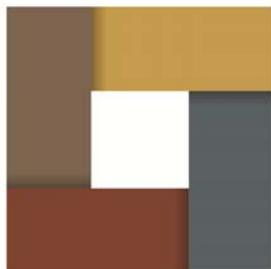


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China: 35 Years of Rapid Growth...How Many More?

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When China embarked on its gradual transition away from Communism in 1978 its \$148 billion Gross Domestic Product (GDP) was only 6% of America's \$8.2 trillion economy. After 35 years of rapid expansion China's GDP is now \$8.2 trillion, ranked second below U.S. GDP of \$17 trillion. Adjusted for inflation, Chinese annual economic growth averaged 9.8% during this 35 year period of time. If China were to maintain a 9.8% growth rate in the coming 35 years its economy would approach \$216 trillion, per capita income would be \$140,000 (in 2013 dollars) and China would comprise 75% of the world economy - a very unrealistic scenario to say the least. Despite recent consternation in the financial markets, slowing growth in China is hardly surprising.

China's economy is big because its population is large, but it is still a poor country. Per capita GDP is only \$5,720 vs. \$52,000 in America. On a per capita basis China's GDP is ranked a mere 120th in the world. Chinese GDP per capita is lower than Mexico (\$9,640), Brazil (\$11,630), Costa Rica (\$8,820), Malaysia (\$9,820) or even Botswana (\$7,650). For example, Mexicans own 190 automobiles for every 1,000 people vs. only 44 in China (vs. 423 in the United States). In China, 35% of the labor force is employed in agriculture vs. only 13.4% in Mexico (vs. 0.7% in the U.S.). Half of China's population lives in cities, whereas 78% of Mexicans are urbanized. The popular perception, however, is that China is becoming wealthy while Mexico is an economic laggard.

China's annual GDP per capita was \$190 in 1978 and only crossed \$1,000 in 2001. GDP per capita grew 7.5% per year during this period, but the largest annual increase only amounted to \$100. Since 2001,

income growth accelerated sharply to 17.1% per year. Even so, annual per capita GDP gains averaged just \$429. Our annual per capita GDP growth in the United States averaged 3.2% during the same period of time, but this much slower percentage growth still amounted to an average annual increase of \$1,354 – more than triple China’s.

The preceding discussion was not intended to belittle China’s remarkable rise from abject poverty over the past 35 years. Rather the goal was to reframe the conversation about Chinese economic growth from a different perspective. China was and still is a very underdeveloped country with significant room for further economic expansion. The percentage rate of growth will most likely decelerate, but the dollar increase will be larger in the coming decades than the previous decades. For example, if China’s GDP per capita increases by \$429 per year over the next 10 years – exactly the same increase as the prior decade – its average growth rate will only be 5.7% rather than 17.1%, but the total gain for China and the world economy will be exactly the same.

Unwinding the property boom will slow growth over the next few years

Short-term and long-term factors are contributing to China’s decelerating economy. The biggest short-term factor is the aftermath of China’s stimulus programs during the 2008/2009 global financial crisis. Easy credit by government owned banks sparked a construction boom and potential property bubble. The stimulus helped China successfully skirt the global recession, but inflation accelerated and problem loans increased. Since 2010, China has been gradually tightening credit with economic growth slowing in response.

Investors are increasingly worried that China could experience a recession as the property bubble bursts and bankruptcies mount. Given China’s economic heft many are worried about the global repercussions of a Chinese financial meltdown. We believe the problem is certainly real, but probably exaggerated. The private sector is responsible for the majority of China’s long-term growth, but remains starved for capital. Private companies typically do not have direct access to banks, relying instead on retained earnings, friends and family or “shadow banks”. Meanwhile, state-owned companies juiced with cheap loans from state-owned banks only became big growth engines over the last six years.

Rather than an American style banking panic, we believe the problem for the Chinese government will be how to unshackle private financial institutions while managing the overextended balance sheets of public sector banks and companies. The Chinese government is not heavily indebted and should be able to manage the losses at important state-owned banks and companies. Rather than experiencing a short-term crisis and recession, the more likely scenario is that the public sector will be an extended drag on China’s economic growth.

China needs privately owned financial institutions

The private sector will continue to grow, but faces ongoing constraints that cannot be alleviated quickly. At present, private financial institutions are either prohibited by regulation or inhibited by the sorry state of the Chinese legal system. While the Chinese government is taking steps to create a better legal framework that will foster sound private sector financial institutions, this will continue to be a slow

evolution rather than a sudden revolution. Growth capital will still come from retained earnings or trusted personal networks, with formal financial institutions becoming gradually more important over time.

The recent construction boom in China was fuelled by easy credit, primarily to state-owned companies. The bubble is bursting, loans are going bad and China's GDP growth is slowing. The private sector continues its growth, but faces limits due to China's underdeveloped financial system. As the public sector turns from a tailwind into a headwind, most future economic growth will come from the undercapitalized private sector. The net result will be significantly slower growth for the Chinese economy, but most likely not an American style bank panic.

China will become a much wealthier society, despite slower growth

As we outlined above, even with slower growth China is on track to become a much wealthier society in five or ten years. The same \$429 annual increase in GDP per capita that China produced over the past decade – although reflecting a mere 5.7% annual growth rate going forward rather than the 17.1% growth rate achieved over the prior decade – would place China solidly among Middle Class countries by world standards. High incomes comparable to the United States or Western Europe, however, will require a more significant shift toward the rule of law. This is a long process that will require much deeper economic, political and social reforms. In the meantime, slower growth will still produce substantial gains in wealth for China and the world.