

Trip Report: China on the Eve of Reform

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This note presents observations from a recent visit to China.¹ A number of themes dominated discussions, including consumer sentiment, investment patterns, and the environment. The visit coincided with a landmark Central Committee meeting at which the new leadership rolled out its economic policy roadmap. The direction China would take in the near- and medium terms was on everybody's mind and discussants offered a wide disparity in views and reserved outlooks for the future.

A high-velocity economy

The avidity of consumerism in the big cities is striking: Who said China is a nation of savers? In November, consumer spending was up over 13% year-on-year, according to the government. Most cars crowding Beijing's streets are under five years of age. Hong Kong is awash in shopaholics from the mainland and it rightfully has been dubbed the Great Mall of China. Branded bling is big: Louis Vuitton has emerged as the gold standard for having made it. Foreign car firms are developing special long wheelbase models in China for limousine-like rides. Though China is known for its knock-offs—from clothes to fast food—it's clear that once folks have money, they want the real thing. In this light, counterfeits have served as a powerful gateway for capturing brand- and quality-conscious buyers, said a person I spoke with in the luxury business.

I took the bullet train from Beijing to Shanghai, and, despite the relatively expensive \$90 ticket, all the trains that Sunday afternoon were sold out. The trip is the same distance from New York to Chicago: It took five hours and twenty minutes at a steady 300 kilometers per hour. The bullet trains—plus China's expansive airports, highways, and subways—not only have fueled consumption and growth but they are a potent symbol of China's modernity and its can-do system.

A good share of household income in China goes unreported, so consumer demand exceeds conventional wealth and spending models. Nevertheless, the government is seeking to boost the share of GDP accounted for by the consumer sector. China already has the world's largest market for cars, smart phones, groceries, and gold. The consumer segment in China will do very well in the future and this will lend robustness to the economy.

¹ This note reflects input from conversations with over forty individuals, including business executives, journalists, lawyers, market analysts, investment bankers, venture capitalists, private equity partners, R&D personnel, manufacturers, and small business owners. Sectors covered included retail and consumer, automotive, healthcare, insurance, financial services, real estate, and technology.

Chinese outbound direct investment is surging—up over 17%, according to official data, in the first three quarters of 2013. Portfolio investment is believed to be growing quickly as well. For many years, SOEs have been gaining control of natural resource assets abroad to supply Chinese domestic demand, but interest in resources as a source of reliable financial returns is growing, reported an investment banker. Taking minority stakes is part of this trend—to facilitate target country approvals and to gain expertise. The desire for real assets and reliable returns is making real estate, consumer goods, agriculture, and cinema and restaurant chains attractive targets as well. The US vies with Australia as the top destination—thanks to attractive assets, markets that are seen as reliable, and cultural fit. In many ways, these trends are an indicator that China has become a wealthy, globalized, and normal economy.

I also heard a personal undercurrent in the narrative—China risk. For individuals with resources, hedging strategies include getting your child into a foreign university, buying property abroad, and gaining a residency permit. A real estate advisor spoke of developers being “in a bit of a rush” to do offshore deals. Again, the US and Australia are top destinations—thanks to their popular tourist attractions, perceived safety, and cultural fit. In October, a state-owned developer, Greenland Holding, announced one of the largest Chinese investments in the US to date: a multi-billion deal to build thousands of apartments in Brooklyn targeted at Chinese buyers. The firm has large residential projects underway in Los Angeles, Sydney, and Melbourne as well.

Uncharted territory

During the Global Financial Crisis, a massive economic stimulus helped propel growth in China and helped mitigate the sharp downturn multinationals experienced in their traditional core markets in North America, Europe, and Japan. As a result, China has become core to multinational firms’ growth strategies. But growth is moderating—down from double digits a few years ago to about 7.8% this year. Experts expect further slowing, though there is wide disagreement as to how low growth will go, given economic fundamentals and the leadership’s policy choices.

As growth has slowed, there’s a sense among market watchers that China is speeding into uncharted territory. Concern is focused on massive subsidies and loose lending to state-owned enterprises (SOEs)—over which Beijing has struggled to exert control. This has resulted in excess capacity, low productivity, and losses. The system is “adding risk to risk,” said a respected financial analyst. A prominent economic expert described the situation as “the preconditions for financial crisis” which would be followed by “painful deleveraging and prolonged slow growth.” A number of discussants described zombie cities of see-through apartment, retail, and office complexes, suggesting a real estate bubble on the verge of bursting. Business leaders spoke repeatedly about how the business environment for foreign firms is becoming more challenging—with rising costs, increased competition, growing regulatory and media scrutiny, and intensifying brand risk. “The next few years are going to be rocky,” said one long-time observer.

Yet, I came away with the feeling that most people believe that China somehow will power through this patch, that the data are misleading, and that conventional market forces don't always apply. Western models can't explain China's real estate market, said a real estate advisor. "To have a bubble, you need a market," said a venture capitalist. A run on the currency—a common risk vector in emerging markets—is considered out of the question given government controls and the size of the economy. Should significant numbers of SOEs and the wealthy families behind them find themselves facing hard times, most expect the government to step in with bail-outs or a deferment of the problem—as it has been doing *ad hoc* for the past 30 years. In other words, China is too big to fail and the Party is underwriting its system with an implied sovereign guarantee.

The sharp downturns in many emerging markets in the past couple of years has forced multinational companies to reassess their strategies there. At headquarters, expectations for China remain high, because the market's performance remains significantly stronger relative to other countries. In short, China is becoming even more central to many multinationals' emerging market growth plans. This situation contrasts with the subdued outlooks I heard in China. "It's a Lake Wobegon world," said a company executive—a place where everything is expected to be above average. Then he added, "shit happens" when above-average performance is consistently expected.

The policy agenda: What's real and who's in control?

China has a government-led economic system, so politics shapes outcomes as much as economic fundamentals.

There was a consensus that China's leaders—President Xi Jinping and Premier Li Keqiang in particular—are clear-eyed about the need for fundamental reforms to wean the economy off its reliance on free-flowing loans and subsidies, infrastructure-building, exports, inefficient SOEs, polluting industries, and low-wage migrant labor. They know that entrepreneurs, inventors, and small and medium enterprises need a more supportive business environment and that farmers should be able to own, buy, and sell land. They know they need to at least superficially heed their Communist heritage and improve the pension system, the social safety net, and healthcare. They know they need to ease the day-to-day nuisance of having to bribe public servants, even doctors, to get decent attention.

No one knows how the leadership will get this all done. One perspective I heard holds that Beijing is in command and that its bureaucrats are good at pulling levers to achieve the right outcomes. China's performance in the Global Financial Crisis has reinforced this perception. Others were less sanguine: "We ascribe competence to government leaders in China, but they are not really in control," said a company executive. As an illustration of these contrasting views, some said the government's modest efforts to rein in the credit market in June was a weighty warning shot directed at profligate lenders; others said it was a hapless misadventure that nearly froze up of the banking system, forcing a hasty retreat. Some said that the September unveiling of the Shanghai

Free Trade Zone was a calculated, if halting, signal of important reforms coming to the banking sector; others said it's an unnecessary distraction, a way to ring-fence reforms, and a real estate boondoggle to buy off local officials.

At the top, it was argued, Xi and Li are astutely picking off political opponents. Others alleged that recent arrests and show trials were more anti-corruption theater than substance and that the trials merely show how venal life at the top has become. Some said China's elites are tightly unified—if only around the goals of making money and staying in power. Others said that the Communist Party is pluralistic and that pitched ideological battles are going on behind the curtain. Some said the Party has another ten years to sort this all out; others said the regime has run out of runway.

The lack of consensus on the fundamentals and the high level of uncertainty about the future raise the challenge of getting our understanding of China right.

The politics of the USSR, circa 1986

As someone who studied and spent time in the Soviet Union in its latter years, I see a number of political parallels and contrasts that can be used to frame our thinking about the tremendous forces shaping China today.

I wrote a book about the USSR's grim environmental legacy. China has rewritten it. The shiny bullet train I took to Shanghai passed countless dark satanic mills and scarred landscapes as it sliced through an ominous smog. I felt as though I was sitting in the smoking car. Everyone I spoke with—from executives to drivers—talked about the pollution, and, notably, how it had gotten significantly worse over the past five years. People pay a tremendous premium to procure what they believe is untainted water and food, and they worry about the health of their children. After Chernobyl, the Soviet leadership under Mikhail Gorbachev began to allow people to advocate for the environment in an effort to build popular support for far-reaching economic reforms. But once people got talking about it, environmental destruction became a metaphor for how rotten the Communist system had become and the leadership quickly lost control of the narrative.

President Xi is very Gorbachevian: He's articulate, relaxed, and engaging—a sharp contrast to the wooden poles of the past. He has a glamorous, accomplished, and visible wife. He conveys an impatience with the status quo and he's said to have consolidated power at an unprecedented pace. Xi has branded his ambitious vision of the future the China Dream, an appeal to retro, rosy-Socialist populism. His mastery of political theater has generated tremendous expectations for change both at home and abroad.

Thirty years ago, Gorbachev pitched Uskoreniye (Acceleration) and then Perestroika (Rebuilding), which he underwrote with a massive fiscal stimulus. The West was cheered by the notion of a vigorous, reformist Soviet leader. Others worried that Gorbachev was amassing too much power. Alternately, we fretted that he was a hapless

tinkerer who didn't have enough power or commitment to do real reform and go against entrenched interests in the regions, heavy industry, and the security forces. The USSR's end came when the Communist system's contradictions couldn't be bridged by well-intended reform, the economy stumbled, and the leadership split.

The USSR in the mid-1980s was like a tanker—full of oil and slow-moving. Growth and social mobility had stagnated. The Party and its dogmas felt sclerotic. Few had first-hand exposure to the Western world. Activists were lucky if they had access to a typewriter. Elites were lucky if they access to a decent grocery store. Expectations for change were low, until Gorbachev raised them. China today, in contrast, is incredibly freewheeling. The population has seen a tremendous improvement in its standard of living. People are flocking to the cities to seize even more opportunity. They've seen their country become a forceful international player. They are traveling abroad in record numbers. Social media has emerged as a free market of ideas as well as hearsay, intrigue, and resentment. A sense of entitlement to all of this is emerging. And now, the leadership has upped expectations with calls for even more change...for China to be even more free-wheeling.

Xi is keenly aware of the lessons of Gorbachev. He has sought to address common frustrations (easing the one-child policy was an easy give-away) and passions (upping tensions with Japan and other neighbors is a handy diversion). At the same time, he has aggressively applied the regime's levers of societal control. (The Longview Global Advisors website is not accessible there.) Looking a few years down the track, however, it's hard to imagine how Xi and Li get the difficult reforms done without fundamentally changing the rules that have propelled the economy, maintained control and stability, and enriched the provincial chiefs, the SOE bosses, the top families, and the generals that are the Communist ruling elite.

With China's long, almost monotonic rise, there is little doubt about the country's accomplishments or market relevance. But this has been underpinned by a host of contradictions—environmental, economic, political, and social—that will have to be addressed in the coming years. One can applaud the leadership's reform agenda, but they are engineering it from the top and they won't get it all right. It's like changing the control systems on the bullet train as China speeds down the rails.