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The China Conundrum

In the second decade of the 21st century, China has become a world economic power. There is a growing concern among some economists, investors, and "China watchers" that the recent economic growth in China is overstated and/or is unsustainable, and that China may be on the brink of an economic "meltdown." Worrying economic, political and social developments are taking place in China. This discussion will primarily address the economic theme, which significantly influences the others.

China is now the world's second largest economy, overtaking Japan in 2010. During the past 20 years, China has succeeded in doubling its Gross Domestic Product (GDP) every 10 years. This is a remarkable accomplishment for a nation of 1.3 billion people. Great Britain took 100 years to accomplish this task with significantly fewer people, from 1800-1900. Japan in the 20th century, with 80 million people, doubled its GDP every 20 years.

Chinese Premier Zhou Enlai (1898-1976) and United States President Richard M. Nixon (1913-1994) conspired in 1972 to establish a cultural and economic relationship between both nations, allowing for increased communications and foreign trade between China and the United States. Deng Xiaoping (1904-1997) became the paramount leader of the People's Republic of China from 1978-1992, directing the Chinese economic reform and instituting the "socialist market economy."

A number of factors contributed to this great Chinese economic success. Since the early 1980's the largest economies of the world, the United States, Japan, and Western Europe *leveraged* their balance sheets to a significant degree, creating a tremendous but unsustainable demand for consumer items. Cheap labor and liberalized foreign low-cost production opportunities created a trend of exporting jobs and manufacturing to China.

Advances in global technology during the past 5 decades contributed significantly to the accelerated pace of development. Advances in communications, computers, construction and mining technology and equipment, along with more efficient transportation systems and the like, provided the framework and infrastructure for their economic growth. All of humanities acquired knowledge was available to China in this moment in history. Paraphrasing Newton, China stood on the shoulders of giants!

The Chinese education system was also an important factor. China graduates nearly 500,000 engineers from college annually, (vs. 45,000 in the U.S.) and is believed to graduate more high school honor students per year than the total number of U.S. high school graduates. Over 300 million Chinese speak English, making China the world's largest English speaking nation. In China, education is seen as the key to success and the escape route from poverty.

China's GDP has been reported to be growing between 8 and 12% for the past few years. The questions are: Is this rapid economic growth accurate, and if so, is it sustainable? If not, what might be the consequences to China, the importing nations, and the exporting countries? Could a significantly reduced Chinese economic growth rate create an economic "meltdown" and social unrest in China?

China is a vast country and has abundant resources. It is believed to produce over 90% of our world's rare earth minerals. China is also a major consumer of our world's natural resources and the world's

largest food consumer. In agricultural commodities China consumes 46% of the world's pork, 28% of the rice, 25% of the soybeans and 17% of the world's wheat[1]. It is the world's largest wheat producer as well. The numbers are staggering!

China's Share of World Commodity Consumption (2010)[2]

Commodity	% of World
Cement	53.2
Iron Ore	47.7
Coal	46.9
Pigs	46.4
Steel	45.4
Lead	44.6
Zinc	41.3
Aluminum	40.6
Copper	38.9
Eggs	37.2
Nickel	36.3
Rice	28.1
Soybeans	24.6
Wheat	16.6
Chickens	15.6
PPP GDP	13.6
Oil	10.3
Cattle	9.5
GDP	9.4

The high percentage of economic growth that China has sustained in the past few years is likely to decline in the near future. The leveraged "western" consumers no longer have the purchasing power as they deleverage. It is unknown if internal Chinese consumption can replace declining external consumption. No economy in the history of the world has had a sustained growth rate over 10% for any significant time period.

Because of China's high consumption rate, the supply of the world's commodities could diminish, creating price increases and spot shortages. The world-wide economic and social repercussions could be dangerous and destabilizing , as the emerging market economies could witness rapidly rising food prices which currently consumes over 50% of their household discretionary income.

Chinese credit and money supply was increased dramatically during the 2008 world economic crisis in order to stimulate internal demand. China's capital spending level is currently over 50% of GDP, never before seen in the world's economic history. This rate of capital spending will likely soon decline. Highly respected and insightful hedge fund manager, James Chanos, notes that China's stimulus package and aggressive bank lending created artificial demand thus creating the potential for a crisis in nonperforming loans in China. This stimulus is similar to that which occurred in the United States after the 2008 Financial Crisis. Credit excesses have led to a housing bubble in coastal sectors of the country and initially stimulated stock purchases and speculative capital inflows. Time will tell if China's command-driven economic leadership can successfully manage these excesses.

Inflationary pressure on food and consumer goods has forced higher wages to be paid in China as well, which reduces China's competiveness. Profit margins have declined in a number of areas. Fourth Quarter 2011 car sales slowed in China along with other sales, suggesting the possibility of domestic economic contraction.

Should the Chinese economy decline significantly, aggregate demand for natural resources in the near term will force exporting countries to lower prices and reduce output. Another potential added risk is

[1] Grantham, Jeremy. GMO Quarterly Letter: *Time to Wake Up: Days of Abundant Resources and Falling Prices are Over Forever* (April 2011). Online at: http://www.theravinaproject.org/JGLetterALL_1Q11.pdf

[2] Source: Barclays Capital (2010), Credit Suisse (2010), Goldman Sachs, United States Geological Survey (2009), BP Statistical Review of World Energy (2009), Food and Agriculture Organization of the United Nations (2008), International Monetary Fund (2010)

reduced aggregate demand from the importing mature economies. Should demand start to decline in the next few months, China will run the risk of producing more than it can export.

Such a vicious cycle could potentially create a hard landing for the Chinese economy. The cycle would see higher costs, higher unemployment, lower profits, lower margins, lower exports, and a flight of capital from the country. The economic stimulus and aggressive bank lending which created the artificial demand could increase the risk of nonperforming loans. Should all of these concerns happen within a short time period, does an economic "meltdown" become possible within a few years?

In mid-March, Premier Wen noted that if the country doesn't initiate key reforms, it could experience enough social unrest to precipitate another Cultural Revolution like the one that shook the country between 1966 and 1976[3].

The world's 7 billion citizens are all influenced by the Chinese economy, directly or indirectly. Economists and analysts are closely watching China's economy. Should future events suggest a rapidly weakening Chinese economy, the unintended consequences could be significant to the social, political and economic well being of China, and to Chinese investors as well.

- Roger L. Johnson

[3] Knowledge@Wharton, *China's Gravity-defying Economy: How Hard Will It Fall?* The Wharton School of the University of Pennsylvania, (April 02, 2012).
Online at: http://knowledge.wharton.upenn.edu/arabic/article.cfm?articleid=2802