Whither China?

John Mauldin | June 18, 2013

All weekend long and this morning as I wake up in Monaco, the number of disparate publications screaming at me about problems in China is just overwhelming. Then I get myself up early to hear a speech by the esteemed British economist Charles Dumas of Lombard Street fame, and I am confronted with even more China. I have been watching China for a long time, expecting a crisis, as I readily admit I simply do not understand a country that has defied so many of the economic laws of gravity for so long. Some kind of return to normal economic paradigms seems almost mandated, but the question has always been when. Have the Chinese discovered some new control mechanism, found some different levers to pull that they should share with the rest of the world, or will we see them revert to something that looks more like whatever it is that passes for "normal" these days? My bet has always been the latter.

That said, I do not expect China to slip silently away. It is here to stay, and it will be bigger and more dynamic in the future, but the transition from an economy driven by investment and massive debt into one more soundly based on domestic consumption will not be easy. Today's *Outside the Box* will focus on two readings on China that came my way this weekend. The first is from the formidable Lyric Hughes Hale, an expert on Japan and Asia, founder of *China Online,* who is married to the eminent economist David Hale. I have had the pleasure of meeting with them and find them quite the economic power couple. She gives us a tour of recent work on China. Perhaps, as she asserts, the current Chinese economic model, based on cheap labor and cheap money, has run its course. The challenges that face China are daunting.

Then we turn to a thought-provoking piece of analysis from the *Financial Times* that underscores Hale's central point. China is grossly inefficient, with severe overcapacity in many industries: "The problem with subsidies everywhere is they tend to support activity not outcomes and they become more of a problem when they're just subsidizing inefficiencies…"

Just a few quotes from some of the other pieces I read in the last 48 hours:

> China's shadow banking system is out of control and under mounting stress as borrowers struggle to roll over short-term debts, Fitch Ratings has warned. The agency said the scale of credit was so extreme that the country would find it very hard to grow its way out of the excesses as in past episodes, implying tougher times ahead. "The credit-driven growth model is clearly falling apart. This could feed into a massive over-capacity problem, and potentially into a Japanese-style deflation," said Charlene Chu, the agency's senior director in Beijing." (from Ambrose Evans-Pritchard in the London *Telegraph*)

And then Stratfor writes:

> A cash crunch over the past three weeks has caused rates on loans between banks to spike to the highest levels since mid-2011, drawing attention back to China's financial instability. Rates have

> since subsided, but conditions exist for them to remain elevated over the next month or beyond. Unlike two years ago, at least one bank has already defaulted on a loan and there are rumors that other defaults have occurred. The emergence of bank defaults poses a serious challenge to the central government's efforts to clamp down on credit growth as part of its broader attempt to reform the country's economy.

And finally, my friend Simon Hunt, who has been deeply involved in China for decades and spends many months each year traveling throughout the country meeting manufacturers, writes:

> The credit crisis that we have been warning about has arrived. Debt has reached such peak levels that it can no longer be put under the carpet and rolled over for another day. The economy is having a mini-recovery this month but will weaken again in July.

Not expecting a collapse, Simon does see that serious adjustments are needed and believes they will be enacted:

> Nor is there much of a risk that China's credit markets will implode because banks have built up a US$3 trillion war chest which is lodged with the PBOC and because [the] government has assets that can be utilized. The question is how the pain will be shared out throughout the country.

China always has my attention. I believe that Japan is forcing their hand with its own massive quantitative easing. China may have the easiest answer of all the major global trading countries, however. All they have to do is gradually float their currency. As Charles Dumas noted, they have $4 trillion in savings that will look for a home outside of China. A floating currency will weaken the renminbi against major world currencies and help their export businesses. It will also drive US Senators Schumer and Graham nuts, which is a side benefit. A floating currency with no significant QE when the Fed is printing with full abandon will be the strongest argument against the accusation that China is manipulating its currency. Interesting times.

My speech at GAIM will be tomorrow, and then I will take a few days to explore the south of France before heading off to Cyprus. I will speak at a venue that is being arranged on Wednesday in Nicosia, and the event will be open to the public. I will announce the time and place in this weekend's letter. And then it's on to Croatia and a long weekend with David McWilliams and his family on some idyllic little island in the middle of nowhere. Sounds divine. I hope you are enjoying your summer, wherever you may be.

Your needing more gym time analyst,

John Mauldin, Editor
Outside the Box

China's Innovation Hurdle

By Lyric Hughes Hale

At a meeting in Chicago, the China-United States Exchange Foundation released a report, "U.S.-China Relations in the Next Ten Years." Chicago Mayor Rahm Emanuel opened the meeting, chaired by CH Tung, the former Hong Kong chief executive, as well as Henry Paulson, the former U.S. treasury secretary. The mood was celebratory, especially after the overnight announcement that the presidents of both countries would be meeting in California in June, sooner than expected.

The idea of a bilateral U.S.-China free trade agreement was floated, in effect to create a new G2. The two countries are currently so interdependent that in some ways China and the U.S. are already one nation. I could only imagine the reactions of Japan and the EU to a formal alliance of the world's two largest economies.

My mind wandered back to the book I have been reading recently, Timothy Beardson's *Stumbling Giant - The Threats to China's Future*. In particular I remembered one of the author's pithier comments. He said that when commentators coined the new term 'Chimerica' to describe the interconnectedness of both countries, they might have missed the allusion to the word chimerical or fanciful.

In spite of their opposing points of view, both the conference participants and Mr Beardson would agree on at least one point: the current Chinese economic model, based on cheap labor and cheap money, has run its course.

The demographic challenge is the greatest of all. Here is a bracing forecast: China's population in 2100 will shrink to 941 million, but the U.S. population will grow to 478 million. Instead of four Chinese to every American, there will be two. As Beardson notes:

> Societies with steadily falling populations do not normally have a sustained high rate of economic expansion. As China's population is estimated to peak around 2026 and then to fall, there is a narrowing window for China to continue its high economic growth rates.

Comprehensive reforms are needed in the Chinese economy. Absent government policies that will quickly alter the longstanding behavior patterns of Chinese consumers, the middle class and especially the poor will be incentivized to save for retirement, for health care, and for education. Chinese leaders however have fully subscribed to the mantra of gradualism, and what is missing is a sense of urgency about the transition. While Mr Beardson does not completely dismiss the possibility, he seems unconvinced that these changes, especially the transition to an **innovation economy**, can be made in time:

> The model is comprehensively broken and it faces multiple challenges. China is no longer the cheapest country in which to manufacture. Currency movements have disadvantaged it, wages have risen, social and environmental costs are increasing. Export margins were always thin, but with rising costs there is a little buffer available to absorb the impact... If the old cheap export and fixed investment model is broken, the alternative should be a combination of the long-awaited innovation and domestic consumption. However, the downturn showed that the country's technological and economic competitiveness still lags behind world standards.

Being a superpower involves hard power, military might, soft power and economic dominance. Of course, these are all related, and all are dependent upon the ability to innovate. This, of course, has long been the strong suit of the U.S.

Will China be able to meet the innovation challenge? One of the great successes of Beardson's book is his chapter 'The Elusive Knowledge Economy' in which he describes the current state of innovation in China, as well as the historical and cultural factors that will affect its future development.

> The world appears genuinely worried by China's scientific advances. However, I will argue that the platform is lacking for China to create an innovative economy. This is for reasons of education, history, culture, ethics and politics.

His overall conclusion is stark: *'China is failing in innovation'* but he leaves open the possibility that this might change. He knocks down false indicators, pointing out that China's high ranking in terms of R&D spending has been falsely adjusted to reflect local living standards (PPP) while the costs of laboratory equipment, for example, are really based on global standards. These are the fine distinctions that explain a lot.

Based upon Beardson's long and successful history in Asia, unsurprisingly Chinese culture is not neglected. Here he touches on a subject near to my heart, which is the absolute necessity of freedom of information as the basis for innovation. This is also the Achilles heel of Chinese soft power, which suffers when freedom of expression in China is visibly repressed. According to the *South China Morning Post*, recently university professors in China were given a directive not to discuss the following seven topics: freedom of the press, civil society, civic rights, historical mistakes by the Communist Party, elite cronyism, and an independent judiciary. If universities are the cradle of innovation, this is not the atmosphere in which critical and independent thought can possibly thrive.

> In other words, China may accumulate the funding, build the laboratories and staff them, but it might not possess a 'non-hierarchical scientific culture, fertile institutional framework and critical thinking' -- the necessary soft skills... If critical thinking and social stability are seen as opposites in a zero-sum game, China will be the loser. However, China can achieve much if it wills it.

Essentially, Beardson's argument is that China's heretofore-successful model is about to run out of steam, and it will not be able to innovate its way out of this corner without essential political reforms. Some would disagree and cite China's economic success. They note that Haier has become a global company and brand, and that the Internet in China in particular has created many innovations and changed the lives of hundreds of millions of Chinese. Steve Blank, of the Haas School of Business at Berkeley, recently visited web companies in both China and Japan. He sees China at a turning point, rather than reaching a hard limit, as he describes innovation with Chinese characteristics:

> For the last 10 years China essentially closed its search, media and social network software market to foreign companies with the result that Google, Facebook, Twitter, YouTube, Dropbox, and 30,000 other websites were not accessible from China. This left an open playing field for Chinese software startups as they 'copy to China' existing U.S. business models. Of course 'copy' is too strong a word. Adapt, adopt and extend is probably a better description. But for the last decade 'innovation' in Chinese software meant something different than it did in Silicon Valley. China Startups-The Gold Rush & the Fire Extinguishers

Dan Harris, an intellectual property attorney and author at China Law Blog, looks at another aspect of innovation that is often cited as evidence that China is pulling ahead of the U.S. – the number of patent applications filed by Chinese companies. In a recent article he cites the $18B China now pays for licensing foreign technologies.

Those who say China is innovating often cite the massive numbers of IP filings being made by Chinese companies in China. I use those numbers to counter those who allege that filing trademarks, copyrights and patents in China is a waste of time, but I do not think they show much regarding innovation.

> But the new (to me anyway) numbers that I found most salient are those relating to patent licensing. In 2012 (according to the Financial Times) 'China had a record deficit in royalties and license fees of nearly $17bn – compared with an $82bn surplus for the US'. China's $17bn deficit is a result of China paying out $18bn in royalties and license fees and collecting only $1bn in such fees. I see these numbers as extremely meaningful and what they say is that China is having to pay huge sums to other countries for innovations created outside of China and substantially less is being paid to China for innovations created there. Indeed, it is quite possible that a large chunk of the $1bn going into China for licensing and royalty payments is for innovations created by foreign subsidiaries doing research and development work within China.

Is China Really Innovating? The China Licensing Numbers Say No.

Innovation can be negative as well as positive. China's cyber security and hacking activities are front-page news. The Chinese are investing in U.S. telecommunications companies, and it is a good bet, according to an official at Google, that they have visited you already. According to Beardson however, a good offense doesn't necessarily mean that you can play great defense.

> Surprisingly, an American security researcher, Dillon Beresford, claims to have successfully hacked into many highly classified Chinese military facilities: aggressive behavior is not always matched by proficient cyber security Indeed, he states that China has 'an almost total lack of basic cyber defense'.

China is also behind on some key metrics in defense technology. To give just one example, the traditional blue water navy paradigm leaves China far behind. The U.S. has 19 aircraft carriers, including ten Nimitz class super carriers that are powered by nuclear reactors. China has one aircraft carrier, the Liaoning, which is actually a rebuilt Soviet-era ship, and it is not nuclear-powered.

Health care is another area where the U.S. leads the world in innovation, even if our own citizens pay a high price. China has more pressing concerns however. Lack of access to basic care has erupted into violence against health care workers in China, as illustrated in Yanzhong Huang's seminal article "The Sick Man of Asia." In spite of the high density of mobile technology, which could be an ideal platform for telemedicine, there are simply not enough trained health care workers to make this a feasible alternative to bricks and mortar hospitals, and can never replace long term care for China's rapidly growing population of over 65's. Beardson muses that the aforementioned aircraft carrier might have to be scrapped in order to pay for housing for 150 million elderly Chinese with no place to go.

Worries that China will fizzle out are not new. Back in 2011 I wrote an article … entitled China's 99%: Why China Will Not Surpass the United States. Books on China and its relationship to the rest of the world abound. A quick look at Amazon for titles by country returned the following results:

U.S. 1,631,884
Great Britain 502,241
China 398,784
France 298,075
India 220,043
Canada 201,182
Japan 199,255
Mexico 195,511
Germany 130,885
Russia 74,433
Iran 22,866
Iraq 24,475
Afghanistan 13,956

China is certainly top of mind in the U.S. However, if you are going to read one book on China this year, Stumbling Giant should be it, because of its depth and scope and the even-handedness of its author. I have focused on the subject of innovation, which is a constant throughout the book, but other vital topics are covered as well, such as the environment, military power, and China's relationship with the rest of the world. Beardson recounts vital history that is largely unknown to Westerners. I particularly liked the section on China's relationship with Russia, which was disconcerting – I now feel that Russia has more to fear from Chinese border disputes than Japan.

I would have liked to have seen maps, given the geographically challenged nature of most Americans, and more graphs, given my economic propensities. The addition of photographs might have turned the book into an encyclopaedia, but they would have added to the narrative as well.

Ever since we gained the top spot, Americans have been obsessed with the possibility that other countries might upset our global dominance. After World War II we actively feared the Soviet Union. Then in the 70's we worried that Japan would be Number One, until it suddenly wasn't. Now we look to the Chinese to fill the competitive void.

In spite of a spate of reports from the OECD about China's economic dominance, and breathless media coverage declaring that China will overtake the United States any moment, a sense of reality is returning. China faces a myriad of huge challenges. Their traditional markets have slowed down, and their GDP is falling. A real estate bubble, civic unrest, and massive corporate and local government debt are worrying signs.

While the size of China's economy in absolute terms could be larger than that of the U.S., it certainly isn't on a per capita basis, and that's what counts in terms of satisfaction of a country's citizenry and the stability of its government. China's income inequality is now greater than in the US. Which might be all right if income opportunity were the same, but corruption blocks equal access.

Stumbling Giant should convince you in a highly nuanced way that China is far from unassailable, but we should all hope, very fervently, that she keeps her balance.

Lyric Hughes Hale is the author of What's Next *and a contributor to a range of publications, including the* Financial Times, Los Angeles Times, USA Today, Current History, *and* Institutional Investor. China Takes Off, *published in 2003 and written jointly with her husband David Hale, is one of the most oft-cited surveys of China's economic ascendency. Ms. Hale studied Japanese at Northwestern University and graduated from the University of Chicago with a degree in Near Eastern Languages and Civilizations. She has lived and studied in Europe, Asia, and the Middle East.*

Chinese industry: Ambitions in excess

By Jamil Anderlini

Overcapacity fuelled by subsidies threatens the world's second-biggest economy

Shi Zhengrong became known as the "sun king" around the time he was named China's fifth-richest man in 2006. Barely three years later, Suntech, his New York-listed company, was the world's largest solar panel-maker, producing enough solar cells each year to power 1m energy-guzzling US homes.

To struggling manufacturers in the US and Germany, Suntech was part of an unstoppable juggernaut that undercut markets, flooded the world with ultra-cheap products and put competitors out of business. Indeed, the European Commission is threatening to raise import tariffs on Chinese producers for allegedly selling solar panels in Europe for less than they cost to make.

But China's business model is far from unassailable. In March, Suntech filed for bankruptcy protection. From a market value of $16bn at its peak, the company is now worth about $180m. The sun king has been dethroned as chairman.

In fact, the solar industry is only the most pronounced example of broader overcapacity in China. Its rise and fall has followed a pattern that is becoming familiar across the world's second-biggest economy.

The problems stem from China's industrial policies and a vast array of subsidies that allow whole sectors to spring up overnight. Ambitious local officials are keen to lavish government money on what they hope will be success stories that can further their careers.

"When you have administrative measures you get huge overcapacity and this country has created overcapacity in a whole lot of areas," says Hank Paulson, former US Treasury secretary, who often visits China. "It's not just clean technologies; steel, shipbuilding we can name all the areas."

From chemicals and cement to earthmovers and flatscreen televisions, Chinese industry is awash with excess capacity that is driving down profits inside and outside the country and threatens to further destabilise China's already shaky growth.

It is not a new problem; it was exacerbated by Beijing's response to the financial crisis in 2008 and continues to worsen despite years of government efforts to curtail it. China produces nearly half of the world's aluminium and steel and about 60 per cent of the world's cement but new production is being added rapidly, even as the economy cools.

China's output expanded 7.8 per cent last year – its slowest pace in 13 years – and after a brief rebound in the fourth quarter, growth has slumped further in the first half of this year.

Aluminium prices have dropped precipitously in recent years and more than half of China's aluminium producers operate at a loss. Despite this, smelters are being built nationwide, even though producing the metal requires huge amounts of energy, water and bauxite, all of which are scarce in China. Foreign producers are also being forced to close because of the excess supply spilling out of China.

Only about two-thirds of cement capacity was used last year, according to a survey from the China Enterprise Confederation.

For global manufacturers, the China effect over the past decade has been fearsome. It has destroyed jobs and capacity all over the world, shuttering factories in competitor nations.

But in almost every sector where China's low-cost goods have come to dominate, something strange has happened. Once the bulk of global manufacturing in a given industry has moved to China, overcapacity quickly follows and these sectors begin to cannibalise themselves. Suntech was a prime example.

Li Junfeng, a senior energy policy adviser at China's state planning agency, likens the country's solar sector to a patient on life support and says at least half of global solar capacity needs to be shut. "Overcapacity results in low-price competition; all industries experiencing overcapacity have this problem," Mr Li says.

An older example is the mobile handset market, which the Chinese government set out to dominate a decade ago with national champions sporting names such as Panda, Konka and Ningbo Bird.

Even in China not one of these companies is a household name today. But many analysts had once predicted these low-cost producers would rise to become the Chinese equivalents of Nokia, Ericsson and Motorola.

The Chinese government, particularly local authorities, poured vast subsidies into these companies in the hope of turning them into global forces but they all eventually lost the race to develop new technology.

"There was a lot of talk back then about how these companies would become great new Chinese technology giants and they certainly threatened their international competitors by eating away at the low end of the value chain," says Anne Stevenson-Yang, research director at J Capital Research. "But over time Chinese companies tend to remain factories that manufacture huge amounts of low-end, undifferentiated stuff."

Several studies have found that the ability of Chinese industry to dominate global manufacturing in certain sectors is largely due to subsidies, most of which are provided by local and provincial governments.

In a recent study, Usha and George Haley, US-based academics, studied how Chinese steel, glass, paper and auto parts producers turned from bit players and net importers to the world's largest manufacturers and exporters in just a couple of years.

In each of these highly fragmented, capital-intensive industries, labour accounted for between 2 and 7 per cent of costs and the vast majority of companies enjoyed no economies of scope or scale.

"Our findings contradict the widespread belief that China's enormous success as an exporting nation derives primarily from low labour costs and deliberate currency undervaluation," says Usha Haley. "There is enormous overcapacity and no gauging of supply and demand and we found that subsidies account for about 30 per cent of industrial output. Most of the companies we looked at would probably be bankrupt without subsidies."

Besides direct cash infusions, many local governments in China provide very cheap land, cheap credit, discounted utilities and tax breaks to state-owned and private companies that set up in their backyards.

In a research report on government subsidies to non-state owned Chinese companies, Matthew Forney and Laila Khawaja from the research consultancy Fathom China found that most companies surveyed received some form of direct subsidy.

"The bottom line is that officials who climb the [Communist] party ladder fastest are usually those who oversee the most flashy investment projects and the fastest growth," Mr Forney and Ms Khawaja say. "Offering subsidies to private companies looking to expand can help localities clinch an investment deal that brings jobs and tax revenue."

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Some of the most heavily subsidised companies in China are automakers, such as Chery, BYD and Geely. Some analysts predict they will ultimately meet the same fate as the handset makers.

Overcapacity in the auto industry is rampant and in the case of Geely, which bought Volvo in 2010, more than half of its net profits came directly from subsidies in 2011. In fact, subsidy income for Geely that year was more than 15 times greater than the next biggest source of net profits – "sales of scrap metal" – according to analysis from Fathom China.

In the case of Mr Shi the sun king, subsidies and grants from a local government were crucial in convincing him to return to China from Sydney, where he lived in the suburbs and drove a Toyota Camry to his job as an executive in a solar start-up company. Mr Shi and Suntech both declined to comment. In 2000, the government of Wuxi, near Mr Shi's birthplace in eastern China's Jiangsu province, was eager to establish a solar industry so officials set out to lure him back with promises of support.

"Suntech is a seed sown by the Communist party committee of the Wuxi government," Mr Shi said in a speech in March 2011 to welcome Yang Weize, the former Wuxi party secretary, to Suntech's new headquarters in the city. "During Suntech's start-up phase we experienced intense pressure but Wuxi continuously watered and nurtured this seed."

Thanks partly to his success in fostering Wuxi's solar industry, Mr Yang was promoted in 2010 to become the party secretary of Nanjing, one of China's largest cities. Throughout the country, party officials take note of this kind of meteoric rise and arrive at the conclusion that they too can reach great heights by subsidising businesses.

This drives intense inter-regional competition and a race to the bottom between local governments, which often decide not to enforce environmental, safety and labour laws in order to keep jobs and taxes (and kickbacks) in their jurisdictions.

Another big problem for almost every industry is that companies' investment and growth plans have been predicated on the belief that the government would never allow growth to drop below 8 or 9 per cent.

This perception was encouraged by Beijing's response to the 2008 crisis, when it launched a Rmb4tn ($650bn) stimulus, unleashing a construction boom to prop up stumbling growth.

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Today, as growth slips towards 7.5 per cent and lower, China's new leaders do appear more determined than their predecessors to tackle overcapacity.

"We intend to accelerate the transformation of the economic development model and vigorously adjust and optimise the economic structure," said Zhang Gaoli, the executive vice-premier in charge of the economy and a member of the all-powerful Standing Committee of the politburo, in a speech this month. "We will strictly ban approvals for new projects in industries experiencing overcapacity and resolutely halt construction of projects that violate regulations."

However, Beijing has tried for years to tackle this problem but meets fierce resistance from local governments trying to protect their local "seeds". Analysts and officials say bankruptcies such as that of Suntech are still unusual and tend to happen only when a company is beyond rescue or local officials want to seize ownership. But the scale of overcapacity and the slowdown in Chinese growth suggest many more people will suffer the fate of the sun king.

Mr Shi remains in Wuxi and is still the largest single shareholder in Suntech but, according to Chinese media, he is the subject of an investigation into his role in the company's fall.

"The problem with subsidies everywhere is they tend to support activity not outcomes and they become more of a problem when they're just subsidising inefficiencies," says John Rice, vice-chairman of General Electric, who heads GE's global operations from Hong Kong.

"If you do that in perpetuity it just increases the size of the anchor that drags down growth."

Additional reporting by Leslie Hook

Steelmakers struggle to shut down capacity

When economic growth in the west evaporated during the global financial crisis, China rode to the rescue with a colossal stimulus package that helped the global economy out of the downturn, *writes Leslie Hook*.

Powered by a binge in government spending on infrastructure and construction, as well as an injection of cheap credit into industrial sectors, China's economy steamed along, growing 8.7 per cent and 10.3 per cent in 2009 and 2010.

But today the price of that stimulus is becoming more apparent. Five years on, many of the industries that were beneficiaries of the stimulus – from steel to shipbuilding to metals smelting – are bloated with overcapacity.

For these sectors, the recent slowdown in China's economic growth spells serious losses and a painful process of elimination.

"Five years ago, steel was an industry of huge profits," explains Zhang Xiaogang, who heads Anshan Iron and Steel, China's fourth-largest steelmaker.

"Precisely because it was so lucrative, there was a lot of repetitive construction and a huge amount of assets pouring into the field, causing the overproduction nowadays."

Those boom days derailed the long-planned consolidation and reorganisation of China's steel sector, which has for decades been an illusive goal for Beijing's policy makers.

Today, even though China's steel production is running at record levels, only about 80 per cent of the country's production capacity is being used. Industry chiefs and government officials say more excess capacity needs to be shut down in order for the sector to come back into balance.

But this is easier said than done. Previous efforts to consolidate the steel sector have been sidelined repeatedly.

Regardless of their profitability, steel mills have proved to be almost impossible to close down because of their role in providing employment and providing tax revenues to cash-strapped local governments.

"It is very difficult to find an effective remedy for China's production overcapacity problem," says Mr Zhang.

"Which company are you going to tell to shut down? Do you choose the ones that are losing money, or are heavily polluting, or are violating industry standards, and make them close? This part is quite hard."

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