Are the Global Markets Right to be Concerned about China?

China's influence on the global business environment, economy and markets has been thrown into stark relief by events during the past two months. While China's recent stock market volatility was initially largely only felt internally, it eventually triggered a sell-off that erased more than US$5 trillion in value from stocks globally in the space of two weeks in August. All eyes are now on President Xi Jinping and China's policy-makers to see how they will address the current stock market events and, more importantly, how they will try to restore greater confidence in the Chinese economy that is decelerating before its rebalancing has properly begun.

This paper explores what the market volatility and government policy responses say about the state of China's economy as well as the potential impact of the economic challenges on businesses both inside and outside of China. It examines why a stock market correction in China has precipitated a significant reaction in global capital markets and also discusses potential ramifications for China's reform agenda. In addition, it addresses what companies that have business interests in China should be considering given recent events.

Post-reform Announcement Stock Market Boom

Between mid-2014 and mid-2015, investors piled into China's capital markets on the back of a boom in confidence. This was largely driven by China's reform agenda that hailed the coming of a new era in which the market would be positioned as the decisive driver of the economy.

A number of important steps to liberalise the financial system and open up to global financial markets were taken following the unveiling of China's reform agenda as outlined in the Communist Party's *Decision* document released in November 2013, and a series of articles were subsequently produced in state-run media endorsing equity investment.

Confident about reforms and the government's commitment to ensuring capital markets growth, a bull market ensued as foreign investors and a large number of Chinese retail and institutional investors bought in alongside many state-owned financial investment firms to get their rewards from a stock market that seemed to be going only one way.

Correction and Intervention

All seemed to be proceeding according to plan until the market correction started in mid-June 2015. The Chinese government took several steps to stabilise the markets, including relaxing margin rules, expanding funding channels for brokerages and cutting trading fees, but the stock market fall continued.

By close of day on July 7, trading had been suspended in more than 90% of Chinese stocks, meaning that the investor confidence decline had erased US$3.5 trillion in market capitalisation. Share values had grown 150% within a year but had fallen back one-third within just three weeks.

Chinese policy-makers subsequently announced a wave of interventionist measures including interest rates cuts, short-selling caps, an IPO freeze and a ban against major shareholders and company executives in listed companies reducing their shareholding through trading on the secondary market. This raft of restrictions triggered criticism from some for running counter to China's broader reform agenda, though they initially seemed to work. Investors returned to the market and prices recovered.

However, less than three weeks later on July 27, the Chinese stock market suffered its largest fall since 2007 with the Shanghai stock exchange tumbling 8.5% in a day. This triggered the mobilisation of the so-called 'national team' — a number of large Chinese state-owned brokerages, insurance companies and other institutions — to invest hundreds of billions of Renminbi to provide liquidity and margin financing loans to brokerages.

Global Contagion

The correction in July had largely been confined within China's borders. This all changed when China devalued its currency on August 11. The decision was explained by the central bank as a move to win IMF approval for its Special Drawing Rights push. It was seen by many investors, however, as an attempt by China to shore up its export market in response to weakening growth and a further signal that long-term reforms may have to take a back seat to a patch-up of a faltering economy.

The move accelerated China's domestic stock markets slump and on August 24 — referred to by Xinhua, China's official press agency, and now known broadly in the media as 'Black Monday' — the markets again plunged by 8.5%. At this point, a broader pull-back began to surface — deep concerns took hold in the world's stock markets as it started becoming apparent that the symptoms might be more than a market correction of a bull market. The FTSE 100, also in the middle of a long bull market, lost approximately 10% in value in two weeks following the devaluation and the Dow Jones Industrial Average initially dropped 6% by 1,000 points on Black Monday.

Calls are growing for the Chinese government to take additional steps, though there are concerns that it may already be too late to fully stabilise the domestic market.

Xi's Ambitious Economic Reforms — A Decade Too Late?

Xi moved quickly to outline his vision for reform after taking office as General Secretary of the Communist Party in November 2012. An economic model making the market the driving force was published in the *Decision* of the Communist Party's third plenary session just a year after his appointment.

The *Decision* was bold and comprehensive covering a broad range of financial, fiscal, state-owned enterprise, industrial policy and market liberalisation reforms. It was almost universally welcomed both inside China and abroad.

However, while the *Decision* was released soon after Xi assumed his leadership, it still constituted a full six years since China's then-Premier Wen Jiabao had already identified the Chinese economy as being 'unsustainable, uncoordinated, unbalanced, and unstable'.

The global economic crisis had reared its ugly head in the intervening five years between Wen's statement and Xi's appointment. Consequently, instead of taking steps to move the economy away from a dependence on fixed-asset investment spending and low-end export-orientated production, Wen and then-President Hu Jintao had done the opposite.

China directed massive amounts of stimulus towards infrastructure development projects and the state-owned industrial economy to stave off the effects of the global financial crisis between 2007 and 2012. This drove up the share of investment in China's GDP from 42% in 2007 to 47% in 2012. By the time Xi took power, corporate and government debt had soared, productivity growth had further declined, severe overcapacity had arisen in a number of sectors and returns on capital investment had plummeted.

Xi was right that China had to quickly rouse new drivers of economic growth and the *Decision* was the blueprint of the reforms to shift the economy more towards consumption, services, value-added production and innovation. However, there are signs that it may have come too late.

China's GDP growth statistics show a steady decline from 10.4% in 2010 to 7.4% in 2014. However, it is not just that growth is slowing. The concern of investors is that growth is decelerating before economic rebalancing has properly begun. There are indications that the quality of China's recent growth has worsened, with the share of investment within China's GDP further increasing despite poor productivity. This would seem to mean that China may be generating larger investment and credit bubbles to keep up growth rates.

Lower Growth, a Hard Landing or a Harder Landing Tomorrow

China's growth since the 1970s has been built on a foundation of central planning and state control of the market. This has created a long-term tension among China's leaders who recognise that greater play needs to be given to market forces but are reluctant to give up control.

The government's first reaction to the fall in stock prices was to move aggressively through state intervention. When the real economy was uncovered as the likely culprit they simply swapped intervention to prop up the stock market for intervention to prop up the economy.

China again intervened the day after Black Monday following further falls in the market, with the central bank cutting interest rates and bank reserve rate ratios to encourage more capital to flow into the economy. But with low returns on capital and much evidence of wasted investment, there is a real concern that China is just kicking the can further down the road. The levers the government has recently pulled, the depreciation of its currency and monetary policy easing, are designed to increase both exports and investment — exactly the two areas away from which China is trying to rebalance its economy.

A slowdown can no longer be staved off and a soft landing may be becoming less likely. It appears that China is still rummaging through its old interventionist tool box to navigate the current crisis, but its number of policy options has dwindled.

The Chinese leadership's primary consideration has long been legitimacy through growth and stability. This explains why the government has found it viscerally difficult to reduce its control over the economy and stomach the volatility that market forces will bring.

The months ahead will serve as the litmus test to determine whether China's leaders are able to accept slower economic growth in the short-term and thus the likely direction that China will take on its path to reform its economy. The challenge for China's leaders now is to get through the current turmoil so they can address the bold reforms they themselves have laid out.

History is not on the side of centrally-managed economies. Many centrally-managed economies have developed to levels of per capita income that China is at now through controlling capital and labour to deliver production-based growth – but few have successfully navigated the transformation and rebalancing that China needs.

What This Means for Companies Doing Business in China

China's growth will certainly slow, but it is not all doom and gloom. The economy is still growing at a pace that others envy and there are still relatively untapped avenues of growth that offer potential. China will need to direct capital and resources to these more productive areas of the economy, such as private industry, the service sector and the new economy. If its leaders are able to do this, it may be possible for China to achieve sustainable and stable economic growth into the medium-term, albeit at lower levels than current GDP targets.

However, with that as a backdrop, what is certain is that all companies with exposure to China will have to reappraise their business strategies both inside and outside the country.

Companies — both Chinese and multinationals — will have to discern whether a Chinese slowdown will drag down their results and develop plans to deal with the situation. The eyes of the world are on China and all market participants are unsurprisingly jittery. To manage risk, companies will have to effectively communicate their corporate strategies relating to China to their primary stakeholders.

There are also commercial and regulatory risks. As China's slowdown became apparent in 2013, a raft of investigations for corruption and antitrust violations were initiated against companies in China, with many commentators concluding that foreign companies were being disproportionately singled out. The harsh reality is that in economically challenging times, foreign companies make more attractive targets for increased scrutiny. This adds extra reputational risk for multinational companies. While no amount of planning can anticipate each and every risk a business faces, companies would be advised to both upgrade their crisis preparedness protocols and re-evaluate and tailor their China communications in line with the Chinese policy environment.

The situation will also offer opportunities. The Chinese economy has gone through more than three decades of almost unchecked growth. As a result, most Chinese domestic companies have only really experienced breakneck growth. International companies, on the other hand, are used to market cycles and have thus developed the tools, experience and strategies to secure competitive footholds in times of slowdown. This is valuable to Chinese companies looking for partners.

It should also be remembered that the last time China hit a real economic downturn was in the late 1990s when then-Premier Zhu Rongji drove a privatisation programme focused on inefficient state-owned enterprises that eventually helped China come through the Asian financial crisis relatively unscathed and with a stronger private sector and higher productivity.

While Xi Jinping is a staunch advocate of China's public sector and has exalted its position and strategic importance, another privatisation drive should not be ruled out if China's economy was to hit a hard landing. This would offer significant opportunities for both foreign and private Chinese companies wanting to establish themselves in sectors currently dominated by state industry. With or without privatisation, the downturn will likely foster another wave of Chinese outbound M&A that will be driven by private companies and new priorities. These will likely include a shift away from natural resources and an increasing focus on foreign market access and technology acquisition.

Certain Considerations for Companies with Exposure to China

Both Chinese and multinational companies will have to develop plans to deal with potentially negative business results due to their China exposure and effectively communicate their related corporate strategies to global stakeholders.

With increased scrutiny from international partners and shareholders, Chinese firms doing business abroad will need to convince partners or stakeholders that they are able to navigate regulatory changes at home as well as any impact from a pressured economic climate.

Companies operating in China will need to anticipate political and regulatory developments and then communicate how these developments may affect their business.

As potential targets in market, multinational companies doing business in China should be prepared with defensive strategies and refreshed crisis preparedness protocols.

Many multinationals are used to market cycles and have the tools, experience and strategies to secure competitive footholds in times of slowdown, making them good potential partners for domestic Chinese businesses looking to continue international commerce.

If the Chinese economy hits a hard landing over the long-term and privatisations result, it could potentially offer opportunities for both foreign and private Chinese companies to establish themselves in state industry-dominated sectors.

Lastly, highly volatile markets are often accompanied by unexpected political and regulatory interventions so it is more important than ever for companies doing business in or with China to understand the latest market, political and regulatory developments in order to anticipate the changes that could affect their business. Recognising the political context, building allies and understanding the positions of critical stakeholders are all crucial to making necessary adjustments and realignments in business strategies. And of course, any evolving business strategies should be accompanied by a sophisticated approach to communications in order to ensure a company's interests in China are protected and ideally further enhanced as the country and its economy continue to evolve.

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