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THE VIEW
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China's chrysalis

Constant renewal creates a stronger economy, but nation's metamorphosis could last several years because of the reforms needed to fix inefficiencies

I am a second-generation immigrant. My daughters speak Putonghua – one serves a small non-governmental organisation in Beijing. Three generations of my family have studied at Peking University. It is absolutely in my interest for the Chinese economy to do well. Which part of the word “patriot” do you not understand?

China engineered the most effective economic achievement in history lifting 500 million people from poverty to the aspiring middle class in 30 years. Slowing growth from here is only natural. For those worried about a future hard landing, please don't. We've already arrived.

Capitalism shares with Marxist-Leninist thought the concept of “continuous revolution”. Constant renewal creates a much stronger system. Take the way the very hungry caterpillar wraps itself in silk to form a chrysalis before emerging as a butterfly. This is China's Lost Decade; this is China's Chrysalis.

The Chinese economy needs renewal and the chrysalis is an unexpected hiatus for economists confidently predicting the economy to be the G1 by the end of the decade.

In 2010, economic growth was 10.5 per cent, but it will be about 7 per cent this year and could soon fall to 5 per cent (with the US at 3 per cent). Exports were growing at 30 per cent in 2010, now the IMF says 6.8 per cent. Foreign reserves fell US\$100 billion in the past quarter, and the yuan is only 10 per cent higher in four years. Inflation has fallen from double digits to 1.8 per cent; with deflation looming. The stock market is down almost 30 per cent.



251%

Total Chinese debt as a proportion of gross domestic product at the end of June

The 2008 global financial crisis was the game changer that found fault in China's one-trick pony economy – its frantic export industries. To counteract the slowdown, the government encouraged massive spending on infrastructure providing a wonderful legacy for the next 50 years, but burdening current growth as the see-through buildings of our major cities testify.

The World Bank has described the accumulation of debt in China as “rivalled only by Ireland”. Local governments have borrowed nearly 50 per cent more since last year. Total China debt hit 251 per cent of GDP at the end of June (US is 260 per cent) and the unregulated shadow banking sector could be as large as the official banks.

The stock of residential prop-



The Xi-Li administration does not have the time to evolve economic reform

erty in China is more than 200 per cent of GDP (equal to Japan in 1989). House prices are down 1.3 per cent in a year but building is still growing at 12.5 per cent.

State-owned industries, banks and local authorities are devoid of the moral hazard of going bust if they get it wrong. Interest rates set by the government warp investment decisions. China's stock and bond markets have not been allowed to develop to provide dynamic private companies with long-term capital.

Meanwhile, 49 per cent of Chinese foreign reserves are held in the US. That is only 11 per cent of US government debt, which makes the value of the US dollar China's problem.

The internet is so censored that it is damaging medical and scientific research. Rock star companies like smartphone maker Xiaomi are moving overseas because the spooks have slowed line speeds to a crawl.

Two helpful policies for the long term in China – the crack-down on corruption and the one-child policy – are showing ironic side effects; one is limiting action and the other demand.

The aspiring, educated middle class are concerned about air,

water, soil and food safety. These, together with the hukou (or hometown residency permit), are politicising good citizens.

Despite being a patriot, I admit that China's chrysalis could last a further six to eight years because of the deep reforms needed to correct these structural inefficiencies. The Xi-Li administration does not have the time to evolve economic reform like their predecessors, but must undertake the bold changes of Deng Xiaoping. It would be unthinkable to carry China's chrysalis into the third decade of the millennium.

Theirs is the responsible position of transition leadership, of having to actively manage China's chrysalis in the knowledge that their success will be to benefit the next leadership.

Short of a meltdown, China's chrysalis should be contained as the financial markets are all but closed to global markets. It will of course impact Hong Kong and Chinese stock markets – but our relative underperformance is already telling what is happening. We should periodically see rallies but we should not expect our markets to show much leadership over the next half decade.

The Lost Decade will hopefully fade as the chrysalis transforms into the butterfly of a new economy. However, the timing is really enshrined in the apocryphal words of Deng. When asked by a visiting French president what he thought of the French Revolution, he drew a large breath on his potent cigarette and said, “Too early to say”.

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