

## Will China Survive The Journey to Being a Developed Market?

*“The road from emerging market to developed market is long and littered with economic failures. Many countries have crashed and burned when they tried to short cut the development of key institutions or artificially boosted their economies with excessive debt.”*

### Summary

- Many nations have failed to make the transition from an emerging market to a developed market
- China hasn't developed its global relations, internal politics and freedom of speech foundations that are needed to support future economic growth
- China continues to violate three rudimentary principles for economic growth
- It is no longer an argument of high growth versus soft landing, but soft landing versus hard landing

I've written of my concerns with China a number of times in the past two years, highlighting the excessive use of debt and poor allocation of capital. In the past few months the signs of a slowdown have become much more obvious. Trade data, commodity imports, underlying production data and a slowdown in consumer purchases have all pointed to general weakness in the economy. The falls in the stock market and the devaluation of the currency have drawn much greater attention to the issues.

In writing about how China may fair on its journey towards being a developed market I will first go beyond the economic and financial issues, to more political and philosophical issues. These are important as they are the foundations that support investment and economic growth. The failure to support the maturing of these doesn't immediately reduce growth but in the long term they are vital cogs of a developed economy. In these areas China is still struggling badly and appears to have gone backwards in recent years.

### Global Relations

On a recent visit to Australia the Chinese President likened his country to being “like a big guy in the crowd. Others will naturally wonder how the big guy will move and act”<sup>1</sup>. In many ways this is an apt description. China has entered the world stage like a teenager brimming with strength and vitality but still unsure of its place and the appropriate ways to act with others. It has strong opinions, voices them loudly and uses its size to force many outcomes its way.

Diplomacy is not yet well developed as most recently evidenced by the disputes in the East China Sea. The constant threats of retribution if leaders of western nations meet with the Dalai Lama is another. The lack of tactful diplomacy has not yet been a major issue in East Asia or Africa where Chinese money or power has been sufficient to bulldoze small countries. However, in the big league with developed nations China is still sometimes left out, such as the Trans Pacific Partnership. It has been noted that China is seeking to have power without responsibility and that its contribution to global aid and peace keeping has been lacking<sup>2</sup>.

One novel response to being occasionally snubbed has been to start its own development bank. The initial response has been overwhelmingly positive but the real test will come when capital commitments are required and when partners are asked to decide whether deals are worthy of funding. The world is watching to see whether China is capable of operating well with other countries in this forum, or if it will find potential members leaving after disputes.

China is also increasingly finding itself allied with Russia and other “outsider” nations. This might be politically expedient for a time but these countries are typically suffering economically and China will be pressed to support them



financially in return for continued influence. These are also more unstable countries and the alliances can break down quickly if politics or economics no longer suit one party.

### **Internal Politics**

Many commentators have voiced the opinion that the current President of China is politically stronger than any President since Mao. This has been achieved by methodically isolating key opponents, who have typically ended up in prison or executed on corruption charges. The crackdown on Hong Kong activists and ignoring the demands there for a free election is just another sign that this current administration will not tolerate any threats to its authority.

Power has been centralised and this inevitably closes down the debate on key issues and lessens the willingness of political and business leaders to challenge the consensus. Given this climate, which bureaucrats or economists would be willing to challenge the naïve actions in promoting the stock market and then trying to stop it from falling? Who would be willing to say that government funds are being wasted or that loans will never be repaid? Are any government officials brave enough to say that GDP targets simply cannot be met or that the official numbers are fabricated?

### **Freedom of Speech**

The internal politics section above covers the higher level actors, but lower level actors are also being crushed for speaking out. China routinely threatens and locks up bloggers and journalists who rock the boat. These outspoken citizens are key to the functioning of society as they hold local powers to account for corruption and incompetency. How would local citizens know of the health risks after the Tianjin explosions if not for the writers? Who would expose the regular thefts of land from ordinary citizens that benefits well connected property developers and local politicians? Who would uncover the corruption and bias in the judicial system that robs citizens of their rights and assets?

These sorts of issues can seem like a minor irritant but they have major impacts on the way people act. When corruption and dishonesty is commonplace an economy will be held back. Entrepreneurs waste time on cultivating government relationships rather than developing new products and more efficient systems of delivering products and services. Investment is discouraged as intellectual property and ownership of businesses can be stolen by the well connected. Contracts and permits are granted based on the amount of influence or “gifts” given by the applicants, rather than the cost, or the potential jobs or economic activity created.

The “tigers and flies” crackdown has been successful in eliminating political threats, which arguably is its real purpose. Shutting down the avenues for ordinary citizens to make complaints about corrupt and incompetent activities is not just hypocritical but also damaging to the economic prospects of the nation. The leaders of China haven’t yet realised they cannot completely control what individuals think and say with a barrage of government propaganda and censorship. There is a risk that the dam wall of deception breaks at some point, with a flood of truth leading to widespread dissent and disobedience. You cannot fool all of the people all of the time.

### **Financial and Economic Issues**

One of the key signs of a bubble in any economic or financial area is that the overwhelming majority believe that a bad outcome is not possible. The overwhelming majority of commentators and forecasters fall into the “continued high growth” or “soft landing” camps on China. The leadership of China, and the China bulls who believe that the Chinese government is omnipotent seem to think that three rudimentary economic principles can be indefinitely violated. These principles are:

1. Debt levels cannot grow materially faster than an economy in the long term

2. Capital must be well allocated to support long term growth
3. Efficient industries must be free to grow and inefficient industries left to shrink

The small but growing group of “hard landing” thinkers cannot see how the long standing violation of these principles leads to anything other than an economic mess. Chinese debt levels have been growing faster than almost any other country has ever seen and all comparable incidents of similar debt growth have ended badly. Anecdotes abound of ghost cities and vacant properties, listed companies with greater market capitalisation than revenues and massive over-investment and subsidies provided to favoured industries. Local governments are known to be propping up zombie companies, often with debt funding, in order to protect local jobs. This all looks more like a banana republic than a developed economy.

The recent round of policy changes is particularly concerning. The answer to every economic issue has been more debt, whether this is allowing more leverage in property purchases and margins loans for equities, or in refinancing bad debts of local governments. At the same time as the bad loan ratios at banks are rising, the government is reducing their reserve ratios and encouraging them to lend more. It is difficult to see this as anything but amateur hour.

The idea that China could have a recession in coming years currently seems farfetched to most. Yet there is solid evidence that the economic miracle is at least partly a mirage and that the economy is already slowing substantially. Capital outflows have been substantial this year, and with the currency being devalued there’s a real chance that the outflows accelerate as citizens and international investors fear that the currency can only fall further.

A withdrawal of investment capital at the same time as the central and local governments are withdrawing stimulus will substantially reduce growth levels. Pumping up the economy with more debt may work for a time, but the risk of a banking system collapse from bad loans could halt this. This leaves only quantitative easing, which would trash the exchange rate, bankrupt companies with foreign currency loans and runs the risk of creating hyperinflation.

## **Conclusion**

In the past three decades China has grown up from a predominantly rural nation into one that now plays on the world stage as the second largest economy. Whilst the rate of growth in economic terms has been extraordinary, the growth in basic social institutions has not kept pace and has gone backwards since the change in the key government figures in 2012. China has the financial and military strength to challenge many nations but has failed to learn that brute force and megaphone diplomacy only gets you so far.

Power in China has been centralised in the last year under the cover of a corruption crackdown. This is particularly concerning as the key politicians have been implementing naïve economic and financial policies, with few insiders willing or able to challenge these errors. The poor economic management raises the risk of a hard landing with bad loans, as well as corrections in equity and property markets dominating the financial outlook.

At this point China appears to be shaping up as more likely to be a wreck on the road to being a developed economy than one that fully makes the journey. Its neighbours Singapore, Japan and Korea all completed the journey, but these have far more developed foundations. Comparisons with Indonesia, Malaysia or Thailand prior to the Asian financial crisis seem to be a better fit. The lessons of Japan’s lost decades may be salutary for China, with Japan’s over-investment and excessive debt levels of the 1980’s having strong parallels with China’s current position.



The old argument of high growth versus soft landing no longer applies. High levels of growth may continue in the official statistics for a time yet, but the underlying measures have already turned down. Further debt stimulus can postpone the inevitable decline, but the more debt is allowed to grow the harder and faster an inevitable collapse will be. It is now a case of soft landing or hard landing with the probability of a hard landing growing.

Written by Jonathan Rochford for Narrow Road Capital on September 15, 2015. Comments and criticisms are welcomed and can be sent to [info@narrowroadcapital.com](mailto:info@narrowroadcapital.com)

## Links Referenced

- 1 <http://theconversation.com/xi-gives-reassuring-message-about-chinas-benign-intentions-34316>
- 2 <http://www.bloombergvew.com/articles/2015-08-19/china-wants-great-power-not-great-responsibility>

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