Off-Balance

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Many experts are predicting that within 10 years, China could surpass the United States as the largest economy in the world. The meteoric rise of China's economy from a "closed country" in the 1970's to one of the world's largest exporters has been nothing less than astounding. Yet, as China's economy has grown, so has the imbalance in its economy. This has caused economist Michael Pettis to predict that unless China changes course, it could face economic decline.

At the heart of China's economic growth are government programs that have focused on promoting themselves as an export economy. Similar to what we wrote in our Fall 2016 newsletter, "Hobson's Imperial England," China is growing its economy by producing more items for export and less for their own citizens to consume. Only 39% of what China produces is purchased by Chinese citizens, which is significantly less than in the U.S., where citizens currently consume 70% of what is made here. The lack of personal consumption makes the Chinese economy vulnerable, as it is highly dependent on foreign demand.

In the early 1960's, China had little interaction with the Western world, as their government viewed these nations as adversaries. Instead, China relied on the Soviet Union for trade and investment. However, as the Soviet Union began to collapse in the 1970's and 1980's, China was forced to alter its economic policies and seek growth by attracting Western investment. In short, the Chinese government decided to become an export economy – a nation whose economic growth comes primarily from selling goods abroad.

To attract foreigners to invest in China, the nation promoted the idea that companies could go there and take advantage of the low cost of labor and production. It also invested heavily in the construction of new roads, ports and manufacturing hubs. Foreign companies, in turn, could sell these products back home at much higher profit margins. It is an

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idea that was embraced by many American businesses, including Walmart, whose founder, Sam Walton, was the architect of their unpublicized “Buy Asia” program.

As we discussed in our Winter 2017 newsletter, China has been able to maintain its trade surplus with the United States and other nations due to their government’s ability to keep the value of its currency (yuan) significantly low relative to the dollar. It accomplishes this by purchasing U.S. government debt, which keeps the demand for dollars high, and ensures that Chinese products will be less expensive than those made in the U.S. In our newsletter, we explained how this policy is affecting the United States by keeping inflation low, while at the same time making many products more affordable for average Americans. However, what we did not expound upon was how precarious this policy is for China – an idea illuminated in Michael Pettis’ insightful (yet esoteric) book, *The Great Rebalancing*.

Pettis starts his book with the simple idea that if a country produces more than its own citizens consume, they will have a trade surplus, and for every nation that has a trade surplus there must be a nation that is consuming more than it produces, thus having a trade deficit. This is exactly what is happening between China and the U.S. It is important to realize that in the world economy, for every economic action there is an equal and opposite reaction: things must balance out.

Understanding how one action counterbalances another in the world economy, Pettis then provides a startling, yet profound, argument: the trade surplus that China has with the U.S. causes excess savings in China. (“Savings are simply the difference between total production and total consumption,” Pettis notes.) These surplus savings are exacerbated by the wealth disparity in China between state-run businesses and domestic consumers. This in turn causes “under-consumption” since many workers lack the income to purchase the very products they manufacture for wealthier consumers abroad. Following Pettis’ argument, the under-consumption (and over-savings) in China is counterbalanced by the over-consumption (and low savings) in the U.S. As American workers have lost jobs to China, they have benefited by being able to purchase items that cost a fraction of what they would if they were made domestically. These low-cost items have kept inflation, and therefore interest rates, low in the U.S. For China, the excess savings and under-consumption has led to speculative investing at home and abroad.

While suppressing the value of the yuan relative to the dollar may benefit Chinese companies, the effects of this policy are not as favorable for the average worker, who has been receiving a declining share of China’s growing economic pie and has little purchasing power. The average real per capita income in China is equivalent to $12,473, which is only 25% of the average American worker’s wages. With weak environmental laws, poor worker rights and a nationalized health care system that is grossly underfunded, China’s economic growth has been subsidized by the average worker. An ironic thing for a communist country!

As Pettis points out, China’s dependency on exports to grow its economy makes them vulnerable. U.S. debt (treasury bills, bonds) to China is over $1.12 trillion, and the only way to keep the value of the yuan low is to purchase more U.S. debt. Eventually, the U.S. and other nations will be unable (or unwilling) to consume more Chinese goods. Thus, future economic growth will need to come from within China by increasing the wealth of the average Chinese consumer. To do so would require a transfer of wealth that is currently opposed by strong vested interests who have benefited greatly from the imbalance.

While the idea that the Chinese economy is off-balance may seem apparent, what is often overlooked is what will occur if and when the world economy rebalances. We have speculated for years that the lack of inflation in the U.S. may be the result of Chinese trade surpluses. If Pettis is correct, any rebalancing will result in higher inflation rates and higher interest rates for the U.S.

What is most sobering is the possibility that China could fall into a “lost decade” of low economic growth. For Pettis, who is an expert on their economy, China’s economic miracle is simply the latest and largest example of a nation that attempts to sustain economic growth through an export economy. Like Brazil in the 1970’s and Japan in the 1980’s, who grew rapidly only to later flounder, unless China changes, it will be a victim of its own making when the world economy rebalances.