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2014: a critical year

By *Saro Capozzoli, Founder of JESA Investment Ltd*

The reforms recently released by the Chinese government are an important watershed for this country. It has been long time since I have seen announcements that have marked China's development path. I remember the post-reform protests in 1989 that allowed individuals to enrich themselves and the state to ensure national cohesion indicating principles as well as economic and foreign affairs guidelines to be followed. This is to let Chinese people to give vent to their spasmodic research of lifestyle improvements.

I also remember the 1994 when it was abolished the working Saturday to enable households to have more free time to consume. My Chinese friends and collaborators' comments make me smile again. They felt lost: "What we can do now on Saturday?". They basically perceived the reduction of working hours as a decrease in potential income but they were also genuinely disoriented because they have never experienced two rest days in a row. In fact, many of them decided later to organize their spare time differently getting new part-time job opportunities over the weekend left free by the new Government policy!

In the same year, the Foreign Exchange Currency was eliminated; it was the only one valid currency for foreigners in China working as a RMB parallel currency. Few people remember that and we are only talking about couple of years ago. You will have to take a leap of almost 10 years to remember the time when Government allowed foreign companies to open enterprises in activities carried out by only Chinese players, such as import-export. Then, in 2005, was set the Foreign Invested Commercial Enterprises framework and we have seen the contextual liberalization of many activities not permitted to foreigners until then.

This year will be recorded as key moment for Beijng; the stage on which the Communist Party finally decides to leave the control room and begins to allow the market to move by itself. It will not be an immediate process, these are only guidelines but reforms will be implemented gradually. The road is marked.

It is to be noted that at this moment entities defined as absolutist monarchy, like Vatican City, are managing to find the strength to renew themselves trying to adapt to the times, while our democracies are mired in an inconclusive ballet, unable to innovate and to choose new avenues for reforms. Unfortunately I have to say that at the end Europe, and of course Italy in the lead, will find themselves chasing the world that has evolved, which does not wait for our inertia dictated by elections that follow other polls. We are locked in a democracy that cannot be renewed and does not do it job: to administrate. Perhaps because those who guide us is not able to understand our time and there are too many personal interests that block our future.

*** * * ITALIAN VERSION * * ***

Le riforme da poco annunciate dal governo cinese sono uno spartiacque importante per questo Paese. Poche volte ho assistito ad annunci che hanno segnato il percorso di sviluppo della Cina. Ricordo le riforme post-proteste 1989 che hanno permesso al singolo di potersi arricchire e allo stato di garantire la coesione nazionale indicando le linee guida da seguire per l'economia e la politica estera. Questo per permettere di dare uno sfogo ai cinesi in spasmodica ricerca di migliorare la propria condizione.

Ricordo quando nel 1994 è stato abolito il sabato lavorativo obbligatorio per permettere alle famiglie di avere più tempo per consumare. Mi fanno ancora sorridere i commenti dei miei amici e collaboratori cinesi che si sentivano persi: "ed ora che facciamo il sabato?". In pratica loro vedevano la riduzione dell'orario di lavoro come una diminuzione potenziale di reddito ma erano anche sinceramente spaesati dato che non si erano mai trovati ad avere due giorni di fila di riposo. Infatti, molti di loro si sono poi organizzati nel crearsi lavori part time nel week end lasciato libero! Nello stesso anno è stata eliminata la valuta valida solo per gli stranieri in Cina, il Foreign Exchange Currency, moneta parallela al RMB che pochi ricordano e stiamo parlando solo di pochi anni fa. Si dovrà fare un salto di quasi 10 anni per ricordare il momento in cui è stato permesso alle imprese straniere di aprire attività svolte solo dai cinesi, come le import-export. Ecco quindi arrivare nel 2005 le Foreign Invested Commercial Enterprises e la liberalizzazione di tante attività non permesse agli stranieri fino ad allora.

Quest'anno verrà ricordato come l'anno dell'esame di maturità per la Cina, l'anno in cui lo Stato decide definitivamente di uscire dalla sala di controllo e inizia a permettere al mercato di muoversi da solo. Non sarà un processo immediato, queste sono solo linee guida, ma che verranno implementate gradualmente. La strada è segnata.

E' da constatare che in questo momento entità definite assolutiste e quasi monarchiche come il Vaticano, riescono a trovare la forza di rinnovarsi e di adeguarsi ai tempi, mentre le nostre democrazie sono impantanate in un balletto inconcludente, incapaci di rinnovarsi e di scegliere strade nuove per riformarsi. Mi spiace dirlo ma alla fine l'Europa, e l'Italia in testa, si troveranno a rincorrere il mondo che si è evoluto, che non aspetta le nostre inerzie dettate da una elezione e l'altra. Siamo bloccati da una democrazia che non sa rinnovarsi e non fa il proprio mestiere: governare. Forse proprio perchè chi ci guida non è in grado di capire il nostro tempo e ci sono troppi interessi personali, di parte e lobbistici, che bloccano il nostro futuro.

China's new reform plan

By Marco Rastelli

The Chinese leadership's 60-point reform plan announced two days after the close of the China's Communist third plenum on Nov. 15 went way beyond most expectations. The Communist Party (CCP) has unveiled its most sweeping reform agenda[1] in more than 30 years with the aim to convert China to a more free-market consumer economy with fewer social controls and a wider welfare state, dealing with most of the critical issues facing China as it reaches for the next stage of development.

The document, however, is likely to disappoint many commentators – especially foreigners – who will be looking for specific, implementable, policies but this is not its purpose: it is to set out broad directions for policy development. The plan mainly contains principles and guidelines to follow in achieving the predetermined objectives and the strategy perfectly adheres to the logic of the Communist Party. Usually when the CCP makes speeches or release new documents there will not be direct indication of concrete reforms. They want to illustrate the next (crucial) step on the table of the Government in Beijing. The blueprint is poised to promise land and residence registration reforms needed to boost China's urban population and allow its transition to a western-style services and consumption-driven economy. President Xi Jinping and Premier Li Keqiang, appointed in March, aim to reshape the competitive landscape, allowing private companies to compete with state-owned ventures in some sectors and to profit by the new market structure that will emerge by 2020. Refer to the appendix for an executive summary on the contents.

Which industries could benefit from this new plan? The decision to increase the level of welfare state could guarantee big opportunities for foreign enterprises. First and foremost companies related to health care and consumer goods, in general, will have strong positive repercussions in the mid-long term given the rising impact of welfare state. The growth of those industries goes hand in hand with this kind of social reforms. Consumer goods industry could take advantage of a general reduction in the propensity to save and a simultaneous demand increase. A progress in services offered by hospitals along with the concurring intensification of public resources allocation to the sector (30% of profits from state-owned enterprises will go toward public finance, predominantly social security) will guarantee interesting growth opportunities for new or newcomer health care service providers.

Loosening the *only-child policy* will grant benefits to the baby food sector. The policy relaxation could boost Chinese demand for diapers, infant milk powder and other baby-related sectors but the impact may be seen only in 2015. How did react companies directly involved? *Nestle*, the world's biggest food maker, had no comment to make about the new policy or on how it might affect its business in Greater China (company's fourth-largest market with annual sales of about USD 5.7 billion[2]). *Mengniu*, the dairy producer, already stated that they will increase the ratio of infant formula in its product offering. Diaper maker *Hengan International Group* jumped 6.5 percent[3] to a record high the day after the document release and *Vinda International Holdings Ltd,* which owns a stake in a diaper business, surged 7.4 percent riding the wave of market's emphasis. Even the food care industry could have wide margins of growth in a country where the issues of healthy food and security are becoming more and more important.

The insurance sector is in ferment. There could be the room for the creation of new joint ventures between local and large international insurance corporations with the objective to leverage the "foreign" expertise in managing and delivering more and more complex insurance services in a local market characterized by new needs. On the other hand, local player will grant to insurance giants the opportunity to directly access the Chinese market: huge numbers and massive growth perspectives. Vast developments are also expected in the financial sector as Beijing is gradually opening doors to foreign investors and financial institutions. Non-governmental capital will be permitted to sponsor the establishment of small and mid-size banks and other such financial organs according to the law. There will certainly be challenging situations and the growing fear of the debt bubble burst does not help in this regard. China's top banks posted their biggest increase in bad loans since at least 2010[4] as a five-year credit spree left companies with excess manufacturing capacity and slower profit growth amid a cooling economy. The new deposit insurance scheme will protect depositors as China is worried that some smaller lenders are at risk of going under as banks compete for deposits in a more open regime.

Alibaba's entry into the lending industry "should give the nationwide banks some concerns about future competition", said Jim Antos from Mizuho Securities Asia Ltd, and other players will surely follow the path set by Jack Ma, *Alibaba* executive chairman. The reforms also include a re-boost of IPOs, which have been suspended in mainland markets for more than a year, making procedures to launch an initial public offering easier for firms although there is no reference at this moment.

All in all, the proposed reforms are part of China's grand transformation design: retooling the economy towards greater reliance on consumption, services, while tackling deepening inequality and discontent, sources of great anxiety for a leadership that prizes stability over everything else. Policymakers want to speed up the migration to bolster consumption and services, which they see as the future of the economy after years of investment- and export-led growth. US Treasury Secretary Jack Lew, during a stopover in Beijing[5] on his Asian tour, described the blueprint as "ambitious" and noted that key was how soon they would become reality: "The direction is significant, but the character and the pace of change matters", Mr Lew told reporters. At least CCP showed a strong commitment; it is definitely a good point to start with but there will be a long way to go.

References:

[1] *Official resolution of the 18th Central Committee of the Chinese Communist Party*

[2] Bloomberg: *China Reshapes Landscape for Firms From Alibaba to GM*

[3] Wall Street Journal, *China Details Ambitious Reforms*

[4] The Financial Times: *China banks' bad loans point to trouble ahead*

[5] NBC News: *China to relax one-child policy as part of economic, social reforms*

(read the executive summary of the Reform Plan below)

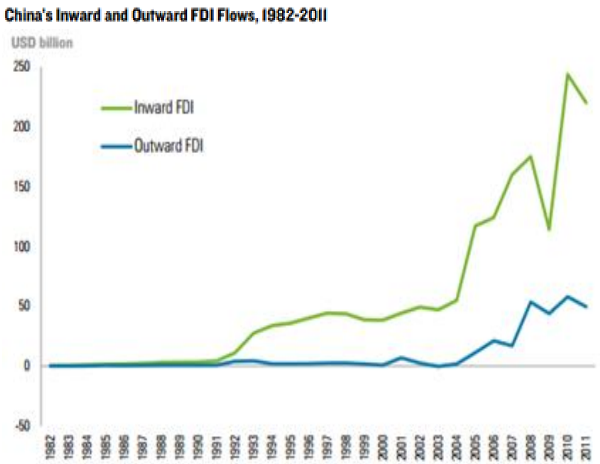
APPENDIX I: Reform plan executive summary extracted from the official resolution of the 18th Chinese Communist Party Central Committee

China's new reform plan – Executive Summary	
Market reform	▪ push pricing reform for oil, gas, power, water, transportation, telecom and key resources; ▪ accelerate Yuan convertibility, interest rates reform and revamping IPOs procedure; ▪ permit qualified private investors to set up small and mid-sized banks; ▪ allow local governments to expand financing channels for construction projects, including the issuance of bonds; ▪ set up free-trade zones in more areas; ▪ improve treasury yield curves to reflect market supply and demand
Property reform	Push through legislation for a property tax and go ahead with further reforms at an "appropriate time"
State-Owned Enterprise reform	▪ 30% of profits from state run will go toward public finances, principally social security; ▪ allow non-state involvement in Gov. projects; ▪ pursue a mixed ownership economy
Population reform	▪ relax the one-child policy. Couples may have two children if one parent is an only child; ▪ accelerate so-called *Hukou system* reform. Nowadays, under this system, migrants give up the public services they are entitled to when they move to urban areas. In future, this will allow people in rural areas easier to get residence permits in small and mid-sized cities; ▪ farmers will be granted to possess, benefit from and transfer their contracted land; ▪ study policies to delay the retirement age
Political reform	▪ abolish re-education labour camps; ▪ more emphasis on management of resource consumption, capacity and the environment; ▪ change policy of judging performance of officials primarily by growth rates achieved; ▪ strengthen anti-corruption measures
Legal reform	Reduce the power of local governments over the court system and move towards an independent and fair judiciary

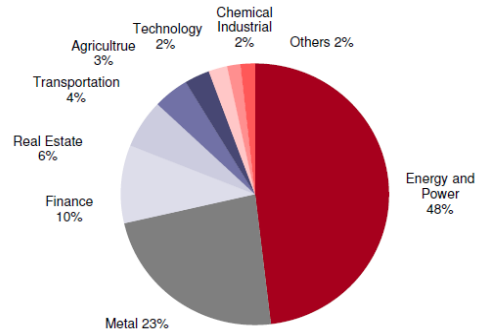
Chinese outbound FDI

By Marco Rastelli

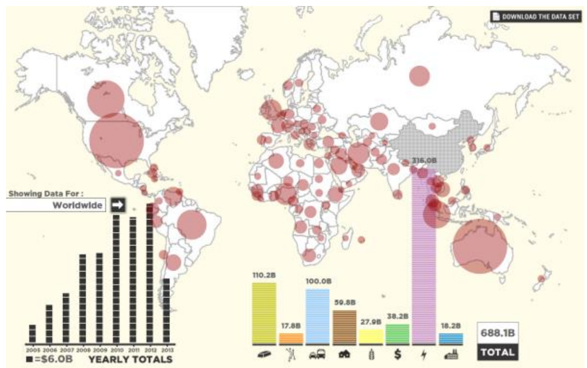
Despite the much-desired signs of recovery are slow to arrive, despite the constant turmoil, despite everything, foreign direct investment (FDI) globally increased in 2012 totalling at USD 1.5 trillion.[1] China keeps also moving forward on this way. Local private and public investors perceive at this time the impelling need to diversify their portfolio, continuing to make great strides in their level of outbound foreign investments targeting new strategic opportunities. Capital outflows have been strengthened throughout 2012 and first ten months of 2013, confirming the trend supported by a well-defined *going out strategy* and backed up by the local government.



Official data released by China's Ministries of Commerce and Finance exhibit that outbound FDI have topped at **USD 87.8 billion** in 2012[2] (+17% yoy), allowing the country to reach the podium for the first time in the annual FDI ranking. Beijing has set a series of ambitious targets in this regard. In his opening speech at the *Dalian Summer Davos Forum*, Premier Li Keqiang has confirmed that the government aims to sustain a 15% annual growth rate of direct outbound FDI to achieve the target of **USD 150 billion per year** by 2015[3]. However, in terms of stock, the volume of Chinese overseas investment topped at **USD 531 billion**[4], a mediocre thirteenth place in the world's ranking: one-tenth of US figure, a third of German level and a half of Japan. Still far from the leading positions but it seem that China has taken the right way. According to data provided by the *China International Chamber of Commerce for the Private Sector*, private companies accounted for 45% of China's total non-financial FDI in 2012, while the figure was only 14% and 20% in 2008 and 2011. To whom do these financial resources go? Chinese companies are massively investing in many industries: energy and power (48%), metal (23%), finance (10%), real estate (6%) and transportation (4%).



The main recipient of such direct capital flows remains Hong Kong with more than USD 30 billion, followed by the United States (USD 4.05 bn)[5] with a quick recovery from the 2011 decline. Looking at deals with USD 100+ million size, the *Heritage Foundation* exhibits that on over USD 688 billion[6] of investments, unsurprisingly, energy is still the main target for Beijing but, in addition, transportation construction contracts are prominent while commitment to the financial sector receded.



What are the real reasons that push Chinese investors to focus on these areas? Why they bet on energy and metals rather than food for example?

First and foremost China's commitment to oil, energy and power in general bases on solid grounds. The Government set a specific strategy with the goal of being as independent as possible by the other world's superpowers, considering these areas the turning points on the intricate chessboard of geopolitics. Although there has been a slight decline in figures, the financial sector is still relevant for Chinese investors. The main objective is to follow an expansion strategy aimed to transform Chinese local and international players into global banks through a crucial restructuring of the whole banking system. If we look at the metal industry, a further analysis becomes necessary. Investments in metal resources as well as commitments in the energy industry perfectly match with the above-described Beijing's strategy being so far independent but they also reflect the Chinese Communist perspective of having an exceptional heavy industry as a source of pride for the nation. If we consider that China is today the world's largest steel maker (China's steel output is expected to rise 9 percent from a year ago to a record high of about 780 million tonnes in 2013)[7] and if we think that putting together the steel outputs of the other nine countries belonging to the top 10 largest steel makers we do not reach the tons produced in Mainland China, we can get a better understanding of the situation. We need also to understand that most of the Chinese leading players that invest abroad do that to answer to the compelling need of geographically diversifying their risks and therefore when they look outside China they prefer to avoid venture in industries that they are not familiar with. This happens not only to companies involved in the steel industry but also for leading Chinese real estate developer. Many of them need to recalibrate their exposure to risks by investing in prime locations and prestigious properties in regions different from China and Hong Kong as well as where legal certainty and the stability of returns are granted.

Chinese investors are looking for full and effective protection of property rights, low levels of corruption and corporate taxation or regions where infrastructure and highly skilled human capital are available. But they follow also other logics. In fact, China is conspicuously investing in Africa and Latin America, where legal systems or local governments are not so transparent and stable. They want to ensure the access to cheap raw materials and natural resources markets. There is therefore no wonder if China's investors have injected a large part of their capital commitment in Asian countries since this chunk alone accounts for more than 60% of 2011 outbound FDI[8]. It would be a terrible understatement to mention only geographical proximity or strategic location. These countries offer low labour costs, minimum tax rates and deep expertise in oil&gas and mining, sectors on which, as we have seen, Beijing strongly bets when crosses the border.

References:

[1] International Trade Center, 2013

[2] China's Ministry of Commerce, *National Bureau of Statistics and State Administration of Foreign Exchange*

[3] Extracted from the full text speech

[4] Xinhuanet News, *Big investments but small stock*

[5] Xinhuanet News, *Big investments but small stock*

[6] The Heritage Foundation, *China global investments map*

[7] Reuters UK: *China's steel output to hit new record high*

[8] Xinhuanet News, *Big investments but small stock*

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