Dragoman Digest

Evergrande turmoil has Chinese and global markets on edge

It is still far from clear whether Evergrande will receive a bailout

Security police moved anxious investors away from the Shenzhen headquarters of **China** Evergrande Group this week, a domestic manifestation of rising concerns over the liquidity crisis at China's second largest property company. While domestic investors suffered both an unpaid dividend that had been due to be paid and suspension of trading in the primary domestic entity, global bond investors have been alerted to wider risk of a potential default. Evergrande debt accounts for roughly 6.5 percent of bonds raised in domestic property markets and about 9 percent ($US19 billion) of property debt sourced internationally.

Poor property sales and an inability to raise further funds have led to rising concerns of a "credit event" – a potential default. There is no certainty in the current environment that official bailout support would emerge, even though there is clear potential for Evergrande's failure to cause serious damage among its many related parties in China's property market.

Until now, Evergrande Chairman Hui Ka Yuan had often obtained support from a "poker club" of very wealthy property investors for struggling projects such as his electric vehicle project. Chen Hua, the chairman of Kingkey Group, personally put HK$5 billion into the China Evergrande EV start-up. Wong Kwong Miu, who controls mainland-listed Shenzhen Centralcon Investment Holding Co, also personally invested HK$5 billion. Liu Ming Hui, chairman of China Gas Holdings Ltd., invested HK$3 billion. Wang Zhongming's Shenzhen Greenwoods Investment Group invested HK$5 billion. Chan Hoi-wan, CEO of Chinese Estates Holdings Ltd. and wife of Hong Kong billionaire Joseph Lau, invested HK$3 billion. In total, more than US$3.4 billion was tipped into the EV start-up, which has since lost 70 percent of its initial value.

International investors will no doubt be alert to the delivery or otherwise of interest payments due from 23 September. The larger issue of bailout or restructuring may rely on perceptions in China of the "too big to fail" mindset. Letting Evergrande default would send a clear message in this regard – though Beijing will also be extremely cautious about the potential for social instability and any knock-on effects impacting broader financial stability.

US adopts multilateral approach to China tech export controls

Biden's push to curb the transfer of sensitive technologies to China relies on a united front

The **US** has considerably tightened enforcement of restrictions on **China**'s access to sensitive technologies this year. According to recent data from the Bureau of Industry and Security – which sits under the US Department of Commerce – policing of China-related transactions has led to 226 months of prison time, around US$1 million in legal fines and US$4 million in civil penalties this year. Though this figure is fairly modest, it is a huge increase from last year – when only 80 months prison time and US$60,000 in criminal fines were doled out. Further, the US entity list – which hinders American companies from selling goods and equipment to firms deemed "national security threats" or human rights violators – has grown considerably this year. There are currently 420 Chinese entities on the list, with 23 added in July alone.

Whilst continuing with former President Trump's tough strategy on China, the Biden administration has adopted a more multilateral approach to categorising Chinese technology, developing common export controls with allied nations. The formation of the US-**EU** Trade and Technology Council has been cited as a key US milestone in aligning Western democracies and their approach to Beijing.

There is however, some potential for divergence in US-EU interests. The EU do not see themselves in a zero-sum competition with China like the US does, and they will likely be reluctant to impose export controls which would unduly hurt European economic competitiveness. Moreover, some within the US, particularly the US-China Economic and Security Review Commission (USCC), argue that Washington is not moving fast enough due to its emphasis on multilateralism. A more unilateral approach – if implemented – would raise European hackles.

Whilst a unilateral approach could accelerate US action and expand the entity list, this would not necessarily prevent the EU from exporting dual-use technology. By multilateralising export restrictions, the US can ultimately create a stronger front and better avoid leakages of key technologies.

Suga finally launches Digital Agency

Despite urgency, cyber reform faces slow progress

Just two days before Prime Minister **Yoshihide** Suga announced his resignation, **Japan** finally launched a new Digital Agency that aims to strengthen Japan's cyber capabilities. The Digital Agency hopes to undertake large-scale reforms to increase Japan's resilience to cyber-attacks and digitise the government's bureaucracy. A comprehensive cyber strategy will also be released in December. In coordination with these recent moves, Japan's defence ministry submitted a US$50 billion budget increase for the coming fiscal year, aimed at developing novel cyber weaponry.

Chinese cyber warfare in the Indo-Pacific and several cyber-attacks carried out by hackers with links to China this year appears to have pushed Japan to prioritise digital security. The International Institute for Strategic Studies ranked Japan as a third-tier cyber power, highlighting its vulnerability to an attack on its critical and digital infrastructure. The current system functions to mainly protect government agencies, failing to shield citizens and businesses from cybercrime.

Further delays to cyber reform are likely as the country faces the prospect of a new prime minister and government reshuffle. Japan's new leader will no doubt inherit substantial digital woes and an urgent need to pursue reforms.

Chinese "common prosperity"

Xi's "common prosperity" may be more about optics and politics than reducing inequality

After declaring that **China** had eliminated extreme poverty last year, paramount leader **Xi Jinping** established "common prosperity" as a strategic goal for the Chinese Communist Party (CCP) to achieve by 2035. With around 600 million of the Chinese population earning a monthly income of US$141 or less, the CCP recognises the importance of appearing to tackle inequality.

To achieve this goal, Beijing has encouraged high-income enterprises and individuals to give away some of their wealth to charity, via the idea of "third distribution". Xi has targeted some of China's most successful private enterprises. Tencent, one of China's largest social media, gaming and fintech groups, donated US$7.7 billion whilst Alibaba's Jack Ma pledged US$15.5 billion.

However, China's common prosperity policy is more about optics than taking legitimate steps to reducing inequality. Xi's decision to place pressure on wealthy enterprises and individuals ignores the need for complicated policy reforms that would be more efficient in addressing wealth distribution. For instance, the continuing lack of a national property tax has allowed party elites to gain massive wealth through real estate. Improving China's paltry social safety net would also be a markedly more efficient way to redistribute money. However, these would all require politically sensitive and complicated structural reforms, such as increasing the revenue share of local and provincial governments that carry much of the welfare burden in China. This would be a reversal of the direction of recent policy changes.

The overriding goal of the "common prosperity" campaign is to reduce the perceivably disproportionate economic and social influence that decades of lax regulation has allowed companies like Alibaba, Ant and Weibo to amass. Alibaba for example, has a larger ecommerce market share at 58 percent than Amazon does in the **US** at 39 percent. Considerable financial risk was also involved in the rise of these giants – Ant Group had much lower capital adequacy requirements in its lending than traditional banks. Regulatory steps taken as part of the "common prosperity" campaign are clearly designed to prevent the CCP being beholden to privately controlled companies that are "too big to fail".

In its current form Xi's "common prosperity" campaign is unlikely to significantly reduce wealth inequality. This is not to say nothing will improve. Nationwide debate on workers' rights has seen the eradication of the weekend overtime policy in the big tech companies. Yet, Xi's campaign seems to be more a piecemeal effort devoid of fundamental change, aimed at bringing big private interests to heel.

Guinea's coup unnerves major investors

Political uncertainty in Guinea threatens China's iron ore prospects in Simandou

The recent military coup in Guinea has sparked supply fears over key iron ore and bauxite deposits. An elite Special Forces unit led by Colonel Mamady Doumbouya ousted President Alpha Condé and imposed an 8pm curfew last week, causing prices of benchmark aluminium to rise 2 per cent on Monday to their highest level since May 2011.

Guinea is the world's second biggest producer of bauxite and is home to the world's largest untapped reserves of iron ore. Guinea has consistently been promoted as an alternative source of iron ore that would allow China to (at least marginally) reduce its dependence on Australian exports. However, the coup threatens China's efforts in Guinea, particularly in the Simandou region. Chinese-backed consortium SMB-Winning, signed a deal with the Guinean government in 2019 to build mines and a 650-kilometre infrastructure network that could produce 80 million tonnes of iron ore per year by 2027. For its part, Rio Tinto – which has a 45 percent stake in Blocks 3 and 4 of Simandou – has been working on technical studies for the required infrastructure, as well as a social and environmental impact assessment. However, even before the coup, the US$12 billion Simandou project had encountered multiple obstacles, with Guinea's political instability making it difficult to source funds.

China's already strained plan depends heavily on the new regime and its approach to Guinea's mining sector. Whilst Junta leaders have stated their intention to honour existing agreements, it is not inconceivable that they may seek to alter contracts with SMB-Winning and propose new terms that could dilute shares held by Chinese investors. Beijing may care little as long as the iron ore is delivered to China – the more material issue here is the prospect of regulatory uncertainty which may further delay the project. Additionally, it will be even more difficult to seek funding for Simandou following the coup, likely placing the project on hold. The Chinese government could step in to fund the project itself. Beijing has however, been more hesitant in recent years to make huge capital investments in politically volatile environments.

Despite sour relations between Canberra and Beijing, the uncertainty created by Guinea's current developments signals that Chinese dependence on Australian iron ore is likely to remain for the foreseeable future. Further, as Guinea accounts for 55 per cent of China's bauxite imports, China may turn to Australia for alternative bauxite sources, increasing its overall dependence.

Iran appoints new hardliner nuclear chief

Appointment of Eslami is part of a hardliner campaign to pressure the US to remove sanctions

Iran has appointed hardliner Mohammed Eslami as the new head of the Atomic Energy Organisation of Iran (AEOI). Eslami, a **US**-educated engineer, has held senior positions in Iran's defence ministry for nearly four decades. His role in Iran's nuclear program has seen him remain under international sanctions for over a decade, initiated by the **U**N, **EU** and signed by **Russia**.

Eslami has already made moves to resume Joint Comprehensive Plan of Action (JCPOA) dialogue. A meeting between the head of the International Atomic Energy Agency (IAEA), Rafael Grossi, and Eslami last Sunday, saw Iran agree to allow UN inspectors to install new memory cards into monitoring cameras at Iran's nuclear facilities. By cooperating with the UN nuclear watchdog, Eslami avoided an anti-Iran resolution from being announced by the E3 – the **UK**, **France** and **Germany** – at next week's IAEA meeting. Eslami is also set to meet Grossi on the sidelines of the IAEA Board of Governors conference in Vienna next week.

Since the Trump administration withdrew from the JCPOA and imposed sanctions in 2018, Iran has ignored restrictions on its nuclear program. It has limited the entry of IAEA inspectors and in April, pledged to triple enrichment of uranium to up to 60 percent. By cooperating with the IAEA, Iran seems to be placing pressure on the US to remove wide-ranging sanctions. However, the appointment of a hardliner does not bode well for the prospects of progress in already stalled US-Iran talks.