China Watch

A China Business Report prepared by David Mahon,
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AUTUMN 2015

The mind of man is more perilous than mountains or rivers,
harder to understand than Heaven.

Zhuangzi, fourth century BC

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Figures and facts

When China's stock market stumbles, despite its small size and the fact that it does not reflect the core Chinese economy, world markets fall. International stock markets ascribe too great an importance to the short-term global influence of China's economy. As the Global Financial Crisis spread recession and fear throughout the world, the West hoped that Chinese GDP growth and consumer demand would be its salvation. Chinese demand for commodities helped some countries such as Australia and New Zealand to weather the worst of the recession, and perceived good news from the Chinese economy boosted global confidence. But the United States and Europe have procrastinated in fixing their problems, waiting for outside forces to bring solutions. After almost seven years, Western growth and confidence are still low. Westerners often look at China as they would smaller, developed economies, or more export-dependent developing economies, misperceiving the nature of Chinese debt, the currency and the makeup of GDP growth. China is bound by the same laws of economics as the West, but the context within which China is evolving differs due to its scale and the varying stages of its sectors' and regions' economic development. Its economic cycles are determined more by internal than external forces. Economic forecasts are difficult in China and need to be viewed with especial caution when, citing exceptionalism and historical paradigm shifts, they are extremely positive or negative, just as the West's debt-fuelled growth of the last 20 years should have been questioned more rigorously.

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China remains a net creditor to the world and finances most of its debt within its own borders. China's largely state-owned banks can engineer discounts and forgive debt more easily than Western financial institutions, which have more complex regulatory restraints and shareholder obligations. Although governance is often weak, the Chinese Government has adequate power to curtail provincial and municipal overspending and punish noncompliance. China's recent stock market chaos has cost the country billions in bungled bailouts, but the People's Bank of China maintains reserves of over US$3 trillion. The devaluation of the renminbi over the last month understandably shocked global markets further, but it was simply an unfortunately timed but overdue currency correction, not the over-reaction of an administration to a localised crisis.

Resetting the renminbi

China has broadened the band within which the renminbi trades on a daily basis to allow for a more market-based valuation. This is something that the United States and, to a lesser degree, Brussels have been pushing China to do for 20 years. Over the last month, the renminbi did not appreciate as the United States would have liked but instead depreciated, reflecting that it had been overvalued against the US dollar. Between 2007 and 2015 the renminbi rose 52% in real terms against the dollar. Washington is still pushing China to implement more radical currency reform. This will intensify as the United States' complex presidential election process runs over the next 15 months, during which both Democrats and Republicans will criticise China to deflect public criticism of their own economic leadership. If there has been currency manipulation over the last five years, it has been the United States and the Eurozone, with their quantitative easing policies, that have effectively exported deflation to the world.

Between 2007 and 2015 the renminbi rose 52% in real terms against the dollar.

The devaluation of the renminbi was an attempt by regulators to expose China's non-convertible currency to a more rational, market valuation. It was not intended to create a short-term boost to exports. On the contrary, it will have little effect on China's exports, as cheap mass-produced products now account for a minority of exports. Electronic and industrial goods make up the majority and are not as price-sensitive as cheap consumer products. Even if China had allowed its currency to appreciate more over the last decades, the economic effect on the United States and Europe would have been negligible, as other Asian and Central American countries would have taken over as sources of low-cost labour and cheap goods. This shift is already taking place, with mass-produced consumer goods flowing increasingly from countries such as Bangladesh, Vietnam and Mexico. There have been job losses and factory closures in some sectors of the Chinese economy, but these are part of inevitable and tolerable adjustments to the country's manufacturing sector and trade account, and stem from the drive to ensure that exports are more valuable and sustainable.

Many China watchers have suggested that the mishandling of attempts to expand the stock market, the devaluation of the renminbi and nominal slowing of industrial output indicate that the economy is in deep trouble and a hard landing and recession are imminent. They are wrong. The Chinese economy is slowing and the government will increase infrastructure investment over the remainder of the year to ensure that employment levels are maintained and GDP growth is as close as possible to 7%. A good measure of economic strength is that current unemployment in China is just over 4%, less than half that of the European Union. Figures in China are always debated, but an unemployment rate of even 6% is low in a developing country still urbanising tens of millions of workers each year.

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Economic reform is often, by necessity, disruptive to normal commercial activities. The shocks being inflicted on the Chinese economy by policymakers and regulators are crucial to allowing it to adapt to its own growing sophistication and complexity, and to the protracted and faltering global economic recovery. The Chinese Government is managing to rebalance its economy, albeit awkwardly. It is now focused on reducing government debt and expenditure and reforming the powerful economic engines of its service sector.

Better serving the people

The service sector makes up more than 50% of China's GDP and is growing. There has been a historical bias towards manufacturing in China as interest rates and the comparative value of the renminbi were low for the first two decades of reform, and therefore the returns in manufacturing investments were higher than those in the service sector. Service-sector reforms are years overdue and resistance to change among state-owned enterprises is stiff. China's service sector is far more restricted than those in OECD economies, with the state dominating key activities such as transport, ports and logistics, telecommunications, and utilities. Restricted sectors have historically performed poorly compared to those open to domestic and international competition. The state will need to remain involved significantly in transport and key utilities, but privatisation of most other service industries will help to make the economy more efficient and deliver better-quality growth. This will also help maintain acceptable levels of employment for newly urbanised families and those made redundant from the manufacturing sector. Urban disposable incomes grew 7% in the first two quarters of 2015 and urban employers now compete for workers.

While it is incorrect to perceive China as an economy in trouble, the government does face formidable challenges in the coming years. Overinvestment in manufacturing has resulted in oversupply of some consumer products and an inability to adapt to rapidly changing consumer tastes. The food and beverage sector expanded rapidly over the last five years, but increased supply has hurt margins for some products, and in some cases, sharp increases in imports have made matters worse. A good example is the Chinese dairy industry.

Fatted calves

Chinese per-capita dairy consumption has been low historically, and despite sharp increases over the last decade, small even by Asian standards. China consumes 11 kg of milk per capita per year, while Taiwan consumes 15 kg and Japan more than 30 kg. Chinese consumption grew rapidly from 2004, driven in part by the elaborate and often exaggerated claims of the benefits of dairy products made by the two major dairy companies, Mengniu and Yili, which created a level of demand that local and imported milk supply could not meet. Dilution and engineering of the milk that was available resulted in the melamine crisis of 2008. Milk consumption plummeted and domestic herds were culled, so that when demand recovered, the lack of local raw milk as well as food safety fears spurred demand for imported products.

Due to lack of domestic milk, Chinese beverage companies began marketing cheap dairy drinks containing mostly water, sugar, flavouring and colouring, with a small quantity of often imported whole milk powder (WMP). Official dairy industry data recorded dairy drinks as liquid milk, causing what appeared to be an unprecedented spike in demand for dairy products when what had increased was in fact the consumption of water and sugar. As consumer understanding improves, many are now rejecting dairy beverages, with a resultant apparent fall in demand for liquid milk.

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In the distorted boom years, Western dairy exporters increased production substantially, thinking that they would find the growth and value in China that their own more sluggish markets could not deliver. The lifting of quotas in the European Union, a Russian embargo on European dairy imports in retaliation for Western sanctions, the low cost of animal feed in the United States and overinvestment in milk production in Australasia contributed to a global dairy glut, culminating in this year being a bad year for the global dairy industry.

There is strong medium- and long-term potential for growth in Chinese dairy demand, but prices are unlikely to improve in China until the global glut and Chinese WMP inventories clear. This will probably be in the second quarter of 2016.

Old rules for new games

The boom and bust seen recently in the dairy industry has been a problem throughout China's consumer sector over the last two decades. Chinese and foreign companies repeatedly misunderstand surges in key sectors due to the opaque nature of the Chinese economy. Misjudgement is usually fuelled by a measure of optimism and greed, and an inability to question the sustainability of the booming sector because of a fixation on short-term growth. It is innate to commercial thinking to conceive of times when the immutable economic laws will be defied, cycles broken, and profit and prosperity ensured indefinitely. This delusion dogs both Chinese and Western businesses.

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China is increasingly more a value than a growth proposition. In the food and beverage sector, Western companies with the ability to do so need to set up their own processing and distribution in China, or at least find local partners with which to establish a presence in the market. Shipping consumer goods to China without managing customers' perceptions and controlling distribution is increasingly risky, as in an often oversupplied domestic market, misperceptions are hard to change once established. Once the Chinese Government opens its service sector more widely, there will be good opportunities in sectors such as freight forwarding, product distribution and eventually financial services. This will provide rafts of new opportunities but also bring more booms and busts.

Despite the often stilted and nationalistic nature of Chinese government rhetoric, this one-party state realises that its legitimacy depends on economic stability and growth. Premier Li Keqiang, who is primarily responsible for management of the economy, and his team have made serious mistakes over the last 18 months, but what matters is that they learn from them and avoid repeating them. The Chinese leadership is not unique in failing to interpret market forces correctly while trying to facilitate and maintain economic prosperity and stability with sound policies. Although the West must not ascribe unrealistic value to the importance of the Chinese economy, China and the West are bound inextricably, and need to understand their interdependence before they can correct their own economic imbalances. ☯