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Why China's Heading for a Hard Landing, Part 1: A. Gary Shilling

By A. Gary Shilling - Jun 27, 2011

Few countries are more important to the global economy than China. But its reputation as an unstoppable giant -- as a country with an unending supply of cheap labor and limitless capacity for growth -- masks some serious and worsening economic problems.

China's labor force is aging. Its consumers save too much and spend too little. Its political and economic policy tools remain crude. Its state bureaucracy seems likely to curb spending just as exports weaken, and thus risks deflation. As U.S. consumers retrench, and as the global commodity bubble begins to dissipate, these fundamental weaknesses will combine in a way that's unlikely to end well for China -- or for the rest of the world.

To start, China is much more vulnerable to an international slowdown than is generally understood. In late 2007, my firm's research found that too few people in China had the discretionary spending capability to support its economy domestically. Our analysis showed that it took a per-capita gross domestic product of about $5,000 to have meaningful discretionary spending power in China.

About 110 million Chinese had that much or more, but they constituted only 8 percent of the population and accounted for just 35 percent of GDP in 2009, while exports accounted for 27 percent. Even China's middle and upper classes had only 6 percent of Americans' purchasing power.

Why Overconfidence Abounds

With such limited domestic spending, why do so many analysts predict that China can continue its robust growth?

In part because they believe in the misguided concept of global decoupling -- the idea that even if the U.S. economy suffers a setback, the rest of the world, especially developing countries such as China and India, will continue to flourish. Recently -- after China's huge $586 billion stimulus program in 2009; massive imports of industrial materials such as iron ore and copper; booms in construction of cement, steel and power plants, and other industrial capacity; and a pickup in economic growth -- the decoupling argument has been back in vogue.

This concept is flawed for a simple reason: Almost all developing countries depend on exports for growth, a point underscored by their persistent trade surpluses and the huge size of Asian exports relative to GDP. Further, the majority of exports by Asian countries go directly or indirectly to the U.S. We saw the effects of this starting in 2008: As U.S. consumers retrenched and global recession reigned, China and most other developing Asian countries suffered keenly.

Overconfidence in China's ability to keep its economy booming is also partly psychological. It reminds me of the admiration and envy (even fear) that many felt toward Japan during its bubble days in the 1980s. As Japanese companies bought California's Pebble Beach, Iowa farmland and Rockefeller Center in New York, what was safe from their zillions? Then the Japanese stock and real-estate bubbles collapsed, and Japan entered the deflationary depression in which it's still mired.

Success and Complacency

What's more, China's recent successes have been so pronounced that they've led many to conclude that its economy is a juggernaut. And, indeed, the Chinese have much to be proud of: Last year, China passed Japan to become the world's second largest economy, a huge achievement considering China started in the late 1970s with a tiny pre-industrialized economy.

But this success may have led to complacency. I suspect that the 2007-2009 global recession, and the dramatic transformation by U.S. consumers from gay-abandon borrowers-and- spenders to Scrooge-like savers, caught Chinese leaders flat- footed. They probably planned to encourage consumer spending and domestic-led growth, but later -- much later.

Growth Machine

They were enjoying a well-oiled growth machine. Growing exports, especially to American consumers, stimulated the capital spending needed to produce yet more exports and jobs for the millions of Chinese streaming from farms to cities. Wages remained low, due to ample labor supplies, and held down consumer spending. So did the high Chinese consumer saving rate. Because Chinese could not invest offshore, much of that saving went into state banks at low interest rates. The money was then lent to the many inefficient government-owned enterprises at subsidized rates.

In a country where stability is almost worshipped, why would any leader want to disrupt such a smoothly running economy?

But before you worry about China's becoming No. 1 any time soon, consider the remaining gap between its economy and the U.S. economy. In 2009, China's GDP was $4.9 trillion, only 34 percent of the U.S.'s $14.3 trillion. Because China has 1.32 billion people, or 4.3 times as many as the U.S. has, the gap in per-capita GDP was even bigger: China's $3,709 was only 8 percent of the U.S.'s $46,405.

A Wide Gap

Just to maintain this gap at current levels, Chinese GDP will need to grow at double-digit rates for four years before tapering off, or rise sixfold in three decades (assuming that U.S. real GDP increases 2 percent per year on average for the next 30 years, and using government population projections). To close the per-capita GDP gap in 30 years, Chinese GDP would need to grow about 10 percent per year for three decades, or expand to 17.8 times its current size in that period.

Such rates of growth seem close to impossible if the global economy slows.

As the announcer for the Cleveland Indians used to say when the Tribe was hopelessly behind, “They have their work cut out for them!”

(A. Gary Shilling is president of A. Gary Shilling & Co. and author of “The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation.” The opinions expressed are his own. This is the first in a five-part series.)

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