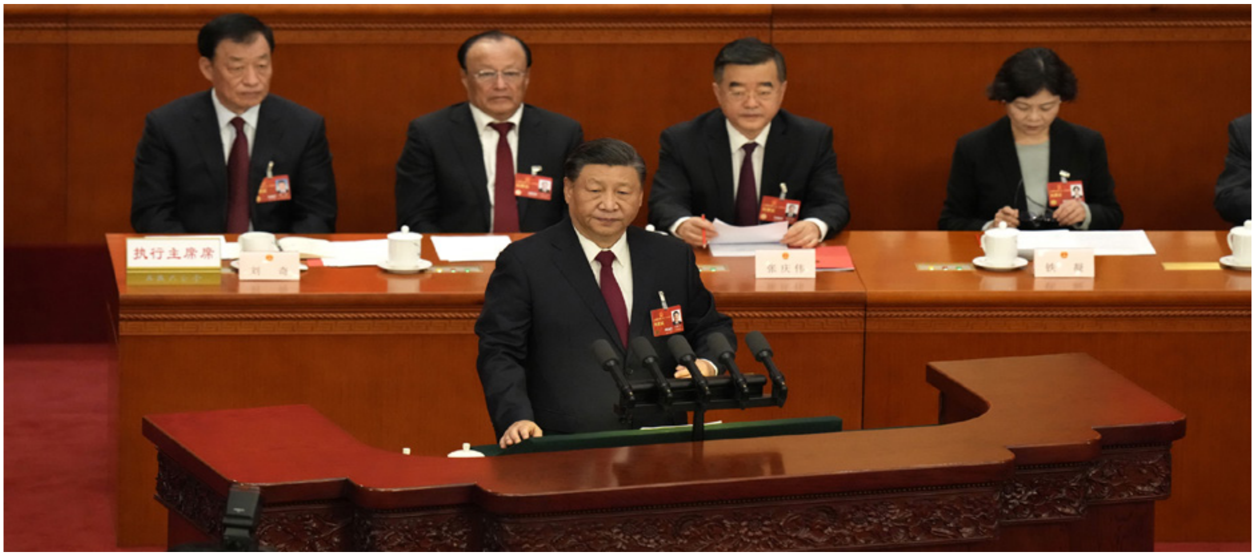
THOUGHTS FROM THE FRONTLINE

Chinese Exceptionalism

By John Mauldin | May 11, 2024



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Any way you care to measure it, the United States has the world's largest economy. It is not, however, the fastest-growing economy. And growth rates matter because, other things being equal, a faster-growing economy might eventually challenge US leadership. China is doing so now. Where is this going? That was a frequent topic at this year's SIC.

The US and China aren't simply "rivals" in the Cold War sense. Our two countries are each other's customers, suppliers, and competitors, all at the same time. Both are immersed in a boiling pot of economic, business, and geopolitical ingredients.

Understanding this mixture is a tough and maybe impossible task. Even experts see things differently. Nevertheless, at SIC I pulled together a China panel with three distinct viewpoints. I did that because I knew they would clash on some points and agree on others.

That's exactly what happened, and far more effectively than I expected. Emily de La Bruyère, Louis Gave, and Lyric Hughes Hale revealed angles I had never considered, even though I've been watching China's rise for decades. Whatever you think you know about China, they'll make you see it differently. And then the final panel focused on China. In general, China was probably the most discussed topic for this year's SIC.

This is important even if you have no interest in Chinese investments… because in fact, you *are* invested in China, either directly or indirectly.

Gold Alternative

In this publication's 20+-year history, I think I probably wrote a letter specifically about China once a year or so, in addition to mentioning China in relation to other topics. Searching the old files, the word "China" appears at least once in almost half my letters—another indicator of its importance.

My January 2023 Slow Change Speeds Up letter talked about the then-big news Xi Jinping was lifting the "Zero COVID" restrictions. I quoted a Gavekal report predicting China's economy, along with its demand for resources, would bounce back once the new infection wave receded.

That was right on target; China is recovering, but many problems remain. I think Xi's assertion of greater control over the economy—and suppression of entrepreneurial activity—will have deep long-term consequences (see below). But China has more immediate issues and effects on the world. That's where our panel started.

My partner Ed D'Agostino, who was moderating, asked Lyric Hughes Hale to describe what is happening with the Chinese economy right now. Lyric is fluent in six languages, including Chinese and Japanese, and lived in both countries. She brought the Super Bowl to China in 1986. She is wired and knows China intimately. Her letter is excellent.

Here is part of Lyric's comment from the transcript (which, by the way, is 19 full pages so I can only share some short clips).

> "I think what we're seeing right now is the end of Chinese exceptionalism, economic exceptionalism. I do believe that somehow communism and capitalism are incompatible. And right now, China was able to not do anything to reform many of its political institutions because just the growth rate was so quick, and the base was so low when they started out that it looked like a miracle that could go on forever.
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> "And then China, many people said, would exceed the growth of the United States. According to my calculations, it's not even true demographically. By the end of this century, the United States could have a larger population than that of the People's Republic of China.
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> "So what we're seeing right now, all the problems that we're seeing, I believe the economic decline is real. And the best way for investors to measure that, I think, right now is the price of gold. China is now the largest buyer of gold, and it's not just at the retail level where they far exceeded Indian purchases, but it's also at the governmental level. The rise in the price of gold to me is an inverse indicator of the problems with the Chinese economy…"

Louis Gave then jumped in with another explanation for Chinese gold buying. He thinks Chinese investors see the Western sanctions on Russia, don't want to be next and are thus urgently trying to get out of dollar assets. Here's Louis:

> "One of the key priorities today of Chinese policymakers is to de-dollarize their trade, is to reduce their dependency on the US dollar. And this is much more for geostrategic reasons than economic reasons.

"I think in the past 15, 20 years, you have seen the US dollar weaponized time and time again to confront geopolitical rivals or problematic countries, whether... call them Iran, call them Venezuela, call them Sudan, call them Russia... And the US politicians have used the hammer of the US dollar to beat people up, and China doesn't want to be on the other side of that hammer…

"For most of my career, gold was always said to be the anti-US dollar. It was always said that when the policy mix in the US is wrong, when monetary policy is too loose, when fiscal policy is too loose, that gets reflected in a stronger gold price and a weaker dollar vis-a-vis gold. So I was smiling to hear that now a weaker dollar, stronger gold is actually a reflection on China, much more so than on the US.

"I think if you're Chinese and you look... if my choices are Vancouver real estate or gold because I don't want to invest in China, maybe now gold makes more sense."

If this is right, then Chinese gold buying isn't so much about wanting gold but about not having any better alternatives. Emily de La Bruyère then said it's even broader than that; China wants to reduce outside dependence on everything else, too.

"There was a point already about China's effort to rid itself of dependence on the US dollar. That's important because China's industrial policy more generally hinges on ridding itself of dependence on other players, or at least shifting the relative balance of dependence so that China is relatively more independent in any product than its competitors, adversaries, or even partners, because that gives Beijing leverage."

I found this darkly amusing in a way. We seem to be regressing back to the time when physical gold—"specie," as they called it—was the measure of power. And this time it's gold plus a bunch of modern gold equivalents like microchips.

Decoupling and Diversion

If you believe some of the Wall Street narratives, this desire for economic independence—which exists in the US, too, we should note—is behind the "decoupling" of China and the US. Remember when people talked about "Chimerica" (a term coined by my friend Niall Ferguson)? You don't hear that anymore.

Louis Gave says China sees this differently.

"Yes, the Western world is trying to reduce its dependency on supply chains, but meanwhile, China's footprint across emerging markets is growing by leaps and bounds. And so, when you look at China's trade surplus that has gone from $30 billion to $70 billion over the past five years.

"Five years ago, the Western world decides—basically the US and then others tag along—that China's a bad actor, that we need to freeze them out, we need to block them from global supply chains. We fast-forward to today, and the trade surplus is up 2.5X.

> “So arguably, you could say, ‘Okay, well, that’s been a failure,’ but that whole growth has come from trade with emerging markets. If you go back to just five years ago, China’s exports to Southeast Asia, to ASEAN countries—so, the Indonesias, the Philippines, the Malaysias of this world, the ASEAN countries—was about 60% of China’s trade to the US.
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> “Now, in the past five years, China’s trade to the US has basically flatlined. Meanwhile, China’s trade to the ASEAN has more than doubled. So that today, China’s trade into Southeast Asia is 120% of China’s trade to the US. So today, for China, Southeast Asia is arguably now more important than the US.
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> “This is how the decoupling is working, and it’s not working in favor of the US. It’s actually working in favor of China because China is getting bigger and bigger inroads in the markets that are going to be the growth markets of the future…
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> “China’s growth is no longer about selling plastic toys and tennis shoes. It’s now selling cars, earth-moving equipment, solar panels, telecom switches, and it’s selling it not to the US, not to Europe, it’s selling to all these other emerging-market countries.”

Louis makes sense, but it’s fair to wonder how much of this business would have gone to US companies. We simply don’t produce those kinds of products anymore. For better or worse, we’ve pivoted over the last two decades to exporting intangibles: software, financial services, etc. Those are our strengths now.

(Note: I have a close friend who sells Chinese “earth-moving” equipment, think Caterpillar or John Deere, here in the US. He has become the largest distributor of Chinese-made equipment in the world, in under two years. They literally cannot keep up with demand here in the US. Think about that. And then ask where Caterpillar and Deere manufacture a lot of their equipment. Just one more example of how difficult China policy is.)

But to Louis’s point, Lyric and Emily both think much of China’s export volume to these other countries is “diversionary” and still ends up in the US. Here’s Emily:

> “Both of these things can be true. Yes, China’s exports to emerging markets have gone way up and China dominates their production, but at the same time, China is also using emerging markets and other international markets as ways to access the US, EU, and other developed countries’ markets where there are higher barriers to entry.
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> “If you look at diversionary trade through Mexico to the US, 100%. Where are the solar panels in the US coming from? They’re coming from China. Where are the EVs in Europe increasingly coming from? They’re coming from China.
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> “So yes, no question to the emerging markets point, but that doesn’t mean that the US and the European markets are not still really, really important for China. And why is that important? Because of dependence on China, but also because that means that there is this political opportunity in the geopolitical contest for the US and Europe to use their markets as leverage against China.”

This is what I mean about the relationship being complicated. Neither the US nor China is yet able to decouple in the way leaders on both sides want. American consumers need Chinese goods and Chinese producers need American customers, which means they have to take our dollars. This is changing, but slowly.

The Next China?

What you just read is maybe 20% of the China panel. There was so much more but space limits me. (You can, however, still get the full video and transcripts of the entire conference.)

We ended with audience questions. We have a system for SIC where people can submit a question and then others give their vote. This lets the moderators ask what the audience wants to hear. Oddly, the top question for the China panel was about India. Can India be the next China? All three panelists weighed in, Lyric first.

> "Well, India and China are vastly different countries, obviously. I think the way that I look at the world, we have two spheres of influence now, the US, Europe, Japan, and then also China, Russia, North Korea, and Iran. And then you have a whole category of other countries that are trying to create some kind of multipolarity. India is trying to be friends with Russia, with China, and with us. And if the world becomes more contentious, that will become more and more difficult for them.
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> "But obviously India, I think, today is the most populous nation in the world if the statistics were reported correctly. I think there's a huge amount of hope for India, but it's not the same. It doesn't have that same ecosystem as China does in terms of manufacturing.
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> "And Louis, I think you would agree with me, there is a tremendous amount of innovation that takes place on the factory floor in China with all of these similar kinds of component parts, people who work together. And while Apple might send them the design, real innovation is done there as well, and I think that takes time to recreate that ecosystem. I don't see that in India yet."

Louis Gave added:

> "Building an industrial ecosystem takes a long time. It's an old generation that trains a new generation, and that's why once you lose it, it's very hard to bring back together. And today, there's no doubt that there is one industrial superpower in the world, and that industrial superpower is China. I think Japan and Germany are other industrial superpowers, but that's basically it. India is nowhere near.
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> "Now, I think India has a great story to tell. There's lots of super-exciting things happening there. Big productivity gains as you get the low-hanging-fruit infrastructure spending done and demographic growth, improvement in the population through education. There are tons of great stories about India, but it's not going to be an industrial powerhouse, I think, in my lifetime."

Emily de La Bruyère concluded:

> "One thing to add on is the nature of China's system, and part of why it's so unique is both China's scale and its centralization, and it's like those forces together that make China what it is. And India doesn't and probably will never have that kind of centralization… I would argue that that's really important for how their trajectories will differ."

In the Western context we think of "centralization" as bad. We let ideas compete and see what works, rather than impose it from the top down. That's the key to much of our success. In contrast, the Chinese found ways to both centralize authority and let individual creativity flourish. The results are obvious.

The question now is whether it can continue as Xi Jinping cracks down on individual rights and business freedom. Count me dubious the country's economic success can continue under those conditions.

The Final Panel on China

China was on the mind of the final panel. Space limits but here are a few highlights:

From Bill White:

> "Demographics [have] turned negative in China in terms of their future capacities to throw labor at markets. Another thing is the anti-technology or the anti-business approach that Xi is following. And I think John said earlier on, that in America, when you have a success, it just breeds more success, whereas in China, what's happening now is that the successful entrepreneurs are basically putting their heads down and trying to get their money out. Now, this is not a solid foundation for future growth."

We had a very rousing discussion and I concluded it this way (with the luxury of editing myself):

> "If you look back over the last century, I think clearly one of the five most important people of the last century was Deng Xiaoping. He came in 1980 and turned that country on a dime, grabbing it by the neck and said, 'We're going this way,' and allowed free markets, and the country simply took off.
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> "For those of us who travel around the world, it's hard not to notice that the Chinese, everywhere in the world they land, are entrepreneurial. In many countries in Asia, they become dominant. Deng Xiaoping changed everything. Xi Jinping comes along, and he's consolidated power, and now, to Bill's point, when somebody rises up in tech, they get slapped down. [They're] losing the momentum of growth.
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> "When Deng started in '80, we didn't really start going 'Wow' until the aughts. I mean, it was cool to watch, but you got to the middle aughts and 'Wow. Look what's happening here.' It takes time for these major shifts to come to fruition.

> "Along comes Xi. When you start crushing innovation and entrepreneurship, it takes time for that to filter into the broader economy. We've talked a lot about artificial intelligence at this conference. The US isn't just ahead, it's moving ahead faster because China is not allowing artificial intelligence to come into the country in any meaningful manner. It is going to take time, as Joe Lonsdale and others said, for AI to really show up in our productivity figures, it's going to take time for the lack of AI to demonstrate itself in China. Unless they reverse course, they are basically saying... And this is not what they think, but it's what's going to happen.
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> "When you push against free markets, when you push against innovation, when you don't adapt to the latest new systems, it's like saying, 'Well, we don't want to have railroads,' or 'We don't want to have phones.' If you don't want to have AI, you're going to fall behind. So I think it's too early to say China's going to be the end-all and be-all here and the rest of the world's going to revolve around it, because they're going to visibly slow down vis-a-vis the US over the next decade."

And to Lyric's point, China has demographics working against them. Coupled with their focus on top-down innovation rather than bottom-up, which is never as efficient, and it reminds me of Japan in 1989. Everyone thought Japan would own the world. That's what the trend suggested. Yes, different times and circumstances, but it rhymes.

Food for thought the next time you think China will swallow the world.

South Africa, Fishing, and Deadlines

In less than 30 days, Shane and I will be returning from Cape Town. We plan to spend a few weeks here and there exploring the Caribbean. And at the end of the summer, I'll go fishing in British Columbia.

My sadly departed mentor, Dr. Gary North, who wrote 50+ books and gods know how many letters, once said that he wanted his tombstone to say: "Oh Deadline, Where Is Thy Sting?" I am feeling it. I have committed to my publisher to have my book on cycles and debt finished by the end of June. Many thanks to the 100+ readers who suggested multiple hundreds of book titles. If only I could crowdsource the rest of the book. Then again, collectively my readers would probably write a better book.

And with that, I will hit the send button and wish you a great week. Spend some time with friends and hit the gym!

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