“Blue Skies” Thinking in China

The Chinese leadership is now promising “to make our skies blue again” in a popular move to address an issue that has given rise to public protests across China against the industrial smog that blights so many cities. The solution to a pressing economic problem is now linked to an emotive popular issue. The pollution is the result of coal burning by heavy industry, the very sector that is weighed down by excess capacity and debt, which threaten China’s economic survival. The government needs this sector to cut debt and capacity but they have encountered resistance from local governments and vested interests. Environmental reasons have been used before by central government as a tool to push through change. Now they appear to be leading with it.

At the opening of China’s annual National People’s Congress the premier, Li Keqiang promised “We will make our skies blue again” by tackling pollution caused by coal burning for heat and power. The economic growth target has been set at "around 6.5 percent or higher, if possible." This is lower and more flexible than last year’s target and suggests a more determined approach to economic reform and closure of excess industrial capacity at the expense of growth.

China produces over 1 billion tonnes of steel and almost 3.5 billion tonnes of coal each year, far more than China needs. Over the next 3-5 years it is China’s stated aim to close 140 million tonnes of steel and 800 million tonnes of coal capacity and there are those who say that it too modest. Many feel that progress toward addressing excess capacity and the growing debt issue associated with it has been too slow.

Debt concerns have dominated the minds of investors and policymakers alike in recent years as the rate of new lending has increased as over twice the rate of economic growth. Fears of imminent collapse have been misplaced as it is clear that China does have the capacity to absorb more. But two things are also clear: they cannot do so indefinitely, and the longer the problem persists the harder, and riskier, it will be to unwind.

The obstacles are significant. Excess capacity industries tend to be major employers and tend to dominate the local economies. They are often poorly run and require both economic growth and new credit to survive. Under China’s more complex system of government the central government often does not have direct control over much of this excess capacity. (For example, the State is said to control no more than 50% of China’s steel industry, limiting its ability to take direct action.)

There are also, often substantial vested interests associated with these businesses that have grown up under China’s investment boom. Career prospects for local government officials have long depended on delivery of economic growth and the process of deleveraging and industrial closures have the opposite effect. In China, economic clout and patronage are bound together with political power.

This emphasis on environmental issues by the leadership represents a shift in approach. They are aware of public concern about pollution – there have been widespread protests – which are always a worry to the leadership. But the leadership too is frustrated with the slow progress made and the foot-dragging by local business and government officials. So environmental issues, in response to popular demand, is the stick with which to beat them. And by introducing some flexibility into the growth target, local officials now know that their future career prospects are now dependent upon something other than economic growth.

This is a reminder for investors that economic growth is not an appropriate yardstick on which to base an investment decision. The policy now is to trade off higher overall growth for slower, more profitable and therefore more sustainable growth. Instead, investors may want to think about the specific stock they want to buy. China is now more integrated than ever into the global supply chain for high end products both for industrial and consumer customers. We believe there are good quality businesses operating in these areas whose valuations are depressed by the ‘China discount’ which means there are opportunities for those ready to take a good look.