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The China *Temptation*

Are Western investors being foolhardy?

BY PHILIPPA MALMGREN

Do you believe that the best business managers in the world are the communist leaders of China? Most investors seem to think so. Billions of dollars are being thrown at firms in China that are either directly controlled by the Politburo or subject to micro-management by politicians to some degree or another. After all, who decides whether the state-owned banks will make capital available to businesses that are engaged in construction or those that are involved in supplying auto parts? Who really makes the decision to invest when Chinese state-owned or state-backed firms start to engage in foreign deals or make acquisitions of a foreign company? That would be the Politburo.

Of course many state-owned firms have been given a high degree of autonomy in their management of the balance sheet. But we cannot ignore that fact that Chinese companies have become the darlings of the mergers and acquisitions professionals. When a Chinese state-owned firm announces its intention to expand internationally or acquire a foreign firm, the order comes from Beijing. These firms do not want their investment banking advisors to prepare any cash flow analyses or profitability parameters because those tasks are plainly irrelevant. The point is simply to identify the price at which the deal can be done.

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—P. Malmgren

People's Bank of China *headquarters, Beijing*

AP PHOTO/NG HAN GUAN

No deal is too risky and no price is too high to pay if Beijing has ordered it to happen. That means fantastic fees for the advisors (with very little work) and it should raise some questions about the use of capital.

Perhaps we should also be asking about who these decision makers are and what they know about investing. It seems that only one member of the standing committee of the Politburo (where all the instructions come from) has any market experience or any international experience. Happily we can all be reassured that comrade Luo Gan was educated in engineering at the Karl Marx University in the former East Germany where he then spent eight years working in a steel factory. Unfortunately, this reservoir of market experience is now being deployed on "interior" matters rather than asset allocation decisions.

Let us consider Beijing's priorities. Obviously, there is an overwhelming need to secure access to oil, raw materials, and even food. Strategic security priorities are driving the allocation of capital. Consider Beijing's offer to build an oil refinery for Mr. Chavez in Venezuela. Or, consider the efforts by China to become the largest buyer of oil from Iran. The Iranian oil minister has welcomed China's efforts and said that Iran is glad to see China displace Japan as the nation's largest buyer of oil. In order to secure the deal, China had to offer Iran satellite navigation technology which has now given Tehran the ability to accurately aim their modified Taepo-dong missiles (as is evident from recent missile tests). The United States is so angry about this technology transfer the State Department has legally sanctioned eight Chinese companies (all of which are owned by the military and therefore controlled by Beijing). It is not surprising that these same firms (like Norinco) are now building Tehran's new metro system, among other things. Is building a metro in Iran a profitable venture? Perhaps it is, if it allows China to secure years of access to oil.

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Consider also the efforts to reach out to resource-rich but broken or weak states—Sudan, Sierra Leone, West Africa and the many Caspian "stans" (Turkmenistan, Uzbekistan, etc.). No doubt it makes sense for China to go wherever they have to in order to secure oil supplies. But, perhaps there are good reasons that Western firms will not touch these places with a ten foot barge pole. This is not only because these places are difficult but because they are probably not profitable considering the risks.

Somehow, it is difficult to imagine the state-owned enterprises and the state-owned banks that lend capital to them telling Beijing that these deals may be good for the nation but they are not necessarily good for the nation's balance sheets.

It also matters that these very deals which are good for the nation but questionable for the balance sheet are provoking the ire of China's largest trading partner, the United States. American hardliners are not very happy to see Venezuelan oil supplies diverted from the U.S. market to China, nor are they happy to see Mr. Chavez secure a stable source of income for the next quarter century (Beijing tends to cut long-term deals at fixed but renegotiable prices since capital is free and profitability does not really matter). It is fairly apparent that the satellite technology-for-oil deal between Iran and Beijing has unnerved the Americans and even the Europeans.

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The blurry line between China's commercial and national interest becomes further apparent when we turn to the arms embargo. China has told France that it will buy every Airbus the French can construct if they get the arms embargo lifted. Germany has been told that their engineering firms can participate in every new power generation project, if they get the arms embargo lifted. Is Beijing really so sure that Airbus offers Chinese airlines the best value for money or is this really about using commercial enterprises and commercial deals secure China's strategic security objectives?

Recent protests in China against Japan raise another issue for the markets. For Beijing, anti-Japanese sentiment is seen as a unifying force. Only when the protesters started to gather in real numbers (in the thousands) did Beijing put a stop to it. Beijing was simply worried that protests against Japan, or any other cause, show the public that protests are possible and therefore anti-Beijing protests might ensue. They did not have any qualms about allowing the Chinese public to protest against one of the largest suppliers of foreign direct investment in China—Japan. They were not worried about jeopardizing foreign capital. So, when we see China and Japan start skirmishing over a tiny disputed oil-rich island in the Pacific, we should not be surprised. Beijing would certainly be willing to jeopardize the flow of capital from Japan in order to secure a flow of oil.

No doubt it is perfectly reasonable for China to have such security objectives and it is reasonable for China to pursue its national interests. But the question is whether this is the best way for Western capital to achieve profitability, performance, and returns. If not, then why are we handing over our hard-earned money to firms that are being used as pawns in a political power game?

Let us go one step further. China's pursuit of strategic security interests is now increasingly aggravating China's largest trade partner, the United States. The United States is not happy to see China reaching out to America's ideological opponents or those that pose problems for the United States including Venezuela, Cuba, Iran, and the Sudan. China's efforts to use its commercial power to drive a wedge between America and its European allies over the arms embargo are not welcomed by Washington. But there are other even touchier subjects like North Korea. For some time the Americans have believed that China is using the six-party talks as a means of managing the Americans rather than as a means of managing the North Koreans. The United States is increasingly suspicious that Beijing has been facilitating the Hermit Kingdom rather than seeking to contain it and undermine it, as the United States would prefer. The recent tension over Taiwan between the two countries rather speaks for itself.

On top of all this, Beijing is not responding to Washington's demands for a currency revaluation. But here we arrive back at the crux of the matter. For Beijing, the strategic security interests drive their decision making. The United States may have pushed so hard that it is impossible for China to take action. They cannot give in to the bullying superpower and retain their stature in the eyes of the world.

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Meanwhile, Beijing worries that the economy cannot comfortably handle a revaluation. They believe that changing the price of the currency would destabilize the nation and therefore be a risk to national security. If anything, they are terrified that a change in the currency mechanism would lead to a devaluation of the yuan, given the huge amount of money that wants to leave

China. That is why the Politburo has ordered the technocrats at the central bank to come up with ways in which they could announce a change in the currency mechanism which will ensure that the actual price of the currency does not move. This concept comes as a surprise to most investors, who assume that a price change is the whole point of the exercise. It will come as a terrible shock to the Americans who will be enraged if China can say they have complied with America's demands but without actually having an impact on the price of the exchange rate. And, the Chinese will say, of course, that is a typical Chinese solution to such a problem.

If there is any doubt about this, think for a moment about who is on the other side of all those trades which are betting on an imminent revaluation announcement from Beijing. Can we really be surprised to find that Chinese banks are making a fortune out of every story that hints of a currency announcement from Beijing? Do we really think that Beijing is going to tell the Chinese banks to go ahead and take the sell side of these bets and then damage their own banks by surprising them with a dramatic announcement?

If Beijing is indeed thinking along these lines, then we should not be surprised to see the U.S. Congress react very violently. Democrats in Congress are already arguing that the President has done nothing to protect Americans from the China threat. But the Schumer bill will show that Democrats can protect American jobs from being moved to China. Republicans in Congress are worried that the Social Security agenda is a vote loser. They are happy to jump on the China-bashing bandwagon or any other vote winner. And the hardliners on both sides are so angry with China's strategic security strategy that they believe that a dose of Congressional "shock treatment" would be helpful. And so, protectionism is supported by an unholy but rather broad alliance.

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Both sides ask themselves, "Who will be hurt most by a trade war between us?" Beijing says the answer is obvious—Washington. And Washington says the answer is obvious—Beijing. Neither side believes they have much to lose themselves. That makes it difficult to resolve differences. Into this vast gulf between the two most important engines of growth, China and the United States, investors are happy to keep throwing their money. While U.S. firms move their cost base to China, congressmen seek to penalize that decision. While capital moves into China, the Politburo seeks to deploy it in ways that may be suboptimal. As the tension grows between the two superpowers over economic and security issues, investors will take fright. That cannot be good for the world economy.

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It is ironic, but the United States and China share one common economic goal. Both sides believe that their economies are too capital rich, too speculative, and therefore interest rates will need to rise. Obviously if Beijing is not going to materially change the currency regime, then the only way to slow the economy to a sustainable pace is to raise interest rates. The Federal Reserve has reached much the same conclusion: rate hikes are necessary to end the speculative behavior.

So investors should be asking themselves whether it makes sense to hand over their capital to an economy where the national security interests of the nation dictate the use of balance sheets much more than the investors' needs for returns. Does it make sense to deploy capital into China when the disputes between the United States and China threaten to disrupt the performance of capital in a fairly profound way in both economies? Finally, does it make sense to continue deploying capital at all when the two engines of growth are tightening monetary policy? Given all these risks I hope that they bring back Luo Gan from interior security matters to figure this mess out. On the other hand, if they don't get this all figured out they may well need Luo Gan's skills right where he is, in order to maintain political stability in China. ◆