China Watch

A China Business Report prepared by David Mahon
and the partners of Mahon China Investment Management Ltd

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He who, conscious of being strong, is content to be weak,
Shall be the paragon of mankind.
Virtue will never desert him.
He returns to the state of a little child.

Lao Zi, 5th century BCE

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A gradual recovery

The Chinese economy is recovering slower than forecast. Assumptions that consumers would spend as freely as they did before the pandemic within months of zero-COVID rules being abandoned were always unrealistic, yet few expected consumption to be so sluggish at the end of the second quarter of this year.

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Many Chinese consumers have not recovered from the clumsy, opaque manner in which Beijing handled COVID restrictions last year. Until they regain a level of trust in their government, these consumers will struggle to have confidence in the stability of the economy.

> *All governments make mistakes, and this one made a big mistake in trying to manage Omicron too tightly, when evidence from around the world was that it was impossible to control. But the government has achieved difficult things in the last twenty years, like lifting millions out of poverty and growing the economy by many multiples. The anti-corruption campaign seemed an impossible task, but they achieved a lot. They even broke the power of the Chinese mafia. China is more stable now than at any time in my life. I know they will get the economy going again as consumer confidence will come back naturally.*
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> Retired Chinese economist

Economic indicators in real estate, foreign trade, and services are improving, and the continued recovery of productivity and rise in middle-class salaries and general consumption will lead consumer sentiment to improve too. Over the last decade, Chinese average per capita income rose 6.2% per annum, compared to 1.4% in the US and 1% in the UK. China's economic recovery will come later than the more bullish economists have forecast, but it will come, for while national morale may be temporarily weak, underlying demand is strong.

The Chinese economy is likely to exceed the 5% GDP growth target set by the government this year, driven by a recovery of exports (albeit modest), flexible credit policies, and government investment. General consumption is already a palpable driver. Distributors of fresh produce are expecting the trend of the last two years of revenue growth in excess of 25% to continue, and probably exceed 30% this year. In April, reflecting post-COVID demand in the health and fitness sector, sporting-goods sales reached 174% of April 2019 levels, gym attendances recovered, and although the key gym chains are investing cautiously, they will likely expand strongly in 2024. Cosmetics sales reached 132% of April 2019 figures, and gold and jewellery 124%. A recovery in the property sector is key, and once the first-tier cities show stronger sales growth, lower-tier cities tend to follow.

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Thus far, the Chinese Government has relied less on quantitative easing to drive economic growth than its Western counterparts at similar stages of their post-COVID doldrums, but if growth does not pick up by the end of the third quarter, Beijing is likely to stimulate the real estate sector further. Lowering bank deposit rates in mid-June to dissuade excessive household saving and dropping lending rates to encourage SMEs to invest will have an impact in the next quarter.

It appears Beijing has chosen to let market forces arbitrate value even in the face of weak consumer confidence in the property sector. The Chinese Government has considerable financial means to intervene more comprehensibly if needed. Crucially it is not as impatient as international investors for its economy to regain momentum. After five years deleveraging the economy and rebalancing the major banks, Beijing is wary of mortgaging financial stability for short-term growth. There are also still serious flaws in China's banking system, especially among the smaller local banks, which excessive widespread stimulus would only exacerbate.

Structural flaws

Three years of COVID restrictions have stressed and exposed structural weaknesses among the smaller banks and lending institutions. These may not derail China's economic recovery now, but left unattended, will prevent China from realising its full potential over the next five to ten years. Observers tend to focus on the fortunes of larger state-owned banks and asset management companies as indicators of the sector's stability. These are currently in good shape, but many of the smaller municipal and rural banks are not.

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Throughout the pandemic years, the central government encouraged smaller banks to relax their usually strict collateral requirements when lending to SMEs. This supported China's general economic endurance, and avoided widespread unemployment, but now many SMEs cannot repay those loans, so the government has instructed some banks to suspend SME interest and principal payments, sometimes for several years. This is difficult for most smaller banks which now face dramatic drops in earnings and will have less money to lend to good businesses.

> *Our restaurant survived, but we had no way to fund our recovery after COVID. The bank has suspended our restaurant's repayments, but I already personally guaranteed some of the loans. The restaurant is actually bankrupt, but we are not allowed to shut it down. I still owe the bank so that is why I am driving you today. I may just hang onto my house.*
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> Shandong ride-sharing driver

Some debt-burdened banks will stagger but few will be allowed to fall. Local governments will go to great lengths to avoid bank failures for fear that they will start waves of instability in the municipal and rural banking sectors. Higher than usual turnover this year of leaders of local banks and finance companies is an indication that reforms are under way. It is one thing to restructure bank balance sheets, but quite another to challenge deeply embedded social privileges, such as residency in first-tier cities.

The urban elite

By the mid-1990s, urbanisation drove the Chinese economy, helping to deliver high GDP growth often exceeding 9%. Urbanisation has slowed in the last ten years, due in part to China's outdated residency (hukou) policies, and this has contributed to slowing growth. Even authoritarian governments have some constituencies that make them more anxious than others. The Chinese Government defers frequently to the now-sizeable urban middle class, which is possessive of its privileges, and frequently expresses its discomfort with internal migration.

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> *Urbanisation is primarily responsible for China's economic success, even more so than the Party's or Deng Xiaoping's leadership, or the boom years of foreign trade. The urban middle class are now blocking migrant workers from settling into cities, and yet these people are the resources that will ensure everyone's future prosperity. City-dwellers mistakenly think migrants will undermine what they have gained. This is not unique to China; it is the insecurity of the middle class globally.*
>
> Retired Chinese economist

China's residential policies favour those born to urban parents or migrants who have qualified for residency due to exceptional educational or vocational accomplishments, but discriminate against those who have migrated from the China's poorer provinces to, in particular, first-tier cities. Internal migrants, who now constitute 30-40% of inhabitants of coastal first-tier cities, are vital to these economies, yet do not receive the same access to education, health and housing as native residents. They therefore save inordinate amounts of their incomes to pay for these services.

If Beijing could mandate that first-tier cities relax their residency rules gradually to allow internal migrants a share of the benefits and services enjoyed by existing residents, those migrants would invest and spend more, adding profound stimuli to their cities' and ultimately the national economy. In the resource and network-rich first-tier cities, such migrants are often 30% more productive than they would be in third- or lower-tier cities. City governments would resent the burden on their already taxed health and education services, but the net social gain would be greater than any short-term municipal pain.

Many second- and third-tier cities have relaxed residency requirements to boost growth. This suggests that some leaders already recognise that allowing urban populations greater flexibility to live where they wish in pursuit of greater opportunities is ultimately worth it, despite the cost to upgrade services. The central government is unlikely to change this situation soon however. Beijing may be capable of acting swiftly in the midst of crises compared to more developed economies, but as it demonstrated with the one-child policy and its zero-COVID measures, it can be agonisingly slow in rescinding them even when they become obstructive.

War footing

China's economic recovery will benefit the beleaguered global economy, and by 2024 China will account once more for between one third and half of global trade. China's trade with the ASEAN nations is already greater than US-EU trade. Perversely, the recovery of consumer confidence in China is taking place in a worsening geopolitical environment. Washington's determination to isolate China has ceased to be the wish of a few, and become a dangerous political reality seemingly supported by a majority of US politicians. Meanwhile, China is maintaining its harder stance against perceived American slights, often to its own detriment.

Washington's policies aimed at containing China diplomatically, economically and technologically are measures a country takes against another it sees as an active, or even existential adversary. The US, which in the aftermath of the Second World War did much to help the global economy recover from destruction and despair, now seems to be working ardently in the opposite direction as it pressures and rallies 'like-minded' allies into potential confrontation with China.

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The US Government's attempts to decouple (or 'de-risk' in more recent language) from China will fail, but in the meantime the world's economy will suffer years of unnecessarily low growth and lost opportunities. The US has already reaped unintended consequences from its strategic attempts to block, or at least slow, China's rise, in that the US is more isolated from the global economy than it was ten years ago, and China is more integrated.

When great powers collide

The US will continue to misperceive China as an enemy it never needed to become. Leaders in Washington spuriously fear a loss of US power and relevance, something that need not eventuate in this or the coming generation. The US will endure as an arbiter of international banking and finance, and the world's strongest military power for a long time to come. But these strengths will realise diminishing returns if it cannot resolve its domestic conflicts within a bruised democracy, and reassess its efforts to preserve its dissolving imperial legacy.

The Iran - Saudi accord China facilitated this year provided observers with a glimpse of the global leadership China could show, rather than its often more reactive stances when dealing with the US. China may yet play a major role in helping to halt hostilities between Russia and Ukraine, despite widespread distrust and scepticism in the West. And China's importance to African and Central Asian development, and Latin America economic growth, will likely increase, for it now has the money that the West once had.

Sensing the extent of its isolation, Beijing appears to be trying to take a more conciliatory regional stance, improving ties with Vietnam and Indonesia, and embarking on a reproachment with Australia after the change of government in Canberra last year. China's defence minister, Gen. Li Shangfu, met his Japanese counterpart in the wings of the Shangri-La Dialogue in Singapore in June, suggesting that tensions regarding the Diaoyu/Senkaku Islands dispute should not define their diplomatic relations in the future.

China should probably aim to become stronger economically without becoming more politically dominant. It depends too much on the global economy to be in simultaneous conflict with its major trading partners. The threat of internal political instability should Xi Jinping fall ill or die without a succession plan remains, although it would be a power and not an ideological struggle, at most disrupting but not overturning the Party's commitment to market forces.

China will continue to be a key driver of global growth and prosperity into the foreseeable future, for the Chinese Communist Party (communist in name only) depends on the market-driven system that presently underpins the economy to meet the growing needs of its population. Most Chinese people see the open market, with a measure of socialist government initiatives', as the best means through which their own aspirations may be fulfilled. ☯