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## **China: What Could Go Wrong?**

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## INTRODUCTION

The People's Republic of China (PRC) has averaged nearly nine percent annual GDP growth since 1978, the beginning of economic reform. Breathless predictions are made about how China will dominate the world economy in this, the Asian Century. But before concluding that the Chinese are ten-feet tall (as was once thought of the Japanese before fifteen years of recession), it is worth surveying what could go wrong in the Middle Kingdom.

This report identifies key risks in China (political, economic, other), paying particular attention to those that have historical resonance. These are not predictions. They are risks that investors should consider and price accordingly.

Each risk is assigned a non-scientific estimate of its likelihood. Aside from economic contraction, none by itself is very probable, but they cannot be dismissed out of hand in their entirety. After all, Russian bond spreads weren't supposed to move against Long-Term Capital Management in 1998, but they did. AAA-rated CDO tranches were believed to be unsinkable in 2008, but the unthinkable happened instead. Anyone assuming that China will be the first tree to grow to heaven is in for a rude awakening eventually.

## POLITICAL RISKS

### **Social Unrest (# in #)**

For a country without free speech rights, China sure does have a lot of protesters making noise in the streets. There were 74,000 'mass incidents' in 2004, each involving more than a hundred people with perhaps 3.4 million dissenters involved in all. The number of protests had been steadily rising since at least 1993. The 35-60 million workers laid off from state factories always top the list of discontented groups. Unemployment is 40 percent in some northeastern rust belt cities. The military has had to quash large-scale labor unrest in several regions. The government also keeps a wary eye on ethnic minorities (discussed below), religious groups (Falun Gong, anti-communist Christians), urban migrants, subversives (China Democracy Party), retired army veterans, and students (who mounted 25 violent protests against Japan in April 2005)....

### **Dysfunctional Democracy (# in #)**

Many have observed that political reform has not kept pace with economic development in China. Some argue that a market economy without democracy is an inherently unstable situation and warn that a rising middle class will eventually demand political rights and freedoms....

### **Empire Break-Up (# in #)**

China was formed by conquest - originally wars between "Three Kingdoms" - and now incorporates 56 ethnicities, as trumpeted with great fanfare during the 2008 Beijing Olympics opening ceremony. As an imperialist power attempting to control a large territory bordering many countries, it is subject (like Russia) to reconfiguration around the edges as the power of the center waxes and wanes.....

### **Road Back to Marxism (# in #)**

Can communists change their stripes? China has been liberalizing its economy since 1978. But 30 years of economic reform are no guarantee there will be no ideological swings in the future. History did not quite end and communism as a force in world affairs is not completely spent....

### **The Succession Problem (# in #)**

The death of Hua Guofeng in August 2008 serves as a reminder that China still has a succession problem - the selection of new leaders is not procedurally assured and can be a source of political strife. As Mao Zedong's health began to decline in 1971, a leadership struggle ensued. Hua Guofeng briefly ruled China until he was forced out by Deng Xiaoping who took control as de facto leader in 1978. Deng never held formal office as head of state. Deng's first two choices for his successor fell into disgrace and his third, Jiang Zemin, is said to have ruled as a weak figure with no power base of his own. Zemin was succeeded by Hu Jintao who must leave office after 2012 under a new system of term limits....

### **Militarization (# in #)**

Rising powers are likely to provoke wars. Athens in ancient times and Germany and Japan in the 20th Century are cited as examples. In China, the military is politically powerful and has a great deal of autonomy....

## **INTERGOVERNMENTAL RISKS**

### **War With Taiwan (# in #)**

Taiwan is widely perceived to be the most dangerous flashpoint that could embroil China in military conflict. The Taiwan issue dominates all others in the Chinese national consciousness. China took control of the island in the 17th century, but Japan 'stole' it in the Sino-Japanese War of 1895. Taiwan should have been returned to China when Japan was defeated in World War II, but the U.S. 'prevented' it. Taiwan is thus the last uncompleted mission to end China's Century of Humiliation....

### **Conflict with Japan (# in #)**

The brutal Japanese occupation of China in World War II remains a well-spring of difficulty in relations between the two nations. With the Chinese government at times encouraging anti-Japanese sentiment among the people, conflict with Japan remains a remote but more than theoretical possibility....

## **ECONOMIC RISKS**

### **State Capitalism Fails (# in #)**

Although China is widely perceived to have a free market economy that functions like those in the West, it's not true. 'State capitalism' or 'back-door socialism' would be a more accurate description. There are still price controls, meant to contain politically-sensitive inflation but predictably leading to shortages and rationing (with long lines at gas stations in 2007) as a result. There were 110,000 state-owned enterprises (SOEs) in 1999 - including publicly listed companies - employing 41 percent of the urban work force....

### **Economic Growth Stalls (# in #) –**

Thirty years of average nine percent growth is an impressive achievement, but nothing lasts forever. It is inevitable that economic growth will stall in China at some future point. GDP growth is forecast to 'slow' to 8.4 percent in 2012. This is still above the magic 7 percent often cited as necessary to keep potentially destabilizing unemployment from ballooning....

## OTHER RISKS

Here are some other plausible eventualities that could pose problems for those invested in China in the future:

- \* Trade friction....
- \* The aging population....
- \* Food security....
- \* Water....
- \* North Korea finally melts down causing a huge refugee problem.
- \* Specific investments are threatened....
- \* The regime changes character....

## CONCLUSION

There is no shortage of doomsday scenarios for China. One has fighter jets accidentally colliding over the Taiwan Strait and masses demonstrating on the Chinese street for the government finally to stand up to foreigners or face dismissal. Another, perhaps brought on by a split in the leadership, is where the center weakens and becomes vulnerable to a whole host of opportunistic diseases - a shrinking economy, social and ethnic unrest, loss of territory, organized crime, terrorism, and other indicia of chronic instability. The state withers away but not quite in the way Marx intended. One does not have to believe in such scenarios before concluding from the infirmities catalogued in this report that the Chinese are not 10-feet tall or that the investment risk-reward ratio is appreciably different than widely thought.

### ***Author's Disclaimer:***

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### ***About the Author:***

Christopher M. Wright regularly interviews CEOs, book authors, and analysts from major Wall Street firms for columns and articles on the stock market in major publications. In 2004, he started his own investment newsletter, *The Sine Wave Investor* (tm) ([www.sinewaveinvestor.com](http://www.sinewaveinvestor.com)). He has made numerous presentations on the stock market to young professionals, academic institution staff, and investor groups. In 2000, Mr. Wright successfully completed the academic portion of the grueling and respected Chartered Financial Analyst (CFA) program. The course of study is equivalent to a finance-focused MBA. Before beginning to write on business and investment topics for national and international clients in 2001, Mr. Wright worked as an attorney for 20 years. He makes his home in Arlington, Virginia.

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