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2014: China at a Turning Point **-Can we Hope for the Best?**

Dear Friends, Partners and Readers,

2013 has been an eventful and challenging year all over the world, but particularly so in China. What should we make out of it and what should we expect for the future?

The change of leadership to President Xi Jinping, Premier Li Keqiang and their team was not as smooth as it was planned by party elders.

In defiance of traditional political practices, Bo Xilai competed for a position in the inner-circles of the Chinese leadership sparking the most important post-Mao political crisis.

All the while, it became clear to ordinary citizens that their leaders were involved in allowing the enrichment of their allies and families to levels rivaling those of China's wealthiest entrepreneurs.

Worse, the Chinese people realized that the peddling of political influence was not only unfair but that it additionally threatens their daily lives. Collapsed bridges, train collisions, food scandals, and pollution levels have all increased considerably in the last few years, pointing to growing mismanagement by government officials.

Over the course of 18 months, from 2011 to 2012, eight bridges collapsed; corruption was attributed as the most likely cause of these incidents. In the week of 7 October 2013 alone, [59 people were sentenced to jail terms](#), some for life, as a result of 4 different food scandals. The week of 21 October, saw the concentration of particles of 2.5 micron and smaller (one key measure of pollution) [soar to a record 40 times higher than international safety standards](#) set by the World Health Organization in Harbin, a provincial capital of 11 million.

On November 5th, [the story of an 8 year old Chinese girl diagnosed by her doctor with lung cancer because of air pollution](#), went viral on the internet.

Meanwhile, a [scientific study](#) concluded that the average life expectancy of Chinese in large parts of North China is reduced by 5 years, due to the heavy use of coal for heating.

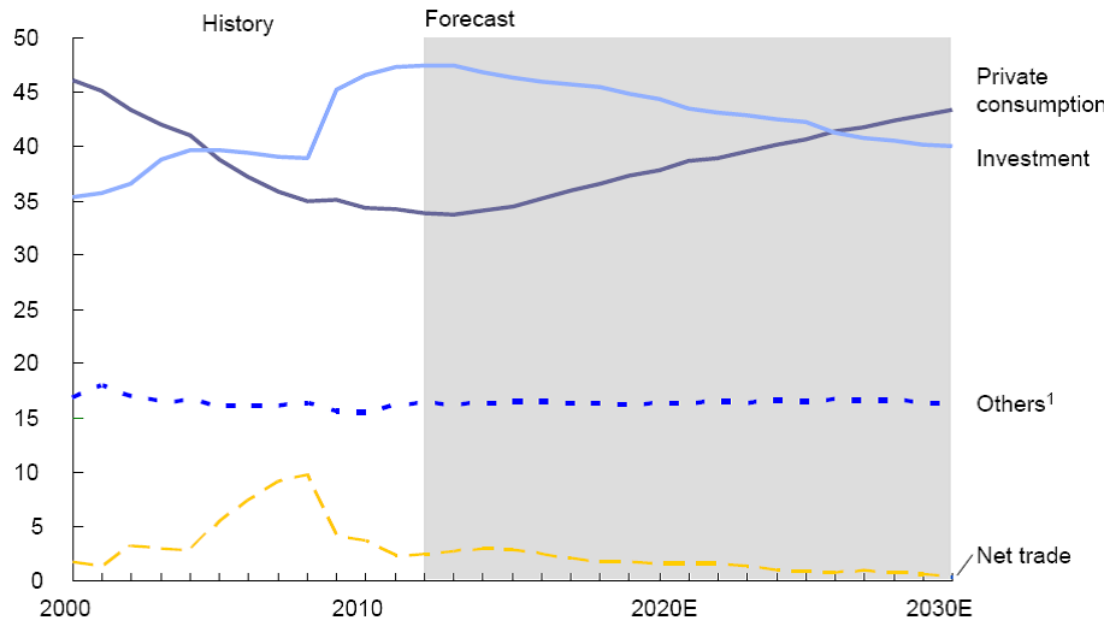
In its most moderate form, this has led to a growing sense of disenfranchisement amongst large segments of the Chinese population, manifesting itself at worst, in the form of cynicism or outright anger towards the leadership, regularly vented over the internet.

Meanwhile, on the economic front, investment has become increasingly prominent as a share of China's GDP. From 2000 to 2012, consumption went down from 46% of GDP to 33%; about half of what it is in Western economies. (By comparison, in the USA and Switzerland, private consumption share of GDP is slightly under 60% and 70%, respectively.)

Below is the historical composition of GDP as well as the projection until 2030 forecasted by McKinsey.

Share of components

%



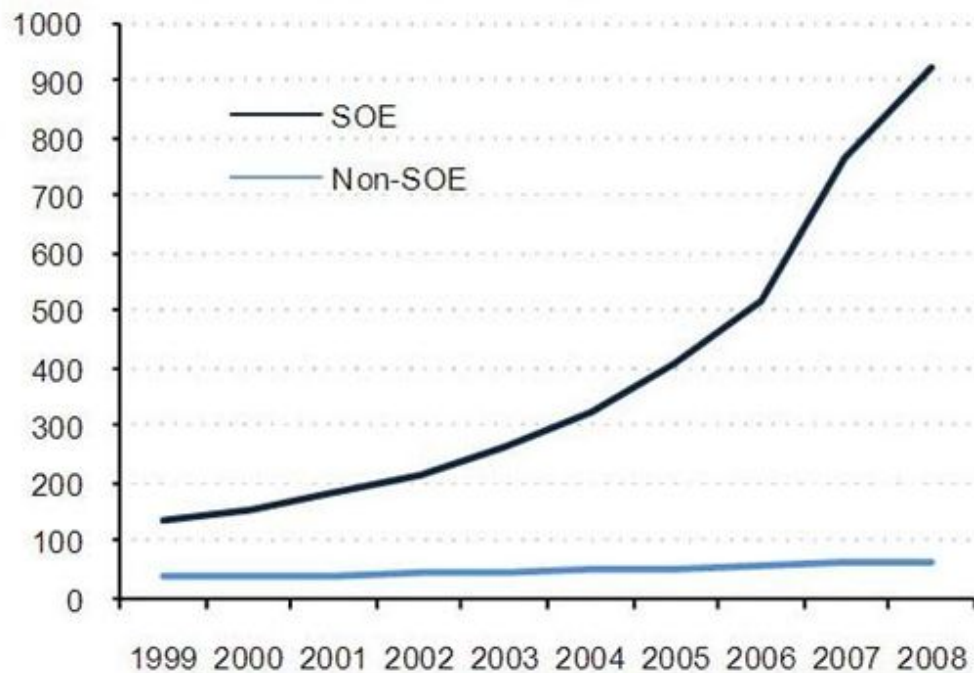
¹ Others include government consumption and inventory.

Source: Global Insights; McKinsey Insights China macroeconomic model update (2012)

During this time, state-owned companies grew exponentially bigger, using their weight to maintain their advantages, strengthen their monopolistic positions and resist change.

Figure 2. Average asset size of SOEs and non-SOEs

Average assets per enterprise (RMB mn)

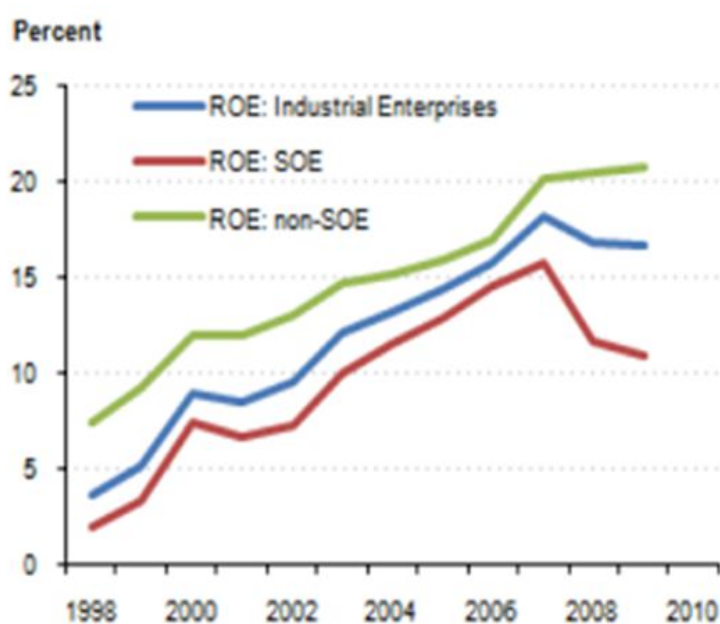


Source: CEIC, and author's calculation.

After the courageous reforms of the 1990s which reduced the size of the state sector and freed the natural entrepreneurial spirit of Chinese individuals, the “fourth generation” of communist leaders, Hu Jintao and Wen Jiabao, turned to a form of state capitalism, where growth and economic development became increasingly dependent on state investments financed by state banks. With interest rates fixed by the state, Chinese citizens today, have no better choice than to deposit their savings in state banks that yield interests often lower than inflation. The whole process has funded the state’s investments cheaply and at the expense of its citizens.

All the while, families and friends of politicians and past leaders took advantage of their privileged relations to obtain contracts from state-owned companies or to buy shares in these companies at the right time. They enriched themselves easily via the state system which, despite its advantages, returned steadily lower profits than the private sector.

This trend accelerated after the financial crisis while State-Owned Enterprises (SOE) continued on growing.



Unsurprisingly, this investment-based growth model led to a sharp surge in government debt. In the first 6 months of 2013, total (including local) debt was evaluated by a state audit and found to have increased by 13%, or 26% if accounted for annually. From 2010 to June 2013, the total government debt grew by 6.6 percentage points as a share of GDP.

With a total government debt of only 56%, China remains far healthier than all but some small Western countries, but the trend is alarming.

Clearly, China’s growth model had become unsustainable for the long-term and will likely result in a financial crisis or very slow growth if not addressed properly. Additionally, in a depressed world economy, exports can no longer be counted on to contribute significantly to GDP growth.

Sluggish growth (or a financial crisis which would ultimately turn into a recession) are unacceptable outcomes for the population. Indeed, such a situation would erode the unspoken contract that binds the Chinese government to its people, whereby the leadership continuously provides improved living conditions against the population accepting not to be involved in the political decision-making process.

Moreover, failure to manage the economic development of their country would prevent China’s current leaders from earning a favorable place in History, which remains their ultimate motivation after reaching the top of the political system. Indeed, should these leaders bring about the demise of the “New China” they would be blamed for ruining the widely respected work of the first and

second generation of leaders (led by Mao Zedong and Deng Xiaoping), an act that would incite upon them, the hate of the entire nation.

The obvious solution is to turn China's growth model away from its current reliance on investment towards greater domestic consumption. This would mean encouraging citizens to spend more of their money on improving their lives, instead of having to lend their savings to the government who spends it on infrastructure projects or lends it further to state-owned companies.

But increasing consumption is only part of the solution to achieve sustainable growth. Since the working population (the number of people generating GDP) is reaching a plateau, productivity needs to improve to maintain a growing economy. Indeed, without more people joining the workforce, each of those working need to generate more economic output to deliver overall growth.

Since state-run companies channel income to a small elite and are less profitable and efficient, encouraging and providing opportunities to the private sector is the obvious answer to increase productivity and private consumption.

The solution is evident, but its implementation goes against the vested interest of the state-owned sector, the politicians who control it and the entourage that derives gains from it.

In other words, to ensure long-term sustainable growth (and eventually nothing less than the future of China), there is no alternative than to reduce the influence of the state sector - and therefore the power of those who benefit from it.

It is no wonder, then, that Xi Jinping warned in his acceptance speech as newly appointed President, that corruption had become a threat to the communist party and its leadership of the country.

From then on, the key questions that will decide China's future, is whether the current government will be determined and strong enough to rein in the state sector and oppose its vested interests.

Fortunately enough, events that have unfolded in the past few months have given us room for optimism.

Unlike his 2 predecessors (Jiang Zemin and Hu Jintao, the "third" and "fourth" generations), Xi Jinping became Secretary General of the Communist Party, President of the People's Republic and Chairman of the Military Commission, all at once. Jiang and Hu both had to wait a number of years to lead the Military Commission. This is a clear indication that there has been sufficient consensus amongst the Chinese leadership to concentrate power swiftly.

In addition, Xi Jinping is the son of one of Mao's comrade and a former Vice-Premier, Xi Zhongxun, who is credited with the launch of the reforms in Shenzhen in 1980.

As such, Xi Jinping is part of those who don't want to see the work of contemporary China's forefathers go to waste. Just as importantly, being the son of an early communist leader gives him the background and legitimacy to gather and rein in, other descendants of early revolutionaries.

A clear indication of both his determination and the support that he commands is the decision to investigate Zhou Yongkang, one key supporter of Bo Xilai. Remarkably, it is the first time in the history of the People's Republic of China that a former Standing Member of the Politburo is investigated. Though the move is certainly a part of Xi Jinping's power-consolidation, it is also goes to show that in today's China, no one is untouchable. What's more, it means that no former leader can be strong enough to protect allies or subordinates against their unethical behavior. As a result, any official that wants to feel safe now will need to apply policy ethically.

In our view, this in itself is a strong indication, that corruption at high levels will be considerably reduced in the coming years.

On the economic front, equally strong determination has been demonstrated by Li Keqiang, the new Prime Minister. The Shanghai Pilot Free Trade Zone (Pilot FTZ) was officially opened at the end of September 2013, prior to the third plenum of the Communist Party (in early-mid November) which debated and issued the new reform policies. The rumor has it that Li Keqiang, facing opposition from the bureaucracy, literally banged on the table to push the project through.

In addition to opening education and healthcare (among other industries) to foreign investment, preparing for financial liberalization, and changing the concept of approving new companies to the one of simply registering them, the pilot zone is turning around a basic principle of Chinese law: what is not explicitly allowed is forbidden. In Shanghai's pilot zone, however, a "negative list" has been set out, outlining the list of business activities that are not allowed. Anything falling outside of it should now be automatically authorized.

While this is our normal understanding of how the law should work, it is a major philosophical change for China, since it no longer allows the government to micromanage business. As such it is a clear step towards establishing a fundamental level playing field, if not the rule of law in which Li Keqiang is rumored to be a strong believer.

What is happening in the Shanghai Pilot FTZ is particularly significant precisely because of the zone's "Pilot" status. Indeed, once the new policies are tested in this framework and become successful, they will be rolled out to the rest of China.

One cannot help but draw parallels between the establishment of the Shanghai Pilot Zone and the policies that were tested in Shenzhen in the 1980s, by none other than Xi Jinping's father.

It is therefore clear to us that China is taking the right turns and has the right leadership to skillfully guide the country along its bends. Growth will no longer be pursued at all costs and quality will be just as important as speed in maintaining China's path towards sustainable development.

Still, in absolute terms, GDP will keep accelerating, turning China in the process, into the biggest consumer market of the world. (You may also be interested in [our previous analysis](#) assessing this trend)

This path will definitely not be without obstacles or stumbling blocks. Among other issues, China will also have to handle its territorial conflict with Japan very carefully; all the while having to manage an unpredictable North Korean leadership.

Education reform will be equally important to train the human resources, managers and leaders that the country will need in taking this new course.

Yet, for now, we can look forward to 2014 (and to a few more years!) with much optimism. For international and local businesses alike, it is the time to participate in the opportunities that China's second set of big reforms will inevitably offer.

We are glad to wish you a very confident, healthy and happy New Year!

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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