# China: House of Cards or Emerging Superpower?

By Robert Huebscher
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Few topics are as contentious as the fate of the Chinese economy. The bulls argue that its growth will propel the global economic recovery and that China will ultimately supplant the United States as the leading world superpower. According to the bears, the Chinese economy has been fueled by unsustainable fiscal stimuli and is a prototypical bubble poised to burst.

These divergent outlooks were on display as five of the foremost thinkers in the investment industry tangled over China's future at last week's Strategic Investment Conference, held in San Diego and hosted by Altergis Investments and Millennium Wave Investments. Millennium's John Mauldin, author of popular *Thoughts from the Frontline* newsletter, was joined on the panel by Gary Shilling, President of the economic consulting firm that bears his name, David Rosenberg, Chief Economist and Strategist at Gluskin Sheff, author and Harvard professor Niall Ferguson, and George Friedman, founder and CEO of the political intelligence company Stratfor.

**Bubbles, bad loans, and overcapacity**

Shilling advanced the bearish case, arguing that China in the short term is nothing more than a "house of cards." According to Shilling, China has fed its economy a $585 billion stimulus program, which would be equivalent to a $1.7 trillion stimulus for the US's economy, which is nearly 2.9 times the size of China's. A byproduct of that stimulus was 11.1% GDP growth in the first quarter of this year.

That growth, though, was accompanied by a trade deficit, China's first in six years.

Where did that stimulus go? Toward infrastructure projects that built excess manufacturing capacity and to bank loans, many of which may never be repaid, Shilling said.

Mauldin echoed this concern. "I don't get China," he said, noting that investors have more attractive options among other developing economies. "How can you have an economy where 50% of its GDP last year was bank loans, a lot of which are non-performing?" Investors in China face huge uncertainty, he said.

Shilling questioned the quality of China's growth. The Chinese, he said, have built more industrial capacity than can be justified by domestic or foreign demand. Overbuilding has insidiously distorted China's reported GDP growth, Shilling said, because, for example, it takes a lot of steel and cement to build steel or cement plants.

Low quality is evident as well in China's lack of environmental standards, Shilling said, noting that China does not have an equivalent of the EPA. "If they want to build a road, and you are in their way, you are likely to become part of the pavement," he said.

China's domestic markets are too small to drive its growth, according to Shilling. Consumer consumption represents 36% of Chinese GDP and is declining, as compared to 71% in the US.

Investors, he said, perennially believe China has decoupled from the rest of the world, especially with respect to its exports, but that is not the case. Exports represent 38% of GDP and have been weak lately with the retrenchment of the US consumer.

China's decline is one of a series of events that will be part of a deleveraging process Shilling foresees for the coming decade. While Shilling is pessimistic about growth for China in that time period, he said that his longer term forecast is more positive.

**The next global leader**

Ferguson, on the other hand, believes in China in both the short and long term. "When things change as profoundly as they are changing now, and when the possibility exists that after 500 years of western predominance an Asian economy is going to catch up with the US, we find it difficult to believe," he said. "We want to tell ourselves it is some sort of bubble and they will fall on their faces. It sounds like wishful thinking when I hear Americans say that."

When Ferguson has spoken to the Chinese leaders, what he has heard is a striking self-confidence. "It is the self-confidence of a regime that has proven most people wrong," he said. "Most people said if there is a Depression in western economies, China, with its export-driven economy will be absolutely stuffed."

That was not the case. China's exports fell dramatically from peak to trough in the wake of the Lehman bankruptcy, Ferguson said. "Yet, China managed their stimulus so successfully – much more so than we did ours – that they dodged the bullet of a global Depression," he said.

"It would be foolhardy to bet against China," agreed Gluskin's Rosenberg. He credited the intellectual sophistication of the Chinese, noting that their central bank has not bought at Treasury securities since October of last year, instead building its strategic resources.

"Make no mistake: The reason the world economy is bouncing back has virtually nothing to do with what is happening in the US and has everything to do with what is happening in Asia," Ferguson said. The effects of the Chinese stimulus are not confined to China. Every Asian economy has benefited to some degree from China's successful counter-cyclical policies, he said.

**Demographics and public policy**

Friedman made the bearish case for China based on its demographics and public policy issues. Large segments of the country live in "sparsely populated buffer states" in the western and southern parts of the country and in sub-Saharan-style poverty, with the remainder residing in large cities. According to Chinese government data, 600 million Chinese – nearly half of the country's 1.3 billion people – live in households earning $3 or less monthly, and another 440 million households earn between $3 and $6 dollars monthly.

Both Friedman and Shilling have estimated the size of China's middle class. A mere 60 million Chinese earn more than $20,000 annually, which Friedman considers the threshold to middle-class status. In 2007, Shilling did a study and found that it takes about $5,000 in annual income for the average Chinese to have meaningful discretionary spending, which is Shilling's definition of middle class. Only 110 million people, or 8% of China's population, meet that standard. "They are not far enough along the way to industrialization to have a domestically driven economy," he said.

Those demographic challenges translate to huge impediments to growth in Chinese consumer spending, both economists said.

Coupled with the demographic problem is China's 29% savings rate, an impediment to consumer spending that is magnitudes higher than the 3% rate in the US.

And the Chinese government has a more pressing concern than demographics or saving, Friedman said. Over the past decade, hundreds of millions of Chinese have migrated to cities in search of higher-paying jobs. Because of the recession and because China faces increased competition from other countries with lower wage bases, many of those jobs no longer exist. The central policy issue for the

Chinese government is whether to offer those workers unemployment benefits or to send them back to their villages.

"If you look at China today, you see a government that is clearly very concerned about internal stability," Friedman said. "Other countries may have the room to maneuver with unemployment, but China does not. China's public policy doesn't match its bravado."

China's politicians may be interested in maximizing economic growth, but they have other items on their agenda, Friedman said.

**Real estate and exports**

China has an overheated residential real estate market, and it will have to "cool things down" in the second half of this year, Ferguson said. Rosenberg agreed, noting that, although there are lots of cities with residential real estate bubbles, that problem is not endemic to the country.

Concerns with China's banks are not a serious problem, according to Ferguson. "They can recapitalize their banking system and have done so in the past," he said. "There is nothing to stop a centrally managed economy from dealing with the problem of non-performing loans."

Although Rosenberg lined up with Ferguson as bullish on China, he said that the country is an enigma to him and to his many of his clients, half of whom visit China and come back as bulls while the other half return as bears.

China has a plan to reduce their reliance on the US consumer, and it has been in place for some time, Ferguson said. The US consumer is not the biggest market for the Chinese, nor has it been for some time.

To the contrary, Ferguson said, China wants to reduce its exports to the US. "Their strategy is very clear: diversify out of cash claims on the US capital markets and into commodities and build a strategic position – not by buying golf courses in the US, but by buying copper mines and primary agricultural real estate in the rest of the developed markets," he said.

"We sit here – and I hear this from politicians as well as from finance experts – complacently telling ourselves it is not a serious threat and they won't pull it off," Ferguson said. "I think they are pulling it off."

Ferguson admitted that India has more attractive growth opportunities than China, because of its favorable demographics and more evolved legal system. Demographics, he said, is the major weakness China must face, but that problem is at least two decades away. In the meantime, he said, China's GDP would overtake the US's.

Friedman disagreed. He said China will not sustain its relative advantage in GDP growth rates long enough for it to supplant the US. Labor shortages, high land costs, and infrastructure weaknesses will eventually retard Chinese growth. He likened its situation to that of the US in the 19th century, when its GDP lagged that of Great Britain. "It took two World Wars for the US to overtake Great Britain," he said. "The idea of China overtaking the US in the absence of a catalyst, such as a war, is not going to happen."

**Tallying the score**

The bears on the panel (Shilling, Friedman and Mauldin) outnumbered the bulls (Ferguson and Rosenberg), but don't take that as a sign that China represents a poor investment opportunity. None of the panelists addressed the question of whether Chinese equities, for example, were fairly valued. Rosenberg noted that there has been no correlation between China's economic growth and the performance of its markets. Even a bearish outlook on Chinese growth might justify an investment.

The core issue of this debate won't be settled for another twenty years: whether the US or China will be the dominant economic superpower. If one subscribes to Ferguson's and Rosenberg's view that the Chinese are shrewd and adept managers of their economy, the issues of real estate bubbles, bank solvency, and industrial overcapacity do not represent long-term threats to growth, even though they may be disruptive in the short term.

For China to outgrow the US, however, it must develop a domestically-based consumer market, and if you believe the bears, for now that seems a long way off.