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THE VIEW
RICHARD HARRIS

The year of judgment

Investors beware as mounting debt levels, an unprofitable state sector and a volatile yuan pose headwinds to an economic rebound in China in 2017

You can promise so much for only so long.

China's economic growth has been falling continuously for more than eight years now. We have seen the hard landing and now the economy must begin to pick up – or people will start to talk.

Admittedly, the slowdown has come from a high of 14.2 per cent in 2007 – a golden year fuelled by debt and the red mist.

We know that no economy can grow at a rapid rate forever, especially one containing 1.3 billion souls.

We also know that figures concerning the country's gross domestic product have been manipulated to flatter and smooth, never showing the true slowdown, and that makes it difficult to forecast a recovery.

But after so many years, the excuses run thin. The economy needs to improve. 2017 is judgment year.

The Xi Jinping administration has fought hard to earn a place at the top table of global superpowers. It has made many financial commitments along the way and a successful economy is key to sustaining that position.

Yet China is still spending borrowed money like a gambler spending his winnings. The huge sums pledged for the "One Belt, One Road" initiative are estimated at between US\$4 trillion and US\$8 trillion – much to be invest-



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ed outside the country's primary economic regions.

For years, analysts have looked to China's future economic growth being with the domestic consumers and the technology sector.

However, fixed-asset investments in old, fragile, state-owned smokestacks are still growing at more than 20 per cent, with single-digit returns.

Heavy infrastructure spending is only beneficial if questions are asked about why the money is spent. On what? How? What are the payback times? And how much is lost to corruption?

Even in the private sector, a company with admitted financial difficulties, LeEco, has just received US\$1.4 billion – as if by magic – to keep its unstrategic businesses going.

HNA Group, the Chinese conglomerate, last month made no commercial sense in paying a massive 25 per cent over the very

highest market valuations to buy land at Kai Tak.

China's total debt-to-GDP ratio is a staggering 290 per cent, according to McKinsey.

Debts have to be earned back somewhere. The Soviet empire collapsed believing that money would always be there to spray around.

Life is likely to get harder. The Shanghai Composite Index ended 5.8 per cent lower even as the currency fell more than 7 per cent last year.

Trying to keep the currency stable in the face of difficult economic conditions has encouraged expectations of further declines and big currency outflows, tightening liquidity at home.

Donald Trump has made nothing but conciliatory gestures towards Russia but only hostile comments towards China, as if stuck in some 2009 time warp. It will be tough to let the currency fall, as it should, when Trump is threatening to call out China as a currency manipulator.

Worse news is that China's outbound investments increased



Investments in state firms are still growing at more than 20 per cent.

by half last year while inbound investments suffered a rare slowdown.

The *Beijing Times* spoke of vehicle glass manufacturer Fuyao Glass Industry Group investing US\$600 million in the United States because taxes and operational costs were now lower in the US than in China.

The authorities were sparked into action last week to ease restrictions on foreign investment in "an orderly way". However, it will take longer to ease foreign mistrust.

"We sense a growing tendency

in China towards market closure and a favouring of indigenous production," said Michael Clauss, the German ambassador to China.

Managing a command and control economy requires taming asset bubbles and handling badly managed, unprofitable state companies at the same time.

The natural reaction by the authorities is to fight every setback, ever tightening rather than relaxing control.

It makes things worse and (horrors!) you get blamed for everything that goes wrong. Free

market economics means that you have to lose some economic battles because you cannot win them all.

This column would not dare to tell smart Chinese policymakers what to do, but we can point out to investors what they should be looking for.

Time is running short to rein in debt, free the currency, reform the state sector, liberalise investments or allow unprofitable companies to go bankrupt, even in strategic areas.

At present, businessmen in China have no moral hazard preventing them from borrowing more and spending irrationally... even on football players.

It is almost too late for this to happen without a recession to clear the decks.

Investors have to watch China closely in 2017. The immortal message of policymakers everywhere holds just as true in China: "It's the economy, stupid."

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Illustration: Joe Lo