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Private investment proving to be Chinese economy's Achilles' heel

China's headline economic growth numbers are becoming steadier, but maintaining the dynamism of the world's second-biggest economy is becoming more complicated. The *South China Morning Post* is sending its journalists to talk to those on the frontline of China's growth story – menswear designers, cement factory owners, developers, jewellers and venture capitalists – to see behind the numbers. In the first story of the series, Maggie Zhang discovers the reasons behind weak private investment

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A few years ago, businessman Zhou Long had ambitious plans to open at least 100 menswear stores across mainland China.

But the 36-year-old has seen the private business environment deteriorate over the past decade, with higher costs and bleaker profit prospects, and he says he is now much cautious as rising rents, changing tastes and competition from online retailers make it harder to make money from brick-and-mortar stores.

The AK Club brand he has managed as chief executive since last year presently has eight stores, and he now plans to add another 20 or so this year as it builds up its presence in mainland malls after starting out in China seven years ago as an online operation.

Before joining AK Club, Zhou worked for Shanghai Metersbonwe Fashion & Accessories, a Shenzhen-listed garment brand that posted annual sales of about 10 billion yuan (HK$11.7 billion) in its heyday. Last year it reported a fourth straight annual decline in sales, to 6.3 billion yuan.

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> *Zhou Tianyong, Central Party School*

"It's more difficult to do business than before," he said, smoking a cigar in his office, piled with vintage, military-style menswear he and his business partners sourced in overseas markets. "You have to find your niche market, and you must do it in a very careful way."

His caution and concerns are shared across a broad spectrum of Chinese industries, from clothing to equipment making, leading to a stagnation in private sector investment that has seen Beijing

venture further down the dangerous path of bolstering growth by pumping credit to state-backed projects.

"It's quite a worrying sign," said Zhou Tianyong, deputy head of the Institute for International Strategic Studies at the Central Party School, the training ground of senior Communist Party cadres. "China is in dire need of finding new growth dynamism but it just can't find it, and private funds are fleeing out of China."

He said that to shore up private investment confidence and take China's economic development to the next stage, Beijing had to come up with, and have the guts to implement, a grand reform package, just as it did in the 1980s, when it allowed farmers to sell surplus produce, in the early 1990s, when it encouraged private businesses to flourish, and in the early 2000s, when it joined the World Trade Organisation and integrated into the world economy.

China's private sector investment growth fell off a cliff in the first seven months of this year, decelerating to just 2.1 per cent year on year, the slowest growth since China began publishing such data in 2012, while state sector investment surged 21.8 per cent.

Private sector investment grew 10.1 per cent last year and 18.1 per cent in 2014.

Banks from HSBC to Societe Generale have called soft private investment sentiment a major concern for the future health of the world's second-biggest economy.

The lack of private business confidence in a market of 1.3 billion consumers with an annual economic growth rate of at least 6.5 per cent is a reflection of deep structural problems in China.

While Beijing has been trying to aid the real economy by maintaining an accommodative monetary policy stance, the additional cash unleashed by the central bank is simply being hoarded by Chinese enterprises, with their cash holdings jumping 18 per cent in the second quarter of the year, the biggest increase in six years, Bloomberg reported this month.

The rush for cash and safe assets is not confined to big companies with easy access to credit, but also extends to millions of private business owners like Annie Fan, who runs a jewellery store at the landmark Jin Mao Tower in Shanghai's financial hub.

Fan, in her 40s, was busy taking pictures of her inventory with a view to selling it via WeChat, a social media app. She said she had no plans to procure any more because "almost all" her rich clients were moving their assets offshore.

The jeweller, who has been in the business for more than a decade, said she had seen clear signs of "capital exodus" from Shanghai, China's most populous city, to overseas destinations. As a result, she planned to halve her store area next year. She's now paying rent of 50,000 yuan a month for 50 square metres.

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China's official foreign exchange reserves shrank US$450 billion in the past 12 months, and market watchers say capital outflows are set to continue as Chinese individuals and companies diversify their assets abroad, despite recent signs of an easing in outflow pressure.

In 2015, China's outbound investment grew 14.7 per cent year on year to a record high of US$118 billion, according to data from the commerce ministry. It has been rising for 13 straight years with a compound annual growth rate of 33.6 per cent. In the first half of this year it surged 58.7 per cent year on year.

"It's natural to see wealthy individuals invest overseas, mainly through buying property, due to the need for children's overseas education, asset diversification and soaring home prices in major domestic markets," said Zhou Hao, senior emerging market economist for Asia at Commerzbank in Singapore.

By the end last year, total Chinese outbound real estate investment had reached nearly US$30 billion, double the amount a year earlier, as rich Chinese investors snapped up property in Sydney, London and Manhattan to diversify their assets amid depreciation of the yuan and stock market turbulence, research by property consultant Knight Frank showed.

Following the money

Monthly investment in private fixed assets by sector (100m yuan)

Smelting and pressing
- Ferrous metals
- Non-ferrous metals

- Health and social welfare
- Culture, sports and entertainment

Source: National Bureau of Statistics SCMP

Beijing is clearly worried about Chinese private investors' reluctance to invest on the mainland. Premier Li Keqiang was so concerned that he held a series of meetings with senior government officials in the past two months to address the slowdown in private investment, and Beijing even created special teams to inspect local governments, urging them to be friendlier to private investment.

But Tao Dong, chief Asia ex-Japan economist at Credit Suisse, said there was no need for such inspection teams.

"Break the state-owned enterprise' monopoly, free up those profitable high-end services sectors from the grip of SOEs, and private capital interest will come naturally," he wrote in a recent blog.

China's private businesses account for most of the country's economic growth, fiscal revenues and jobs, but often encounter bias. Some government officials, cowed by Beijing's anti-corruption and belt-tightening campaigns, see little incentive in helping private business.

Founder Securities said in a research note in July that a new round of "SOE aggression and private enterprise retreat" lay at the core of slumping private investment.

The brokerage house said entrepreneurs frequently encountered invisible barriers and biased treatment.

On top of that, China's banks, most owned by the state or local authorities, are not eager to lend to private borrowers and can be downright unfriendly to them.

A bank executive said banks usually preferred to grant loans to state-owned businesses and often charged higher interest rates to private borrowers, who frequently lacked the collateral needed to secure low-interest lending.

"To be honest, we are more like offering icing on the cake rather than a shot in the arm when lending to private business," he said.

That means private businesses are often the first to be squeezed of funding support when there's a tightening and the last to be aided by the trickling down of funds. When the economic situation worsens, private businesses can be trapped by unpaid debts or accounts receivable, stripping them of investment capability.

You Jia, who's been running a small private firm that makes lifts with a number of business partners for more than five years, said a major client had once delayed a payment of about 1 million yuan for a year. He could not push the client for fear of losing future orders, and he had to use his own funds to pay employees and meet other operating costs.

The 30-something Shanghai native said that if he had been paid more promptly, he would have been able to buy raw materials and submit tenders to win new orders.

"How can I made an investment short of 1 million yuan on hand?" he asked.

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China's weak private investment is happening in tandem with a scary property price rally in big cities like Shenzhen and Shanghai, since speculating in the housing market offers much higher returns than investing in any other projects.

Frank Wang, who heads a firm of architects and is vice-chairman of the China Builder Ratings Association, said China's real economy had been "kidnapped" by property.

"The crazy land auctions in Shanghai encapsulate the desperate desire for developers to avert risks from third- and lower-tier cities to hoard assets in mega cities like Shanghai," he said.

"Why are people rushing to buy homes in Shanghai? Because they have no better investment options, and buying property in cities like Shanghai and Beijing seems to be the last safe haven, especially when capital outflows are now under tight control."

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Staying out ofChina's business