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Malinvestment in China?

A famous quote attributed to Deng Xiaoping is that "it doesn't matter if a cat is black or white, so long as it catches mice", suggesting that the ideological foundations of policy were only of secondary concern to the pursuit of economic growth. But many commentators take Chinese growth as given. Indeed the real question isn't "what explains Chinese growth?" but "what *is* Chinese growth?" We're not sure of the answer, but this report is an attempt to pursue this question by breaking it down into several, more focused questions. In doing so we hope to identify some of the critical uncertainties that will help us interpret the unfolding history of Chinese economic development.

What is the right historical parallel?

Attempts to extrapolate growth trends are prone to error, but on many measures China is already eclipsing the USA. It consumers more steel, has more manufacturing output and sells more cars. According to *The Economist*, GDP at PPP will surpass the USA in 2014, stockmarket capitalisation will in 2020, and defence spending in 2025.[1] They claim that absolute size is more important than per capita measures, but this may exaggerate China's influence. In terms of universities, Hollywood and innovation – intangible reflections of cultural ascendancy - there is little evidence that the USAs hegemony is under threat. For all its defence spending China has just built its first aircraft carrier and the technology is ex Soviet.

There are three key parallels that are often alluded to when debating the future role of China. The first is to compare Britain vs. the USA after the Industrial Revolution. Then, the "workshop of the world" became overtaken by a former colony that became a dependable ally and firm partner in terms of cultural, economic, and political exchange. The second is the USA vs. the USSR in the 1950s and 60s. There, a genuine belief that democracy hindered growth and the credible threat of military dominance turned out to be built on an illusion of efficiency. Finally, USA vs. Japan in the 1980s and 90s – anticipated subservience to a fast growing "rival" that petered into a stable and mutually beneficial alliance. The role of China, especially with regard to the USA, is of course different. But it will also echo history.

[1] "How to get a date", The Economist, December 31st 2011

Are GDP figures accurate?

When the National People's Conference reduced the GDP growth target to 7.5%, it could be viewed as an admission that development is slowing. Although actual rates are typically larger than targets, this effect has lessened recently and 8% is conventionally viewed as the threshold maintaining social stability.[2] But even if GDP growth continued its recent trajectory, it could be masking several important imbalances. The total value of Chinese companies de listed from US stock exchanges exceeded the amount of money that Chinese companies raised through IPOs in the US. And there's mounting evidence of the scale of bad loans being made (this may well be why Chinese banks have failed to enter Western markets in the way that Nomura did in the 80s). Diana Choyleva of Lombard Street Research has attempted to dig beneath the official figures and finds that massive monetary expansions are feeding their way into inflation. As Allister Heath summarises,

> "state-directed liquidity is hiding insolvency. There have been waves of recapitalisations of the banking industry, and regular attempts at removing vast amounts of bad debt from the system. Yet it remains crippled by the legacy of the bad loans of the 1980s and 1990s, as well as by huge amounts of excessive and misallocated lending during the past 12 years."[3]

Around a third of Chinese GDP is comprised of exports (and the sheer size of the economy means that it's also one of the world biggest importers), demonstrating how important exchange rates are to our understanding of economic performance. But it's the domestic economy where the Keynesian style national accounting gives rise to Keynesian style public policy programs. Commentators point out that the fiscal stimulus constitutes around 15% of GDP, but what does this mean in a country where so much economic activity is centrally planned? The textbook treatment of aggregate demand policy is to use government spending (G) to offset declines in consumption (C) and investment (I). But so much of C and I bear the fingerprint of the state this identity is near useless. Retail sales figures include some government spending, and – as Kaleidic Economics publishes for the UK – the "investment" component of GDP does not even pretend to be purely private.

Many commentators believe it is this commitment to stimulus that will ensure China's continued growth. We think it undermines it – perhaps not in the short run, but certainly over time. However they certainly posses enough reserves to keep growth rates buoyed.

How much growth is due to a housing boom?

Construction accounts for around 10-15% of Chinese GDP and a slowdown in the housing market could have serious ramifications for the wider economy. Although the key driver in the demand for housing is urbanisation (and this shows little sign of letting up), there's no doubt that both monetary

[2] "Year of the tortoise", The Economist, March 10th 2012
[3] Allister Heath, "China's bad debts will fuel next crisis", City AM, February 29th 2012

and fiscal stimuli have distorted the market. There are reports of prices falling by up to 30% even in Beijing, whilst Fitch have suggested two main indicators: firstly, accumulated inventory (suggesting a supply overhang) and secondly, a change in government policy (requiring more private sector involvement to compensate). Hugh Hendry is just one hedge fund manager that has been surprised by the scale of vacancies within new office buildings in major cities, and several "ghost cities" have emerged as inert testimonies to the folly of public works programs. The archetype Austrian style credit boom is characterised by dormant skycrapers of the kind dotting up throughout China.

Does economic growth translate into raised living standards?

Ultimately the purpose of economic development is not growth per se, but higher living standards. But these are hard to measure, and thus tend to receive less attention. One middle ground is to focus on consumption, as an approximation of how production is converted into goods and services that increase utility. There is mixed evidence on this. Barclays Capital have attempted to strip out non-consumer spending from retail sales figures, finding that consumption is rising (as a share of GDP). By contrast, whilst accepting that consumption is higher than official figures suggest, Nicholas Lardy suggests that private consumption has dramatically fallen over the last 10 years.[4]

The national accounts are the obvious place to look for rising consumption, but this should coincide with more families on middle incomes and the emergence of a genuine middle class. The January 2012 *McKinsey Quarterly* shows that the percentage of urban households that earn $16,000-$34,000 has risen from1% in 2000, to 6% in 2010, and is forecast to reach 51% in 2020 (a growth rate of over 20%). The litmus test of the new Chinese middle classes – holidaymakers in Europe – is starting to be met and Chinese travel agents are blossoming.

Where are the brands?

A major difference between China's growth and previous superpowers, for example Britain, is that Britain had a genuine global lead. However Chinese growth as been characterised by the utilisation of existing technologies, and it's unclear for how much longer a labour cost advantage can last. By the middle of the c18th British literature had already begun to appear that chronicled the business class of the industrial revolution. One could argue that China's development is still embryonic, and that the cultural consequences of growth will lag behind the sheer magnitude of productivity. But for a country that loves brands – especially amongst the quick growing affluent middle classes – there is a distinct lack of homegrown ones. It will be telling to see the emergence of Chinese brands that have global recognition, and publicity conveyed upon Chinese entrepreneurs and businessmen (such as magazine profiles, Harvard cases, etc). But this depends on how tight a leash such wealth creators will be granted

[4] "The incredible shrinking surplus, The Economist, February 18th 2012

– it is telling that the US immigration service report that the number of wealthy Chinese people applying for American visas have skyrocketed.[5]

Will China democratise?

Political and economic freedoms can be intertwined, but it isn't only the forces of economic progress pushing China towards transparency. Technology is making dissent harder to suppress, and the social media revolution poses fascinating a challenge to the Chinese elite. The "storm of criticism" across various microblogging platforms following a train crash in July 2011[6] may signal the growing importance of public opinion, and it is fair to assume that the people will demand reforms at some stage.

In the c13th China was way ahead of the West, but then turned inwards and became autarkic. It's conceivable that the Chinese leaders consider this a mistake, that it burnt their pride, and that they are keen to learn the lessons of the past. The key to genuine prosperity is globalisation and a division of labour, and thus broad and deep trading partners. Chinese foreign policy has thus far been characterised more by dignity (consider the Hong Kong handover) than the self-destructive use of power. Whilst cyber crime and trafficking are sources of concern, it's not as though Chinese operatives are assassinating people on the streets of London. Whether "enterprise zones" are part of the core of economic reform, or a tolerated source of foreign exchange that exist along the periphery of the country, remains to be seen.

Can policy errors be exported?

The conventional view of the US financial crisis pins the blame on domestic policymakers – the Fed for keeping interest rates too low, and the government for mandating reduced lending standards and incentivising excessive risk taking. In a world with free capital flows and floating exchange rates trade "imbalances" shouldn't be a problem. In the same way that a high savings rate in Virginia may be challenged towards investment opportunities in California, capital should find its highest return globally. There is nothing wrong per se with the USA running a current account deficit (and thus capital account surplus) with countries in the Middle East and Asia. But an alternative explanation for low US interest rates following the dot com bubble is that high demand from overseas were pushing down yields. It shouldn't come as a surprise that countries such as China have relatively high savings rates. This is in part a consequence of the lack of a welfare state, which crowds out private insurance. The irony is that Communist China has a less generous welfare state than the West, meaning that

[5] Tara Loader Wilkinson, "Wealthy Chinese queue up for US visas", Wealth Briefing, November 10th 2012
[6] Yu Liu and Dingding Chen, "Will China Democratise?" Washington Quarterly 35(1), 2012

Chinese people wanting a pension, healthcare, or education for their children need to provide it for themselves.

This "savings glut" thesis raises the notion that policy errors in one country can have significant externalities. In the case of Europe, the relatively sounder run economies (such as Sweden or Switzerland) have seen their currencies appreciate vis-à-vis the likes of the Euro or Sterling (where the relative stability masks the absolute decline in the value of both). But when a country is actively manipulating its currency the prognosis becomes more difficult to make. In short, more work needs to be done on how to conduct monetary policy when trading with other partners that are engaged in currency manipulation and policy interventions. Theories of the trade cycle need to be updated to account for a system of global fiat currencies.

Colour aside, the Chinese "cat" is catching mice indeed. But that only scratches the surface. Do they catch as many as they claim? Are they causing indigestion? And are they the right type of mice? This report has asked several questions and it will take time to see what the answers are. China will serve as a fascinating case in economic development, and we are witnessing a controversy in Austrian business cycle theory. There is more to come.

Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: http://kaleidic.org

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