

Xi's Big Mistake

By John Mauldin | July 17, 2021



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Washington DC, Maine, and Colorado

I have mixed feelings about China. On the plus side, I think the country’s massive economic transformation may be one of the most impressive events in human history. Bringing hundreds of millions from primitive rural lives into relatively prosperous cities within a few years was awe-inspiring. I greatly admire the millions of Chinese entrepreneurs worldwide who create jobs and technology. They’ve helped the entire world in countless ways.

And yet, I can’t forget that China’s leaders are devoted, ideologically centralist communists. Americans sometimes apply that term casually to our political opponents. Xi Jinping is an *actual* communist. His regime permits some limited market-like activity, but only to help achieve the government’s goals, which remain communist.

When the West first began engaging with China in the 1980s and then allowed it into the World Trade Organization in 2001, many hoped exposure to our ways would tug China toward capitalism. It seemed to be happening for the first few decades, too. But the hope is fading.

In a 2015 letter ([When China Stopped Acting Chinese](#)), I said this:

Beijing’s stimulus efforts created the stock market bubble; now their unsuccessful efforts to keep it from bursting are shaking my confidence in their desire to allow market forces to play a greater role in the transition from a top-down society to a consumer-driven, bottom-up society.

Still, I've learned not to underestimate the Chinese leadership. They make mistakes but usually recognize them and change course quickly. We'll see what they learn from their current misadventures in stimulus and their attempts at top-down control of an essentially uncontrollable market. If they don't learn the right lessons, China will face an even harder lesson in the future.

Six years later, it looks like Chinese leaders didn't learn the right lessons. Xi has been trying to balance economic freedom and authoritarian control and it's not working like it used to.

Today we'll review some recent events that illustrate where Xi went wrong. Then we'll think about whether the Xi government can change course, whether it wants to... and whether it will survive.

Selling the Rope

Chinese ride-hailing company Didi Chuxing had its US initial "public offering" (I'll explain those quote marks in a minute) last month, raising \$4.4 billion. The shares plunged a few days later. Why? Widely called the "Uber of China," Didi seems to have good prospects. The problems came from outside.

For one, the Chinese government decided to investigate whether Didi presented a "cybersecurity threat." The company was ordered not to accept new users and its mobile apps were taken down from online app stores. But audits, or lack thereof, may be a bigger problem, and not just for Didi. My friend Mark Grant explains in one of his letters this week:

The core of the issue is that the Chinese government will no longer give US market regulators, any of the regulating bodies, the power to inspect the audits of Chinese companies listed on US exchanges. There are at least 248 Chinese companies, listed on three major US exchanges, with a total market capitalization of \$2.1 trillion, according to the US-China Economic and Security Review Commission.

Earlier this year the Securities and Exchange Commission began rolling out rules threatening to delist foreign companies from American exchanges if they do not meet US auditing standards for three years. The Chinese response was that Chinese regulators will conduct the audit inspections and deliver their conclusions to the US Public Company Accounting Oversight Board. ***This was soundly rejected, as it should have been, by the SEC.*** (emphasis mine)

In the press, recently, there has been all kinds of talk about the Didi IPO fiasco and the effect on Chinese tech companies and on new Chinese listings. This is all fine, but it does not go nearly far enough. The issues are much, much bigger.

On the equity side, how can you invest in a Chinese company, any Chinese company, regardless of size, or theoretical revenues or profits, without audited financials? There will be no way to know if any of it is accurate and foreign assertions will have all of the reliability of a drop of water purportedly not dripping down the Great Wall, because of the Chinese sunlight. No one will have any reliable knowledge of what is actually going on. No one, in his right mind, would invest in any company, domiciled anywhere, on this basis.

Mark is right; investors shouldn't throw money at companies based on financial statements that don't have some kind of trusted third-party verification.

But there's a bigger problem here. The Didi IPO was not a normal IPO, at least as we think of them in the West. US investors who bought these "shares" don't actually own equity. They own pieces of a Caymans "variable interest entity," (VIE) which has a contract with the parent company. This structure is necessary because under Chinese law foreigners can't own Chinese shares directly.

Didi duly warned investors in its US offering (see risk factors in their [registration statement](#)) that they had no shareholder rights and the Chinese government had final control. This isn't new. US-listed Chinese companies since at least Alibaba in 2014 have used the VIE structure. It's one of those things that works great until it doesn't.

This arrangement did have a key advantage, though, at least for the Chinese. It let Chinese enterprises rake in foreign capital while giving up no ownership and reserving the right to leave their own "investors" high and dry. This method may now be approaching its expiration date but it worked well for a long time.

That's how Xi and the Chinese Communist Party operate. They do things that *look* capitalist but really aren't, lacing them with unnoticed poison pills for later use. It's similar to their appropriation of US technology, trademarks, and other intellectual property. We are literally selling them the rope.

"Prepare for War"

We should distinguish between Chinese business leaders and the Chinese government. I think the former are mostly just trying to run their companies the right way. They are like entrepreneurs everywhere, trying to grow their businesses to the best of their ability. The latter group makes it difficult and sometimes impossible.

This can be hard to grasp. Xi and the other communists really believe they can have it both ways, conducting "business" while also maintaining iron-like control over everything. They may not exercise their control, but they want to have it.

Those VIE companies are a good example. Some experts say the whole structure is illegal under Chinese law, yet it is widely used. The government looks the other way. But by doing so, the authorities give themselves a giant weapon they can use any time. The business executives are aware of this and modify their behavior accordingly. (Note that verb "modify.")

In theory, this could still end well. Having successfully allowed people a taste of capitalism and its benefits, the government might think it can continue. Meanwhile those capitalist benefits might gradually usurp the Communist ideology.

Recent events say that's unlikely, though. Beijing appears to be concluding it has squeezed all the advantage it can from capitalism. Is Didi any more a technological risk than scores of other companies? Not really. Sometimes you have to create object lessons to keep everyone in line.

In hindsight, things seem to have gone wrong after the 2008 financial crisis. Facing potential social unrest, China responded with massive debt-financed investment in infrastructure, housing, and other projects. Some were needed, others were make-work distractions. But all the debt was real. And over time, it has become a heavier burden.

Xi Jinping inherited this situation when he took power in 2013. What is his plan? According to Cai Xia, a Chinese professor and high-level CCP member and now expatriate dissident living in the US, Chinese Communism hasn't changed. She wrote a [lengthy paper](#) under the auspices of the Hoover Institution. She maintains Xi is merely dropping the pretense.

Here's Ambrose Evans-Prichard in a recent [Telegraph](#) column, writing a useful summary.

Like many amateur observers of China, I had assumed that Xi Jinping's iron-fist policies at home and abroad were a break with the more emollient approach from Deng to Hu Jintao (if you can call the Tiananmen Square massacre emollient), when China seemed to be softening from a totalitarian to an authoritarian regime. Cai Xia makes clear that the fundamental character of the CCP has been unchanging.

The party has merely dropped the facade and dispensed with Deng Xiaoping's tactical dictum: "bide your time, and hide your strength". It has also acquired the means of totalitarian control that Hitler and Stalin could only dream of, whether face recognition technology or digital tracking through the Social Credit System.

The long list of Xi's affronts, from the Nine Dash Line to the South China Sea, to the pitiless asphyxiation of Hong Kong, to the intimidation of Australia, to the Uighur camps, are by now well-known, culminating in wolf warrior diplomacy and state-sponsored disinformation on Covid-19.

We are so inured to it that President Xi's "wall of steel" speech at the 100th birthday party almost seems banal. We know what the party thinks. The Fifth Plenum text setting out China's strategy until 2035 revives the term "prepare for war", not used for over half a century.

"Prepare for War" is an exaggeration, at least I hope, but it is growing less unthinkable. When you have two great powers whose systems are irreconcilable, and neither is willing to change, the options list shrinks.

Sleepwalking to Confrontation

Not everyone thinks disengagement and confrontation is inevitable. Ian Bremmer outlined the issues in his last letter, reaching a different conclusion.

Ian pointed out that unlike the US-USSR Cold War, the US and China are highly interdependent. He broke it down into three components:

Hostility (where both countries want the other to fail): This includes mostly the national security issues like Taiwan and the South China Sea, plus issues both countries see as core principles, like China's treatment of Hong Kong, the Uighurs, and Tibet.

Competition (each wants to outperform, but not destroy the other): These are the economic issues, like international trade and investment, technology, and domestic political stability. Both countries are the other's supplier as well as customer. Each wants to win, but also needs the other.

Cooperation (both want to work together for mutual gain): This includes the global challenges like climate change, terrorism, etc. They agree on the goals but lack of trust makes cooperation difficult.

We naturally focus on the areas of conflict, but Ian thinks the full US-China relationship is actually working pretty well. It changes with time, of course. Ian rates the relationship as currently 20% hostility, 70% competition, and 10% cooperation. But he also says much of the competition is becoming hostility.

Ian takes as given that neither country will do anything that would be perceived as "weakness." But if no one will blink, how do you avoid coming to blows? Ian thinks it is possible.

More likely, a change in policy comes from internal failures of the present trajectory. How would that happen?

In China: Xi leans into more state control of strategic sectors, high-performing talent starts to leave, productivity dives, and growth stalls and debt spirals... giving technocratic Chinese political leaders more space to nudge Beijing policymaking back towards more interdependence.

In the United States: Domestic divisions make industrial policy half-hearted, the private sector retains capture of the regulatory environment, the post-Biden administration renders strategic reorientation of the US economy incoherent and affords allies more space to direct their own course.

Historians tell us the dangers of sleepwalking into confrontation. But in the US-China relationship, domestic incoherence and lack of ability to effectively implement long-term strategy makes cold war less likely... precisely because it allows existing forces of interdependence to persist unmolested.

I hope Ian is right. From my perch, I'm not sure much of this is feasible. I think Xi has made a giant mistake with recent business crackdowns. He may have calculated he can do without Western companies. But without them, what will happen to the Chinese businesses that still turn to the US and Europe for capital, customers, expertise, and technology?

Moreover, can the Chinese miracle continue if millions of small entrepreneurs stop believing the government will let them succeed? I don't mean big companies. I'm talking about restaurant owners, drivers, shopkeepers—all those who keep the economy moving.

Cai Xia, who was in a position to know, has an even more chilling outlook.

Cai Xia's contention is that the Communist regime is more brittle than it looks, like the Soviet regime before the end. "I recommend that the US be fully prepared for the possible sudden disintegration of the [Chinese Communist Party]," she said.

Imagining what such a "sudden disintegration" would look like, I suspect it wouldn't be pretty, even if good in the long run. Economically, it could make 2008 or even the COVID pandemic look mild.

China Problems and Big Brother

China is facing large problems, some obvious and others more subtle. But I think problem number one is Xi has made a giant mistake with recent business crackdowns.

China is the ultimate Orwellian Big Brother state. Especially within the cities, the government can literally watch everything you do and track everything you buy, from your noodles to your clothes, who you talk to, what websites you visit. All of the data Chinese corporations gather is available to the CCP, who use it to create China's "[social credit system](#)." If you Google that, the first thing that pops up says this:

The **China social credit system** is a broad regulatory framework, intended to report on the "trustworthiness" of individuals, corporations, and governmental entities across China.

The consequences of a poor social credit score can be serious. **It affects travel prospects, employment, banking access, and ability to enter contracts.** On the other hand, a positive credit score can make a range of business transactions easier for both individuals and corporations. Foreign businesses have to work with consultants to make sure they have good social credit scores, and the CCP dictates what that means. It is the ultimate top-down centralist panopticon.

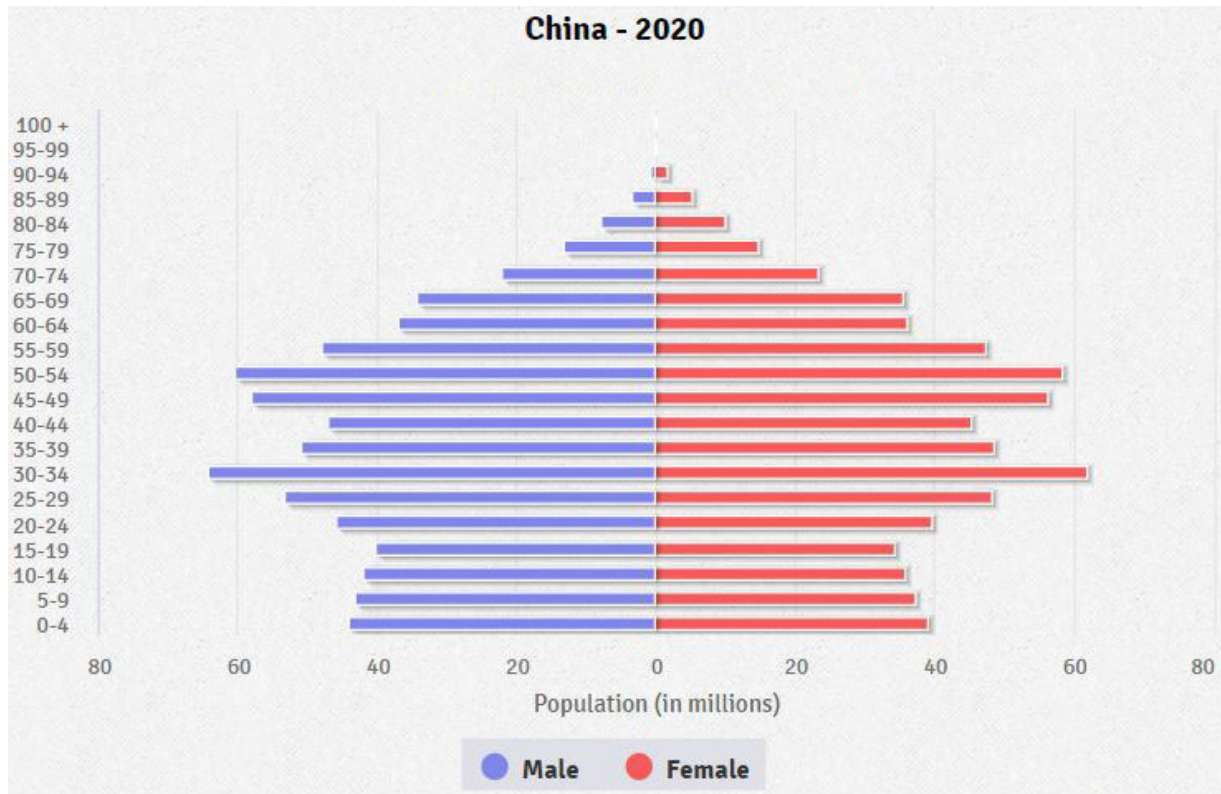
As mentioned at the beginning, many Chinese are quite entrepreneurial, given the opportunity. That being said, entrepreneurialism is not a racial characteristic. There is something in an entrepreneur that makes them want to start their own business or enterprise. A willingness to take risk is obviously part of that DNA. The United States is extraordinarily lucky in that we attracted people who were willing to take risks simply to come here.

I may not understand the Chinese mindset, but I think I have a pretty good grasp of the entrepreneurial mindset. Successful entrepreneurs don't fit into a mold. You can see why some entrepreneurs thrive and you have to scratch your head to figure out how others did it. Some work well within their system. Others simply create new territory and methods.

Xi is going to deprive China of that second set of entrepreneurs, those willing to create something entirely new that might not fit well within the current social credit system. I think the growing Big Brother state will stifle innovation. Who wants to risk their social credit score? It is one thing to risk your reputation and capital, and another to risk your ability to live and work.

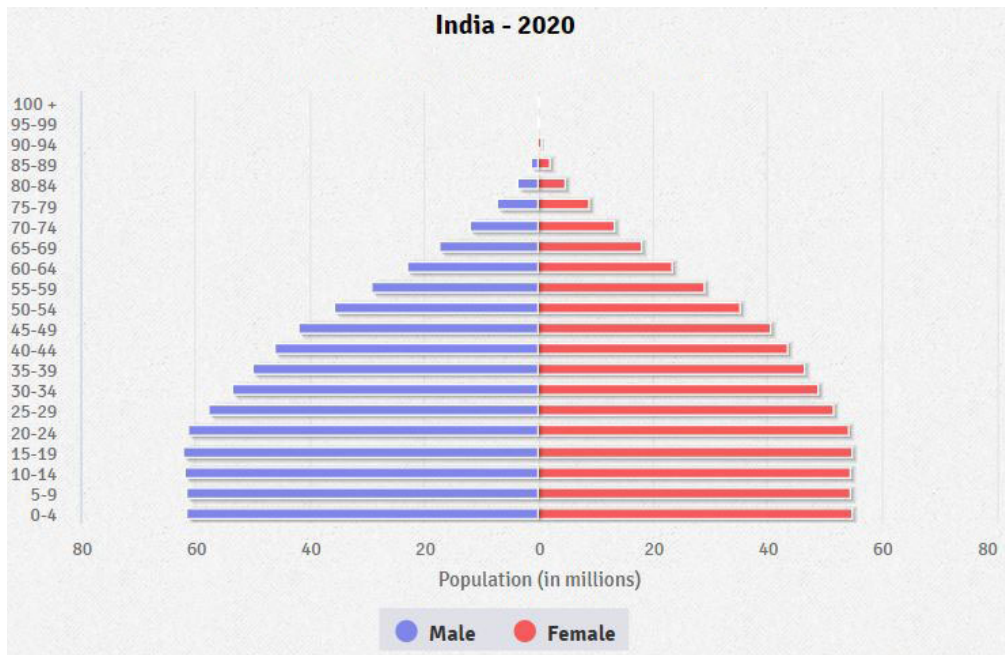
China's panopticon blocks that risk-taking impulse. The consequences will accumulate and reduce growth. And with over half the country still living in extreme poverty, that doesn't bode well for the future.

Further, China has a serious demographic problem. The one-child policy instituted in 1980 really kicked in around 1990, as you can see in the population pyramid below.



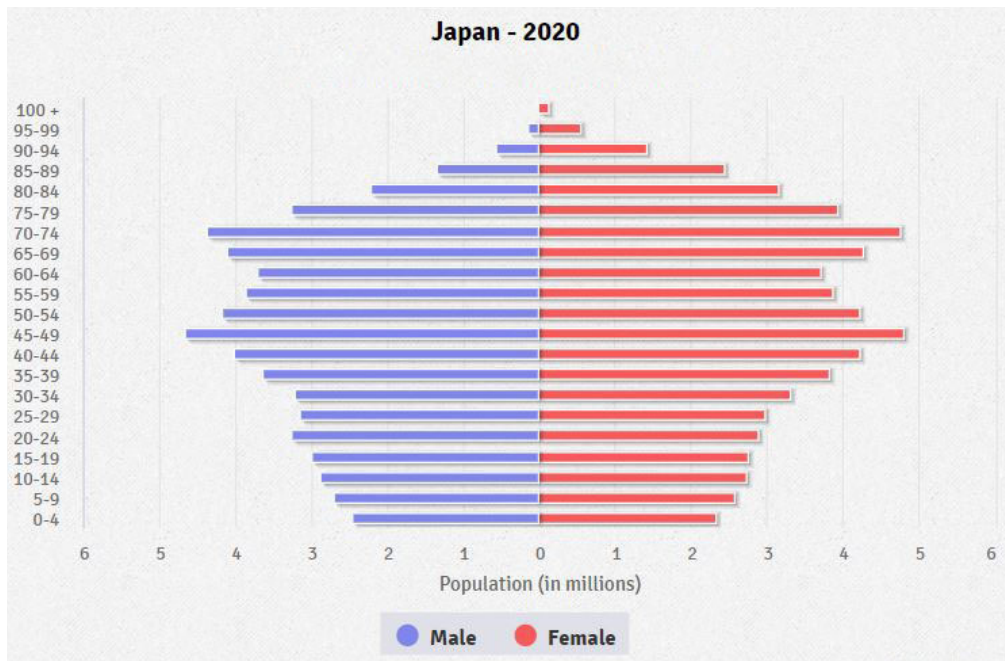
Source: Index Mundi

Normally, population pyramids are actual pyramids. Let's look at India as an example. This is a population pyramid.



Source: Index Mundi

While we are on this, let's look at Japan:



Source: Index Mundi

Japan has similar demographic characteristics to China, but with one huge difference. Japan grew rich while it grew older. China has grown older before growing rich.

All countries have problems, but even with all its impressive growth and infrastructure, China has more. Which to me makes it more dangerous.

The SEC is correctly insisting on audits for Chinese companies listed on US exchanges. I personally think we should ban new Chinese listings unless they agree to US audit standards. Kicking out currently-listed Chinese companies will be trickier, as US investors don't actually own the shares many think they do. We don't want to blow a \$2 trillion hole into US investor assets.

US corporations need to rethink how they approach China. For some, there will be few issues. For others? Real problems.

This week the Biden administration [warned](#) US companies about doing business in Hong Kong. China has essentially removed the rule of law that enabled Hong Kong's financial activity. The US advisory reportedly cites the risks of electronic surveillance and having to surrender corporate and customer data to the government.

Xi apparently thinks that it is time to forgo access to the US markets. Maybe he thinks Chinese companies can list in Hong Kong and Westerners will still invest. Maybe. Then again, maybe not.

Rule of law should be critical to any right-thinking investor. When the CCP can nudge an auditor to give a thumbs-up or thumbs-down based on some concept of social credit, how can you trust their assurances? Will that happen often? We don't know. But we know it's possible.

I'm not saying avoid China entirely, as there are still opportunities. But you should have your eyes wide open and understand the risks. I would prefer China-exposed US or other Western companies that give you real audits and normal shareholder rights.

China is going to be a massive headache for the world over the next few decades.

Washington DC, Maine, and Colorado

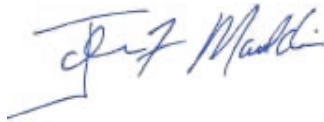
I plan to go to Washington DC for a few days before heading out to Bangor, Maine, and then Grand Lake Stream for Camp Kotok, the annual fishing and economic fest. This year my youngest son Trey (who is now 26) will once again accompany me, which he has done for most years since he was 12. Then I will go to Steamboat, Colorado, for a speaking engagement before heading home.

The problems in Cuba are a topic of interest here in Puerto Rico. Interesting conversations. People ask why the US turns away Cubans fleeing political unrest and persecution but accepts those fleeing Central America for similar reasons? I don't have a good answer, at least one that is politically correct.

We also talked about entrepreneurs. The Cuban community in Florida is nothing if not entrepreneurial. They have been a huge plus to the local and national culture. Growing up with immigrants (legal and illegal) from mostly Mexico, I would argue that they have also contributed to a vibrant culture within Texas and the border states. I have consistently been pro-immigration for 40 years. I want risk-takers and freedom-lovers from all over the world, especially those with education and talent, to share in the American experiment.

And with that, I will hit the send button. Have a great week and remember where your ancestors came from. Most of us came from risk-taking immigrants.

Your needing more space to talk about China analyst,



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