intensity that it more often reinforces spurious US claims rather than deflecting them.

Beijing miscalculated that US preoccupation with the Russia-Ukraine war would mean that Washington would have less time and fewer resources to focus on containing China; this may have contributed to China lending Moscow tacit support by not condemning the war. Washington has nevertheless increased pressure on China relentlessly.

It is possible that the US will escalate its confrontations with China in the future. This is unlikely to be over Taiwan, for the strategic risks for both sides are currently too great and unquantifiable. Minor regional naval or air clashes are not impossible, but more likely to be the result of miscalculations than deliberate.

In the short term, the best hope to inspire Washington's restraint will be the undeniable recovery of the Chinese domestic economy and the impact this will have on global economic recovery. Foreign visitors will return to China, albeit at a slower pace than before the pandemic, and this will be led by the return of businesses. Multinational businesspeople are typically politically agnostic, and focused more on commercial success than nationalism. Nearly all global firms have a presence and business interests in China, and many continue to see China as core to their success, despite media reports that they are diversifying away. History shows us that while competing interests can lead to wars if they are left unmanaged, economic self-interest has often been a strong force for preventing conflicts. ☯