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 5 - 2 0 1 6

Keep a sober eye on the hustle and bustle of life
and you will be spared a lot of worrying thoughts.
Maintain a little enthusiasm in times of suffering
and you may taste true joy.

Hong Zhicheng, Ming Dynasty

www.mahonchina.com

Not the present fire, but the distant flood

The weeks between the Western and Chinese New Years are normally uneventful for the economy. 2016 has been a marked exception. Not only did China's stock market shut down twice within three days of opening due to an automatic 'circuit breaker', but also the People's Bank of China (PBOC), which manages the renminbi against a basket of other currencies, allowed the renminbi to slide and then drop sharply in a week of what appears to have been pointless devaluations.

I used to think that we had astute economic leaders. But they messed up the capital markets last year, wasting billions in reserves, and then repeated the mistake this month. And I cannot understand what they tried to do with the currency. I am not so concerned about the long term. It's just these sudden interventions. It's un-nerving.

Beijing marketing executive

...investors react irrationally to any bad news from China.

The PBOC has unwittingly frightened global capital markets and currency traders again, exposing China's economy to widespread criticism and misinterpretation. Global market anxiety has been heightened by concerns about the ramifications of conflicts in the Middle East, terrorism in Europe and the United States, and ongoing uncertainty in Asia generated by factors such as North Korean belligerence and the change of government in Taiwan. Against this backdrop, investors react irrationally to any bad news from China. The country's February announcement that GDP growth in 2015 slipped to 6.9%, from 7.3% in 2014, has led some media commentators to suggest erroneously that the numbers are false and that China actually grew by no more than 4%. With senior Chinese officials apparently reluctant to clarify their actions or outline

economic policy objectives, it is unfair to judge Western journalists and global market commentators too harshly for their alarm. But journalists who ignore the facts that interfere with their apocalyptic scenarios should be dismissed.

China faces serious economic challenges over the next two years, and some of its recent market interventions have been radically misjudged. The problem is partially one of economic cognizance, and there are also systemic issues to address.

I would not have thought this 12 months ago, but now I am concerned that Xi Jinping may have gone too far in centralising power and therefore risks damaging the relatively well-functioning process established by Deng Xiaoping of decision making by consensus. I know that Xi has been trying to reduce bureaucratic inertia, but perhaps a number of officials who otherwise would have spoken out now feel that they must conform to this leaner and more singular administration. I still believe that Xi Jinping is a good president, but there are downsides for any government that is dominated by the understanding of one man. I am not clear as to whether the recent stock market and exchange rate debacles were the result of his decisions or of those close to him.

Financial official in Beijing

The underlying Chinese economy is relatively stable despite its small and volatile capital markets, which under current circumstances will take years to play a significant role in the wider financial system. Any further instability in China's stock market will wreak more havoc on the perceptions of global market investors and traders than on the domestic Chinese economy. Over the last five years China's economic policy has been relatively measured and correct in its focus on reining in past excesses. A major underlying flaw in China's economic management is the local propensity to slacken credit policy out of fear of the social consequences of austerity. Demand within China's domestic economy and consumer confidence remain reasonably firm. Many Chinese households are afraid to reinvest in the Shanghai Index, but they continue to buy property, save with banks, and consume a growing number of increasingly varied goods and services.

A major underlying flaw in China's economic management is the local propensity to slacken credit policy out of fear of the social consequences of austerity.

The PBOC's bungled attempts to adjust the value of the nonconvertible renminbi against the dollar and the euro accelerated capital flight, but this too failed to influence the general domestic consumer. It is not the instability of China's capital markets or the PBOC's mismanagement of the currency that threaten medium- and long-term economic stability, but ballooning corporate and municipal debt.

Living on borrowed time

In 2012, the Chinese financial authorities began to restrain credit, forcing many smaller private and state-owned enterprises out of business or to become consolidated by larger competitors, but stronger firms were allowed to borrow and expand. This slowly released pressure from the debt bubble that had built up as a result of excessive economic stimulus in the wake of the Global Financial Crisis. The measures were neither comprehensive nor consistent but in keeping with the gradualist rather than radical approach to economic reform of previous decades.

China accrued as much debt in 2015 as it did in the 2009 post-financial-crisis stimulus.

In 2015 the PBOC changed direction and released credit to corporations, largely in the form of bonds, resulting in debt increases over eleven months at an unprecedented velocity of 39% year-on-year. China accrued as much debt in 2015 as it did in the 2009 post-financial-crisis stimulus. As the stock market fluctuated wildly in 2015, institutional investors reallocated their capital to this bond market, and many bonds were promptly pawned by companies to raise capital, creating a new layer of derivative debt. A reasonable programme initiated in March to swap local governments' 'shadow' borrowings for central-government-backed bonds has now reached RMB 3 trillion, while a large portion of local government debt still remains hidden. The full extent of credit expansion is unclear, but in the third quarter of 2015 alone, overall bond issuance totalled RMB 6.75 trillion, almost double the amount issued in the third quarter of 2014. This constitutes a stimulus package for many industries that are a drain on the national economy, while slowing the important destocking of the industrial sector and creating more deflation.

We have just come from negotiations with a flooring company in Jiangsu where we attempted to recover our loan principal and six months of unpaid interest. We were told to wait in line as the company owed even more money to the local banks. Officials in the city explained that the flooring company was probably insolvent, but they did not want it to go bankrupt as it still paid some of its suppliers, many of whom were also heavily in debt. When we visited the Chinese banks they said that over one hundred weak, small- and medium-sized enterprises were barely surviving due to arrangements delaying the repayment of loans and reducing interest.

Western banker

The banker's story is common among foreign institutions invested in China, and indicates a high degree of local and regional government support for unsustainable businesses in the industrial sector, creating an illusion of economic activity. For decades local officials have been expected to deliver GDP growth as the key indicator of their performance. It is

somewhat understandable that they continue to focus slavishly on achieving growth, however unreal.

There is too little commentary about China's rising debt levels, even among China's more independent and discerning economists. China does have the financial means to continue its unhealthy economic stimulus for at least two, perhaps even three years. But it must return to the relative austerity of previous years if it is to avoid bubbles, fuelled by debt in key industrial sectors, that will eventually rupture at great cost to the wider economy. At least, due to regulatory pressure, the shadow banking and the often reckless trust sectors shrank markedly over the past 18 months to the extent that they no longer pose such hidden risks. The risks are now more in the traditional banking sector, but are at least in plain sight.

...risks are now more in the traditional banking sector, but are at least in plain sight.

The Chinese economy is strong enough to endure a tighter credit regime. The current stimulus should not be maintained out of fear of unemployment, despite unfounded media references to legions of unemployed struggling at the fringes of Chinese cities. The market suffers from a shortage rather than an oversupply of industrial workers. Chinese workers' wages have risen an average of 12% each year since 2001. As the working population peaked in 2012, the rate of urbanisation has also begun to slow.

The previously steady hands of China's leaders seem to be trembling. They have fumbled some aspects of economic management over the past six months, but are unlikely to continue doing so. The attested capacity of the Chinese leadership to repair past mistakes and to act pragmatically rather than ideologically suggests that a debt crisis four to five years from now is likely to be avoided. The government has 18 to 24 months to reverse credit trends and repair any major damage.

Reflection and repair

All well-functioning markets depend upon high degrees of corporate and consumer confidence, often regardless of poor fundamentals. China is no exception. Consumer confidence is presently reasonable, but the negative impact of a bursting debt bubble on Chinese consumers would be profound, in a way that stumbling capital markets and mishandled exchange rates can never be. China's leaders understand this.

If the global economy recovers significantly in the next two years, despite the IMF's 2016 forecast that global GDP is unlikely to exceed 3.4%, considerable pressure would be taken off the Chinese domestic economy. China is well placed to participate in sizable infrastructure projects in other emerging markets, which would accelerate the reduction of the country's

industrial overcapacity. An improved global economy would also benefit general Chinese exports, which are now focused significantly on the electronics, high-tech and industrial sectors.

Since the recession, too much lip service has been paid to the idea of a globalised economy and the need to recover consumer confidence.

The economic issues that China struggles with are the same as those that dog the economic development of all nations. Since the recession, too much lip service has been paid to the idea of a globalised economy and the need to recover consumer confidence. Most nations are in fact focused primarily on their own wealth and protecting what remains after the crisis. This breaks down to regions and companies within national economies, and then households and individuals. Some Chinese policymakers, and some in governments around the world, do focus on global commonwealth above national self-interest, but they are few. Despite the unique power China's centralised system affords it, most provinces, cities and even counties work to maximise their own short-term profits and share of industrial and financial resources without much consideration for the wider economy. The significance of trade and the value of goods and commodities is self-evident, but fair and stable exchange needs to be understood at a higher level than local interests. This is not a competition between the principles of free market and command economics. It is simply a need for unimpeded but moderately governed trade and investment.

The European experiment of a single market attempted to create a shared economy based on the principle of a higher good, but the politicians charged with delivering the single open market became distracted by local economic interests and national political ambitions. Similarly, globalisation initially brought considerable benefit to emerging markets and lifted millions out of poverty, and shifted the centres of economic growth from the developed to the developing world. But it was inconsistent and facilitated many abuses. Capital moved freely but often outside the reasonable restraints of governance and law, while labour could barely flow at all. Multinationals took refuge in tax havens and strengthened their monopolies in technology, finance and logistics. In China, too many officials and businesspeople lost sight of commonwealth and saw themselves as elites above the law and common process, just as in the West bankers and financial-market officials saw themselves as exceptional to justify their looting of the coffers, triggering the Global Financial Crisis.

Trial and error

Xi Jinping has demonstrated that he has the capacity to make serious mistakes and yet repair them in time. There is evidence of this in his regional political relationships. He deepened China's rift with Japan that he inherited as a result of the Diaoyu Islands dispute, confronted the Philippines over territorial claims that nearly resulted in violence between Chinese and Filipino vessels, clashed with Vietnamese tugboats around disputed undersea oil reserves, and faced off against the Indian army along the line of control at the foot of the Himalayas. Xi and his advisors realised that China risked becoming embroiled in major disputes on multiple fronts, and sought more diplomatic means to further the country's interests.

Although Xi continues to equip fragile platforms on atolls in the South China Sea, his recent diplomacy has eased tensions and moved the region towards détente. Concrete offers of investment and economic aid alongside the formation of the Asian Infrastructure Investment Bank and the pursuit of the grand, yet rather vague, 'One Belt, One Road' strategy, are all tools of further repair.

The success of the economy over the past decades has made it even harder to govern…

This capacity for reconsideration and correction gives cause for hope. As complex and hard to govern as the Chinese economy may be, the Party has a track record of making practical and incremental improvements to the economy over the last three decades that, taken together, radically changed China from a Communist country to one based on rising standards of governance and functioning markets. The success of the economy over the past decades has made it even harder to govern, and the social stability that is now more firmly rooted than at any time in modern Chinese history exists concurrently with the potential for economic crises. However hard China's choices may be in the next three years, we must remember that the government has been managing a globally-connected, market-driven economy for only a few decades. Mistakes will be made, as China encounters for the first time problems that the West has been grappling with for generations. Success for China will depend on how quickly it can learn from its mistakes. ☯