
China Visit Report
By Simon Hunt

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We once again turn our focus on China. Simon Hunt has been visiting China for many years and offers us his latest insight from a recent visit. Many analysts forecast the recent past into the future and the outlook on china is no different, but Simon says this is incorrect and China is about to go through a major change. As he sees it, China is changing its focus from growth at any price to one that might be a bit more rationalized.

This is a very important point and why this was picked for this week's Outside the Box. I suggest you put your thinking caps on as we take advantage of Simon's insider knowledge.

- John Mauldin

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Simon Hunt Strategic Services
By: Simon Hunt
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SUMMARY

- This note combines findings from our discussions in Beijing and plant visits with what we see is emerging from the NPC meeting.
- Less attention should be given to the detail and more to the thrust of policy, because this government is embarking on a new course for China's economy. The unwary will be

caught by surprise.

- Past policies have embraced developments that drove industrialisation at any cost, which enabled GDP to grow by over 9% a year since 1995. There were two elements that allowed this extraordinary growth to take place.
- First, key input prices, such as land, electricity and utilities, including water, were kept low through subsidies and controlled pricing.
- Second, cheap finance was channeled into industry, particularly to large companies and SOEs, often effectively zero cost capital.
- Local governments, over which Beijing had limited control, vied with each other to construct plant and infrastructure even if it made little or no economic sense.
- What followed was the world's largest ever fixed asset investment binge.
- Not only did these policies, which have been in place since the mid-to-late 1990s, create a gross surplus of capacity in so many industry sectors and throughout the manufacturing chain, but also the consequences were a degradation of the environment and a misuse of the country's natural resources, including energy.
- This orgy of investment has resulted in so much capacity that there is no pricing power and with costs, both inland and imported, rising rapidly, margins have become under pressure and the foundations for the next round of NPLs laid. Premier Wen Jiabao addressed this issue in blunt language (see below) in his speech to the NPC.
- The policy, introduced by Jiang Zemin, perhaps, arguably the correct one at that time, will now be abandoned. In its place, growth will be given a broader interpretation. It will include environmental issues and a better usage of natural resources, which are now viewed as strategic.
- In sum, energy intensity and improving air and land pollution are as important as the quantity of growth in the new policy. In other words, it is not so much the quantity of growth that is important, but its quality.
- A start will be made this year, the first year of the new 5-Year Plan. The main thrust will be to stop the continued development of duplicated capacity. It will be achieved by banks denying credit to all but their most credit worthy customers; manufacturing, especially in the private sector, will be hardest hit. This has started, as we have heard from friends.
- Second, over 100,000 local government officials come up for re-election both this year and next. The election procedure will be quite different; it will not be based on growth criteria alone, as in the past. It will mean that Beijing will end up having more influence over local governments than hitherto. And the change was probably the reason why there was such a jump in reported disturbances in the rural area last year.
- A corollary to this change is that Beijing will come down very hard on corruption.
- There will be a structural move away from energy and natural resource intensive industries towards the services sectors and IT industries. This is why government is forecasting electricity demand to grow by an average of 7% a year over the next five years compared with 10% a year over the last five years. Perhaps it also implies an implicit slowdown in the growth of industrial production.
- Natural resources, including energy, are now considered to be strategic; their use should not be frittered away on silly projects. Where products are exported, which have a high natural resource content, they will be discriminated against via taxes.
- A start has been made by imposing a 10% tax on certain copper and copper alloy

semis; we suspect that this will become much broader with consequences for global markets. It will mean that more of China's capacity of primary goods, steel, copper and copper semis, aluminum products etc., will be used domestically with a consequential impact on imported materials and goods. It also means that domestic producers will move up the value added chain to achieve this objective.

- The second major thrust in policy is to focus on the rural sector. This is not just because 57% of China's citizens live in the rural areas, nor because the income divide between it and the urban community has reached 3.2 times that of the rural sector, but also, because in the last 20-odd years the coastal cities have received the bulk of central government support. It is now time for the rural sector to become the primary focus of attention and for the richer coastal cities to support this development.
- Moreover, urbanisation has run its full course. Its development has been taking around 200,000 hectares of agricultural land each year. If these trends persisted, by 2020 China would lose some 25% of its farming land, something which no sensible government would allow.
- And costs of doing business in many of these cities have got out of hand. In fact, some say it is cheaper to relocate back to Singapore for many sectors.
- The corollary of slowing down urbanisation is to bring industry to the countryside, though no longer industry that is energy intensive – that trend has finished. This means also that the migration of rural workers will come to an end. China's surplus rural workers, which are probably, anyway, mostly in the age bracket of over 40 years, will stay at home as jobs will come to them.
- Farming will be restructured to improve its yield and in so doing labour productivity.
- China will persist with its step-by-step approach to the RMB; for the next few years it should appreciate by no more than 2-3% a year against the US\$.
- Where do these factors leave the economy? Two factors point to a slowdown, apart from the cyclical forces. First, a slowdown in the growth of bank lending will lead to slower growth in many sectors.
- In our factory visits, nowhere did we find that business was robust or booming, except for some companies that had niche markets.
- Second, Beijing will attack fixed asset investment. Both will be done via the banks; the credit spigots will be stopped for many companies and local governments, as we can attest to after talking with friends.
- This will establish the crisis environment from which restructuring will emerge. In the short term, there will be some pain, which will lead to lower output. Bloated inventories, which are seen in some sectors (and remarked upon by Premier Wen Jiabao), such as compressors, electrical appliances etc, will have to be liquidated.
- Moreover, government wants to see further price adjustments in the real estate market, especially in Shanghai. Here prices have fallen by some 15-20% since the peak, but need to fall another 20-25%. It is expected that this price adjustment will not be completed until end 2007.
- Other parts of the economy should continue to blossom, such as consumption, but not enough to prevent a significant slowdown.
- And should the US economy slow in the second half, as we expect, due to issues related to housing, exports of goods will fall more than government is now forecasting.
- How much of a slowdown is difficult to forecast. But, in our view, real GDP will fall

to under 8% this year and around 7% in 2007; manufacturing will be hit harder as so much of industry will be restructured and this sector accounted for 41% of GDP last year.

- Against this background, it is interesting to note that our friends in Shanghai are very positive on China's stock markets.
- For the longer term, what we find is worrying is the large increase in costs. Skilled wage rates are rising by 30-40% a year and unskilled by 10-20%, depending on location. But all other cost inputs are rising and are threatening to do so at higher rates – electricity, fuels, water, land etc.
- We hear of companies quietly leaving China for other shores, but some like Flextronics, have publicly aired their concerns. A combination of these cost increases together with a modest revaluation of the RMB over the next five years could accelerate this trend out of China.
- Once industry has been restructured, say in 3-5 years, pricing power will return. Profitability will be the motto, not critical mass. Then, China will no longer be exporting deflation. And then, the rest of the world will need to watch out for a different set of dynamics, because other countries will not go down the route of creating critical mass at the expense of profits.
- Global consumers will find that prices for so much of what they buy now will be rising. 2010 may see the start of this period of rising prices for goods like appliances.

The annual National Peoples Congress is almost half way through its sessions. Enough has been said to know the drift of future policy.

The debate between the conservatives, who want to roll back many of the reforms, blaming them on the growing economic and political divide between the rural and urban communities, and the reformists, who respond by saying that reforms have not yet gone far enough, is all but over.

The reformists have won, despite having to postpone the introduction of the new property law. Premier Wen Jiabao stated, *"The decision to implement the reform and opening up policy constitutes a major decision on the destiny of our country...Reform is now going through a very difficult period, and we must strengthen our resolve to accelerate all reforms and continue making progress in major reforms."*

What does this all mean? We set our conclusions out in a brief "In" and "Out" balance sheet.

Out:

- Economic growth at all and any cost
- Central government focus on the development of coastal cities growth
- Degradation of the environment
- Wasteful use of energy
- Misallocation of capital.
- Duplication of capacity

- Corruption
- Dependence for growth on trade

In:

- Growth that adds value to the economy and its people
- Narrowing disposable income between rural and urban households
- Deploying funding to the rural sector, not just this year, but over the longer term
- A focus on the intangibles of growth, such as education, Health care and the creation of a social security network. None of these can be implemented as instant policies but have to be thought through over the next couple of years to produce a coherent set of initiatives.
- Industry restructuring
- The environment
- Husbanding the country's natural resources
- Profitability, not the creation of critical mass
- Bank lending to be based on proper risk assessments
- A balanced economy with greater emphasis on consumption
- Increasing focus on technology, in the process moving away from low-technology industries.

In short, this leadership is moving China away from being just the workshop of the world towards a country where the profits are shared more evenly and where so much of the baggage that has accompanied this massive industrial growth starts to be eliminated. This baggage takes four main forms:-

1. The environment
2. Wasteful use of energy
3. Industry surplus capacity
4. Growing income and wealth divide between urban and rural areas.

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1. The environment

Anyone who has traveled through the countryside will be appalled by the filth in the streams and rivers that run through towns and cities. China's factories, other than some new higher-tech ones, belch pollution into the atmosphere making it difficult for ordinary people to live in many of these towns.

Howard French's letter in the Herald Tribune of 9 March tells it all. *"During a jaunt of several days through Hebei province (which this writer visited last September and can attest*

to this description), which borders on Beijing, I never once saw the sun in the sky. What I mean by this is that the air appeared thick as gruel, due to the heavy burden of particulates that come from coal mines, steel mills and other smoke-stacked industries."

The list of recent environmental accidents need not be repeated. Suffice to say that 70% of the country's rivers and lakes are seriously polluted. WHO reports that two-thirds of Chinese cities have air quality below standard, of which nine are in the world's top ten of the most polluted having the highest rates of carbon monoxide. Anyone who has visited some of these cities will know just how bad pollution has become. Chinese government estimates that around 400,000 people die each year of diseases related to air pollution.

But, in recent years government has put a lot of effort towards fighting air and ground pollution, often with its dictates being ignored by local governments. The Environmental Protection Administration (SEPA) has been given added powers to overcome local government influence. One way, for instance, is by having the authority to freeze a company's accounts if they ignore SEPA's rules.

China is moving also on several fronts to limit air pollution. Its fuel efficiency standards for new cars are now stricter than those in the USA. Beijing has the largest fleet of natural gas buses in the world (1700); and China is undertaking research with W European companies to drastically reduce emissions from coal fired power stations. Furthermore, China's nuclear Pebble-Bed Reactor (PBR) will be capable of producing clean electricity. These plants are small enough to be assembled from mass-produced parts and cheap enough to be available in large numbers. They come with the ability of having no spent fuel rods and are meltdown proof.

China will no longer allow low-tech plants, which are environmentally unfriendly, to be built. This prohibition won't be effective immediately, but it will become totally effective over a five-year period. We will see this in basic industries such as steel, aluminum and copper, for instance.

Government is also starting to impose export taxes on goods that are energy and/or natural resource intensive. The recent 10% tax on the export of certain copper and copper alloy semis is a start.

In short, both environmental issues and improving natural resource, including energy, usage has a very high priority. The first is because China will ruin itself if current trends to continually build low-tech industries persist; and the second is a need to husband precious resources.

2. Wasteful Use of Energy

China's energy intensity has improved dramatically since the 1970s but is still well below international levels. Government is focusing on improving its use of energy with a goal of cutting it by 4% this year and by 20% in five years.

There are three basic ways of achieving this objective. The first is to do away with building surplus industrial capacity (see following section) and the second is to introduce modern technology in the use of energy. The third is to ban the export of products that are low-tech and are energy intensive. (see Thursday's export tax of 10% on certain copper and alloy products).

To meet the challenge, indices of national energy consumption will be published in connection with the growth rates of GDP, starting this year. The new "green" index will be applied to local government to assess the quality of growth in the region rather than just the quantity.

Cynics will say that these officials will simply turn a blind eye to these proposals and continue with their wayward ways. But there is a twist. Some 100,000 officials of the ruling Communist Party's committees at provincial, municipal, county and township levels are facing re-election both this year and in 2007.

A new cadre appraisal system will be employed which focuses on their popularity rather than their efforts to pursue GDP growth. In the past, it was GDP growth that was the primary appraisal method. The new election system will include the use of public opinion polls, analysis of political achievements, face-to-face discussions and comprehensive assessments, according to an official from the Organisation Department of the CPC Central Committee.

In and of itself, this is a far-reaching development in China's step-by-step move towards a form of democracy, but it is also important in ensuring that guidelines from central government are adhered to. (This will have an impact on FAI, for example). Thus, the centuries old battle between the centre and the provinces is again swinging back to the centre, because those elected will owe some allegiance to Beijing.

Government's goal is to reduce energy consumption per unit of GNP by 16% from 2.68 tons of coal equivalent in 2002 to 2.25 tons in 2010 and 1.54 tons in 2020. By 2010, the goal is to bring energy usage for major industrial products, such as steel, aluminum and electricity up to the levels seen in the Group of Seven countries in the early 1990s.

Several development plans have been initiated to reach this goal, such as the development of China's own liquidization and gasification projects to produce clean energy from coal; and the ten-point plan to reduce energy usage in the construction industry.

3. Industrial Surplus Capacity

This is the heart of China's problems. Manufacturing accounted for 41% of GDP last year, according to Jim Walker of CLSA. The policy initiated by China's former president was growth at any and all costs. There developed what we have termed China's trilogy of local company, local government and local bank. Each had a vested interest in building whatever plant was in vogue, whether a steel mill, a power station, an aircon factory or a copper tube plant and so on. Very often these plants were financed with zero cost capital. The result was

the development of huge surplus capacity, which has caused margins to shrink, in many cases sale prices are below cash operating costs (we know of one company selling its brass mill product at material cost!) and which lays the foundation for the next round of NPLs.

One new example of a sector that is moving from shortage to surplus is the country's electricity generating sector, according to Zhang Guobao, deputy head of the NDRC. Electricity production is expected to reach 570GW by the end of this year. By 2010, total installed capacity should be at least 750GW, up from 500GW late last year. Electricity consumption is now forecast to rise by 7% a year over the next five years compared with an average of 10% a year over the last five years.

This slower rate of demand is a product of curbing investment in energy intensive sectors, such as steel and machinery and encouraging growth in the services sector and IT industries, which are not energy intensive. It may also be a product of a slower rate of growth in industrial production.

We have written about this conundrum repeatedly and we know, from our discussions, that this subject of capital misallocation and duplication of capacity has been high on the leadership's agenda for the last few months. It culminated in a very interesting paragraph in Premier Wen Jiabao's speech to the NPC.

"Production gluts are increasingly severe, prices of related goods are falling and inventories are rising. Business profits are shrinking, losses are growing and latent financial risks are increasing. Over-investment and over-capacity are undercutting the efficiency of China's economy and collecting a mountain of bad loans in the banking sector."

There you have it; the issue is formally recognised. Internally, the leadership is so worried by the consequences of this stupid competition between local governments to build whatever capacity they think is in vogue that they talk of a recession if the trend is not broken.

One way that this process of industrialisation was promoted was by keeping prices of energy, electricity, utilities, including water and land, low, via subsidies, and by not being able to enforce strict environmental regulations. It was a free-for-all environment. The process was also made possible by the availability of finance on very favourable terms, especially for SOEs (zero cost capital).

But, this free-for-all has come with a cost: falling profitability, weak return on capital, wasted capital, the risk of a new round of NPLs, the degradation of the environment, a wasteful use of the country's natural resources and in buying land from farmers at agricultural prices and selling it at prices for factories and buildings created an environment that was open to abuse.

All this is about to change. Change won't come all at once but it will start this year. First, government now considers natural resources to be strategic. This means that they should not be used wastefully and it might imply the re-emergence of central control in this area.

Second, over the next 3-5 years, industry will be restructured. Restructuring always emerges from a crisis. The crisis will come from a shortage of credit. Banks will be risk averse this year and will not issue loans to any but the best credits. Bank loan growth will slow this year. Hardest hit will be the manufacturing sector, especially in the private sector. It is this clampdown on bank lending that should lead to industry being restructured. What will follow will be mergers and bankruptcies.

The objective is to introduce the concept of profitability and return on capital rather than the creation of critical mass. Achieving this objective will be helped by changes in the composition of local governments, as detailed earlier.

In recent days we have had anecdotal confirmation of banks tightening up on their issuance of credit lines. One FDI Company told us that for one of their factories a major bank refused to renew their facilities and for the remaining factories they had to work much harder to have them renewed.

A major importer of garden furniture to the UK told us three interesting things: one that his many suppliers in China were having large problems with working capital and getting bank credits, second that for the first time they were not prepared to fix prices for the year, because of rising costs and, third, that payment for the goods, which always had winged straight back into China, is staying outside the country.

Third, much stricter curbs will be placed on land acquisitions. Too much farming land is being lost to urbanisation. If current trends persisted official data shows that almost 200,000 hectares of farmland will be lost each year for development purposes. By 2020, this would mean that around 25% of the country's farmland would be taken over for development purposes, the sort of figure, which is unacceptable.

4. Income Divide

"Making industries feed the countryside and cities support rural regions in return is not only an economic move to balance the national economic picture. It is repaying a long overdue moral debt. We must address the rural-urban divide, not because it has become a clumsy drag on national development, but because the countryside is home to the majority of Chinese citizens." Leader in the China Daily.

Last year, urban per capita disposable income rose by 9.6% to RMB 10,493, but the rural equivalent increased by just 6.2% to RMB 3,255. Thus, the urban growth rate was over 50% faster and the actual income was 3.2 times greater. When account is taken of intangibles, such as education etc. the disparity is even greater.

57.4% of Chinese citizens live in the rural areas, or 739 million last year. 57% are of a working age, 12% are over 60 and 31% under 20.

Improving the lot of the rural worker is not just to eliminate the risk of social instability, but also to develop a new consumer market. Many products in the big cities, like aircons and

other household appliances have become mature markets dependent on the replacement market, partly a product of the country's demographics. The rural sector is underdeveloped for many consumer appliances, because many of these appliances are considered luxury goods for the moment. Nor will the rural sector become an instantaneous new market. It will take a few years for the average rural household to raise its disposable income level to the point that it will start to become a significant buyer of these goods.

Government's focus on the countryside has other aspects too. It wants to attract industry to the rural sector, where wages and land etc are often one third or so cheaper than in the coastal cities. It intends to improve farming yields and thus labour productivity. It will introduce laws that give farmers due and rightful compensation for land that they have lost the right to farm. It will restrict land taken for development, which is also a natural corollary of slowing fixed asset investment. The migration of labour from the rural areas to the coastal cities will slow and should almost stop in five years.

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This development will have implications for the wage structure of the country. Rising wages will mean more consumption, but a less competitive global workshop. With China now starting to husband its natural resources and setting environmental costs to the market place, China's days of exporting cheap goods are fast ending. The consequences of this change in direction are global. And it will diffuse the confrontational pressure on trade issues.

The implications of what we have discussed are far reaching for China's economy and for the world. The transition from rapid growth, or growth at all costs, to one that is sustainable and which adds value to the economy and its people is now starting. Watch out!

Your excited about China's future analyst,

A handwritten signature in blue ink, appearing to read 'John F. Mauldin'.

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