The **China Integrated** Analysis
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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 Maoist?

The answer to these questions is particularly critical in this new era of unpredictability in the West, 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.

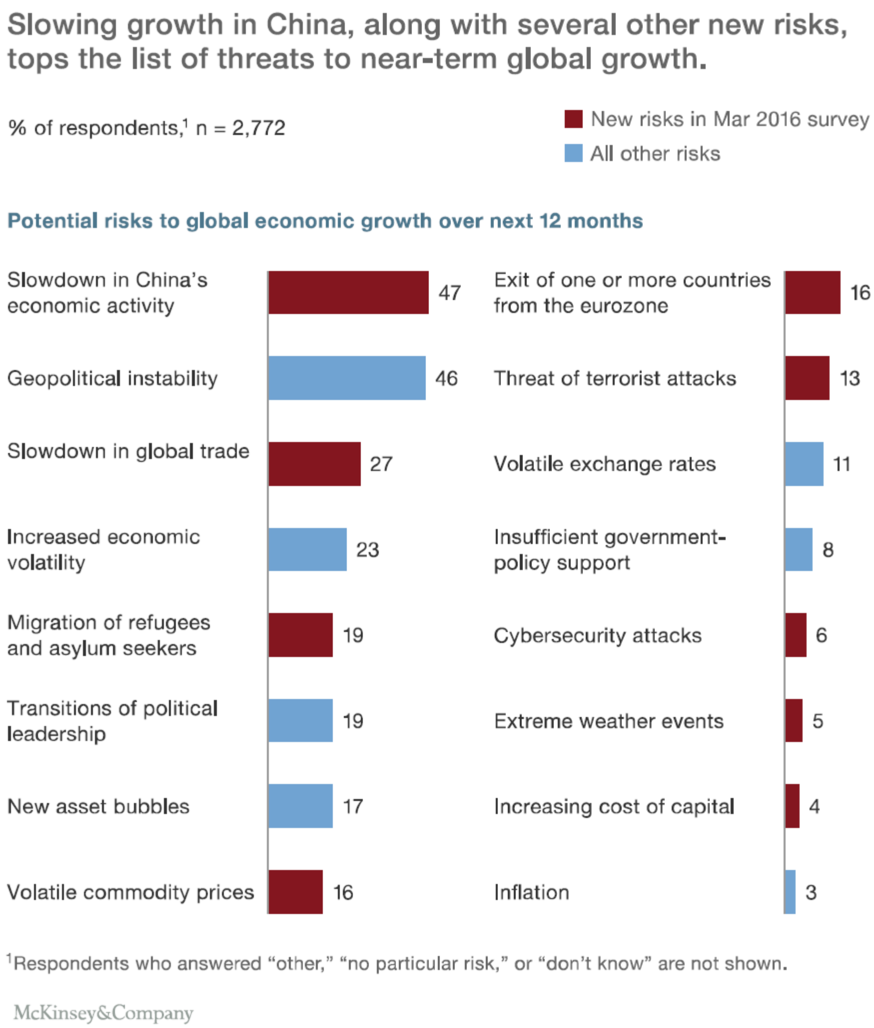
Paradoxically, even though risks and uncertainty are building up, China's best time is probably yet to come, only if China succeeds in its turnaround.

This time, however, the challenges keep accumulating and the stakes are higher than usual!

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, compounded by Brexit, the general weakening of the European Union, the instability created by the conflicts in the Middle East, and the unheard-of unpredictability of the new US administration, an economic crash in China could be the start of a new global crisis. As a result, understanding what to expect from China becomes a crucial part of evaluating how well our economies and businesses will be able to progress.

China's new leaders have announced far reaching reforms to put the country in a position to develop further as a society and as a nation. McKinsey identified China's economic slowdown as the top risk to global growth: most of us are not aware how very different tomorrow's world could be if China's reforms succeed or fail.



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

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

In Chinese eyes, this is only natural: throughout its 2'000 years of history as a united country, China was both independent and a key, if not dominant, player within the world it knew. Predictably so, in the last 30 years, China's position among nations has again become a preeminent one, at least in economic terms.

And while a few years ago China's fast growth was perceived to be dangerous competition to developing and developed economies alike, today we fear that if China sneezes the rest of the world will catch a cold. The fact is that whichever way we look at it, China's development has become an inescapable factor of our economic lives and well-being.

But recently, a stock market crash and devaluations in 2015, an ongoing and unbridled increase in corporate debts fueling real estate and other asset bubbles, ballooning nonperforming loans delivering slower growth, and now capital flight, have created much uncertainty about China's economic health.

At the same time, strong-arm tactics in the South China Sea, repression of civil society and an increase in censorship and internet control have weakened international trust. Nor are these policy directions giving the impression that China's new leadership is establishing freer and fairer conditions for the private sector, which should replace government investment to become China's new engine of growth.

Until now, the country's opaque inner workings and misunderstandings surrounding its intentions have rendered most foreign economists' predictions, especially those announcing unavoidable economic collapses, inaccurate.

In fact, China's most worrying characteristic to many, its typically top-down system that does not rely on universal suffrage, is also the reason why China is actually quite predictable (certainly much more so than large Western democracies recently).

Indeed, the Communist Party develops long and mid-term plans, which are discussed by a large number of civil servant and experts, made public for comment, then 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 preparation.[1]

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

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

In addition to the top-down, target-driven management of the country, the emphasis on pragmatism instead of ideology that is espoused by the Chinese leadership is another element necessary to understand how China functions. It is very paradoxical to us since we are used to the idea of Communists putting ideology first; China under Chairman Mao was indeed ideological to the point of denying practical realities.

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

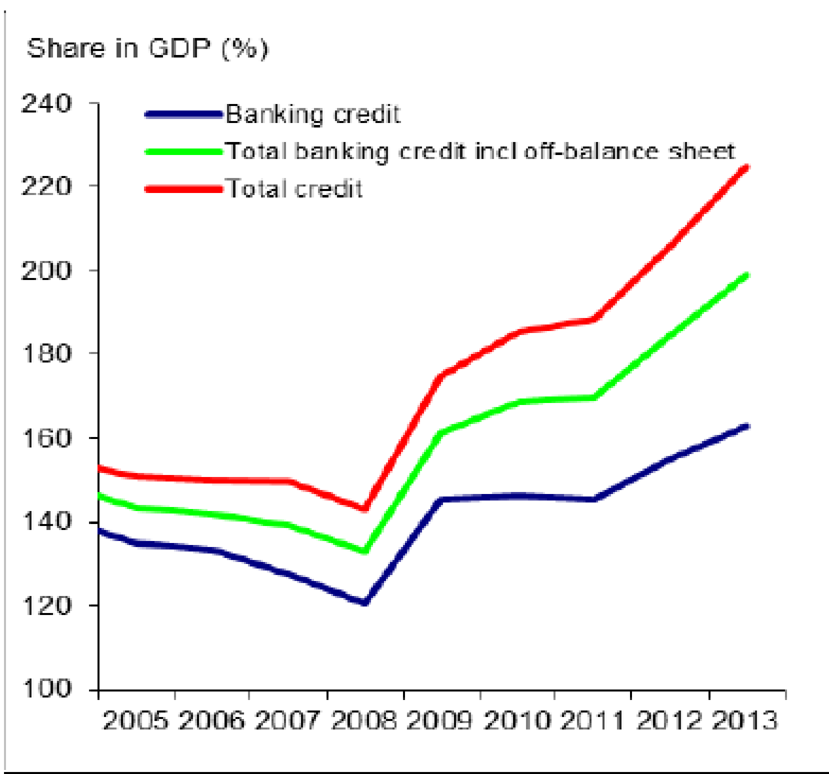
However, recent years have seen China run by one of the most fact-based and logical governments in the world, at least in economic and technological aspects. Scientific evidence, climate change for example, is not questioned and ideology does not influence analysis of economic facts. Deng Xiaoping's concept of "seeking truth from facts" and famous quote "who cares about the cat's color as long as it catches mice" still define the leadership's approach to governance.

In this context, those who are in charge in China have all the evidence in hand to know perfectly well that the current credit-fueled, investment-lead headlong rush for GDP growth has entered a dead end.

China's current economic model is simply unsustainable

The Wen Jiabao government, fearing the potential for social unrest after the 2008 economic crisis, concluded that China needed to continue to grow at high speed no matter the resources needed. China's finances were very healthy, the leadership could afford to increase debt and to streamline expansion of the country's infrastructure. Indeed, until 2008, 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

Since 2008, infrastructure construction has been staggering. 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 20 years from 1988 to 2008.[2]

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.

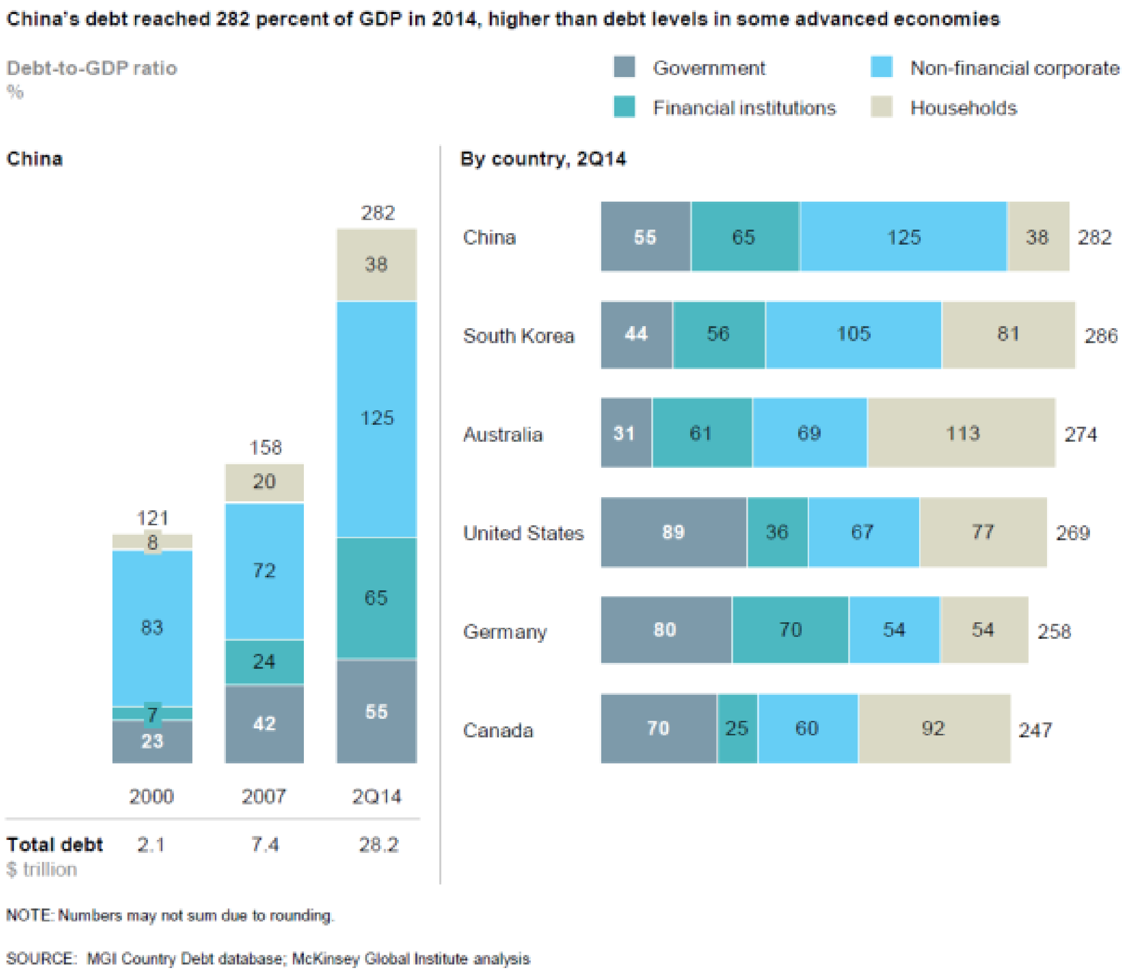
In addition, officials may make decisions to grow their local economy that do not make sense at the country level. Under pressure to meet growth targets, provincial leaders launch large projects that will have a significant economic impact. The most striking example is the 210 coal fired power plants that were locally approved for construction in 2015, while coal consumption decreased in China for the first time in 2015.[3] As a result,103 of these projects (many already under construction) have just been ordered to stop by the central government. Indeed, almost no new coal power plants will be needed, as the country's increase in electricity consumption is anticipated to be increasingly covered by non-fossil fuel sources of energy in the push to reduce CO2 emissions!

Powered by the same logic, the state-lead investments of the past 7 years have created considerable overcapacity in the traditional heavy industry sectors (steel, 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.

Moreover, not only are state investments increasingly inefficient, the increase in loans that are needed to finance them is becoming dangerously unsustainable. As the chart below shows, from 2007 to 2014 China's total debt rose every year by about 20% of GDP on average (from 158% to 282% of GDP).

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

[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 (reaching 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 debt burdens.

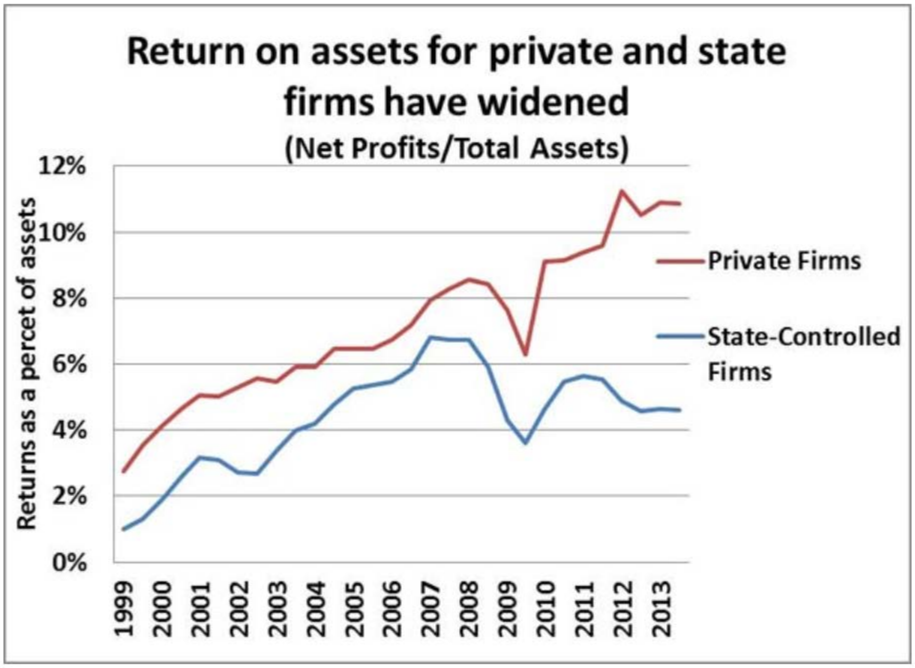
Fortunately for China, the financing of the debt is almost completely domestic (as it is in Japan), supplied essentially by the nearly 30% of disposable income that the Chinese citizens accumulate in their bank accounts.[4] This does not put China in the position of some emerging markets which depend on international loans to finance their development and which are at the mercy of such loans' recall. Additionally, foreign exchange controls limit Chinese individuals 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.

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

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 should save less and participate more directly in the economy, either by consuming more or by investing directly in existing or new businesses. In such a case, spending will be maintained, but it will be carried out directly by the people, without generating debt.

Additionally, the private sector is significantly more efficient (has a much better Return on Investment - ROI) than the state one. Favoring private investments will naturally ensure much better efficiency of the investments made and a virtuous cycle of growth.



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 put in place 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 2020.[5]

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

[5] Hu, F. B., Liu, Y., and Willett, W.C. (2011). Preventing chronic diseases by promoting healthy diet and lifestyle: public policy implications for China. Obesity Reviews, 7, 552-559.

"Innovation" and "mass entrepreneurship" are the new buzzwords of China's economic policy.

Included in the reforms package to promote new businesses are development of the rule of law, streamlining of bureaucracy, and the speeding up of 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 progress in the speed of company registration, it is certainly not amounting to a sea change in everyday business life. 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 is announced.

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. As a consequence, some have questioned whether the current reforms are genuinely meant by the new leadership and its President. The power he has consolidated into his own role has given rise to the talk of a new Mao-like era, preventing economic reforms under the responsibility of 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 out in the latest Five Year Plan (No. 13, announced in May 2016) have certainly be overseen by the President as well (the delay with which the plan has been published is an indication that the President has wanted to go into details of the plan himself).[6]

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

Officials want to avoid making mistakes and therefore play it safe, interpreting regulations more strictly than necessary. In addition, a number of civil servants may act passively on purpose, taking the economy hostage and hoping that they will get freer reins if the economic slowdown becomes too acute and creates unhappiness within the population.

In other words, we believe that a power play is underway between the central 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 of (the announcement was received last July for an effective date of January 1st 2017). Opportunities for additional gains have disappeared with anti-corruption enforcement; and maybe most importantly, the status and influence of officials is constantly reduced by new internal regulations aiming at professionalizing the administration.

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

While business people in China don't perceive these internal tensions directly, it is certain that they are building up under the surface, particularly in view of the intra-party elections in October this year that will select the new Politburo (China's supreme organ of power). Whether the current power struggle turns into a plain sight eruption, and what consequences such eruption would have, is still difficult to evaluate.

New Ruler - New rules of the game

Since the accession to power of the new President and Party Secretary in Spring 2013, much has changed.

He has concentrated power astonishingly quickly, most probably in a way that has surprised even the former political elite that brought him to his position.
This appears to be a big break with the Deng Xiaoping era, during which collective leadership was the norm and political compromise had required that Hu Jintao's Standing Politburo be extended from 7 to 9 members, to accommodate the different factions within the party.

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

As part of his power consolidation, the President has ensured in priority his control over the military, the ultimate guarantee of political power when worse comes to worst. As a consequence, the two most powerful officers (the Vice-Chairmen of the Military Commission) have been removed and the subsequent reduction of 300 thousand personnel of the armed forces is allowing the promotion of a loyal new guard.

Getting the military's support has certainly entailed taking a number of nationalistic positions, including the strong stance in the South China sea. Besides, in China, where the population is currently focused on improving its material conditions, appealing to nationalism is the best (if not the only) assurance of maintaining popular support in the case of too fast an economic slowdown, or of a full-blown crisis.

A strongman – For better or worse?

Opinions vary on whether the President is nationalistic and dictatorial by nature, whether he strives to achieve goals that he believes are for the good of the country or whether he is a populist concentrating power for his and his close associates' sake under the guise of fighting corruption.

An answer reflecting the reality is not as straightforward as one might want it to be and the truth probably contains some of both theories. International observers generally do not believe in the Chinese President’s genuine intentions. But while many well-off

Chinese have become quite cynical about their leadership, a large majority of the common population are convinced by and supportive of their President. His approval rating is generally considered to be between 70% and 80%.

In fairness, and considering the size and complexity of the country, how could any leader be successful at the change management job that China needs today without concentrating power? Achieving such a turnaround in the middle of economic slowdown, with a time horizon of a few years and the certainty of antagonizing the administration, is making it an even more daunting challenge.

As far as we are concerned, we believe to a large extent in the truthful intentions of the leadership. In any case, we are convinced that the economic improvements and anti-corruption activities are genuinely meant and that the President stands personally behind the reforms.

The critical question is then whether the current leadership will prevail in the political struggle underway. By all means, the outcome should be clear in October.
In the meantime, we think that the President will prevail. As a result, and provided no trade war erupts with the USA, China will manage its shift to an economy led by the private sector and fueled by market forces, which in turn will usher in a new era of considerable opportunities, for both local and foreign businesses.

The Year of the Rooster opens up in an environment that has rarely been so unpredictable. Yet, we can be optimistic and we certainly hope for the best.

We therefore wish you and all of us another year filled with **joy**, **health** and **many Chinese opportunities** followed by **numerous successes**!

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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