Ruminations – July 2014
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China Risen

After three and a half decades of China rising economically, it has finally *risen* to reach parity with the U.S. in physical size of Gross Domestic Product.

Thirty-six years have now elapsed since Deng Xiaoping released his country from the harsh anti-business Communist economic policies of Mao Tse Tung and pointed China toward a market economy. Since then the innate capabilities of the hard-working Chinese people have propelled its economy from a small, weak position (with a GDP less than a quarter the size of America's) to a strong, relatively prosperous position of equal size with the highly efficient American economy.

For many centuries, up to the 1800s, China had the largest, and by far the most innovative economy in the world. Its notable inventions included gunpowder, mortar for masonry, wood block printing, the first manufacture of paper, the spinning wheel and the compass. These were accompanied by the spread of books and major advances in mathematics, the natural sciences, astronomy, and engineering.

But that leadership was destroyed by a total political breakdown – through a series of inept emperors, followed by a collection of regional warlords in the early 1900's as the country disintegrated, and then the destructive policies of Mao when the Communists gained control of the nation after World War II. But since he died in 1976 and more reasonable leaders took over, there's been a striking turnaround in China's political direction and especially in its economy – notwithstanding the continuation of Communist control.

Today China has four times the population of the U.S. so its per capita GDP is only about one-quarter of America's. But that's double its 2005 level. Thus, the large gap has been closing rapidly. As a result, China has become a huge factor in the world economy and a strong competitor of the U.S. But the country does have significant problems now that will make it impossible to continue gaining so rapidly in the global economic race.

The primary challenge for China's leaders is to keep its economy growing fast enough and its wages rising rapidly enough to allow the country's eager horde of citizens to gain more of the good life that they've come to realize (partly through the Internet) is widespread in many parts of the outside world.

Like all political leaders, China's top officials fervently wish to retain firm control of the country because they still have a strong belief in one-party rule, and like all politicians, they cherish their jobs. So to keep the populace satisfied and disinclined to revolt, they have created a tenuous balance between Communism and capitalism, aimed at continually improving workers' prosperity. In effect, what they are trying to do is what the famous old Yale football coach of decades ago, Herman Hickman, said he had to do to keep his job: "(I have) to win enough games to keep the alumni sullen, and not mutinous." But that's getting harder to do in China. Here are the problems.

First, inevitably <u>economic growth</u> has slowed from 10% annually in 1980-2011 to 7.5% in the last three years. This is close to the minimum needed to hold unemployment low, but it has enabled pay rates to rise at 15% per year. Improving productivity has made this possible without too much inflation. Now the government's plan calls for future wage increases of 13% per year. *If* the plan works, that should allow for acceptable gains in standard of living for present industrial workers and the additional ones who will move from farms to factories.

But higher labor costs are pricing some Chinese manufacturers out of export markets. So the simplest forms of manufacturing are moving to countries like Bangladesh and Vietnam, where labor costs, respectively, are 60% and 40% lower. Also affecting the country's exports today, Chinese factory workers' average pay has reached 25% of their U.S. counterparts', way up from only 5% in 2000. The result has been that this rise plus high shipping costs and lengthy transit times have caused some American companies to "re-shore" their Chinese manufacturing back to the U.S., or relocate it in reasonably efficient, nearby Mexico.

To ease this problem, China is moving more into high-end manufacturing and doing a lot to raise worker productivity, especially through the use of robots. To help in this process, last year China became the world's largest buyer of industrial robots. Certainly, Chinese firms will have to push hard to remain competitive in many export markets.

As an underdeveloped country until recently, China has had to make huge investments in infrastructure, productive facilities, and better housing for its citizens. But recent high investing has proven to be excessive, as the country has caught up with most of its needs and over-run them in some key instances. The gigantic scale of its investing up to now is shown in the following breakdown of the country's GDP in comparison with the United States.

	% of GDP – 2012	
	China	U.S.
Investment – Government & Private	48%	18%
Personal Consumption	35	69
Government Expenses	14	16
Net Exports or (Imports)	3	(3)
	100%	100%

These figures show the massive investment spending that has been a major cause of China's rapid economic growth. And recently that was the key factor sustaining the country's continued strong growth in 2009-2012 when the great financial crash pushed the rest of the world into deep recession.

But now most of the needed highways, airports, railroad lines, electric power plants, and factories for basic industries have been built. And for the time being, so has much of the needed housing. As a result, China has reached the point of over-capacity. One striking example is the steel industry, which today is operating at 60% of capacity, down from 90% just three years ago.

However, housing is the prime example of over-investment. This is more of a temporary situation than most sectors because growing incomes will gradually enable many more workers to afford comfortable living in city apartments as the years go along. Up to now, the government has stimulated housing investment mainly through an easy monetary policy, both to aid overall economic growth and to satisfy citizens' desires. So housing investment ballooned to a startling 25% share of GDP last year, three and a half times housing investment's 7% share of U.S. GDP in our huge residential boom of the early 2000s.

Of course, China has a big catch-up ahead to get most of its citizens into decent housing, but for now new supply has run well ahead of current ability to pay. Hence, the government has had to tighten up financing to deflate the bubble before it gets any worse; and the likely slump in new housing construction could be large enough to become a significant depressant on economic growth for at least a few years.

Not surprisingly, a large portion of China's massive investments has been financed by borrowing, so the country's debt has been skyrocketing. This year its total amount will reach at least 230% of GDP, nearly double the 125% ratio of just six years ago. That percentage is not high compared to some major western countries, but those nations are in bad shape today. Certainly the pace of China's debt increases is worrying -- especially since the quality of many loans is weak. This is evidenced by a doubling of bad loan write-offs by Chinese banks last year. Also of concern is the fact that debt – a big force in the country's rapid economic growth – is losing its power. Five years ago, one yuan (China's currency) of added debt produced one yuan more GDP. Recently it has taken *five* yuan to generate the same amount of growth.

Given the excessive size of capital investments recently and the huge debt load China has accumulated, some outside observers are forecasting a big financial slump for the country fairly soon. However, that may be too pessimistic and other analysts do not expect such a bad development. The Chinese are pretty smart about basic economics and financial affairs, and the chances are that they'll maneuver through this problem satisfactorily, but at the cost of slower economic growth for a while.

In addition, the country does have other problems that are causing painful consideration among the leadership. Here are five of the worst ones.

China's breakneck economic growth has led to massive despoilment of the environment: air, water, and soil. All the country's huge electricity needs are met from power plants fueled with highly polluting coal, as are factories producing steel and other basic materials. Also, as the standard of living has risen, cars have rapidly replaced bicycles as the preferred means of transportation, spewing much more carbon into the atmosphere. As a result, all of China's many large cities now have air that's often literally dangerous to breathe.

At the same time, little attention has been paid to environmental considerations by factory owners or farmers, so an alarmingly large amount of the nation's water and soil has become badly polluted. Finally, big needs for irrigation of farms have drained huge amounts of water from rivers and streams – to the extent that when the Yellow River, China's second largest, reaches the seacoast, its volume of water is literally a small trickle.

Environmental degradation has reached a crisis point – exacerbated by widespread demonstrations of protest by angry citizens (in a country where protests are usually prevented). So the leaders are starting to deal with it. This is especially hard in a coal-based nation but costly remediation efforts are starting. These will restrain business growth and profits.

Corruption has emerged as a serious blot on the country's leadership (mostly through the money-grabbing of local officials, and close relatives of high officials, instead of them directly). This arouses citizen ire and redirects assets away from their most productive uses. The new top leader of the national government, Xi Jinping, is one of the strongest people to have occupied that position, and he is forcefully pursuing and penalizing corruption. This is one of the country's most constructive initiatives now.

A persistent drag on the Chinese economy comes from the large, over-staffed, inefficient state-owned enterprises that account for 25% of the country's total output. These companies dominate several essential basic industries, including oil, steel, railroads, and telecommunications, plus aluminum, shipping and shipbuilding. They receive favored treatment from the government, to the detriment of private firms. Some action has been taken to streamline these giants, and even privatize a few (which is really anathema to Communists). But much more of this needs to be done.

Demography is becoming an increasingly negative long-term factor for China. Back in the 1970's (near the end of Mao's rule) with a massive population that was hard to employ productively under the Communist system, the government imposed a rigid one-child-per-family rule. That drastic population control continued until six months ago when a very slight easing was instituted. The result has been an extremely low birth rate that has significantly reduced the number of young people entering the labor force. For a long time that shortage did not hurt manufacturing because millions of farm people wanted to move to factories to earn higher income, and as they left the farms it was possible to increase agricultural productivity to keep the entire population fed.

But in the past few years the number of people seeking manufacturing work has stagnated and only sharply higher wages have attracted them to move to the cities. This will be an increasingly difficult problem, with no obvious solution, as the younger-age population shrinks more. Further, as more older people retire, there will be proportionately fewer active workers to support them and to keep the economy growing. Clearly, much bigger productivity gains are the only means of easing this problem and even stopping all birth restrictions now couldn't start to alleviate this difficulty for nearly two decades.

Finally, China has a collective, committee-type governance system that's very cumbersome and difficult to operate effectively. Its leaders are still deeply committed to Communism, but the days of simple one-man dictatorship, as under Mao, are long past. The public will never again tolerate that. So the country is stuck with the collective leadership. And getting any group of strong, stubborn, ambitious men to work together is extremely difficult. Imagine all the pushing and hauling, the politicking, and the back-biting that goes on inside the walled compound in Beijing where these tough men live and work.

All basic policy decisions are made by the Party leaders who sit on the Politburo Standing Committee, and they select new members of their group when old ones retire, plus the new top leaders. Obviously, the politicking to get on the Politburo is intense. The policies established by that Committee are carried out under its control by the General Secretary of the Communist Party and the Premier.

Occasionally, a strong, capable person maneuvers himself above the group and provides real leadership. Fortunately, that happened in the late 1970s with Deng Xiaoping and to some degree it may have happened in 2012-2013 with the rise to General Secretary of the Communist Party by Xi Jinping. He has really taken charge, and his initial ideas and plans look quite sensible. If he is successful, China could benefit from good leadership in the next six years. It will need that!

This is still a secretive country in many respects and that, added to its great complexity, makes it hard to analyze. But all I've described here seems to indicate that China's former super-rapid economic growth is over, and even the recent pace of 7.5% annual GDP gains will be hard to sustain. Furthermore, there are serious imbalances in its economy and financial system today that could cause major temporary upsets in the next few years – difficult ones if they occur. But beyond that, China will benefit from the strengths of its superior education (which is producing more capable engineers and scientists than any other country), improving innovation ability, capable business managers, and a highly motivated workforce.

Thus, over the long term, China should still be a beneficial source of growth for the world economy and a continuing strong competitor of the United States.

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