

China Watch

Observations by David Mahon,
Managing Director, Mahon China Investment Management Ltd
S U M M E R 2 0 0 9

Loss is not as bad as wanting more. —Laozi, 5th century BC

www.mahonchina.com

China's flawed economic recovery

With the current momentum in the Chinese economy it is clear that the government will achieve its stated objective of 8% GDP growth this year. The majority of international observers, investment banks, think tanks and media organisations that all but ridiculed China's confidence in a growth rate of 8% in 2009 are now clamouring to identify with its success.

The US\$400 billion government stimulus package was the major factor in China's strong growth, but the fundamental economy is also strong. Some real gains have been made in increasing consumption and a great deal of the infrastructure investments, particularly in the transport network, are of high quality and will provide the bases for the development of many regions in China.

A New York fund manager visiting Beijing recently commented: 'Growth in China is largely false. It is just another communist ploy to pump the economy. You can't build an economy on the back of dams and highways.' Yet in the nineteenth century the American economy was built (at a similar evolutionary stage) on the back of infrastructure projects: railroads, canals, dams and highways. As in China, money was wasted in the process, and capacity, especially in railways, often exceeded demand. It was this infrastructure that later bore the weight of economic booms as the United States evolved to become the strongest economy in the world.

China did not borrow internationally to finance its stimulus package as most Western governments have done. It has used and can go on using its substantial cash reserves. Even at the end of June this year, China's foreign exchange reserves stood at US\$2.13 trillion, having increased US\$177.9 billion in the second quarter alone. It should allay the anxieties of those who believe China is trying to seize assets in the West unduly that in the first six months of 2009 China's outward investment fell by 51.7% year on year to US\$12.4 billion.

So, is all well in China? All is not well.

Abusing the people

In the last eight months the state-owned industrial sector has benefited hugely from the Chinese stimulus package. Gaining access to inexpensive loans, the conditions of which were softer than they had been for a decade, a significant minority of enterprises gambled with the hard-won tax revenues of the government and the savings of ordinary people. These savings are the backbone of the Chinese banking system.

‘Do not take a single needle or piece of thread from the masses’.

Mao Zedong

China's capital markets are a poor proxy for the Chinese economy itself

Partly due to reckless investment by these state-owned enterprises, the stock exchange rose 75% in the first two quarters of this year. Foreign funds, unable to find growth in capital markets anywhere else in the world, have also contributed to the exponential increases. This speculative fever has once again drawn in the hapless Chinese household investors, yet China's capital markets are a poor proxy for the Chinese economy itself, and as such cannot sustain current values.

With stocks and many portions of the real-estate sector inflated beyond their value the ramifications of SOE disobedience and reckless investment practices are considerable. In Beijing the construction of new homes increased 76% in the first two quarters of this year compared with last year. Auctions of parcels of government land resulted in prices four times higher than the original bids. Most participants in these transactions were SOE's using money earmarked for fundamental stimulus of the economy.

It is a massive lapse on the part of the Chinese government to have allowed, in the first two quarters of 2009, a 200% increase in bank loans (RMB7.37trillion) over the total lending for all of 2008. It shows the lack of economic unity in China. Provinces act in their own selfish interests and cities within provinces compete with neighbouring cities for resources. In ordinary times this competition is simply an aspect of market forces; at a time of economic crisis, and within a programme of stimulus using ‘the people's money’, it is theft. It is the same in the West where banks saved by taxpayers' money are now refusing to lend to good solvent companies at reasonable rates and therefore prolonging the world recession. While Western banks in their restraint are protecting their own profits, the SOE's are looking selfishly to their short-term gains.

It is unlikely that China will acknowledge this problem officially, but instead will make general references to restricting bank credit to avoid overheating. An internal investigation is already underway. The Chinese government has the ability to bring some prominent managers of SOEs to account and curtail the current high rate of speculation. Although lax in governing the abuses in the stimulus programme to date, the Chinese government is unlikely to be tardy in punishing the miscreants.

'Those in public office who do not love the people are salary thieves.'

Huanchu Daoren, 1600

The private sector is the spine of the Party

The pattern of bank loans over the last six months also shows an alarming neglect of private enterprises, the real engine of the Chinese economy. It has always been difficult for private companies to secure investment capital from the state-owned banking system. In 2009 it has been doubly difficult for private companies as state-owned banks and local governments favour state and recently state-owned assets and their close affiliates.

An exception is Zhejiang Province in which more than 50% of mergers and acquisitions in the first two quarters of the year were undertaken by private enterprises acquiring weaker companies in the sectors. Throughout

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the history of economic reform Zhejiang has been an example of more balanced free markets. In other parts of China, such as Jiangsu province, where SOE's have always made up the majority of companies, most of the investment activity is through SOEs. Further inland and west, private companies are struggling to sustain even simple working capital loans. At a time when the foreign

private equity firms suffer from a reduction of either capital or courage or both, the situation offers some historical private equity opportunities. Restraining these private Chinese companies by starving them of credit is, however, bad for the Chinese economy in the medium term.

Thus far the price of stimulating the economy has been much higher than it should have been and an historical opportunity to reform further both the SOE and state banking sectors and rein in provincial governments has been missed.

The central government understands what many provincial and city leaders choose to ignore; that the creation of free markets in which the private sector was dominant brought the three decades of economic development

that has benefited so many. The setbacks are temporary and will not undermine the strength and potential of the Chinese economy as a whole.

There is a perception among some in the West that China's approach to government and economic development stems from a unique and superior political model ... that China, because its government does not appear to have to answer to its people and can set economic and social policies by fiat, will soon exceed the United States in economic scale and power. While China towers over other countries in its solvency, strong underlying economy and ability to take bold steps to ensure resiliency in a climate of global economic recession and fear, the errors on the part of the government prove that it is not unique and that it struggles with the mechanisms of the free market as much as Western nations. It is as vulnerable to public opinion and, in some measure, as addicted to growth for growth's sake in order to win approval as the reckless Western governments of the past decade.

Finding internal balance

China has for some time been taking a more prominent place in the world and has become a vital economic arbiter. The world is not, as many Western observers fear, entering an age in which China will inevitably confront the West and replace America as the economic superpower.

China faces complex issues within its own borders that will absorb a great deal of its energies and ensure that its capacity to influence countries beyond those borders is constrained. The imbalance in the current stimulus programme is one example of these complex challenges.

The Chinese government has managed to mitigate the extreme downside risks of abject urban poverty

The Chinese government has a challenge to regulate the burgeoning growth in the wealthy coastal cities and provincial capitals, while allowing market forces to arbitrate the economic expansion and social change. At the same time it must remain engaged in a constant programme of economic development and poverty alleviation in some of its central and all of its westernmost provinces. The Chinese government has managed to mitigate the extreme downside risks of abject urban poverty that has resulted from industrialisation and urbanisation in most other nations in history. From Shanghai to Urumqi there are few shantytowns.

China can look with confidence to the last half of 2009 and to 2010, but it has so far not made the changes to ensure that it has an economy that has found its internal balance. Allowing a property market to recover in some

cities through dramatic price increases is simply facilitating the trade of the very wealthy and well connected, but does not give that sector firm roots. China managed to deliver a 12% increase in housing starts in the second quarter of 2009, which is a major achievement, but has still to embark on any meaningful programme of affordable housing. The impact of affordable housing will be slower on the economy than the high-end market but more profound in creating broad industrial demand for materials and labour and consumer demand for furnishings, appliances and sundry household items.

There has been little development in the pension, education and health sectors as a result of the stimulus package. Instead of being invested in pension and health plans and helping to fuel the creation of a more secure and confident society, personal savings continue to rise in banks offering pitiful interest rates. Through their anxious savings habits urban Chinese manage to sterilise trillions of renminbi each year, while giving the banks a false sense of their attractiveness as custodians of the people's wealth. Building better structured health and education systems and a savings culture in which the private sector is a significant partner will do more for the stability of China's future growth than any prolonged stimulus package. Allowing the state banks to lend more freely to private enterprise will do more to increase real consumption and alleviate unemployment than any blind commitments to SOEs.

The Chinese government will learn from these last six months that it must be a ruthless regulator and improve the quality of corporate and social governance

The Chinese government will learn from these last six months that it must be a ruthless regulator and improve the quality of corporate and social governance, giving less attention to building its public image as the originator and leader of public campaigns.

The Chinese Communist Party is an immensely powerful and adaptable organisation, the core ideology of which is economic development and pragmatism. It has not been lost on the Chinese leadership that the same deliberation in which it is currently engaged internally dominates senates and parliaments across the world: how to find the balance between government intervention in markets at risk and the extent to which they must they be allowed to correct themselves. The difference for China is that, due to its fiscal robustness and the stamina of its largely un pampered population, it has greater flexibility and tolerance than most other countries to experiment with that balance for many years to come. ☺