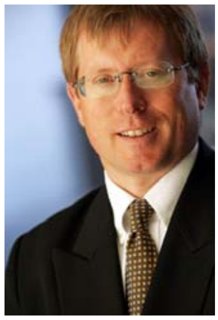
Tyndall Comment

February 2011

Looking China's Gift Horse in the Mouth



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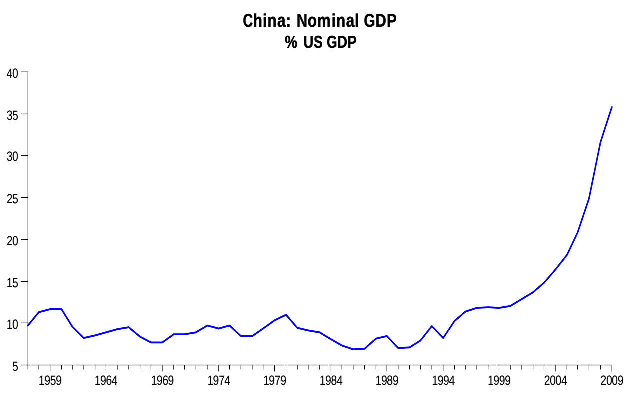
We first visited China during late 1988 and, at that time, the economy had a total GDP equivalent to only $412 billion, roughly twice the size of South Korea in GDP terms, despite its 20 times larger population. By 1993, China's reported GDP had increased to $630 billion and, although it subsequently fell to $580 billion in 1994 as a result of China's 1994 currency devaluation and recession, by the end of the decade it had doubled to $1.2 trillion and today it stands at around $6 trillion. In the space of 20 years, China's economy has expanded from the relatively stable equivalent of around 10% of US GDP in the 1980s until the 1990s to the equivalent of almost 40% of US GDP today. Given such arithmetic, few can fail to be impressed by China's growth and China's emergence as a economic force has apparently obliged Obama to note that this implied challenge to the US's economic pre-eminence represents something of a new 'Sputnik moment'.

Using China's admittedly sometimes suspect data, we find that the economy apparently achieved its relative economic take-off (at least relative to the USA or global GDP) not following the introduction of Deng's Great Leap Forward in the mid 1980s or even during the massive industrial expansion of the 1990s but rather in the late 2000s in the aftermath of its own 2004 draconian monetary policy tightening and during the Global Financial Crisis. Intuition would suggest that this period was an unlikely if not improbable time for a supposedly trade sensitive and relatively highly indebted economy to prosper, particularly in relative terms. Nevertheless, clearly something happened in China to dramatically improve its GDP level and in particular its relative share of reported world GDP in the late 2000s and we wonder if the story is simply a conventional take off (or catch up in China's case given its historical domination of world GDP a thousand years ago) or whether the story is a little more complex.



The standard explanation for China's late 2000s' take off revolves around its booming export sector. China's exports grew from a 2000-2002 average of around $30 billion a month to around $140 billion per month now but while this is impressive, we find it difficult to believe that even this improvement in exports could have led by itself to a $5 trillion increase in GDP over the same period, even on the assumption of some very hefty 'multiplier effects'. Also, we note that the level of net exports actually peaked in 2007 and that if anything net trade has tended to detract from overall GDP since the global financial crisis.

Moreover, we would also note that in profit terms (which is presumably what should be of more importance to portfolio investors in the country than GDP per se), China's absolute level of profits has essentially been flat over the last three years and that, relative to US profits, Chinese corporate profits peaked four or five years ago, a situation that does not suggest that China has become a 'hyper competitive' exporter. Consequently, we have been left looking for other explanations for China's recent growth spurt.

In practice, we find that there have been two very notable features of China's economy over recent years. Firstly, there has been a massive increase in China's money supply since the mid 2000s: the M2 measure of the money supply has grown by 200% since 2005 in absolute terms and which now comfortably exceeds the equivalent US measure of the money supply. Secondly, we would note that the government's share of GDP has – according to China's GDP data - risen sharply since the mid 2000s, despite the supposed buoyancy of exports and the private sector. (Cynics might suggest that this would explain the relative lack of profitability that has been associated with this growth, in that it has been policy induced rather than organic efficient private sector-led growth.)

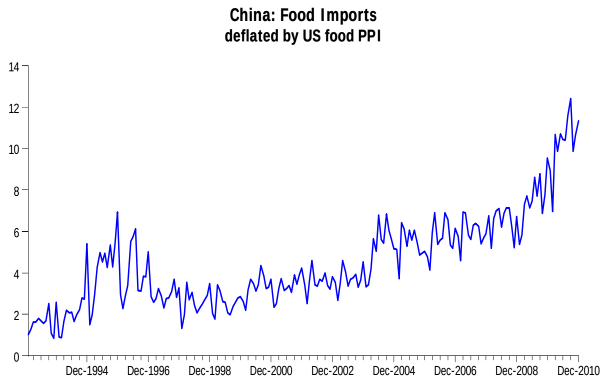
More specifically, we find that if we use China's fixed investment data, we find that fully 90% of reported Fixed Asset Investment in China is currently 'public sector initiated' and that the vast majority (i.e. virtually all) of this public sector investment spending has been at the behest of local authorities and their affiliated institutions. Separately, we also find that the level of expenditure by these public sector institutions is running far ahead of their allocated tax revenues and that they may be spending five times as much as they receive in revenues. Their implied budget deficit for China's entire state sector is therefore in the region of 10% or more of GDP on the basis of these figures, and this ongoing deficit appears to be being financed through a mixture of simple bank borrowing (hence the continued strength in the loan data and the heavy levels of bond issuance which the rating agencies seem to be very happy to underwrite by awarding high credit rating to…). Moreover, if we include all of these local authority debts and related contingent liabilities to China's official estimate of its public debt stock, we estimate that China's aggregate public sector to debt ratio may be as much as 80% of GDP, a ratio that looks high by the standards of an emerging market and even elevated by the standards of EMU.

In summary, we find that according to China's own GDP figures, between 60% and 90% of GDP growth in China in the last four years (i.e. that period in which China's GDP has soared relative to that of the USA) has come from capital expenditure and according to the separate investment data, 80-90% of the investment has come from the local authorities. On this logic, we might argue that three quarters of China's growth during its 'Great Catch Up' has come from local authority deficit spending on construction projects that has been financed through simple bank loans or bond issues.

As to whether all of this spending was efficient or justified we will never know but there is clearly a significant probability that, through a mixture of over enthusiasm and probable lack of fiscal discipline, some of these projects were not warranted and we wonder quite what value some of the projects and the loans and other debts secured on them actually possess.

This expenditure will have added to Gross National Product and it will have involved hiring people, importing machinery from Japan and Korea and materials from Australia, Indonesia, etc and so in that sense even the 'bad' projects will have had some near term value for the global economy but, if many of the assets turn out to be redundant, ill-sited or wasteful, we doubt that they will have added much to China's real long term prosperity. Instead, some of these assets could simply be China's "sub-prime" problem of property related speculation and expenditure that was not really useful and which was financed by debts that may never be serviced let alone repaid.

Moreover, we can also suggest that China's Local Authority Building Boom (which still appears to be continuing) also appears to be exerting an unwelcome influence on both its economy and the world. As China has paved over its core agricultural areas and the rapid urbanisation that was associated with these building booms absorbed labour supplies from the notoriously unproductive agricultural sector, China's food production levels have slumped



(Chinese food output is now lower than it was a decade ago – a very different performance to that of aggregate GDP). This combination of galloping urbanisation and falling food output has resulted in rising rates of food price inflation in China and a greater need to import food from abroad (something that NZ producers have benefitted from). Presumably, the latter has contributed to the recent increase in global food prices which is exerting an unwelcome effect on the poorer members of the world's population and global political stability in general.

As food prices and other subsistence costs have increased in China, domestic manufacturing sector workers in the cities have been obliged to ask for higher wages and, with wage inflation now running at rates that are believed to be close to twice that of aggregate productivity growth, China has begun to experience rapid rates of unit labour cost inflation. As a result of these rising costs, China is not only losing competitiveness (a factor supported by the weak profit data discussed above) but it is also beginning to export inflation to third parties, such as the West.

Given this state of affairs we can perhaps see why equity investors in China have fared quite poorly over recent years but we are now beginning to wonder whether China's much hyped boom is about to turn sour for the global economy as well, as China imparts an upward bias to inflation rates the world over, at least until its public sector boom turns to a bust.

Andrew's 2011 New Zealand Presentation Dates

Monday, 21 March 2011

9.00 am	**Christchurch** The George Hotel
3.45 pm	**Wellington** Wellington Club

Tuesday, 22 March 2011

7.15 am	**Auckland** Northern Club

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London