China–Crouching Tiger or Hidden Dragon?

By E. Ted Prince, PhD

To study wealth creation is to study China because of its increasingly pivotal position as a global engine of wealth creation.

In such a huge and complex nation much goes on beneath the surface, unseen by foreigners and even many Chinese. Though China’s short-term future appears bright, some of these submerged issues could result in disruptions in the medium- to long-term.

Politics
China’s hallmark inscrutability on the domestic political front camouflages a lively political system that is largely hidden from foreigners. Even where it is more visible, it is less understood because it plays out within a nominal one-party system that nonetheless conceals numerous factions and interests. More kabuki than road-show, the political system serves to represent China’s most important societal interests, and though unstated, one of those interests undoubtedly is wealth creation and management.

The Chinese model famously involves a tradeoff between political and economic activity. It aspires to be like Singapore, which operates with a one-party system that has a high degree of economic flexibility and freedom. After observing recent financial and political problems in developed countries, China is even more committed to the superiority of its approach, which provides strong national direction and allows for fast action. The Chinese stimulus plan shows the Chinese system at its best, enviable for its social and apparent economic effectiveness.

Consumer surveys show that Chinese citizens are more satisfied with their government than citizens of almost any other country in the world. Thus we can expect this political model to endure for the foreseeable future. It will increasingly act as an anchor for Chinese contributions to enhanced global financial frameworks. It also will enhance avenues that Chinese see as crucial to their wealth creation, particularly in the area of trade.

Until very recently, the Chinese were using their vast energy to catch up to the United States. This is no longer their goal. Their goal now is to surpass the United States and other developed nations. This is reflected in China’s moves to strengthen overseas mergers and acquisitions, to restrict foreign investment in China, and to gain control of certain Western technologies and brands. This strategy is producing a powerful dynamic that will drive some of the greatest opportunities for foreigners who have access to these resources and can suitably leverage them.

The Social Side
In contrast to the political side, the social side of China is much messier. China has a weak center, despite its one-party political system. Cities and other local governments are very strong, leaving the central government with only weak control. This means that the strong policies that China directs outwardly to the rest of the world are not necessarily matched by directives to its own regions in strength, effectiveness, and execution.

This dichotomy has major implications, particularly for foreign investment. It means that in China the effectiveness of capital generally decreases dramatically among the regional and more local areas. Indeed, the center often has little or no information about what the regions are really up to, a situation demonstrated in recent revelations about local governments’ huge levels of debt. The center only recently has become aware of the enormity of these debts and their serious financial implications. This lack of control is also exacerbated by China’s relatively poor statistical systems, which have resulted in poor information about what is happening at the grass-roots level.

Some of China’s more serious social issues are demographic. Developing countries usually have young populations, but China’s one-child policy is turning it into a rapidly aging nation. China’s demographics resemble those of a developed nation: a growing aged population relying on a shrinking proportion of young people. This situation imposes limits on China’s growth and implies that increases in gross domestic product will fall faster than expected at some stage in the future, particularly if Chinese consumption rates don’t increase.

China’s great gender imbalance is also a serious social issue. We don’t know its impact, but it’s unlikely to be pretty. At the very least, crime rates—currently extremely low in China—will increase, compromising public security and increasing the cost of maintaining security in the investment calculations of foreign business people and investors. Expanding the military may be an option for handling China’s growing cohort of young men, and this has other implications beside the fact that China already has a larger-than-average military.
China's rural-urban divide and internal migration are also vexing. Chinese authorities seem to be moving toward more-effective policy that will relax restrictions and reduce social stress. This should improve social stability and open opportunities for China as well as for foreign investors—provided they can broker China's growing resistance to foreign investment.

**Macroeconomy and Trade**

China is still on a roll in the areas of trade and macroeconomy. But some major stress points may emerge sooner than most observers would expect.

First we should recognize that the Chinese—both the elite as well as the general population—deeply resent what they see as unfair terms of trade for China. Westerners tend to be dismissive; they point to China's huge trade surplus. But the Chinese see an unfair playing field that's the 21st-century equivalent of the Great Powers' 19th-century rape of China. This resentment will continue to impact financial and investment relationships between China and the rest of the world. It will be reflected in China's financial, trade, and investment policies toward the West and even in its defense policies.

The West's response focuses on its huge (but of late declining) trade imbalance with China, China's massive foreign currency reserves, and the associated unemployment that has resulted in Western nations. The Chinese acknowledge that the real problem, however, is China's lack of institutional capacity—including its lack of domestic credit mechanisms for consumers along with its lack of a social welfare net that would obviate the need for high savings levels—to soak up this surplus via domestic consumption. The Chinese argue that increasing the nation's domestic consumption, among other things, is more important than manipulating foreign exchange conversion rates in terms of developing a sustainable Chinese economy, and that this is also in the West's best interests.

Westerners also have overlooked that China's economy itself has its own major issues. As China has taken its banks public over the past few years, the nation has been forced to recapitalize them with huge investments—i.e., the equivalent of Western bailouts, and such bailouts may be necessary in the future.

Recent revelations show that China's banks are staggering beneath enormous loans to local governments, which have kept the loans off their own books and often used them for highly speculative investments or worse. This precarious situation, plus the massive overbuilding of commercial property in China, increases the probability that more bailouts—possibly worth hundreds of billions of dollars—are to come.

In this case, the Chinese need their nation's reserves so they can keep their own banks solvent and still constructively contribute to global economic progress. In other words, China's reserves exist for its next set of bailouts, as a cushion against the nation's own possible financial miscues. Without reserves, the result could be a broken Chinese banking system, just like the Japanese banking system in the 1990s.

The reserves themselves have immediate consequences. China's reserves are forcing the nation to choose between hot money flowing into the country and reducing interest rates or increasing yuan parity. But no matter China's statements to the contrary, the Chinese have good reasons to gradually increase the value of the yuan at some point, probably sooner rather than later.

Increasing the value of the yuan may excite foreign investors (or at least hedge funds and foreign currency speculators), but it gives the Chinese another problem. Even if foreign investment were always patient capital, the Chinese don't really want it, so expect to see a combination of informal barriers to investment, which will require foreign investors to work extra hard to understand what the Chinese really want and need in order to get them to accept foreign investment.

Informal barriers to investment will put more pressure on China to treat foreign investors as they themselves would like to be treated. This will inevitably lead to greater Chinese involvement in global financial institutions, an involvement that the Chinese regard as a mixed blessing. But they will need to protect their investments overseas; it is now China's policy to aggressively push its companies to gain control of overseas technology and brands, which is another use for its foreign currency reserves.

Paradoxically, we can expect the long-term rewards of this policy to go mostly to the foreign entities acquired. Chinese acquirers of overseas assets are deploying huge amounts of capital in developed countries, and in many cases neophytes are using that capital ineffectively. We can expect some of these acquisitions to be sold back to foreigners at vastly lower prices, as happened with the Japanese in the 1990s in similar state-promoted acquisitions of foreign companies; recall how New York's Rockefeller Center did a round trip in ownership.

**Microeconomy**

The millions of small and larger Chinese companies that are busy creating wealth are where the rubber meets the road in China's economy.

The following factors impinge on what is really going on here:

- The vast majority of enterprises have unreliable financial statements.
- Corporate governance is incredibly weak, so shareholders and direct investors often get short shrift, even if they are large and powerful companies (e.g., Danone's dispute with its Chinese distributor).
- Commercial real estate is vastly overbought and due for a major correction.
- Local-government debt is at enormous and dangerous levels.
- Audit regimes are weak or nonexistent. But the good news is that China has a growing number of innovative companies that are being teased out by venture capital.

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capital. State-owned enterprises, generally regarded as lumbering and bureaucratic, are undergoing a multi-year transition to become more like private-sector enterprises. The central government has directed many of the state-owned enterprises to adopt economic value-added accounting, which not even the most-advanced Western companies use. As a result, Chinese microeconomics should be lively but volatile; investors beware.

Trends and Results
Social issues are more pressing than political issues in China right now. Microeconomic issues are of higher priority than macroeconomic issues. Local-government and commercial debt both loom large, along with the possibility of a huge bailout, which will necessarily tap China’s surplus.

China’s central economic-policy makers are bright, globally knowledgeable, flexible, action-oriented, and free of ideology. In an economic discontinuity, we can expect them to be flexible, pragmatic, and fast, likely nipping any macroeconomic problem in the bud. But even that could lead to a two- to four-year slowdown in China, which would have global economic impacts, including impacts on investment plans and equity prices.

The most significant problems are long-term: aging population and gender imbalance. The long-term social consequences are hard to predict but the economic consequences are clear: decelerating growth at a rate more pronounced than expected given the present-day heady tone of the Chinese economy.

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Endnotes
2 Economic value-added accounting or EVA is a performance metric that calculates the creation of shareholder value, but it distinguishes itself from traditional financial performance metrics such as net profit and earnings per share. EVA is the calculation of what profits remain after the costs of a company’s capital—both debt and equity—are deducted from operating profit. (www.investopedia.com)