Dragoman Digest

China's struggling economic rebound suggests potential systemic financial risk

High debt levels are creating strife for China's SOEs

One of Dragoman's Counsellors, an expert on **China**, remarked this week that "**Xi**'s luck appears to have run out". On the same day, China's latest customs data showed that – rather than bouncing back after COVID strictures were removed – exports in January and February were 6.8 percent lower than last year. Commodity markets promptly sold off iron ore and coking coal. Coming on the back of a political set piece – the 'two sessions' of 'consultative' forums – China's leadership announced a modest 5 percent GDP growth target for the fiscal year and flagged new centralised structures for financial and technology oversight.

As Dragoman's China service clients would be aware, our analysis suggests potential systemic financial risk – the burden of decades of capital-intensive growth stimulus that became increasingly ineffective. China's debt burden is widely distributed and has a sclerotic effect on local government and state-owned enterprises (SOEs), which appear in too many cases to have come to treat debt as revenue. The picture now, with China's property market unstuck and global challenges to a resumed export stimulus, is troubled. S&P found that 90 percent in a sample of 6363 SOEs are stuck in a 'debt trap' and will need help. Between 13 and 28 percent of China's corporates – including not only property, but also industrial and consumer goods businesses – would be cash flow negative in 2023, the credit analyst reported.

The move to create new centralised powers for financial oversight may be a response to what Dragoman's expects will be disruptive consequences as President Xi seeks to manage deeply entrenched financial troubles. The new vehicle for technology, on the other hand, likely heightens the stated goal for innovation-driven renewal. Though it must also have an eye to the unexpected effectiveness of **US** curbs on China's access to important technologies.

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Renewable energy local content requirements threaten to slow the transition

LCRs have found little success in countries lacking a complex manufacturing base

As more countries acknowledge energy technology as a national security issue and local industry opportunity alike, governments are imposing local content requirements (LCRs) for renewable energy projects. From 2011 to 2021, the number of jurisdictions with LCRs doubled to 24, including the **US**, **Indonesia**, **India** and **South Africa**. Washington's *Inflation Reduction Act*, for example, makes tax credits contingent on certain LCRs – notably for batteries and electric vehicles.

This attempt to grab a slice of the renewable energy manufacturing industry is generating detrimental effects to the deployment of renewables. Take the example of South Africa. In 2019, the country imposed a 100 percent LCR for solar components. This has stymied the transition. Despite South Africa's abundant renewables potential, solar only represents around 6 percent of the energy mix. **Australia**, which has no LCRs but has similarly high prospects for wind and solar generation, increased solar in its energy mix nearly sixfold to 20 percent over the decade to 2021. Success in deploying LCRs may ultimately only be reserved for manufacturing juggernauts like the **EU**, the US and above all, **China**. Even in the US' case, however, attempts to develop a local solar industry have failed. Countries may increasingly have to choose between expediting the transition – and increasing reliance on China – or risk a slower but less China-dependent transition.

The dire state of South Africa's power sector

Systematic crime and government collusion continue to stifle efforts at reform

Following months of unabating blackouts, **South Africa**'s President **Cyril Ramaphosa** last month declared a 'state of disaster'. South Africa's state-owned power company Eskom, which provides 95 percent of power to the country, continues to struggle amid high levels of institutionalised crime. Last December, Eskom's CEO, Andre de Ruyter resigned just one day after giving an interview on national television in which he promised to end corruption in the company, alleging that around US$55 million a month was being lost to graft and theft. Last month, De Ruyter, who was allegedly poisoned using cyanide, was replaced by Calib Cassim.

Corruption is holding back attempts to overhaul South Africa's energy sector. Criminal gangs are reportedly stealing copper cables from critical infrastructure and damaging energy plants, which, in some cases, they are subsequently contracted to repair. The gangs are known to steal up to 65 trucks worth of coal at a time. Efforts to address criminal activity in the sector are frequently obstructed by collusion between the groups and the ruling African National Congress (ANC). Their influence over the ANC is so strong that last July Ramaphosa was required to override his own energy minister, who was resisting changes which would temper Eskom's monopoly on power generation. This has contributed to South Africa recently experiencing regular 12-hour power cuts, which contributed to the country's 1.3 percent GDP contraction in Q4 last year. Given that the ANC has little capacity to institute a wholesale change, the outlook of South Africa's energy sector, and indeed Africa's most industrialised economy, remains bleak.

Vietnam appoints Thuong as new president

General Secretary Trong aims to solidify his political legacy with the appointment of a loyal ally

Last week, **Vietnam**'s ruling Communist Party of Vietnam (CPV) elected **Vo Van Thuong** as the new president in a re-organisation of the country's top leaders amid the most recent anti-corruption drive. Previously the Executive Secretary of the CPV and ranked number five in the Politburo, Thuong received 487 out of 488 votes cast. His appointment comes after his predecessor **Nguyen Xuan Phuc** unexpectedly resigned in January, the most senior official implicated in the party's anti-corruption efforts. Despite being the youngest member of the party's 16-member Politburo, Thuong is widely considered a party veteran, having spent his entire career in the CPV. He is also recognised as a close ally of General Secretary **Nguyen Phu Trong**.

The leadership re-shuffle is inextricably tied to Trong's attempts to ensure his legacy. In poor health, 78-year-old Trong is in his unprecedented third, five-year term, scheduled to conclude in 2026. Apart from spearheading a broad anti-corruption campaign, his primary focus has been to identify a successor, which he was unable to do at the 13th Party Congress. While ranked number two in the Politburo, the President is mainly a ceremonial role. However, it has traditionally been a stepping stone to the General Secretary position. The presidency will elevate Thuong's status, potentially putting him in the box seat to eventually succeed Trong at the next Party Congress in 2026 or indeed before.

Washington nears finalisation of outbound investment restrictions

Some US companies are already trying to get out in front of likely changes

Over the coming months, the **Biden** administration is expected to finalise restrictions on outbound investments into **China**. The US currently lacks procedures to review and block such investments. The **EU** is also contemplating implementing its own 'outbound investment controls' in this year's work program, as outbound investment restrictions become the next regulatory frontier.

Restricting outbound investments will bring challenges. Firstly, the available data on US investment flows into **China** is limited. A significant concern is that if US companies are prevented from investing in China, it will harm their competitiveness, especially if foreign rivals face no such restrictions. China is, and will remain, one of the largest markets for most technological goods and, as such, is crucial to companies establishing economies of scale and funding R&D efforts. It is expected that Washington will adopt a pilot program, with restrictions scaled up over time.

Some US firms are already acting. In late 2022, US venture capital firm Sequoia began screening its China subsidiary's investments. Sequoia Capital China raised over US$9 billion in new funds in July 2022 but did not commit new investments into Chinese semiconductor or quantum-computing start-ups. Given the bipartisan consensus for a hard line on China, Sequoia's proactive strategy may be a prudent one and one that other US companies may follow.