On China's Punch Bowl

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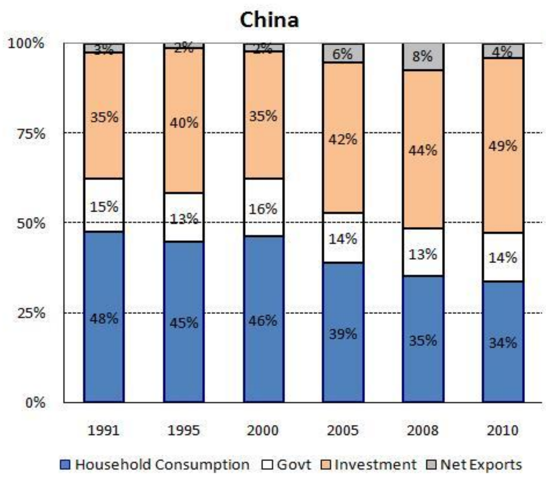
China's New Year is January 23rd and this year will be the year of the dragon. How fitting. As much of the developed world is struggling to meet even sub-trend growth, China will itself enter a period of "slow growth" (consensus has it somewhere between 7.9% and 8.6%). Not bad by western standards.

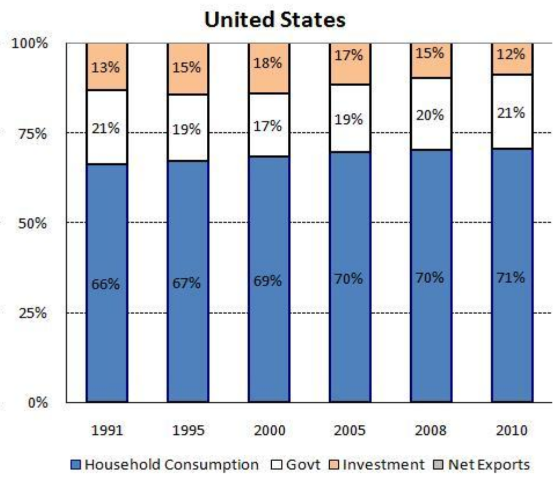
Yet there is little doubt that the economy is sputtering: the housing bubble appears to have been pricked, exports are waning and internally the consumer is still too weak to pick up the baton. But the Chinese, unlike their western brethren, haven't come to the end of their policy rope. Rates, reserve requirements, and Beijing's coffers are all still comfortably unstretched. And there are large incentives for the Chinese to maintain their growth rates. A hard landing would exacerbate the already bubbling social unrest and destroy a good chunk of the newly minted wealth China has been able to create. Moreover, the CCP will want to insure a tranquil year as the Politburo is rechristened in late Oct/early November.

But this makes China a prisoner to its own growth story. In order to sustain growth the Chinese will have to continue supporting a lopsided growth model: one driven by expanding leverage and increased investment and infrastructure spending. And while in the short run, investment (and even a little overinvestment is 'ok') at some point the consumer and organic demand must become the driving force of an economy. Supply side economics in other words has a finite shelf life.

What's puzzling is the fact that China has always prided itself on having patient resolve. Creating a five year plan and sticking to it. And building a consumption driven economy has always been been something they've voiced support for. So why hasn't this been reflected in the *hard numbers*? I will invariably get some slack for pointing to this tired graph on consumption vs. investment, but no one has adequately been able to explain why the long term trend for consumption is down.



Source: BBG, China Economic Information Network



Source: BEA.gov

To me, this brings into focus a troubling, long term structural problem. China's hand is being forced into investments for a few very simple reasons. First, consumption based economies can usually only offer their patrons 3-4% of real growth, far below China’s comfort level and the Street's expectation. Second and perhaps most importantly, China is trying to build a society of consumption off a tradition of saving. Historical savings rates for the Chinese are very high and the proletariat would almost always prefer to save then to spend. So in many respects the government is 'spending' for its constituents in what can only be described as the longest running Keynesian experiment ever. But in the end the government can only hope that one day the masses will turn from net savers to net spenders. But as a strategist I work with so aptly put it: “this isn’t *Field of Dreams*. He won’t come just because you build it”.

Tired of waiting for this sleeping dragon to awake, China found one product every Chinese national was willing to buy. Real Estate. They took what would ordinarily be an investment product and turned it into a consumption-*like* good. Today, 25% of China's fixed asset investment is in real estate. By comparison: at the height of the US housing bubble in 2005, real estate as a share of fixed asset investment was 31%. Now one could argue that China (with nearly 4 times the US population), can support these levels as household formations alone would demand it. But most of the purchases were pure speculation by owners with multiple homes, in numerous cities. The Chinese recognized the trend and tried countering it with purchase restrictions linked to tax payments. (This is why we saw property prices in 2nd tier cities decline first).

Industry	**% of Fixed Asset Investment**
Manufacturing	34.2
Real Estate	25.3
Transportation	8.7
Environment	8.1
Utilities	4.8

Other*	18.7

[Cumulative YTD thru 11/30/2011. Source: NBS](#)

*Other includes 14 smaller investment sectors to: Mining, Agriculture, Education, Hotels, etc.

Today, 13% of China's overall GDP is property construction and if you add in upstream industries like concrete and steel the figure is closer to 20%. But even these figures ignore the ripple effects that will permeate through the economy. Many provincial governments rely on land sales and real estate taxes to generate revenue and banks have significant, albeit subordinate exposure to real estate. With the Chinese facing a weakened outlook and yet to-be-determined landing type, the PBC will have little choice but to continue feeding an insatiable beast built off increasing leverage, infrastructure spending, and speculative real estate.

China will hit a soft patch over the next two quarters, but I believe they have (and will take advantage of) sufficient policy rope to meet their full year 2012 growth targets. Yet over the long term that same rope will become a noose around their neck: China cannot continue to front run demand indefinitely. For that which cannot last, won't.

China: Twenty Years on..

Shanghai – 1990	**Shanghai - 2010**
	

Source: *BusinessInsider.com*