



# Chi on China

FOR PROFESSIONAL INVESTORS – 10 January 2018

## CHINA'S ANTI-CORRUPTION WAR – PROGRESS, OUTLOOK AND IMPLICATIONS

*This is no time for ease and comfort. It is time to dare and endure.*

*Winston Churchill*

### SUMMARY

- Some investors are wondering if China's war against corruption has gone far enough so that its negative impact on Chinese growth and in particular demand for luxury goods (and, hence, on the performance of luxury goods stocks) may have come to an end.
- The ultimate question for the market is whether reducing the role of the state in the Chinese economy, as conventional wisdom has it, will allow market forces to clean up corruption, improve economic efficiency and, hence, increase the valuation of Chinese assets?
- Evidence argues that China's war against corruption still has a long way to go. Chinese demand for luxury goods should improve in the long-term by improving growth quality and industrial upgrading, but not dependent on the truce of the anti-corruption war.

Academic research has not been able to conclude with conviction a correlation between corruption and economic performance of a country because bribery and economic performance can feedback effect on each other through other unobservable factors (due mostly to the lack of data). However, the consensus is that corruption obstructs the law of economics from functioning and, hence, hurts economic growth.

World Bank data shows that the average income of countries with high level corruption is only about a third of that of countries with low level of corruption, and the infant mortality rate in such countries is three times higher and literacy rate is 25% lower. The theoretical justification for such evidence is that corruption leads to dead-weight loss via collusion in the form of monopolies and/or oligopolies. Corruption also has a negative effect on



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the quality of education and healthcare by increasing the cost of these services, thus leading to higher illiteracy and infant mortality rates.

## PROGRESS ON CHINA'S WAR ON CORRUPTION

In a nutshell, corruption hurts economic performance by misallocating resources and distorting wealth distribution. President Xi Jinping is well aware of corruption's destructive potential, which could also undermine the legitimacy of the Communist Party to run the country. Hence, he has embarked on a massive anti-corruption campaign since he came to power in late 2012 that is unprecedented in scale, scope and depth.

Between 2013 and 2016, the campaign resulted in dismissal and different forms of sanction (ranging from jail terms, even capital punishment, to deprivation of political rights and expulsion from the Communist Party) of more than 440 provincial officials, 8,900 municipal officials, 63,000 county officials and 278,000 village officials. Almost 60,000 individuals have been put under criminal investigation. Overall, 1.5 million (or 1.7%) of the Communist Party's 89 million members (including many very senior party leaders dubbed "tigers" in the Politburo) have been affected, according to official statistics.

However, the anti-graft initiative is not over. At the 19<sup>th</sup> Communist Party Congress last month, the Party created a national Supervision Commission to consolidate and deepen the anti-corruption efforts to expand beyond Party members to cover all officials exercising public power at all levels. Despite all these efforts, Beijing's anti-graft campaign has not yet covered private-sector-to-private-sector dealings.

## THE HANDICAP OF MARKET FORCES

Sustaining robust anti-corruption institutions is easier said than done due to the enduring ability of corrupt officials to capture, and meddle in, such institutions. From this perspective, the conventional wisdom that Beijing should reduce its role and let market forces to transform the system and to fight corruption may just be a conventional thinking without wisdom. This is because corruption is not only a failure of the state. It is also closely linked to the failure of market and institutional frameworks (witness corruption in the developed, free market system). If the network of economic and social power that free-market economies tend to create can be used to capture and control political power, an effective system of checks and balances becomes impossible.

The irony of the market's failure to direct effective forces to fight corruption is well illustrated by recent academic research which argues that those on the political right condemn excessive bureaucracy but yet their solution of reducing the role of the state and allow market forces to take over has backfired by fueling cumbersome bureaucratic expansion. The so-called "iron law of liberalism" states that any government initiative to reduce red tape and promote market forces would have the ultimate effect of increasing the total number of regulations, the total amount of paperwork and the total number of bureaucrats the government employs."<sup>1</sup>

## THE RELEVANCE TO CHINA

In other words, markets can work efficiently only with the guidance of a competent benevolent and fair state that designs a system that protects against abuses and graft from both the public and market sectors. But such a state is a Utopia.

The state in China is unfair by default. Firstly, the pay of the public sector is too low to commensurate with the power vested in the government officials so that they face very high temptation to use their power to extract

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<sup>1</sup> Graeber, David (2015), *The Utopia of Rules: On Technology, Stupidity and the Secret Joys of Bureaucracy*, Melville House Publishing.

rents/profits from the system. Secondly, despite decades of economic liberalisation, China still lacks modern mechanisms for resolving civil disputes arising from unclear property rights, which is another area that needs clarification and improvement urgently.

In economies with low level of corruption, officials not only receive much higher pay, they are also subject to checks and balances that limit what they can do and require transparency through reporting. They are also subject to legal limitations on their private sector involvement after they leave office.

This means that China will have to develop a modern institutional framework for defining clearly property rights and for resolving disputes arising from market transactions. It needs to raise significantly the accountability of the public sector and prevent vested interests from capturing institutions. All these are tall orders that involve fighting corruption and creating a system with effective checks and balances. Market forces alone cannot do it. China's war against corruption still has a long way to go, and it may well be the toughest challenge that President Xi faces in realising the "Chinese Dream".

## CHINESE LUXURY DEMAND

So it is not practical to expect a truce of Beijing's anti-corruption war anytime soon to help revive Chinese demand for luxury goods and, hence the earnings of the luxury goods sector. But the economic fundamentals for growing Chinese luxury demand has already unfolded, albeit only gradually.

Even at an average growth rate of 6.3% a year, China is on the way to double per capital real income by 2020 from the 2010 level. Chinese households will want to eat better, live better and enjoy more luxury. Furthermore, the Life Cycle Theory suggests that China's ageing population could set off a consumption boom in the medium-term<sup>2</sup>. As I argued earlier<sup>3</sup>, the number of affluent consumers should grow by more than proportional to income growth so that demand for non-essential goods and services and financial assets will rise in the coming decades.

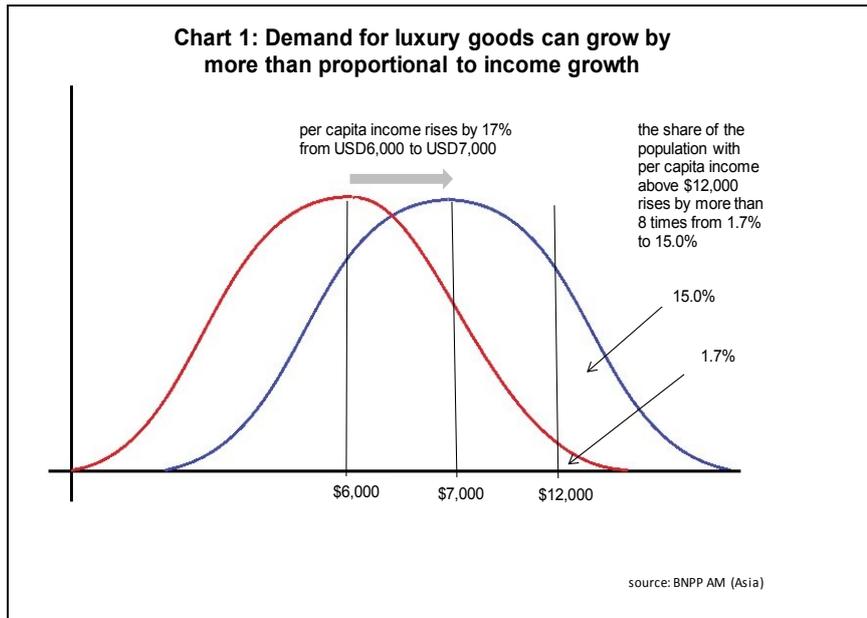
Despite an ageing population, industrial upgrading and industrial migration to the inland provinces should also support Chinese consumption. This industrialisation trend is expected to help shift the whole income distribution curve forward (Chart 1)<sup>4</sup>, augmenting the growth of affluent consumers, benefiting staples and discretionary consumption segments and the share of e-commerce in total consumption.

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<sup>2</sup> Lo, Chi (2017), "Demystifying China's Megatrends – the Driving Forces That Will Shake Up China and the World", Emerald Publishing, pp. 51-53.

<sup>3</sup> "Chi on China: Mega Trends of China (1): Domestic Demand for Financial Assets", 5 August 2015

<sup>4</sup> See reference in footnote 3.



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