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What Should we Expect from China?

- **is the country heading for an economic crisis?**
- **and is the new leadership reformist? Or maoïst ?**

The answer to these questions is critical not only to envisage the future of the most populous nation on earth but also to predict the economic well-being of the rest of the world.

Paradoxically, though risks and uncertainty are building up, China's best time is probably yet to come, if only China succeeds in its turn around. This time, however, the stakes are higher than usual!

Stock market crash and devaluations in 2015, an ongoing and unbridled increase of corporate debts fueling real estate and other assets bubbles, ballooning nonperforming loans delivering slower and slower growth have created much uncertainty about China's economic health.

At the same time increased censorship, repression of the civil society and the strong arm tactics in the South China Sea are not promoting international trust. Nor are they giving the impression that China's new government is establishing fairer frame conditions for the private sector, which should replace government ordained investment to become the new engine of growth.

Despite its much publicized slow down, China accounts for an estimated 50% of world growth.

When one takes note of the economic uncertainty for Europe in the brexit process and keeps in mind the instability created by the conflicts of the Middle East, understanding what is happening in China becomes crucial for evaluating how well the world, and therefore our economies, will do.

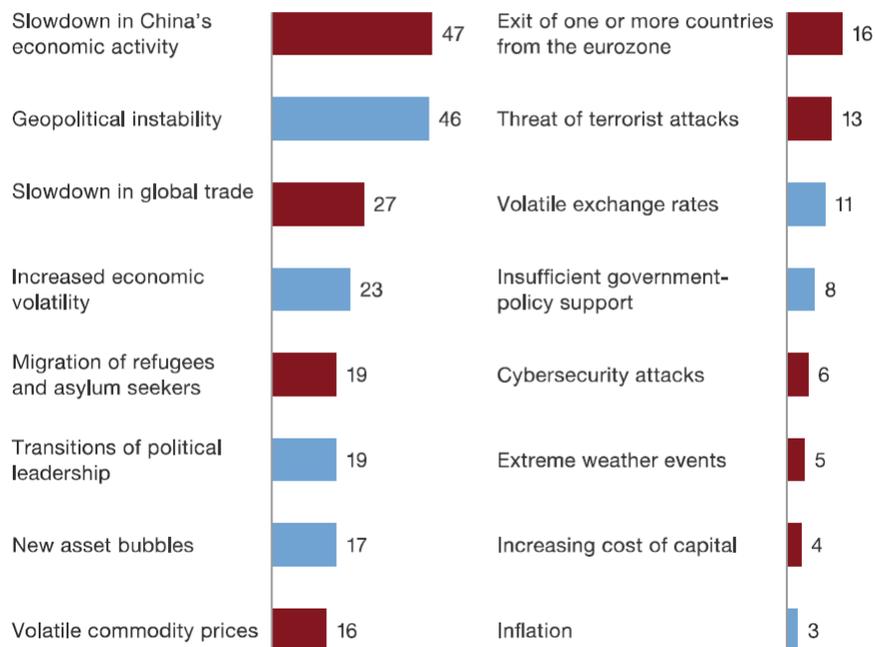
China's new leaders have launched very far reaching reforms to put the country in a position to develop further as a society and as a nation. We may not be aware enough how very different tomorrow's world will be if they succeed or fail.

Slowing growth in China, along with several other new risks, tops the list of threats to near-term global growth.

% of respondents,¹ n = 2,772

■ New risks in Mar 2016 survey
■ All other risks

Potential risks to global economic growth over next 12 months



¹ Respondents who answered "other," "no particular risk," or "don't know" are not shown.

McKinsey&Company

Until recently, China's mid-term evolution has been quite predictable

Since the Deng Xiaoping era, the Communist Party's key target has been to develop China, both for the well-being of its people and for the country to be economically strong and having the means to be an independent world power.

In Chinese eyes, this is only natural: all along its 2000 years of history as a united country, China has been both independent and a key, if not dominant, player of its then known world.

In the recent 35 years, China's position among nations has again become a preeminent one, at least in economic terms and if we use the world markets as a gauge.

And while a few years back China's fast growth was perceived to be a dangerous competition to developing and developed economies alike, today we fear that if China

sneezes the rest of the world will catch a cold. Whichever way we look at it, China has become an unavoidable factor in our economic lives and our well being.

There is not much doubt that a hard landing of China today would create a new global recession. Since the country's workings are opaque to most and are generally poorly understood, almost all predictions of foreign economists on China, and particularly those announcing imminent economic collapses, have failed.

Yet, China's most worrying characteristic to many, its generally top-down system that does not rely on universal suffrage, is also the reason why China is actually quite predictable, often much more so than many Western democracies. Indeed, the Chinese communist government develops long and mid-term plans, which are discussed by a large number of people in the administration, made public and carried out. The regular and comprehensive five year plans are the best known, but not the only ones. They are complemented by longer term, functional ones. The Prime Minister launched a 10 year "Made in China 2025" plan last year. And a "Sci-Tech Innovation 2030 Megaprojects" plan is under preparation¹.

Within the plans frame, government officers at all levels receive and are measured on targets that feed into the overall objectives and they are promoted if they achieve them. This is very much how our multinational companies work to ensure predictability.

In general, the plans are carried out and the objectives achieved. Yet, that does not ensure that nothing goes wrong: the focus on GDP growth at almost all costs of the previous government has had very negative side-effects on China's environment.

One other element that allows understanding what is happening in China is more paradoxical. Indeed, we are used to the concept of communists being ideological. And indeed, it is a fact that China under its Chairman Mao has been ideological to the point of being in denial of the practical reality.

Pragmatism pushed to the almost total absence of ideology is difficult to imagine, even more so when it is a country officially run by a communist party. Yet, China has been run by one of the most fact-based and logical government in the world.

As a result, those who are in charge in China have all elements in hand and know perfectly well that the current credit-fueled, headlong rush for GDP growth has entered a dead end.

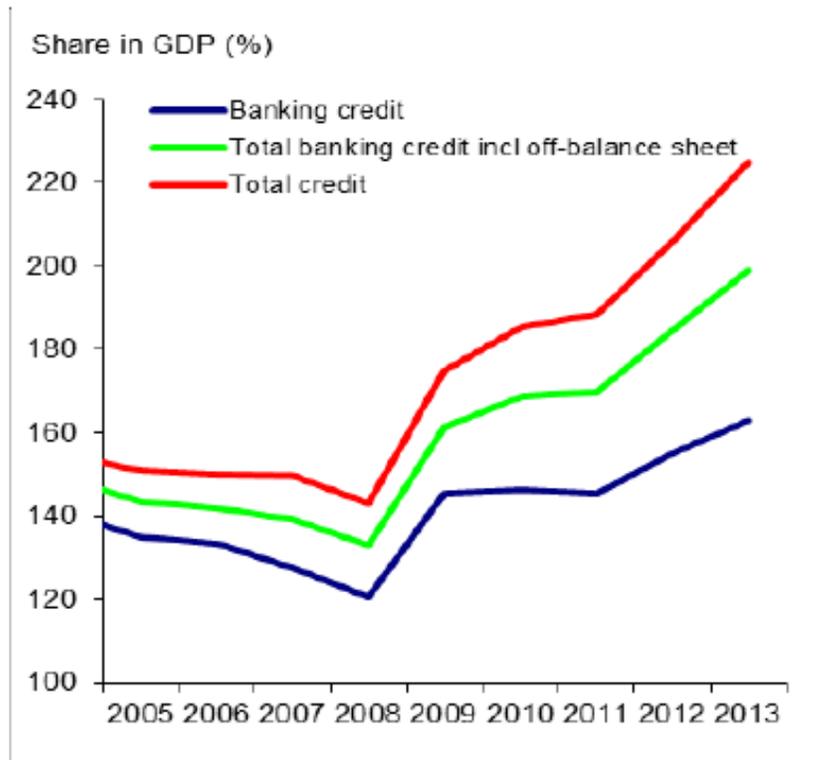
China's current economic model is just unsustainable

Following the 2008 economic crisis, afraid of potential social unrest, the Wen Jiabao government concluded that China needed to continue to grow at high speed no matter

¹ [Perfecting China Inc., the 13th Five Year Plan, Center for Strategic & International Studies, May 2016](#)

the resources needed. China's finances were very healthy so that the leadership could afford to increase debt and to fast forward the building of the country's infrastructure. Indeed the total level of debt, as a percentage of GDP had been going down.

Figure 3: The sharp increase in leverage is testament to strong credit support for the economy



Source: CEIC, UBS estimates

From 2008 to 2015, in just 7 years, 40'000 Km of railway tracks were built. This compares to the 68'000 Km of tracks which were laid in the 60 years from the establishment of the PRC until 2008.

In the same 7 years, 63'000 Km of freeways were constructed, more than the total network that was built in the 20 years from 1988 to 2008².

However, while the early infrastructure investments are certainly beneficial to the economic development of the country, as time goes by, worthwhile projects are more difficult to define and realize.

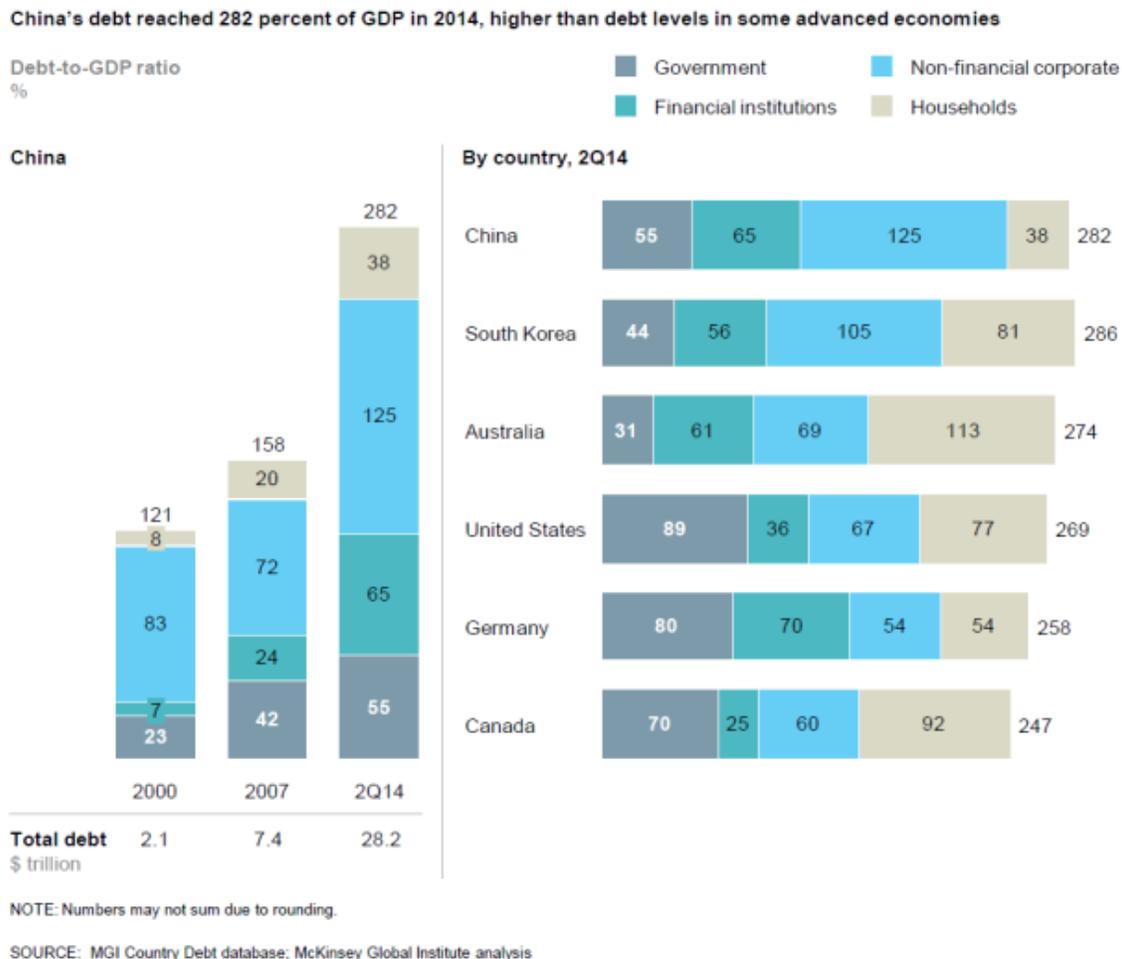
Besides, officials may make decisions to grow their local economy that do not make sense at the country level. The most recent example is the 155 coal fired power plants that have received approval for construction in 2015 (this number was later revised to

² Wikipedia: [Expressways of China](#) & [Rail Transport in China](#)

210). It is more probable that none of these power plants will be needed, as the country's increase in electricity consumption is now covered by non-fossil fuels. And indeed coal consumption decreased in China for the first time last year³.

In addition, the state lead investments of the past 7 years have created considerable overcapacity in the traditional heavy industry sectors (steel and cement, coal mining, among others), making whole industries unprofitable as they compete in an oversupplied market. Eventually, these overcapacities spill over to international markets, generating international trade frictions as the producers in these industries are desperately trying to find markets worldwide.

But not only are the state investment increasingly inefficient, the increase in loans that are needed to finance them is growing thoroughly unsustainably. As the chart below shows, from 2007 to 2014 the total debt has risen by about 20% of GDP on average, every year (from 158% to 282% of GDP)



³ [Glut of Coal-Fired Plants Casts Doubts on China's Energy Priorities, New York Times, Nov 11 2015](#)

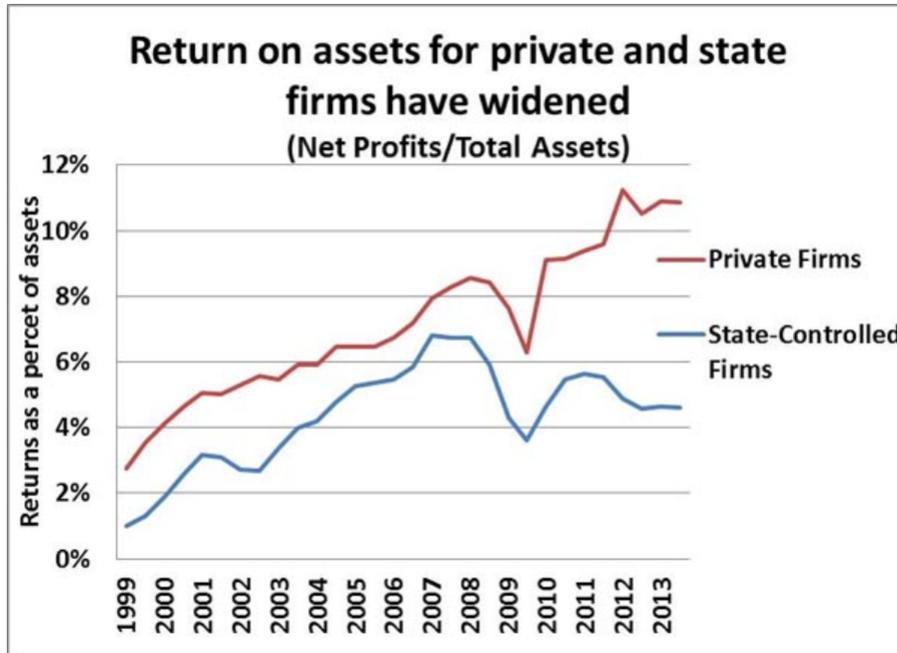
While the total amount of loans is not unbearable (at the level of South Korea), the speed with which they are increasing is mind-boggling. By all estimates, the current model has another 3-5 years to live until it creates unmanageable burdens.

Fortunately for China, the financing of the debt is almost completely domestic (as it is in Japan), coming essentially from the about 30% of disposable income that the Chinese people save⁴. This does not put China in the position of some emerging markets depending on international loans to finance their development and which are at the mercy of such loans recall. Additionally, foreign exchange controls limits individual Chinese from investing abroad, ensuring that the local population puts its savings in Chinese banks.

Nevertheless, confidence of depositors may erode and, more importantly, interest payments and the need to reduce the overall debt at some stage will reduce profitability of enterprises and the availability of funds to make new investments.

It is therefore obvious that China needs to change its "business model" if it wants to maintain growth levels. The solution to the problem is not difficult in itself: the population must save less and participate directly in the economy, either because Chinese consume more or because they invest directly and start new businesses. As a result, spending will be maintained, but it will be carried out directly by the people, without going through the generation of debt. Additionally, the private sector is notoriously more efficient (has a much better Return on Investment - ROE) than the state one. Favoring private investments will naturally ensure a much better efficiency of the investments made.

⁴ [The Chinese Can't Kick their Savings Habit](#), Bloomberg, May 2015



Reforms 2.0 - And simmering tensions below the surface

To set in motion the necessary economic changes, a wide-ranging package of reforms has been announced since 2013.

To encourage private consumption, social security is being expanded with the target of providing the population with a comprehensive social safety net, including basic healthcare for all, by 2020⁵.

To develop the private sector, considerable government incentives for entrepreneurs who start new ventures are offered. For those having good technologies ready to industrialize the government provides up to RMB 5 Mio (USD 750 thousand) in non-refundable grants.

"Innovation" and "Mass Entrepreneurship" are the new buzzwords of China's economic policy.

Included in the reforms package to promote new businesses, the government has announced the development of the rule of law, the streamlining of the bureaucracy and the speeding up of government approvals to favor the development of new small businesses. According to news releases, hundreds of approvals and administrative steps have been removed.

Yet, while we see some limited progresses in the speed of registering local companies, they are certainly not amounting to a sea change in the everyday business life.

⁵ [Wikipedia](#)

In fact, while some formalities are eliminated, many of those which remain tend to take longer so that, as an overall result, the practical business environment is getting more difficult and slower, quite to the contrary of what the government announces.

This is a new factor in China's recent history. Up to now and broadly speaking, important reforms have been felt as they were announced. Some have questioned whether reforms are genuinely meant by the new President. The powers he has accumulated in his hand have given rise to the talk of a new Mao-like era, preventing economic reforms prepared by the Prime Minister to really happen.

We believe that this is unlikely, precisely because of the influence that the President has taken in all aspects of government. Economic development and reforms as they are laid down in the latest Five Year Plan (No 13, announced in May of this year) have certainly be overseen by the President as well. One indication of it is the delay with which the plan has been published: the President has wanted to go into details himself⁶.

Instead, we see this to be an unexpected consequence of the new discipline required from the administration, which is forcefully enforced with the anti-corruption campaign.

Officials either want to avoid making mistakes and therefore play safe and interpret regulations more strictly than reasonable. And a number of them may act passively on purpose, taking the economy hostage and hoping that they will get freer reins if the the economic slowdown becomes too acute and creates risks for the economy.

In other words, a power play is underway between the new leadership and the country's administration. Indeed, government officials are the ones to lose most from the current reforms. Salaries of cadres have been reduced by 30% in a Beijing state-owned company we know-off (the announcement was received this July for an effective date on January 1st 2016 ...). Opportunities for additional gains have disappeared and, maybe most importantly, the status and influence of officials is constantly reduced by new internal regulations aiming at professionalizing the administration.

While we don't perceive them directly, it is quite certain that powerful tensions are building up under the surface. Whether they may turn into a plain sight eruption, and what consequences such eruption would have, is still difficult to evaluate.

New Ruler - New Rules of the Game

Indeed, since the accession to power of the new Party Secretary in 2013, some things have changed quite fundamentally. He has concentrated power astonishingly quickly, surprising everyone, including most certainly the former political elite that brought him to his position.

⁶ [Perfecting China Inc., the 13th Five Year Plan, Center for Strategic & International Studies, May 2016](#)

Key decisions affecting China have become less and less collegial so that the new leader's personality and beliefs become determining.

This is however a big break with the Deng Xiaoping era. Compromise had been pushed to the point that Hu Jintao's Standing Politburo needed to be extended from 7 to 9 members, in order to accommodate the different views and factions.

Many (most in intellectual circles) believe that the anti-corruption campaign is only a front for the elimination of political rivals. For them (and many international commentators) the President's accumulation of power, the nationalistic policies and the whiffs of a new personality cult herald a quasi- or neo-maoist leader.

Yet and in fairness, considering the size and complexity of the country, how could any leader be successful at the change management job that China needs without concentrating power? Doing it in a time of economic slowdown and with limited (in fact very short) time, is making it an even more daunting challenge.

Under these truly dire circumstances, one priority of the President has clearly be the military and its reform. Indeed, military power is the ultimate guarantee of political power. As a result, the two most powerful officers (the Vice-Chairmen of the Military Commission) have been removed. The reduction of 300 thousand personnel of the armed forces is also allowing the promotion of a new guard and a change of culture.

Getting the military's support has certainly entailed a measure of nationalistic positions, including the strong position in the South China sea.

In China, where the population is currently focused in improving its material conditions, nationalism is also the ultimate guarantee of popular support in case of too fast an economic slowdown (or a full blown crisis).

Opinions on whether the President is nationalistic and dictatorial or whether he concentrates power for his own sake fighting corruption and using a Chinese version of populism abound and differ diametrically. Simply said, international observers generally don't believe in genuine intentions while a wide majority of Chinese are convinced by and supportive of their new President.

An answer reflecting the reality is not as straightforward as one might want it to be, which is a reason why it has taken us quite some time to form our opinion and write this analysis.

One point is however clear: China's era of pure economic development has passed. As a member of the China Consultative Political Conference and a heir of one of Mao's close comrade once privately summed up this mood: "it is incredible that, today, we in China have nothing else than money"

Social norms and moral values are brought to the front stage as also expressed in the motto of the new leader, himself the son of a Vice-Premier of the early years of the People's Republic: realizing the "China Dream" or the "great rejuvenation of the Chinese nation".

All in all, we do believe that the new leadership's intentions are genuine and that the President stands personally behind the reforms. But, as well, he probably naturally behaves in an "strong leader" way that is more reminiscent of the pre-Deng era.

The good news, however, is that this very style is probably the best guarantee (at the moment, at least) of the success of China's reforms. And the very depth of them, the tackling of the root causes of the problems is bound to lay the ground for another round of healthy economic growth and another 10 or 20 years of stability for China.

Indeed, we do believe that the best for China is yet to come!

Your China Integrated Team

We hope that the above can be of support for your China strategy and plans. For more information about this topic, do not hesitate to contact n.musy@ch-ina.com.

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