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China: Great Success But An Enigma

History

Knowing the history of China is key to understanding the spectacular economic development of that country in recent years – to become a major threat to the dominance of the United States in world markets. And this story is particularly interesting because China was the super-dominant economy in the world for one thousand years, before a steep slide to insignificance in the mid-20th century. Now it seems to be heading back to a strong number-one position again, if it avoids some pitfalls.

Shares of World Gross Domestic Product

	1820	1870	1950	1980	2000	2010
China	32%	17%	4%	2%	7%	12%
US	2%	9%	26%	23%	23%	20%

Source: When China Rules the World

China has existed within its present borders for almost two thousand years, longer than any other nation; but only in the past sixty years has it become a unified country. For centuries it was a federation of states, ruled by an emperor, as best he could. But way back in the years either side of 1000 A.D., China developed a truly remarkable series of inventions (not matched anywhere else in the world). Leading to great economic success, these included gunpowder, mortar for masonry, wood-block printing, the spinning wheel, the compass, the first manufacture of paper, the wheelbarrow, and important for effective sailing vessels: the sternpost rudder.

These were accompanied by the spread of books and major advances in mathematics, natural sciences, astronomy, geography, and engineering. (How else could they later build the greatest public works edifice in history, The Great Wall, between 1368 and 1644?) China was the scientific and economic leader of the world way back then, and as Europe entered the medieval period (the 5th through the 15th centuries) it borrowed heavily from Chinese innovations.

Through its long history, right up to today, the primary force holding China together has been the philosophy of Confucianism – with its beliefs in moral virtue (admittedly not followed by all Chinese now), the supreme importance of government in human affairs, and the overriding priority of stability and unity. These principles were tested severely in the early 20th century as the political structure fragmented during the reigns of the last, quite weak emperors and the rise of regional war-lords. Then in the middle of that century came the negative influence of Mao Zedong, who imposed ruthless Communism on the country and almost ruined it.

But Confucianism continued to simmer beneath the surface, and it re-emerged after Mao's death in 1976, as his successor, Deng Xiaoping harked back to China's earlier, illustrious history and re-directed the country toward its heritage of commercial success. And today the tenets of Confucianism bolster general (but not universal) acceptance of a strong national government that is aggressively promoting economic development, pretty much in the free-market form that has worked so well in the West.

Though lacking the political freedom we so cherish, in many respects China's economy is freer than ours. Its taxes are lower and its regulation is much lighter. It has no welfare system for support of poor people, no government retirement programs, no free healthcare, etc. As a result, citizens are expected to take care of themselves; and to do so, they save a remarkable 40% (yes, FORTY PERCENT) of their incomes. How Ben Franklin would like that! ("A penny saved is a penny earned.")

Education and self-improvement are also central to the Confucian ethic, and China's government spends huge amounts on schooling, right up to its outstanding universities that now match almost any others in the world. Needless to say, given the country's great focus on economic development, the biggest educational emphasis is on mathematics, science, and engineering. Chinese universities now graduate many more engineers than any other nation.

Business Success

Chinese businesses are generally well managed, many as well as the best western companies. This is remarkable since business is a new activity for modern China. The combination of good management, hard work by employees, and low wage rates has made Chinese firms strong competitors in world markets. Hence, the development of huge exports and very rapid economic growth, as shown in these recent figures.

GDP Growth

	2009	2010 Est.
China	8.5%	10.0%
India	7.5	7.5
U.S.	2.3	2.8
Europe	0.7	1.3

Even when the U.S. economy regains more momentum, China will continue to greatly outpace us as more rural workers migrate to its factories, exports rise further, and internal consumption grows. Accordingly, Goldman Sachs and Morgan Stanley both estimate that by 2027 China's GDP will exceed that of the U.S., and by 2050 it will be 85% greater than our national output. That, however, will occur only if the country avoids the pitfalls now confronting it.

Such growth will be stimulated by major technological developments by China as its scientific capabilities catch up with ours and surge ahead of us in some areas. One sector in which this is already happening is "green technology." China is the biggest air polluter in the world, and they are looking at that status as an opportunity more than a problem. Aided by massive government subsidies, they have already become the world leader in solar power, and one of the leaders in wind power. Further, the Chinese company, BYD, is the current leader in batteries for electric-powered automobiles, and its smaller batteries are used in more than a quarter of all mobile phones produced today. Moreover, thanks to state mandates, China already has the largest fleet of clean-energy vehicles in the world.

But despite all its successes to date and its promising outlook, China does have problems that could hamper its progress in coming years.

Potential Problems

The most serious short-term risk lies in the real estate and capital spending bubbles that have developed in the past year as a result of the massive economic stimulus program the government instituted in 2008, when the breakdown of the western world's financial system caused a global business recession. This hit China's exports quite hard, and the government quickly inaugurated a $585 billion program to spur real estate development, greater infrastructure building, and more capital spending by businesses. Relative to the size of its smaller economy, this was larger than the United States' stimulus effort – and it supercharged Chinese economic activity, offsetting any slowdown in GDP growth.

The result has been big boom in housing production (for upper-income buyers). Soaring demand for these homes has produced price rises of 50% in 2009 and at the same rate so far in 2010. Even though the Chinese use much less mortgage financing than the U.S., most observers expect a crash in the overheated residential market before long. The same is likely in the retail and office building sectors. Consider this arresting fact: Today 30 BILLION square feet of office space is under construction in China – 25 square feet for every man, woman, and child in that vast country – while the current office vacancy rate in China is 20%, well above the 14% rate in the U.S., which is in a slump now.

The Chinese government has recognized this bubble risk and taken steps to restrain it, but as with the U.S., it appears their actions are a little late, so some grief in this area certainly lies ahead, particularly large loan losses for banks and perhaps some deceleration of economic growth.

Other areas of excessive spending have been infrastructure (roads, airports, etc.) and capital expenditures by businesses. (China kept right on building new steel mills through the past several years when steel demand had temporarily completely stopped growing.) These excesses don't have the same risk of bank loan losses as residential and commercial construction, but spending here will have to slow down, causing some drag on GDP growth.

Most observers do not believe that China is facing a financial breakdown of the magnitude experienced by the West in the past few years. But the condition of its banks and the financial status of the Chinese government are quite opaque, so we just don't know what might happen. And with so much of the government's acceptance by the citizenry dependent on continued economic growth, any financial crisis in that country could be extremely disruptive. This is part of what makes China an enigma today.

Despite all of the country's free-market growth, state-owned business enterprises (SOEs) remain a big, and negative, feature of China. While information about them is limited, it is estimated that these giants still employ 25-40% of the nation's urban workforce. Inefficient and riddled with corruption, their profitability is uncertain, and they are financed with huge bank loans. It is safe to say that much of that debt is quite shaky.

Some SOEs have been privatized in recent years, with difficulty. Trying to do that with the rest of them would create lots of unrest, because personnel layoffs would be large and even so most of these companies could not survive in the competitive arena. So the SOEs are a risky, costly form of welfare – about the only welfare in the country.

Wage rate pressures are picking up in China. Working conditions are harsh in many Chinese factories and so are living conditions for their employees who have moved in from the farms. Further, pay rates are low, and as they rise, inevitably they will erode the country's competitive advantage in export markets.

The Chinese government knows full well what happened in Poland starting in 1980, when a bitter shipyard strike in Gdansk empowered the local Solidarity union to eventually become a broad anti-Soviet movement. It actually forced free elections within a few years, causing the overthrow of the

Soviet government and the installation of Solidarity leader Lech Walesa as president. Beijing does not want to experience a repeat of that event.

But recently, serious labor unrest has developed in various parts of China, with a series of strikes in Japanese auto parts plants and other companies' factories. These have led to quick wage boosts of 25% or more. The success of these job actions is emboldening employees elsewhere to strike for higher pay and better working conditions. Faced with this new and threatening phenomenon, the government has started an energetic effort to improve the standard of living of its industrial workers, allowing big wage increases in the process. This will help stimulate domestic consumption, one of its key goals, but the offset will be more expensive, and less competitive, export prices as wage rates soar.

Already, as a result of rising wages, manufacture of low-cost products like apparel and footwear has been leaving China and going to Vietnam, Bangladesh, and Cambodia, where labor costs are lower. Whether this trend accelerates and how much it hurts China's export strength remains to be seen.

Currency valuation is another uncertainty for China. Over many years, with one timeout in 2005-2008, it has maneuvered to hold the exchange value of its renminbi (also known as yuan) down at artificially low levels, in order to maintain cheap export prices and overwhelm the U.S. and other nations with inexpensive products. Naturally, these countries have reacted negatively to the unfair trade terms and exerted all the pressure they could to force China to let the renminbi float freely in the world currency markets and reach fair value.

Finally, on June 19 the Chinese central bank announced that it would allow greater flexibility in the value of its currency, permitting it to appreciate gradually. But it stated a determination to limit the rate of increase; so the key word for the new process is *gradual* – as demonstrated by just an 0.4% rise in the first week. This, for a currency that may be 15-20% undervalued, is infinitesimal. How the change to "flexibility" will evolve is uncertain today, but any significant resulting price increases on Chinese exports will limit their future growth, and growth of the country's economy.

Demographics are a certain long-term problem. Among its gigantic 1.3 billion population, China still has plenty of workers down on the farm, many of whom will move into factories for some years to come and further boost output. But the country's long-standing, and very strict, policy of allowing only one child per family is already producing a shortage of younger workers and a rapidly aging population. So China's workforce is growing very slowly, and it will soon level off. Its total population will grow by only 6% in the next forty years (less than 0.2% per year) versus a total of 43% projected for the U.S.

That slow growth is better than the *declines* expected for some European countries, like Germany and Italy, but it will leave China with a difficult barrier to long-term economic growth and a costly retirement problem. By 2040 it will have 400 million elderly citizens, most of whom will have no pensions, and it may not have enough working-age people to support its elderly if their large savings prove inadequate.

Political pressures are a chronic problem in China, despite the general acceptance of a powerful national government. These result in an average of 100,000 serious *local* riots every year across the huge country. They involve ethnic conflicts, land disputes, reaction to government corruption, and backlashes at overbearing local officials.

There is also the dichotomy between factory workers who earn, by Chinese standards, decent wages and the great mass of rural residents (some 40% of the total population) still stuck trying to eke out a modest living by farming small plots of land – and fighting to hold onto their land. While the demands for greater political participation by citizens are still not widespread, they are growing, and China's leaders have not yet found a way to accommodate them.

To a great extent, the legitimacy of the ruling Communist Party depends on economic growth and rising living standards, so it is pushing these as hard as it can. I suspect that in dealing with its citizens, China is following the approach of Yale's old football coach of fifty years ago, Herman Hickman, who when referring to his "good enough" team said, "It fits into my policy of keeping the alumni sullen but not mutinous." But no one knows how the country's political future will evolve and how that will affect its economic growth. These uncertainties – another part of the Chinese enigma – have to be a concern to long-term investors.

Conclusion

The economic success of China has been so great that it's easy to say it will continue indefinitely. But in cases like this, it's prudent to invoke the old adage: "When something looks too good to be true, perhaps it is." Clearly China has potential problems that could derail its uninterrupted rapid growth for a while sometime in the future. So investors seeking to participate in the country's apparently very bright outlook should move into Chinese stocks quite cautiously, waiting now for better values produced by one of the occasional price declines that volatile market has been subject to.

China has recently enjoyed the greatest business success of any nation in history, and it's very tempting to investors to climb aboard now. But patience and caution should temper optimism about the country's remarkable economic development.

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Note: For my understanding of Chinese history, I am particularly indebted to *When China Rules the World*, an excellent book by Martin Jacques, an old China hand who is now a columnist for the British newspaper, *The Guardian*.

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