October 22, 2014 – The Real Economic Story In China – By Jeffrey Hagenmeier

The latest economic reports coming out of China, the worlds second largest economy are troubling. Domestic demand is weakening and industrial production is continuing to slacken. The real estate market in China is vastly overheated, with the peak already reached and the overall vacancy rate still quickening. Over speculation and the run up in state and local debt, is largely responsible for this situation. Official statistics put growth in the third business quarter at 7.3%. This is the slowest rate in five years. It was above the 7.2% forecast, but still a diminution from the 7.5% reported in the second quarter.

What to do? In response to these GDP (Gross Domestic Product) reports in China, there are some analysts that are calling for more stimulus to avert a further decline in growth. Of course, these same individuals call for similar action everywhere. The mistaken belief that continued government spending and accumulation of debt will somehow ensure prosperity, will not be put aside easily.

At this point, there are several things to consider. Although the Chinese government is reporting a slowdown in growth, this investment writer believes the situation is more dire than many would choose to accept. The Chinese economy which grew at an average annual rate of 10% in the years from 1993 to 2011, is no longer going to be able export its way to wealth and good fortune. This is a result of the slowing demand for Chinese goods and services, that is attributed to a general deceleration in global output. In other words, there are fewer customers for what China has to sell.

The second component is that the miracle of Chinese expansion is most likely over. Slower rates of economic growth predicted in the future of 4% to 5% in my estimate are already here. Which means the official statistics cannot really be believed. The long term survivability of the Chinese government will soon come into question, once the public can no longer be bribed into silence by promises of continued rapid growth. Therefore, one must become highly suspect of future economic data provided by the government.

China is most likely facing a period of upheaval and doubt. What is happening in Hong Kong is not occurring in isolation. The more the Chinese government moves to tighten control there and elsewhere, the less legitimacy they actually prove to have. You cannot control a population that is rapidly modernizing with intimidation and threats of oppression forever.

The explanation for the recent slowdown in Chinese growth, is attributed to a tightening of credit which was put in place by government authorities. But one needs to contemplate whether they were given much choice? There are twin forces that are threatening to derail the Chinese growth train. These are the enormous real estate market, which is overvalued and a practically scandalous banking situation.

The leadership of China would like to engineer a soft landing, but is it really possible? For years the extension of credit had exceeded economic growth. It encouraged the development of so many projects in commercial and residential property, that vastly exceeded market demand. It was all funded by easy money from local and state banks, who were encouraged to make loans by the government and corrupt politicians. The result is that many of these financial institutions are left with portfolios that are over leveraged in real estate projects, that will not be profitable.

Another challenge for the Chinese government will be how to transform elements of a command economy, to a more dynamic and creative capitalist market. The growth model of the past is no longer viable. Further investment in heavy industry and low cost manufacturing made possible by abundant cheap labor, will be nonsensical.

Future growth in China will be more dependent on developing an internal market of expanding consumer demand. Chinese industry will need to innovate and modernize with gains in productivity. This will be difficult in a society where the government likes to direct the movement of market forces. In the United States, the advent of the Information Age brought opportunity and new wealth. In China it could well bring down the government. One can see the obvious dilemma.

Debt has become a problem in China, despite the huge foreign exchange holdings of the government. Private sector debt is estimated to be close to 200% of GDP and still expanding. These levels of liability have usually sparked financial crises in the West. The Chinese government cannot ignore this economic reality forever. It is likely the Chinese government will infuse these banks with new funds to keep them solvent, but that does not solve the problem. As more bad loans become due, the government will find it increasingly difficult to cover the rising losses.

If international investors are making decisions based on continuing rapid growth in China, it may be time to reconsider that approach. Companies looking to make major investments in the Chinese market need to be cognitive, that China is a nation facing some major challenges. One can still make advantageous and profitable business deals with the

Chinese, but more scrutiny will now become necessary. China can no longer just simply grow, to solve underlining problems with the economy.