INVESTMENT PROSPECTS FOR A RE-EMERGENT CHINA

An Investor's Port in the Storm?

As the first to suffer the shock of the COVID-19 crisis, China is showing signs of being the first to emerge into recovery. The hard-hit city of Wuhan led the return to normality as it laid on a midnight light show, celebrating its reopening after nearly three months of lockdown. Meanwhile, April has seen President Xi Jinping symbolically forgo a surgical mask on his customary provincial visits, as state-controlled media portrays a China hurrying back to work.

Around the world markets have ground to a halt amid projections that we are entering the worst recession since the Great Depression. Longer-sighted investors may be looking to diversify, or just to learn what the future might hold. China appears to offer a potential answer given that it is entering the 'recovery' stage. However, it is still unclear how a full recovery will develop in reality. At a time when even many of the world's most sure-fire investments are in rough waters, could Chinese markets offer a safe harbour to weary investors? In a state-managed economy such as China's, this not only depends directly on its economic health, but also on what steps the Government is taking to revive it.

The Politburo's New Priorities

Ensure:

- Employment
- People's basic livelihood
- Companies' survival
- Food and energy security
- Stability of the supply chain
- The operation of public institutions

COVID-19's toll on the economy

In 2018, the Government issued the "six stabilities", aiming to stabilise "employment, finance, foreign trade, foreign investment, investment and expectations" in the Chinese economy. In April 2020, in the wake of the Coronavirus crisis, the Politburo produced a new set of priorities, terming them "The Six Ensures", which are detailed above. The contrast between the two neatly conveys the Communist Party's (CCP) change in policy – from managing strong economic growth, to entering survival mode.

Indeed, the outbreak has delivered a seismic blow to the Chinese economy. Any hope of achieving the government's GDP growth target of 6% that is so central to the CCP's hold on power has been dashed, and replaced with widespread recognition that this is unrealistic. Some domestic economists and financiers favour dropping the target altogether. Although a government revision has not yet been made for the target itself, the National Bureau of Statistics quantified the damage so far on 17th April, announcing that the economy contracted 6.8% in Q1.

Foreign business has suffered as a result of the crisis. Unsurprisingly, 97% of British businesses in China experienced a negative impact on their business at the time of the crisis, citing decreased demand and uncertainty as the primary reasons. Half of EU companies in the country forecast a double-digit drop in revenues for the first half of 2020, with unpredictable government rules a key factor. However, as business operations begin to resume, stress for the Chinese economy has shifted from supply to demand. January and February exports tumbled 17.2%, first quarter Foreign Direct Investment (FDI) decreased by 10.8%, and domestic consumption was at rock bottom. With China's main export markets of the US and EU themselves facing dwindling consumption as they struggle through their own emergency, this trough will not be easy to climb out of.

Green shoots of recovery

However, the country nevertheless shows clear signs of progress in the twin growth drivers of consumption and exports. Its latest export figures show a marked, if not full, improvement not too dissimilar to that after the milder outbreak of the SARS Coronavirus in 2002-4. March exports fell only 6.6% on last year, which markets took as a win, given the expected 14% drop. Consumption also rallied in March, with the Consumer Price Index up 4.3%. Finally, whilst concerns of low growth are warranted, even China's predicted 1% growth for the year will be cause for envy for many developed economies, as they brace themselves ahead of a virus-induced recession.

Encouragingly, there has also been a considerable rebound in industrial activity, with combined statistics on published resumption and capacity use rates currently indicating a national economy operating at 82.8% of typical output. All the same, China has so far undergone a rapid return to activity which is now likely to slow, making it difficult to close the gap back to typical activity rates. The Manufacturing Purchasing Managers' Index, an important indicator of economic activity comprising a survey of purchasers across various manufacturing sectors, tells the same story, bursting out of COVID-induced contraction.

Policy response

The global pandemic has triggered differing economic responses across the world, determined by differing political cultures, economic and financial systems, and wealth levels, as well as which stage of the pandemic a given country is at. For example, approaches to supporting businesses with cashflow range from the German method of credit provision and uncapped borrowing from the state, to the Danish model of paying firms 90% of their wage bill. Many European countries are expanding unemployment benefits and welfare payments, whereas the US is supporting citizens through direct cash transfers. Each country will be dealing with the crisis according to its own circumstances and values. The system of "socialism with Chinese characteristics" is fiercely unique, and its stage in the course of the pandemic different.

Given China's model of state-led industry and public infrastructure projects, current debt and risk structures, and position at the 'vanguard of the curve', what will the authorities do to lead the economy through the transition and encourage inbound investment? President Xi Jinping's solution is hitting the right balance between jump-starting the economy and managing medical safety, promising to "accelerate the full recovery of production and living conditions while normalising epidemic prevention and control." In terms of foreign investment, Ministry of Commerce (MOFCOM) spokesman Gao Feng vows not to let reform flag: "In the face of the challenges, China will open still wider to the outside world, continue to liberalise market access, further expand imports, and promote trade and investment liberalisation and facilitation".

The Mandate of Heaven

Generations of Chinese leaders from Deng Xiaoping to Xi Jinping have built their legitimacy on the collective aim to "build a moderately prosperous [*xiaokang*] society", promising increased prosperity and development in tacit exchange for power. Historically, Emperors were awarded the 'Mandate of Heaven', which lent authority on the basis of material provision for citizens. An Emperor whose society suffered from natural disasters such as famines or plagues was believed to have lost the mandate, and often fell victim to social unrest.

Economic measures for domestic firms

President Xi first outlined his investment-based economic stimulus plan at a meeting of the Politburo Standing Committee in early March. The Government is introducing targeted economic measures, refraining from resorting to the mammoth state aid packages brought in by most Western countries. This is consistent with the Government's financial deleveraging campaign that seeks to reduce the considerable state debt resulting from the extensive stimulus programme after the 2008 financial crash. Those hoping for a repeat of 2009 in which China's exceptional growth hauled the world out of its economic slump will therefore be disappointed. However, this more muted plan nevertheless aims to tackle the slowdown on several fronts.

Economically and financially, the central bank, the People's Bank of China (PBoC) has been cutting the Reserve Requirement Ratio, resulting in increased lending from banks going out to cash-strapped firms, particularly SMEs which have been hit hardest. It will continue to do so this year, but has stopped short of adjusting deposit rates. Bank loans in the first quarter reached a record 7.1 trillion yuan, which translates to March credit and liquidity growth rising 11.5% year-on-year. Still more liquidity is being injected directly by the PBoC, and Ruan Jianhong, head of the PBoC's statistics department, predicted "rapid growth" in future loan demand in the second quarter. The main objective of this is to provide businesses with cash to keep them afloat. In line with the focus on SMEs, many local governments have issued grants and lowered or suspended taxes, administrative costs and utility fees, and the PBoC has also made provisions to allow SMEs to defer loans by up to five months without incurring penalties.

Another way that the Government is looking to galvanise new growth is by raising local government spending caps, with sectors such as telecommunications infrastructure, environmental protection equipment and healthcare facilities in the crosshairs for investment. Such investment plans have historically favoured state-owned enterprises. However, China's National People's Congress committee members have put forward proposals to ensure that private sector companies will be able to participate in the construction of 'new infrastructure', and so there may be improved opportunity for private investment. The majority of China's provinces have already announced their 'key project investment plans', and as of late March, these amount to a combined total of CNY 49.6 trillion (~GBP 562 billion).

Domestic consumer spending is one key driver for national growth, and the administration has been keen to promote it as the autarkic alternative to exports. To shore up consumption, local governments have been handing out retail vouchers. So far RMB 200 million worth of vouchers have been redeemed, leading to RMB 2.2 billion in consumption. Furthermore, 67 million low-income citizens will also see an increase in government assistance programmes.

Market access openings and practical support for foreign business

The other element of the struggle to stabilise demand still lies outside of the Government's domestic control, in exports. The administration recognises this, and Premier Li Keqiang noted in the first week of April's State Council (Cabinet) meeting that global trade and investment is "persistently going downward", and promised steps to sustain international trade and investment. Most of these involve an extension of existing measures, some of which took on new urgency during US-China trade tensions.

First on Mr Li's list is free trade zones (FTZs). 59 FTZs around the country already benefit from relaxed regulation and preferential tax rates. A new framework proposes the addition of 46 new pilot zones for cross-border e-commerce, to further spur the development of digital services already accelerated by social distancing measures. These zones are used as experimental areas for new policies. Any strategies that deliver may later be introduced nationwide.

The *Catalogue of Encouraged Industries for Foreign Investment* is a list of sectors in which national policy welcomes foreign investment through preferential tax rates, streamlined approvals procedures, discounted land prices and others. Mr Li pointed to the authorities' recent promise to accelerate the addition of new sectors to this list in the face of the crisis. Whilst the list has yet to be released, it is likely to be published around May and see improvements in healthcare; industries catering to the elderly; transport and logistics; tourism; education; and telecommunications. Similarly, the announcement of the removals from this year's *Foreign Investment National Negative List* is also to be expedited. This is a favourite route for opening up domestic markets, as the list details those industries that are prohibited or restricted to foreign investment, and has been steadily shortened each year. Liberalisation is expected in the manufacturing, high-tech, energy conservation and environmental protection, and service industries, and both lists are likely to guide increased investment toward the country's deprived central, western and northeast regions to balance development. Certain sectors continue to be a safe bet in terms of government policy, with finance enjoying a raft of regulatory loosening that has most recently seen approvals for mutual fund businesses to such firms as Black Rock, and for such companies as Goldman Sachs to take majority stakes in their securities ventures for the first time. The healthcare sector has also experienced considerable regulatory relaxation as the Government strives to fulfil its promises of a 'Healthy China' with a nationwide life expectancy of 79 by 2030.

The Foreign Investment Law came into effect at the start of this year, having been rushed through at breakneck speed under pressure from the US-China Trade War. It serves as a standardised umbrella guideline for foreign businesses, aiming to place them on a level playing field with domestic firms. While it remains a 'broad stroke' law, it seeks to address many common complaints of foreign businesses by actions such as explicitly banning forced technology transfers, promising better intellectual property rights protection, and ensuring equal treatment for foreign firms in government procurement. It also implements the standardisation of rules and anti-corruption practices across the country.

Finally, a number of government agencies, such MOFCOM and the powerful National Development and Reform Commission (NDRC) have called for local government to come to foreign business' aid specifically. In mid-February, MOFCOM issued additional measures to support foreign trade and investment through easing administrative friction, offering legal protections and providing a crutch for logistical operations. Much of this lacks specificity, but is nevertheless an important demonstration to local governments that FDI should be prioritised.

Whilst many foreign businesses still have numerous legitimate complaints, and the Chinese economic model will never be as open as those in the West, these are nevertheless positive signals that the Government does not intend for 'opening-up' to be left to flag, and investors should study those areas in which the Government has policy imperatives to reform.

What to watch

The Chinese economy then is beginning to find its feet, if stumbling somewhat. Although production has taken a hit, it has responded as positively as could be expected, and the concern is shifting to demand, where consumption is being stimulated by government, and exports are bucking expectations. This remains an unnerving state of affairs for a regime keenly intent on growth, motivating it to move to reconstruct demand. Investors should see a potential opportunity here.

It would be over-simplistic to call China a safe refuge, given that its current reliance on the world's economy leads it to be buffeted by global headwinds, in addition to its own storms at home. On the other hand, there are opportunities resulting from its status as an early COVID-19 reemergent enjoying a gradual return to activity, and from the government's support. Indeed, policy is at the centre of this, and following it will keep investors alert to opportunity in the markets. Given China's recognised resilience as an engine for growth, it would be prudent to maintain a long-term perspective and continue to monitor opportunity, in order to be ready when it arrives. Whilst nowhere can provide perfect shelter from the virus tidal wave, China might offer calmer waters.

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