

FEATURE ARTICLE II



PUTTING CHINA'S GROWTH IN PERSPECTIVE[©]

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It is an oft-repeated statement that China's economy will surpass the U.S.'s in the next 20 to 30 years. The thinking behind this statement is that China is experiencing a phenomenal rate of growth while the U. S. is currently growing at fairly low rate. In 2006 China's Gross Domestic Product (GDP) was an estimated \$2.527 trillion with a real growth rate of 11.1%. The corresponding figures for the U.S. are \$13.16 trillion and 2.9%. If the growth rates do not change, in 2026 China's GDP will be \$20.744 trillion and U.S.'s will be \$23.311 trillion; and in 2036, they will be \$59.433 trillion and \$31.025 trillion, respectively. Thus, the Chinese economy will eclipse the U.S. in 2028 (using 2005 figures, it will happen in 2033). Assuming that the growth rates of all nations remain unchanged, China will then economically rule the world. **The problem is that this conclusion is not based on sound reasoning; rather, it is rife with logical and factual errors.**

STATISTICAL & LOGIC ISSUES

The simplest fallacy involved is hasty generalization, which means the conclusion is drawn from too little information. It is not valid to assume that China's growth rate will remain unchanged, or continue to increase, over the next 20 to 30 years. In fact, there are myriad reasons to

expect the opposite. Remember, an abnormal and unprecedented growth rate is just that, abnormal and unprecedented. What is normal, for both firms and whole economies, is that growth rates decrease as the size increases. This fact is a consequence of diminishing marginal returns, economies of scale, shifting economic advantages, finite natural

resources, a limited number of customers, etc. Historically, growth rates of most nations' GDP have widely fluctuated during such spans of time. Additionally, it is not logical to assume that China will be immune to recessions, depressions, industry bubbles, stock market crashes, etc. in the decades to come. It is more reasonable to expect that the Chinese economy will reach a plateau, or hit a trough, within the next 10 or 15 years.

More problematic is the fact that forecasts of China's future dominance come from a superficial analysis. One cannot take a few data points, such as GDP and growth rate, and accurately forecast the long-term state of complex systems, especially not with systems involving human beings. It is necessary to look at the full context: the meaning and sources of the data, all the relevant facts, and anything that might affect the situation. To ignore such information is the logical fallacy of neglected aspect. In other words, to understand what is happening and will happen with the Chinese economy one must look at what is behind the numbers—what is the cause of the growth.

First, it must be realized that GDP measures the market value of goods and services produced by the capital and labor within a country without regard to the nationality of labor or capital owners. If a U.S. company borrows money from a U.S. bank, purchases U.S.-made equipment, sets up a factory in Shenzhen, where it uses non-Chinese labor to manufacture products that it exports to the U.S., and then pays interest to the U.S. bank and dividends to U.S. investors, it contributes to China's GDP.

This assignment of all value to one entity is no small point since the Chinese economy is dominated by foreign-funded enterprises (FFE) and foreign-owned enterprises (FOEs)—they account for the majority of China's exportation and a significant portion of the domestic trade. These enterprises are usually larger in size and number and more efficient and productive than the domestic Chinese firms. If new foreign direct investment (FDI), which funds these firms, were to cease or slow, China's growth rate would fall. Another possible scenario albeit more remote a probability: if foreign investors were to pull out of China altogether, there would be a huge and immediate drop in its GDP.

Second, although the statistics don't reflect this factor, FDI also improves the U.S. economy. The U.S. investors earn profit, U.S. consumers can purchase less expensive products, and U.S. labor can focus on higher paying skilled positions. Economic theory and history demonstrate these

foreign investment effects, which have also been confirmed by numerous current studies. One McKinsey study shows that every U. S. \$1 spent on offshore outsourcing results in \$1.12 spent domestically. In percentage terms, however, the \$1 contributes more to China's GDP than the \$1.12 does to the U.S.'s GDP.

Third, the GDP figures provided are aggregate. If one is concerned about the control that China might be able to exert over the World economy, one should consider the per capita figures. China's per capita GDP is \$1,900, which adjusted for purchasing power parity is \$7,800 for 2006. The average Chinese citizen may no longer be on the verge of starvation; but, clearly, the vast majority of the population is still struggling. The U.S. figure is roughly six times higher at \$43,800. Given such numbers, it hardly seems as China poses an economic threat.

The above facts provide a context that more accurately interprets the significance of the GDP and growth statistics, but correcting for the logical fallacy of neglected aspect is only the beginning. To attain an understanding of the actual possibilities, one needs to look deeper. One needs to examine the nature of economic growth and the state of affairs in China. Economic growth results from investment and increased productivity, which, in turn, result from specific economic, social and political conditions.



ECONOMIC & POLITICAL ISSUES

Investors are motivated by the prospect of profits, which has its own set of economic preconditions. Fundamentally, the vital question is not whether a product will generate a profit, but whether the investor will receive and retain net income. In the last 40 years, the Chinese government has taken many measures to make this possible to foreign investors. The convertibility of the Yuan was an essential early step. Another measure was to permit increasing degrees of freedom to foreign investors. For instance, in the 1980s and early 1990s, foreign investment was allowed but investors were

required to establish joint ventures with local firms or governments, most of which resulted in losses. Today, FDI can be entirely used for wholly-foreign-owned enterprises, which enables more profit to return to the foreign investors. Beijing has also, periodically and in certain industries, lowered taxes and tariffs and eased regulations for FFEs and FOEs. The government also promises to respect the ownership for the firms and to not nationalize the assets. Looking at a timeline of these policy changes and economic growth reveals a positive developing relationship between the Chinese government and foreign investors.

However, these issues are far from resolved. China fails to embrace the principle of property rights, both for real and intellectual assets. The promises and small improvements made so far do not mean much given that there is no independent judiciary to enforce them. Remember, the Communist Party still rules without opposition. The twentieth century is full of totalitarian governments momentarily allowing economic freedoms followed by new restrictions, nationalizations, imprisonments, etc. Twenty-first century examples can be found in Venezuela, Zimbabwe and Russia—which, except for Russia, receive economic and political support from China. For the present, FDI and FOEs are somewhat protected due to Beijing's desire for capital importation. However, history shows that radical government restructuring remains a future risk for FDI and FOEs.

Another hurdle for China's future growth is the reliance on foreign capital. As the Chinese economy grows, labor and other production costs will increase, which means that many FOEs and much of the FDI might leave for lesser-developed nations, especially, if those nations offer more economic freedom. The departure of capital would probably not be large enough to cause China's economy to shrink, but definitely enough to slow growth. Yet, for the economy to keep growing as it is, there will need to be a great deal more investment (10% of \$20 trillion is bigger than 10% of \$2 trillion). Since the bulk of the productive capital in China is at present FDI, the level of investment will only increase if other economies are also growing. As to the domestic capital, the majority of it is in the hands of the government or in generally less efficient state-owned enterprises (SOEs). Chinese laws forbid domestic investment from going to FOEs. Also partly because regulations limit privately-owned domestic ventures access to investment capital, these privately-owned domestic ventures appear destined to remain a small portion of China's economy.

There is a growing middle class in China that has some money to invest, and private citizens often do put their money in the Chinese stock market—although most of their savings is held, unproductively, as cash. The problem in investing that cash more productively, however, is that the market is dominated by many inefficient SOEs. These firms generally issue an insignificant amount of shares, giving investors little or no voting status.

Compounding this structural investment issue, many Chinese investors have not had as much investment experience as investors in, say the U.S., so many times they appear to be more unsophisticated and unknowledgeable about markets and finance. Consequently, there are concerns that the stock market might become overheated, which has resulted in the Chinese government considering interventions that may actually create more problems.

On the same theme, an additional hazard is the issue of potential government reaction to rising prices. As wages have increased, so have the prices of products. With many products there has been a greater increase in demand than in supply, which further increases prices. Additionally, livestock diseases have caused the price of pork, the most popular meat, to sky-rocket. Granted that there is still more food and other products available than 20 years ago, but the public is voicing some protest to rising prices and the government is admitting that it is a problem. For this reason, as well as stock market concerns, Beijing has imposed numerous new price controls and hiked up the interest rate (6 times in 2007). New export restrictions have also been placed on various goods, including grains and iron.

There are always growing pains in emerging markets: there will be bad investments, too much growth in some industries, not enough investment in others, which result in temporary shortages and higher prices. There will be lessons to be learned, but the market needs to work out these problems. Government restrictions probably will serve only to exacerbate the problems in retail and capital markets, especially since history shows that other countries' efforts with this type of approach have usually failed plus the Chinese Communist Party is usually far from predictable with its policies...and markets react better to predictable policy as it gives investors a sense of security. As evidence of this point in another country – the U.S., witness the effects of: the U.S. government's 1970's price controls, the last 10+ years of the U.S. Federal Reserve's manipulation of interest rates coupled with government-sponsored low down payment

mortgage programs, or the U.S. Congress' sugar tariffs on the U.S. candy industry.

Actually, it is not just stock and retail prices that the Chinese government is trying to rein in as officials have been speaking of plans to slow the growth of the economy as a whole. Beijing is starting to voice acceptance of the idea of "sustainable growth." This concept is not simply the recognition that 11% growth cannot be maintained for decades on end or that growth decreases as the entity increases in size. These factors cause growth rates to naturally decrease, with few economic shocks and no need for the government to artificially restrict growth. Rather, politicians and economists who speak of "sustainable growth" hold that high rates of growth lead to sudden crashes, depressions or recessions. The idea is implied or explicitly held that the growth is not productive or real, that it is just a bubble. In order to avoid such a crash, the theory argues that economic growth needs to be tightly controlled by the government.

Setting aside the truth or falsity of "sustainable growth," the fact is that Beijing has expressed some acceptance of the view that economic growth needs to be artificially limited and has shown its willingness to act accordingly. This viewpoint was the explanation given for recent hikes in the interest rate. Additionally, curbs have been placed on domestic investment in real estate, auto manufacturing and a few other industries. Such measures will, undoubtedly, slow China's economic growth.

These actions are not the only policy positions that will soon lower the Chinese growth rate. The current 5-year plan of the Chinese Communist Party places renewed emphasis on attaining a "harmonious society," giving more priority to economic equality and traditional Chinese values and less to economic growth. The plan also lists improvement of environmental conditions as a major goal. Whatever one's views on the issues, the fact is that environmental regulations may hinder economic growth—in fact, restricting growth is usually mentioned as a necessary means. There will be fewer power plants built, even hydroelectric ones, less land developed for agriculture or factories, less mining, etc.

For a partial estimation of potential consequences from these actions, look at the U.S. environmental policies such as the promotion of alternative fuels, which has led to a dramatic change in agriculture decisions resulting in the production of a glut of ethanol and a shortage of food corn, wheat and soy, consequently affecting a number of food prices in

the process. Or, consider the numerous development projects in the U.S.: power plants, factories, ski resorts, farms and residential housing that have been delayed or halted to satisfy environmental goals.

There is also the continued repression of the Chinese people that keeps domestic entrepreneurial and innovative activity in check. The government still severely restricts what its citizens can own, what they can read and write, what they can say publicly, what art they can produce, and how many children they can have, etc. This control does not create an environment where people are willing to, or can, be creative.



SOCIAL ISSUES

Another hurdle is the state of the Chinese educational system. There has been significant progress during the last couple of decades in the Chinese university system, primarily in the engineering and technical fields, but there is a long way to go before the system rivals that of the West. Chinese business schools have seen recent development, including joint programs with U.S. and European schools although improvements are not coming fast enough to meet demand.

Many Western companies would like to hire Chinese engineers, programmers and managers yet are unable to find qualified applicants. It has also been reported that there is a shortage of skilled laborers. Such shortages will only increase in the next several years as demand increases at a faster pace than educational improvements arrive. Academia generally is slow to respond to external conditions while the development of educational

programs and facilities is also usually not a quick process, especially at the advanced level required for innovation in today's technical and financial fields. Similar bottlenecks appeared in the British, U.S. and European Industrial Revolutions, but the ones confronting China's communist rule today appear to be many times more troublesome.

Over the last 30 years the productivity of Chinese labor has greatly improved due to the importation of Western capital, technology and knowledge. China has essentially been condensing 300 years of economic progress into 30 years. This practice, though, has its limits. Even under the best circumstances, this process would probably only allow China to approach, not surpass, the level of the West. However, even that scenario might not be possible without a deeper understanding and

acceptance of Western ideals and values that drive the economic progress outside of China. In fact,

much of the expertise and technology that has caused China's increased productivity resides in the FOEs and would leave if the foreign investors pulled out.

To maintain a high growth rate beyond the next 5 or 10 years, China must be on the forefront of technological invention and innovation, which means that it must become a leader in science, business management, economics, finance and creative thinking. These requirements simply cannot occur given the censorship and lack of individual freedoms in China. Additionally, the Chinese mixture of mysticism, Confucianism, Eastern stoicism, Marxist dialectical materialism and collectivism is often at odds with the worldly, scientific, individualist, and capitalist ideas that have created the last three centuries of industrial growth in the West.

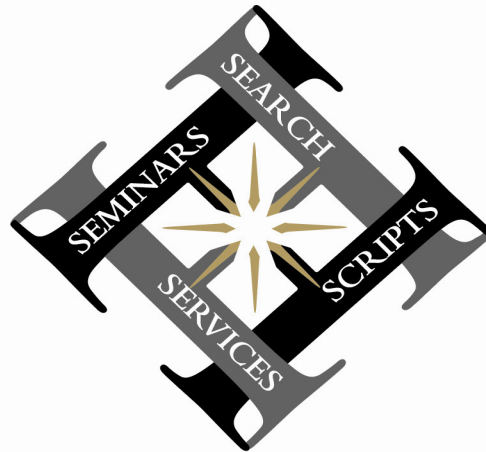


SUMMARY & CONCLUSION

Lately there has been a handful of commentators who, citing the social and political conditions, have asserted that China's economy will implode in a few years. Such predictions in my opinion will definitely be proven false, just as will the predictions of China's surpassing the U.S. as the largest economy. What time will show is that China's growth rate will soon slow because of the factors discussed previously in this article. Given present conditions, its economy will likely grow for another 20 or 30 years, but not at 11% per year. Radical change is unlikely in the near future but the factors are already in place for the start of a decline. Each week additional indicators are reported – many more than I could possibly mention in this article.

As a final note, I must point out that I have only been discussing the prospects of China's economy. As one who has spent years studying and teaching philosophy, I would be remiss if I did not mention that there are some other serious moral and political issues concerning trade with China that have not been discussed.

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HIGHEST QUALITY SEARCH, INC.

CAREER IMPLICATIONS:

LONG-RUN THINKING

FOR THE MOST PROFITABLE CAREER[®]

This article does an outstanding job of presenting a number of issues that investors, analysts, bankers, corporate finance, and financiers in general should always remember, namely:

1. Avoid hasty generalizations. When creating or reviewing discounted cash flows or other types of analysis, using unrealistic growth rates ad infinitum will likely cause the overall asset value to reach unattainable levels since, as Dan mentions, “growth rates decrease as size increases”.
2. Look at truly the worst case scenarios (for a review of the latest tools and what works/what doesn't, visit Dr. Izzy Nelken's “The Rise of the Humans” in this issue) because what Dan points out for China applies to everything and everyone else, namely: nothing and no one is immune to recessions, depressions, bubbles, crashes, or plateaus.

Yes, using these 2 guidelines you might in the short run have to pass on purchasing some investments that just about everyone is saying is the way to make lots of money. Yes, using these 2 guidelines you might have to change jobs in the short run if you discover that you're working for a boss who wants only end values that will sell products or projects.

On the other hand, using these 2 guidelines as an investor will save you from investing in dotcom bubbles, overvalued real estate, etc.. (isn't it interesting how these investments are usually touted as their future value can only go one way –

up – when a review of history shows the case for all assets to be different?).

As an employee, using these 2 guidelines will save you from taking another job before thoroughly researching all aspects – including human capital. It will also provide you with peace of mind in the short run and might even save you from the public humiliation of a “perp” walk or jail time.

In the long run, either as an investor, financier, or financial employee, you will have a more profitable career because when markets become rational again (and history shows that markets do over a relatively short time become rational again), people do remember and alter their future behavior accordingly by determining who sold them what and who bought what.

When those reflections occur, your reputation as a savvy investor or as an honest banker, financier or employee will grow, which will permit you to make even more money than if you didn't live by these 2 guidelines.

While we're on the subject, do take lots of time to reflect on and plan for your most valuable asset, your career. Ask yourself:

1. Have I made any hasty generalizations about my own career's potential future growth based upon projecting the current scenario as if it's going to last forever? If yes, what can I do to correct that assumption now before or if the current scenario changes?
2. What am I going to do when a recession, depression, bubble, crash, or plateau hits my career, job, or industry?

Planning the answers to these questions now will allow you to enjoy today even more and tomorrow even more so.