Challenges for China
and implications for Hong Kong

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No more low-hanging fruit

- When you start from command economy in 1979, it is hard not to produce prosperity - the only way is up.
- Easy wins come from liberalizing street prices, freedom to choose whom you work for, abandonment of production quotas etc.
- It took 11 years to re-open the stock market, in Dec-1990
- I worked on a Shanghai B-share IPO in 1992: the Chairman told me “let’s be clear, I won’t pay as much interest on my shares as on my bank loans, OK?”. He thought shares were financing, not ownership
- 2 decades later, most of the national SOEs are listed
- But almost all of them are still state-controlled. Investors hold minority positions in a giant conglomerate, China Inc.
- Top management are party appointees, often shuffled between listed entities (banks, airlines, telecoms, petroleum etc.) or in and out of government
- Market forces are not at work
- Compare that with the UK state-owned enterprises of the 1970s. These are almost all now free-market entities.

China, Inc.

- In 2009 GFC, China commanded banks: go forth and lend. Policy-driven and corruption-driven lending, not based on credit analysis
- Before bank IPOs, bad loans were taken out, but not bad lenders
- At end of 2013, top 40 SOEs with HK listings had market value, based on all-shares, of US$2tn, or about 21% of GDP (US$9.4tn)
- SASAC results for 2013: its 110 national enterprises had consolidated revenue of CNY24.2tn (US$4.0tn) and profit of CNY1.3tn (US$214bn)
- That excludes banks under Central Huijin (owned by China Investment Corp), China National Tobacco monopoly (~$100bn revenue), etc.
- Head of SASAC (ex-Petrochina) has been arrested for alleged corruption, amongst many others
- Entrepreneurs are promising, but many had to cut legal corners to succeed, and might not treat their minority shareholders any better. A substantial discount should be applied relative to developed markets
- Private sector crowded out by policy SOE lending
- Capital diverted to uneconomic infrastructure to pump-prime

What market economy?

- The State controls:
  - Capital movement in/out
  - The media, via propaganda department
  - The internet (censorship, including microblogs domestically, and blocking via the Great Firewall of China)
  - Foreign exchange rate
  - Banks which prioritize credit to SOEs; policy-driven
  - Caps on interest rates on bank deposits – leading to $2.2tn trust products time-bomb
  - When companies can go public (on/off/queue)
  - Appointments to SOEs (musical chairs in various sectors)
  - Where you can live and obtain education, healthcare and welfare (hukou system)

The bubble and ongoing crash of 2015

- Shanghai Composite Index rose 152% from 2052 on 12-Jun-2014 to 5166 a year later
- Driven by an explosion of credit, not a 152% improvement in the economy. Trust products money diverted from property to stocks
- Retail investors buying on margin, and often borrowing the deposit too, from shadow banking (inc P2P lending)
- So far (21-Aug) it has fallen 32% to 3508
- Leadership blames “malicious short-sellers”, foreigners (they are barely allowed in the market), bans large (5%) holders from selling for 6 months, suspends IPOs (again) and orders banks to lend to margin-lending hub CSFC. Meanwhile a large chunk of the market suspends itself.
- We’ve been here before: on 16-Oct-2007, the index reached its daily high of 6092
- Wisdom of crowds: alongside our article “Incredibubble” on 16-Sep-2007, in a Webb-site poll, we asked what was the lowest level the index would ever reach again? 60% of respondents said it would go below 2000
- The index lost 72% to a daily low of 1707 on 4-Nov-2008

Change or be changed

- The easy work is done. GDP/capita now ~$6k in PRC v ~$36k in EU
- CCP has no electoral mandate but consensual mandate of (most of) The People by delivering prosperity
- No prosperity=no mandate. You can't lend your way to prosperity.
- The next doublings of GDP depend on a <u>real</u> market economy and liberalization
- Freedom of speech & free media to hold leaders accountable, or corruption will remain endemic
- Sell-down SOEs to 0%, break up monopolies, allow market forces to work
- Freedom of capital movement
- Abolition of foreign ownership limits to enhance competition
- Abolish hukou, reform local government finance; money follows citizen
- Progressive democratization
- 2 ways to get there – visionary leaders produce smooth transition; or dislocation when an economic crisis produces a "Chinese spring"
- Risk of nationalistic military actions to distract from failings at home

What about Hong Kong?

- Probably the only place on Earth that seeks to combine civic freedoms with a lack of democracy. Elsewhere you get both or neither.
- An unsustainable combination – that's why we're the only place.
- Iranian-style democracy was offered, but not taken
- Two possible outcomes – authoritarianism and oppression of dissent, or allow the city to freely elect its own mayor, as New York and London do, without any threat to sovereignty
- If Government gets 2/3 of LegCo in 2016, then it can pass any electoral changes it wants, and will likely enact Article 23 legislation.
- Clock ticking on the Second Handover – where will we be in 2047?

14 years to go, not 32

- In 1983, HK was in crisis, due to uncertainty over the New Territories lease expiry on 30-Jun-1997. The HK$ peg was introduced in Oct-1983
- Talks began with Governor MacLehose's visit to Beijing in 1979, 18 years before the Handover
- We will need to start talking, by about 2029, about whether we will still have our own courts, rule of law, tax system etc after 2047
- Long-term contracts, franchises and land leases mean this cannot be deferred nearer to 2047
- An extension of the Basic Law to 2097 would be reassuring to all in HK
- Prediction: China will be an open and democratic society by 2047, either by revolution or peaceful transition, because the prosperity and economic growth will end without such freedoms
- Put simply, Chinese governance in its current form is unsustainable.

About Webb-site

- Founded in 1998. Not-for-profit, the site and related activity takes about half my time. Partly funded by speaker fees (not today), but mostly funded by me
- The other half, I research and invest in HK small-caps, currently holding >5% of 14 listed companies
- Corporate horror stories end up as *Webb-site Reports* (time permitting)
- under-valued well-governed companies go into my portfolio
- Over 20,000 subscribers to a free newsletter, opt-in/out
- Opinion polling
- Hall of Shame for jailed directors, CCB watch, SFC watch, ICAC watch
- Site covers economic governance too, advocating free and fair markets, transparency, accountability, civil liberties, tax reform, land revenue reform, minimal intervention and economically-rational policy-making
- *Webb-site Who's Who* database covers all HK-listed directors, auditors, advisers since 1990; legislators, district councilors, statutory/advisory bodies, CE election committee, and the relationships between them
- *Webb-site Total Returns* series – since 1994, all HK stocks including delisted
- Tracking all SFC-licensees, and all HK-incorporated companies (over 1 million live)
- CCASS Analysis System for stock movements

Thank you!


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