

Our Notes from the 65th Annual CFA Conference
Michael Pettis on China: “The Growth Rate in Investment Is Going to Collapse”

China’s Growth “Miracle”: The Untold Story

Liz Ann Sonders, Charles Schwab’s Chief Investment Strategist, frequently reminds investors that stock and bond markets are forward looking. Therefore, prices reflect consensus expectations and prevailing views of the future. Because prevailing expectations and views are baked into prices, Liz Ann is always most intrigued by the stories that are not being told. Those gathered at the 65th Annual CFA Conference in Chicago were treated to an untold story about China presented by Michael Pettis, professor of finance at the Guanghua School at Peking University, chief strategist at Guosen Securities, senior associate at the Carnegie Endowment for Peace and former Wall Street trader of Latin American debt.

China Growth a Miracle? We’ve Read This Story Before

In 2002, when Professor Pettis stepped into China, he subscribed to the commonly-held perception that China’s economic miracle story was distinctly unique from the stories of past emerging economies. As Professor Pettis became more familiar with China’s economy, he realized China’s story is one he had read before in

- Germany during the 1930s,
- the Soviet Union during the 1950s and 1960s
- Brazil during the 1960s and 1970s
- Japan during the 1980s

All these stories ended with debilitating debt crises and/or very long periods of no growth. China’s distinctiveness, he contends, lies not with their growth model, but rather with the extreme extent to which household consumption has been suppressed for growth’s sake.

The professor’s assessment leads to two questions:

1. Why did those emerging economies growth models lead to debt crises?
2. Is the chance that China’s economic growth “miracle” will end in a debt crisis?

The explanation of prior debt crises stories, in every case, rests in the misallocation of capital and wasted investments. Early stages of development were powered with high levels of investment made by the central government. Central governments initially grab hold of capital investment because the financial sector was not doing a good job allocating capital, leaving huge gaps between what was needed for economic development and the infrastructure these countries had.

At first, since the investment gaps were so huge, it was easy for bureaucrats to identify projects with real economic returns. For example, early on, China made investments in infrastructure that reduced the time it took to travel between two large cities from 9 hours to 1.5 hours.

State directed investments were funded through “financial repression” by directing bankers to divert household savings held in banks to investments in infrastructure and manufacturing capacity. Real

interest rates paid to savers were set extremely low, often close to zero. Keeping interest rates low does not make sense for rapidly growing economies. Real interest rates should be close to real GDP growth for savings to accumulate.

As the gap between needed and existing infrastructure and manufacturing capacity narrows, projects with real economic returns become less obvious. At this point, governments should stop allocating capital and develop another model that allows pricing signals (including market interest rates) to drive capital allocation.

Yet, at the point when another mechanism for capital allocation is needed, it is very difficult for governments to stop driving investment. First, it is difficult to know when this point has been reached. Second, there are very strong political incentives to keep investments high. Politicians become addicted to investment where the benefits accrue to a few within a specific political jurisdiction while the costs are distributed throughout the banking system to the entire economy. Political favoritism and corruption becomes the driving force in capital allocation. As capital is misallocated, returns on projects funded cannot service debt incurred and debt accumulates.

China's Debt Explosion: Have You Heard This Story?

A study published in 2009 by Victor Shih at Northwestern University concluded that accumulation of debt in China at the local and municipal levels had reached at least 30% of GDP during the 2000s. Victor identified this accumulating debt as "classic Ponzi schemes." There simply was not enough cash generated by investments to service the debt. Local politicians expected to be bailed out by ever-rising real estate prices, while the debt continued to accumulate. Victor's study changed the mood regarding local and municipal debt, which led the Chinese government to consolidate those debts into the central bank balance sheet. In 2011, debt exploded in the informal banking sector. Debt of state-owned enterprises has also exploded. Everywhere one looks in China, debt continues to accumulate as capital is misallocated into non-economically feasible projects due to the absence of pricing mechanisms, which have been disabled by the central government.

At some point, China will reach its debt capacity, but no one knows when, especially since we do not know exactly how much debt is in China. Not many observers trust economic statistics produced by the central government. Professor Pettis guesses that China will reach the debt tipping point in about four to five years, and a crisis will follow unless China rebalances GDP components. Professor Pettis believes the China can rebalance and avoid a debt crisis. He sees growing concern and nervousness in Beijing over the need to rebalance.

Political leaders in Beijing are learning lessons from prior emerging market debt crises that confirm the urgency to rebalance. None of these stories ended well.

- Germany's debt crisis led to hyper-inflation and a world war.
- The only reason why Russia did not default on their debt during the 1970s is that banks lent them just enough to repay the debt needed to prevent a default.
- Brazil defaulted in 1980 and lost a decade of economic growth.
- Japan's GDP average annual growth has been less than 1% for the past 20 years. Twenty years ago, Japan's government debt as a percent of GDP was 20%. Now it is north of 200% of GDP.

A Brief Macroeconomic Lesson

Components of GDP at a very basic level ...

$$GDP = Household\ Consumption + Investment + Trade\ Surplus$$

Contrary to popular opinion that China's growth has been export driven, Pettis contends that Chinese GDP growth has been fueled by investment at the expense of household consumption. By definition, the Chinese trade surplus is simply the remainder.

The Need to Rebalance GDP: Increase Consumption and Reduce Investment

According to Pettis, consumption in most Asian countries influenced by Confucianism is 50%–55% of GDP. (It is about 70% in the United States and 65% in Europe.) The remarkable distinction between China and other emerging economies is the extent to which their consumers have been repressed for the sake of growth. China's consumption as a percentage of GDP has been trending downward as GDP has grown (see table below).

China's Consumption as a Percentage of China's GDP

Year	Consumption
1980s	50% - 52%
2000	46%
2005	40%
2010	34%

Based on studies of other emerging economies, when household consumption drops to 46% of GDP, it signals a country in crisis. China's 2010 level was unprecedented for a large economy.

China Growth Miracle Story: Denouement Yet to be Written

Pettis thinks that China should aim to get Household Consumption up to 50% in the next 10 years. This will require household consumption to outpace GDP growth by 4% each year.

Notice that the changing share of GDP tells us little or nothing about China's actual GDP growth rate, or about the growth rate either of household wealth or of state wealth. It just tells us something very important about the relative growth rates.

For example consider a case in which GDP grows by 9% annually while household income grows by 12%–13% annually. In that case, the rest of the economy would grow by roughly 5–6% annually (household income is approximately half of GDP), and the distribution of this growth would be shared between the state sector and the business sector. This might be considered the "good case" scenario of rebalancing.

Alternatively, consider the case where annual GDP growth is 0%. In that case the annual growth in household income might be 3–4% while the state and business sectors contract at roughly 3–4%. This would be the "bad case" scenario.

Consensus opinion expects that China's annual growth will fall to 5%–7%. Pettis observed that the consensus skeptics in previous cases (e.g., Japan, Brazil, Soviet Union) were never skeptical enough, and policymakers usually underestimate the difficulty of transition. "Countries always rebalance — the good

way or the bad way — but they always do.” The “good” way is for consumption to surge on its own. The “bad” way is that a constant consumption level means GDP must decline. While Pettis expects that a well-executed transition to a balanced economy will mean a sustained 3% growth rate for China, he alluded to the possibility that he might not be skeptical enough.

Why might the good way not work? Pettis said that households cannot do two things at the same time: clean up the banking sector and increase consumption. He explained that China did not grow quickly *despite* low consumption but *because* of it. China has been systematically transferring income from households to investment via

- an undervalued currency, equivalent to a consumption tax on imports
- low-wage growth versus productivity, a gap that has widened greatly in the last decade (the difference between these is like a tax on consumers)
- financial repression or extremely low interest rates, which taxes savers and subsidizes borrowers

Pettis believes the rebalancing can be successfully accomplished and encouraged us to watch political events as they unfold in China for clues to determine if the politicians are writing a “good” or “bad” denouement to the China Growth Miracle story.