China, Quo Vadis?
Publications

• Third Plenum ‘reality check’: taking stock of the Chinese Government’s reform progress

• Conducted with Roland Berger
Launch of First Three Local Position Papers in 2015
Launch of Two More Local Position Papers in 2016

Tianjin Position Paper published in March 2016

Southwest China Position Paper published in April 2016
Overcapacity in China

- Analysis of eight severely affected industries
- Builds on 2009 report, providing completely updated analysis
- Provides 30 recommendations to tackle the problem
- Received an unprecedented media coverage
### 4) Your Industry

#### 37A. Is there overcapacity in your industry sector?

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Note: Excluding Not applicable

Source: Business Confidence Survey Data, Roland Berger analysis
Survey on June 7th 2016
2) Financial Information

8. How did your company's total Mainland China revenue for 2015 compare to 2014?

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<th>Industry</th>
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<th>N=17</th>
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<td>IT &amp; Telecom</td>
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</table>

Source: Business Confidence Survey Data, Roland Berger analysis
2) Financial Information

Crossing with industry

10A. Please characterize your company’s earnings before interest and tax (EBIT) in Mainland China in 2015.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Positive</th>
<th>Broke even</th>
<th>Negative</th>
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<tbody>
<tr>
<td>Machinery</td>
<td>66%</td>
<td>20%</td>
<td>14%</td>
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<tr>
<td>Chemicals and petroleum</td>
<td>80%</td>
<td>10%</td>
<td>10%</td>
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<tr>
<td>Media and publishing</td>
<td>72%</td>
<td>22%</td>
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<td>Automotive and auto components</td>
<td>70%</td>
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<td>Pharmaceuticals</td>
<td>50%</td>
<td>33%</td>
<td>17%</td>
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</table>

Source: Business Confidence Survey Data, Roland Berger analysis
2) Financial Information

10B. How did your company's EBIT in China for 2015 compare to 2014?

Source: Business Confidence Survey Data, Roland Berger analysis
Commonly cited, but weakly supported in reality:

- China has time
- Muddling through is a viable option (even if suboptimal)
- **China has the tools/resources** to deal with anything slowing down can bring
- China’s leaders recognize the problems
- China’s Leaders can fast-track reform
The New Normal

Source: The Economist
Join the high-flying Chinese stock market

Oh nothing... probably just more champagne corks...

What's that sound?!!
Economic weakness: but regional differences

GDP: percent growth, quarterly, y-o-y

The growth trend started around 6 percent back in 1999

The slowdown will not be linear, but the growth cycle will revolve around a slowing trend

Growth volatility has eased substantially since 2013 as policy support has tempered the pace of the slowdown

Sources: NBS, CEIC, The Conference Board  *stylized growth outlook, not actual projections*
“China is growing at 6.7% in 1Q16 and broadly stabilizing”, but ..............

- The recent improvement in China’s industrial sectors is due to the government’s fiscal and quasi-fiscal spending ramp-up in the second half of last year by 16%, or RMB2.4tn.

- In Q1, increases in total credit exploded to RMB7.5tn, up 58% YoY and equivalent to 47% of nominal GDP – the highest ratios ever.

- Considering also swaps of local government debt into local government bonds, total credit to the non-financial sector actually increased nearly RMB3tn in March.
Chinese equivalents – population

Population 2010, millions

Source: The Economist; Economist Intelligence Unit; CEIC; WTO
Continent China

Chinese equivalents

Nominal GDP PPP, 2014 (US$bn)

- 0 to 250
- 250 to 500
- 500 to 750
- 750 to 1,000
- 1,000 to 1,500
- Over 1,500

Source: Economist Intelligence Unit
The two-speed economy
Li Keqiang: 20% of provinces insolvent
The Continent China Real Estate Market

Estimated housing inventory (cumulative starts minus cumulative sales), by province

- Province total
- Excluding Tier 2 cities

Wind, Gavekal Data/Macrobond
In urgent response to 2015, Q1 stimulus reached new heights
6.6 trillion RMB in new TSF in Q1; and 4x that in interbank lending

Sources: PBoC, CEIC, The Conference Board

Sources: J Capital, The Conference Board
By order? SOEs resume investing

FAI growth: SOE vs. private sector, percent

FAI growth: contribution from SOE and Non-SOE

Sources: CEIC, The Conference Board
Debt is rising much faster than output

- An increasing share of debt is allocated in excess capacity sectors. Eventually, such costs will have to be borne by the financial sector and eventually by savers, asset prices will have to correct, corporate profitability may be depressed, and future growth will be hurt.

- Assets exploded by a record RMB27trn ($4.1trn) in 2015, rising by 15.7% to RMB200trn.

- There are significant limitations to continuing to expand a $31trn banking system by $3 to 4trn in assets per year without resorting to increasingly speculative funding strategies.

- China now accounts for 28% of the global stock of M2, significantly higher than in any other country.
China’s companies have taken on $10trn of debt in the past eight years (10% in Forex)

In 2007 China’s Total non financial debt to GDP ratio was 147%.

Now it is at 260% and climbing, possibly 300% in 2020.

Total debt RMB152tn ($23tn).

Source: FT
$512bn fall in currency reserves in 2015
China has a current account and net direct investment surplus of about $600bn, implied capital outflows must have been close to $1tn

Source: The Economist
Waking up to a critical “loss in translation”....

Reform vs Re-Form

- Liberalization
- Marketization
- Institutionalization
- De-regulation
- Transparency

→ More Market Driven

- Pooling
- Recombination
- Recapitalization
- Control changes
- Extraction

→ More Statist
2) Regulatory Framework

Crossing with industry

26. Has the continued strengthening in measures to tighten Internet control and access restrictions in China been having an even bigger negative impact on your company?

Source: Business Confidence Survey Data, Roland Berger analysis
4) Your Industry

36. How would you describe the business outlook for your sector in China over the next two years? (1/4)

Source: Business Confidence Survey Data, Roland Berger analysis

1) NA: Not applicable
4) Your Industry

36. How would you describe the business outlook for your sector in China over the next two years? (1/4)
1) The Role of China in Your Business

Crossing with industry

46A. Does your company plan on cutting costs in China this year?

Source: Business Confidence Survey Data, Roland Berger analysis
Summary and outlook
The economy looks different to SOEs, POEs, and MNCs

The Last 6 Months –

- Weak 2015 year-end and January offset by a huge credit surge – and its impacts – in Q1
- Resulting uptick of volatility in asset classes and massive swings in investment flows
- Fundamentals continue to deteriorate – investment, industrial performance, trade
- Services and consumption growth rates are also now slowing
- Debt drag is increasing, consuming more of the new liquidity and shifting the grave risks of credit expansion into financialization channels

The Near-Term Outlook –

- More of the same – credit and liquidity support when things over-slow; shuffling away of debt problems in any and every way possible
- Depreciation is more and more likely – 7:1 range expected, accompanied by tightening of capital account processes to slow outflows
- More clamps on re-leveraging
- Stronger and stronger macro-prudential measures and financial innovation to mitigate, mute, obscure, and suspend defaults
- Continued stagnation of the industrial sector

SOEs
- Reform pressures increasing amidst mixed signals
- Continued access to vast credit leaves little incentive to reform

POEs
- Main source of market-sourced capital in system
- Aggressive M&A off monopoly market shares

MNCs
- Consumer interest and demand rising
- Regulatory walls and costs rising

Source: The Conference Board