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NEWSLETTER

China: Mal investment, delayed gratification, and default rates

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ESCAPE FROM POVERTY

In the early 1990s, China had a cave-dwelling population almost as large as the entire population of the UK. Stories of families sharing clothing in turn, to enable them to go out-side, were commonplace. Some used charcoal as a substitute for clothing. Such poverty has thankfully been all but eliminated, but when premier Li Keqiang, earlier this year, pointed out that while "The average per-capita annual income in China is 30,000 yuan (USD 4,193), but there are over 600 million people whose monthly income is barely 1,000 yuan (USD 140), not enough to rent a room in the Chinese cities," he raised some eye-brows among those whose urban centric perception of China has led them to believe that the economic miracle of the past 40 years has put China on a path to prosperity and world economic hegemony.

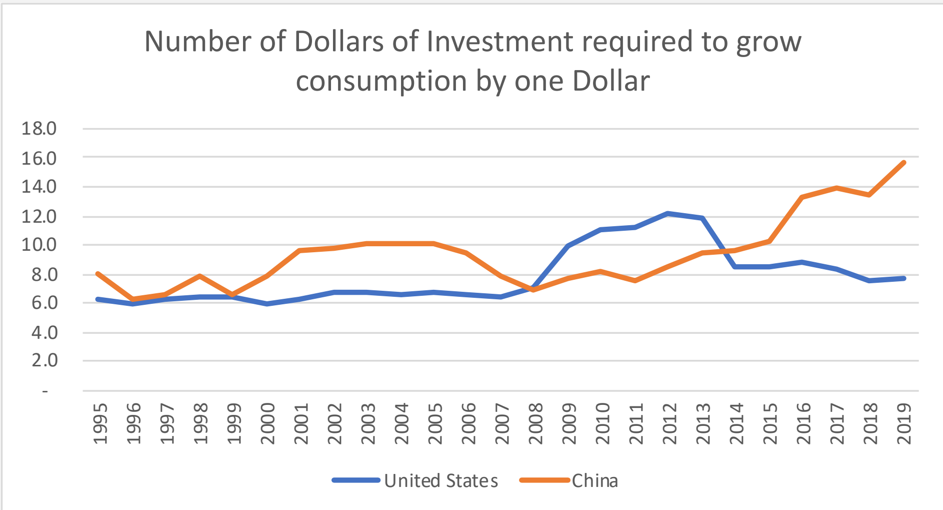
DELAYED GRATIFICATION

In a market economy, consumption is the raison d'etre for economic activity. In order to consume, investment is required: firstly, to replenish depleted capital and secondly, to grow the capital stock so that tomorrow's consumption can be greater than yesterday's. The most efficient economy is the one in which, for any given amount of investment, consumption grows the fastest. If you invest well: you do not need to invest so much. Channelling resources towards investment and away from consumption is therefore a form of delayed gratification. Consumption is forgone in the short term, for the promise of greater consumption in the longer term. Investment is the cost of a better tomorrow.

Delayed gratification is something that China does a lot of. From 2010- 2018, China has spent 43% of its total expenditure on gross fixed capital formation compared to the United States at 20%. In real dollar terms, 25% of China's total investment since 1995 has taken place in the last three years. As a result, China's capital stock has ballooned to about 5x GDP, while the US equivalent is about 3.5x. Are the Chinese people benefiting from this investment though or has "investment for investment's sake" taken over as the driving force behind China's economic planning?

The chart below shows Capital Dialectics "Deferred gratification index" for China and the United States. We take five-year rolling investment expenditure and divide it by the five-year change in household consumption. In other words, it shows how many dollars are being invested to produce a dollar of growth in consumption.

Chart 1: Deferred Gratification Index



Source: OECD & Capital Dialectics.

Between 1991-95 (inclusive), China invested USD1.13 trillion and over the same time frame, annual consumption rose by USD139bn per year (from USD198bn to USD336bn), giving a ratio of about $8 of investment to each $ of consumption growth. In the last five years, though, things have changed dramatically. Investment is becoming far less efficient at driving or facilitating consumption growth. Between 2015-19, China invested USD27 trillion, while consumption grew USD1.7 trillion giving a ratio of nearly 16x. Twice as much investment is required to drive a dollar of consumption growth now

as was the case back in the early 1990s.
For comparisons sake, the US invested USD20.5 trillion in the past 5 years and consumption grew USD2.7 trillion a ratio of 8x. So, the United States, despite already enjoying a far higher level of per capita consumption, is able to grow consumption twice as efficiently as China as things currently stand. Deferred gratification in China is very expensive.

MARXISM VS MARKET

The big issues in political economy are: what to produce? How to produce it? And for whom to produce it? In market economies, these decisions are delegated to consumers via the market mechanism. In planned, Marxist economies, these decisions are contained in five year plans and decided by committee. Capital (saving or delayed consumption) in China, is largely allocated via a banking system that is almost entirely state owned and controlled. That banking system has assets that are now 3x GDP and the corporate sector has loans from the state banking sector totally 180% of GDP. The State -owned Asset Supervision and Administration Commission (SOASAC), the largest holding company in the world, control firms with USD26 trillion of assets. China's vibrant and innovative private sector is increasingly being brought under Party control and starved of resources. The result is the decrease in efficiency of investment that threatens households with an indefinite delay in gratification, as their savings may well not be there when they want to spend them.

Why might they not be there? China's capital stock has grown to reflect the high savings and investment rate. The capital stock is reflected in the financial instruments through which households save: Bank deposits, bonds, and shares but also a range of shadow banking products. As the amount of investment required to produce GDP growth has risen and as the share of GDP accruing to the corporate sector declines, so the ability of companies to service their obligations will deteriorate. This is increasingly becoming evident in "ever- greening" at banks and in default rates on bonds, which Capital Dialectics think will rise dramatically going forward a topic we discuss in more detail in "China's bloated capital stock; a lost decade & what it means for investors." (This report is available here for subscribers and those who sign up for a free 3-month trial).

The penchant for Chinese households to increasingly save by investing in real estate, is perhaps a reflection of the fact that they share Capital Dialectics' view. As it becomes evident that bad investment is not generating sufficient cash flows to service the financial liabilities it is associated with, we expect the Party-State to shuffle economic rents around in the economy to meet their national objectives – primarily the perpetuation of their own power.

Tighter regulation of “Big tech” is just the beginning of this process. As president Xi puts it “ Socialism with Chinse characteristics is socialism not some other ‘ism, and we must continue to use Marxism to observe, interpret and lead the new era.” Foreign investors need to work out where their interests come in the pecking order. We suspect they are low down the priority list.