China Watch

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

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The greater the number of laws and enactments,
The more thieves and robbers there will be.
Therefore, the Sage says: 'So long as I do nothing,
The people will work out their own reformation.'

Lao Zi, 5th century BCE

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Crisis and reform

In 1992 aged 87, Deng Xiaoping travelled to southern China. His only remaining formal role was chairman of the Chinese Contract Bridge Association, yet he was still the arbiter of China's economic policy. At each stop, he promoted the market reforms he had launched as China's paramount leader over a decade earlier. Economic historians tend to credit this trip as triggering the formation of China's first private enterprises, but Deng was taking political ownership of what had already occurred in order to challenge the Party's growing resistance to free market forces in Beijing. Today the Chinese economy is recovering, and contrary to most predictions (including earlier ones made in this publication) the Government is promulgating some effective new policies.

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Six months ago, Beijing appeared flummoxed by the complexity of guiding the economy back to growth and stability. There was no mention of big reforms and only scant references to the private sector, with considerable focus instead on the state. This seems to have changed, and policies announced over the last eight weeks have the potential to facilitate stronger private sector expansion and confer greater autonomy on the provinces.

Beijing cannot lead Chinese entrepreneurs out of their present uncertainty and scepticism by policies alone; they must also relax some of the rules that constrain them.

Fuelling recovery

Having partially curtailed loan sharks and shadow banking schemes, Beijing now needs to fill the funding vacuums this has created for the private sector to expand significantly. Over the last two decades the government has been slow in allowing the development of private retail and investment banks, and now when it needs private sector growth urgently, there are inadequate means to fund that growth. At USD 3 trillion, China's shadow banking sector remains a systemic risk to the economy, but it is also a resource to be converted into a regulated, stable source of private lending and investment, for many of the institutions within it are already adequately managed and hedged. China's lack of financial diversity and flexibility has inhibited its recovery from three years of COVID and the collapse of the property bubble, which have inflicted major costs to public confidence and finances.

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Despite improved macroeconomic indicators in the industrial and service sectors, consumers are still feeling uncertain and overly cautious in their spending on everyday items, waiting for proof that asset prices are rising again.

> *'We have good salaries and savings and most of us are in steady jobs. But I admit: although unemployment is not widespread, I have friends who have lost their jobs and know that many working for the state have had to accept pay cuts. This is making me feel a bit insecure. Everyone is buying cheaper products, even when it comes to essentials. Frugality seems natural in hard times. The middle class is supposed to be hundreds of millions of people, but many were not born into it, so remember some form of poverty. They are conservative. This is a factor behind China's slow recovery.'*
>
> Manager of a private trading company in Shanghai

Hoping for the worst

Most leading global economists have written off the Chinese economy and forecast a long decline, on the assumption that China rose on the basis of an unsustainable growth model driven by non-market factors over recent decades and is paying for it now. Western commentators tend to view Chinese economic data through distorting political lenses. Chinese economic gains are often reported as ill-gotten and tools of coercion, while economic contraction is presented as evidence of inherent instability and political illegitimacy. Much commentary is more akin to war rhetoric than rational economic analysis. It is true that China's present economic recovery will likely continue to be uneven and any growth incremental. The risk of setbacks due to administrative blunders and external factors is ever-present, there are deflationary trends in many sectors, but the current recovery has momentum, and the policy direction is encouraging.

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In October, Chinese industrial value-added (net manufacturing gains) rose 22% and retail sales were 14% higher than in October 2019. Supply and demand are both expanding, and apart from the residential property sector, prices are stable. New residential property purchases are still down in China's 20 top cities, while existing homes are being purchased at significant discounts. Buyers across China fear they will lose their deposits on new apartments if developers fail. If the government were to establish a real estate deposit insurance scheme, similar to that which exists in banking, buyers would have more confidence in the better, medium-sized developers.

Winter's awakening

Beijing appears to be initiating good policies to spur SME growth in particular, and there are signs that provinces are being given more fiscal autonomy, allowing them to restore their finances beleaguered by the costs of fighting the pandemic and the collapse of property prices. The appearance of monolithic power projected by the Party means outside observers often miss the fragmented nature of China and the degree to which the government generally rules more by consultation and compromise with local officials — particularly in the wealthier regions — than by fiat. There were more political checks and balances before Xi's era, but the scale and diversity of the Chinese economy today creates an economic equilibrium of sorts. The messages from the leaders in China's top 20 cities to policymakers appears to constitute a unanimous demand for the central government to pay attention to the private sector and not expect to drive reform and repair though SOEs as much as in the past.

Few governments today seem to be managing their country's markets well — understandable given the world is recovering from one of the greatest shared economic calamities since the Great Depression.

Public confidence after crises tends to return gradually, often imperceptibly, as individuals overcome their fears and make ordinary economic decisions again, each influencing the other, until hope becomes a subtle, steadily rising tide. This shift is now palpable in China, not so much among the wealthy in the major cities where people have more to lose, but among poorer folk in lesser coastal towns and significantly in the interior cities and rural areas.

New engines

Beijing has announced it will increase support for the private technology sector. Although Chinese state bankers will continue to favour lending to SOEs over riskier private enterprises in an effort to avoid making mistakes that might cost them their jobs, the impact of more flexible credit practices is already apparent. In late November, President Xi Jinping visited the Shanghai futures exchange and a number of technology companies in an attempt to demonstrate the government's priorities.

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Adequately funded, the technology sector will become a significant driver of the economy, replacing some of the impetus previously supplied by the real estate sector. In the foreseeable future the Chinese property sector will not return as a prime driver of the economy, and it must not become the forum for the reckless speculation of previous decades. In 2022, the tech sector grew 10% year-on-year, contributing 41% to China's GDP. Year-on-year credit growth to SMEs could increase by as much as 20% by the spring of 2024.

Despite Washington's embargoes on technology exports to China, Huawei developed a cutting-edge smartphone with chips supplied by a relatively obscure Shanghai company, Semiconductor Manufacturing International Corp — ironically backlisted by the US in 2020. Huawei and other tech companies have demonstrated that trade restrictions designed to cripple have instead spurred a greater impetus to innovate and become more independent of global supply chains, faster than they would have aspired otherwise. From space stations to trans-oceanic fibreoptic cables and fourth generation fighter aircraft, China is matching and often exceeding its Western peers.

US tech companies are losing billions of dollars each year due to lost sales to China. President Biden's conciliatory tone when meeting Xi Jinping in San Francisco last month could well have been due in part to US tech companies lobbying Washington to ease sanctions.

Crisis, the mother of reform

The World Bank and the IMF are forecasting that China will achieve GDP growth in excess of 5% this year, recording the second highest GDP in the world in 2023. Even with 4.5% GDP growth in 2024 it would be second only to India. China's accumulated GDP growth over the last three years is approximately 20%, while US GDP grew 7.7% and Europe by 3%. The fact that Chinese GDP growth will reach or exceed 5% this year without significant government stimulus should encourage foreign investors. They should, however, assess each sector carefully, as recovery will be patchy and there is little evidence that nationwide public trust in government will be restored soon. Confidence is especially low in cities like Shanghai which suffered stringent, extended lockdowns during COVID, and this in turn depresses household consumption. Consumption of nutritional supplements and quality food products in coastal cities is still strong, especially of imported premium-quality fruit, as the upper middle-class remain willing to pay for established brands of reliable provenance.

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Although some in local government have speculated that Beijing will resort to subsidising households if consumption does not recover by the spring, it is more likely to pay subsidies to companies expanding in key sectors enabling them to employ more people. Despite China's communist past and the current administration's commitment to poverty alleviation, there are no traditions of welfare as there are in the West. The government will invest less in poverty alleviation programmes and infrastructure projects in the poorer central provinces over the next 12 to 24 months as it concentrates on the areas of the economy that can offer better short-term yields. Critical poverty alleviation programmes will nevertheless continue, particularly where they support the improvement of agriculture.

> *'I know this may sound selfish, but the government spent too much on developing western China in recent years. If they had focused more on the middle class in the coastal cities they would have achieved greater economic and social returns, and the economy would be stronger.'*
>
> Hangzhou-based fund manager

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There is some truth in critics' assessments of China's social investments, but over the past 50 years most trickle-down economic strategies have failed. Beijing will focus its future fiscal reforms on coastal cities to restore middle-class citizens' confidence in the system, but unless these are complemented by relaxing hukou (residency) reforms to allow greater internal migration — so rural workers can enjoy some of the benefits of urban life — they will only bring temporary prosperity and ultimately exacerbate the already large gap between rich and poor.

San Francisco

The recent Xi-Biden summit in San Francisco was significant largely because it took place at all. It has been seized on by some businesspeople as a sign of a major geopolitical shift, more out of their need for good news than reality, after alarming economic losses over the last three years.

> *'The drought's over, mate. We can sell our wine in China again. Albo's visit was the first step in a new era. And you blokes shouldn't read too much into the subs and all that AUKUS stuff. We only care about the Pacific because you do. The stand-off was all about nothing.'*
>
> Australian wine company sales manger

> *'Easy for you to say. The 'subs' you mention will get deployed off the Chinese coast. How would you feel if we sent nuclear powered submarines with ballistic missiles to cruise in international waters just off Perth?'*
>
> Chinese distribution manager

Xi and Biden were motivated in part by a mutual requirement to repair the economic damage resulting from prolonged political estrangement and the imposition of trade tariffs. Biden asserted that the US was not trying to decouple from China, perhaps acknowledging tacitly that attempts to do so have been unsuccessful. Both economies need each other's markets to ensure future growth. Yet there are powerful people in Beijing and especially Washington who are prepared to mortgage economic stability and growth for what they perceive as wider geopolitical advantages, even at the risk of military conflict.

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In early December, the US House of Representatives' China committee recommended Congress legislate to allow it to sanction the Chinese Communist Party economically and diplomatically if China engages in military action against Taiwan or other US allies and partners (partners could mean any country). The committee also advised the administration to revoke licences that currently allow US companies to supply Huawei.

Whatever conciliatory statements President Biden made in San Francisco, he will likely be forced to repudiate next year as he fights to win the support of Americans who have been conditioned to see China as an enemy and want to see him 'stand up' to Beijing. The Democrats and Republicans are unified in their characterisation of China as the architect of America's domestic ills. When both American political parties unite over foreign commercial and political conflicts, Washington has sometimes made its worst mistakes, such as the escalation of the Vietnam War and recent military interventions in the Middle East, resulting in the deaths of hundreds of thousands and the diminution of American power and legitimacy.

While the Chinese economy will strengthen in 2024 and Beijing has enjoyed some rapprochement with both Washington and Canberra, global geopolitical threats have not diminished. The dangerous jousts between the US and Chinese navies along the fringes of China's territorial waters continue. Although Taiwan and Vietnam are not the potential flashpoints they appeared to be a year ago, Biden's military guarantee of the Philippines has created a new theatre for a proxy conflict with China. France just announced it will conduct joint exercises with the Filipino miliary and that it intends to garrison soldiers in the country. The US and China continue inching towards a Second Cold War, evidenced by the AUKUS pact, the QUAD, Papua

New Guinea's security agreements with both Canberra and Washington, and the US' recent announcement that it will deploy intercontinental ballistic missiles in the region soon — probably on Guam.

China remains committed to globalisation; it has no choice, for it depends on imports for so many essential materials and components. As the Chinese economy recovers, so will the global economy, hopefully prompting many of its trading partners to restrain Washington's paranoid struggle to contain China's inexorable rise.

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Foreign investors will need to consider geopolitical risks more carefully now and, in the years, to come, as the US is likely to impose more restrictions on Chinese technology and continue to highlight selective (Chinese, as opposed to its allies') human rights issues, all in the attempt to slow China's growth. Chinese defensive rhetoric will only intensify in response, and it will continue to increase its military spending.

> *'We hear a lot about China's political tensions, but at least Xi is talking to foreign leaders again. I fly to the US next week to buy oranges. If we just do business as normal, hopefully things will become more normal again.'*
>
> Beverage company supply-chain manager, southwest China

Brussels

China's trade and investment with the European Union is 2.5 times bigger than its amount with the US, but this is under threat from strong anti-Chinese sentiment in Brussels. China's trade surplus with the EU has grown in the last three years and the relationship is beginning to resemble one of acrimonious competition rather than collaboration.

Italy has just announced it will withdraw from China's Belt and Road initiatives, complaining that trade and investment have benefited China inordinately, while damaging the Italian economy.

Brussels has called for an investigation into subsidisation in the Chinese electric vehicle sector as European automobile companies are losing market share to cheaper, more advanced Chinese EVs. Beijing wants to further China-EU détente to maintain Europe as some form of counterbalance to its dependence on the US market and imports of US technology, but the barriers to this are high. European commissioners are demanding greater access to China's domestic market while, in step with the US, banning exports of dual use (civilian/military) technology to China, including advanced semiconductors, cloud computing, and artificial intelligence. Meanwhile European public opinion towards China has continued to sour due to China's choice not to condemn Russia's invasion of Ukraine. Many in Europe and the West do not consider China's own need to maintain reasonable relations with Russia, with which it shares a border of over 4000 km. As the war in Ukraine drags on, it appears that each side is too strong to lose and yet too weak to win, and European politicians will lean more towards Washington than Beijing.

The EU is unlikely to try to decouple economic links with China as ardently as the US, and European companies will invariably resist trade restraints. The global economy will suffer profoundly if China becomes estranged further from the world's two great trading blocs. It is in the interests of smaller trading nations to resist pressure to pick sides and avoid adding to the larger players' intemperate rhetoric.

Despite all of the considerable challenges, China will continue to offer the strongest and most investible market for the rest of the decade. All those nations, firms, and people around the world who benefit from peace and stability should not treat disengagement and conflict as our unavoidable future. ☯