China Watch

A China Business Report prepared by David Mahon, Executive Chairman,
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With waves rising to heaven, those in the boat are not afraid,
but those ashore are greatly alarmed.
When the party becomes quarrelsome, those attending are not upset, but those outside are greatly distressed.
Thus the noble person, while attending to things, must also be mindful of matters outside.
Hong Zicheng, sixteenth century

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The Party rules

Following the chaotic later years of Chairman Mao's reign, it appeared that leadership succession in the Chinese Communist Party could only come about through the death of a leader or a coup d'état. Under Deng Xiaoping's guidance, the Party developed a system of consensus to manage the succession of senior leaders. This system remains in place, despite foreign commentators' concerns regarding President Xi Jinping.

In Autumn 2017, President Xi will indicate the members of the Standing Committee of the Politburo, and hint which of these members is most likely to succeed him as president after he finishes his second five-year term. Whoever is appointed to the post of vice president has the greatest potential to be the next president. In itself, the office of the President of China is ceremonial, only gaining substance when combined with the roles of General Secretary of the Chinese Communist Party and Chairman of the Central Military Commission. These are the three positions held presently by President Xi. Observers will also be judging Xi's appointments as an indication of the power that he wields. Xi will demonstrate that he has consolidated considerable power if the vice president role and other top posts are filled by his close allies rather than compromise choices.

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Some China watchers in the West are speculating that Xi may delay anointing a potential successor, either because he is so powerful that he does not have to show his hand, or because factional fighting will prevent him from elevating an ally. Both reasons are possible, but Xi is unlikely to depart from custom. He may have taken more direct responsibility for setting political and economic policy than any Chinese leader since Mao, thereby increasing his personal power, but he relies upon the stability of society that is rooted in the legitimacy of the Party. Xi appears to have enough control of the Party to prevent any anointed successor from diluting his power in his last years in office. The vice president is likely to anyway demonstrate complete obedience to Xi to ensure that there is no chance that Xi may rescind his decision.

Another Western speculation is that Xi may extend his tenure as president beyond his second five-year term and seek a third term, but this too is unlikely. Xi will relinquish his formal roles within a year or two, and gradually lose his influence — a circumstance described by the Chinese as, 'After the guests have left, the tea goes cold.' However, Xi will retain his influence for a time as Deng Xiaoping did, and probably more so than did Jiang Zemin or Hu Jintao. Deng was never president or general party secretary and relinquished his role of Chairman of the Central Military Commission in 1989 shortly after Jiang Zemin became general party secretary, but continued to influence the country's direction. In 1992, Deng's tour of southern China indicated his decisive support for a more open, market-forces-driven China.

A fine balance

The Chinese Government is still struggling with a complex economic transition, although there are signs the economy stabilised in the last quarter driven in part by government stimulus. In recently released third-quarter economic data, China's GDP growth rate remained at 6.7%, while social electricity consumption — a proxy for industrial productivity — increased 4.5% compared with second quarter 2016, and 3.7% compared with third quarter last year. China's producer price index in September increased 0.1% compared with August, the first time this index reflected growth since March 2012. The services sector, now a better barometer for the overall economy, increased in value by 7.6% from third quarter last year to approximately RMB 28 trillion. Despite the generally positive data, it is still too early to say anything definitive about the Chinese economy. But the 'bears' trumpeting China's financial collapse will need to continue their wait, and some are even paying dearly. A hedge fund majority owned by the Carlyle Group, which began at the start of 2016 with half a billion dollars under management betting against the Chinese economy, saw its assets shrink to approximately 125 million by this August.

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While the general manufacturing and service economies are enjoying firm demand and slow but steady growth, banks continue to dispense credit profligately to infrastructure and municipal vanity projects. The debt, accruing largely on government balance sheets that may be absorbed without seriously damaging the wider economy, is still cash drawn from household savings, various state bonds and other instruments held by the financial sector. As substantial as government reserves may be, there are limits. If sustained for two more years at the present rate, this financial largesse could trigger a credit crisis for the banks.

Not all decisions are well considered and at times the government creates new barriers to medium-term economic efficiency in its attempts to meet the perceived need for short-term growth. After restraining the housing sector last year in order to reduce the oversupply of predominantly high-end developments, the government then allowed too many new property projects, thus creating further unwanted surpluses. This move to support the building materials and construction sectors and meet spurious GDP targets caused a dramatic increase in property prices from February to August of this year. Among 70 major cities in China, property prices in 17 cities increased more than 10% (with the highest rising by some 40%), while prices in 15 cities increased by 5-10%. Another 25 cities saw price increases within 5%, and prices dropped in only 13 cities.

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During this period, individual property owners also became more leveraged. For the first three quarters of 2016, individual property loans accounted for 35.7% of total loans. By September, the proportion had increased to 39%. This is likely due in part to the Chinese Government lowering interest rates five times last year; property mortgages are now the only way that individuals can borrow large amounts of money at relatively lower interest rates. Home buyers can pay 20% down payment and borrow the rest.

While the overall scale of property mortgages still lies within a sustainable range, the government has realised that household leverage and speculation on the property market cannot be allowed to continue unchecked, and has started to restrict property loans and re-enforce limitation policies on property purchases in major cities. In October, property prices started to drop again in first-tier and major second-tier cities. Only six among the 15 highest-growth cities saw price increases of more than 2% in early October.

The problems within the property sector relate to the fact that the Chinese Government has always been overly focused on achieving macro GDP targets. Although it would hurt many state-owned industries and create short-term economic and social problems for some provincial governments, China can and must manage lower GDP growth coupled with a measure of austerity in order to sustain the ongoing reform of the economy. The choice the government must make is austerity in the short term or a credit crisis in the medium term. The forces against the government choosing the former are the entrenched provincial and industrial interest groups, but there are signs that difficult decisions are starting to be made. The recent approval of a merger between two of the largest steel companies in the country, Baosteel and Wuhan Iron and Steel (WISCO), came despite insider reports that the managements of the companies objected to the merger. When the government first noted its intention to reduce oversupply in the steel and coal sectors, many commentators speculated that efforts to cut capacity would primarily entail larger firms acquiring smaller ones. If successful the merger of Baosteel and WISCO, influential firms that share largely overlapping businesses, may serve as a template for deeper and more difficult reforms in the future.

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> *We don't expect perfect economic management but we do want the government to be competent. The government does not always know what it is doing and makes mistakes, but we assume that it is not easy balancing many factors: employment, growth, the demands of interest groups and simple economic confidence. Many of us who have some idea how the Party and government work understand that no president can micromanage economic policy, whether it is the stock market or the property market. Actually the economy is the responsibility of the premier, but we hold our own provincial and city officials more responsible for our country's problems. The presence of government in business is both a source of comfort and a frustration. Officials may intervene to avert a crisis but they also interfere in the flexible functioning of the market. I would say that in China, government is too involved in business, and in the United States, through lobbyists and campaign finance, business is too involved in government.*

Chinese industrialist

The central government's approach to dealing with the economy's problems is similar to how a Chinese doctor would approach treating a sick patient. There are always two kinds of treatment available: gentler medicines and harder options, such as surgery. The doctor will always try to solve the problem with gentler medicines first, and observe if the patient gets better. But if the patient takes a turn for the worse and becomes critically unwell, the doctor will immediately begin more invasive procedures. Once the patient begins to recover, the doctor will then turn again to medicines.

Chinese factory manager

China is still in the throes of dynamic industrial, agricultural and social revolutions compressed into fractions of the timeframes experienced during periods of comparable change in the West. Although battered and bruised by a backward financial sector, public confidence remains high. Chinese culture is coping not simply with the last three, eight, or even 30 years of internal evolution and exterior shocks; the struggle has been ongoing for over 100 years. The Chinese people have proven that they are resilient and industrious, just as the government has proven it has the ability to shift direction when required. Per capita GDP has grown from a low in 1962 of USD 130 to approximately USD 8000 in 2015. This aggregate does not reflect the fact that while a significant proportion of the population may be well-off in global terms, the majority are still poor, while national per capita GDP is comparable to countries such as Turkmenistan and the Dominican Republic. In 2015, only 13 of 31 provinces had a per capita GDP higher than the national per capita GDP, a simple expression of the development gap. The per capita GDP of Gansu, the lowest one in China, is only about a quarter of that in Tianjin, the highest in China.

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China has a long way to go before it becomes a fully industrialised urban society, and herein lies the economic and social opportunity. For the wealth of China's coastal cities, while demonstrating middle-class purchasing power, masks the straitened circumstances of many citizens living in third- and fourth-tier cities and in rural China. These people will depend on the Chinese Government to make the difficult decisions necessary to continue economic reform, avoid stagnation, and maintain social stability. The challenge remains of assuring the middle class and those on the threshold of becoming middle class that their assets will be secure, while convincing the majority who are struggling economically day-to-day that their lives will continue to improve. ☯

Reading between the lines

The Chinese economy has been under fluctuating degrees of stress since economic reforms began in the 1980s. Whether during boom times or in periods of slower growth, valuing businesses and assessing sectors has always been hard, and the difficulty is often exacerbated by incomplete or misleading company financial reporting. Resolving disputes is delayed by the slow and at times arbitrary application of commercial law. It is further complicated by the poor-quality contracts commonly signed between foreign institutions and their Chinese counterparts, contracts that are open to conflicting interpretation and suffer from weak enforceability. But more than any other single factor, it is foreign institutions' lack of regular and holistic engagement with their Chinese investees or debtors, together with other local stakeholders including government officials, that has led to a proliferation of stressed assets and non-performing loans (NPLs).

From a foreign manager in a joint venture beverage company:

> *The relationship started well. Our Chinese partners seemed to provide us with the key to the market, and despite the cultural and language differences, the good will we sensed gave us even more assurance than the contracts we signed. We relied on our partners to assess the sector, and the rates of growth they reported were stronger than any we had experienced in our company's history. In any case, anecdotal evidence from our own research indicated that beverages similar to our products were in great demand.*
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> *The first year or so was good and we all made money, while it appeared that we were expanding our market share. We seemed to have oversight of product quality and financial management as outlined in our contract. Before long, our own CEO became enamoured of China and grew intolerant of any views challenging our partners or the strength of the market. The few sceptics on the board at home found themselves marginalised.*
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> *Eighteen months into the partnership things began to go wrong. The joint venture's finances began to show inconsistences, which we first dismissed as the differences between Chinese and international accounting practices. Local employees working closely with the managers we had seconded to the business cautioned that quality standards were slipping because the company was struggling in an increasingly competitive market and felt compelled to cut costs. They warned us that too many business decisions were being made without*

the joint venture board's approval. At first these claims were dismissed by our CEO as signs of disloyalty, and he even allowed the joint venture to fire one of our seconded managers. Our people there could not speak Chinese, and high-level contact with the local business remained infrequent. I now understand that we had no way of really knowing what was going on for months at a time, while our Chinese partners had felt unfairly constrained by us in what they saw as their attempts to adapt to changing circumstances.

As market conditions became worse, arguments between the parties over transparency and decision-making became more frequent. Where there was once good will, now all we seemed to share was frustration and distrust. We eventually commissioned an independent study of the sector and an assessment of the market for our specific product, and found that we had made our investment at the peak of the market, a market that subsequently went into steep decline. Through the study, we also discovered disturbing rumours that the joint venture had borrowed money from other factories and individuals at high interest rates without telling us. We invoked our arbitration clause but the fact that our contract specified a European jurisdiction limited its enforceability, failed to restrain our partner, and only deepened the conflict.

In hindsight, we should have made the effort to understand our sector in China more deeply and undertaken more thorough due diligence on our partner before making the investment. And once we made it, we should have mitigated the inevitable miscommunication that occurs in intercultural joint ventures by putting in place good local staff representing the head office.

It would also have helped if we had formed our own, independent relationships with local officials. Unfortunately, we had to try to form the relationships we needed after the problems with our partner had already arisen, and this hindered our ability to obtain reliable information and gain support for our proposed resolution plans.

We stepped back from our problems, temporarily suspended our foreign arbitration case, and engaged local advisors with experience in resolving these types of issues to help us develop a strategy. They began by approaching the relevant local officials for their advice, and eventually convinced the local government that it would be against their interests to allow a dispute involving a foreign party to potentially bring bad publicity to the county and its investment environment.

With the blessing of the local party secretary, an industrial and commercial bureau deputy-director is now helping to mediate in the dispute with our partner. Our advisors also helped us to find out our partner's other obligations, which included debts to local banks and even local business people and government officials. It is still early *days but our partner now knows that we are not just going to go away, and that all we want is a reasonable resolution that can work for both parties.*

Disputes in joint ventures in China are not uncommon, and the resulting crippling stalemates all too frequent. Foreign investors tend to rely too much on their local partners and fail to play active roles in the governance and operational management of the investee businesses. Without taking into account local circumstances, foreign managers often expect Chinese or joint venture companies to adhere naturally to international management standards. They do not give enough attention to the networks upon which their partners depend and the manner in which most Chinese businesses are forced to navigate the country's often difficult and opaque regulatory and commercial environment. Foreign investors need to regularly survey their own sectors and track competition closely, sharing their findings with their partners and developing the insights to offer concrete solutions. In parallel, the foreign party should maintain constant engagement with its Chinese partner at multiple levels of management, and form its own independent relationships with local government stakeholders.

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The Chinese economy faces some difficult years ahead during which time we will likely see a patchwork of incremental reform and sluggish growth. As hard as it is to invest in China presently, with some sectors weakening and protectionism more common, China remains one of the few markets in the world that offers long-term growth grounded in fundamental social development and a culture of aspiration and industry. ☯