China's New Normal: Anything but normal

BIAC China Task Force Meeting with the OECD Reflection Group on China

10 June 2016, Paris
Overview

I. Economic assessment

II. China in the Primaries

III. Overcapacity

IV. 13th 5-Year Plan: focus on Environment

V. China goes global

VI. ICT

VII. Conclusions and Next Steps
I. Economic assessment:
Recap: BIAC Conclusions from June 2014

What to expect?
- Financial stress – possible reform?
- Regional economic slowdown, real estate bubble
- Increasing awareness of environmental damage in water, soil, air
- Stronger environmental law enforcement
- More food quality problems
- Stronger social media control
- People’s demand for better corporate governance
- Increase of disclosed corruption cases
- Increased globalization of Chinese business
- Increased involvement in international economic organizations

What not to bet on
- Political reform
- SOE reform – privatization

The main risks
- Increasing gap between middle class expectations and Party’s ability to ‘deliver’
- Too rapid economic hard landing might lead to social crisis and increasing nationalism
THE CONVENTIONAL THINKING...

Commonly cited, but weakly supported in reality:

- China has time
- Muddling through is a viable option (even if suboptimal)
- China has the tools/resources to deal with anything slowing down can bring
- China’s leaders recognize the problems
- China’s leaders can fast-track reform
THE NEW NORMAL

Source: The Economist
CONTINENT CHINA

Chinese equivalents

Nominal GDP PPP, 2014 (US$bn)

- 0 to 250
- 250 to 500
- 500 to 750
- 750 to 1,000
- 1,000 to 1,500
- Over 1,500

Source: Economist Intelligence Unit
THE TWO-SPEED ECONOMY

CEIC, Gavekal Dragonomics

The Business and Industry Advisory Committee to the OECD
Comité consultatif économique et industriel auprès de l’OCDE
CHINA’S COMPANIES HAVE TAKEN ON $10TRN OF DEBT IN THE PAST EIGHT YEARS (10% IN $)

In 2007, on the eve of the global financial crisis, China’s overall debt to GDP ratio was 147%. Now it is at 231% and climbing. Total debt Rmb152tn ($23tn).

Debt-deflation trap a big macro risk, but no major credit event or systematic financial distress

Source: FT
KEY THEMES IN 2016

- Real GDP growth to grind lower to 6% in 2016
- Officials are determined to lower corporate costs in 2016: Lower interest rates due to weaker growth and rising debt burden
- RMB to depreciate by 5% against the USD but less against the basket
- Do not expect a stimulus package equivalent to the November 2008 stimulus program
- More aggressive fiscal and monetary policy
- The official (central government) fiscal deficit will widen in 2016
CHINA’S TAX SYSTEM

- China aims to promote cross-border business activities while protecting its tax base.
- China is part of the OECD project to tackle Base Erosion and Profit Shifting (“BEPS”).
  - This is the first time China has worked on an equal footing with the US, Europe and other OECD countries in the setting of international tax rules.
  - China will adopt the OECD’s BEPS recommendations but they will be tailored to China’s circumstance.
- State Administration of Taxation have initiated “Golden Tax System” project which links technology and tax.
  - Business now required to use certificated tax software to generate VAT invoices and to create statutory tax reports.
  - A programme to collect data from business in respect of their corporate income tax position recently instigated.
Over three-fourths of member companies feel less welcome

Do you feel foreign businesses are more or less welcome in China than before?

77% Less welcome than before
23% More welcome than before
IF GREATER MARKET ACCESS WERE GRANTED TO FOREIGN COMPANIES IN YOUR INDUSTRY, HOW WOULD THIS IMPACT YOUR COMPANY’S INVESTMENT DECISIONS IN CHINA?

Source: Business Confidence Survey Data, Roland Berger analysis
MADE IN CHINA 2025; THREAT OR OPPORTUNITY?

What is it?

- MIIT, NDRC, MOST, MOF, AQSIQ & CAE issued on 19.05.2015; The Green Book
- A 10-year blueprint to improve China’s manufacturing competitiveness
- Indigenous innovation, domestic production, and Chinese brands are overriding themes

- E.G.: High-end Numerical Control Machinery and Robotics
- By 2020: Indigenous brands of industrial robots to reach 50% market share for the domestic market, and domestically produced critical components to reach 50% of the domestic market.
- By 2025: Indigenous industrial robotic brands to reach over 70% market share domestically and domestically produced core components to reach 70% market share domestically. Have 1-2 companies enter the top 5 companies.
II. China in the Primaries
The man who must change China

Beware the cult of Xi
III. Overcapacity
UTILIZATION RATES IN SIX INDUSTRIES
## ZOOMING-IN ON STEEL & REFINING

<table>
<thead>
<tr>
<th></th>
<th>Crude Steel</th>
<th></th>
<th>Refining</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capacity</strong></td>
<td>644m tons</td>
<td>1.14bn tons</td>
<td>391m tons</td>
<td>686m tons</td>
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<tr>
<td><strong>Production</strong></td>
<td>512m tons</td>
<td>813m tons</td>
<td>314m tons</td>
<td>456m tons</td>
</tr>
<tr>
<td><strong>Utilization rate</strong></td>
<td>80%</td>
<td>71%</td>
<td>80%</td>
<td>66%</td>
</tr>
<tr>
<td><strong>Overcapacity</strong></td>
<td>132m tons</td>
<td><strong>327m tons</strong></td>
<td>77m tons</td>
<td><strong>230m tons</strong></td>
</tr>
</tbody>
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Trade tensions around steel as restructuring is postponed, while “teapot” refineries help aggravate overcapacity, enjoying cheap oil imports.
IV. 13\textsuperscript{th} 5-Year Plan: focus on Environment
13TH 5-YEAR PLAN: ADJUSTING TO THE NEW NORMAL, REBALANCING & CLEANER ENVIRONMENT...

* Plan again released step by step, A.Kroeber: "the Five-Year Plan has evolved far beyond its original purpose of setting production targets in a command economy into an ongoing procedure for converting information from the grassroots into policy and adjusting policies as conditions change."

5 key priorities:
1. Innovation and High Tech [Made in China 2025]
2. More business friendly initiatives, cutting red tape
3. Accelerated urbanization / more social programs
4. Reduce housing sector imbalances
5. Tighten environmental regulations implementations…

* Focus Solar / Wind / New Energy Vehicles / ETS launch
TACKLING SMOG ...THREE YEARS AFTER...

- Presidents Obama & XI 2014 landmark deal on emissions translated into Success of COP 21 viewed from China; Capping emissions well before 2030 appears realistic as “new normal” growth model spreads

- Ministry of Environment arsenal of measures growing

- Beijing Winter Olympics 2022 clean up under way for Hebei / Tianjin / Beijing

- Hangzhou G20 Sept 2016: a window for blue skies China; PM2.5 to decline by 18% by 2020 in major cities

- Which role for coal? Boilers converted from coal to gas ; still > 50 GW coal power added in 2015, some 40 GW/year to be added in next 3 years ...?!
V. China goes Global
China first announced its Outflow Direct Investment Strategy with its 11th 5-Year Plan (2006 – 2010)

With 12th 5-Year Plan (2011 – 2015), China established its ODI strategy:

- **Expansion**: Manufacturing networks of strategic industries
- **Promotion**: Establishing R&D and marketing centers abroad
- **Prioritise**: Investments in energy and agriculture

13th 5-Year Plan (2016 – 2020) also supports China’s existing investment strategy
In 2015, Chinese enterprises invested $14.8 billion directly in countries along "The Belt and Road" – an increase of 18.2%.

The 13th Five-Year period is the key stage of full implementation of “One Belt One Road" construction.

AIIB and Silk Road Fund are designed to finance these initiatives.
CHINA AS A NEW GLOBAL INVESTOR

Outward direct investments are China’s way of going global

- In recent years China became one of the leading international investors.
- PRC is one of the few nations which has positive growth in FDI outflows for the last ten years.
- Chinese investors generated 15% (over $100bn) of global deal activity ($682bn) in 2016 Q1*

* Thomson Reuters
ODI: SOME EXAMPLES

- Alibaba Group Holding Ltd. took a stake of more than 9% which is worth more than $150 million in U.S. online retailer Zulily Inc.

- Lenovo acquired most of Motorola Mobility for US$2.91 billion from Google.

- Chinese property and entertainment giant Dalian Wanda Group Co. has bought Swiss sports-marketing company Infront Sports & Media AG for €1.05 billion.

- As part of their Silk Road strategy, China has completed the following transactions:
  - Chinese shipping group COSCO acquired Piraeus Port (Athens) for €368.5 million
  - The same group also acquired Kumport in Istanbul for $940 million
  - Geely Holding Group then acquired Volvo Cars from Ford for $1.8 billion
  - Australia's largest dairy firm Van Diemen's Land Company sold to two Chinese Business Groups for $280 million
ODI: WHY DOES CHINA HAVE TO GO GLOBAL?

Reasons behind PRC’s increasing outbound direct investments:

- China’s high FX reserves:
  - The foreign-exchange reserves of China were **US$3.19 trillion** (the largest in the world), as of May 2016.
- Ease overcapacity
- Increasing need for energy and raw materials
- Slowdown of domestic economy

- Increasing population of Chinese middle class and their increasing demand for high quality products
- Aim to gain a better position in global value chains
- Reaching strategic resources
- Transfer of technology and know-how
VI. ICT
CHINESE ICT MARKET AT A GLANCE

Chinese ICT market at 351 billion USD (2015, estimated)

- 11% growth, compared to 0.x % ICT market growth in the European Union

- Major players keep on expanding and include an international dimension
CHINESE VISION OF CYBERSPACE CHALLENGES

Domestic dimension:

- Increase competitiveness by strengthening information infrastructure and resource integration (“Internet Plus”)
- Indigenous products, “secure and controllable”
- “Internet Plus” action plan

International dimension:

- Cyber sovereignty
- Peace and security
- Openness and coordination
- Good order

Sectoral regulation in banking (circular 317) and insurance, affecting domestic and international players alike

Deviations from international standards, licensing, testing and certification requirements; encryption technology regulation; localisation, data storage, source code disclosure etc.

Public procurement: GPA submission?

Anti-terrorism law

Image source: http://www.rand.org/topics/china.html
VI. Conclusions and Next Steps
2016 Conclusions

What to expect?
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• Regional economic slowdown, real estate bubble
• Increasing awareness of environmental damage in water, soil, air
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• People’s demand for better corporate governance
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What not to bet on
• Political reform
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The main risks
• Policy Mistakes
• Too rapid economic hard landing might lead to social crisis and increasing nationalism
• Regional tensions
Recommendations to OECD

• **Target the following issues for the OECD-China work program** – e.g. SOE reform, digital economy, anticorruption, responsible business conduct, corporate governance, competition, tax...

• **Ensure OECD representative in Beijing** has resources to scale-up OECD presence in China, but remain focused and manage expectations

• **Continue to engage BIAC experts in OECD events and projects** with lead notice via the BIAC Secretariat.