# China Watch

A China Business Report prepared by David Mahon,
Managing Director, Mahon China Investment Management Ltd
W I N T E R 2 0 1 4 - 2 0 1 5

*In hard wind and driving rain, you must stand firm.*
*Amid lush flowers and alluring willows, you must fix your eyes above them.*
*On reaching a precipitous place on a dangerous path, you must turn back.*

**Hong Zhicheng, Ming Dynasty**

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## Treading its own path

The outer manifestations of China's 30 years of economic reforms have been impressive and volatile, while their true nature has, in contrast, been wary and practical. The current Chinese leadership is trying to ensure the accrual and continuity of the fundamental evolution of China's recent development.

The scope and the depth of China's reforms in the next five years will need to be as bold as those in the 1980s and early 1990s if the government is to correct the imbalances that have developed in the economy over the boom years of the last two decades. While president Xi Jinping does not face the ideological opposition Deng Xiaoping faced 30 years ago, he must overcome the resistance of corrupt senior officials with vested economic interests, and alter the direction of an economy that is more than five times larger by GDP and immeasurably more complex than it was 10 years ago.

Xi Jinping's anti-corruption campaign has intensified since the summer and remains widely popular. Chinese people have confidence in him, whereas five years ago, many were cynical and felt powerless in the face of corruption and a perceived lack of leadership. Despite public concern over falling property prices and a slowing economy, few now question President Xi's strength and focus.

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President Xi is no social liberal and has resisted granting significant new press or artistic freedoms, stating that the Chinese Government will not tolerate 'vulgar and stereotyped cultural dross' and that the Party expects journalists and film makers to be patriotic and 'serve socialism'. His conservatism will be the focus of much foreign commentary in 2015 but should be a secondary consideration when assessing the overall quality of Chinese reforms.

> *I know that President Xi is conservative, but he is also strong and appears incorruptible. It is frustrating trying to find ways to avoid the government's interference with the internet, but this is not the major issue in my life. I observed the demonstrations in Hong Kong recently and thought, 'You are spoilt. You have more wealth and freedom than people on the Mainland. We have no choice but to work hard and be patient; why are you dragging your protests out so long and preventing your fellow citizens from getting to work?' The present crackdown on corruption in China is revolutionary enough for now. We need a more stable economy before we can radically change our society.*

Beijing teacher

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With over half the Chinese people still dragging themselves out of poverty and the government making some gains in building a more functional administration, Xi's conservative social views are more shared than resented. As the economic benefit from improved administrative discipline and greater commercial transparency becomes more apparent, Xi Jinping will nevertheless need to accommodate the expectations, particularly among younger Chinese people, for a more open and liberal society. Even now the Chinese Government cannot stem the increased flow of information online and the interaction between citizens on social media. The Chinese Government must be practical enough to accept that it cannot afford to restrict the application of tools that are crucial in commercial communications, the gathering of market intelligence, and in marketing and distribution.

## Learning from others' mistakes

The Chinese Government has yet to find a new balance between government ownership and intervention on the one hand and private enterprise and free markets on the other. The Party claims it has applied 'Socialism with Chinese characteristics', while it has in fact pursued free market policies based on laissez-faire capitalism on an inconsistent basis and then intervened crudely when sectors became unstable or state interests faced strong competition from foreign or private companies. The United States and Europe's inability to undertake meaningful structural reforms and contribute significantly to a global recovery has forced China to reconsider the Western economic model. Xi Jinping and his ministers appear to now be taking a more considered and balanced approach appropriate to China's unique needs. 2015 will be a year in which they are tested. They must produce concrete results for not only the Chinese middle class and the mass of workers in the industrial and service sectors, but also the millions of new job seekers disgorged from schools and universities, and those arriving from the countryside every year.

China does not yet face the same problems as the United States or the southern Euro zone. Most Western governments have gleaned little from the Global Financial Crisis and responded with amnesia and denial that investment banks are once again putting the global economy at risk. Instead of curtailing investment banks, regulations aimed at retail banking have discouraged investment in productive sectors and redirected capital into government programmes.

In the United States, mergers and acquisitions, leveraged buyouts and derivative-based trades that deliver little real value to the economy are disingenuously presented by the authorities as evidence of a significant economic recovery. Disposable personal incomes in the United States have risen by an average of just 5% since 2009. Household savings rates remain negative and real employment gains are largely in the service sector, offering little job security and widening the gap between rich and poor. In contrast, Chinese urban wages have increased over 10% per year in the last three years and are forecast to continue to grow at these levels at least over the next two years. Households continue to save over 50% (and over 60% in first-tier cities) of what they earn in an effort to buy houses, travel and consume in more sophisticated ways.

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The Chinese Government does spend heavily each year, but largely on infrastructure that is needed, which also creates employment and stimulates demand. China runs surpluses with most of its trading partners and, while it has a high overall debt-to-GDP ratio (over 200%), most is domestically generated and held between state-owned banks and enterprises. The state is unlikely to foreclose on itself and has shown historically that it can manage domestic debt issues gradually and steadily. It must ensure, however, that it slows the rate of debt increase in the next 24 months, as the velocity of the debt's growth is more troublesome than the absolute amount. But the banking crisis predicted by foreign analysts 18 months ago never materialised and the property sector situation, as complex and damaging as it is, has not derailed the economy. China is coping.

Historically, the economic development path followed by China has not been markedly different to that of the United States or Europe, but it is at a different stage of its development. In the last 20 years China has taken on both positive and negative aspects of Western 'free markets', and while it has strived for a relatively uninhibited relationship between supply and demand, increasingly free migration of labour between regions and a growing integrity of commercial law, it has also allowed certain weaknesses of capitalism to crystallise in the wider economy. Of primary concern are monopoly interests and poorly governed market speculation in sectors as diverse as housing, medicine and food ingredients. The Chinese Government has been as obsessed as the West with GDP growth as a singular indicator of economic development, without enough regard to real productivity and realistic consumption. It has allowed an inordinate measure of value to accrue to capital rather than innovation and labour.

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The current Chinese leadership is becoming strong enough to implement major policy changes and nurture a more egalitarian economy, one that is less an arena for speculation by robber barons, newly wealthy elites and families with government connections. The policy initiatives for 2015 indicate that a significant change in direction has begun and the term 'rebalancing', rather than being a metaphor for redundancy and bankrupting of weaker enterprises, is apposite.

What is unclear is how effective China will be, in the short term, in managing the continued property sector slowdown. Western observers' continued use of dramatic images — such as 'ghost' towns and cities — to describe the oversupply does not help objective assessment of the impact of property on the wider economy. There have long been underutilised suburbs and industrial parks in China but not of such scale that they could cripple the economy. The property sector (the focus of the Summer 2014 edition of China Watch) remains a leading indicator.

## Property update

Due to widespread speculation and a lack of investment alternatives in the economy, real estate has played too great a role in China's overall economic development, and the correction of this flaw will continue to dampen economic growth in 2015, particularly in secondary cities and central and western China. According to the World Bank, the property sector accounts for 15% of China's economy. Prices in Shanghai and Beijing have, at worst, been flat over the past year, but government statistics understate the extent of the property downturn in some of the other wealthier coastal cities such as Hangzhou and Ningbo, where prices have fallen by up to 50%, twice as much as official data would indicate.

*My apartment in Ningbo was worth RMB 8 million in 2013; it is now worth RMB 5 million. It is still worth more than I paid for it but my friends fear for the near term as they see their personal wealth has been eroded. Many of those who were speculating have sold extensive portfolios at less than half what they paid for them. But these are wealthy people, and most have the means to deal with the losses. 2015 will be a tough year for the Chinese Government as it tries to ease credit in parts of the property sector, but not so much as to rekindle speculation. Intervention can achieve only so much as market forces always rule in the end, even in this semi-command economy. I assume that the Government does not really know what to do about property in the short term. Market forces have been variously distorted and restrained for years, yet the market demand has brought its own corrections. China needs tens of millions of new houses each year so this situation will also somewhat correct itself over the next 18 months.*

Factory manager in Ningbo

Demand for affordable housing is strong but despite announcements by the central government that construction of low-cost housing would accelerate in 2014, there has been too little evidence of any impact and many projects that were completed earlier in the year remain empty as applicants struggle through the tortuous and often corrupt approval process.

*We were told that we were eligible for an apartment in the new project at the edge of town but we are not clear what is required to go through the approval process. And we don't know who to bribe.*

Hebei householder

## The counterbalance

The property sector will continue to be a drag on the economy, but after so many boom years it was inevitable that it become so unbalanced. The most important reform to ensure the long-term balance of the economy is still the growth, quality and scale of the private sector. There have been some positive signs of private-sector growth recently.

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The State Administration for Industry and Commerce reported that between March — when business registration rules were simplified — and December 2014, 2.8 million new (largely private) companies had been established, representing an increase of 54% from the same period the previous year. Together, these companies accounted for registered capital of RMB 15 trillion (USD 2.4 trillion), an increase of 93%. Wider reform of approvals and procedures for business registration will result in faster growth of China's service sector

**and support the development of more sophisticated manufacturing and technology companies. It will help the government's aim to increase the private sector's share of the economy, but it cannot be just a phase to rebalance the economy in the short term. It must facilitate a permanent shift to the degree that the private sector accounts for at least 65% of China's GDP. As businesses become more flexible in meeting the needs of China's expanding urban population and middle class, consumer demand as a portion of GDP will also increase. The sectors that will deliver the best investment return over the next three years will be agriculture / food & beverage, entertainment, logistics and healthcare, particularly for the increased number of retirees. The government has even begun privatisation of retirement homes in major cities across China.**

**While the Central Bank will try to maintain the stricter credit policies of the past 12 months, the government must open China's banking sector and capital markets further to build a modern and flexible financial sector able to serve the increasingly sophisticated needs of the economy. The government has committed to licensing five private banks in 2015 as a major step in widespread financial reforms. Due to a government campaign to curtail the often usurious and unstable shadow banking sector, the private sector has been put in an even greater predicament, as even good companies struggle to find essential working capital.**

**The Chinese economy is far from contracting in absolute terms under present circumstances. Chinese GDP grew in excess of 7% in 2014 and will grow at roughly the same rate this year, but China still needs to alter the make-up of GDP growth to rely more on domestic consumption than investment, and more on domestic market competitiveness and trade than returning to a strong trade account heavily dependent upon global, particularly Western, consumption. The West will recover some of its lost economic strength, but as Vietnam, Malaysia, Indonesia and India continue to enjoy aggregate growth rates of over 5%, China will find greater value within its own region.**

**The West is nevertheless important to China, for although China has economic scale and momentum, it still suffers from a lack of domestic innovation, dynastic management cultures, and an education system that relies on conformity, rote learning, and obedience at the expense of individual initiative and responsibility. The quality of manufacturing, individual worker productivity, and innovation in technology and management are high in both Europe and the United States. Rather than struggling within their relatively protected domestic markets in an effort to generate marginal, often phantom GDP growth, or simply hoping to sell more to China, the West would be better to back their companies to leverage these strengths within China. China, along with other rising Asian economies, can be the catalyst of the West's recovery rather than its downfall.** ☯