

China Watch

A China Business Report prepared by David Mahon,
Managing Director, Mahon China Investment Management Ltd

S P R I N G 2 0 0 8

*Understand other countries
by means of your own country.
How can you know what is right for the world?
By knowing what is right for your own life.*
Lao Tzu, 5th century BC

www.mahonchina.com

China's harmonious society

In the first quarter of 2008 China enjoyed strong economic growth which will continue throughout the year. Year-on-year GDP is likely to increase by close to 10%, with retail sales, a proxy of domestic consumption, expanding by over 15%. China will not suffer from the recession in the US to any great degree, for domestic trade, consumption and domestic investment remain the major drivers of the economy. Weakening demand

China's is not a fragile, export-dependent economy.

in the United States will result in slower export growth this year, denting GDP growth by 1 to 1.5 percentage points in 2008. China is heavily dependent on imports of raw materials and components for its exports, and actually earns a fraction of their landed value in the US; often no more than 20%. Therefore, contrary to the views of many analysts, even sharp changes to the trade account from one year to the next have less impact than their gross values would indicate. China's is not a fragile, export-dependent economy. Since January, China has already received US\$18 billion of foreign direct investment, portending another strong year for FDI. This too needs to be seen in context. Total domestic investment last year was US\$1.96 trillion and is likely to remain at least at that level for 2008. ☺

Inflation

Over the past three years, prices of land, building and labour have risen steeply in China's coastal cities. In the southeast, migrant labour costs have nearly doubled in just two years. Nevertheless, much of this may be viewed as normal in the context of an economy in which GDP has been growing at over 10% for two years in a row. Overall wages, among both

urban salary earners and farmers, have increased little in the past seven years. In China's hinterland, asset prices, utility costs and wages are lower and logistical links to coastal consumer markets are good. Selected manufacturing investment opportunities are still many, the food sector offers firm, long-term value and the nascent service sector is growing by double-digit percentages. Price increases are actually due more to specific structural changes than any classic causes of general inflation.

...inflation is largely restricted to meat, dairy products, eggs and edible oils.

Inflation of the price of food is the biggest economic challenge for the Chinese government in 2008. China's consumer price index rose 4.5% in 2007 and is likely to advance by at least 6% in 2008, as forecast by private-

sector economists. The price of nonfood items accounts for all but about 1.5% of inflation. Even within the food category inflation is largely restricted to meat, dairy products, eggs and edible oils. Supply of these items will increase to meet demand and it is unlikely that prices will remain at present levels by the time the fourth quarter is reached. Still, food inflation is felt most by the hundreds of millions of semisubsistence farmers and migrant workers, such as those swarming over the last major projects being completed in Beijing for this summer's Olympic Games. Their incomes are fractions of those earned by more established urban residents and recent price increases have made their marginal lives even harder. The current levels of inflation stand as a warning sign to the Chinese government and present a chance for them to practise a more sophisticated form of economic management than in the past.

The challenge will be to see whether this time the government can use the passive tools of economic management in preference to a more interventionist approach. Over-reaction to the inflation of the mid 1990s and strong intervention deepened the deflationary crisis that followed. Price controls, subsidies and investment prohibitions will bring the same results again if China is not careful. At the end of 2007, and in early January 2008, the government resorted to some command economic measures, such as simple subsidies to farmers and price controls to deal with the immediate impact of food inflation. Other actions in the past few weeks are, nevertheless, promising, with pronouncements by the central bank that interest rates will continue to rise and that bank reserve requirements will increase. Increasing the price of capital, undervalued for so long, can only be good for the long-term balance of the Chinese economy.

Inflation will be a major concern in 2008 and the government will struggle with the endemic issue of poor adherence on the part of provinces and cities to national economic policies. How successful the Chinese government can be in restraining parts of the economy, while allowing the wider market to flourish, will not be fully evident until the first quarter of 2009. The issues of social stability, however, are before us in starker relief

than any consumer price index. It is the recent events in western China that have exposed the depth of the social problems facing the Chinese government, indicating that economic growth at any price is no longer an option. ☹

Instability

The Chinese government's struggle to manage the political crisis in Tibet and the western provinces is under daily scrutiny. Even when the startling effects of the situation settle down, which is likely in the next few months, the issues and underlying causes of the recent riots in Lhasa and a number of towns and counties in neighbouring western provinces will need to be dealt with by Beijing in a firm and sensitive manner. As with its management of the economy, the Chinese government cannot afford to resort to the crude measures for handling dissent that it has used in the past.

Social stability is fundamental to business confidence. Foreign investors will have observed the events of the last two weeks in China with justifiable concern. Such concerns will have covered a spectrum, from the practical (the security of assets and financial returns) to the ethical (moral obligations as foreign corporate citizens of China). Resisting initial, blind reactions is the first step in understanding this complex situation.

...non-Han Chinese make up no more than 4% of China's 1.3 billion people...

Those who would see these events as the beginning of some meltdown of Chinese society should not be paid any attention. We should remember that non-Han Chinese make up no more than 4% of China's 1.3 billion people, and most of these live in the country's more remote regions. Dissent in Tibet and adjoining provinces will not spill over to the wider population and destabilise China. Failing to deal with the underlying causes of the dissent, however, will have ramifications for the long-term stable development of China as a whole.

The major causes of the recent dissent in Tibet and other parts of western China are twofold.

The first cause is lack of true religious freedom. The Chinese government reacted severely to Tibetan dissent, the source of which some officials only dimly comprehend. The atheism that is central to Chinese Communist Party doctrine can only condescend to the religious convictions held by Tibetan Buddhists, or for that matter Christians and Muslims. It is hard to understand something to which you condescend.

In the case of Tibet and Xinjiang, local policies are also at fault. In contravention of Chinese law, bans on religious study have been enforced for students and government employees across western China.

The second cause of dissent is economic jealousy and resentment.

The second cause of dissent is economic jealousy and resentment. Han Chinese businesses have been successful in the Tibetan capital, as they have been across most of

western China, often incurring the deep resentment of local ethnic minorities. This resentment motivated, in part, the Tibetans who incinerated Han Chinese in their own businesses in Lhasa's old city this month. The reality of this violence on the part of ordinary Tibetans is a factor lost on many outside observers who want to see simple scenarios of 'bad' Chinese and 'good' Tibetans.

It is no coincidence that after 20 years of relative stability in Tibet, these demonstrations have taken place in this Olympic year. The influence of outside interests is highly likely, although the extent to which the Chinese government focuses on this shows a lack of balance, when it is its own local policies and a lack of sensitivity to local issues that are the immediate causes with which it needs to deal. For the Chinese government to deal with the present situation without a high degree of self analysis and critical evaluation would be a mistake. A radical change in the manner in which Tibet is handled is vital. ☺

China's crisis is our crisis

As we foreigners assess China, we must also look to our own recent histories and be careful not to resort to simplistic judgements.

The causes of the 2004 riots, small as they were, that left Australian Aboriginal protestors and police injured, and Sydney's Redfern railway station in flames, have aspects in common with the causes of the recent violence in China. So too did the riots by Muslims in France in 2005 that led to orgies of arson and violence in 300 cities and towns. In our own cultures we do not tolerate violence and arson. While we hold China to international standards of human rights, we must allow some space for their efforts to restore social order as we would strive to accomplish it in our countries.

The marginalisation and suffering of immigrants and Aboriginal, American Indian and numberless other indigenous minority groups continues without substantial redress across the so-called developed world. As long as justice and compassion come second to the interests of profit, such human suffering and hypocrisy will exist in all nations.

Either the Chinese government is presently at a stepping stone in its evolution, before moving to higher ground of more open, confident leadership, or it is in the process of reverting to a position it held at the end of the 1970s and 1980s when, baffled by the desire of its people for greater freedom and choice, it reacted in fear and resorted to repression as a tool to ensure social stability. In this era of China's domestic development and integration into global markets, crude suppression is not an option. Blocking foreign television broadcasts and international websites and restricting the movement of the media only reduces the Chinese government's credibility at home and abroad.

Track the development of transparency and justice in China since the open-door policies in 1978 were promulgated and there is a clear picture that human rights gains in China have been considerable. The last two decades have not been characterised by social unrest or police brutalising protestors in China's cities.

There is good reason to hope that recent events in Tibet do not represent the beginning of social devolution in China. Hu Jintao has already made efforts to focus on the plight of China's farmers and minorities. His statement of the principles necessary to create a harmonious society made specific reference to support for Buddhism in China. They may not have been obeyed, but perhaps he learned something during his time as party secretary of Tibet 20 years ago. ☺

A question of conscience

The dilemma for many foreign business people in China is their dependence upon the country in which they earn their livelihoods. Our governments face similar issues of self-interest and dependence. China is now embedded in the global economy. Our collective challenge is to be honest and objective and not indulge in subjective responses. It is inevitable that foreign observers and some foreign residents of China will expect widespread social and economic instability as a result of recent events. This has more to do with their emotional reactions and their poor understanding of the wider issues at stake than any rational forecasts.

The true expression of political conscience is action, not armchair outrage.

The true expression of political conscience is action, not armchair outrage. Some foreign companies have chosen to sponsor professionals, who have been educated and are currently working in China's privileged coastal provinces, to work for a year in China's remote areas. The cost is no more than a few thousand dollars per person, per year. Such professionals help those they work among, and they themselves may change and perhaps also inform and help

change the thinking of those in China's economically developed regions when they return.

Even in action, we must accept that, as foreigners trading in China — in this one fifth of the world's population, this great case study of humanity — we count for very little. What matters in these difficult months is that we remain engaged, speak our minds as we struggle to understand not just this Chinese dilemma, but also the human dilemma it represents and of which we are all a part, in some way or another. ☯