Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

Transformation or Bust

JOHN MAULDIN | August 2, 2014

IN THIS ISSUE

China continues to be front and center on my list of concerns, even moreso than the latest Federal Reserve press release or fluctuation in the Dow (although you should pay attention). I believe China is the single biggest risk to world economic equilibrium, even larger than Japan or Europe. This week my young associate Worth Wray provides us with a keenly insightful essay on what is currently happening in China. I will admit to not having written about China very much in the past five years, primarily because, prior to Worth's coming to work with me I really had no secure understanding of what was happening there. I know some readers may be surprised, but I really don't like to write about things I have no understanding of. Worth has helped me focus. (It helps that he studied Mandarin and lived in China for a while, and is obsessed with China.)

Worth has been working directly with me for over one year now. I have had the privilege of working with a number of impressive (lately mostly younger) people over the years, but Worth brings something extra to the table. He is one of the best young macroeconomic minds I have been with in years. He constantly challenges me to step up my game. And so without further ado, let me give you Worth's thinking regarding our latest discussions on China.

Transformation or Bust, China Version

The People's Republic of China is running up against its debt capacity; and its consumption-repressing, credit-fueled, investment-heavy growth model is nearly exhausted. History suggests that China's "miracle" could dissipate into a long period of painfully slow growth or terminate abruptly with a banking crisis and sudden collapse. That said, China's modern economic transformation has defied historical precedents for decades. However unlikely, China could surprise us again. Miracles will happen in the Age of Transformation.

What happens next depends largely on the economic wisdom and political resolve of China's reformers, who must find a way to gradually deleverage overextended regional governments and investment-intensive sectors while simultaneously rebalancing the national economy toward a more sustainable consumption-driven, service-intensive model. The trouble is, their efforts may prove too little too late to slowly let the air out of a massive debt bubble. Even rapid productivity growth from "new economy" sectors may not be enough to overcome the debt equation.

At first blush, China's ruling elite do not appear to be in denial about the severity of the debt problem, the urgent need for structural reforms, or the opposition from vested interests within the Communist Party; but the jury is still out on whether President Xi Jinping and his allies will maintain the political capital necessary to complete, or even continue, the task. With little margin for error, he will either lead the Middle Kingdom through the greatest transformation in world history... or he will preside over one of the most spectacular busts on record.

Before we dive into recent data and explore the transformation taking place across the People's Republic, let's step back and think intentionally about the conditions that often set "rich" developed economies apart from their "poor" developing peers.

I am going to quote extensively in the next two sections from a recent blog post by Peking University Professor Michael Pettis. Pettis provides a CRITICAL foundation for understanding the transformation taking place and the reforms required to keep it going, so please bear with me. We will have plenty of time to delve into the recent data in the second half of the letter. Unless otherwise noted, all quotes are excerpted from his brilliant post, "The Four Stages of Chinese Growth."

Becoming a Developed Economy

Becoming a truly developed country depends on far more than just accumulating an abundant capital stock or a highly capable workforce. Durable growth and sustainable development depend on "social capital" – or institutional structures including property rights, the legal code and the justice system, the financial system, corporate governance, political culture and practice, tax structures, etc. – which establish and/or maintain the right incentives for economic resources to be used efficiently, creatively, and ultimately, productively.

Pettis explains: "In a country with highly developed social capital, incentive structures are aligned and frictional costs reduced in such a way that agents are rewarded for innovation and productive activity. The higher the level of social capital, the more likely they are to act individually and creatively to exploit current economic conditions and infrastructure to generate productive growth." Extending his argument, John and I would contend that high levels of social capital effectively incubate innovation and entrepreneurship so that, with disciplined savings and investment over time, the right incentives produce lasting wealth and ever-higher levels of development.

I think MIT Professor Robert Solow would agree with us on this front. Solow's work on the US economy – which has become a textbook economics lesson – explains that innovation has accounted for more than 80% of the long-term growth in US per capita income, with capital investments accounting for only 20% of per capita income growth. In other words, the United States and the rest of the post-industrial, developed world owe their epic rise in living standards to the underlying "social capital" that properly incentivized innovation, entrepreneurship, and thus technological transformation over the last two centuries.

The lesson here is powerful. It is not enough just to mobilize resources and direct investments to the "right" sectors as China's central planners have been doing for the last few decades. Once the basic building blocks of economic development are at hand, they still need to be used creatively, effectively, and productively.

Pettis elaborates, "In developed countries … abundant social capital encourages residents and businesses to use available conditions and infrastructure in the most productive ways possible. Undeveloped countries, on the other hand, are poor because they do not have the often-intangible qualities that allow citizens spontaneously, and without planning, to exploit their economic and infrastructure resources most efficiently and productively."

Emphasizing the importance of incentive-aligning institutions, developing economies must not only strive to create (1) policies aimed at providing and improving the basic building blocks of production like adequate infrastructure, abundant capital stocks, and healthy, educated workforces but also (2) policies and institutions capable of streamlining the commercial incentives for using those resources as productively as possible with as little waste as possible.

Like the USSR in the Cold War era, the People's Republic has been wildly successful in mobilizing resources; but failing to use those resources efficiently may be its downfall.

[As an aside, I would encourage anyone and everyone interested in these ideas to read this 1994 Foreign Affairs article by Paul Krugman. It's one of those papers that has stuck with me since college and has dramatically informed my thinking about consumption-repressing, resource-marshaling, investment-driven growth miracles.]

Today China enjoys access to an abundance of raw materials, a plentiful supply of human capital, a large and growing capital stock, and extensive infrastructure assets; but after decades of policies meant to build up the supply of those basic economic building blocks, the institutions and incentive structures underlying its socialist market economy are deeply and inherently skewed in favor of vested interests at various levels of government.

And this is precisely why Xi Jinping's widespread crackdown on corruption is SO important. Transforming China into a more developed, consumption-driven, service-intensive economy requires that China achieve, according to Pettis, "a dismantling of the distortions and frictions that create rent for the elite, thus undermining the ability of the elite to capture a disproportionate share of the benefits of growth."

Overcoming vested interests and reforming China's underlying institutional structures to properly incentivize innovation is absolutely possible, but it demands strong and unwavering leadership. As we will see in the next section, Xi will have to channel his inner Deng Xiaoping to guide the People's Republic through its next great transformation.

The Four Eras of Chinese Growth & Development

In contrast to popular development narratives, Dr. Pettis thinks of China's modern growth and development in four stages. Let's see what he has to say…

(1) **The First Liberalizing Period**, late 1970s to early 1990s

In the late 1970s and early 1980s Beijing forced through a series of liberalizing reforms that I would characterize as aimed at building social capital. By eliminating laws that severely constrained the ability of Chinese to behave productively, these reforms unleashed an explosion of economic activity that generated tremendous wealth creation. It became legal, for example, for Chinese to produce and sell as individuals, not just through the relevant and usually badly managed state-controlled collectives or organizations. A limited number of farmers were allowed to keep anything they produced above some quota, and agricultural yields doubled almost immediately. If a man believed there was a shortage of bricks in his town, he could create a company to manufacture bricks, and China's hopeless jumble of soaring brick inventories in one part of the province matched by severe brick shortages nearly everywhere else was replaced with a system in which the more efficiently you made and delivered bricks, the richer both you and the country became.

But the implementation of the reforms was not easy. It undermined a very powerful party structure (not to mention the managers of the old state-controlled brick manufacturer) that had been built up over the previous three decades around the ability of its members to constrain and direct economic activity, and so these reforms met with powerful elite resistance. It was only, I would argue, because of the credibility, prestige, and power that Deng Xiaoping and the men around him had, and the loyalty they had built within the PLA, that Beijing was able to overcome elite resistance and successfully implement the reforms. Even in the 1990s, Deng struggled with elite opposition and my understanding is that his famous 1992 Southern Tour was arranged mainly to outflank and defeat provincial opposition to continued economic liberalization.

(2) The Gershenkron Period, early 1990s to early 2000s

As Chinese productive activity swelled it soon began, however, to run into infrastructure and capacity constraints. This began the second phase of China's astonishing growth, one characterized by the marshaling of domestic resources to fund an investment boom aimed at creating infrastructure and capacity. Like the many previous examples of investment-driven growth miracles, China embarked on a program to resolve the major constraints identified by Alexander Gershenkron in the 1950s and 1960s as constraining backward economies: a) insufficient savings to fund domestic investment needs, which had to be resolved by policies that constrained consumption growth by constraining household income growth, and b) the widespread failure of the private sector to engage in productive investment, perhaps because of legal uncertainties and their inability to capture many of the externalities associated with these investments, which could be resolved by having the state identify needed investment and controlling and allocating the savings that were generated by resolving the savings constraint.

Because China's infrastructure was far below its ability to absorb and exploit infrastructure efficiently and productively (its social capital exceeded its physical capital, in other words), it was relatively easy for the central authorities to identify productive investment projects, and as they poured money into these projects, the result was another surge in wealth creation from the early 1990s to the early 2000s. Although all Chinese benefitted from this wealth creation, the new elite benefitted disproportionately, in large part because of the constraints imposed on the growth of household income aimed at generating higher savings. Of course over time these new elites became politically entrenched. This elite today is famously referred to (in China) as the "vested interests".

(3) Investment Overshooting, early 2000s to 2014?

But China was still an undeveloped economy with "backward" (in Gershenkron's sense) social, legal, financial and economic institutions that sharply constrained its citizens from achieving the levels of productivity that characterize developed countries. Its social capital was still very low, in some cases perhaps even as a partial consequence of policies that had led to the earlier rapid investment-led growth by allowing elites to control access to cheap capital, land, and subsidies. As investment surged, China's physical capital converged with its social capital (i.e. its infrastructure more or less converged to its ability to exploit this infrastructure productively), after which additional physical capital was no longer capable, or much less so, of creating real wealth.

Instead, continued rapid increases in investment directed by the controlling elites (especially at the local and municipal levels) created the illusion of rapid growth. Because this growth was backed by even faster growth in debt, however, it was ultimately unsustainable. This period began around the beginning of the last decade, I would argue, and it is the period in which we currently find ourselves.

(4) The Second Liberalizing Period, could begin in 2014?

What China needs now is another set of liberalizing reforms that cause a surge in social capital such that Chinese individuals and businesses have incentives to change their behavior in ways that generate greater productive activity from the same set of assets. These must include changing the legal structure, predictably enforcing business law, changing the way capital is priced and allocated, and other factors that determined the incentives, so that Chinese are more heavily rewarded for activity that increases productivity and penalized, or at least less heavily rewarded, for rent seeking.

But because this means almost by definition undermining the very policies that allow elite rent capturing (preferential access to cheap credit, most importantly), it was always likely to be strongly resisted until debt levels got high enough to create a sense of urgency. This resistance to reform over the past 7-10 years was the origin of the "vested interests" debate.

Most of the reforms proposed during the Third Plenum and championed by President Xi Jinping and Premier Li Keqiang are liberalizing reforms aimed implicitly and even sometimes very explicitly at increasing social capital. In nearly every case – land reform, hukou reform [note: household registration system or the removal of the distinction between rural and urban citizens and thus the freer movement of labor], environmental repair, interest rate liberalization, governance reform in the process of allocating capital, market pricing and elimination of subsidies, privatization, etc. – these reforms effectively transfer wealth from the state and the elites to the household sector and to small and medium enterprises. By doing so, they eliminate frictions that constrain productive behavior, but of course this comes at the cost of elite rent-seeking behavior.

Drawing on this four-stage development framework, Pettis' research reveals an insight that many economists and China watchers are simply missing. ***China's current overcapacity and over-indebtedness is not just the unfortunate consequence of hurried post-crisis stimulus, but an inherent by-product of its command-and-control growth model.***

After decades of marshaling resources, educating its workforce, and building out a modern infrastructure, China has amassed the building blocks for economic development. China's central planners successfully overcame the country's capacity constraints during the so-called Gershenkron Period, but the problem today is overcapacity and widespread misallocation. More investment in bloated "old economy" sectors like low-value-added manufacturing or construction may support employment and keep the economy growing at or above its headline growth target for a while longer; but as John and I explored in our last China letter ("Can Central Planners Revive China's Economic Miracle?") – the investment boom cannot go on forever.

It's time for central planners to take another step back in order for China to take a giant step forward.

Mini-Stimulus & Third Plenum Progress Report

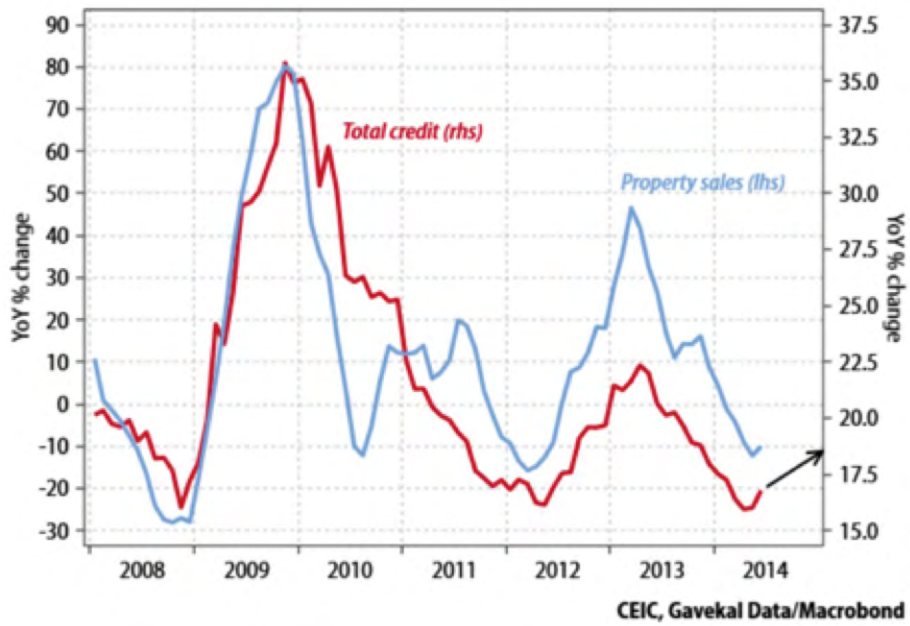
Among the various reforms set forth in last November's Communist Party Third Plenum, ranging from financial liberalization to a crackdown on corruption and pollution, the most challenging is the gradual deleveraging of the Chinese economy while simultaneously rebalancing the national accounts toward a more sustainable consumption and service-heavy mix.

As John and I have argued for several months, these kinds of liberalizing reforms will not be easy and may require a far greater slowdown than anyone in Beijing publicly admits – but they are China's only hope of avoiding either a hard landing or a long, frustrating period of depressed growth. Debt has a cost, and that cost must be paid in one form or another.

Although Xi and China's State Council members seem to understand this dynamic, they are not following through with timely reforms. After a period of weakness in the first half of the year, the State Council announced what could be best described as a mini-stimulus in early April, which in the following months has turned into a full-blown stimulus package.

Rather than encouraging the national economy to rebalance toward domestic consumption or allowing previously misallocated capital to seek out more productive uses in "new economy" sectors like services and technology, ***China's State Council is responding to slowing economic growth with more of the same: (1) government spending on railway expansion and shantytown renovations*** (which may or may not be productive) ***to replace decelerating private sector demand, (2) "targeted" interest rate cuts to encourage additional credit growth*** (which will almost certainly be unproductive), ***(3) last-minute bailouts to prevent corporate defaults*** (which they told the world to expect a lot more of in 2014), and ***(4) tax breaks for small and medium-sized enterprises*** (which remain seriously disadvantaged relative to larger public or state-owned firms).

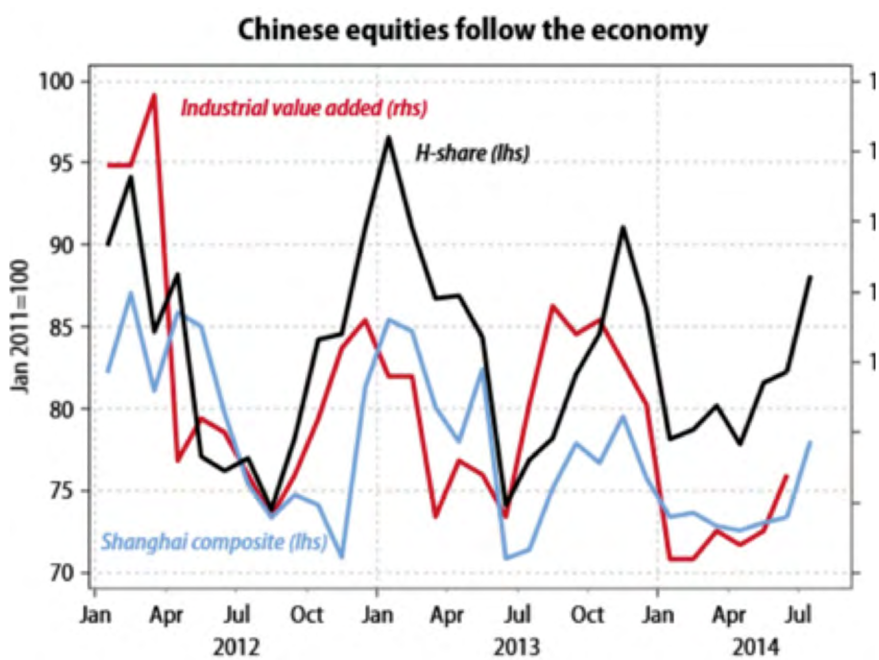
Since the State Council's announcement in early April and Premier Li Keqiang's subsequent guarantee that 2014 economic growth would top 7.5%, the so-called "mini-stimulus" has led to another surge in lending activity,



slightly better real GDP growth (7.5% YOY in Q2 compared to 7.4% YOY in Q1 – according to the highly questionable National Bureau of Statistics),

and the strongest manufacturing PMI print in eight months (51.7 in July, compared to 51.0 in June, 50.8 in May, and 50.4 in April).

And, of course, Chinese stocks are SURGING on improving "old economy" indicators like industrial activity.



John and I believe this kind of stimulus-fueled "improvement" – although it is boosting China's economy and lifting Chinese markets in the short term – is a very bearish sign that Beijing is afraid of the short-term pain associated with its admittedly urgent reform agenda. This kind of about-face may reveal one of two things: (1) the reformers' resolve is fading, or (2) the economic reality in China is more unstable than we outsiders realize.

A Few Final Thoughts

[John here] As he did the last time he wrote on China, Worth actually ended up writing enough content for two letters. We'll see Part Two next week.

As I've been saying for some time, we think China looms as the single biggest risk to the world economy, if only because no one yet fully recognizes the substantial and I think principal risk that derives from the innumerable global interconnections – with almost everything of a financial nature – that the world's second-largest economy has forged over the last two decades. I say that fully cognizant of the risks that both Japan and Europe create for the world, risks Jonathan Tepper and I explored at some length in our book *Code Red*. Next week Worth and I will pin down realities we all need to recognize regarding the global risks posed by the ongoing political machinations within China. Stay tuned.

Montana, San Antonio, DC, Barefoot, and Boston

That sounds like an ambitious schedule, but it is actually stretched over three months, which is the lightest travel schedule I've had in five years. Which of course means it will change. Who knows, I may show up in a city near you. My travel life takes some strange twists. In a few weeks I will go up to Flathead Lake, Montana, to be with my partner Darrell Cain for a very long weekend, trying to actually relax. Last year when I was there I was finishing my book Code Red (ergo massive deadline), so I really had no time just to sit and read and think and meditate. My full intention is for this year to be different.

Tonight finds me in Grand Lake Stream, Maine, at Camp Kotok at Leen's Lodge (highly recommended), where I've spent the first Friday of August for the last eight summers with my youngest son, Trey. This annual ritual has been a special time for me, marking the years as my youngest son has grown into a young man. And the reminder is made physical by the pictures in my phone. There are a few more tattoos and other things that make the old-fogey dad a little uncomfortable, but as we sit and catch fish I remember the 12-year-old kid who caught his first fish. He still has the same joy and facial expressions. Where did my little boy go? It's hard for me to think back over how fast the time has flown.

Philosophical moment. Most of us of with older children experience the phenomenon of how fast our children grow up. It is both thrilling and uncomfortable. But life around us has otherwise tended to flow on smoothly, for the most part. What if the life we experience also changes rapidly in the future, which I think is the likely probability? Does the difficulty we have dealing with how quickly our children grow and change suggest that we will also find ourselves challenged in dealing with accelerating change in the world around us? Just asking…

I had the privilege here of sitting next to Paul LePage, who is the governor of Maine and running a very competitive and combative race for reelection. His problem is that the local media hates him, although he has won over a significant portion of the population with the substantial successes that he has had in the last four years. He has turned Maine around from being an economic joke and a disaster case into a state that is more than respectable. Maine's unemployment rate has gone from being among the worst to being among the best. Taxes are significantly down. Growth is up. He's reduced the welfare rolls from 27% to 19%.

He is an interesting character. I've been around politicians for the last 35 years, at all levels. And while I'm not significantly involved in politics today, there was a time when I was really into it. After a while, it dawns on you that there are politicians on both teams who are there for the personal benefits they can grab as opposed to the passion they bring to the table. Sadly, the first group is much larger than the second.

Paul is one of the passionate ones. Actually rather extremely so. Four years ago he was a businessman who got fed up and decided to run for governor, and in a very odd election year won as a Republican in a very deep-blue state. In the world of politics strange things happen.

Paul is rather outspoken, which is what has gotten him in trouble with the media. (Besides the fact that he is a libertarian in a state with a very liberal media.) He tells a story about Barbara Bush, who was with him at a collegiate event last year and asked if she could speak to him in private. Who tells Barbara Bush no? She leaned into his ear and said, "Governor, it is very important to get reelected. Maine needs you. Zip it!" He said "Yes ma'am" and has been a good boy ever since (at least on a relative basis).

Given his views and track record, if LePage were governing a state with a population of 10 million (Maine has 1.3 million), the media would be following him as a potential presidential candidate. As it is, he is off everyone's radar screen. Unless you are in Maine. As I sat at the table and listened to him rattle off businesslike answers to question after question posed by members of the media (for the purposes of this dinner I got to sit with Bloomberg and a few of the other big dogs – go figure), I saw a man who translated his personal philosophy into practical solutions.

Sometimes his solutions were nuanced, but he decided to simply override his Democratic legislature, which wanted to postpone what he felt was a needed nursing home subsidy until after the election cycle – a delay that would have meant even more much-needed nursing homes in Maine would be closing down. He mandated the expenditure in a somewhat Obama-like fashion (or at least that's what it sounds like to me, but then I'm just a country boy from Texas).

Governor LePage is an original. I'm not sure how he would play on a national stage, but he fits right into my image of Maine over the last 30 years. And I would make him an honorary Texan in about two heartbeats.

That's all the news from Maine, where the world is a perfect sunset, the fish are all biting (we caught 36 today), and all the children are forever young. Have a great week and enjoy the wild ride into the Age of Transformation.

Your sometimes wishing things would slow down analyst,

John Mauldin

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