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China: the White Elephant Versus the Dragon

By goncalvesm
Benzinga Contributor
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As Brazil, Russia, India and China, the BRIC countries, advance full-steam ahead, Jim O'Neill's decade-old prediction for this group of only four countries remains prescient.

BRIC is growing an economy that will surpass the combined size of the great G7 economies by 2035. Very little is said, however, about China's shattering stories of the hordes of small business owners committing suicide, leaving China, or flat out emigrating to the west. It makes me wonder how much vested interest Goldman Sachs (NYSE: GS [FREE Stock Trend Analysis]) has in such predictions.

Don't get me wrong. I am an avid proponent of the rise and formidable influence the BRIC countries are having on the global economy. In my *Advanced Economies and Emerging Market* classes, my students are exposed to detailed characteristics of the engine propelling the BRICs, its impact on the G7, and how to position themselves professionally to capitalize on it. But we cannot ignore the public outcry of Chinese entrepreneurs facing the deterioration of business conditions in that country.

The somewhat positive step taken by the People's Bank of China ("PBOC") last December, to alleviate China's alleged liquidity crisis, should cause us to reassess the sustainability of its economy at current rates. China is far from a liquidity crisis, however, possessing an M2 that has surpassed the U.S., reaching nearly US $ 11.55 trillion. This was due, in part, by reducing the reserve requirement ratio, ("RRR"), to 21 percent from its record high of 21.5 percent.

It is not clear to me whether China is on a sustainable economic path, at least until it slows down its equity investments and begins to pay more attention to, and empower, its middle class. The Chinese people won't be willing to spend if they don't have a decent health or retirement system, which impels them to save, on average, 30 percent of their income. China's obsession with extreme growth, sustained now for over a decade, has become the huge white elephant for global markets. Unless the Chinese government begins to deal diligently with this issue, it may not be able to prevent an epic hard landing of its economy.

Much like the west economies, China blames the tightening of monetary policy as the feeder of its ever-growing white elephant. Again, much like the west, it looks more like a systemic issue, since its main markets - the U.S. and Europe - are both battling a probably imminent double recession, which is squeezing their buying power.

In addition, ahead of the west, inflation is rising; especially wage inflation, causing the hungry elephant to erode China's main competitive advantage in the manufacturing industry. The tightening of monetary policy is anathema to this, but the transformative systemic change in the Chinese economy isn't. Just look at the Purchasing Manager

Index ("PMI"), which dropped to 49 in December, much lower than market expectations, to realize that the manufacturing sector is bleeding. Since then,the PMI climbed to 53, but manufacturing goods in China has been declining.

This produces a ripple effect of stocks piling up, thereby driving the cost of doing business higher: so much so that it has become cheaper for China to transfer its manufacturing to the U.S., primarily to South Carolina. Certainly, labor costs, even in the south of the U.S., are higher than in China. But the cost of energy is a lot cheaper, as is the cost of real estate, infrastructure, and shipping across the Pacific.

What makes China's white elephant so pale is that small and medium businesses ("SMBs"), the driving force of China's manufacturing, do not have easy access to credit. China's four major banks - Bank of China, the China Construction Bank, the Industrial and Commercial Bank of China and the Agricultural Bank of China - control more than 70 percent of its banking market. These are state-owned banks which favor state-owned companies, and rarely, some fortunate private corporations. This resource misallocation is feeding the pallid pachyderm at the expense of SMBs, left with their only option of costly business financing.

I do not profess to be an economist, but looking at the sheer size of China's white elephant, it is clear to me that monetary policy alone cannot fix the systemic insufficiencies of China's economy. As long as the economy remains vastly dependent on the U.S. and European consumerism, countries currently dealing with their own herd of white elephants. Unable to consume as before, China's exports will remain massively strained. Consequently, the country is being burdened with a severe excess capacity problem - pushing down the marginal returns of investment and GDP - while fostering an uptick of inflation, unemployment, and possibly more bubbles.

As the U.S. and Europe deal with their own economic crisis, they are being forced to place their deficit-fueled consumption economies on a stringent diet. To deal with their own white elephant they will have to shop and consume less - even engaging in Yankee swaps instead - to give room for increasing saving rates, chronically lowa at the moment, and higher productivity.

Such an unavoidable consumer diet could be disastrous for China, as data from the Economist Intelligence Unit and the U.S. DOC's Bureau of Economic Analysis suggests that China will remain dependent on an export-led economy until at least late 2030. If true, China must find new markets and reduce its dependence on the west's economies.

Could the BRIC countries be the ace under China's sleeves? After all, as O'Neill predicted, these four countries alone will, in the next two decades, account for half of the population of the entire world (i.e., huge middle-class) and their economies will be larger than the G7 countries combined. Europe today has 35 cities with a population over one million, but by 2030, India alone will have 68 cities with over one million and China itself will have over one billion consumers living in cities.

This staggering fact alone could mark the slow death of China's white elephant, by letting go of its dependence on the west, and the return of a progressive flame-thrower dragon, ready to sizzle its middle-class economy and the BRIC's with sales aplenty of manufactured goods.

The question remains, which will have more weight: the shortsighted state-capitalist elephant or the farsighted free-market driven dragon?