

China Watch

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

W I N T E R 2 0 1 9 - 2 0 2 0

If the blame is on me, everything I encounter can be a remedy.
If I blame others, each turn of thought will be a weapon.

Hong Zicheng, 17th century

www.mahonchina.com

False reprieve

China and the United States have agreed the terms of a trade deal. While not without substance, it is shallow and constitutes a shaky ceasefire rather than peace of any kind. If it is signed in January as expected, it will be in an atmosphere of deep, mutual distrust. The four-decade US-China partnership will not be rebuilt until Washington accepts that China cannot be contained. China should also open its economy further to foreign investors, commensurate to the degree of access it enjoys overseas. The broken US-China relationship may already be irreparable for the foreseeable future.

The Chinese economy has been more accessible to foreign investors than any other developing country in modern history for, in Deng Xiaoping's pragmatism, he saw in the early 1980s that China could not develop without foreign investment and commercial partnerships. China has not reversed the momentum of its economic reform as many commentators claim, but allowed it to slow out of a concern of losing control, particularly of its financial system. It considers the global banking system as inherently unstable since 2009. The Chinese Government is also responsible for slowing the economy with over-regulation, created to curtail corruption but also to exert greater control over Chinese society.

While focusing somewhat spuriously on GDP growth as most countries do, the Chinese Government knows that it has a robust economy, with over 70% of growth coming from consumption and services, backed by foreign exchange reserves of USD 3.1 trillion. But China needs to accelerate economic reforms. When it allows more foreign banking competition it may resolve flaws such as ill-considered lending practices, particularly within the state corporate and municipal sectors.

The US global trade deficit, which the White House claimed was primarily China's fault, increased by 26% in 2019 to USD 984 billion, while the US deficit with China fell by 12%. While American demands for China to afford US companies greater market access were fair, a trade war based on the fallacy that China caused the US deficit was not.

China has agreed to buy USD 50 billion of American farm and agricultural goods, despite the most it ever purchased previously being USD 26 billion, in 2012. Even if implemented partially, the new deal will beggar many of China's current non-US suppliers. It will help Boeing win bids that may otherwise have gone to Airbus, and allow American soybean farmers to regain some market share now enjoyed by Brazil. But Beijing will still diversify supply in key sectors over time, and will be unlikely to relax existing grain import quotas, for it knows it cannot afford to trust the United States in the future.

This round to China

China is the world's largest economy by purchasing power parity. Rome was not built in a day, but the three decades it took to build the modern

China's leaders and its people are still coming to terms with the implications of their strength in the world.

Chinese economy is little more than a blink of the historical eye. China's leaders and its people are still coming to terms with the implications of their strength in the world. It is little wonder that the West struggles to understand China's rise.

China is somewhat politically isolated from Western countries, but an increasingly vital contributor to the global economy. China's rise has been a massive boon to many countries, not least the United States. Since China joining the WTO in December 2001, US exports to China have grown around 500%. China's current annual GDP growth of around 6% is greater than that of the US, EU and Japan combined. As a net importer of a wide range of products and materials — particularly minerals, medical equipment and vehicles — China is a key driver of world consumption and will remain so as its future growth depends upon continued integration into the world's economy.

The US, desperate to retain what it sees as its waning economic status, continues to blame China for its economic problems, which in fact stem from US domestic fiscal policies and excessive foreign borrowing. History will look back on this trade war as a gross political indulgence at a time when the major economies of the world should have been establishing stronger standards of governance and transparency to ensure more robust, sustainable markets. The tariffs Washington imposed on Chinese goods last year have hurt American businesses and consumers, while China's retaliatory tariffs have devastated large parts of the US agricultural sector.

Thousands of large multi-generational grain, dairy, and livestock farms in the US have gone bankrupt. To date, Washington has spent USD 30 billion inadequately subsidising farmers' losses, twice the government bailout of the auto industry in 2009.

Contrary to White House pronouncements, the Chinese economy has not been damaged greatly by US tariffs.

Contrary to White House pronouncements, the Chinese economy has not been damaged greatly by US tariffs. Beijing is, however, keen to reach an agreement because it knows another six months of the trade war will further damage domestic business confidence and disrupt its

supply lines, costing as much as one GDP percentage point of growth. It is encouraging that the People's Bank of China has announced that it will reduce reserve ratio requirements by 50 basis points, releasing RMB 800 billion for banks to lend to small- and medium-sized private enterprises. China has the tools required to maintain domestic growth that many Western nations lack, such as the means to increase the rate of urbanisation and undertake further privatisation of its service sector.

The White House will continue to issue declarations of victory as the trade agreement is implemented, and these claims will unlikely be contradicted by Beijing. But it is evident that China, not the US, has won this round.

Broken trust

As Washington and Beijing announced their deal, negotiators concluded the revised NAFTA, renamed the United States - Mexico - Canada Agreement. For all its machinations, threats, and tariffs, the US gained few concessions from any of these trading partners. Washington insisted that it be granted oversight of Beijing's currency management and compliance with trade terms as a condition of any agreement. Beijing seems to have agreed to vague mechanisms that will be hard for the US to govern. But Beijing insisted it would reject US interference in its economic sovereignty, and appears to have done so. Leading American economists argue that the US may now avoid a recession, due not to trade agreements, but the Federal Reserve lowering interest rates, constituting economic stimulus that will exact its own cost in the future.

China's foremost challenge in the coming decade will be its struggle with the United States. Once largely confined to Asia, and although at times abstract, China's relationship with the US is one of real global competition that will increasingly affect its trading partners. Businesses would be wise to factor this into their strategic plans and not allow temporary trade rapprochement to be the cause of too much short-term optimism. In the medium-term, the economic world map will be redrawn as China forges better economic links with its immediate Asian neighbours and, in time, Europe. The quality of these bonds will require China to take a different

diplomatic tone, have a more relaxed attitude with its partners, and adopt greater flexibility and less anxiety in its approach to its domestic security.

Stability begins at home

Beijing tends to react rigidly when challenged, often in archaic Communist Party language more reminiscent of the 1960s or 1970s than apposite to the 21st century. This contradicts the relative restraint it has shown in its actions regarding strategic issues. Beijing has largely avoided reacting to Trump's hectoring trade-war rhetoric, and despite months of violence and vandalism in Hong Kong, has not intervened directly.

No country in history has become economically powerful and influential without resorting to annexation and war. China's South China Sea claims are contentious, but differ little from Washington's more-than-century-old focus on ensuring it has no rivals in the Caribbean and Central America.

Like the US, China is claiming spheres of influence commensurate with its

The West will have to accept China's sphere of influence eventually, as China may need to accept a measure of continued American influence in the region.

physical size and economic power. The West will have to accept China's sphere of influence eventually, as China may need to accept a measure of continued American influence in the region. Many Southeast Asian nations see an equilibrium between the two powers as key to their future autonomy.

China's Achilles heel is its administration of its minority peoples. Uyghur resentment has been building for decades, particularly over Han Chinese migration to Xinjiang from eastern China. In 2009, 197 Han Chinese were killed by Uyghurs rioting in Urumqi, the capital of Xinjiang. In 2014, Uyghurs detonated a car bomb in the city, killing 31, and attacked civilians in a railway station in Kunming, killing 29. Beijing imposed effective martial law on the 'autonomous region', reducing violence almost completely, but it also made the choice of interning hundreds of thousands of Uyghurs for 're-education'. This has sparked widespread international condemnation. It appears that international pressure has resulted in some of the camps in Xinjiang being closed in recent months and a large number of internees being released. The facilities, together with many parts of Xinjiang, remain inaccessible to outsiders and so it is hard to verify what is happening. It has not helped that Beijing initially denied the camps' existence.

China has a genuine issues with separatism and terrorism in its western regions. No nation should be expected to tolerate terrorism, no matter how justified the sense of injury on the part of the perpetrators. Many in Tibet and Xinjiang are socially and economically disadvantaged and their cultural and religious practices marginalised. China now has the level of prosperity and the capacity to deal with its minority peoples more justly,

and can diffuse generations of ethnic conflict if it takes a more enlightened approach. This would require the Chinese leadership to go against its instinct to maintain tighter control, and instead allow a greater degree of genuine autonomy and cultural-religious expression.

China now has the level of prosperity and the capacity to deal with its minority peoples more justly, and can diffuse generations of ethnic conflict if it takes a more enlightened approach.

Despite increased surveillance of its citizens and some mishandling of ethnic minority issues, China has made strides in the development of its citizens' living standards, rights, and civil liberties. The majority of Chinese citizens do not take issue with their

government's security measures, focusing more on their improved lives and choices. It is reasonable to assess the development of human rights in China relative to the country's previous decades, rather than solely comparing Chinese shortcomings to assumed (and not always practised) Western norms. The West's traditions of relative political transparency, the rule of law, and freedom of the press are precious, but while developed nations join in condemning human rights violations in developing countries, there is seldom contrition for their own violations. The blood spilt in Iraq (600,000 dead), Afghanistan (100,000 dead), and Saudi Arabia's war in Yemen (100,000 dead) still drenches American, British and their allies' hands. China needs to improve its human and civil rights, but the West needs to address its own hypocrisy before it passes judgement.

China will remain important to its neighbours and trading partners as long as its economy is strong. It will be more respected and trusted when it demonstrates the capacity to manage its internal conflicts without resorting to martial control, and meet challenges to its regional influence without intervening militarily. It would need to differentiate itself from the great powers that have gone before it.

Despite China's sometimes awkward attempts to project soft power and its tendency for peevishness when slighted, it has changed the manner in which it contributes to international organisations. Beijing is the second largest contributor to the United Nations and presently has 2,500 peacekeepers in the field, more than all the other permanent members of the United Nation's Security Council combined. It has used its veto fewer times than its fellow Security Council members, supporting 182 of 190 resolutions between 2000 and 2018.

China will continue to change and become a more open society as wealth and greater choice spread to its remaining one billion people, and particularly when the next 400 million are lifted out of their largely marginal, rural lives. China's youth, who have experienced better education, more personal freedom, and extensive world travel — rather than the hardship, revolution, and isolation endured by many in the

current leadership — are a force for change. These young people tend to be optimistic, and patriotic without being anti-Western. They want to be a part of the world, and expect much of their country's capacity to open and liberalise. ☺