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The Long Soft Fall in Chinese Growth

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The Long Soft Fall in Chinese Growth

Business Realities, Risks and Opportunities

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By David Hoffman and Andrew Polk

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Section 1: China's Long Soft Fall – The Big Picture Narrative

As recently as the fourth quarter of 2013, there were few detractors from an optimistic assessment of China's prospects to achieve a "soft landing" and continue to enjoy relatively stable growth in the 7 to 8 percent range for the next 10 years and more. According to that baseline extrapolation China would become the world's largest economy and consumer market in only a few years' time. This consensus scenario was the key projection promoted by China's state-run media, and it was generally passed on through the global business media as well. In simplest terms, it foresaw a China that had reached a level of maturity where it was subject to normal downturns and corrections that were familiar to investors and analysts in developed economies around the world. By 2010, China's leaders had embraced the global "soft landing" vs "hard landing" framework, and a year ago reported with considerable satisfaction that a "soft landing" had been achieved.

Using our diverse and vetted data and rigorous analytical methodologies The Conference Board has consistently been more cautious on its China economic outlook, and early on identified a number of deeply rooted risks and imbalances that could trigger a deep structural slowdown and compel major policy reorientations. This process, now underway, is likely to last four to five years (2014 to 2019), and ultimately down-shift China's trend growth rate to the 4 percent range. Our official projection calls for China's trend GDP growth rate to ease to 5.5 percent over the coming five years (2015-2019) before settling at 3.9 percent for the 2020-2025 period (see Chart 12, page 21). Fluctuations around this growth rate – "trend" referring to the average growth rate for a period – could see sub-periods of lower or even negative growth. Our dissenting scenario is predicated on a belief that China's stunning growth, during the last decade and one-half in particular, transpired as a result of a unique development model—a model that nurtured world-pacing growth through consistent and substantial State retention of wealth, capital allocation, and investment along with monetary policy responsive to immediate, explicit, and politically-essential growth goals. It bore within its successes the seeds of potential crises caused by the distortionary impact of the State's role in the economy. Put simply, it bore the potential for a deceleration at least as rapid as its acceleration.

Many of the precursors of The Conference Board base case scenario for Chinese growth—a "long soft fall" of the trend growth rate—have come to pass and are now a visible part of the record. We acknowledge that there are possibilities for higher growth in the long term if supporting reforms can be implemented in the near term, and there are scenarios that could bring considerably lower growth or genuine crises, potentially caused by debt-induced stagnation or financial market seizures. In this report, we explore the extent to which these alternative futures are probabilities or simply possibilities.

The Time Has Come for Structural Economic Adjustment in China

After one generation of reform that took China from a stagnant economy to the world's fastest growing, China's growth model has reached a transition point that inevitably requires significant structural adjustment. There is no debate about the desired direction: decrease the economy's reliance on credit-fueled investment, de-lever non-performing debt, consolidate massive industrial over-capacity, bolster both returns on capital and productivity growth, and promote household wealth and welfare accumulation and consumption. Enacting reform policies to achieve these aims would not only elevate household consumption and private sector investment to be the key next-stage growth drivers, but also ensure that the transformation ultimately leads to more balanced and sustainable economic development from an environmental and societal perspective. More than five years ago, then Premier Wen Jiabao was clear in asserting that China had to accept slower growth to achieve higher quality growth. In the near term, this adjustment process will necessarily be painful insofar as it involves a period of substantially weaker economic expansion caused, in particular, by a marked decrease in fixed asset investment—a driver that has accounted for close to 50 percent of Chinese growth in recent years.

For foreign investors in China, this period of transition encompasses both risks and opportunities. A critical success factor for multinational companies (MNCs) at this juncture will be preparing their China organizations and teams to manage down-market conditions, something most local talent has little experience in doing. In the short term (i.e. the next two to three years), we have difficulty seeing anything but a rocky and turbulent adjustment. On the other side of that, however, the prospects are good that policy reorientation will ultimately induce marketizing reforms that improve operating conditions for business in the long term. By "marketizing" we mean reforms that reduce the State's current granular involvement in the economy, in particular central planning and policy-directed investment with financial support for and protection of state-owned enterprises (SOEs) and government-vested firms as the major allocators of capital. We also mean elevation of the role of true

> At this difficult juncture, MNCs should base their business planning for China on actual experience and observable realities – and not on the policy proclamations of China's leaders.

market competition, and the creative destruction it involves, as the key drivers of investment and corporate success. And finally, we mean the establishment of reliable institutions in China's business space to improve consistency, fairness, and transparency of regulation to reduce the role of politics in regulatory activity and the distortions politics introduce to market behavior.

The full transition of China's economic growth model is likely to be a long slog as it presents many challenges: political, economic, social, and even cultural. For foreign investors, clearly understanding these challenges—and planning and preparing accordingly for the plausible features of the transition—is critical to weathering the near-term difficulties and assuring long-term success.

What the Transition Means for MNCs

Ultimately, it stands to reason that the "crises breed opportunity" tenet should hold true for China, just as it has elsewhere. As China's soft fall deepens, a number of important silver linings for MNCs should foreseeably emerge and yield improvements in operating conditions – even before the economic adjustment is fully complete. For example:

- China's talent environment should improve dramatically as the intensity of demand for talent diminishes, wage escalation abates, and the expectations of Chinese employees begin to rationalize. High potentials in China stand to become more long-term oriented and more appreciative of stable employers that invest in building their skill sets, respect work-life balance and undertake valuable CSR activities in China. Career planning should finally become a viable leadership development tool, as tenures lengthen and turnover rates drop.

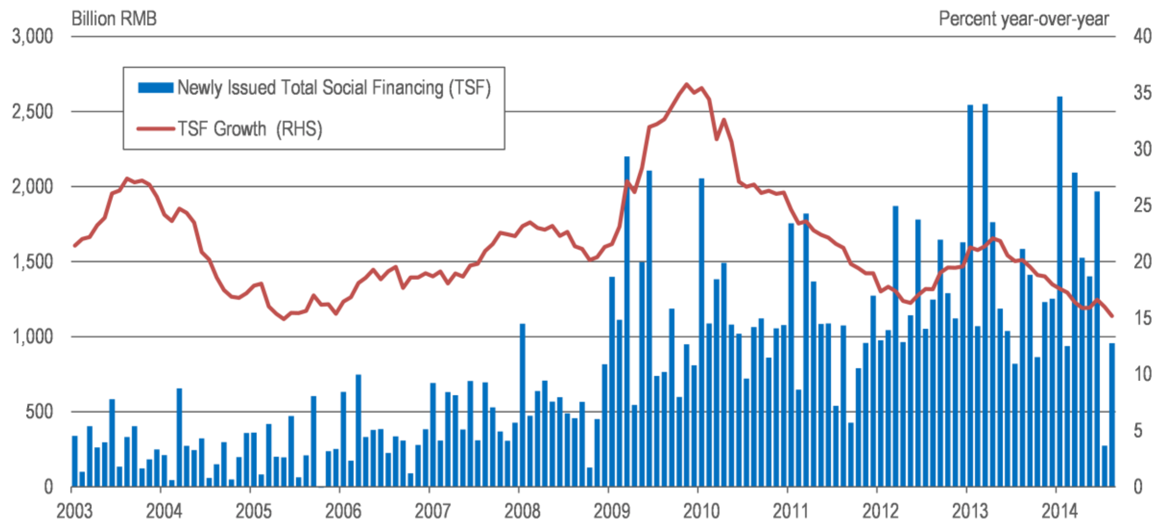
- In addition to better talent conditions, the M&A environment should improve as valuations come to ground and sellers become more receptive and reasonable. Distressed asset roll-up opportunities – and even privatizations – should arise, maybe in high volume. New partnering options with local firms, driven now by urgent commercial motivations, should emerge.

- Competitive intensity may drop as weak local firms fail and access to capital – even for the stronger local firms – becomes harder to get and more expensive. Local firms will consequently be forced to compete more rationally to preserve their balance sheets.

- Local government and Chinese Communist Party("Party") officials stand to become more hospitable towards foreign investors as it becomes clear that MNCs are – and always have been – key providers of quality investment, employment, tax revenues, and corporate social investing in their jurisdictions.

Among other things, early signals suggest that the hubris of government officials toward foreign investors –a defining feature since 2008 (when certain Western practices and governance models imploded and arguably caused the Global Financial Crisis) – is likely to diminish. But while it may be replaced by receptiveness and open mindedness in some localities, insecurity and defensiveness may manifest in others. The basis of location choices for MNCs, both for target markets and productions bases, is likely to change according to new hospitality factors.

Chart 1 **Credit creation in China – growth of bank and non-bank lending**
Chinese monetary and credit creation have been used as policy tools to drive strong economic growth and combat slowdowns in the recent past



Sources: PBoC, CEIC, The Conference Board

At this difficult juncture, MNCs should base their business planning for China on actual experience and observable realities—and not on the policy proclamations of China's leaders. A China growing at 4 percent still presents tremendous opportunity and upside for MNCs that are appropriately lean, mean, and focused.

- Realistic targets for China growth and profitability should be set, factoring in difficult operating conditions and an exceptionally difficult compliance environment for MNCs driven by desperate local regulators and competitors.
- Headquarter C-suites and boards need to be on the same page with country management regarding risks and contingencies.
- Cost management and productivity improvement should become paramount, as should teaching local organizations the tactics and mechanics for successfully managing down-market conditions.

In this report, we seek to develop a portrait of China today that outlines the factors important for foreign investors in the country – near-, medium- and long-term. Specifically, we examine China's economic and political development path to date and lay out the important economic and policy crossroads at which China now finds itself. Finally, recognizing that the ascent of a new administration, under President and Party General Secretary Xi Jinping, is the most visible guidepost on the road to China's next decade, we will detail China's recent responses to domestic economic and greater geopolitical changes to envision the future operating environment for foreign businesses in China and the factors that will likely be critical to business success. The rest of this section of the report provides a high-level overview of our main narrative before we move on to describe the structural and policy factors behind China's economic slowdown in more detail.

A Difficult Crossroad

At least five years ago China's leaders not only recognized but promoted the idea that China had to undertake deep, painful reforms, once likened by Premier Li Keqiang to "slitting one's own wrists." Despite this rhetoric, the Chinese government has so far resisted "taking the pain" per se. Consistently – and in arguably all Party and government touch-points with the economy – China's leaders have forestalled needed structural adjustments through providing monetary, fiscal and administrative support – a sizeable stimulus package really – to prop up the economy. Monetary support peaked in 2009 and 2010 in the wake of the global financial crisis, but continues to be significant to this day (Chart 1). Such economic support, and the flow of ebullient proclamations of China's leaders in the face of the previously dire rhetoric, creates major challenges in accurately reading the economy. But today's positive publicity, and the optimistic headline reports on the official data, are increasingly at odds with a ubiquitously visible reality for businesses in China, both MNC and domestic alike, and the findings suggested by alternative data.

China's continued reliance on high levels of investment, supported by new credit and directed by political interests at every level of the system, has driven returns on capital formation to world-low benchmarks. In turn, the commitment to meet explicit growth goals, recently described by Premier Li Keqiang as a "contract" between the Party and the people,[1] leaves the Party no option but to allow a growing surge in leverage, inversely related to the decline in investment returns. This conundrum is easily illustrated by measuring the credit intensity of Chinese growth (i.e., the units of credit required to yield corresponding units of growth) (Chart 2, page 9). Debt levels and overall money supply have consequently ballooned, especially since 2009, and have done so at a pace well in excess of the thresholds that have historically triggered financial crises in other countries (Chart 3, page 9). Private sector debt, now at almost 200 percent of GDP and up from 117 percent at the end of 2009, is still accruing at 15 percentage points per year, an unprecedented pace for China, especially from such a high base.

While the "contract" to deliver promised GDP growth rates constrains the freedom to make major policy adjustments, the longer the needed adjustments are delayed, the more exacerbated the structural imbalances become and the longer will be the eventual period of slow growth and restructuring. The government's continuing efforts to stave off the needed adjustment, and cushion its impacts, have provided headline stability for the time being, even as instances of volatility accumulate. But this "kicking the can" response has also continued to erode the industrial and commercial foundations of the economy. The current policy stasis cannot continue indefinitely as debt continues to accumulate and the related downward economic pressure continues to build. We are now able to draw direct links between key mechanisms of credit expansion, such as grossly and artificially inflated property values, to paralysis in core industrial and commercial sectors that are ushering in a period of lowering tide for the economy overall.

This lowering tide will eventually begin to sink too many boats – in particular, overly indebted companies and city governments and speculative financial products – for the government to rescue. While it is difficult to determine with precision when the leadership will reach the point where their currency itself groans under the weight of the under-secured credit it must carry, such a deleveraging must occur at some point – it cannot be forestalled forever. Nor can China grow out of the problem. Anticipated nominal GDP growth comes nowhere close to being able to service the debt that has been accumulated since 2009. Something's got to give. Looking ahead, this transition period for China's economy will necessarily be both protracted and policy dependent, and, for these reasons, highly uncertain. We are currently witnessing the emergence of just such highly uncertain if not dubious new regulatory moves, centered on anti-monopoly and anti-corruption investigations of foreign investors in China – strong evidence, we assert, of the building pressures of the long, soft fall in growth.

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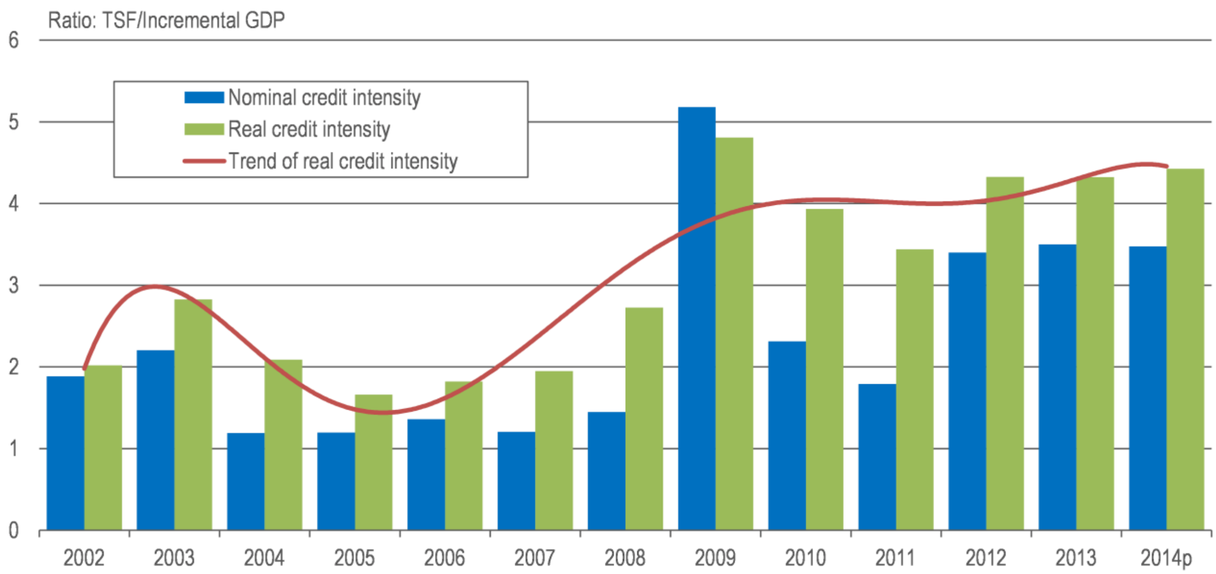
Going forward, MNCs should be prepared to think differently about China and be clear-minded about the challenges ahead. Companies should also be realistic and objective in interpreting policy signals (and in estimating policy capabilities), and be sharply focused on targeting tangible opportunities, managing costs and maximizing operational efficiency. Although the transition will likely continue to feature growth in the aggregate economy, and potentially continued high growth in many sectors, it will also feature many characteristics of a down market, especially in the overcapacity industrial sectors.

[1] Murdoch, Scott. "China vows to meet growth targets." The Australian. June 11th, 2014.

Chart 2 **China credit-intensity of growth: the amount of RMB credit required to produce one unit of GDP**

The increasingly innefficient credit allocation mechanism is highlighted by the economy's worsening credit intensity; it now takes almost 4.5 RMB of credit to achieve 1 RMB of GDP growth

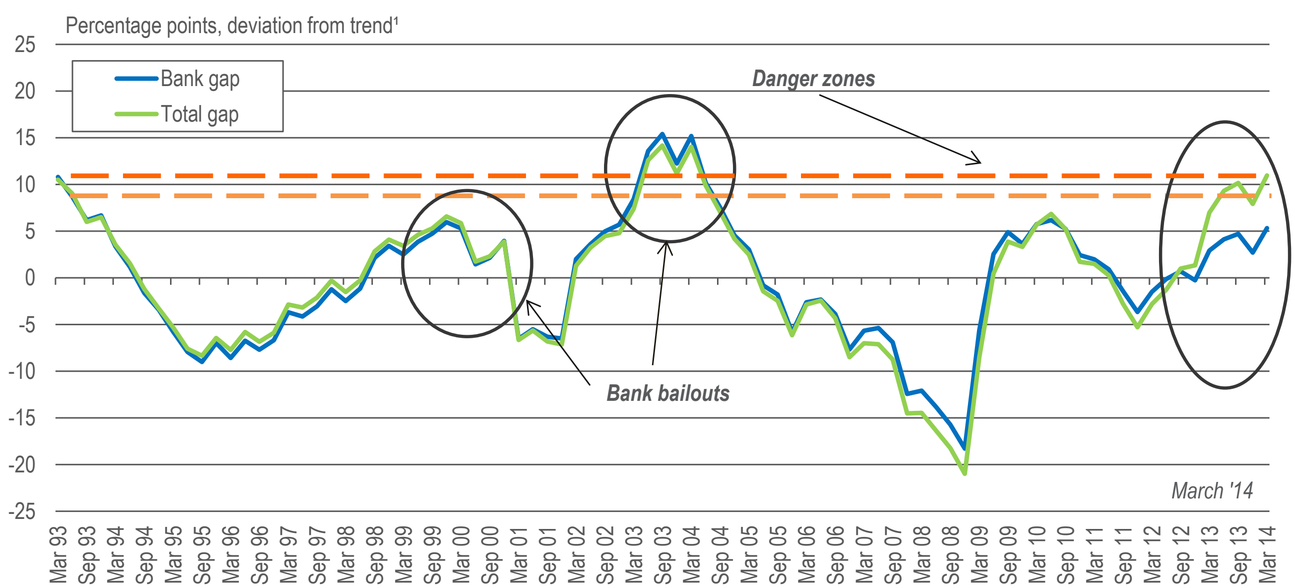


Note: p = projected

Sources: PBoC, NBS,CEIC, The Conference Board

Chart 3 **China's credit-to-GDP gap: the deviation from China's long-term credit-to-GDP trend**

Reasearch from the Bank of International Settlements has found that the best indicator of financial instability is a country's credit-to-GDP gap; China's gap is at levels that have preceded financial crises in several other countries

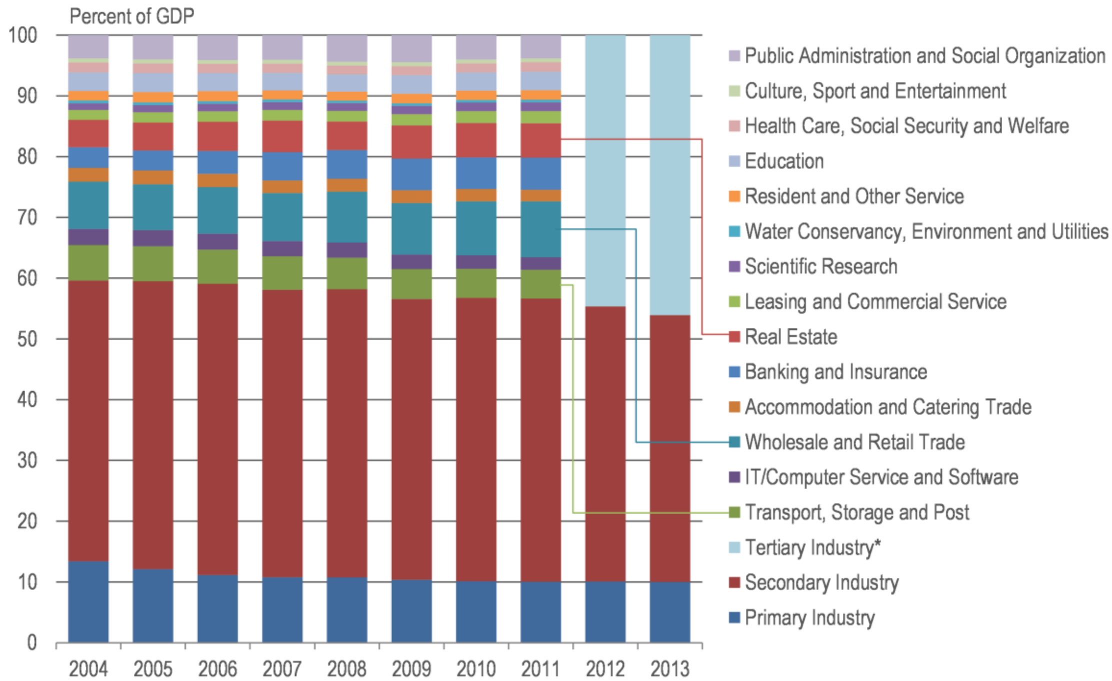


Sources: PBoC, NBS, BIS, CEIC, The Conference Board

[1] Trend calculated using Hodrick-Prescott method

Chart 4 **China's GDP breakdown between agriculture, manufactuing and industry, and services sectors**

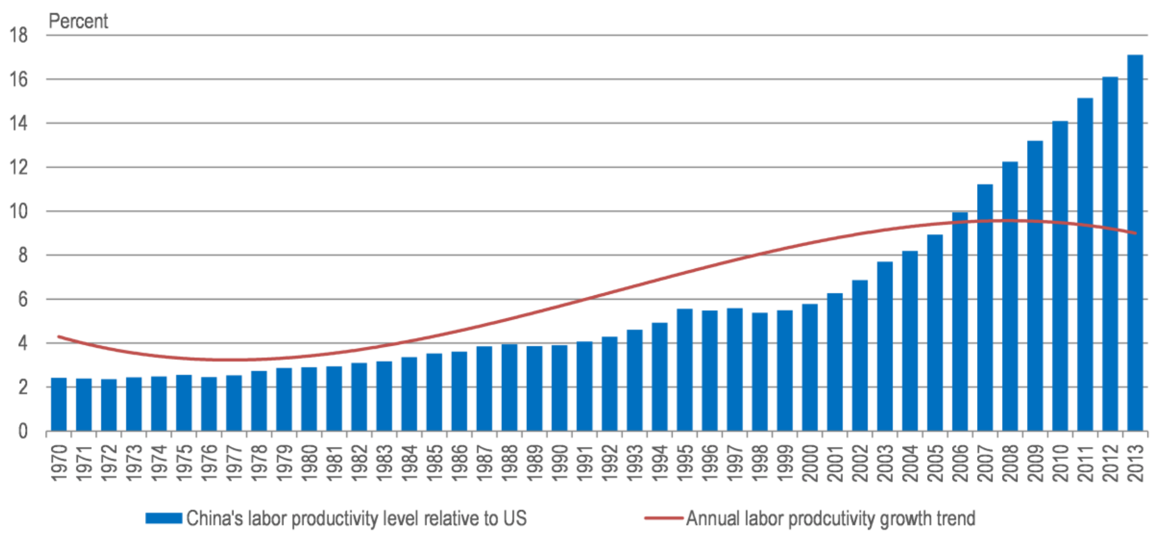
Services are growing as a proportion of China's GDP, but the largest sectors are at the low-end of the value chain, especially transport, wholesale trade and real estate services



Sources: NBS, CEIC, The Conference Board
*Tertiary sector breakdowns not available for 2012 and 2013
**Primary industries are agricultural and related activites; secondary inclueds mining, manufacturing and power production ; tertiary includes the services wsectors

Chart 5 **China's labor productivity in proportion to the United States**

Chinese labor productivity has grown swiftly throughout the 2000's but from a comparatively low base, and the momentum has already started to ease



Source: The Conference Board *Total Economy Database*™, January 2014, https://www.conference-board.org/data/economydatabase/

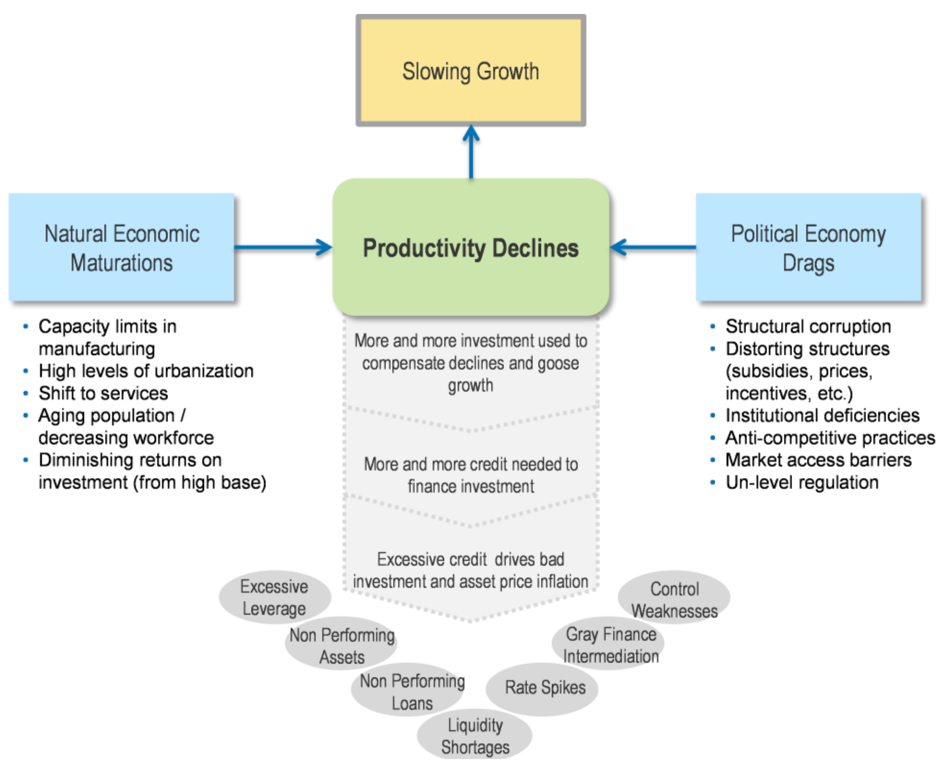
The Productivity Crisis

The root cause of China's economic slowdown is a productivity crisis caused by a confluence of many factors—some common to maturing economies and some idiosyncratic to China (Exhibit 1). The early, relatively easy catch-up gains in productivity that China enjoyed in the 80s and 90s, and even into the 2000s (with WTO entry in 2001), are largely exhausted. Productivity growth can no longer be gained from moving rural residents into cities and their factories. There are too many new cities and there is way too much factory capacity. And while service sector growth is positive and promising, most of the growth today is at the low end of the services value chain, for example in the retail and hospitality sectors versus business or technical services (Chart 4, page 10).

But while weakening productivity growth is the primary cause of the easing of headline GDP growth, the phenomenon is not simply a natural evolution. In China's case, productivity is being dragged down by a host of fundamental institutional factors (Exhibit 1), in particular, political economy distortions that are, in effect, self-inflicted wounds. Not only has China's movement toward middle-income status dampened some of the competitive advantages that helped to propel the economy's "miraculously" high growth through the early 2000s, but this process has begun to occur at a time when the aforementioned self-inflicted barriers to productivity growth have been greatly exacerbated by the country's investment-heavy response to the global financial crisis in 2008. This is why the economic reform agenda has taken on such urgency.

Research by The Conference Board shows Chinese labor productivity growth rates are rapidly decelerating, even from their comparatively low base (Chart 5, page 10). The fact that labor productivity is decelerating, even as capital per worker continues to increase, evidences significant inefficiency in investment. Our estimations further show China's historic Total Factor Productivity (TFP) performance—in our view the strongest measure by which we can assess a country's ability to become more efficient, innovative and competitive—is subpar compared to other fast-growing economic peers in Asia. Moreover, our adjusted estimates of China's economic growth indicates that TFP growth has potentially gone negative in recent

Exhibit 1 **China's productivity crisis**



years. These results show that China's fundamental productivity problems do not simply arise from the normal economic maturation process. Rather, a confluence of political-economy challenges—from deficiencies in institutional support, to mis-incentives throughout the Chinese business system, to widespread structural corruption—is now exerting a significant drag on productive economic capacity. The massive over-building of unproductive assets in real estate and industrial capacity is a direct result of political-economy forces that rely on investment to achieve bureaucratic incentives and enrich patronage networks.

Economic reform must restore productivity and efficiency to capital allocation, in part by enabling entrepreneurial private firms to obtain fairly priced credit for investment and laborers to accumulate a greater portion of national income. The hugely disproportionate allocation of capital, through the State banking system, to SOEs and "championed" private firms – and the subsequent on-flow of much of this capital into asset speculation (e.g. in real estate) and gray finance – has not only contributed to the slide in productive capacity, but has also begun to destabilize China's financial system. Meanwhile, the privileged recipients of this funding and beneficiaries of the status quo – the "vested interests" per se – have essentially militated against the reforms necessary to put China's economy back on a sustainable path. The ubiquitous "ghost cities" across China exemplify the capital misallocation problem at hand, as do the legions of Chinese firms who struggle to differentiate along dimensions other than low price – a positioning enabled by artificially low costs of capital, and that typically comes at the expense of socially responsible behavior and product quality and safety.

The Reform Imperative: The Friends and Family Conundrum

What are the hopes for marketizing reforms to address these productivity problems and restore an upward growth trajectory? Both history and current political-economy signals strongly suggest that the Chinese government will opt for stability rather than risk policy error, over-slowing, or an unexpected seizure. This policy orientation, and the growth-supporting intervention it requires, will not yield the required structural adjustments to put China's economy on a sustainable path. Indeed the approach is specifically "anti-reform" from a market perspective in that it relies almost entirely on the heavy hand of the State to continue investing and financing to boost growth, even though it is economically irrational to do so.

While the recent reform proclamations of China's leaders have been copious, attendant action – as evidenced by detailed written regulations and/or actual laws – has been almost entirely absent. The inertia exists in large part, we believe, because of the impact reforms would necessarily have on the business interests and financial fortunes of elites and their families across all levels of government in China. The stark reality is that arguably any conceivable "marketizing" reform would necessarily undermine one or several levers of elite control, wealth extraction, or both. Simply put, if markets are allowed to play a decisive role in the economy – as was specified in the Third Plenum "Decision" document – then the government elites who today manage market access and opportunity will necessarily have to be sidelined.

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There is also the equally important and very real risk that reforms, once started, could lead to unintended consequences, or uncontainable volatility in the near-term that could undermine public support for the Chinese Communist Party or cause irreparable schisms with the Party's leadership. In our estimation, even judicious, well implemented reforms would likely detract from near-term growth, possibly quite significantly, before they began to yield growth dividends longer-term. So far, there appears to be no appetite for risking short-term growth, or missing the all-important GDP growth target, something seen by many as the determinant factor of political legitimacy for the Party. Indeed, we consider the GDP target to be one of the most critical mis-incentives in play in China, as pursuing the target essentially gives the State sector carte blanche leeway to continue borrowing and investing in the name of growth and economic stability. The continued reassertion of the growth target means, in effect, that marketizing reforms must be postponed.

Along with diminishing returns, maintaining the politically charged growth rate comes at a high cost to the government's fiscal resources. Already, the government's monetary support is having shorter and shorter lived impacts. As fiscal resources become more constrained, the ongoing deterioration in economic growth will inevitably become more pronounced. This process is already evident across a number of cities in China that most significantly overbuilt real estate, infrastructure and industrial capacity in the 2009 to 2013 "bubble years", and are now running out of money and entering a sort of "debt paralysis". The debt paralysis is a unique Chinese phenomenon enabled by a controlled financial system and the lack of legal mechanisms to efficiently write off debt, remediate stakeholders, and consolidate or liquidate insolvent firms – and is the main reason why a Lehman Brothers type seizure is considered highly unlikely in China. Looking forward, however, this debt drag will undoubtedly cause greater disparities to emerge across Chinese cities, creating a more fragmented marketplace. (Charts 6 and 7).

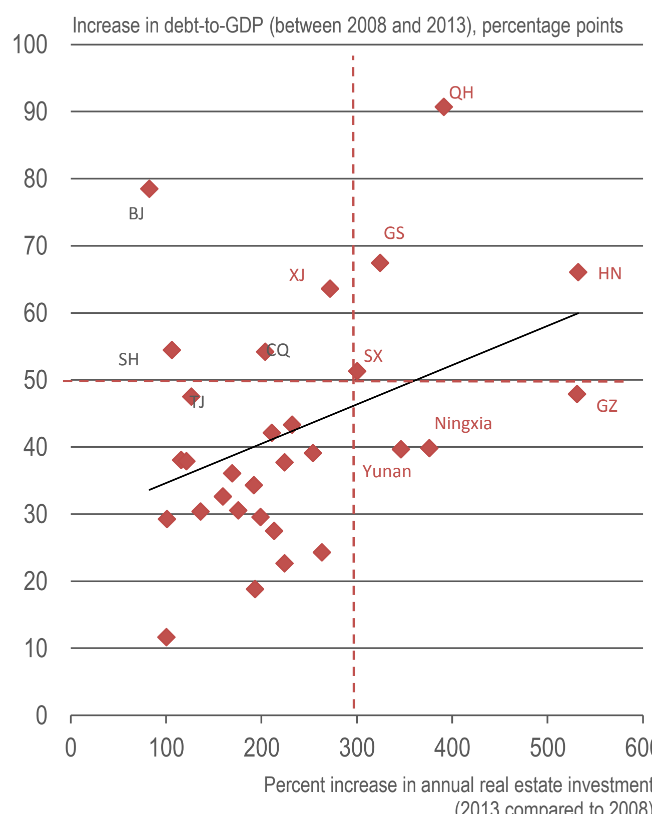
Tough Policy Choices

Against this backdrop, there is much hope among foreign investors that the Chinese government will soon embark on a program of marketizing reforms to address the productivity problems outlined above, and that they have the capability to be successful at implementing the program. The good news is that China enters this transitional period with significant

Chart 6 and 7 **The provincial breakout of increases in debt-to-GDP and real estate investment froom 2008-2013**

Debt has grown swiftly across almost all of China in the past five years; the provinces that have seen the quickest debt buildup have often relied most heavily on real estate investment for growth

Sources: NBS, PBoC, CEIC, The Conference Board



Sources: NBS, PBoC, CEIC, The Conference Board growth potential IF the needed policy and institutional reforms can be successfully made. Fundamentally, China is a large and diverse economy, with ample factor endowments, and the capability for great dynamism if only the political-economy factors constraining productivity growth can be removed, or at least tempered, via "marketizing" reforms. These political-economy constraints include, for example:

- deficient IP protection that impedes innovation and efficient investment in intangible assets (Chart 8);
- the preferential treatment of state-owned enterprises that impedes efficient competition and severely distorts markets;
- the widespread involvement of government elites in business via championed "private" firms; and
- weak institutional support for assuring fair competition, product quality and safety, compliance, and ownership and operating rights.

Local champion firms now span all sectors, from industrials to consumer to services. They enjoy opaque, non-market competitive advantages that serve to smother the real private sector and its dynamism. In many sectors, these firms have emerged as the chief competitors for MNCs.

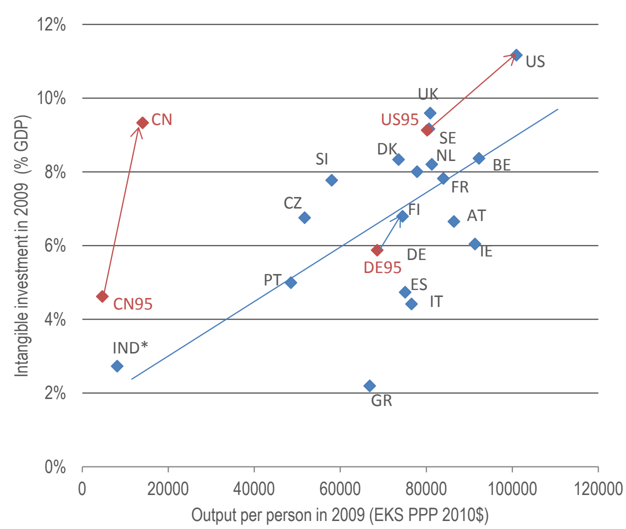
Difficult Times for MNC Business in China

These policy developments call into question the status of the "Open Door Policy", initiated by Deng Xiaoping in December 1978, with respect to foreign investment in China and MNC participation in the Chinese market. Most MNCs assume, de facto, that the open door policy is still in effect, and that it incontrovertibly promises an ever-more open market for foreign investors, albeit in a gradual fashion, and with some hiccups and back-steps along the way. This view is supported by the shrill and continual proclamations by China's leaders about the country's reform imperatives and their near messianic commitment to continued "reform and opening up". In fact though, the official talk is rarely matched by action. Even the 60 reform points outlined in the Third Plenum Decision document are carefully caveated to preserve the legacy Statist features of the economy, as well as totally non-committal in terms of the timing for reforms. Moreover, almost all of the Decision's reform points have been stated as top reform imperatives for a long, long time – some for more than two decades – and yet they remain perennially on the "to-do list", unaddressed and unresolved.

The reality is that foreign investors in most sectors have faced an increasingly restrictive market for well over ten years, with negligible progress on greater market access, and ever-increasing competition from connected local champions supported by the hidden hands of the government elites who control them. Moreover, a review of the liberalizations that have occurred, and the statutes and policies governing foreign participation in China over the last 30-plus years, reveals a design focused on temporariness, revocability and containment. Not surprisingly, the minority of MNCs that have actually managed to breakthrough with a product or service line and amass share and create strong profitability growth have typically discovered that they are somehow curtailed after three to five years of success by new regulations, imposed compliance costs or the emergence of local competitors with infinitely deep pockets and irrationally low prices. In the past two years, as mentioned, this curtailment has often involved attacks by State media on leading foreign brands for alleged corrupt practices, product safety or quality failures or

Chart 8 **International comparisons of intangible investment in relation to per capita GDP**

China has grown its intangible investment rates quickly over the past two decades, but those expenitures do not appear to have yielded comensurate growth of output -- the country is a significant outlier for its level of development



Sources: Corrado, Carol; Jonathan Haskel, Cecilia Jona-Lasinio and Massimiliano Iommi, (2012), "Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results" Working Paper, June, available at http://www.intan-invest.net; Hulten, C. R. and J. X. Hao (2012), "The Role of Intangible Capital in the Transformation and Growth of the Chinese Economy", NBER Working Paper 18405, September; Hulten, Charles, Xiaohui Hao and Kirsten Jaeger, 2012. The Measurement of India's Intangible Capital," paper prepared for the World Input-Output Data project, The Conference Board.

for non-compliance of various sorts.

While these attacks may indeed be for real transgressions, the fact that MNCs are being disproportionally targeted, held out as solitary culprits for problems well known to be systemic in nature, and proclaimed guilty to the Chinese public (their customers) before being proven so in court, suggests that ulterior motives are at work. These are symptoms, we assert, of the stresses being caused by the long soft fall. Historic precedent since 1978, and the very contemporary experience of today, suggests that China won't be getting any easier for MNCs anytime soon.

The Long View on China

Yet even with these challenges and uncertainties, China remains a top global opportunity for most MNCs, as it should. After all, China is a very large market – with niche markets often the size of country markets elsewhere. Moreover, China boasts a growth rate that, even while slowing, remains standout globally. China's manufacturing sector enjoys unparalleled advantages of scale in terms of supporting infrastructure; and even with tightening supply conditions and rising wages, China's labor pool remains much larger and above average in terms of skill level and work ethos when compared to other emerging markets. Moreover, most

The Re-Reform Path that Appears to Be Unfolding

In our view, paralysis and friction in the policy sphere is palpable, as evidenced by the increasingly purge-like nature of President Xi Jinping's anticorruption campaign, along with the tight clampdown on public debate, data flow, and media reporting on China's economic status and societal challenges. Optimists infer that social stability and Party/bureaucratic order is seen by President Xi as a prerequisite first step to introducing marketizing reforms in the second stage, such that the reforms can be implemented successfully and according to plan without resistance or obstruction from the lower levels of government (i.e., the "bottom making counter policy," an old Chinese idiom).

There is however no concrete evidence of President Xi's ultimate intention with respect to reform, or whether he favors a marketization path or a Statist path. The ***observable realities*** so far, now two years into the new leadership's administration, show a "reform" program taking shape that seems biased toward the Statist path. The re-reform program that can be observed comprises six noteworthy features:[a]

1. a recentralization and concentration of political power in the hands of a paramount leader and his inner circle of hereditary elites;
2. a deinstitutionalization of top policy processes to transfer authority over and control of key development and economic administrative decisions to trusted Party elites;
3. the enfeeblement and alignment of ministries, local governments, and major SOEs via anti-corruption and indoctrination campaigns, to assure that their behavior is aligned with the Center's wishes;
4. a cleansing and rectification of the lower level bureaucracy via the anti-corruption and mass line campaigns to reduce petty corruption, instill some rectitude, improve responsiveness to dictates from the Center, and improve the Party's reputation with the populace—or at least the optics;
5. stepped up security and societal control—even involving outright repression—to assure social stability, and leave no doubt about the heavy hand of the leadership; and
6. hard-line geopolitics and military/security stewardship presumably to engender popular support from the masses and from the powerful military bureaucracy.

This emergent policy stance – a redirection and regression from the former marketization path of Deng Xiaoping – apparently induced by intensifying economic stress and the over-arching desire to maintain stability and absolute Party power, is manifesting in two important trends: an "isolating from the outside" and an "insulating of the inside." Repressing public debate and peaceful petitioning—even on issues seemingly aligned with the government's stated objectives (for example, requiring government officials to disclose their family business interests)—are examples of the "insulating of the inside" trend, as is the intensifying control of the internet and crackdown on social, political, and economic commentators airing "unfriendly" views on China. The hardline stance China has taken on external trade, diplomatic, and geo-political issues – and most recently in Hong Kong – exemplifies the isolationist trend, as does, we believe, the overt singling out of MNC brands for product and compliance failures, and now monopolistic practices, by regulators and the Chinese State media. History indicates that these trends are likely to worsen before they abate.

[a] Kenneth DeWoskin, "The Opportunity in Xi's 'Re-Reform,'" Quick Note, China Center for Economics and Business, The Conference Board, June 9, 2014.

emerging markets have challenging economic and marketplace problems and difficult operating conditions; China is arguably not such an outlier in this regard. Moreover, for most MNCs, China's domestic market offers much headroom for growth via market share gain.

The important thing for MNCs to realize is that China is amidst a long, slow fall in economic growth, and that the competitive game has changed from one of investment-driven expansion to one of fighting for market share, controlling costs, and enhancing productivity. Foreign companies with deep-rooted corporate DNA in dealing with business cycles stand to be more prepared for this new reality than their Chinese competitors – firms who've only known 35 years of high-growth, easy credit and irrationally exuberant valuations. But MNCs need to embrace and re-orient for this new reality and prepare for it accordingly. The days of high, double-digit growth and above average margins are over. As mentioned, a critical success factor for MNCs at this juncture will be preparing their China organizations and teams to manage down market conditions, something most local talent has little experience in doing.

Expect Positive Breakthroughs Eventually

Longer-term, the potential is high for positive policy change directed specifically at MNCs and foreign financial investors, but probably only when the soft fall reaches its lower depths and the risks of policy inaction undeniably outweigh the risks of action. Three assumptions underpin our assertion that the door will remain open for foreign investors in China, and that it will eventually open more widely and more fairly as a policy response for restoring China's economic vitality.

- First, the need for capital in China will only intensify and serve to elevate the importance of access to global capital markets and foreign direct investment. Old timers will recall the red-carpet treatment foreign investors bearing capital investment received in the 80s and early 90s. The features of those days are likely to return, and not just in the warm welcome for capital, but also in terms of the quid pro quos and special dispensations offered to foreign investors who bring deals that are appropriately aligned with the interests of key government stakeholders and backed by strong relationships. In many ways, WTO entry, and its ensuing growth boom and national treatment provisions, closed these types of preferential access points to foreign investors.

- Second, the need for foreign technology and knowhow to restore industrial competitiveness, propel the services sector up the value curve, and restore productivity growth is acute. This need will eventually force the door to be opened more widely for foreign firms with the capabilities to provide workable solutions. Better market access provisions and competitive safeguards will be required, this time around, to induce timely and concerted skills and technology transfer. Deeper foreign participation in the Chinese market is arguably the fastest path for restoring Chinese productivity growth and competitiveness. Eventually, putrefying indigenous innovation programs will be discarded in favor of closer foreign cooperation – the concept articulated, but never implemented, in the 12th Five Year Plan as the means to securing China's role as a global supply chain hub in the "seven strategic emerging industries".

- Finally, as growth continues to slow in China, the country's truly competitive firms will genuinely need to tap international markets for growth, just as Japan's competitive firms did in the 1980s. "Going Out" will thus become a commercial imperative, not just a slogan. Destination countries for these aspirants will necessarily grant access and support only in return for resolutions on market access problems for their firms in China, and newfound weight and mutuality will enter the trade negotiation environment to the benefit of all MNCs in China.

These prognostications are not without precedent. When Deng Xiaoping made his famous Nanxun visit to South China in 1991 to attempt to revive China's sputtering economy after two years of stagnation post-Tiananmen, it was telling that two of the most important reforms he enacted involved substantively improving operating conditions for foreign investors. Specifically, these were the introduction of the "Wholly Foreign Owned Enterprise" (WFOE) holding structure and the expansion and elevation of the manufacturing and trade reform programs housed in the Shenzhen Special Economic Zone, and the extension of these programs to new zones in other cities. These policy changes garnered rapid enthusiasm and ushered in a huge wave of foreign investment. They also greatly improved the operating environment for MNCs in China, for a time.

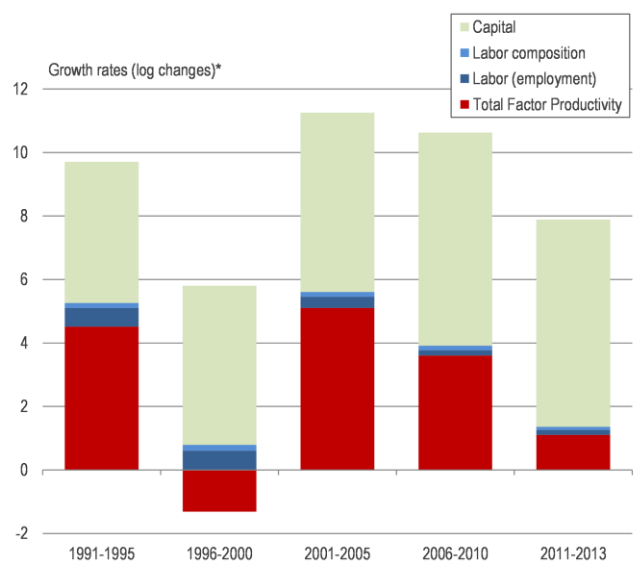
This relatively optimistic long-term view should be tempered with the very real possibility of even more difficult short- and medium-term operating conditions for MNCs in China. Simply put, things are likely to get worse before they get better; and improvements, when they start to come, are likely to be very gradual. China has the financial resources to finesse the soft fall for a long time, and hence the luxury to move slowly. Moreover, there is significant, perhaps immovable bureaucratic resistance to change. The possibility of a more autocratic digression and period of re-isolation in response to economic malaise is not unthinkable – nor is the possibility of political instability should economic stress and the anti-corruption campaign cause a schism among Party elites. It is a highly uncertain time, even in the most optimistic scenarios. Robust contingency planning is essential.

Section 2a: The Structural Slowdown – Trends and Dynamics

The Conference Board's primary message, when it comes to China's economic challenges, is that the country is inflicted with a productivity crisis that is driven by a host of economic and institutional factors. Such an obstacle may not make for sexy headlines, as productivity issues do not tend to engender sudden economic catastrophe. But while weaker productivity growth may not be as visibly evident as a financial crisis or an oil shock, in China this underlying problem is driving more easily observed volatilities, for example: non-performing debt, more frequent liquidity shortages, and increased volatility in the RMB exchange rate. Perhaps more insidiously, slower productivity and weakening economic efficiency are much more intractable challenges precisely because they do not cause sudden economic contraction. Indeed, their existence and extent can be denied and papered over with credit growth for many years, which has been and continues to be the case in China.

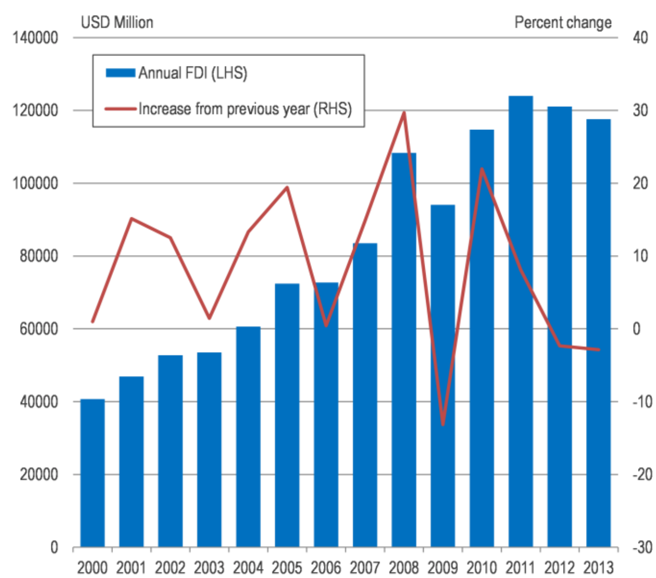
When looking at China's official economic data, it becomes quite clear that the country has been productivity-challenged for some time – even during high growth phases – and that the productivity performance has worsened markedly since the global economic and financial crisis (GEFC) in 2008. From 1991 to 2001, for example, China's official statistics indicate that an average 1.9 percentage points of economic growth per year came from productivity growth – a time during which GDP growth averaged 7.4 percent (Chart 9). To be certain, this period was a volatile one in China's recent history, as Zhu Rongji undertook SOE reform (mostly a consolidation program) on a broad scale, tens of millions of workers were laid off or furloughed as a result of the program, the entire fiscal system was retooled to give the center more control over fiscal flows, and all the while the government began taking steps to bailout an insolvent banking system. But while a growth contribution of 1.9 percentage points from TFP is not terrible, with the

Chart 9 **China's contributions to GDP growth**
The high productivity growth that China has experienced since WTO accession is rapidly easing



Sources: The Conference Board Global Economic Outlook 2015(forthcoming November 12, 2014), The Conference Board Total Economy Database
*Note: log changes will be slightly different from annual percent changes due to technical details

Chart 10 **China's Inbound Foreign Direct Investmnet**
The rapid increase in foreign investment throughout the 2000's was one factor that enables rapid catch up gains in growth



Sources: Ministry of Commerce, CEIC, The Conference Board unleashing of private sector forces that took place during this period, one might expect a much higher contribution to growth from gains in productivity. The numbers show a different story, indicating that even during this surge in private sector activity capital investment led the way for growth by contributing an average 3.9 percentage points per year to GDP over the period; and the contribution from labor almost matched the boost from TFP, offering 1.6 percentage points to growth on average.

Meanwhile, in the 2001 to 2007 period, when Chinese GDP growth stood at an average 11.6 percent per year, TFP growth shot up to account for 5.3 percentage points of growth per year – about 46 percent of total growth during this period. This improvement was driven in large part by the economy's unprecedented opening to outside markets and the large-scale adoption of modern technologies from the outside world via foreign direct investment – which grew 78 percent during the period to 84 billion USD in 2007 from 47 billion USD in 2001 (Chart 10, page 18).

Unfortunately, not only was this seven-year stint the only truly productivity-led period of growth in the reform era, but it also dissipated quickly when rapidly slowing global demand in the wake of the GEFC combined with China's domestic stimulus policies to exacerbate overcapacity and undermine the previous periods' productivity growth drivers. Indeed, from 2010 to 2013, productivity steadily eased from contributing 2.9 percentage points of growth per year to basically zero – and that is down from a full 6 percentage points as recently as 2007. Such a rapid decrease in productivity growth indicates that the domestic portion of China's economy was facing severe inefficiency issues – driven by dynamics that we outline below – even before the manifestation of the GEFC. The unusually buoyant export markets pre-2008 worked to mask the vulnerabilities.

China's fundamental problem from a financial standpoint – and it is intimately related to the weakening of productivity growth – is that the capital allocation mechanism is distorted by policy and political factors, as opposed to operating according to market-oriented principles. The good news for China, its people and their policymakers is that a realignment of capital allocation and a redistribution of economic resources – from the unproductive State sector to the productive but smothered private sector – would yield immense dividends in terms of renewing the economy's efficiency and productive capacity. But even so, in the very short term this redistribution of resources would likely place intense downward pressure on economic growth as insolvent companies go through bankruptcy, workers are laid off, investors lose money, and debt is written off. The key question then is whether or not China's current leadership is ready and willing to accept this short term pain for the long term productivity boost it would provide.

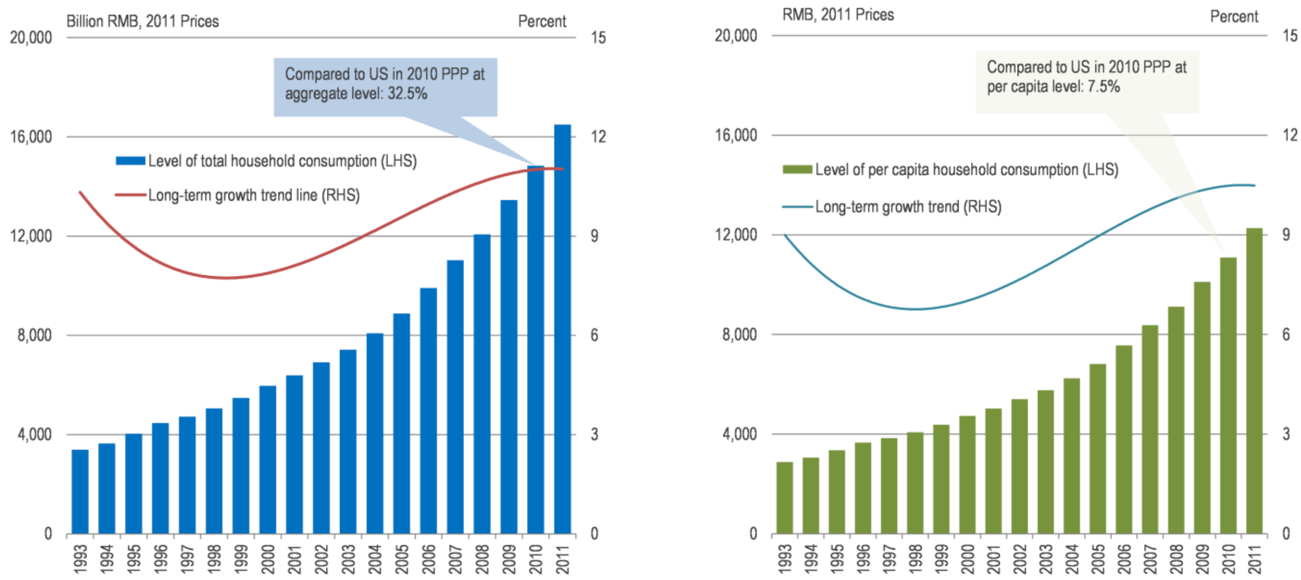
Economic Growing Pains

When reading financial or economic news about China over the past three years, one has generally been confronted with headlines relating to some of the economy's more obvious challenges, for example: the overall debt burden, local government borrowing, shadow banking, poor stock market performance and real estate bubbles. But while these topics may garner the most media (and often the most analytical) attention, the fundamental drivers of China's economic slowdown are both less obvious and more deeply structural in nature.

Ever-growing inefficiency – due to wide-spread capital misallocation combined with intrusions of government and other vested interests into commercial markets – appears to have finally reached a level where it is beginning to fundamentally pull down China's potential growth rate.[2] These political-economy challenges to productive capacity are combining with other "natural" decelerators that have arisen as China's economy matures, including: a shift to services, diminishing "catch up" gains in productivity, and an aging population and decreasing workforce. Thus, an overly rapid slowing of productivity growth, brought on primarily by a host of idiosyncratic institutional factors, is the true "disease" that now afflicts China's economic performance. The more headline-grabbing outcomes mentioned above are symptoms caused by the underlying productivity challenge. The other more "natural" decelerating factors – as we will discuss now – are simply growing pains.

[2] Potential GDP is the amount of output that an economy can sustain in the long term without causing inflation, given its fundmental factor endowments labor, capital and productivity: http://stats.oecd.org/glossary/detail.asp?ID=2094

Chart 11 **Chinese consummption is growing rapidly but from a low base**
China's consumers are doing their part to boost economic growth, but the level of consumption is not high enough to offset the coming slowdown in investment



Sources: NBS, CEIC, The Conference Board

The Conference Board's emphasis on productivity as a sustainable driver of economic growth is a key reason why we expect China's economic performance to continue slowing, essentially *without landing*, over the coming 4 to 5 years. Moreover, growth will likely remain subdued for many years beyond that timeframe if reforms that enable the revival of productivity growth are not enacted.

When looked at from the demand-side, it may appear that China's economy can continue to grow at a fast clip for some years to come. After all, on a country-wide basis the economy still needs plenty more investment in roads, railways and other infrastructure, particularly in the western part of the country. Furthermore, the country's consumers are rapidly expanding their ability and penchant to purchase goods and services (Chart 11). By contrast, when one looks at the fundamental supply-side inputs to China's economy, it becomes clear that continually slowing growth will be the norm for China for the foreseeable future.

Economic theory stipulates that an economy has two fundamental inputs – capital and labor – that drive growth, along with a third more ephemeral factor, which is the efficiency with which capital and labor are used within an economy. This latter factor is dubbed "Total Factor Productivity" (TFP) in economic terms and relates to less directly observable portions of growth such as technological progress, innovation, institutional improvements, and more streamlined business operations among many other elements. When looking at China through this supply-side lens, one begins to see that each of the country's fundamental inputs to economic growth will continue to slow in the coming years – the current downward trends over the past several years are clear, and nothing at present looks set to abate those trends.

The Demographic Drag

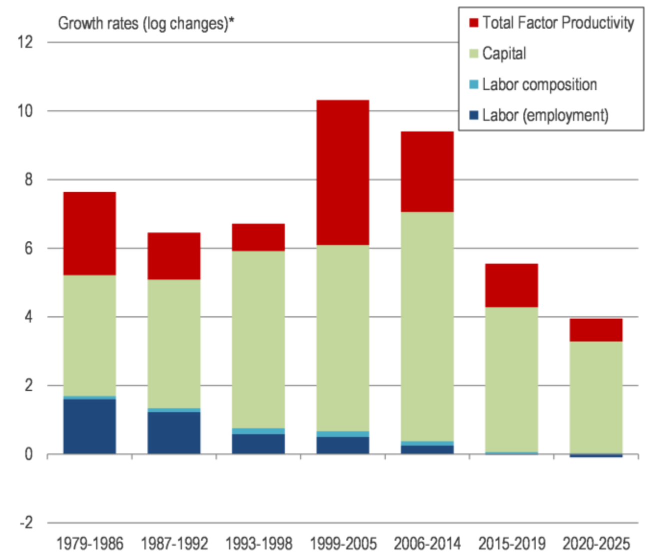
We start with labor. It is well known that China's population is aging swiftly. Indeed, as China measures it,[3] the country's working age population (ages 15 to 59) began shrinking in 2012 and it is set to continue falling for the foreseeable future. The easing of China's population growth has been a long time coming and mainly attributable to population control policies implemented throughout the 1970s and 1980s. Typically, demographers blame the one-child policy implemented by Deng Xiaoping in 1980 as the key culprit in today's shrinking population. However, as Wu, Yang and Fang point out, the "Triple L" policy implemented in 1973 was also an important factor in slowing the birthrate, as it sought to push for later marriage, longer intervals between births, and fewer children per couple.[4] This policy was implemented in the wake of the 1963-1971 baby boom, which largely occurred in response to the devastation of the "Great Famine" of 1959-1961 when 30 to 40 million premature deaths occurred in China. Hence, while the baby boom seemed to be leading to a major boost in the overall population, Wu et al argue it did not even make up for the lives lost over the previous four years.[5] While the increase in the birthrate throughout the 1960's did lead to a strong boost to the working age population just as the economy was opening up, and led to a sustained healthy workforce during the manufacturing acceleration in the early 2000s, the population control policies ultimately meant that this demographic dividend quickly – and predictably – turned into a demographic drag.

But despite a recent relaxation to the one-child policy in China,[6] the country has yet to see a marked acceleration in birth rates. In many cases, modern Chinese urbanites simply don't want to have more children due to the rising costs of childcare and general rising living expenses in cities.[7] Furthermore, Chinese couples often do not want to give up increasingly well-paid women's salaries that a mother might have to forego in order to raise multiple children. But more fundamentally, even if China's birth rate were to accelerate rapidly in the face of loosened policy, such a change would not be able to offer a positive effect on China's economic growth rate for at least 15 years, when current newborns would finally begin to enter the workforce. And in the near-term, more children in China would only serve to push up the country's dependency ratio,[8] causing more of the labor forces' resources and wages to go toward supporting those who are not contributing to economic growth. So for the foreseeable time horizon, the quantity of China's labor force will continue shrinking, thus placing a drag on China's potential growth rate.

There is, however, another way in which the labor force can add to economic growth, besides simply getting larger – people can become better educated and thus more skilled. On this score, China's working age population is certainly improving. According to NBS data, 8 million Chinese students earned a high school diploma in 2013, up from 4.6 million only a decade

Chart 12 **China's long soft fall**

China's coming slowdown will emanate in part from natural factors, but be primarily driven by institutional constraints on productivity



Sources: The Conference Board Global Economic Outlook 2015(forthcoming November 12, 2014), The Conference Board Total Economy Database
*Note: log changes will be slightly different from annual percent changes due to technical details

[3] Most countries measure the working age population as between the ages of 15 to 64, but the NBS emphasizes a slightly narrower range: http://www.chinadaily.com.cn/china/2014-01/20/content_17246718.htm
[4] Wu, Harry X., Yang Du and Fang Cai, "China's Premature Demographic Transition in Governmnet-engineered Growth". Prepared for CEDES-IDRC Project "Assymatric Demography and Global Financial Governance." June 2014.
[5] Ibid.
[6] See: Zhang, Melinda. "Changes to the One-Child Policy – Assessing the Impacts" The Conference Board. September 2014. https://www.conference-board.org/retrievefile.cfm?filename=TCBCC-QN-Sep2014.pdf&type=subsite
[7] Ibid.
[8] Ibid.

earlier in 2003. Similarly, the number of college graduates has increased by 240 percent over that timeframe, while individuals earning post-graduate degrees have increased by 360 percent. According to our estimations, this improvement in the quality of the labor force will offset the drop in the quantity of the labor force over our medium term time horizon (2015-2019). However, beginning in 2020 the accelerating pace of China's aging will begin to more than offset the quality improvement and will impose a slight net drag on economic growth of about 0.1 percentage points over the next period (2020-2025) (Chart 12, page 21).

Even as China is likely to continue increasing the amount of individuals earning higher-education degrees over the long term, improvements in education and workforce readiness still have a long way to go – as many MNCs struggle to find college graduates that are ready for the rigor of working in a corporate environment.[9] Moreover, increasing the overall skill level of a population is a notoriously slow process,[10] so while the quality of China's workforce will continue to improve, it will simply do so slowly – and more slowly than the pace at which the population will be shrinking. In sum, over the medium term, changes to China's labor force will essentially be a wash as far as economic growth potential is concerned – neither adding nor detracting – while in the longer term, the shrinking population will begin to drag slightly on growth.

Capital Formation Must Slow

The second fundamental economic input – capital – will have a greater impact on China's potential growth over the next several years. Since economic reform began in earnest under Deng Xiaoping in 1978, China's economic growth has been primarily driven by capital accumulation (see Chart 9, page 18). Indeed, in the 1990 to 2013 period, over 52 percent of GDP growth was driven by expansion in capital services,[11] even as the country was enjoying a demographic dividend and relatively high productivity expansion. While capital accumulation is the main driving force in any rapidly emerging economy, international comparisons show that this has been unusually rapid in the case of China.[12] In the supply-side model that we use to estimate China's growth, it is not just the accumulation of capital that adds to economic growth, but also the value-added from the existing capital stock. For many forms of capital investment, it takes several years before those projects begin to yield economic returns. Thus returns on the existing capital stock are included in capital's overall contribution to growth. But before we look at China's returns on capital, we first examine the basic growth of its capital stock.

In recent years, China has rapidly been accumulating capital. In 2013 alone, it spent 660 billion RMB on rail development, built 118,000 kilometers of new roadways and built ten new airports – a pace it expects to increase in the coming years. The economy meanwhile broke ground on 2 billion square meters of floor space for real estate and spent 8.6 trillion RMB on fixed asset investment in the property sector. Even manufacturers, who had a fairly dismal 2013, invested 14.7 trillion RMB in the year – a staggering amount, but still representing the lowest growth rate for investment in the sector in at least a decade.[13] Over the past eight years, real growth of fixed capital formation has expanded by an average of 8.8 percent per year. This type of rapid spending on new capital formation is not unusual for a developing economy – especially one like China where economic policy during the planning period of 1952-1977 left the country's overall infrastructure and productive industrial capacity depleted.

9 The Conference Board, 2014 Research Working Group: "Cultural Fluency: Indentifying Skills for Business Leadership in Global Asian Markets."

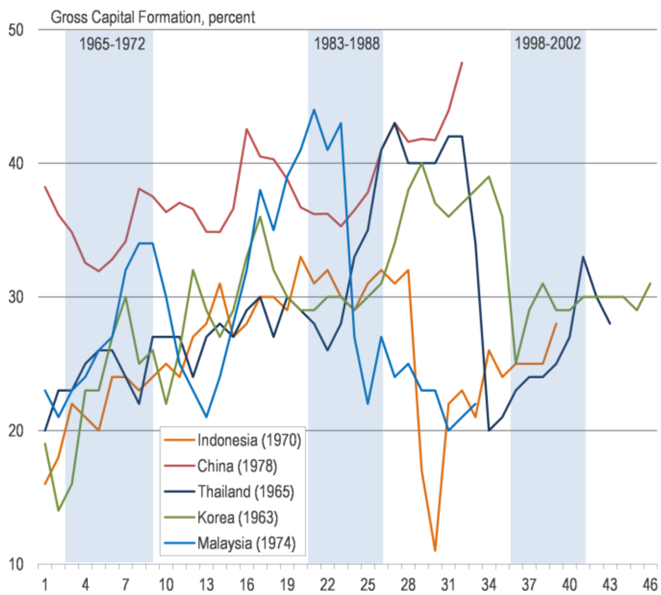
10 Erumban, Abul, Klaas de Vries and Bart van Ark "New Measures of Global Growth Projection for The Conference Board Global Economic Outlook 2014" The Conference Board, November 2013.

11 The Conference Board, Total Economy Database: https://www.conference-board.org/data/economydatabase/

12 We can refer to the 2011 productivity report in which we discuss this extensively.

Chart 13 **Domestic economic imbalances**

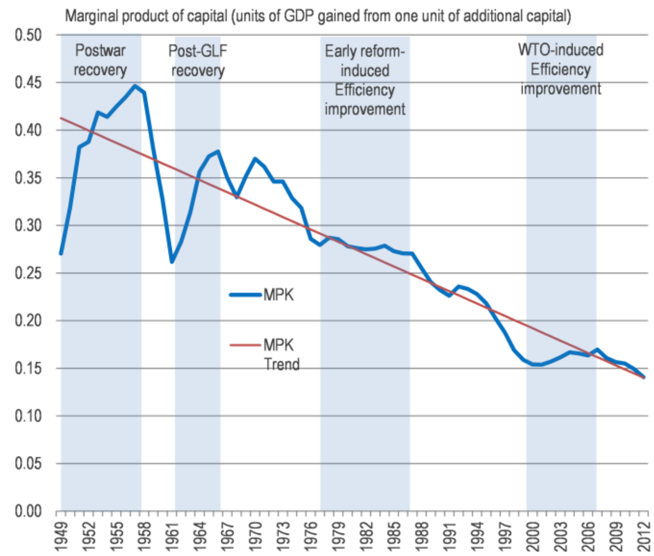
China's reliance on investment to drive growth has surpassed similar fast-growing, investment-led economies



Sources: Lee, Il Houng, Murtaza Syed and Liu Xueyan. "Is China Over-investing and Does it Matter?", IMF WP/12/277, November 2012.

Chart 14 **Returns on capital in China**

China's returns to capital have been falling steady for decades, although punctuated by bouts of increased efficiency via reform



Sources: Wu, Harry X. "China's Growth and Productivity Perfromance Debate Revisited – Accounting for China's Sources of Growth with a New Data Set" The Conference Board Working Paper Series. EPWP #14, February 2014. https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2690

Thus, it was the development of this new capital base over the past 25 years that led to China's stellar official growth rate over the same period. What's more, due to a strikingly different demographic picture at that time – when an average of 9 million people were entering the work force each year, as opposed to today's contracting of the working age population – an increasing amount of manufacturing workers were available to put the fast-growing capital stock to use. This method of capital-intensive, manufacturing-led development culminated with China's accession into the WTO in 2001 – a move which greatly enlarged China's available end markets and swiftly increased export demand for Chinese products. This sweet spot for Chinese development between 2001 and 2007 led, however, to well-known economic imbalances, both internally and externally. The internal imbalance is reflected in a investment-output ratio[14] that has averaged 47.8 percent from 2009 to 2013. While other economies, especially the fast-developing East Asian economies of the 1950's and 1960's similarly experienced significant reliance on investment-driven growth, none of them reached levels of imbalance that China has experienced (Chart 13).[15]

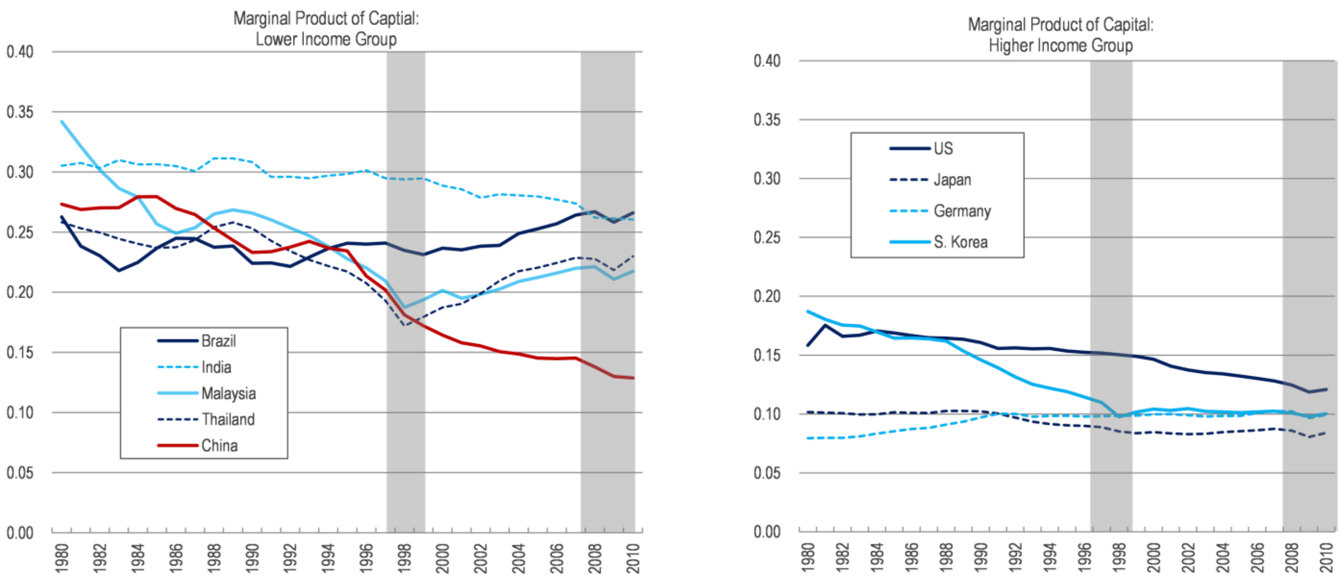
As is well known, China's reliance on investment to drive growth only further intensified in the wake of the global economic and financial crisis, as policymakers sought to offset the contraction in global trade by ramping up capital expenditure. However, since the end of 2011, two structural factors have combined to slow the growth of capital formation. The first is simply payback from the ramp up of investment in the 2009-2011 period when policymakers implemented the economic stimulus program – sky-high investment rates during that period have partly just reverted toward the longer term trend. The second part, though, is driven by a structural, and to some extent purely mathematical, dynamic. As China's total capital stock continues to expand, the ever-larger base means that sustained levels of investment represent a smaller proportional addition to total capital. This process is a

[14] The investment output-ratio is the percent of GDP in a given year that is attributable to investment (as measured by gross fixed capital formation)

[15] Singapore briefly reached an investment-output ratio on par with China's in recent years (47 percent of GDP in 1984 according to the World Bank) but stayed there for only a very short time (one year), and is considered to be an outlier as a very small, open economy that is highly dependant on trade

Chart 15 **International comparisons of MPK**

China's returns on capital are now on par with rich world countries, indicating investment is highly innefficient for China's level of development



Sources: World Bank, Wu, Harry X. "China's Growth and Productivity Perfromance Debate Revisited – Accounting for China's Sources of Growth with a New Data Set" The Conference Board Working Paper Series. EPWP #14, February 2014. https://www.conferenceboard.org/publications/publicationdetail.cfm?publicationid=2690

"natural" aspect of a maturing economy, whereby capital deepening[16] provides less and less topline economic growth as marginal additions to the capital stock become smaller in comparison to the overall size of the existing base of capital.

Two ways to offset the diminishing impact of the level of capital investment include garnering gains from the already-existing stock of capital, or redistributing new investment toward more productive uses. Akin to improving labor force quality, more effective use the existing capital stock helps to boost the contribution of capital services to overall GDP growth. In this sense it is often difficult to differentiate between growth in productivity (which we discuss below) and growth in capital services because the two components interact with one another and are thus closely linked. However, one way to identify the contribution of existing capital is to look at the level of returns that an economy gets from adding one very small unit of addition capital, or what economists term the Marginal Product of Capital (MPK). In economies with a very low stock of capital, small additions to the amount of available capital should produce high returns as business processes become more automated and new infrastructure development makes it easier to get goods to market. At a relatively early economic development stage, those additions often also help to make the entire capital stock more productive, as rudimentary or fragmented logistical and business structures begin to turn into networked supply chains.

As economies become more advanced, and are thus employing their capital stocks at more efficient rates, MPK drops rapidly because the additional capital does little to improve an already high-performing capital base. In contrast, low returns on new additions to a relatively small capital base indicate that the existing amount of capital is doing little to add to future economic growth. In other words, the raw output – building of buildings, roads, railways, etc. – creates GDP as it is built, but does little to improve growth in the next period because the overall returns to capital are low. Alternatively, MPK tends to fall if new investment is geared toward relatively unproductive projects (e.g. buildings and other structures as opposed to high-tech machinery), regardless of the current size and state of the capital stock. Those declines can be

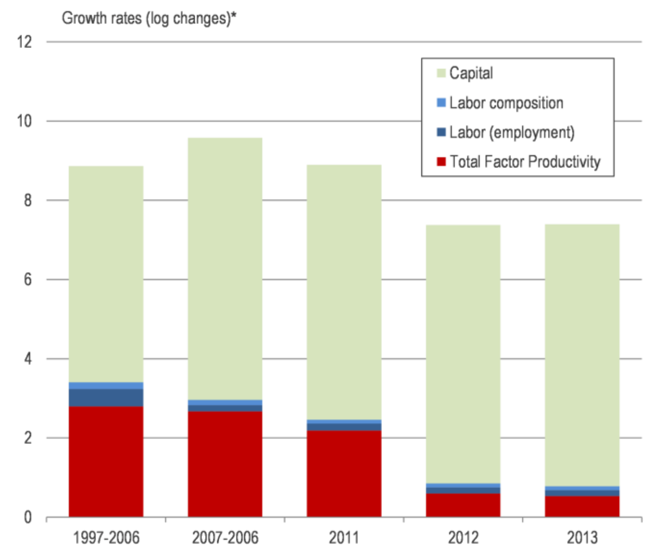
[16] The ratio between the capital stock and employment (i.e. capital stock per worker)

reversed by reallocating capital toward the more productive and innovative sectors going forward.

In chart 15 (page 24), one can see that China's returns to capital (MPK) have fallen dramatically over the past three decades, and now stand at levels well below emerging market peers (Charts 14 and 15, page 23 and 24). China's relatively low returns on investment despite the fact that capital deepening is still in its early stages, suggests that the existing capital stock is doing little to boost growth due to inefficient allocation. In other words, dividends from previous rounds of capital formation are not showing up in improved capital services. So unlike the dynamics in China's labor market, where an improvement in quality is offsetting a deceleration in size, the pace of growth in both quantity and quality of capital is diminishing in China. This decelerating improvement in the quality of China's capital stock is intimately connected to the broader slowdown in economy-wide productivity (TFP), which (as we discuss below) encapsulates not just improvements in the quality of capital, but also the interaction between capital and labor along with other exogenous factors such as technological improvements and institutional dynamics.

Chart 16 **China's productivity challenge**

China's TFP has fallen steadily in recent years, essentially flatlining in 2012 and 2013



Sources: The Conference Board Global Economic Outlook 2015(forthcoming November 12, 2014), The Conference Board Total Economy Database
*Note: log changes will be slightly different from annual percent changes due to technical details

Productivity is the Real Culprit

Thus, the final, and most fundamental, factor driving China's slowdown comes from this third input to growth – productivity. As much recent Conference Board work has shown, we view China's weakening efficiency as THE very crux of the economy's current slowdown and future trajectory. And as we will discuss later in this report, it is also the factor over which policymakers and institutions have the most influence, can be most affected by economic reform, and could ultimately change China's current economic trajectory – for better or worse. By almost any measure, China's economic efficiency has deteriorated since the GEFC. Using official data, our estimates indicate that China's TFP growth flat-lined in 2013, after falling each year since 2010 when it contributed 2.2 percentage points to GDP growth (Chart 16). What's more, our alternative estimates of China's historical GDP growth[17] indicate that TFP growthactually turned negative after the GEFC, suggesting that the economy is getting less and less efficient each year. We will later discuss the implications of these latter findings in greater detail, but first we examine the concept of TFP and discuss the reasons why its growth appears to be rapidly decelerating (and potentially even contracting) in China.

[17] Wu, Harry X. "China's Growth and Productivity Perfromance Debate Revisited – Accounting for China's Sources of Growth with a New Data Set" The Conference Board Working Paper Series. EPWP #14, February 2014. https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2690

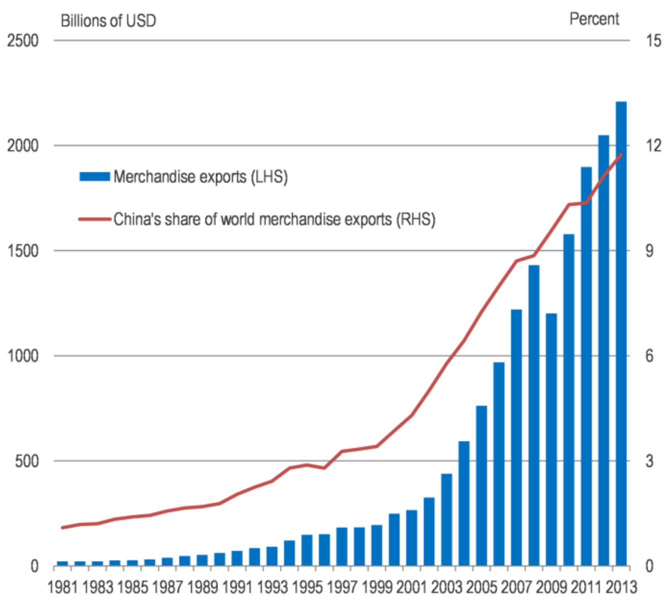
Section 2b – The Underlying Productivity Crisis

Part Growing Pain…

As we discussed earlier, the measurable inputs into China's economy – capital and labor – are both clearly on a slowing trend for various reasons. However, the third input into economic growth comes from the complicated interaction between those two factors. Finding better, more efficient uses of capital and labor is broadly attributed to technological progress. However, other things can affect factor efficiency as well, most notably: institutional or policy influences and external shocks. In our view it is the idiosyncratic aspects of China's "socialist-market economy" – namely, perverse and distorting economic incentives at almost every level of government, the heavy intervention of the State in resource allocation and pricing, the rampant participation of government-owned companies in business, a financial system that disadvantages savers, and many more – that have truly become the binding constraints on Chinese productivity growth, as we delineate later in this portion of the report. But even absent these exogenous influences on the use of economic resources, developing economies will generally experience a natural slowing of productivity growth as they move up the income ladder.

Chart 17 **Chinese merchandise exports**

China's share of world manufacturing exports rose rapidly in the 2000s, from 3.9 percent in 2000 to 11.4 percent in 2013



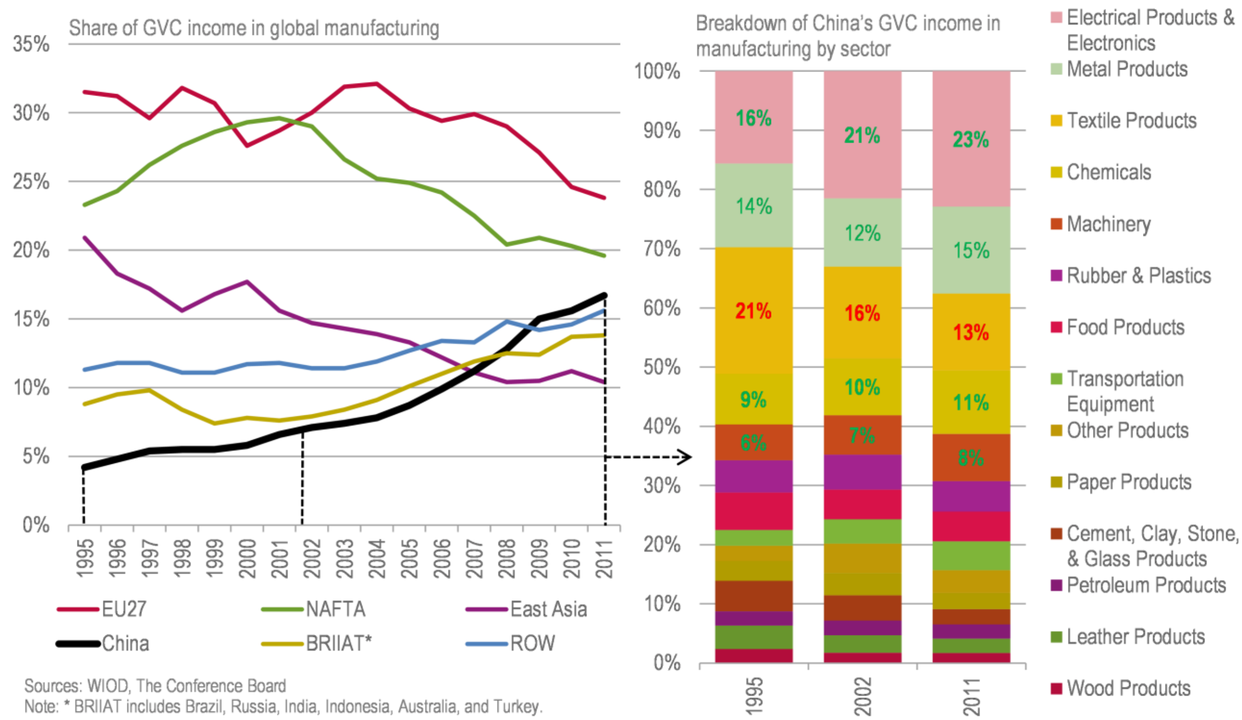
Sources: World Trade Organization, The Conference Board

This abstract idea is more concretely explained by the broad shift that relatively poor countries experience as they move from an economy dominated by agricultural production to one more focused on manufacturing. This was clearly evidenced by China's high productivity growth in the 2001-2007 period, following WTO accession, when the country's manufacturing sector truly took off. On top of the natural increase in production that occurred as China focused intently on manufacturing, its increased openness to the outside world – through greater access to export markets and substantially enlarged foreign investment during the period – gave it an additional boost to productivity via the quick adoption of global technology and knowhow. This dynamic is generally referred to as "catch up" gains, which occur as an economy closes the technology gap between itself and global best practices.

After the rapid shift toward manufacturing and the initial phase of "catch up" growth has run its course, as appears to be the case in China now, the next phase of development is typically slower because gains in productivity logically become more difficult to achieve when technology frontiers have been reached. First, after developing a large, solid manufacturing base, as China has clearly done – now accounting for an average 11.7 percent of world manufacturing exports[18] (Chart 17) – the next hurdle is to develop a successful service sector industry. Gaining productivity out of the service sector is more difficult than in manufacturing for several reasons. First, due to the more labor-intensive nature of the service sector, achieving marginal gains is more difficult. For example, it is generally easier to increase the speed of a toy production line than it is to have an insurance salesman sell more policies. Secondly, service sector development is also typically not as straightforward as that of manufacturing. Making a quality vehicle may not be easy, but it is much more concrete than

[18] According to data calucaltions from the World Trade Organization

Chart 18 **China's movement up the manufacturing value chain**
China has made significant strides in capturing value from global manufacturing, but moving to the next phase requires more diffficult firm-level innovation



designing financial products for investors with various levels of sophistication or a tour package that is flexible enough to meet the needs of a diverse group of potential travelers.

Finally, many sectors in the service industry are not tradable and thus less exposed to international competition and investment, which keeps them from experiencing the same "catch up" gains that manufacturers often experience. Indeed, the service sectors often experience a walling off from foreign investment and market participation – especially in East Asia. For this reason, both Japan and South Korea, for example, have struggled to transform their economies from manufacturing-driven export machines to more modern service economies. China is likely to struggle to make this pivot as well, and for similar reasons. While each country may have slightly different motivations, the instinct to preserve service industries for domestic companies, who are often (and often rightly) seen as more capable and appropriate candidates to influence, develop and cater to homegrown preferences, serves to inhibit innovation, and this further drags down on productivity. The classic example of this phenomenon is national airlines, many of which are supported through subsidies or other preferences in order to avoid depending on foreign carriers.

The other more natural drivers of slower productivity growth, besides the switch to services, include the dissipation of "catch up" gains as an economy gets closer to the global technology frontier and firms encounter difficulties moving up the manufacturing value-chain beyond commoditized goods. It is debatable as to how much further China has to go before it reaches global technology frontiers. Those that argue that China still has plenty of room for catch up gains point to the poor domestic quality of the telecoms sector and the inability to produce desirable vehicles even for the domestic market. But in some areas, such as small appliance manufacturing and machine tools, China's factories employ cutting-edge technology and highly advanced processes. Even though China does still have sectors that could easily stand to gain fast improvements from technology –

stock trades for examples are routinely executed via faxed requests[19] – some observers often forget that the path to the global technology frontier is neither given, nor linear. In other words, the rate of productivity growth from catch up gains begins to diminish well before an economy adopts global best practices across all industries, and a portion of China's weakening productivity growth is simply an outcome of its previous success in adopting global technologies at such a fast pace.

Related to this point, China's past achievements in developing manufacturing business and moving from relatively low value-added goods like textiles and simple toys and cigarette lighters to more sophisticated items like cell phones and white goods also creates challenges for keeping productivity growth high (Chart 18, page 27). Moving into higher-value added production requires domestic, firm-level innovation, both in business operations and in areas like product design and branding. Developing the ability to compete with Japan in producing Chinese-designed LED screens or even have Huawei in the conversation with Apple and Samsung when it comes to globally recognized, owned and coveted brands, represents one of the most challenging innovation hurdles for any country. That is one reason why only a handful of companies tend to dominate the global marketplace in so many industries. Moreover, because the competition to become a globally recognized brand is so fierce, the innovations that create such an opportunity must be accomplished on a firm-by-firm basis and initially in a domestic context, with homegrown ideas and capabilities.

For all of these reasons, Chinese productivity growth has naturally slowed in recent years; this accords with well understood dynamics of the process of economic development. Many countries have had to deal with the changes that occur as these economic maturations take place. It's a difficult transition because it occurs in the wake of a high-growth phase that produced a burgeoning middle class, an improved per capita GDP and subsequent rising labor costs – all of which tend to stall during the transition, or possibly reverse. This phenomenon is referred to as the "middle income trap" (Charts 19 and 20, page 29). Dealing with the challenges that come with entering the middle-income phase of development is a daunting task in and of itself, but the productivity dynamics described above only tell a part of the story in China's case.

…Part Self-Inflicted Wound

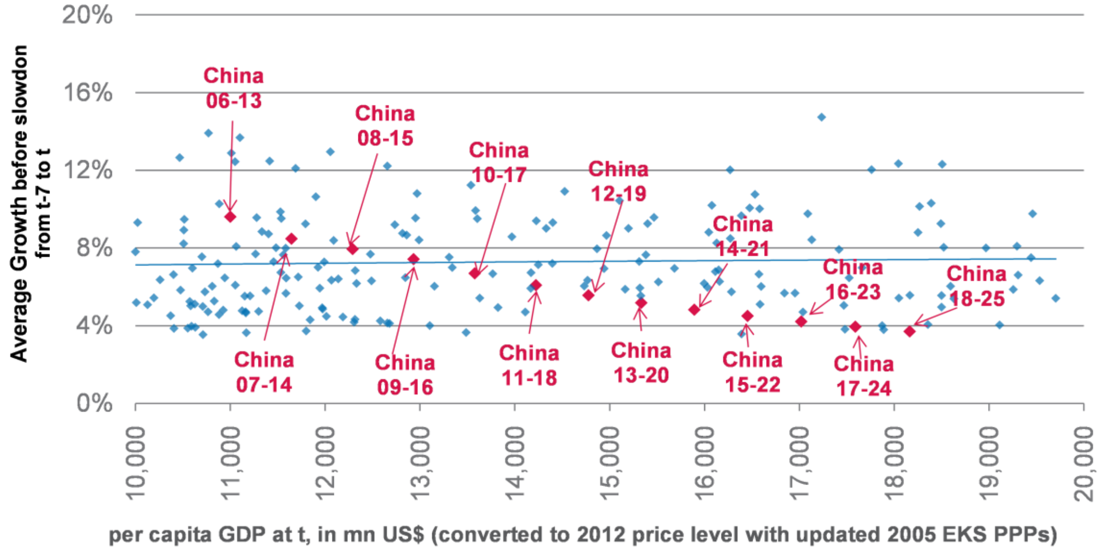
Beyond the challenges of a naturally maturing economic structure, China has many other factors that are acting as drags on productivity improvements. Most of these are idiosyncratic to the nature and structure of the Chinese economy, and many fall under the rubric of institutional barriers that to some extent represent exogenous influences on productivity growth, as mentioned above. In China's case, many of the barriers to future productivity performance are "self-inflicted wounds." While the economy enjoyed the natural growth advantages of a large, low-income developing economy, these productivity "wounds" were more than offset. However, China's movement toward middle-income status has dampened some of the competitive advantages that helped to propel the economy through the early 2000s. Moreover, this has begun to occur at a time when China's self-imposed barriers to productive growth have been greatly exacerbated by the country's investment-heavy response to the global economic and financial crisis. While the economy's trajectory, with these constraints in mind, may seem dire, the good news is that many of these productivity inhibitors are within China's power to alter – and this is why the potential economic reform agenda has taken on such urgency.

With weakened demand from abroad set to continue through the foreseeable future, China must now address the domestic institutional constraints to productivity growth head on. In our view it is the idiosyncratic factors of China's socialist-market economy that have truly become the binding constraints on Chinese productivity growth. Here we review a few of these characteristics.

[19] Hunter, Gregor Stuart. "New China Stocks Link Seen Carrying Risks." The Wall Street Journal, August 22, 2014. http://online.wsj.com/articles/china-stocks-link-seen-posing-risks-1408689373

Chart 19 **Projected China GDP growth rates compared to other countries that slowed at middle income level**

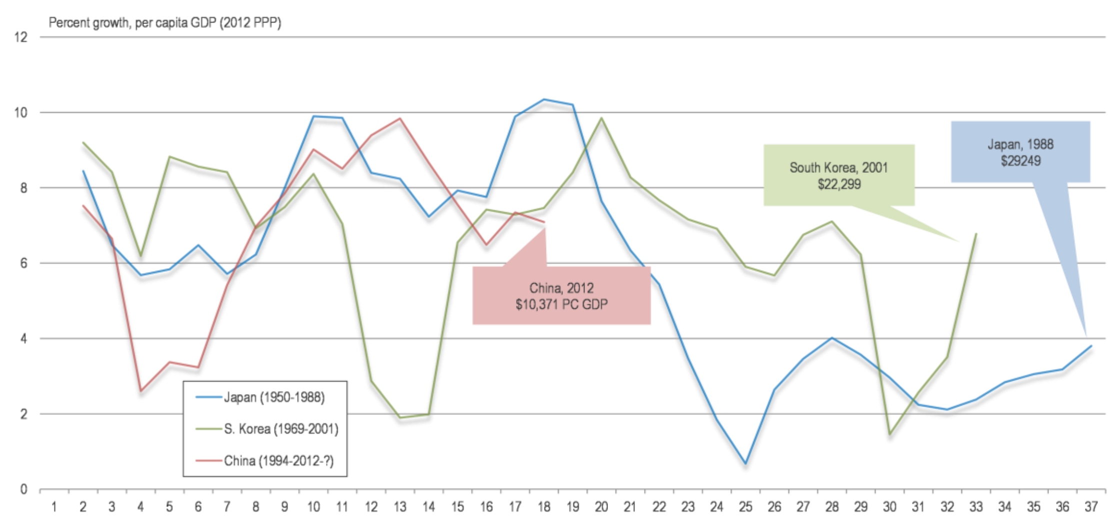
Growth projections suggest that China could well drop right into the range of middle income trap economies



Sources: The Conference Board Total Economy Database, January 2013 (https://www.conference-board.org/data/economydatabase/);
The Conference Board Global Economic Outlook 2013 (https://www.conference-board.org/data/globaloutlook.cfm);

Chart 20 **Annual Growth Rate of Per Capita GDP at the Stage of about $3000 to $30000 (in 2012 US$)**

On a per capita basis, Chinese growth is not unprecedented – can it follow the path that Japan and Korea took to high income status?



Sources: The Conference Board Total Economy Database, January 2013

SOEs

One of the primary inhibitors to improved productivity performance in recent years has been the resurgence of the state-owned portion of the economy at the expense of the private sector. While centrally-owned and administered State companies only number 117, the proliferation of small state-owned entities at the provincial level and below – in the neighborhood of 155,000 companies across China's 31 provinces – means that smaller, genuine private players are facing an uphill battle in the competition for resources and market share. Indeed, the amount of state-owned assets in the industrial sector has increased from 3.9 trillion RMB in 2004 to 12.5 trillion RMB in 2013 (an increase of 218 percent), and the proportion of those assets that are in sectors beyond what the Chinese leadership itself has dubbed "strategic sectors" (e.g. defense, electricity, oil and petrochemicals, telecommunications, coal, aviation and shipping) has risen from 43 percent in 2001 to 49 percent in 2011.[20] Meanwhile the return on state-owned assets has dwindled in recent years. As officially measured, returns on state assets have fallen since the global financial crises, from 5 percent back in 2007 to 3.1 percent in 2012.[21]

Meanwhile, the cost of critical input factors, from people to land to credit, all remain underpriced for the State sector and expensive for private players, prohibitively so in the case of credit. So far in 2014, interest rates on one-year bank loans to the "most credit worthy borrowers" (i.e. large SOEs) have stayed near the benchmark policy rate of 6 percent, with about 20 percent of loans being extended at the benchmark rate through the first half of 2014 and almost 10 percent issued below the policy rate. Smaller private players, meanwhile, pay anywhere from 10 percent to four times the policy rate (about 25 percent). And perhaps more fundamentally, many state companies are completely insensitive to movements in interest rates anyway, as financing lines from banks are regularly rolled over for them or bailed out by local governments once it comes time to repay. Moreover, private SMEs have difficulty scaling in China either because they are directly and purposefully blocked from the market to protect state champions, or because reaching scale requires the pursuit of non-market (i.e. government-directed) objectives and often the costly cooption of local officials. All these factors make it clear how the growing imprint of the state in the economy has acted as an inhibitor to productivity growth by funneling the bulk of the economy's resources into the least efficient businesses – which effectively have no incentives to achieve healthy performance in a truly commercial sense. Because SOEs are backed by the State, and can't go bankrupt, they understandably pay little heed to commercial matters such as debt-to-equity ratios, return on capital employed, overcapacity, or speculative investment risk. Thus, the large and growing presence of the State sector is perhaps the most fundamental challenge that China faces when it comes to boosting growth through economic reform. However, it is also one of the most intractable, as SOEs at all levels – whether officially delineated or not – are owned or controlled by powerful government elites, and the major source of their private wealth creation.

Real Estate

The real estate boom over the last decade, which went into hyper-drive in the wake of the 2009 to 2010 investment binge, is perhaps the second most deleterious characteristic of China's economy when it comes to realizing productive potential. Floor space under construction grew by 135 percent throughout the country from 2008 to 2013 (Chart 21, page 31), and while 2014 has seen a significant cooling of the market, most private estimates (by Chinese real estate companies) put the inventory of Chinese real estate at 5 to 6 years of current sales. Seven individual provinces increased investment in real estate by 300 percent or more between 2008 and 2013 – Gansu, Shanxi, Yunnan, Ningxia, Qinghai, Hainan and Guizhou. And while it's evident to any visitor that the housing glut is concentrated more in the 3rd- and 4th-tier cities rather than the major metropolises, the data on the stock, number of purchases and the pace of current price declines is patchy to say the least, especially outside of the largest cities. Of overall fixed asset investment, real estate spending makes up about 20 percent each year, and the real estate market and its supply chains (both up and down stream) are estimated to account for about

[20] Batson, Andrew. "How to Fix China's State Sector." Gavekal Dragonomics, March 2014.
[21] Ibid.

20 percent of GDP each year, up from 16 percent in 2007.[22]

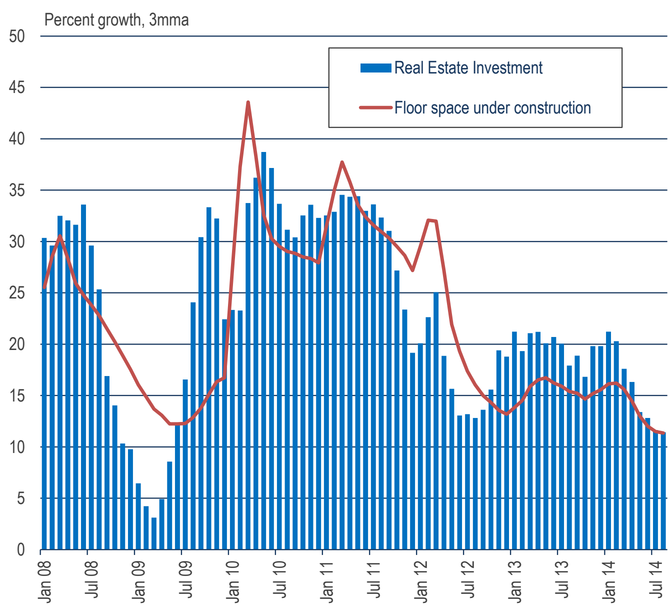
The key problems with the over-building of real estate are several. First, real estate is by nature a much less productive asset than other investment types. If a person purchases a home, it rarely makes them a more efficient worker, unless perhaps they were previously homeless. Of course, more efficiently built, and even attractive, office spaces can help to improve employee production, but in many cities – especially outside of the major ones, and arguably within them as well – efficiency and attractiveness in commercial real estate is often trumped by haste, grandeur and kitsch. Secondly, such a high reliance on real estate spending is not only unproductive in and of itself, but it also diverts resources away from more productive uses, such as private manufacturing investment, in order to enter either the property development or real estate speculation business. Anecdotal evidence suggests that many private business leaders have re-directed their investments into real estate over these last several years, instead of re-investing in their core business. The city of Wenzhou, once arguably the pinnacle of private sector manufacturing competitiveness in China, has been recessed for four years now on the back of a real estate correction and the associated collapse in the city's credit markets.

Finally, such a large-scale boom in property construction is almost always associated with an equally expansive jump in real estate prices. Such a misalignment of asset prices serves to exacerbate the above-mentioned dynamics, inducing the shifting of ever-more resources into ever-less productive investments as speculation ramps up. Moreover, since so many loans in China are collateralized by real estate or land, the resulting over-statement of collateral value is likely to channel other funds to non-credit worthy borrowers. It has become clear throughout 2014, as default pressures across the financial landscape have risen, that a good portion of borrowers in China should not have had their investments financed. Were the value of those unproductive investors' collateral not inflated, the amount of sour loans would likely have been much smaller. Thus, the difficulty with a potential real estate bubble is that it is both a driver and an outcome of reduced productivity – especially in an environment where asset prices are rarely allowed to correct once they've become misaligned – leading to a compounding cycle of ever-more resources shifting into the *unproductive* property sector.

Financial Repression More Broadly

There are many idiosyncratic elements to China's over-investment in real estate, but one of the fundamental drivers of the over-allocation of resources to the sector is the fact that savers have few other options for getting a decent return on their savings. The appreciation in the property market has thus made apartments a popular destination for households' spare cash. But the fact that interest rates on savings deposits are kept artificially low in China – a policy termed "financial repression" – not only fuels property speculation as savers chase yield, but it also encourages further capital misallocation due to the resulting underpricing of capital more broadly. From 2003 through mid-2014, real interest rates for savers have averaged -0.2 percent per annum, a negative return vis-à-vis inflation (Chart 22, page 32). This suppression of savings rates for

Chart 21 **Real estate activity has cooled markedly in 2014**
Real estate investment and constuction soared from mid-2009, but the structural oversupply has led to weak growth in 2014



Sources: NBS, CEIC, The Conference Board

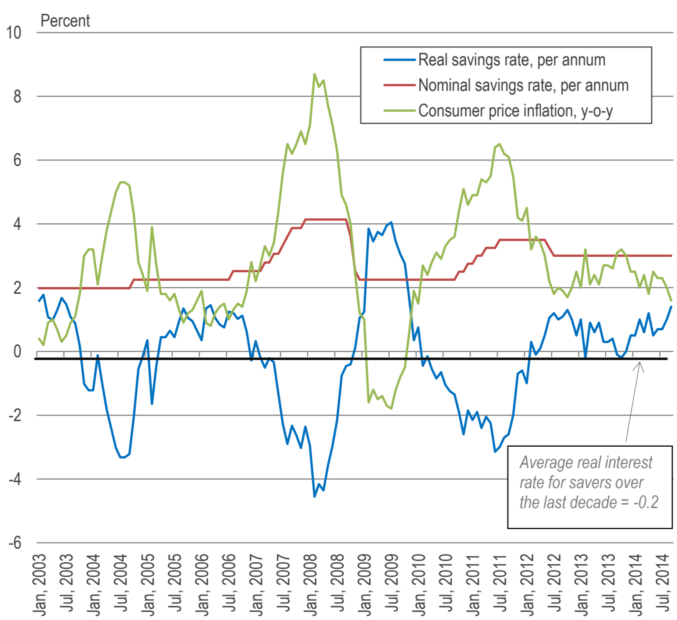
[22] Adams, William. "Real Estate and Related Activities account for more than 15% of China's GDP." The Conference Board, May 2010. https://www.conference-board.org/retrievefile.cfm?filename=1314_1310526650.pdf&type=subsite

depositors not only aided bank profitability but reduced the cost of capital for borrowers – especially state-owned companies and preferred real estate developers. Over time, the underpricing of capital costs for a range of State-owned and connected investors has served to exacerbate the misallocation of capital, increase inefficiency and drag down productivity growth.

And while the capital buildup had arguably already been too rapid throughout the 2000s, the export demand increase from WTO accession was able to mask the economy's quickly rising overcapacity. The global economic and financial crisis, and the subsequent response by China's leadership, threw these counter-productive dynamics into even starker relief, as global demand plummeted in 2008 while China's domestic capacity – from steel, to coal, to autos to real estate – ramped up to maintain the economy's growth rate. During this most recent ramp-up in spending, raw output on capital investment kept GDP growth high, seemingly in defiance of the global slowdown. But in each year since 2010 the economy's productive use of the existing capital stock slowed – with TFP growth even reaching zero in 2013. That expansion in capital expenditure was enabled through the banking system, which was able to take on such a role due to the low

Chart 22 **Chinese financial repression**

Average interest rates for savers have been negative in China for the past decade, leading to subsidized credit and inefficient investment



Sources: NBS, PBoC, The Conference Board

costs it has to pay savers, relative both to inflation and returns on loans. Thus, subsidized credit costs enabled by financial repression over the past 11 years have been one key cause of China's current productivity challenge. Moreover, households effectively pay for the subsidy, and for the high priced real estate as well, both of which serve to constrain household wealth (in cash terms) and consumption.

Overcapacity

Two other dynamics related to financial repression and underpriced capital costs involve China's current historically low returns on capital and its systemic overcapacity in the industrial sector. Acute overcapacity is evident in most heavy industrial sectors, and the outcome of this overcapacity is historically low returns on capital invested in China. Chart 14 (on page 23) shows that China's marginal product of capital – a measure of economy-wide return on investment – has fallen from 0.19 in 2001 to 0.14 in 2012 – a reduction of 25 percent over that period. In other words, an increase in investment of 1 RMB used to produce 0.19 RMB worth of GDP growth in 2001, whereas that ratio stands at 0.14 RMB of growth today. This development is one reason that China's recent mini-stimulus measures, largely carried out through increased infrastructure spending, have had less and less impact on growth with each subsequent installment. Moreover, it's clear from chart 15 (page 24) that China's MPK has fallen to levels commensurate with much higher levels of GDP per capita and capital deepening – on par with capital returns in the developed world and well below China's emerging market peers. As we outlined previously, this development suggests a significantly less efficient capital stock than expected given China's level of per capita GDP.

The lower return on capital in China is, in many ways, a symptom of the country's industrial overcapacity, especially when combined with non-market incentives that drive capital expenditure in many sectors. Recent developments in the iron ore industry provide a concrete example of the conundrum. As of the beginning of September 2014, iron ore prices fell by 35 percent from beginning of the year – from over 130 USD/tonne in January, to 87 USD/tonne at the end of August. However, despite the fall-off in prices, local production of ore increased by 10 percent through the first half of the year. And this ramp up in domestic production has coincided with an increase in output by major international players. China has an estimated 6,000 mines, producing ore with iron content of about 22 percent on average[23] compared to closer to 60 percent iron content for the higher quality international mines – which also produce at much lower cost. Thus, with a sustained increase in supply, it's only a matter of time until many of China's mines are run out of business. But rather than accept this fate, these domestic companies – along with their local government patrons – are throwing good money after bad, not in hopes of an eventual turn around, but in order to simply survive for as long as possible. These negative returns on invested capital – with no end in sight – would normally cause an industry consolidation in a more market-driven economy, but in China they only serve to produce even greater requests for government support and further increases in overcapacity.

Incentives

It is not just the iron ore industry where such perverse incentives predominate. Most industries – from chemicals to heavy metals to autos to solar energy to *baijiu* (China's domestic white liquor) – operate in such fashion because a broad swath of China's businesses are not profit maximizing, but volume maximizing. And this is being enabled by ever higher leverage. Everything seems focused on creating the biggest of all things, not the best. This approach ultimately results in terrible balance sheet deterioration and high debt levels. It's been well known for some time that local government officials are promoted largely on their performance as stewards of economic growth. And while the Chinese leadership claims that it is attempting to change this dynamic[24], progress has been slow (if it has advanced at all). Moreover, messages have been mixed – with Li Keqiang reminding cadres recently that the country's overall 7.5 percent growth target for GDP this year is legally binding.[25]

But it's not solely the pursuit of the growth target that makes for unproductive investment and production. Local government tax authorities are perennially starved for cash, because most tax receipts are channeled to and administered by the central government, leading them to employ a range of less-than-transparent tactics to gain funding. Selling cheap land to property developers, which lines government coffers while also producing GDP growth through real estate construction is a favorite gambit. But leaning on companies to ramp up production in slowing economic times – in order to gain higher revenues from business taxes (which are assessed on a volume basis as opposed to a value-added basis) – also incentivizes local governments to encourage investment even in overcapacity sectors. This incentive structure that offers short-term rewards for individuals, companies and local governments for pursuing capital formation in industry and infrastructure –even with diminishing, deficient or negative economic returns – underlies many of the other more direct causes of China's poor productivity performance.

This distorted incentive structure is causal to short-termism, pushing local Party and government leaders to seek to provide high growth during their tenures in order to be promoted to higher-level positions within the bureaucracy. Raw capital investment, whether efficient and productive or not, is the easiest way to boost economic growth quickly – at least over a short time horizon. Moreover, keeping large, non-viable companies humming helps to ensure adequate fiscal revenues, and forestall unemployment, while the costs of subsidized credit do not have to be recognized until some unknown time in the future – long after the attendant officials have moved on. The overarching point then is that such a vast bureaucratic system, with over to 600,000 political jurisdictions by some counts[26] operates less as a behemoth with top-down directions from the center, but more as a vast array of individual fiefdoms, who's leaders make similar decisions because they each face the same set of incentives – incentives that consistently encourage an inefficient distribution of resources. The gap between fixed asset investment measures and gross capital formation measures indicates a huge amount of leakage in the investment process.

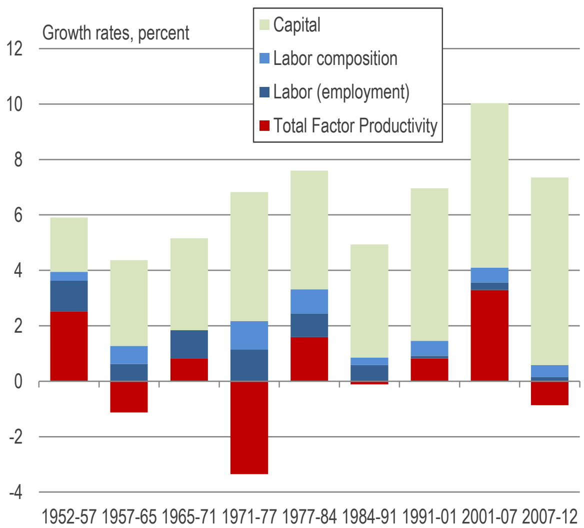
[23] Komesaroff, Michael. "Iron Ore's Battle of Attrittion." Gavekal Dargonomics, August 2014.
[24] Wildau, Gabriel. "Small Chinese Cities Steer Away from GDP as Measure of Success" Financial Times, August 13, 2014. http://www.ft.com/intl/cms/s/0/a0288bd4-22b0-11e4-8dae-00144feabdc0.html#axzz3G0Xnp6wT
[25] See footnote number 1.

[26] The China Statistical Yearbook 2007 indicates that there are 623,699 village-level committess (村民委员会).

Productivity Performance May Be Worse than We Think

The challenges of rapidly slowing productivity growth are borne out in study after study that examines China's official economic data,[a] but recent Conference Board work suggests the situation may be even more critical.[b] Led by Dr. Harry Wu, our work's re-estimation of Chinese growth and productivity represents a systematic, transparent approach to addressing some of the elemental data issues that confound China analysis. In our view, this work – executed over the course of decades – represents the most credible and exhaustive effort to date to overcome many well-known challenges with China's historical economic data. And indeed, while many analysts agree with the argument that China's economic growth is overstated, few have concrete alternative estimates of China's growth either historically or in the present. While a full examination of re-estimation results are beyond the scope of this current publication, some numbers pertaining to productivity are especially relevant (Chart 23).

Chart 23 **Alternative estimates for China's GDP growth and productivity**



Sources: Wu, Harry X. "China's Growth and Productivity Perfromance Debate Revisited – Accounting for China's Sources of Growth with a New Data Set" The Conference Board

Looking at the same periods of growth that we outlined above, our analysis confirms the general trends, but suggests the downward turn in productivity growth is much deeper than the official numbers suggest – and that it is actually already in negative territory. We estimate that TFP growth contributed a mere 0.8 percentage points to China's growth in the 1991-2001 period, while average GDP stood at 7 percent per annum. Similar to the official numbers, these estimates show that China's accession into WTO truly did unleash the country's productive capacity as TFP growth jumped to average 3.3 percent throughout the period, underpinning an average 10 percent growth rate. Finally, our numbers show that TFP growth has, on average, subtracted -0.9 percentage points from GDP growth from 2007-2012. While some of the data that we use to obtain these estimates have yet to be updated for 2013, the fundamental drivers that have pushed TFP growth into negative territory in recent years remain unaddressed, if not exacerbated, by China's recently appointed new leadership.

What exactly does it mean for China's TFP growth to be negative? Can an economy that is still as relatively poor and underdeveloped as China's truly be becoming less efficient each year? On an aggregate scale we do believe this could be the case for China. Several factors could combine to create such an environment – driven by all the underlying dynamics that drive capital investment decisions and hinder productivity growth that we outlined in this report.

The first way to think about potential negative productivity growth in China is that the rapid pace of capital investment may be negatively affecting workers' abilities to make use of new investment. The Conference Board's estimates of labor productivity in China continue to grow – standing at an average rate of 10.2 percent growth from 2001 to 2013 – but the rate is slowing, from 14 percent as recently as 2007 down to 7.13 percent in 2013. This slowdown is occurring even while the level of labor productivity is only 23 percent of that of the United States. Moreover, TFP is a measure of the efficient interaction between labor and capital, so even as workers continue to grow their skills and abilities, their efficiency per unit of capital could actually be declining based on rates of capital investment that cannot fully be absorbed by the labor force.

China's widespread capital misallocation is leading to poor quality of physical structures as well, causing the deprecation rate of capital investments to rise – especially in comparison to the rates of return on that capital. China watchers are familiar with new apartment buildings that quickly begin to dilapidate, shopping malls that are idle and decaying or commercial offices that make little commercial sense – either from a location or functionality perspective. If China's true depreciation rate is actually much higher than an average economy – especially in comparison to the historically low returns on capital that we outlined earlier – then the productive use of the capital stock would be even more negatively impacted.

And finally, the crowding out of the more productive private sector, especially as State-run and vested companies have increasingly begun to move outside of their core operations to speculate in real estate and financial markets, has meant that resources are flowing ever-more swiftly in the wrong direction. Unfortunately, it's impossible to put exact estimates on the toll that each of these dynamics are taking on the overall efficiency of the Chinese economy. But here the point is simply to illustrate how these multiple constraints combine to actually detract from the productive capacity of the Chinese economy – even as it remains clear that China will continue to need more investment in the coming years.

[a] For examples see: Nabar, Malhar and Papa N'Diaye, "Enhancing China's Medium-Term Growth Prospects: The Path to a High-Income Economy" IMF, October 2013; Zhu, Haibin, "China's Big Fall in Productivity," J.P. Morgan Research, August 2014; Zheng, Jinghai, Arne Bigsten, and Angagn Hu, "Can China's Growth be Sustained? A Productivity Perspective," *World Development* Vol. 37, No 4 pp 874-888, 2009.
[b] Wu, Harry X. "China's Growth and Productivity Perfromance Debate Revisited – Accounting for China's Sources of Growth with a New Data Set" The Conference Board Working Paper Series. EPWP #14, February 2014. https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2690

Section 2c: Growth Targets vs. Structural Trends – Resultant Impacts on the Financial System, Debt, and Asset Prices

Now that we have examined the underlying cause of China's economic deterioration (the productivity "disease"), we can examine the most concerning manifestations (i.e. the symptoms): debt, shadow banking, non-performing loans (NPLs), and financial disruptions. These upshots of low and weakening productivity growth are more tangible and worrying to businesses operating within the country, and front-and-center for the business media.

The reason that we take this approach is because economists often focus solely on China's economic symptoms – particularly if they engage in a demand-driven analysis – and therefore miss the structural issues that must be addressed to remedy the symptoms in a sustainable manner. Indeed, when it comes to economic reform, as we will address in the next section, it will be imperative for China's economic policymakers to design policies aimed at the heart of China's challenges rather than its byproducts. Otherwise, the clearance of hurdles now will only lead back to a recurrence of the same issues down the line, but in a more severe form. Indeed, one can argue that today's situation is a replay of the mid-90s, when reform was initiated but not fully carried through – only worse. And this time around, the hope is nil that China will be able to once again park and outgrow its debt.

The economic challenges that this section enumerates emanate from the disconnect between a slowing structural growth trend and the Chinese leadership's attempt to achieve a politically-driven (if largely arbitrarily determined) economic growth target – standing at 7.5 percent for 2014. Simply put, China is trying to grow above its potential. And doing so, almost by definition, requires that it invests at a faster pace than the economy can productively absorb, thus reinforcing, rather than relieving, the many roadblocks to productivity growth. As the factors that drive weaker productivity growth are reinforced, weaker and weaker economic returns show up most obviously in the financial system and in credit markets more broadly.

Indeed, a large stock of unproductive financial assets requires ever more debt to fuel the next phase of expansion, and a rapidly growing debt burden eventually leads to widely documented vulnerabilities and volatility in financial markets[27], which have clearly been evident in China in recent years. It is for this reason that we view the GDP growth target as one root cause of China's economic misalignment, and why a host of economists, and most recently the IMF, have suggested lowering the growth target as an important first step in achieving economic reform.[28] Until the ongoing weakening of China's growth rate is acknowledged by Chinese policymakers, an overly high growth target will preclude fundamental reforms to the economic system from taking place, and the outcomes of unproductive investment will only continue to worsen.

Debt

The most obvious manifestation of China's productivity problem is the rapid run up in the country's debt load since 2008. From 2008 to mid-2014, China's total debt burden has ratcheted up to 251 percent of GDP from 147 percent at the beginning of the period.[29] Credit to the private sector looks set to increase to almost 200 percent of GDP from 117 percent over the same period, indicating that China's primary debt vulnerability lies in the corporate sector (Chart 24, page 36). This portion of debt has risen by approximately 15 percentage points per year over the past two years and is likely to do so again in 2014 – a staggering pace and one unprecedented for China. Indeed, in the IMF's most recent Article IV Consultation, the Fund explained that only four economies have seen a similarly rapid buildup in debt within the past 50 years, and in each case a financial crisis ultimately occurred.[30] While our baseline scenario is not for a financial crisis, the high and rising

[27] Reinhart, Carmen and Kenneth Rogoff. *This Time is Different.* Princeton University Press, 2011.
[28] IMF. "People's Republic of China: 2014 Article IV Consultation-Staff Report."July 2014.
[29] Green, Stephen. "China – Total Debt Breaks 250% of GDP." Standard Chartered Bank Reserach, July 2014.
[30] IMF. "People's Republic of China: 2014 Article IV Consultation-Staff Report."July 2014.

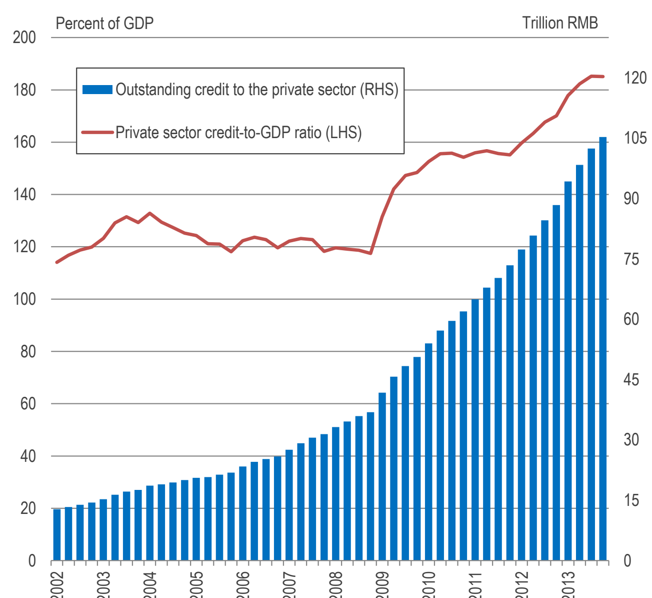
debt burden is increasingly becoming a constraint on growth.

Debt levels naturally rise as productivity falls. Because returns on investment (which is often funded through borrowing) are lower than expected when productivity undershoots, a quickly rising debt burden is a clear sign of weakening productivity growth.

The link between debt growth and productivity is even more apparent in the case of China because the accumulation of leverage has been most acute in the corporate sector. Some argue that China is relatively immune to the more nefarious aspects of a growing debt load because both its household sector and its government balance sheet hold low levels of debt. Household debt, for example, officially stands at 35 percent of GDP, and total government debt at a mere 56 percent of GDP as of June 2013 – well below the levels of economies that have experienced sudden bouts of deleveraging. However, these comparisons are most often made by those individuals seeking to benchmark current Chinese debt levels against recent crises like the sub-prime crisis in the U.S., which put many home-owners underwater owing to the fact that households had used rising home equity to ratchet up borrowing to 96 percent of GDP as of 2007. Greece, by contrast, saw government debt levels spike to 170 percent of GDP during its sovereign debt crisis in 2012. Because these and other recent crises have mainly involved household mortgage debt or sovereign debt, many observers consider that China's relatively clean balance sheets in these regards offer safety. Finally, some argue that the oft-drawn parallel with the Japanese lost (two) decade(s) is not truly commensurate with China today, as Japanese government debt stood at almost 70 percent of GDP in 1990 when the onset of that country's slowdown occurred. Similarly, total debt (including household and corporate) stood just shy of 450 percent of GDP at that time, compared to China's 56 percent for government debt and 251 percent total today.

Chart 24 **China's private debt load (corporate and household)**

China's primary debt build up over recent years has been among businesses, not the government, suggesting severe corporate balance sheet deterioration



Sources: PBoC, NBS, CEIC, BIS, The Conference Board

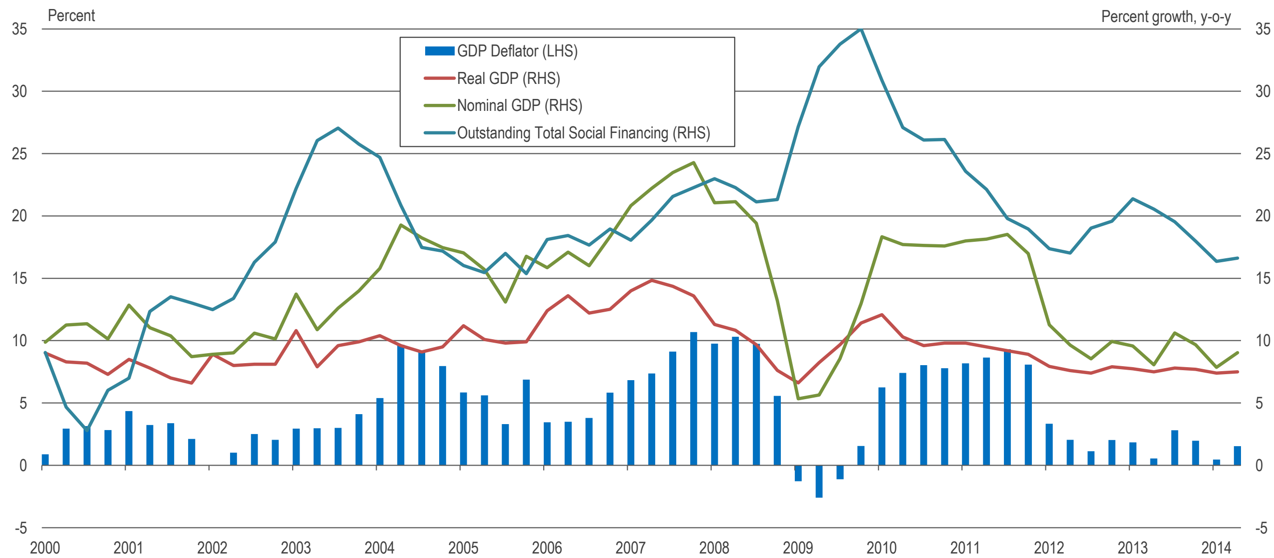
But, as with everything, China's rapid rise in leverage has been a "debt buildup with Chinese characteristics." To start, while China's overall level of leverage remains below many of the developed economies, it is the rate of debt accumulation that is more worrying than the outright level. Nowhere is this dynamic more evident than in China's offshore borrowings. Debt owed by Chinese companies offshore stands at 1.13 trillion USD as of Q1 2014 – accounting for only about 13 percent of GDP and only about 5 percent of total outstanding debt. However, that amount is up from only 621 billion USD as recently as Q1 2012, an 82 percent rise in only two years. As economists have regularly pointed out over time, it is not the absolute debt levels that are truly destabilizing – Argentina for example experienced a crisis when central government debt-to-GDP stood at only 54 percent – but it is pace of growth that can become destabilizing.[31]

Moreover, fast-moving debt accumulation is often an outcropping of widespread capital misallocation and resultant deterioration in productivity performance. This largely occurs as a growing base of non-performing assets requires ever-more new lending in order to refinance previous obligations. Thus, the longer bad debt is left unrecognized the quicker the outstanding leverage position of the economy can rise – something that is quite clearly occurring in China today. And unlike debt problems that accumulate in the household and government sectors, corporate debt accumulation, especially on an economy-wide scale, is

[31] Reinhart, Carmen and Kenneth Rogoff. *This Time is Different.* Princeton University Press, 2011.

Chart 25 **Slowing credit and GDP growth**

In Q1 2014 slowing credit served to choke of GDP growth, sending the GDP deflator to 0.5 percent; in Q2 the authorities loosened credit growth very slightly



Sources: PBoC, NBS,CEIC, The Conference Board

a clear indicator of under-performing businesses or businesses that have expanded too rapidly ahead of demand. And finally, as recent episodes in the U.S. and Europe have reminded us, corporate debt often becomes government debt during times of economic stress, leading to a sudden rise public sector leverage.[32] This type of liability transfer is even more likely to happen in China because the State owns so much of corporate China.

Another way to view the increasing debt-to-GDP ratio is by looking at the credit-intensity of growth. As inefficiency in capital spending increases, and a larger portion of new credit is used to refinance existing loans, the amount of economic growth that an economy achieves from one dollar (or RMB) of credit deteriorates. Thus it takes ever larger amounts of lending in order to achieve the same level of GDP growth. In 2013, China's credit intensity of real GDP growth had grown to a ratio of 4.3, in other words it took 4.3 RMB of lending to achieve one RMB of GDP. As recently as 2007 that ratio had been 1.9, meaning that it now requires 122 percent more credit to get the exact same amount of GDP growth. In comparative terms, it is an astonishing deterioration over such a short period of time.

This ramp up in the debt burden and the slide in credit efficiency is not an easy challenge to address. Indeed, China's central bank, the People's Bank of China (PBoC) has actively sought to slow the pace of outstanding credit growth since the middle of 2013, when outstanding Total Social Financing[33] (TSF) was running at a y-o-y growth rate of 21.8 percent. By April of 2014, the PBoC had gradually brought that rate down to 15.9 percent growth. However, rather than help to ease the pace of debt accumulation, slower credit went hand-in-hand with weaker GDP growth. In Q3, 2013 TSF expanded by 19.9 percent y-o-y while nominal GDP grew at a 10.6 percent y-o-y pace. But by Q1 2014, the rate of TSF growth had slowed to 17.1 percent y-o-y while nominal GDP grew at a mere 7.9 percent (Chart 25).

[32] Ibid

[33] Total Social Financing (TSF) is a metric used by the People's Bank of China to track the amount of financing that goes to the real economy in a given month. TSF includes both traditional bank lending and other forms of bank and non-bank credit along with some non-debt financing such as equity issuance.

This development meant that not only did the debt build up, as measured by the debt-to-GDP ratio, continue to rise, but the pace of overall leverage had not slowed despite the easing of outstanding credit growth. This conundrum – easing credit growth without pulling down economic activity with it – highlights the need for China to increase the efficiency and efficacy of its credit allocation at the same time as it is slowing credit creation. Without an improvement in the performance of financing, or the transmission process between credit and growth, it will be impossible for the economy to deleverage. This observation, then, goes back to the fundamental productivity challenge. If the fundamental factors that are inhibiting productivity performance (poor SOE governance, over-reliance on real estate, etc) are not dealt with, then any attempt to slow credit creation will only serve to either slash economic growth, or push financing further beyond the reach of regulators into informal markets – a dynamic that has defined Chinese credit creation in recent years with ever new innovation to create more leverage.

Growth of Shadow Banking

Part and parcel of the debt build up since 2011 has been the rapid rise of shadow banking in China. As authorities sought to close off the credit taps that had been so widely opened in 2009 to 2010, and to gradually restrict lending to the sectors that experienced the most over-building during that time, money increasingly began to flow outside of the formal banking system. This development was a direct consequence of weaker growth, poorer productivity performance and the related falloff in returns on capital – as a plethora of companies became ever more desperate to borrow once the loans from the stimulus years came due, but the investments they had financed failed to pay out sufficiently. Not only did borrowers become increasingly desperate to roll over loans, often taking higher interest loans from the shadow markets to refinance existing debt, but banks began to find creative, opaque ways to tap into those returns via complex transactions with non-bank actors.

The popular use of the term "shadow banking" in China essentially refers to any non-bank issued credit, even if some of those forms of credit are underwritten by a bank. Thus, many forms of "shadow credit" in China are regulated, bank-related activities (such as issuance of undiscounted bankers' acceptances, wealth management products and entrusted loans) that would not typically fall under the scope of shadow banking in another economy – where the term is often reserved for more lightly regulated or completely unregulated financing activity. Still, we use the term as it is popularly applied, and examine the multiple types of credit that it covers for two related reasons: (1) shadow credit is often used as a tool of regulatory arbitrage in China, and (2) each form of shadow lending represents an avenue through which borrowers are able to continue obtaining large amounts of credit despite the positioning of monetary authorities.

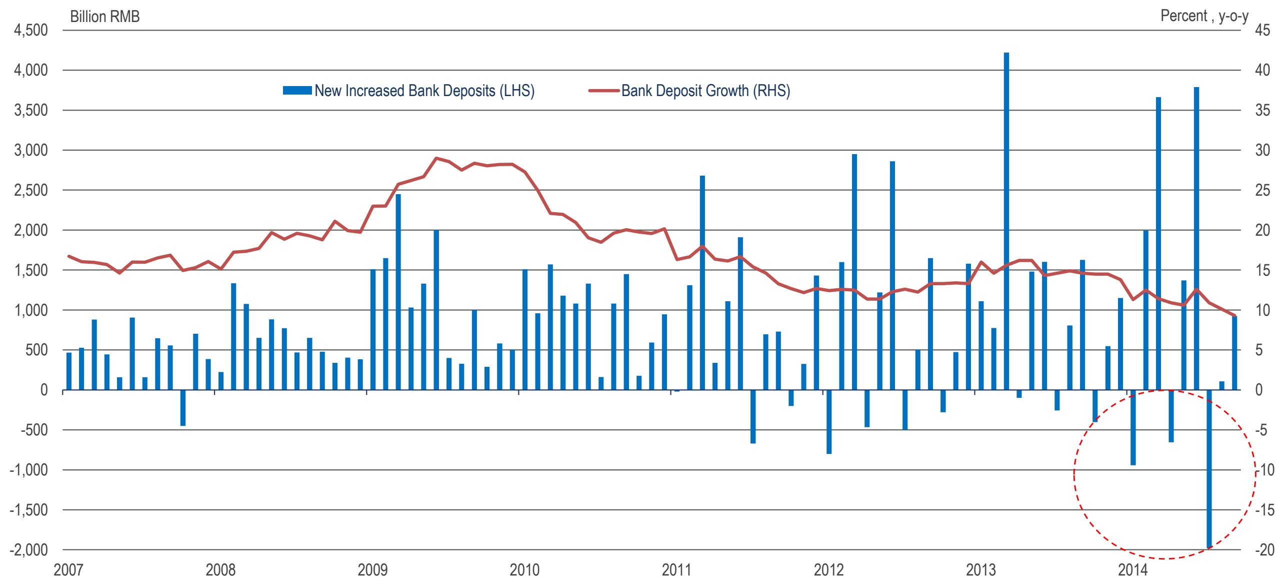
The poster child for Chinese shadow banking is the Wealth Management Product (WMP). WMPs first really came into focus in mid-2011, when their growth exploded by about 250 percent over the first half of H1 2010 – as banks started cooperating with trust companies (on which more below) to package pooled deposits into structured investment products on behalf of wealthy savers (households and corporates), thus earning them an interest rate higher than they could achieve on basic bank deposits. At the time, China's real interest rate on deposits (the savings rate minus inflation) was negative, at -2.3 percent per annum on average in the first half of 2011, indicating that the growth of these types of products was directly tied to the financial repression that we highlighted previously. Since that time, WMP growth has sky-rocketed to 12.7 trillion RMB as of June 2014 – growth of 24 percent in the first half of 2014 and up 535 percent from the first half of 2010. Although regulators have since cracked down on the types of investment products that WMPs are allowed to contain, early expansion of the these vehicles featured a large amount of bank-trust cooperation, which permitted banks to package high-yielding trust loans in risky industries like coal and real estate into investment products for bank customers.

While the bulk of WMPs are invested in relatively safe instruments, in the money market the most destabilizing effects that these investment vehicles bring on is:

- fluctuation in the bank deposit base, as products are moved on- and off-balance sheet by banks in order to clear regulatory requirements and (Chart 26, page 39);
- the inherent maturity mismatch that most of these products entail.

Chart 26 **Hard times for bank funds**

Growth of bank financing (deposits) has weakened in recent months to all-time lows amd volatility has increased substantially



Sources: PBoC, CEIC, The Conference Board

On the former point, banks like to package WMPs because it allows them to move deposits off of their books for a time, which means that fewer bank funds are subject to the 20 percent reserve requirement (the proportion of deposits that Chinese banks are required to hold in low-yielding deposits at the central bank). However, because banks must also pass quarterly loan-to-deposit inspections at the end of each quarter, WMPs are timed to expire just before quarter-end to bolster the deposit base at each bank when needed – before being rolled into "new" WMP products early in the next quarter. In reality, many banks will not allow WMP investors to cash out at quarter-end, but rather they are required to roll over their funds. This regulatory rigmarole has cause huge swings in bank funding in recent years – with July 2014 (a first-of the quarter month, when banks move funds back into WMPs) seeing an astonishing 1.98 trillion RMB reduction in bank deposits. While it is true that the vast majority of these funds stay within the banking system, if not directly on the banks' balance sheets, the liquidity challenges that such large-scale movements present are obvious – especially when one factors in the maturity mismatch.[34]

This second unnerving aspect of WMPs relates to the fact that banks must pay regular interest on the products, and eventually (if not actually every three months) make good on the principal invested. Meanwhile, according to the China Banking Wealth Management Registration System only 22.7 percent of these products – representing 2.9 trillion RMB – are invested in non-standard assets that almost certainly are going to fund longer dated loans to the likes of real estate companies and coal miners. Because of the maturity mismatch, banks often have to issue new products in order to pay out older WMPs, a practice that was supposed to have been banned, but in practice is very hard to close off. Even Xiao Gang, current chairman of the China Securities Regulatory

[34] Braodly speaking, liquidity within China's banking system appears to remain ample. However, as deposit growth has slowed over the past several years, the movements of various deposit-like products on and off banks' balance sheets have led to strong month- and quarter-end demand for cash in the banking system. The need to temporarily unwind off-balance-sheet products causes a surge in liquidity demand at various times, particularly among small banks – leading to sudden, large jumps in interbank interest rates as was seen most emphatically in late June 2013.

Commision and former chairman of the Bank of China, has called many WMP structures "Ponzi schemes."[35] While the fortunes of WMPs have ebbed and flowed to some extent due to various regulatory reactions – a clear indication of the whack-a-mole style of financial governance that occurs in China – the rest of 2014 is likely set to see fast growth in such vehicles as regulators seek to cut down on more opaque practices within the interbank market.

The recently issued rules (entitled Document #127) which changed the way in which interbank assets are supervised, will affect a variety of products but one of the most important is an agreement between banks to buy and sell something called "trust beneficiary rights" (TBRs) – a key link in the chain for banks to access the shadow banking market and create high-yielding WMPs for their customers. In short, TBRs allow banks with little room on their balance sheets – or with too-high a quotient of non-standard WMP assets – to effectively loan to a trust company by having another entity create the loan. The latter entity, either a bank or a company (SOE) with spare cash, originates the loan and then sells the rights to the loan proceeds – the Trust Beneficiary Rights – to the balance-sheet constrained bank, which in turn guarantees the loan against default through a quiet transaction called a drawer agreement. Meanwhile, the transactions on the books are mostly filed as interbank loans – funds which are assumed to be highly liquid, of short-duration and exceptionally safe.

Sound complicated and potentially destabilizing for a banking system that is not known to be particularly sound? That is precisely the reason that regulators are attempting to shut down the practice. Ironically, as banks begin to shift trust beneficiary rights into more straightforward loans that are clearly demarcated on their books, they will actually have to increase the amount of WMPs on offer in order to absorb these reclassified products –which is why WMP issuance has soared recently even as assets under management (AUM) at trust companies are falling – down 240 billion RMB in June from the previous month (the most recent data), the first monthly fall according to the China Trustee Association.

[35] Xiao Gang, "Regulating Shadow Banking," China Daily, October 12, 2012. http://www.chinadaily.com.cn/opinion/2012-10/12/content_15812305.htm

Like regulators everywhere, China's financial authorities are struggling to keep up with market innovation. The challenges for regulators when it comes to Chinese shadow banking are three-fold:

1. the complexity of such transactions requires careful planning and caution to unwind

2. as with the increase of WMP issuance, policy often brings with it unintended consequences, and

3. because there are many smaller businesses in China struggling to find financing while savers are continually looking for higher returns, money continues to find a way to flow into China's shadow banking market – once one avenue is shut down, another typically springs up to replace it.

The purpose in discussing the debt dynamics occurring outside of China's formal banking system is that they help one to understand the nature of debt and credit flows in China and the increasing complexity and opacity that such flows involve. Furthermore, the rapid acceleration of these often speculative, risky types of lending underscores the weakening productivity environment that we outlined previously. Not only is the total amount of leverage increasing in China, but for a good portion of the economy, that debt is becoming more expensive. One primary reason that loans are becoming pricier and moving into more opaque channels is that a very large but unknown part of China's credit expansion in recent years has been used to refinance existing claims. While banks were originally complicit in the rolling over of loans, they have increasingly become reluctant to provide finance for some of the riskier lenders. Moreover, as regulators have begun to assess and address some of the riskiest areas where credit was funneled during the 2009-2010 boom, such as real estate and mining of heavy metals, banks are increasingly barred from lending directly to such sectors. Finally, because SOEs, local government financing vehicles and other privileged borrowers are seen as being implicitly guaranteed by the government at some level, the majority of credit extended to those entities is underpriced, which places a wedge between the low interest rates for those entities and the higher rates seen by cash-starved SMEs.

All of these dynamics are both caused by and re-enforcers of the productivity challenge that is driving China's structural slowdown. As the State sector has increasingly crowded out the private sector in recent years, the inefficiency caused by stifling private players has contributed to the country's slowing growth rate. Meanwhile, weaker economic growth has only re-enforced the banks' bias for lending to "safe" state-backed entities. This feedback loop not only causes smaller, private companies to have to tap into higher-interest loans offered by non-bank institutions, but as overall growth slows, the performance of bank assets have further deteriorated. Weaker returns on assets within the banking system has subsequently caused the banks to tap into non-bank lending markets indirectly through third-party intermediaries, further fueling shadow financing.

This final point is perhaps the most worrisome aspect of the growth of shadow banking in China – it is deeply and intimately interconnected with China's formal banking system but via highly opaque channels. The positive spin that some Chinese regulators (especially the more reform minded among them) place on these developments is that this is a form of interest rate liberalization and thus, in some ways, represents financial market reform through the back door. However, rather than viewing these developments as "the market" trying to defy tight-fisted regulators, we view the increasing move into the shadows and ratcheting up of the search for yield as evidence that capital is not adding productive value in the same way that it was prior to the global economic and financial crisis. This weakening performance of capital has pushed many non-bank lenders further out the risk curve, and banks have had to follow suit even as the bulk of their observable balance sheets are geared toward the safer, State-backed borrowers. Ultimately this only serves to deplete the capital base and profit margins for the banking system, which must come up with ever more creative ways to protect net interest margins while still channeling the bulk of funds to state-back borrowers. Meanwhile, the economy continues to slow, once again re-enforcing the negative feedback loop through a growing level of outstanding non-performing loans.

NPLs

Perhaps the most straightforward way to observe weakening returns on capital and broader bank asset deterioration in China is via the swiftly rising non-performing loan (NPL) ratio in the banking system. Understanding the true state of China's NPLs is difficult in large part because loans that cannot be paid are often refinanced via the original bank, or through an arrangement with a third party in the shadow banking system. China's official NPL rate, published by the CBRC stood at a mere 1.08 percent of all loans, as of end-June 2014. While this overall proportion is tiny, it is almost certainly understated due to loan "ever-greening."[36] Indeed, China's large banks, which are listed in Hong Kong, are currently trading below book value, indicating that market analysts believe that their loan books are less sound than their officially reported balance sheets imply. In comparison, a typical healthy bank tends to trade at around two-times book value.

Still, while most observers believe that the true NPL ratio is much higher than reported, it is almost certainly nowhere near the estimated 35 percent of loans that had become non-performing the last time that the banking system had to be bailed out in the late 90's.[37] But even so, NPL ratios do not have to reach such extreme levels before they start to test the solvency of the banking system. Indeed, a recent study by the BIS that examined the history of Asset Management Companies (AMCs) throughout Asia, which were used in order to work out non-performing loans in the wake of banking or debt crises, found that the median rate of NPLs stood at 10 percent among the country set studied – a much lower threshold for banking instability to creep in than one might expect.[38]

It is telling then that Beijing has begun approving and encouraging the establishment of provincial Asset Management Companies (AMCs) to compliment the four national AMCs (established in 1998 and 1999) in helping to work-out bad debts on a provincial basis. To date, five local AMCs have been established in Shanghai, Jiangsu, Zhejiang, Anhui and Guangdong. Importantly, the regulations around these entities require that they (1) not be able to transfer assets outside of their province and (2) can only dispose of debt via restructuring, as opposed to the more flexible options such as taking a company through bankruptcy

[36] Evergreening refers to the practice of continually rolling over loans if debtors cannot pay. Banks employ this practice to keep from having to recognize loans as non-performing and subsequently recognize losses on those assets.

[37] Liao, Guomin, and Wei Liu. "Banking Institution, Bankruptcy Cost and Government Guarantee:
An Analytical Framework for the Formation of NPLs at State - Owned Banks." Management World,
no.3, 2005.

[38] Feng, Ben, et al "Public Asset Management Compaies in East Asia." Bank of International Settlements, Occasional Paper No. 3, February 2004.

proceedings or selling distressed loans on again to other investors, that the national AMCs are allowed to pursue. These latter two points suggest that Beijing may be looking to hold each province accountable for its own debt problems, and prevent the transmission of city-level debt problems to the national economy.

Financial Disruptions

One further outcome of the quickly rising debt load, greater diversion of credit flow into shadow banking and broad asset deterioration as evidenced by rising NPLs has been increased financial volatility. Underwater borrowers, rather than being identified as delinquent and classified as such, have often been pushed to the brink of disorderly default and bankruptcy. Anecdotal evidence abounds these days of company bosses, with millions of RMB in debt, either disappearing clandestinely or committing suicide. As such, near and outright defaults on a range of financial products have become commonplace throughout 2014. WMPs, trust loans, corporate bonds, privately placed junk bonds, and even interbank agreements have all come close to missing payments or even fallen short out-right. Putting numbers around these episodes is difficult as far as capturing the outstanding level of distressed debt, but estimates for repayment levels for real estate trust products alone in H2 2014 stand in the 100 billion RMB range,[39] while junk bond redemption looks set to be in the 4 billion RMB range over the same period. The size of these looming obligations may be small in comparison to the overall financial system, but the absolute levels are quite large. Moreover, it's not the number or size of defaults that is concerning so much as the risk of contagion due to complex inter-linkages between the formal and gray financial markets, and the widely entrenched moral hazard in the marketplace whereby financial actors – mostly State owned or connected – all believe that the State will backstop defaults. A quick and unexpected sentiment change could be disastrous.

The ultimate paradox for China's financial regulators, then, is to find a way to introduce market prices – and by implication, market volatility – into credit and financial markets in a non-volatile way. This is a herculean and contradictory task, if not an impossible one.

In one of the more high profile near-defaults early in 2014, a trust product that had been sold through ICBC branches, entitled "Credit Equals Gold #1" was on the brink of defaulting when a mystery investor stepped in to pay out on the product. At the time, the details of the bailout were undisclosed, but, as it turned out, one of the national AMCs, Huarong Asset Management, had come in and purchased the trust loan at 95 cents on the dollar. This response underscores that financial products, banks and non-financial companies cannot fail in China. Even trust loans are considered risk free in many cases despite the fact that interest rates are often in the 10-15 percent range.

Because investment in trust loans are often marketed through bank branches, and the banking system is largely State-owned, the products come with an implicit guarantee that they are backed by the government. More broadly, reputational risk keeps many trust companies and other financial intermediaries from allowing products to fail – leading them to enlist guarantors or recruit assistance from local governments or banks in the event of non-payment. Finally, because financial obligations are often geographically focused and most parties are State-invested – a State-owned Shanxi trust, makes a loan to a State-owned Shanxi coal miner, guaranteed by a State-owned Shanxi bank, for example -- there is always an inventive to come up with funds by hook or crook.

The ultimate paradox for China's financial regulators, then, is to find a way to introduce market prices – and by implication, market volatility – into credit and financial markets in a non-volatile way. This is a herculean and contradictory task, if not an impossible one. The positive outcome of the constant re-enforcement of moral hazard in China is that financial and economic volatility can – and has – been kept at bay for a very long time. However, the direct corollary

[39] J Capital Research. "Trust Falls: Stress Testing China's Trust Market." February 2014.

to that particular strength of the Chinese financial system is that moral hazard is also the very channel that precludes a shift toward more market-based principles.

The inability to pivot to a more market-based financial ecosystem is thus both outcome and cause of the underlying slide in productivity growth. As capital is misallocated to a greater and greater degree, debt builds because assets are less and less productive. Eventually the increase in capital misallocation takes a toll on overall economic efficiency – especially if, as in the case of China, there is an external shock that lays bare ill-judged investments (i.e. the negative demand shock from the global economic and financial crisis laid bare China's widespread industrial overcapacity). As returns on investment fall, the perverse attempt to chase greater yield, or to continue to invest in a non-performing company – as insolvent companies are insensitive to borrowing rates – only further exacerbates the original capital misallocation.

The key question then is whether or not China's current leadership is ready and willing to accept the short-term pain that a widespread reallocation of capital would entail, for the long term productivity gain that it would subsequently provide. There are further concerns as to whether those at the top – or indeed the leaders in any government – have the political clout and policy acumen to enact the types of fundamental changes that need to be put in place. With those questions in mind, the next section of this report will go on to address the policy priorities, imperatives, and obstacles that China's government faces in achieving this momentous transition.

Section 2d: Core Reform Requirements and Priorities

The reforms needed in China are major and fundamental – and anathema to the Party's privileged role as sole economic steward and principle economic beneficiary.

The challenges China's economy faces are not unusual in a comparative sense. China's investment led growth model generated spectacular results for a well over 30 years, far surpassing recent emerging market experience in Asia: Japan in the 70s, the Four Little Dragons in the 80s and early 90s, and Indonesia and Thailand later in the 90s. Like China, these economies experienced export- then investment-driven growth booms with average growth rates upwards of 9 percent[40] that lasted 20 to 30 years. China is now at 34 years (Chart 27). Similar to China, these economies built up structural imbalances over their high growth periods that eventually led to diminishing returns on and sharp reductions in fixed asset investment, a consequent downshifting in growth, and an eventual transition from a growth cycle era to a business cycle era. For all these economies, structural reform did not happen before the downshifting occurred. For some, like Japan, structural reform arguably still hasn't happened yet, some 20 years after the initial downshift. For others – like Korea and Indonesia, the transition brought financial crisis with it that ultimately induced quite significant reforms in favor of a more open and marketized business environment, and a strengthening of institutional safeguards to prevent similar crises from reoccurring in the future.

Also like these other economies, China's boom era spawned powerful beneficiaries who strongly prefer continuation of the status quo, and who have amassed great wealth and political power to promote their preferences and protect their vested interests. Dismantling these vested interest groups in China, presumably to remove them as obstructers of reform, is purportedly core to President Xi's large and sustained anti-corruption campaign that continues, in force, at the time of this report's release. However, many suspect the campaign is more about enfeebling Xi's political rivals than about truly doing away with elite corruption.

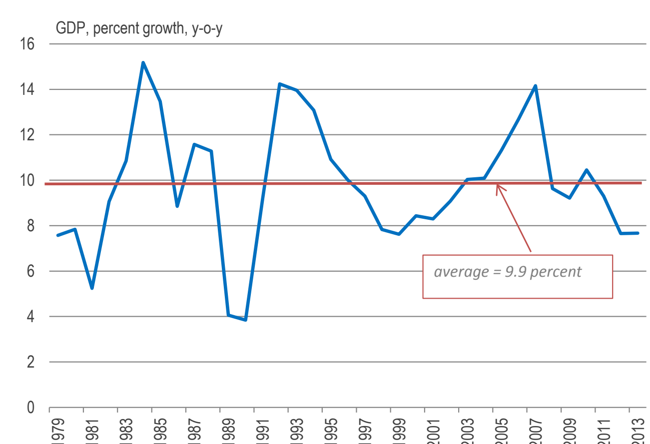
While the truth of the anti-corruption campaign remains to be seen, it is unarguable that the factors that enabled China's unprecedented growth miracle of the last 30 years are now root causes of economic imbalance and risk (Table 1, page 45).

In short, the inherent strength of centralized, autocratic decision making, coupled with the ability to direct massive capital flows, *essentially by fiat*, enabled China's government leaders to breakthrough huge bottlenecks and move unprecedentedly fast on large-scale infrastructure, urban and industrial construction. Once the envy of emerging market rivals like India, and a universal admiration point for global CEOs (especially in comparison to perceived leadership inertia of their home governments) – this feature has now become the Achilles Heel of the Chinese economy.

Earlier we examined the ways in which State intrusion into the economy combines with other political-institutional factors in China to reduce the efficiency of economic growth (i.e. weakened productivity performance). Here we re-examine some of these factors with regard to reform imperatives.

Chart 27 **36 years running of high speed growth**

The export- and investment-led development model, pioneered by Germany, Japan and Korea have served China well for over three decades but led to well known economic challenges today



Sources: NBS, CEIC, The Conference Board

40 Syed, Murtaza. "Is China Over-investing and Does it Matter?", IMF Resident Economist, Panel presentation at European China Chamber of Commerce conference, February 2013.

The Realities of Shifting to Consumption-Led Growth

The features of China's investment driven growth model described above are also anathema to the household consumption-led growth model that the Chinese government now espouses. Indeed, the status quo that has emerged after 30-plus years of investment-driven growth actually sees the interests of the State, and its myriad vested and empowered actors, resolutely pitted against the interests of households – through the banking system, through the residential housing system, and through the public welfare system – with the consequent outcome of growing economic inefficiency, as argued above. In other words, the desired consumption-driven economy of tomorrow is actually pitted against the investment-led economy of China today. Here's the quandary for China's consumption:

The poor quality and unreliability of social services encourages households to save on a precautionary basis, in the 25 to 30 percent of income range (estimates vary widely, and the available data is weak). Demographic trends – imposed by State design – exacerbate this trend with a rapidly aging population and consequent increasing dependency on one-child wage earners. Many one-child wage earners are now heavily burdened by four aging grandparents and two low-earning parents. Housing, education, and healthcare obligations are increasingly burdensome, often requiring illicit facilitating payments and extra administrative costs.

These high household savings fund the State investment engine, even though mandated low interest rates on deposits erode household wealth. This interest rate repression provides State banks an artificially high spread, and State-owned and vested borrowers – those with the requisite political levers to access credit channels – obtain artificially low costs of capital. The low costs of capital lead to misallocation and "leakage", and to speculative investment bubbles in sectors like real estate.

Households thus seek to gain better returns through property purchases, which in turn fund city governments. Because most tax revenue flows to the central government, city governments depend significantly on land transfer sales and real estate development, to the tune of 35 percent of public revenues across all localities in some years[41] (Chart 28, page 46). Land use rights in turn are used to collateralize new loans for local government-connected companies, so both the cities and their vested firms are incentivized to inflate pricing. There is no mandated marking-to-market to check this process. Under pressure, developers tend to develop as quickly and shoddily as possible, and, of course, sell at the highest

Table 1 **Factors that drove growth and wealth creation are now driving economic imbalance and risk**

Factors that Drove Growth and Wealth Creation	Are Now Driving Economic Imbalance and Risk
Concentration of investment capacity supports huge and rapid progress in physical plant modernization	Over-concentration of investment capacity supports growing inefficiency of investment and entrains corruption
Ultra-light regulation of substantial capital flows always great ability and speed in large-scale financing	Deficient debt supervision measures and regulatory controls permits a massive amount of non-performing and triangular debt to accumulate
Strong emphasis on tangible industrial assets throughout the system creates competitive advantage in the mass production space on value chains – "factory of the world"	Lack of attention to and protection for intangible competitive assets limits value addition and weakens value chain positioning, limiting the potential for creating a knowledge economy
Low wealth distribution to households enables high investment in fixed assets by the State and its vested interests	Lack of household spending power makes shift to consumption growth very difficult, and contentious
Gray Space laws and regulations provide agility to Government leaders and bureaucrats to take fast action and make fast progress – even on large scale projects	Gray property and operating rights allow public assets to be converted into the private wealth of the political elites, undermine incentives to deliver quality, and convey non-market competitive advantages to vested interest companies that serve to smother the private economy overall

[41] How important are land sales in local finances? In an effort to more precisely understand the role that land transfers play in local government finances, the National Audit Office has launched its first-ever nationwide audit on the topic. This undertaking started in mid-August (2014) and will conclude at the end of October. It is well known that local governments have been deriving an increasing share of revenue from land transfers since 2003, and today receive approximately 50% of total revenues from this practice. http://economy.caixin.com/2014-08-19/100718454.html

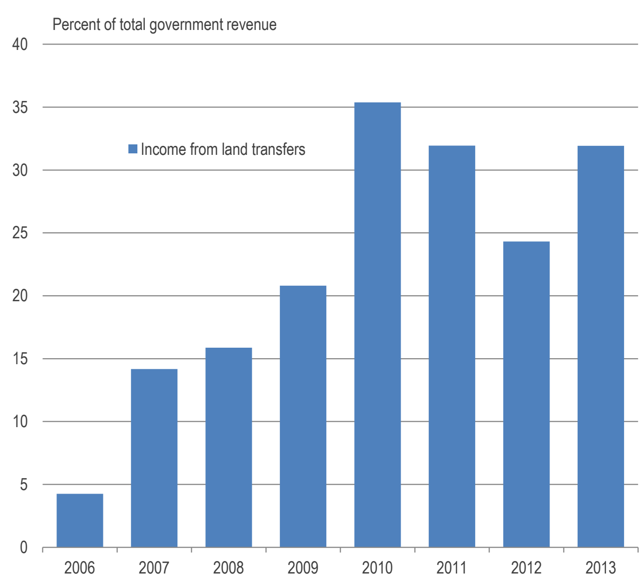
possible price to households, often on the back of extravagant area development pronouncements that never materialize. Lots of intermediaries along the way assure massive leakage to the elites – e.g. he who approves projects, he who appraises value, he who provides a slew of required permits and services, he who designs, he who engineers, he who constructs, he who supplies building materials, and so forth. Ultimately, only a smidgeon of real estate proceeds, it seems, convert into any form of social welfare for households. And households bear the bulk of the capital risk.

Not surprisingly, households are increasingly seeking higher returns than savings deposits offer, and especially as real estate prices have become exorbitant. However, they have very few options where rewards are appropriately balanced against risks. Initially they piled into China's stock markets. (They are not permitted to invest in overseas markets.) For a time, in the early 2000s up to mid-2007, policy driven share-price performance for Chinese A-shares undoubtedly benefitted many investing households. However, over the past 3 to 4 years, numerous politically empowered VCs and PEs have opened shop. These firms have used their connections to attach to promising private companies, fast track IPOs and subsequently inflate offering prices. After the IPO "price-pop" is achieved, they rapidly exit with proceeds in hand, leaving the bill with retail investors. Retail investors, it seems, have caught on to this game, as manifest by low trust and interest in China's stock markets. Consequently, over the last two years, China's stock markets have been among the worst performers globally despite the country's comparatively standout economic performance (Chart 29).

Nimbly taking the torch from the lackluster securities market – and underneath the over-regulated and under-rewarding State-banking sector – a gray wealth management product market has arisen with astonishing pace and scale, as outlined in the previous section. Household buyers believe these products are bank guaranteed, but actually it is not at all clear who will be responsible when and if large-scale defaults collapse some of the platforms – as many are lending to troubled real estate developers and other distressed borrowers. When some of these struggling borrowers

Chart 28 **Government income from land transfers as a percent of total revenue**

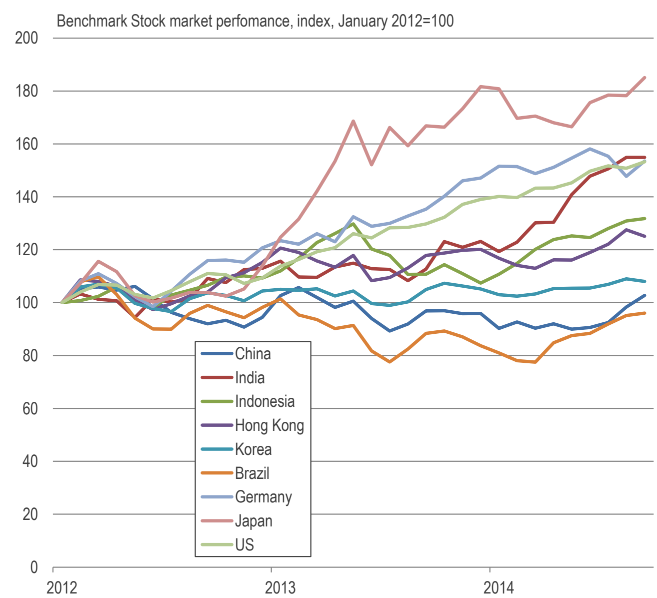
Due to various funding constraints, local governments are heavily reliant on land transfers for revenues



Sources: Ministry of Finance, CEIC, The Conference Board

Chart 29 **Stock market performance: international comparisons**

Even despite a market rally in August and September, China's stocks have been some of the worst performers globally over the past two years



Sources: Haver Analytics, The Conference Board inevitably fail, the wealth management companies will presumably claim collateralized real estate assets for pennies on the dollar. If the volume of incoming new depositors becomes insufficient to pay out the maturing accounts, they will simply close up shop. Households stand to lose significantly in this process, and the specter of significant trapped wealth in real estate looms large.

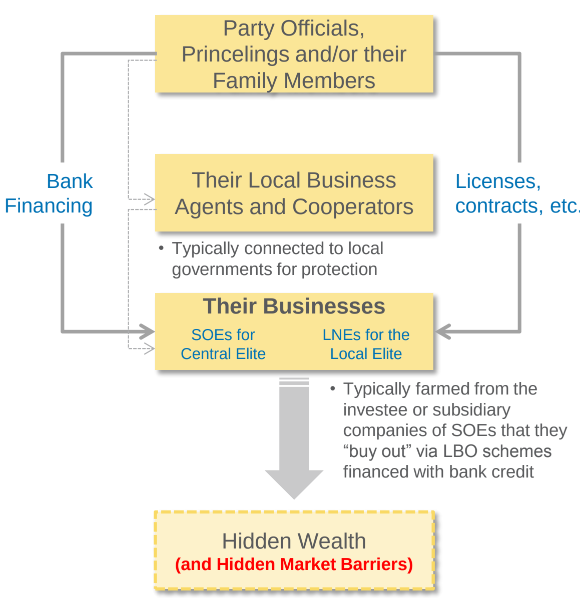
So, while the investment-led growth model did lift many millions of Chinese citizens out of poverty in its earlier years, it is now actively exploiting household wealth to keep the investment "party" going. Moreover, the system has become increasingly and incredibly "innovative" in developing ways to leverage and extract household wealth for its purposes, and divert generous proceeds to elite benefactors along the way. Institutionally, there are effectively no protection measures for China's households and no institutional means of curbing the rampant structural corruption in the investment process described above (Exhibit 2).

The State Advances, the Private Sector Retreats

In parallel with exploiting households, the State's widespread and ever-sprawling involvement in business has also served to undermine the productivity and competitiveness of China's corporate sector. Not surprisingly, as government officials and regulators and SOE executives have watched and learned how private and foreign companies make money in China, they have deigned to capture wealth creation channels for themselves and their patrons through their own vested firms. This has created a new cohort of market competitors that are endowed with preferential rights, exclusive contracts, privileged access to capital, compliance dispensations, and other benefits. These firms are counted as "private", and hailed as the future of growth engine of China. In reality, they are anything but private.

Often these firms emanate from local government initiatives. Sector A, for example, is established as a strategic national development priority by the central government. Local governments around China then

Exhibit 2 **The consequent rise and spread of "structural corruption"**
Many argue that it has now become ubiquitous



- SOEs, Aristocratic Party families, and their parasitic accomplices are at the heart of it.
- It was once contained to capital intensive industrial sectors and infrastructure. No longer.
- "The government has become a monopoly company that invests in everything." – Zong Qinghou, Founder and Chairman of Wahaha Group (at the NPC, March 2012)
- Root causes –
  - Loose, politically obtained credit
  - Weak/low integrity governance mechanisms
  - Multitudinous arbitrage opportunities of State-market economy distortions
  - Weak ownership rights
  - Lax legal controls
  - Opaque structures
  - Ability to legitimize legalities (via petty bribery).
- Why is it unique in China? – because it's not checked – Party and legal mechanisms are deficient, conflicted or both.

rush off to prepare and submit ebullient investment plans promising to make the national plan a success. Once a venture is approved, the funding taps are thrown open, capacity is rapidly and massively built, and new firms thus arise from nowhere, typically with great fanfare. Since bureaucratic measures reward scale, these firms tend to over-invest and underprice, all the while continuing to borrow to expand on all fronts, or at least give the appearance of doing so. But wanton borrowing and overcapacity are not the main problems with this development model. The main problem is the impact these "championed" players have on the real private sector, the local Chinese firms and MNCs that compete on the basis of productivity, innovation and ROCE – the firms that drive innovation and productivity growth in the overall economy. Simply put, it forces them out, or compresses their margins so much that investment in innovation slows, stalls or stops. Low value, highly commoditized industrial value chains are the end result.

Even more insidiously, genuinely private and market-driven firms that manage to gain enough scale to be considered medium-sized enterprises eventually meet their biggest competitor, the Chinese government – a competitor they necessarily need to co-opt to assure the pathway is provided to become a large enterprise, or even survive as is. These firms tend to be in emergent sectors, those outside the national plan, or in industry segments of a more local nature - retail, internet and consumer goods for example. They tend to be hyper competitive and very agile - even innovative, especially at the business model level. Engage the State they must, or else see their growth path closed. Equity is traded for "protection" and for preferential market openings: exclusive rights and licenses, financing, deal flow. Growth is thus assured. But in gaining such non-market growth assurances, market-driven sources of competitive advantage diminish, yielding to reliance on non-market sources of anti-competitive advantage. The same smothering effect on the real private sector occurs, and the innovation and competitiveness of the Chinese corporate sector suffers.

These "championed" private firms conjoin with SOEs and their subsidiaries – whose anticompetitive tendencies are well known – to effectively form a State block against the real private sector from developing to its potential in China, and from driving oh-so-important innovation and productivity growth. It is even questionable whether any truly private firms of scale exist in China's domestic market today. Unfortunately, the data don't exist to evaluate this hypothesis.

At one time, and for a long time, this involvement of the State in the marketplace was limited to upstream, heavy industrial sectors. But over time, and especially recently, SOEs, their subsidiaries, and championed firms have proliferated into all sectors of the economy. This expansion is now supported by a large domestic finance industry of elite-owned PEs and VCs that further extract wealth in the process of creating "champions" and managing the opportunity set to assure their success. This is the fundamental character of China's government-led market economy[42] where more and more of the market is effectively being reserved for or cornered by the State.

The evolution of China's market and domestic economy into its present state is not coincidence. It is a national development plan called "guojinmintui" – literally, the State advances, the private sector retreats. And irrespective of its political considerations, or whether the original vision was contorted, the current status quo is bad for the Chinese economy, bad for households and consumption, bad for productivity growth, and bad for the MNC and private business environment in China.

The Top Three Reform Priorities

Looking forward with these political-economic dynamics in mind, the big reform priorities for MNCs to be most concerned about and aware of are threefold:

1. Financial system reform: bringing order and efficiency to credit markets
2. SOE reform: marketizing SOEs
3. Competition policy: extracting the government from business

The three reform priorities are closely interlinked.

Financial System Reform. China's financial system, and specifically its credit allocation process, is first, foremost and predominantly a patronage tool. In a

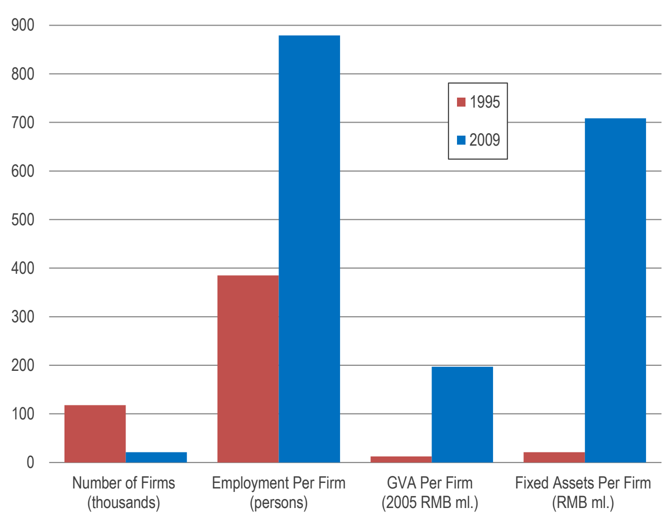
[42] Wu, Jinglian. "China's Economic Achievements and Current Challenges." Kuo-Shu Liang Memorial Lecture, Stanford University, December 8, 2011. http://scid.stanford.edu/system/files/111208China%20Achievement%20and%20Challenge_0.pdf

country where political power rests on loose-knit relationships, and not on due process or the opinion of the public, capital allocation is essential to securing political support. Not surprisingly then, China's credit markets almost entirely serve State owned and government vested firms, with lending based on patronage dynamics and policy directives, not commercial considerations. This sees most credit flow to uncreditworthy borrowers, and to the national development investment projects sponsored by connected elites and involving their vested companies. These cohorts have little or no sensitivity to repaying their loans, and banks are unwilling or unable exert any pressure on them to do so. Often these cohorts don't have an on-going commercial interests in the projects once constructed, hence the ghost cities and over-capacity now dragging on productivity growth. Financial crisis or debt paralysis is inevitable, at some point longer-term, if China's credit markets cannot be brought under control and rationalized to better serve the genuinely productive parts of the economy.

SOE Reform. SOEs are at the core of the productivity crisis, and the key perpetrators of financial market turbulence. While SOEs have been reduced in number, and parsed and joined in various ways over the years in the name of reform, they remain fundamentally un-marketized. And they've grown to gargantuan size

Chart 30 **Growth of State-owned enterprises**

While the overall amount of SOEs have dwindled since the mid-90s, the remaining companies have grown significantly in size and influence



Sources: NBS, CEIC, The Conference Board

(Chart 30), boasting far-and-away the largest firms in the world in most sectors. The primary problem is that SOEs are bankrupt-proof. Implicitly, if not explicitly backed by the State, SOEs needn't care about balance sheet strength, debt-to-equity ratios, return on capital, overcapacity, or the risks of speculative, off-balance sheet investing. Lending to SOEs is politically correct, and seen as risk-free by banks, regardless of the firms' financial standing. The moral hazard and structural corruption impacts of the current system are obvious. Next stage reform requires that SOEs be detached from subsidies, recognize their true costs of capital, respond to their debt liabilities, and manage real balance sheets. Poorly performing SOEs should face bankruptcy or restructuring if they cannot achieve profitability.

Extracting the Government from Business. SOEs, and the ubiquitous "private" companies established by local governments that essentially are SOEs but not called such, are also the primary channel for government elites to encroach on markets and extract wealth via structural corruption. By structural corruption, we mean the use of political power to provide conclusive competitive advantage to companies owned by one's family or *guanxi* network. Wealth is extracted in the abnormal operations of normal commercial enterprise (finance, construction, manufacturing), and normal commercial functions: procurement, borrowing, marketing, etc. In a practical legal sense, much of it is not illegal in China. It needs to be made explicitly illegal (Exhibit 3, page 50).

Even Small Reform Steps Can Make a Big Difference

These reform imperatives may seem daunting, but the reality is that: (1) China is not starting from scratch, and (2) even small steps and incremental improvements in these important areas stand to yield huge dividends. But they have to be real steps.

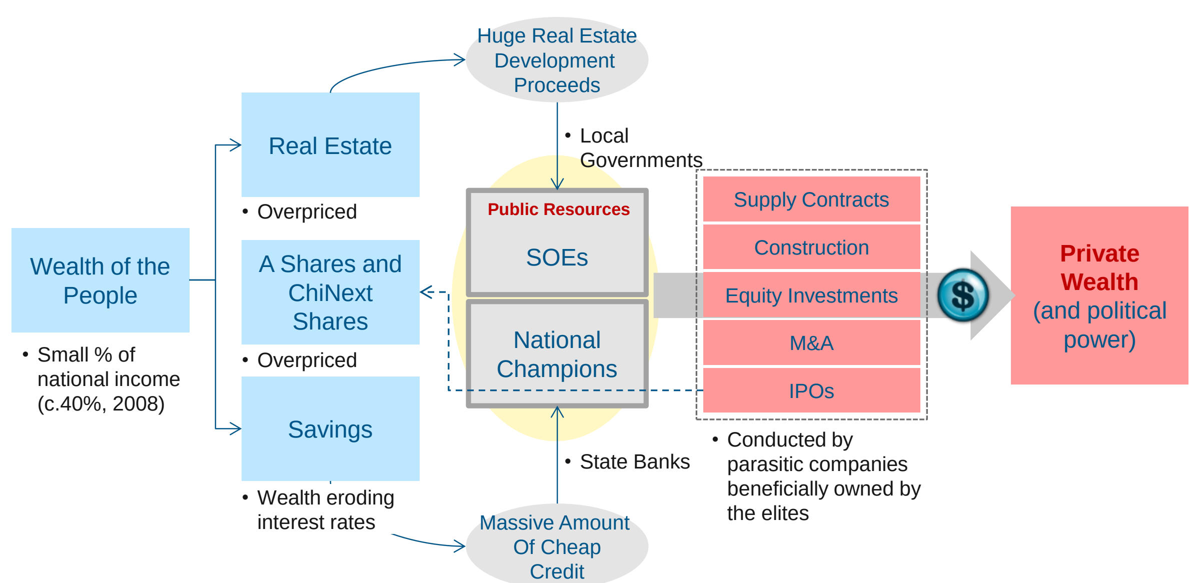
Strengthening the institutional capabilities of the financial regulators, the China Banking Regulatory Commission (CBRC) for example, by enabling them to prevent irresponsible or irrational lending, could go a long way towards rationalizing credit expansion and allocation, and addressing the aforementioned risks in the financial system. Today the CBRC essentially has no decision making capability, or the independence and authority to enforce regulations. Arguably, it is thus not an institution. But "the agency" is filled with capable people and is well resourced. It could be an institution if endowed and empowered as such, and could arguably do the job of bringing more order to China's banking system if it had the remit to do so.

SOEs would be called to task if their financial positions were made more transparent, just as the measurement of air quality in China has focused public attention and motivated policy makers to act on environmental issues. An empowered banking regulator, as mentioned above, could reduce or stop errant SOE borrowing using existing macro prudential tools, thus forcing the process of balance sheet reparation. SOE Boards – often well-constructed with highly engaged independent directors – could be given the right to vote and thus enabled to exert real fiduciary authority.

The participation of government in business would necessarily recede, and quickly, if the business interests of officials and their families were mandatorily disclosed, and the media was permitted to investigate the accuracy and completeness of disclosures. A "Sunshine Law" has been on China's policy agenda for years, but never enacted. Legal covenants about nepotism and conflicts of interest could be easily clarified and enforced. It is hoped that President Xi Jinping's anti-corruption campaign will eventually lead to this outcome, but so far, there is minimal transparency and seemingly little institutionalization of anti-corruption proceedings. Officials are "being disappeared" in a big way, but extra-legal constructs appear the main course of action.

It's critical to note that the policy choices at hand are entirely political – not economic or social. The stark reality is that the reform examples outlined above – and arguably any other conceivable reforms that could address the three key reform priorities – are politically difficult to implement because they would necessarily undermine legacy levers or Party control, wealth extraction, or both. Will the hard political choices be made or won't they – and can the Party change? This is the principle question regarding the prospects for reform. While it may sound simple conceptually, and even seem to include some low hanging fruit, it is anything but easy to do because it must touch and change the core of China's age-old governance system and Government-led market economy.

Exhibit 3 **Stylized illustration of the wealth extraction process**



[Plus Grants and Subsidies]

Section 2e: The Reform Horizon

Marketizing reforms that would benefit foreign investors will likely only manifest as a last resort. That time will come, eventually; but in the meantime, plan on "hard yards."

There is and always has been a strong belief among foreign investors that China is irrevocably on a reform path, that reform equals "marketization", and that marketization, as it comes, will eventually yield better operating conditions for MNCs in China. Current developments, and the actual experience and observable realities for MNCs over the last 10 years and more, should call this long-standing belief into question. Operating conditions are not getting better; indeed they're getting measurably worse – and administrative costs in China for MNCs are skyrocketing, especially in the compliance area.

The question at hand is whether and how China's growth slowdown will impact the reform agenda and the MNC operating environment. Experience suggests that marketizing reforms that would benefit foreign investors will likely only manifest as a last resort, at the point when the pain of enacting such reforms becomes less than the pain of not doing so. We expect that this time will come, eventually, but perhaps not for as long as 8-10 years.

The Systematic Constraints to Reform are Formidable

As alluded to in the last section, the prospects for positive policy change and reform that would make things better for MNCs should be tempered to the realities of the Chinese policy environment and political system. Four enduring truths born out over the last 30 years of MNC experience in China should serve to shape our thinking:

1. **Crossing the River by Feeling the Stones**: China's relationship-based power, business, and governance structures greatly impede timely consensus building among Chinese leaders, and tends toward stalling or inaction on even the most urgent needs of public policy. This results, at best, in a go-slow approach toward policy adjustment. A dramatic shift in course would be unprecedented.

2. **Top Makes Policy, Bottom Makes Counter Policy**: The inherent systemic tensions, and weak control linkages between the central and the local governments make holistic, large scale policy implementation very slow and difficult, at best. More typically, policy implementation is inconsistent and erratic from one city to the next – and again, slow moving.

3. **Government-Led Market Economy**: SOEs and the bureaucratic apparatus that protects them are deeply, deeply entrenched. The regulatory containment of foreign competitive positions vis-à-vis SOEs is embedded as a basic policy tool, at all levels in Government. These two facts manifest in regulations governing MNCs that are voluminous and highly granular, yet vague and arbitrarily applied, and bureaucratic processes that are glacial. The system is age-old and astonishingly resistant to change.

4. **Exceptions to the Rule**: Whatever steps are taken toward the creation of a rule-based government and commercial environment, there is no foreseeable path within the current governance construct to completely and securely unhitch key regulatory levers from the private family and career interests of Party elites. The Chinese system always has been one of "rule of men by law", rather than "rule of law by institutions".

A common view is that Chinese leaders, by virtue of having autocratic powers, can move very quickly and boldly on policy matters. In fact, quite the opposite is true. Chinese leaders at the top operate in a web of personal relationships and bilateral negotiations and arrangements that are both the source of their power and the constraints on their power. Indeed, China is best described as a sprawling collection of bilateral relationships, tailored for the specific situation of each region, and subject to continual negotiation and adjustment to meet the urgent realities of the moment and place. Generally, the architecture of central authority in China seems to enable either glacial change or overly abrupt change more often than gradual, non-disruptive change. That architecture is both the source of China's systemic durability as well as the source of its systemic resistance to change.

This inherent tendency toward inertia is arguably in play now, especially as the supply-side tools to stimulate the economy through investment have lost their effectiveness. In reality, there has been little, if any, progress on the reform front made by the new administration since it came to power nearly 2 years ago. And the previous administration's tenure is widely seen as a "lost decade" for reform. There has been and continues to be a lot of talk; but there's been very little tangible action. Monetary and fiscal adjustments are being applauded as reforms; but while these may provide stability, reforms they are not.

What's unclear is whether the policy inaction is the result of systemic resistance to reform, disagreement regarding reform methods, or whether marketizing reforms are actually not intended by China's new top leadership at this time.

What's Being Said, What's Being Done

Despite the lack of tangible progress on reform, no effort is being spared by China's leaders to convince foreign investors and the global business and trade community otherwise. Pronouncements have been relentless by China's senior leaders promising far reaching reform and an ever-opening door, boasting great strides legal and institutional development, and pledging only the most harmonious and benign intentions in foreign relations. The observable realities tell a different story. Let's look at several examples.

The Third Plenum Decision

In November 2013, the Central Committee of the Communist Party convened the Third Plenum of the 18th Party Congress, a week-long meeting to define economic policy and the reform agenda for the next 10 years. The meeting ended with the issuance of a document called "The Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms", now simply referred to as "The Decision". The Decision outlines 60 reform points, and as such, was applauded globally for its ambitiousness and breadth. Many thought, and still think, that the Decision heralds a sweeping breakthrough in China's reform agenda and the beginning of a new, more marketized era.

The *observable realities* suggest that such enthusiasm is premature:

- Most of the 60 points have been on the reform agenda for years, but remain unresolved or altogether unaddressed.

- Now 11 months on, (from November 2013), none of the high-level reforms in The Decision have progressed to the written plan, written regulation, or legal amendment stage – the stage that would necessarily signify a movement from "theory to practice."

- Each of the reform statements outlined in the Decision is effectively paired with an anti-reform statement, and connected via a timing conditional that is non-committal. For example, (paraphrased): "The market will play a decisive role in resource allocation – at the appropriate time – but the state sector will remain the core of China's socialist market economy."

The Decision recalls the myriad lofty goals of the 12th Five Year Plan, released in March 2011. The Plan – especially its vision for developing the seven strategic emerging industries – was hailed as a breakthrough by the global business community when it was released, and greatly excited many foreign investors. Today, the 12th Five Year Plan seems all but defunct, with very few of its goals met and most altogether unattended. There appears to be no intention to review performance to plan. Discussion of the seven strategic emerging industries has all but stopped. Several of the seven industries have arguably collapsed – solar and wind power technologies, and EV vehicles and batteries – and after many of the Chinese high flyer companies (some that even listed on international markets) ramped capacity to dizzying levels, but accrued massive debt and overcapacity in the process.

Nevertheless, The Decision does hold promise – and is unique for its comprehensiveness and cohesiveness, and it's commitment to "top level design", which is presumed to mean consistent, nationwide approach. But it is too early to tell whether the path forward will go more the reform way or the anti-reform way, and in what timeframe. The Party has effectively left all its options open, whilst keeping the optics of "impending" reform high.

The Shanghai Pilot Free Trade Zone

The Decision mentions that Free Trade Zones (FTZs) are to be the primary tool for piloting reforms and further opening the market beginning with the Shanghai Pilot Free Trade Zone (SPFTZ) in Pudong. Yet over a year since its fanfare launch on September 29, 2013, permissions and regulations for foreign participants in the zone remain unfinished, rudimentary and uninspiring. Irrespective of the SPFTZ's progress to date, historical precedent does not support the premise that zones are beachheads for reform. Indeed, it is difficult to find any reform measures or business adaptations piloted in such zones that were subsequently implemented broadly in the domestic economy, and certainly not if they were originated by foreigners. AT&T, for example, was hugely successful in piloting restricted enterprise value added services in the Lujiazui financial zone in Pudong in the late 90s. Even though proof-of-concept was the agreed pre-requisite, in principle, for extending the JV into the greater domestic market, AT&T was never allowed to operate the services outside the zone. Instead that right was conferred to JV-partner China Telecom, with AT&T relegated to an advisory role.

Even more relevant, in the 11th Five Year Plan (2006-2010), the Binhai special zone in the Tianjin area was designated a national development priority for piloting financial and technology sector reforms, and set an agenda almost identical to that of the SPFTZ today. While Binhai has had some success as a high-tech export zone – in airplane manufacturing with Airbus for example – there has arguably been no progress made on domestic reform pilots in the zone. The vaunted reform to allow Chinese individuals to invest in Hong Kong securities through Binhai based brokerages, for example, was stopped very shortly after launch in late 2007, presumably because higher-than-expected capital outflows unnerved regulators. Other planned reform initiatives basically stalled from then on. What is unarguable is that a phenomenal amount of infrastructure, and commercial and residential real estate was constructed in Binhai, including a replica of Manhattan, (only much larger), that has become the icon of ghost cities in China.

The Anti-Corruption and Anti-Monopoly Campaign

Over the past two years, the criticism, often including outright harassment, of foreign brands and companies by Chinese regulators and State media has reached new heights – first for product quality, then compliance failures and corruption, and now for monopolist pricing practices. While it turns out that many of the accusations related to product quality have been legitimate – *i.e. the chicken patty did remain on the serving rack xx minutes after the prescribed expiry time* – the campaign does not appear to encompass such detailed examination, if any, of the local business community. There is also no transparency about whether and how regulators are addressing the systemic root causes of product quality and safety failures in China. Foreign companies and their Chambers of Commerce have documented the institutional and regulatory problems that plague China, sector by sector, and have lobbied the Chinese Government for years and years to implement institutional changes without resolution. Retailers, for example, bear all legal liabilities for the products they sell while their suppliers bear none – an obvious accountability problem. Without an examination of institutional and regulatory problems, and local company practices and comparative performance, it's hard not to conclude that foreigners are being singled out.

On the corruption issue, again, many of the alleged cases appear legitimate, in illegal pharmaceutical promotion for example. But the discussion of the factor distortions and institutional deficiencies that make the pharmaceutical sector so utterly dysfunctional and corrupt is conspicuously absent, as is the examination and prosecution of the Chinese firms involved in the corrupt pharmaceutical ecosystem.

On the anti-monopoly front, the situation is both difficult and confusing. Foreign retailers are being accused of predatory pricing, even in markets where substitute products abound and no pricing power exists. Foreign product makers of all types are being asked to justify why their pricing in China is above their home market or other international markets. These questions are being asked by regulators, not consumers, which seems contradictory to the reform tenet of the Third Plenum Decision to "let markets play a decisive role." Regulators appear to have no appreciation for the high transaction and compliance costs MNCs face in China, or for the cost structure impacts that corporate structuring and tax policy has on foreign entities in China, or for the need foreign companies have to price according to the return-on-investment requirements of their shareholders. There aren't any channels for the accused foreigners to make their cases and defend themselves; and opening the books and/or disclosing commercial secrets is risky from an IP perspective. Moreover, experience indicates that defensiveness is only met with more severe punishment.

So far, the motivating factors for these campaigns are unclear. There are many possibilities:

- It's a precursor, starting with foreigners, to a much larger compliance enforcement initiative.
- It's an effort to protect championed domestic brands by discrediting their foreign competitors.
- It's a means of collecting needed cash though fines.
- It's retaliation for perceived critical and "unfriendly" views of China and its companies abroad.
- It's a deliberate curtailment of MNC profitability "just because" it is resented by some in government.
- It's an effort to reduce IP royalties paid to foreign IP holders[43].
- It's a response by the NDRC and SAIC – two agencies at risk of being downsized and de-elevated – to demonstrate their prowess, and only coincidental that it affects foreigners.
- It's an effort to contain the spread of foreign brands in China for fear of the soft power elements they bring from their home country[44].
- It's case-by-case and all of the above.

The fact that the motives of such important campaigns remain unclear, and procedural aspects are so opaque, is emblematic of the legal and institutional deficiencies of the Chinese commercial system and the confusion it creates for market participants. While the accusations and charges may be justified against the foreign defendants, the scope and targeting of the campaigns is blatantly un-level. Simply put, the campaigns hurt foreign companies, but don't solve – or seem even to attempt to solve – the core problems: product safety and quality, corruption and anti-competitive practices inflicting the Chinese business system.

There are many other examples where the rhetoric does not match the realities and that call to question the reform intentions of the new leadership. In geo-political matters, China claims to avow only good will and Samaritanism, yet its actions appear anything but peaceable. Information suppression has reached new heights, with strict controls on public debate and media commentary, with stepped-up internet controls, and with restrictions on data production and dissemination. Media channels have been prohibited from discussing reform, unless reporting is released after and is consistent with official Government pronouncements[45]. Why would this be the case, one might ask, if reform was truly espoused? Peaceful petitioners and activists calling for the investigation of corrupt officials – positions seemingly aligned with the Government's stated anti-corruption objectives – are being jailed or preemptively silenced. Public disclosure rules for company ownership have been rescinded, and diligence investigations of ownership and transaction flows banned; and efforts are underway to install the same identity protections for Hong Kong companies. Discussions of constitutionalism have been banned. The list goes on and on. These are the observable realities.

A "New Type of Reform"

While marketizing reforms appear to have stalled, an important change is occurring in the political economy that has major implications for MNCs in China. The change – in essence, a reversion to an older style

[43] See Report from US Chamber of Commerce in China – "Competing Interests in China's Competition Law Enforcement: China's Anti Monopoly Law Application and the Role of Industrial Policy", September 2014. (https://www.uschamber.com/report/competing-interests-chinas-competition-law-enforcement-chinas-anti-monopoly-law-application) for a very rigorous review of specific cases.

[44] DeWoskin, Kenneth. "China's Soft Side." The Conference Board, March 2012. https://www.conference-board.org/retrievefile.cfm?filename=TCBCC---QN---Chinas-Soft-Side-2012-Mar-12.pdf&type=subsite

[45] Source: https://chinadigitaltimes.net/2013/12/minitrue-post-plenum-reforms-china-southern-probe/, December 2, 2013

Confucian governance structure – is something we call the “re-reform”[46].

At the headline level, the unfolding “re-reform” campaign being rolled out by Xi Jinping is most clearly intended to strengthen and sustain the Party through a process of self-cleansing. No organ of the Party has been more active, even before his formal ascent to the Party Chairmanship, than the Party's Disciplinary Inspection Commission. This Commission, which operates entirely outside the government’s judicial and prosecutorial apparatus, is the frontline army of the anti-corruption campaign. Only after the Party's Commission has secretly targeted and investigated Party members of interest does it hand them over for public and formal disposition to the government apparatus, the semi-public trial and sentencing. At that final trial stage, the conviction rate is upwards of 99%.

That the Party, not the government, is the main agent of the anti-corruption drive tells a lot about whose interests are at stake. It also tells a lot about the political factors in determining who gets targeted for investigation. The Commission is certainly not new, but its level of activism and the concerted direction of its projects and targets define the essence of Xi's re-reform project.

No longer is the Chinese Communist Party the vanguard of an international proletariat. Instead, the Party is being recast as the true inheritor of an ancient Chinese tradition: the right to rule based on infallibility and moral rectitude. Under Xi Jinping, as under Mao Zedong, the Party’s proper role, as moral compass for the nation, is to restore a sense of “core values” that have been lost in the recent, frantic "get-rich" years.

China analysts, it seems, have largely missed the unfolding re-reform story by peering at the landscape of reform and trying to find step-by-step progress toward economic liberalization and marketization. The disjunction between foreign and domestic understanding of what constitutes “reform,” in fact, illuminates a fundamental misunderstanding of foreign commercial involvement in China. In today's post Third Plenum China, “reform” means, we assert, to sideline and squash institutionalized bureaucracy and inject personal power, based on hereditary right, into a sclerotic system dominated by corruptible if not deeply corrupt ministerial verticals – the so called “vested interests”. It means cutting through the deadening layers of paperwork that invite bribery. Xi’s success could possibly be in the interests of everyone who wishes to see a thriving Chinese economy.

But what China has never had, and probably never meant by its use of the word “reform”, is the codification in law and practice of rules to govern transparently that would enable an ever-more-marketizing economy. Indeed, rules are seen as stultifying, an impediment to the ability of the core ruling class to impose its unfettered guidance – some would say “its will.” The color of China's huge library of new laws, rules, and regulations is gray, leaving broad license for administrators to enforce them. The consequence is a large measure of chaos in the actual regulation of industry and commerce – and especially, of the MNC playing field.

Toward the “China Dream”

In this light, the disappointing lack of regulatory change out of the Third Plenum last November does not signal weakness of Xi’s reform process but, on the contrary, its success. The new rulers need not submit to anything as confining as a set of laws or channel their influence through layers of unruly and self-serving ministry verticals.

“The China Dream” was the title of the book of essays handed out at the CLSA conference in Beijing in the spring of 2014. It led off with essays on “Growth amid reform,” “A perilous journey of reform,” and “Renminbi reform.” The essays argued, as an article of faith, that China was in the process of rebalancing its economy toward consumption and would, before 2020, become the world’s largest economy, implying that somehow predominant size would convey international leadership for the nation and the arrival for its citizens of a secure and leisurely middle class life.

What financial analysts appear to have missed is that this newly activist Party has not collected and consolidated the system's power in order to achieve an agenda of economic liberalization through new laws and regulations, although these may be forthcoming. Instead its objectives are to stabilize their control, keep building the wealth of the nation, and incidentally

[46] Kenneth DeWoskin, “The Opportunity in Xi's ‘Re-Reform,’” The Conference Board, June 2014. https://www.conference-board.org/retrievefile.cfm?filename=TCBCC-QN---Jun2014.pdf&type=subsite

The Past is the Guide to the Future

In Imperial China, all assets of the land and people governed within the great walls that kept foreigners out and tax payers in belonged to the Imperial family. Land assets, other major assets for production, and lucrative ministerial positions were made available on a revocable "use rights" basis to everyone in the system, from the great Mandarin houses to the most modest rice farmer. For example, China's periodic land reforms that dismantled over-concentration of land resources were about land use rights, not actual ownership.

Similarly, with the founding of the PRC, key industries were established as monopolies belonging vaguely to the people but beneficially owned by the top rulers. The monopoly on salt was established over 2000 years ago and still exists. All metals monopolies were also established 2000 years ago, and, for all intents and purposes, still exit. What are currently called State Owned Enterprises continue this tradition of vague actual ownership but clear beneficial rights. Defined property rights or ownership in a form familiar to capitalist economies have little to do with the extraction of wealth by Government elites from China's massive enterprises.

The congruity of political power and financial wealth is a fundamental characteristic of China. In Imperial China, the fight against corruption was not a principled fight to separate the top legions of political power from creation of family wealth, an undertaking defined in more Westernized systems in concepts like "conflict of interest." Conflicts of interest do not exist, but mutualities of interest dominate. In "Document Nine" that captured essences of Xi's speeches last year, he declared, to the effect, that the masses should have no interest in the wealth of the leaders, and saying they do is a pernicious Western Neoliberal idea that is intended to undermine China.[a] The fight against corruption was always a combination of vigilant oversight and periodic cleansing of the channels that ported assets from every corner of the land to the center where their benefits were to be rightfully delivered.

The accumulation of family wealth by intermediaries below the Imperial tier was the consummate threat to the stability of the center and the benefit of the top rulers. China's "Mandate of Heaven," promoted in public discourse as the multi-generation moral mandate that legitimized the concentration of authority in the Imperial family, was in practice the deed to all assets in the land. The simple reason that eunuchs were often the most trusted members of the Emperor's inner circle is they had no progeny. So theoretically they had no interest in skimming off their own “Five Generations of Wealth.” But of course even that proved to be corruptible, when eunuchs began adopting sons.

In this respect, the Xi government may harken well beyond Deng and Zhu and be the most traditionalist China has seen since the last emperor left the Forbidden City in 1912.

[a] See “Document Nine, A ChinaFile Translation”, http://www.chinafile.com/document-9-chinafile-translation

cleanse the channels that port the wealth of the nation back to into the hands of the leading elites in the Central government. Continued growth of top family wealth absolutely requires continued growth of national wealth. And that is where the mutuality of interests lies for all parties who benefit from China’s economic growth, including MNCs and foreign investors.

Impacts on the MNC Business Environment

The impact of Xi's re-reform is potentially positive. That may come as a surprise, but it is in China's bloated bureaucracy where corruption, protectionism, and obstructionism reside and flourish. Foreign businesses face this massive machine with little or no leverage and little or no recourse. Chairman Xi and foreign business leaders both share an interest in a cleaner, more efficient system that better supports real economic growth.

In the earlier decades of Deng Xiaoping and Zhu Rongji leaders took strong and, in many cases, brilliant steps with their Party leadership muscle to open the economy. The first foreign investments from McDonnell Douglas, VW, American Motors, ITT, and Motorola were personal projects of central or large municipality Party leaders and made epic contributions to China's growth. Important exceptions to stifling investment rules, exceptions that benefitted investors as diverse as AIG and Motorola by allowing, on an ad hoc basis, 100 percent foreign ownership of vanguard businesses where regulations formally permitted only 50 percent, are similar examples of the latitudes permitted by focused Party leadership. To the extent that key Party leaders had a clear vision of what moved

China forward, and the foreign side was aligned and savvy, things got done and good deals were made.

It would be wildly optimistic to predict that we are re-entering such an era for foreign business in China. But, we believe the de-bureaucratization of China, and re-concentration of authority needed to do it, is an essential step to resolving both paralyzed domestic issues and lagging reforms for SOEs and for improving the business environment overall.

In terms of the domestic challenges, which The Conference Board has analyzed in great detail, solutions are not going to emerge from the ministry verticals that for more than ten years have done little but nurture chaos in real estate, financial services, banking, and credit markets. Concentrated, focused, agile, and responsive leadership is needed to cut through the bureaucracy to effect solutions. Similarly, while the SOEs have grown to be massive, "Fortune 500" enterprises, they have successfully resisted any meaningful reform. A strongman in office is required to overcome this resistance and breakdown the barriers impeding efficiency. The actions of Xi Jinping thus far appear directed at this outcome.

It is in the hands of foreign investors to rethink and reinvent continuously what their presence offers China in close alignment with the agenda of the new leaders. The agenda, as has been stated, is to sustain China's growth and redirect it toward a more stable, higher quality model. As we have argued, foreign companies as a whole have made massive contributions to quality growth in China, and, looking ahead, continue to have unique potential to contribute desperately needed solutions to new and genuine agendas focused on quality, efficiency, and safety in energy, mobility, environment, distribution, food, life-style, and so on.

It would not be wildly optimistic to say that improved alignment and communication of alignment with a newly reconstituted decision-making structure, one that appears more sharply focused and more capable of solving China's problems, is the key to keeping the door open.

Early Re-Reform Machinations – Isolate from the Outside; Insulate the Inside

For Xi's re-reform program to succeed, maintaining stability in all respects is paramount, especially at this early juncture, and especially as the pressures of economy's "long soft fall" intensify. The stability imperative is manifesting in two important ways: (1) an "isolating from the outside", and (2) an "insulating of the inside". The overarching objective is, of course, to maintain absolute Party power and control, and literally at any cost. Neither development is good for MNCs.

Historically, "isolating from the outside" is a typical response for China's leadership during times of economic or political stress. The tendency is perhaps currently most pronounced in China's foreign policy stance, for example: inexplicably offensive and trust eroding foreign policy maneuvers; irrational naval provocations; and shrill xenophobia in State media and official public opinion channels regarding the unfairness of Western criticisms of China. The tendency is also manifesting in the business environment in some very tangible ways, for example:

- Purported bans on international auditors
- Purported bans of foreign ICT vendors
- Restrictions on due diligence exercises
- Screening of foreign IT equipment
- The revoking of foreign media visas
- The banning of Chinese companies from doing bond floats with Hong Kong banks that advertise in "subversive" publications
- Limits to Mainland tourist arrivals in Hong Kong (currently under study)
- Stepped up ideological campaigns in Hong Kong
- Harassment of Hong Kong's free press – e.g. Ming Pao and Apple Daily
- The demotion or expulsion of "Naked officials" in Guangdong province (i.e. government and Party officials with family members living and studying abroad)

Together, these isolating developments are making for increasingly difficult Sino-foreign border crossings: for people, via increasingly restrictive visa requirements; for external news, by the closing off of inbound information channels, especially the internet; and by stepped-up restrictions on statistical data production and media reporting in China. And this makes business more difficult for MNCs.

"Insulating the inside" focuses on protecting the Party apparatus and its elites, and is reflected in widespread domestic tightening across all fronts. It is logically a defensive response to increasing cynicism and disaffection in the population, and the perceived threats of public protest. Examples of the insulating trend are also numerous and growing, for example:

- Launch of high-profile, 1-year anti-terror campaign, inclusive of a highly visible security presence
- Arming of police, and providing them paramilitary training; combat clad People's Armed Police patrolling cities
- "Mass Line" frugality and propriety campaign – inclusive of old-style self-criticism sessions
- Mobilization of mass surveillance ("granny police")
- Preemption: some 200 peaceful activists/petitioners reportedly jailed since beginning of year – new "custody and education" substitute for "reeducation through labor"
- Pre-June 4th sweep of threatening citizens. Pu Zhiqiang, Guo Jian – jailed for "failing to forget"
- Wave of new indoctrination campaigns to promote socialist values among cadres – return of the "spiritual pollution" phrase
- New campaign of ideological guidance to study Xi Jinping's thinking (Qiushi)
- Guiding of internal coverage of international disputes: "no questioning of China's actions/positions, and no 'irrational' patriotism"
- Overt pressure on media, celebrities, intellectuals, conference speakers, etc. to "say nice things and agreeable words" – the return of proletarian optimism
- Harsh new laws on "spreading rumors" and "unfriendly" opinions

The isolation and insulation machinations now observable are, in essence, the Party's survival instincts at work. It is likely to be a transitional feature of the Chinese market that will diminish once stability is assured, and Xi's power is fully consolidated. While the dynamic is in play though, the probability is very low that any marketizing reforms will be introduced, as such reforms would necessarily introduce heightened volatility. The dynamic also naturally disfavors foreigners, who are seen as being untrustworthy even despite years of presence, major investments, fulfilled commitments, and demonstrable good will and value delivery to their stakeholders and the Chinese economy in general.

The prevailing hypothesis, considered imminent by many, is that stability and Party/bureaucratic orderliness is seen by Xi as a prerequisite first-step to introducing marketizing reforms in the to-be-determined second stage, such that the reforms can be implemented successfully, and according to the "top level design", by virtue of full alignment and disciplined support from lower levels in government. This does seem to be a logical hypothesis. But the truth is, there is no hard evidence to support it.

The Long View: Pressures to Keep the Door Open, and Eventually Open it Wider

Despite the difficult near- and medium-term outlook for MNC business conditions in China – and the considerable uncertainty at present with respect to the direction of the reform agenda – three very powerful trends promise to keep the door open for foreign investors in China, and indeed force the door open wider as the long soft fall of the Chinese economy exerts more and more pressure on policy makers:

1. The increasing need for capital – both for FDI and for access to global capital markets;
2. The increasing need for foreign technology and know-how to sustain industrial competitiveness and address the productivity crisis; and
3. The increasing need for international markets as a source of growth for Chinese firms.

As discussed throughout this report, much of the heady investment in China of recent years has gone to the wrong places, for example: real estate, excess industrial and infrastructure capacity, speculative financial assets, etc. Massive investment is still required to propel new sources of growth in China: in the services sector, in high value added manufacturing, in technology sectors, in environmental protection and restoration, in resource conservancy, in social infrastructure – in all of the seven strategic emerging industries so adroitly identified in the 12th Five Year Plan as being critical next generation export platforms. These areas have always beckoned for Foreign Direct Investment (FDI), and foreign investors have labored to gain access, but without much success. Championed incumbents and institutional deficiencies have blocked large-scale access in most cases.

Looking forward, the need to develop these sectors beyond the low-end value chain positions they occupy today will only become more pronounced as the economy continues to weaken. And as domestic sources of capital dwindle too as the economy weakens, it seems only logical that access will be granted to permit FDI, and the foreign expertise and technologies *and ownership* together with it, to flow more freely into these markets. The MNCs behind these FDI inflows will necessarily require control positions, and strengthened legal assurances, to avoid the JV and import substitution problems of the past. Negotiating power between foreign investors and Chinese regulators will be much more level. The frenzy by reportedly more than 20 local governments to establish FTZs attests to the intensifying need to attract foreign investment. Some FTZ proposals, for example Guangdong's which suggests building out long promised liberalizations under the CEPA arrangement with Hong Kong, indicate the early stages of potentially positive trends.

Just as FDI will be more needed, and the door opened wider to get it, so too will Chinese firms, and the Chinese government, need to maintain access to global capital markets as a critical source of financing. On the equities side, after nearly 17 years[47] of marketing "the China Inc. value proposition" to global investors in New York and Hong Kong and elsewhere – *i.e. you won't lose money betting on the State* – Chinese issues are losing their luster. Negative reports on long-term returns of much-hyped Chinese equities[48], and the deeper and deeper illuminations on the fraudulent behaviors common to Chinese companies listed overseas, see access to international capital markets diminishing. The lukewarm reception and failure of some Chinese issues in Hong Kong – even as cooperating SOEs and Chinese banks pump the syndications – suggest that global market sentiment may be turning permanently negative on Chinese stocks. Doors will need to be opened more widely to reverse this trend – for audits, for due diligence, and for compliance enforcement.

The need for a more open door to attract foreign technology and knowhow to restore industrial competitiveness and reverse productivity growth decline is even more acute than access to finance. It always has been, it just wasn't obvious in a high-growth environment that masks inefficiency. As growth slows, it stands to reason that this need will become undeniable. "Indigenous Innovation" programs cannot fill the gap for myriad reasons beyond the scope of this report to explain. Foreigners will be needed, and the door will need to be opened more widely to secure their spirited participation. The future is not likely to see foreign investors make the same mistakes in business structuring, licensing and technology transfer that were so costly in the 80s through the 2000s. Everyone's been there, done that. Better terms and binding assurances will be required that will force the door open. It would not be surprising to see the liabilities for IP infringement raised to international levels, for example, as a means of shoring up foreign investor confidence. This step was game changing for IP theft reduction in Taiwan, Korea and Hong Kong, and stands to be so too for China if and when it happens.

Finally, just as Japan's slowdown in the late 70s and early 80s forced its companies out into international markets in search of growth, so too will the long soft fall force Chinese firms out. "Going Out" will thus become a commercial imperative, not just a slogan and a government campaign supported by SOE stalwarts. Destination countries for Chinese aspirants will necessarily grant access only in return for resolutions on market access problems for their firms in China. Newfound weight and mutuality will eventually enter the trade negotiation environment to the benefit of all MNCs in China. Evidence of the harmonizing effect of mutual interest is evident in the case of many MNCs who are collaborating with their Chinese partners abroad and securing better access and conditions in China in return. The sufferings of Chinese companies caught up by diplomatic tensions in Vietnam and other

[47] The trend arguably began with China Mobile's IPO in Hong Kong on October 23, 1997

[48] Lim, Weiyi and Kana Nishizawa, "China Wealth Proves Elusive as Stocks Earn 1% in 20 Years." Bloomberg News, July 15, 2013. http://www.bloomberg.com/news/2013-07-14/china-wealth-eluding-foreigners-as-equities-earn-1-for-20-years.html

Southeast Asian countries must certainly insert a whole new dimension into the calculus for Chinese policy makers, or it will eventually. While trade dispute resolutions unfavorable to China currently result in acrimony and retribution, it stands to reason they will eventually yield compromise. China is hugely dependent on trade, and will only become more so as the domestic economy falters.

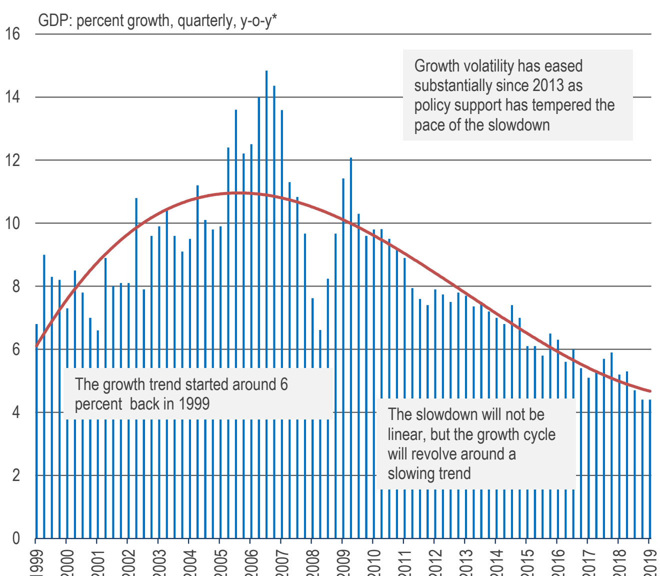
Section 3a – What to Expect in 2015 and Beyond

Up to this point, this report has largely focused on China's previous developmental path and how that evolution has brought China to both its current crossroads and to the urgent need for fundamental economic reform. In this section, we look forward to China's immediate economic future in 2015. The following section will then go on to examine potential longer term implications of weaker Chineses growth and the country's subsequent relationship with foreign businesses.

Our short-term analysis draws heavily on our assessment that each of China's fundamental economic inputs (labor, capital and productivity) are on a slowing trajectory, and we expect the "soft fall" continue throughout 2015 and well beyond. This downward trajectory will not, however, be linear. Rather, it is likely to be punctuated with occasional bouts of renewed upward activity, propagated primarily through targeted stimulus measures, akin to the "mini-stimulus" programs that buoyed growth for a short time in Q2 2012, Q3 2013, and Q2 2014. In other words there will still be growth cycles, but around a slowing trend – the upswings will be shallower and shorter as stimulative measures become increasingly ineffectual, while the cyclical troughs will become progressively deeper (Chart 31).

Chart 31 **How the growth slowdown is likely to play out**

The easing in China's growth rate will not be a linear process, but each growth cycle will become shallower and shallower



Sources: NBS, CEIC, The Conference Board
**Stylized growth outlook for 2015 forward, not actual projections*

It is important to point out here that our baseline scenario does not involve a full blown financial or debt crisis for China. Chinese policymakers have shown a remarkable ability to muddle through, as have governments elsewhere. But, even more importantly, it is the very non-market policy tools that prevent a more volatile correction from occurring that are also causing the fundamental, long-term slowdown in Chinese growth. Take SOEs for example. The existence of State-owned enterprises is a major shock absorber for China's economy. Because they are owned and heavily influenced by the government they can be "told" to increase production in the wake of a negative external shock – as they did in response to the 2008 global financial crisis. Moreover, they provide relative stability for employment and tax revenues even amid an economic downturn. But as they do all of these things, they divert resources away from private actors, increase the opportunity for corruption and worsening overcapacity issues. In other words, SOEs help to forestall the speed of the needed economic correction, but in doing so they cause the economy's long-term challenges to become further entrenched.

In that light, there are two specific policy tools that China's policymakers rely upon heavily in order to suppress volatility, but at the expense of worsening the longer term slowing of the economy's potential growth rate. The first is the economy's relatively strong ability to keep capital within a closed system. It has become ever clearer that China's capital controls are quite permeable – particularly by disguising capital flows under the current account via falsifying trade invoices. Other methods of moving money on and off shore span a range of options from domestic companies with offshore subsidiaries moving funds internally to Macau casinos that launder mainland money. However, by far the bulk of China's domestic money creation stays onshore, and for many years the inflows from the trade surplus and from speculative capital more than offset outflows – most months they still do even now, but the swings in flows are becoming more volatile – so despite the fissures in China's capital controls, the financial system remains largely immune to a sudden stop brought on by widespread capital flight. This strong control over aggregate flows of cash means that it is difficult for the liability side of China's aggregate balance sheet to suddenly balloon due to a run on the financial system by foreigners. That does not mean, however, that a domestic challenge to the banking system could not emerge in the form of a classic bank run. But this latter scenario is also difficult to envision due to the second powerful and idiosyncratic administrative tool that China's policymakers possess.

This second unique ability is the Chinese system's capacity to suspend and defend asset prices of all types. From real estate, to bank loans, to the stock market to the currency, policy makers can and do step in by using the State's vast resources when asset price volatility rises to a level deemed unacceptable. Indeed, while the Shanghai Composite was down -1.8 percent for the year near the end of July (before subsequently ralying to be up 11.7 percent by the end of September), the government used its domestic investment vehicle, Central Huijin to regularly step in and buy different types of shares once they drop below acceptable levels. Over the past several years, the most often reported interventions have occurred for the bank stocks, which as we mentioned previously, are not performing commensurately with what their balance sheets would suggest. On the flip side of the coin, since 2010 governments across the country instituted a spate of fairly successful administrative measures to contain upward pressure on real estate prices by suppressing transactions. Now that prices have started to slide in the real estate sector, those administrative policies have quickly been walked back with some localities even offering subsidies for purchases. Indeed, if prices were to begin to fall more deeply, it's likely that local governments would direct State-owned banks and non-financial enterprises to purchase property in order to stabilize the market, or even in the extreme to suspend the transaction market altogether. Finally, the PBoC's strong control over the price of the currency is well understood and has been used to great effect.

It is this ability to keep asset price volatility suppressed and to defend especially against downward prices on a range of assets that helps to safeguard the shaky financial system from experiencing a shock. While financial and debt crises ultimately emanate from the liability side of the banking system's balance sheet, a swift correction in asset prices often catalyzes this process. When housing prices crash, for example, the amount of debt that homeowners owe (their liabilities) rise suddenly in relation to the amount of assets they hold. Banks, worried that homeowners will eventually start defaulting on mortgages begin calling in those loans. The process is similar in a banking crisis. Once many loans start going sour due to an economic downturn, the liabilities at banks (the deposits they hold) rise in relation to a bank's ability to pay. Customers get wind of this development and all rush to the bank to make sure that they can redeem deposits. However, in most cases if there is not an original asset price correction, the contagion does not move over the liabilities side of the affected sector. Thus, China's ability to ultimately keep the price of real estate from truly crumbling will stave off the popping of the real estate bubble. And the administrative system's ability to maintain prices across a range of key asset prices means that a sudden stop is unlikely to occur. However, this dynamic also means that assets will not be properly valued as the economy slows. Banks will overstate the performance of their assets for example – a practice that is already occurring – and money will continue to be funneled into the real estate market to chase illogical property valuations. Each of these two occurrences will only reinforce the productivity crisis as capital is allocated to sectors that appear more productive than they truly are.

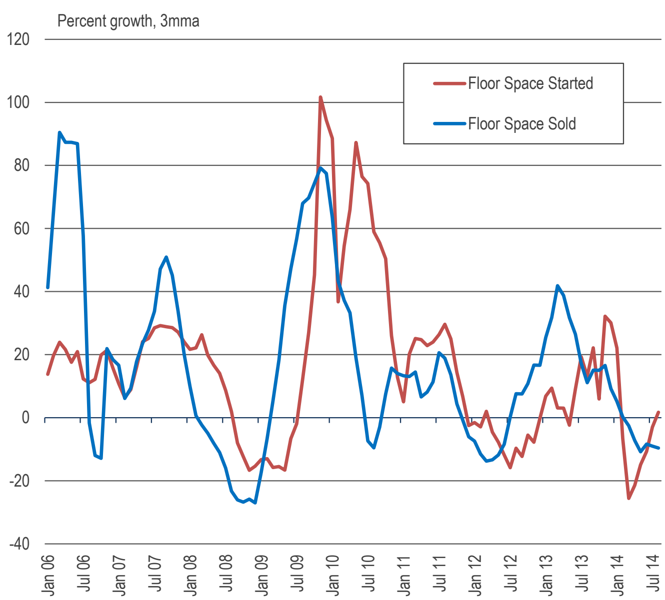
We expect these two powerful tools will continue to come into play as the economy slows further into 2015. At present our projection for China's official 2015 GDP growth is 6.5 percent, down from 7.3 percent in 2014. On the supply side, continued weakness in productivity will be one of the major constraints on capital formation. Thus, 2015 is set to look a lot like 2014 and we expect it to be characterized by three main trends: (1) A sluggish real estate market characterized by lower investment rates, high inventory volumes, downward price pressures and financial difficulties for developers; (2) occasional bouts of mini-stimulus, where credit and liquidity growth will be loosened for a time, but in a targeted manner in line with the overall slowing trend, combined with stepped-up administrative and fiscal relief and infrastructure spending; and (3) Increased disparity in regional and city-level economic performance with particular portions of the country being hit disproportionately hard by the long, soft fall, particularly in places that were overly reliant on real estate expansion, mining or other heavy industry in recent years.

A Tough Real Estate Market

Much of the worsening economic performance throughout 2014 was related to the fact that the real estate market was much more sluggish than many had expected. With real estate and its related sectors accounting for roughly 20 percent of GDP, a pullback in the property market will necessarily have a considerable effect on China's overall growth rate. While it's been clear for some time that property has been overbuilt in China, the steepness of the correction through much of 2014 was surprising. Private property analysts in China estimate that real estate inventories in China have risen to 5 to 6 years based on the current purchasing rates. But even those analyses could be underestimating how long it will take to clear housing inventories in China due to a slowing purchasing rate. Through the first eight months of 2014, purchases of commodity floor space in China fell by -8.3 percent y-o-y (Chart 32). Falling prices look to have pushed some buyers out of the market as they wait for steeper discounts, and despite the PBoC's attempts to encourage banks to lower the cost of funding for mortgages, financial institutions have been reluctant to expand credit to riskier, small borrowers, especially at discounts to the corporate lending rate. Slow purchases

Chart 32 **Sluggish property sales and starts**

Property purchases have yet to pick up, despite easier financing; the sector is unlikely to stabilize until purchases resume



Sources: NBS, CEIC, The Conference Board

have also led to weaker overall activity in the construction sector throughout 2014, with fixed asset investment in real estate easing to 13.2 percent y-o-y growth through August – the lowest rate since mid-2009.

Because of the structural nature of the oversupply in China's real estate markets, these dynamics will only get worse in 2015. As we outlined above, we do not expect the real estate bubble to pop outright on a national level, as the government's powerful administrative tools should be able to combat a property catastrophe. However, as sales remain sluggish and prices begin to decline on a y-o-y basis, property developers will come under immense financial pressure. Thus, the housing malaise from 2014 is set to worsen next year, and drag further on growth. And certain parts of the country are likely to be hit much harder than others – leading us to our next key economic theme of 2015, increasingly disparte regional growth dynamics.

Increased Disparity in Regional Economic Performance

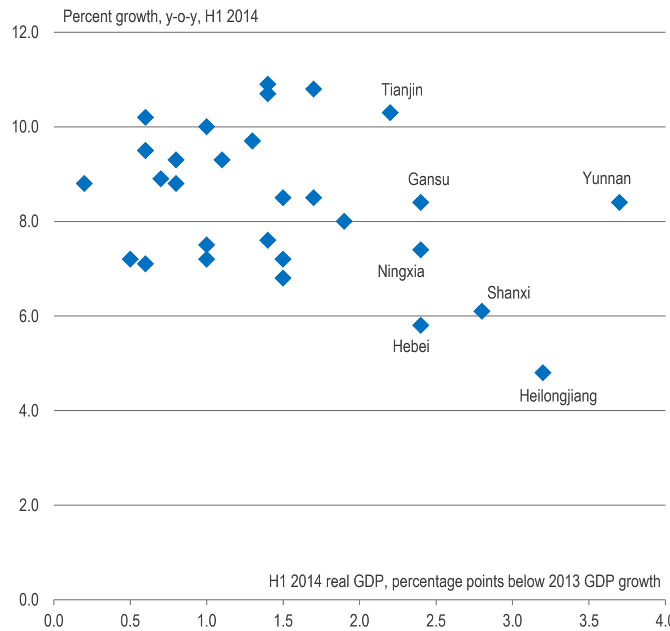
In other sections of this report, we have mentioned our outlook for increased regionalization from the standpoint of openness – or lack thereof – toward foreign investment. Our expectation for divergent sentiments toward foreign businesses, from one locality to the next, is closely tied to our outlook for economic disparities across localities to worsen as the economy slows. At some point, Beijing may seek to increase the size and frequency of fiscal transfers among various provinces and perhaps even to the city levels, but this will take time and over the short-term time horizon we expect the slowdown to be much deeper for the less-diversified provincial and city economies within China. The government's long-term objective, of course, is to increase both development and urbanization within central and western cities, which tend to be poorer and smaller. However, here we again focus on the short term, suggesting that any such changes would not be doable in a way that would affect near-term growth. Moreover, we are far from convinced that a westward urbanization and development push can be successful.

But for now, we leave those longer-term issues for another discussion, as we think 2015 will see greater divergence among cities and regions based on how much different localities have depended on real estate investment, mining or other heavy industries over the past several years. Chart 33 shows the slowdown in China's economy, by province, through H1 2014. The x-axis represents amount in percentage points that each province's GDP growth has slowed as compared to full-year 2013 growth. The clear outlier is Yunnan, with Heilongjiang, and Shanxi not far behind – each losing 3.7, 3.2 and 2.8 percentage points of GDP growth from 2013 to H1 2014. Tianjin, Gansu, Ningxia, and Hebei make up the group of provinces that showed relatively strong weakness, with growth falling 2.4 percentage points on average.

The positive news from an overall Chinese growth perspective is that these localities make up relatively small portions of overall economic activity. But ongoing significant deterioration within each will still have a negative effect on the country's headline growth rate. More importantly, the regional fissures that are already in place are only set to deepen next year. While a dive into each area is beyond the scope of this particular report, ongoing Conference Board China Center research is investigating the divergence among city- and provincial-economies. Bottom line: for MNCs it is more important now than at any time in the past decade to understand where growth will (and will not) come from in China from a geographic perspective.

Chart 33 **Diverging growth prospects among China's provinces**

Economic activity, and thus the overall business environment, is likely to see increased divergence in 2015; understanding the regional dynamics will become even more essential to business success



Regular Bouts of "Mini Stimulus"

The final defining feature of 2015's economic growth in China is that it will likely include recurring bouts of "mini-stimulus," similar to what we have seen for the past three years. The 2015 stimulus is likely to mirror those that occurred in 2012, 2013 and 2014 in that it will likely occur in either Q2 or Q3 and will include targeted policies to ease the economic pain for the hardest-hit parts of the economy. The most recent mini-stimulus in 2014 was put forth on three separate fronts: monetary, fiscal and administrative. In monetary policy, it's important to note that the moves were very gradual and narrow, offering support within the greater context of an ongoing pullback in credit growth over the longer run. Big bang monetary support, as anticipated by many, was not forthcoming and is unlikely to be next year either (Table 2, page 65).

We expect similar tweaks to policy in 2015, with a particular focus on further increasing spending on social housing as a means to buoy construction activity in the struggling real estate sector. And looking forward, we expect recurring mini-stimulus packages to continue to be a feature of the long soft fall through the medium term slowdown. While these will prolong the soft fall, and preserve stability, they will also necessarily thwart much needed reform. An increasing focus on re-lending by the central bank is, for example, a move away from the liberalization of interest rates and a reversion to greater policy-based lending. A focus on subsidized housing ignores the structural oversupply in the real estate market and seeks to forestall a consolidation of the developer and construction community that market forces would bring on more forcefully.

Moreover, it's likely that with every new support package enacted by government actors, analysts and media will start to proclaim the resurgence of the Chinese economy. And while, from a policymaking point of view, it's perfectly reasonable to attempt to slow the pace of the economic correction in any given quarter, the recurring series of stimuli only serves to slow reform by relying on the same old bag of tricks – namely policy-directed lending and investment. Over the past three years, these sorts of measure have done nothing to address the fundamental productivity challenge that the economy is facing, and we expect similar results from policy support that is likely to occur for the fourth year running in 2015.

Other factors to watch:

Although the three elements discussed earlier will, in our view, be the defining characteristics of China's economic growth in 2015, two other factors will merit watching, not only for next year but into the medium term as well. Those factors include price movements, especially on the consumer side, and changing pressures on the currency, which we saw at the beginning of 2014 and which may come back into play as China's growth rate slows over the next several years.

The potential for a run-up in inflation:

Over the past three years growth in consumer prices as shown in the official Consumer Price Index has stayed benign, with CPI growth at 2.6 percent for 2013 and an average 2.2 percent through the first eight months of 2014. While your average consumer believes that the CPI understates the true growth of prices, particularly because growth of housing prices are not properly accounted for and tracked according to international norms, relatively weak upward pressure on prices has given financial policymakers leeway to focus on calibrating the pace of credit expansion to a level that supports growth, yet is not overly expansionary, without having to worry too much about price movements. Moreover, a PPI in negative growth territory for almost three years has helped keep producers from having to pass price increases on to their customers. But as food price growth begins to accelerate toward the end of 2014 and into 2015 – especially as the pork production cycle hits its nadir and the El Nino weather pattern causes droughts across north and southeast Asia, pushing up grain prices – the central bank may find that it is more constrained in providing broad growth support. We have argued for some time that deterioration in bank assets is the true constraint on an expansionary monetary policy, as it would only further encourage investment in non-performing assets, but more quickly rising prices is a more sensitive issue among the public. China's macro-prudential policymaking has been highly successful over the past decade from the standpoint of keeping growth and price volatility at a minimum. However, strong upward bouts of inflation could severely constrain policymakers' ability to focus on growth, and were an inflationary spiral to kick in if policymakers over-stimulate in the face of a declining growth rate (via expanding the money base too much), the subsequent imperative to tighten monetary growth in response could be devastating.

Table 2 **The specific moves in the 2014 stimulus have included:**

Monetary	Fiscal	Administrative
• Required Reserve Ratio (RRR) cuts for county commercial banks • Another small RRR cut for banks with a high proportion of loans to agriculture and SMEs • PBoC encourages 15 banks to lower mortgage rates • Interbank rates have been held low, compared to H2 2013, reducing the cost of funding for the banking system • The PBoC has increased its use of rediscounted loans, allowing it to directly boost credit creation and tie loans to specific policy priorities – a 1 trillion RMB credit line was given to CDB in this manner	• Local governments have been asked to bring forward fiscal expenditures to earlier in the year • The tax threshold for SMEs was lifted earlier in the year, easing the tax burden for those companies • Railway spending has been accelerated and the target for spending for the year has been raised several times • Funds for shanty town renovation have been increased • Infrastructure investment is growing at 23 percent through the first four months of the year	• Many localities have started to ease restrictions on property purchases • Some cities have even floated the idea of subsidizing purchases – a complete about-face in policy • 80 large scale investment projects have been approved to move forward this year • Construction of water management projects has been accelerated • CBRC has loosened loan-to-deposit restrictions

Movements in the RMB:

One development that could potentially catalyze an inflationary spiral would be significant and sustained depreciation of China's currency. At this stage, loss of confidence in the RMB seems unthinkable to most observers. A 259 billion USD annual trade surplus, amounting to 2.8 percent of GDP in 2013, would seem to indicate that the currency is still below its long term equilibrium exchange rate. Moreover, in most months, inflow of speculative capital tends to outpace the outflow, and even if outflows were to become more substantial, China has powerful tools to clampdown on such flows. First, the central banks' 4 trillion USD in foreign exchange reserves are a very powerful tool in defending against downward pressure on the price of the currency, and secondly, while the capital controls are porous, China's administrative capacity to clampdown on cross border flows in case of an emergency remains fairly broad.

Still, the first several months of 2014 showed how quickly the tide can turn. While the PBoC did appear to knock over the first domino of depreciation in order to burn domestic speculators engaged in the carry trade, the subsequent downward market reaction was greater than most expected. Indeed, the RMB-USD exchange rate traded below the fixing rate for 20 weeks, only beginning to see the reassertion of market-driven appreciation pressure on August 6th, after the trading band was widened on March 17th. Going forward, we expect recurring bouts of downward pressure on the RMB, as we saw in early 2014 and in second half of 2012, and greater volatility in the currency, as short-term flows have become the dominant factor in driving the currency's price over any discreet period. Looking further ahead, were China to continue to loosen capital controls more systematically, a loss of confidence in the currency as economic growth slows could be a key vulnerability for China's domestic banking and monetary systems, particularly if the current vulnerabilities within them are not addressed. The bottom line is that genuine RMB internationalization is not a foregone conclusion as many analysts seem to expect – developments in the currency space will be key to watch.

Section 3b: China's Long Soft Fall: Impacts on the MNC Operating Environment

For MNCs, the soft fall will see worsening operating conditions in the near- to medium-term with gradually improving operating conditions longer-term, as and when a genuine reform program ultimately comes into play.

At this difficult juncture, the following eight strategic perspectives are important to bear in mind:

1. **China will remain a key growth market** – Even with the continual slowing, China's growth rate remains standout, and will for some time, as will its scale compared to other emerging markets. Niche markets in China are often the size of country markets elsewhere. This won't change.

2. **China will remain a competitive production base** – China enjoys advantages of scale in manufacturing and export industries that are unparalleled compared to other emerging markets. As such, China continues to gain share of global manufacturing value added. These advantages will offset cost increases for the foreseeable future. Moreover, the soft fall may serve to slow labor and administrative cost increases, a potential silver lining.

3. **Most MNCs have significant headroom for growth** – Although China is a top market globally in most product categories, very few MNCs boast China as one of their top markets. This fact indicates opportunities for market share gain. The consolidating effects brought by the soft fall will potentially open windows of opportunity for share gain.

4. **Most MNCs have significant opportunity for efficiency gains** – During the hyper growth era, many MNCs (like their Chinese peers) focused primarily on keeping up with growth and chasing the perceived frontrunners in their sectors. For many, this resulted in inefficient organization structures and operational processes that were effectively masked by the high growth (and hype). The soft fall is an ideal time for optimization – a process well known to most MNCs though global experience, but not to domestic firms, many of whom have only known China's long period of high growth these last 30-plus years.

5. **China's reform potential is significant** – China enters this transition with significant potential growth, provided the political resistance can be overcome to enable reform to unlock this potential. As a very large, diverse and dynamic economy, China only needs to get a few things right, even if much remains unaddressed, to enjoy significant reform dividends.

6. **The slowdown portends several important silver linings** – In particular, improvements are expected in both the talent and corporate development spaces:

   – Talent: China's talent environment should improve dramatically as the intensity of demand for talent diminishes, wage escalation abates, and the expectations of Chinese employees begin to rationalize. High potentials in China stand to become more long-term oriented and more appreciative of stable employers that invest in building their skill sets, respect work-life balance and undertake much-needed CSR activities in China. Career planning should finally become a viable leadership development tool, as tenures lengthen and turnover rates drop.

   – Corporate Development: The M&A environment should improve as valuations come to ground and sellers become more receptive and reasonable. Distressed asset roll-up opportunities – and even privatizations – should arise, maybe in high volume. New partnering options with local firms, driven now by urgent commercial motivations, should emerge.

7. **Transitions such as this are common, not unusual** – At the end of the day, China's current transition is not so unusual. Most of fast-growing Asia experienced similar transitions after long

periods of high growth: Japan, the "Four Little Dragons"[49], Indonesia and Thailand. In most of these cases, the transitions – while difficult – ultimately resulted in policy change that much improved market access and operating conditions for MNCs. Indonesia and Korea are relevant and encouraging examples.

8. **Down markets breed opportunity** – It stands to reason that this age old adage (albeit read "crisis breeds opportunity") should apply to China, just as it has to other countries and similar situations over time. Companies that are prepared, efficient, agile, and focused stand to significantly improve their share and competitive positions coming out on the other side of the transition.

Near-Term Prognostications – A Downmarket with Chinese Characteristics

The correct mindset will be critical to overcoming extremely difficult near-term operating conditions, and resisting the fatigue and distraction that can be caused by unexpected trials, for example the current regulatory and media scrutiny of foreign business practices in China. As the soft fall deepens, and the government's backstopping gradually loses its effectiveness, difficult business environment features are anticipated to materialize in the real economy.

- **City level economic disparities will become pronounced, if not profound** – Industrial cities and other cities that most significantly overbuilt real estate, infrastructure and industrial capacity in the 2009 to 2013 "bubble years" will stagnate – especially those where growth was mostly policy driven around grandiose projects. Market selection assumptions will need to be revisited, and footprints adjusted as necessary.

- **Unemployment will rise** – Even though zombie companies may be propped up, and closures not recognized in a formal sense, workers will be dispatched or indefinitely furloughed. This will impact household consumption capacity and also create looser labor market conditions.

- **Real estate prices will correct and trap household wealth** – There is significant household wealth invested in real estate in China. A significant correction, if it occurs, will effectively trap household wealth. As of now, reported pricing remains level, or slowly decreasing, but secondary markets have all but disappeared, while, at the same time, administrative barriers have been implemented widely to make it increasingly difficult for houses to be sold. Real estate owning households are thus rich on paper, but not necessarily so in cash terms. This dynamic may have major impacts on household consumption.

- **Triangular debt will proliferate** – As real estate deflates, the financing capabilities by Chinese firms and local government corporations who borrow using real estate as their primary collateral will decrease. Commercial paper, an asset that has become a primary source of corporate finance in recent years, will become less available and tradable. The non-payment or stalled-payment issues for the more distressed firms will ripple throughout their respective supply chains causing liquidity problems even for healthy firms. Accounts receivable management and supply chain financing will become more challenging.

- **Downward pressure on the RMB** – As these factors begin to co-mingle with slowing growth, positive sentiment is likely to diminish, both internationally and domestically, yielding downward pressure on the RMB. Acquiescing to gradual depreciation will serve to help China's struggling export sector, an important pillar of real economy stability. But a weakening RMB will negatively impact input pricing, in particular imported oil, commodities, and food – which are substantial, thus serving to create upward inflationary pressures. Price volatility will likely become a significant management challenge on many fronts, from forex and treasury management to product planning and financial forecasting.

The confluence of these features will, among other things, yield a multi-speed marketplace – with regions of high, medium, low, no, and even negative growth – and with considerable price and liquidity volatility from one city to the next. This stands in stark contrast to the consistently high-speed, price-stable, liquidity flush days of the last ten-plus years.

[49] The "Four Little Dragons" were Taiwan, Singapore, South Korea, and Hong Kong

Making things even more challenging, political-economy influences are likely to factor into this mix to produce a schizophrenic regulatory environment, including:

- Newfound regulatory hospitality in some locales where officials come to realize the importance of foreign investors to their economies versus intensifying predation in other locales where they don't, and where MNCs are seen primarily as moneybags to extort.

- Newfound pro-competitive orientations and rationality from competitors and partners in locales where local firms are denied support and forced to adapt to market conditions and sink or swim, versus other locales where championed firms are ever more strongly supported and therefore behave even less rationally. In many industrial sectors today, this latter situation is in play and working to severely compress MNC margins.

- Signals from government leaders at all levels on the one hand proclaiming everlasting commitment to "reform and opening up" and to letting "markets play a decisive role", while on the other hand overtly do anything but.

All three of these schizophrenic features are visible today, probably most exemplified by the attacks on foreign firms for product quality and safety failures, then compliance failures, and, most recently, monopolistic pricing practices. As the soft fall deepens, and economic stress intensifies, it stands to reason that these features will become even more pronounced, in all probability disproportionally so to the downside in the early stages.

Against this backdrop, success will be contingent on effectively managing down-market conditions, as well as the unique Chinese characteristics we expect to come with them. Managing down-markets is built deep in the DNA of most MNCs through home market and other market experience, but is arguably nascent in China, where the local organizations of most MNCs have only known up-market conditions. Deploying managers with the requisite down-market experience – e.g. in change management, cost management, process optimization, etc. – and training local personnel on essential down-market practices will be essential.

Managing the "Chinese characteristics" will require alert, well resourced, and tightly coordinated government, compliance and corporate communications functions. Predation can most easily be mitigated by avoiding the real problems that invite it, so early warning visibility into potentially inflammatory product and service issues, compliance conflicts, labor issues, and supply chain issues will be paramount. At this juncture, no cost should be spared to monitor control and risk points, both internally and externally, and assure compliance, even at the expense of margins. In parallel, company value propositions – i.e. "how my company benefits China" – should be revisited and strengthened and relentlessly conveyed with Chinese interlocutors at all levels to build the network of friendlies that is so important to effectively responding to predation if at when it comes. Looking forward, the value proposition work will become instrumental in the medium-term to opening new doors.

Medium-Term Prognostications – The Return of "Old School" China

As discussed in section 2e, the "re-reform" program being implemented by Xi Jinping involves a recentralization of power into the hands of Party elite, a de-institutionalization of the policy process that is shifting policy making from the premiership and civil government offices to the Party, and a general de-bureaucratization of the regulatory apparatus across all levels. We assert that the program, at its ideological core, represents a return for China to a type of Confucian governance structure from the past whereby hereditary leaders rule China atop a subservient bureaucracy and an aligned and tightly bound network of powerful regional vassals across China's large geography.

Although the program involves some isolationist features at this early stage, presumably for Xi to maintain political and social stability, the program does not mean that the "open door" policy has come to an end. But it does mean, we think, that the door is different. Assuming President Xi's "re-reform" continues on the current trajectory, it stands to reason that market access for foreigners will increasingly be governed by Party elites empowered to convey rights as they see fit, quite the way things were done in the 80s. WTO conventions, which were never really very meaningful in China anyway, will become even less so. This means even less will be written about the rules of play, much less codified in or enforced by law, and that the Chinese business environment will become even less familiar from a Western point of view.

While these changes sound bad for MNC business, this may not turn out to be the case. Less bureaucracy would be a very good thing. Since WTO accession in 2001, China's bureaucracy, insofar as foreign investor engagement is concerned, has become ever more stifling, not less so. Moreover, assuming the current trajectory holds its course, less lower-level crony corruption would also be a likely outcome – another good thing. This does seem to be where Xi's anti-corruption campaign is headed, although there is little transparency into the true goings on. Finally, and perhaps most importantly, the ability for foreigners to do deals with those on top – a situation akin to 1980s' China – would likely return as a business environment feature. These older days were a period when MNCs with well aligned deals, well informed teams, and strong relationships with the right top decision makers could open doors and even receive special dispensations. Arguably, the most successful foreign investors in China today emanate from the beachhead successes achieved in that era.

The factors that were most important to success in the pre-WTO, "Old School" era were twofold: (1) developing a compelling value proposition around an investment and/or market development proposal, and (2) selecting a target geography where the value proposition most aligned with the respective leader's priorities. Identifying the leader's priorities, gaining access, building trust, conveying the value proposition for maximum alignment, etc. were the core skills required to develop business. MNCs would be well guided to revisit their institutional learnings and the case studies of early MNC experience in China, a repository of information and insight that is now very robust.

As compared with the earlier days, government leaders in China today are now highly sophisticated with regard to the commercial aspects of business, so more effort will necessarily be required to quantify value proposition benefits to the Chinese side, and argue the merits of proposed deal terms and legalities. This too is a good thing. Precedent indicates that the documentation to support these arguments can provide the edifice upon which secure structures can be built and made legally binding. Deal execution will require tight, well-coordinated linkage across the government relations, legal, business planning, and corporate development functions to deal with the fluidity inherent to this deal making environment. The C-suite will need to be on the same page, up-to-speed, and available and able to engage, as necessary, in creative problem solving and relationship management along the way. It's a different way of doing business, that's for sure. But MNCs with the required domain skills can be highly successful in doing it.

Longer-Term Prognostications – A More Marketized China?

Looking forward to the long term, we posit that there are three very powerful forces at work that will open the door wider to foreign investors in China, and guide China gradually toward a business environment that is more and more normalized with international practices, and easier for business. These forces are:

1. The increasing need for foreign investment and access to global capital markets

2. The increasing need for foreign technology and know-how to sustain industrial competitiveness; and,

3. The increasing need for Chinese firms to generate growth through expansion into international markets.

Need for foreign capital. Despite the heady investment "in quantity" of recent years, China still requires massive new investment – *"in quality"* – to create an efficient industrial base, improve social infrastructure, and establish the foundations for a knowledge and consumer economy – and to re-build, if not substantially retrofit, the poor quality infrastructure, physical plant, and housing constructed in recent years. Foreign capital will become more essential as domestic sources of capital constrict due to the soft fall. The deteriorating sentiment with respect to Chinese share issues on international markets, and staunch scrutiny of international bourse regulators, will amplify this need. The long, and ever-lengthening, pipeline of IPO aspirants awaiting approval is evidence of the growing thirst for foreign capital, as is the reported frenzy by more than 20 local governments to establish new, and "more special" free trade zones to attract foreign investment. As the need for capital intensifies, and domestic access to capital diminishes, MNC and foreign investor negotiating power should improve, and with it the terms of investment, and the door should thus open wider and more equitably.

Need for foreign technology. In addition to the need for capital, Chinese enterprise is in dire need of foreign technology and know-how to improve productivity and enable competitiveness based on factors other than low price. The vanguard statements in China's 12th Five Year Plan (released March 2011) speak to this imperative. The possible future vision is most compellingly displayed in the Plan's guidelines on developing the "seven strategic emerging industries" that articulates developing China into a key global production hub for these industries via enablement through normalized partnerships and licensing arrangements with leading global firms. But China's track-record in IP protection is nothing short of terrible, as is the experience of foreign firms that entered technology transfer arrangements based on minority equity positions and/or loose provisos for future market openings. After 30-plus years of accumulated foreign experience in these areas, and the lingering memories of many costly mistakes still fresh, foreign firms with the technology and know-how to provide solutions for China's myriad problems will not be forthcoming without more rigorous IP protections, market access provisions and binding competitive safeguards. As the soft fall deepens, and the need to enhance value addition in industry and services becomes acute, the deficiencies of the putrefying "indigenous innovation" program will become undeniable. As pressure builds and time runs out, again, MNC and foreign investor negotiating power should improve, and with it the terms of investment, and the door should thus open wider and more equitably.

Need for foreign markets. To date, China's "Go Out" campaign to invest abroad has been more a slogan than fact, albeit offshore direct investment has been growing swiftly. Most of the observable deals seem to have focused on cornering concentrated markets (e.g. pork, copper, rare earths, primary vitamins, solar panels, shale gas) or pumping transaction values, presumably to reward vested stakeholders and export their cash. Even most of the resources deals, where by far the most activity has been, appear suspiciously overpriced, and many of them are reportedly struggling. For the most part, China's largest firms have paid only lip service to going out, and instead have concentrated on easier and more lucrative domestic development opportunities made possible by virtue of their insider relationships. This is set to change. As the soft fall deepens, and opportunities in China's speculative financial economy diminish, Chinese firms will need to genuinely and substantively tap international markets for growth, just as Japanese firms did in the late 70s and early 80s. The limited international experience of Chinese firms will create partnership opportunities for MNCs abroad that provide leverage in the domestic market; there are already many observable cases of this dynamic. Over time, the international requirements for good governance, transparency, compliance, and fair competition, etc. stand to slowly influence domestic behaviors. And corporate reputation will begin to matter significantly. Perhaps most importantly, destination countries for internationalizing Chinese firms will necessarily grant access and support only in return for resolutions on market access problems for their firms in China. Hence newfound weight and mutuality will enter the trade negotiation environment to the benefit of all MNCs in China.

An equalization of negotiating power is the key catalyst for change common to all three of these forces, the key premise being that the imminent need to compete more for foreign investment and foreign capital, for foreign technology and for foreign markets, will cause this equalization. The need is caused by the slow fall, and is increasing as the slow fall deepens. While it is possible that China rebuffs this equalization, takes the soft fall to its bitter end, and reverts to the Statist, isolated, repressive country of pre-1978, this path seems highly unlikely given today's globalized economy and the high and rising expectations of China's 600-plus million connected netizens and 40 to 50 million[50] annual global travelers. Pragmatism tends to win out more often than not in China, even when it's blurred by saber rattling and vitriol on the surface. Indeed the bellicosity of late – including the lopsided attacks on foreign companies by Chinese State media – is a strong signal of the intense and growing pressure exerted by the soft fall and the three forces outlined above. Negotiating power is beginning to shift; and it's not comfortable for China's leaders, SOE and local champion executives, regulators, and economic planners.

MNCs should recognize the shift occurring in negotiating power, even though it may take a long time for it to play out, and begin to leverage the trend. Already, MNCs are more carefully scrutinizing their

[50] World Tourism Organization (UNWTO)

China investment plans against alternative investments in other countries. This fact should be conveyed to Chinese interlocutors, of course with due attention to cultural sensitivities and optics. At the same time, MNCs should craft their aforementioned value propositions subtly around the three forces by emphasizing the solutions they provide via:

- New capital to mitigate intensifying liquidity shortfalls
- Updated innovation and technology to improve industrial efficiency, sustain manufacturing competitiveness, and grow the services sector, etc.
- Directly and indirectly enhancing the globalization prospects of Chinese firms
- Job creation for the unemployed or under-employed entry-level professional cohorts that sustains the expansion of the Chinese middle class (and depressurizes social discontent).

As the soft fall deepens, and the three forces grow in strength, it stands to reason that there will be more and more resonance to advocacy positions and investment proposals that are highly attuned to China's pressing needs, both in form and function – and particularly to value propositions that contribute to enhancing economic and social stability. MNCs should prepare to exploit this opportunity, and fully leverage the shift in negotiating power when the timing is right to create the regulatory and operating space needed for sustainable, long-term positions in China.

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