

building
shock resistant
portfolios

[Markets]

I've been thinking about...

**... whether China is a global
shock in waiting**

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CONFERENCE

IN A NUTSHELL

Three major sources of China risk

- **Internal political stability**
 - Can political system cope with stresses?
- **Economic and financial bust**
 - Will boom turn into bust?
- **Geo-political threat**
 - China now 2nd most powerful nation

DOMESTIC POLITICAL STABILITY

CAN COMMUNIST PARTY COPE?

Yes, more strengths than weaknesses

- More challenges for sure
 - Corruption, inequality, new demands
- Success in managing many crises
 - Reflects underlying structural resilience
- It is adjusting and adapting
 - Not totalitarian, more accommodating
 - Leadership dynamics

INCREASING CHALLENGES

China is not an easy place to govern

- **Rising incidents of “mass unrest”**
 - Labour unrest 2010
 - 230,000 in 2009 vs 120k '08, 90k '06
 - Localised, not national, no rallying point
- **Separatist struggles**
 - Tibet: nearing a turning point
 - Xinjiang: simmering tensions

UNRESOLVED ROOTS OF DISSENT

Abuse of power

- **Growing nexus local govt/business**
 - Collusion: local mafias control region
- **Unclear property rights**
 - Farmers' land use rights abused
- **Inadequate mechanisms for grievances**
 - Legal recourse limited
- **Growing consciousness of rights**

UNRESOLVED ROOTS OF DISSENT⁽²⁾

Corruption is widespread

- **Surveys**
 - 23% firms: local govt “bad”; 12% “very bad”
 - Finance sector: 82% –corruption pervasive
- 1996–2005: \$170bn stolen from govt
- 1999–2005: 1m illegal land acquisitions
- Loans: bribes = 9% of loan amount
- Total cost: 3% of GDP + Indirect Costs

RISING INEQUALITY

Widening gap → resentment

- **Gini Coefficient**
 - Now 0.45–0.53, vs 0.3 in 1970
 - One of highest in Asia
- **Rural–urban divide**
 - Ratio is worse than 1:3
 - Was only 1:2.4 in 1992 and 1:1.7 in 1985
- **Strenuous efforts to alleviate this**

A MORE DIVERSIFIED SOCIETY

Political mechanisms need to expand to accommodate this change

Class formation in China 1952 - 1999

Class	1952	1978	1988	1999
composition of China's workforce, %				
Administrators/Managers	0.6	1.2	2.2	3.6
Owners of private enterprises (1)	0.2	0.0	0.0	0.6
Owners of private enterprises (2)	4.1	0.0	3.1	4.2
Technicians/specialists	0.9	3.5	4.8	5.1
Office workers	0.5	1.3	1.7	4.8
Business/service workers	3.1	2.2	6.4	12.0
Manufacturing workers	6.4	19.8	22.4	22.6
Agricultural workers	84.2	67.4	55.8	44.0
Unemployed/under-employed	n.a.	4.6	3.6	3.1

DISSENT CONTAINED SO FAR

Record of containment → strong capacity

- **Succession of crises contained**
 - Tian An Men, surge in layoffs late 1990s
- **Political culture helps – surveys show**
 - Apathy, disengagement from politics
 - Basic support for the political system
 - Still a Confucian culture

PARTY ADAPTING TO CHANGE

Leader's strategy evolving

- Co-opting new social elements
 - CCP allowing businessmen to join
- Grassroots democracy allowed
 - Village elections, party posts contested
- Despite crackdowns, media freer now
- Diverse views tolerated
 - PLA general: need democracy to move up

WILL LEADERS FIGHT?

Systematic leadership succession helps

- **2012 Party Congress: total change**
 - Most leaders will retire, huge jockeying
 - But no life/death issue at stake
- **Evolving system → stability**
 - Fixed terms, age limit
 - Top man not all-powerful
 - Leader doesn't choose successor!

THE BOTTOM LINE

The CCP will still be in power in 2020

- No collapse of Communist rule
- CCP evolving → more tolerant
 - But forget democracy
- Unrest will continue
 - But localised, won't expand nationally

**WILL ECONOMIC BOOM TURN
INTO BUST?**

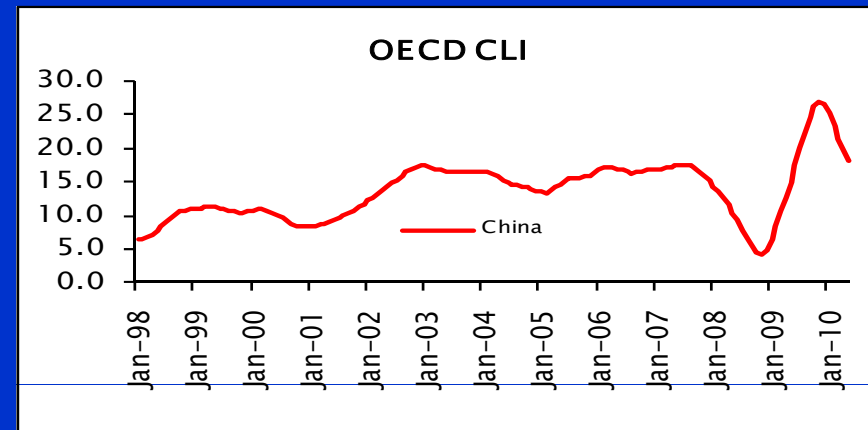
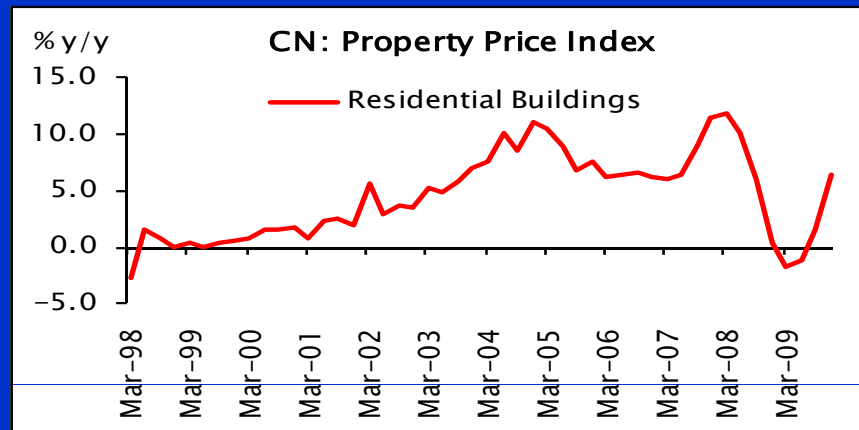
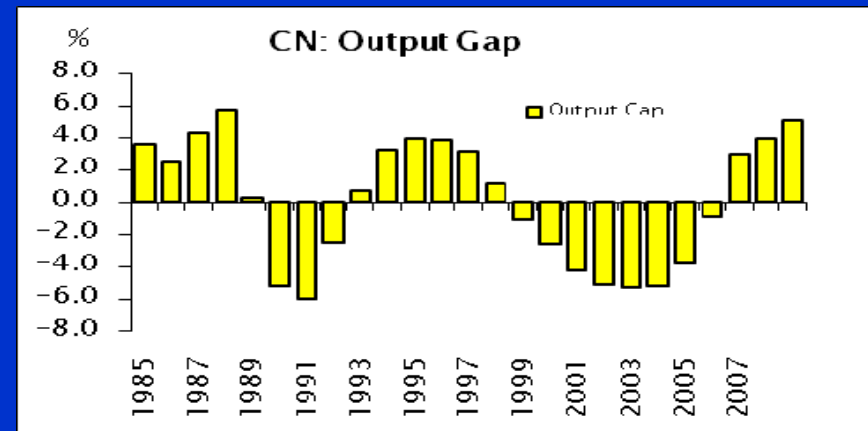
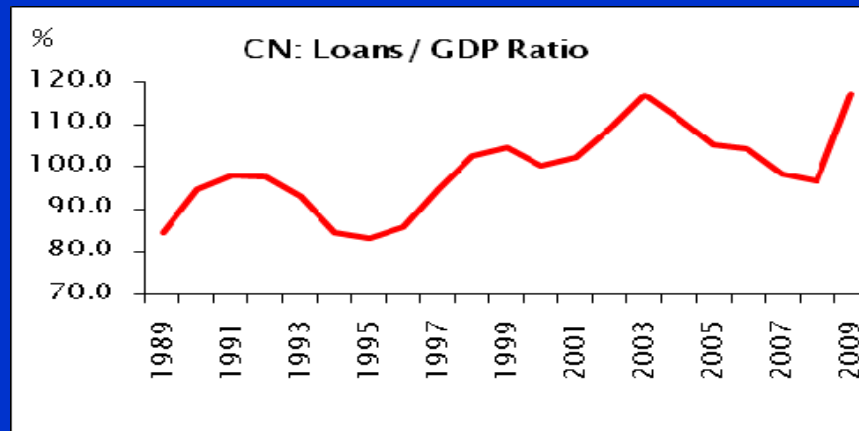
CHINA IMPACT: MORE RISK?

Nature of risks

- Huge surge in lending poses risks
 - Context: still-weak credit culture
- Signs of bubbles
 - Equities spiked up, Real estate up
 - Massive speculation in garlic, copper etc
- Transition/structural weaknesses
 - Rising wages, rising RMB
 - Financial system the Achilles Heel

CHINA: CURRENT STATE

Risks remain



CHINA IMPACT: MORE RISK?(2)

Big Unknown: Structural weaknesses

- **Illegal lending is huge**
 - 20% of all lending?
 - No supervision, no credit checks, ...
 - Abrupt slowdown → downward spiral
 - In Korea, collapse → recession
- **Illegal Local govt funding vehicles**
 - Govt RMB7.7tr, could be RMB12tr!
 - Can these be unwound easily?

CHINA IMPACT: MORE RISK?(3)

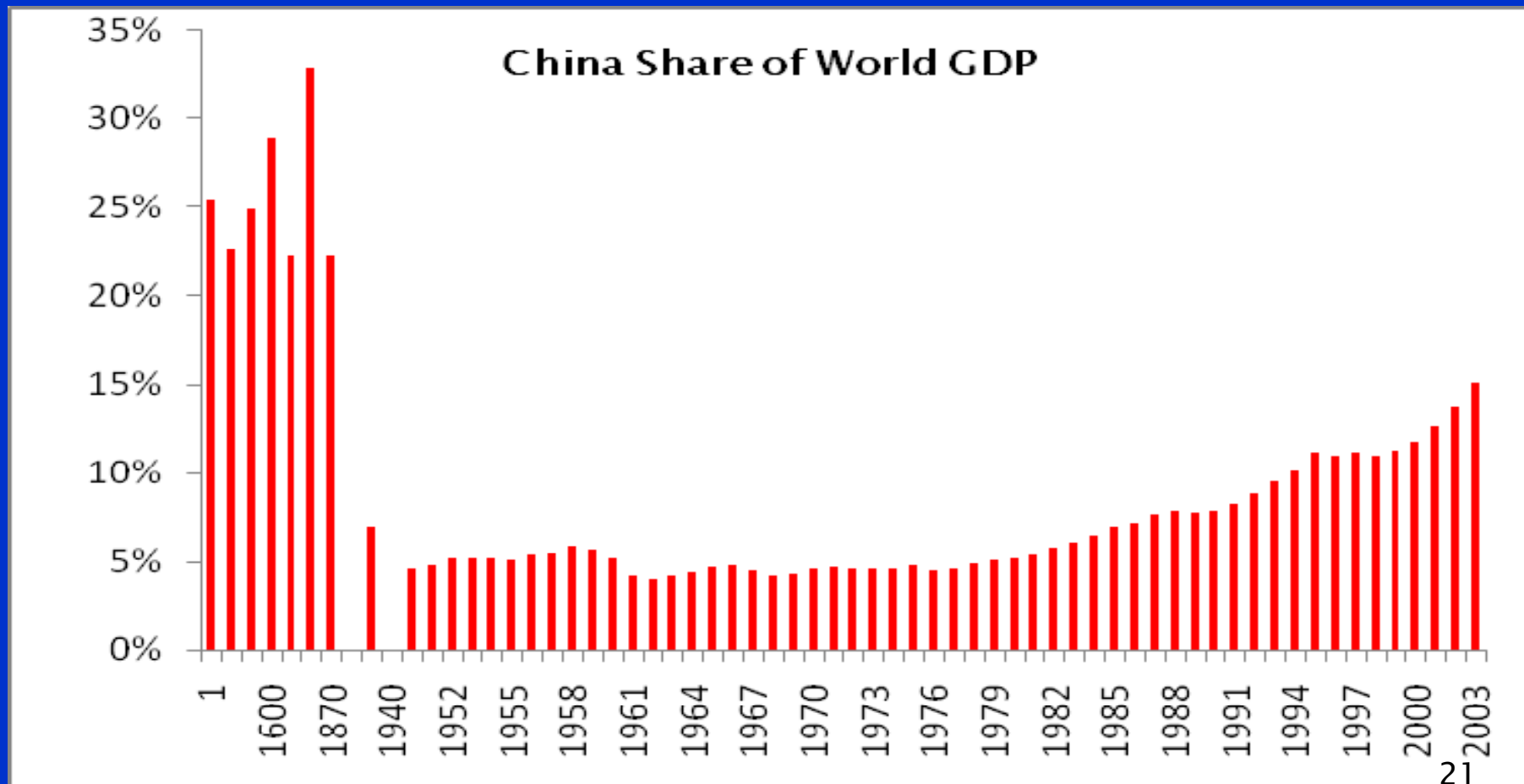
Policy tightening averted crisis

- Risk is of blunt policy tools
 - Admin measures → outsized reaction
 - Stop-go pattern of policy likely
 - Compounded by differences within elite
- Shocks will occur: how resilient is China
 - Shock absorbers: policy, momentum, reserves
 - Shock multipliers: financial system

**CHINA'S RISE:
POLITICAL RISKS FOR THE
REST OF US?**

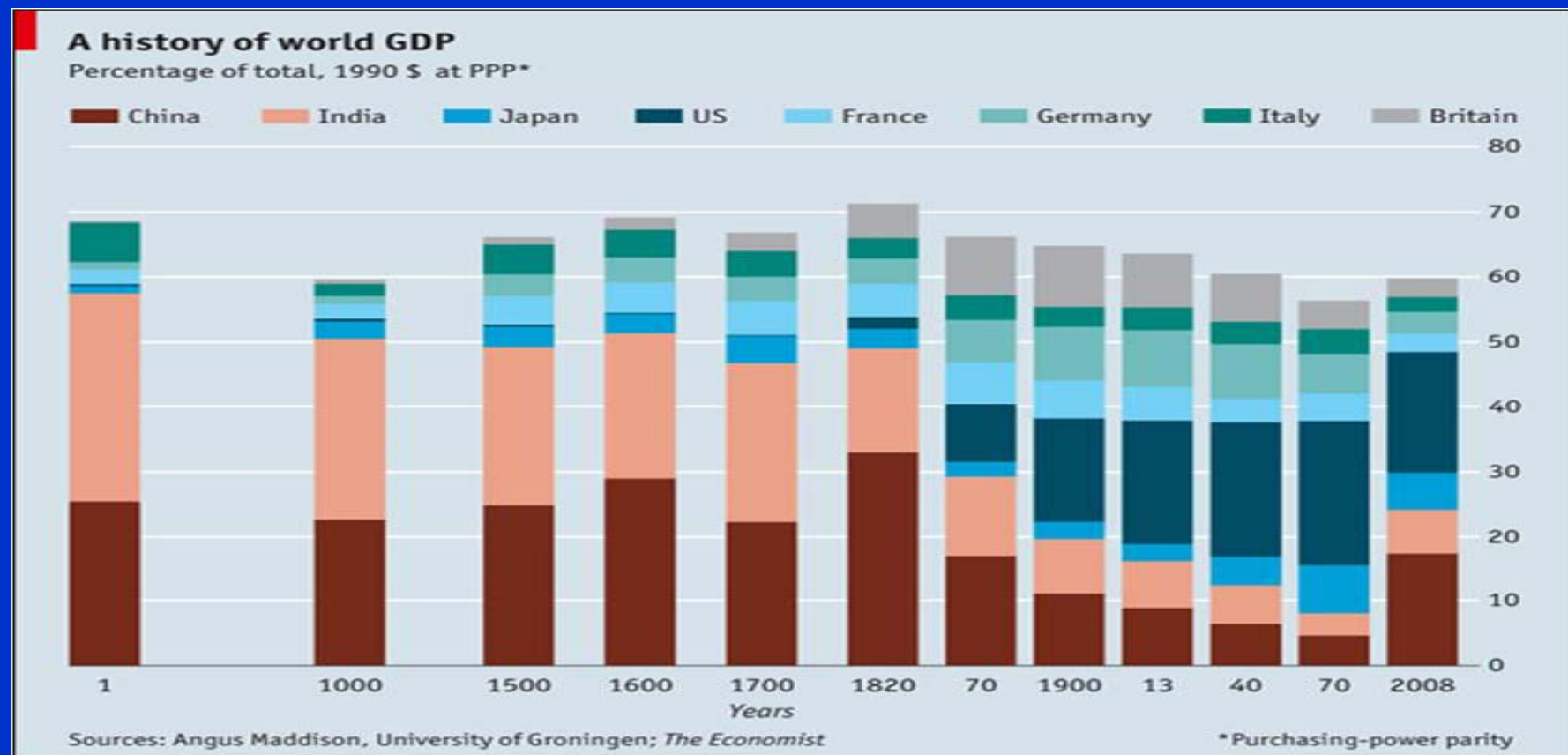
HISTORICAL RECORD

Power Shifts to China again - after 200 years



HISTORICAL RECORD (2)

... or does it really?



CHINA'S RISE

Not just an issue of China rising

- **Simultaneous rise of China AND India**
 - Indian growth to surge past China's 2020
- **The US will not decline, will come back**
 - US will maintain military supremacy
 - And remain economically vibrant – and
 - Culturally appealing: unmatched soft power

INCREASING ASSERTIVENESS

China is flexing its muscles

- **Pushing the envelope**
 - Before: Taiwan, Tibet were “core”
 - Now: “core” areas wider: eg S/E China Sea
- **Smaller neighbours served notice**
 - Must acknowledge China’s rising position
- **US warned as well**
- **Arguing for change in global economy**
- **But doesn’t want to rock the boat**

ONE MAJOR RISK

A clash with India of some kind

- China, India don't fathom each other
 - Fundamentally divergent world views
- India's ties with US alarm China
 - Only India can shift balance vs China
- Will keep bumping into each other
 - China → South Asian power, India horrified
 - Competition for resources
 - Pakistan, Nepal, Myanmar

ONE MAJOR RISK₍₂₎

Recent disagreements

- **Despite high-level visits etc**
 - Neither side wants conflict
- **India worried over Chinese in India**
 - Denying visas, acquisitions by China
- **Border disputes in focus again**
 - China vetoed ADB loan
 - China denied visa to Indian official
- **Flashpoint: Dalai Lama's succession**

CONCLUSION

China's rise: bumpy, not catastrophic

- **Internal political stability**
 - CCP will adjust ahead of changes
- **Economy: huge risks but resilient**
 - More shock absorbers than multipliers
- **Geo-political shock less likely**
 - But a clash of some kind with India likely

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