The Chinese bubble

What happens when the Chinese economy collides with reality?

Globalisation means different things to different people. For optimists, it means a friendly worldwide sharing of goods, services, ideas and cultures. To America, it means the globalisation of American culture. To the multinational corporations, it means a chance to make a quick buck in new markets.

To the multinationals that have roamed the planet for the last two decades, a free market is one where they are free to buy up local key enterprises at bargain basement prices, operate without obeying environmental, business or labour laws and then suck most of the profits back to their own country.

The amazing thing about this process is that these same multinationals present themselves as the kind and generous friends of the developing world.

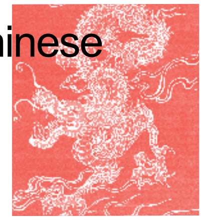
Small countries often don't have much say in the matter; the World Bank is essentially the salesman for the same multinationals. When a country goes to the World Bank for help, the prescription is always the same: "Let the multinationals buy up your key assets and operate within your country without restriction, and you can have the crumbs that fall from their table."

Oddly enough, countries like China and Russia don't quite share the World Bank's enthusiastic view of foreign investments; they see the Japanese and Western multinationals as greedy invaders, keen to bleed China and Russia dry.

It's not that China or Russia have any better morals than America, Europe or Japan; it's just that China or Russia are big enough not to have to take crap from the multinationals. Thus, when the multinational car companies wanted to expand into China, the Chinese weren't silly enough to simply allow them to simply set up shop. As far as China is concerned, if Chinese workers, resources and environment are going to be used and abused, then they are going to be used and abused by Chinese businesses, not Western ones.

The Buddha said that desire clouds the mind, and the desire for expansion into rich new markets seems to be particularly mind-numbing. Over the last few years, Western & Japanese carmakers have poured billions into the Chinese car industry. This investment is partly to manufacture cars and parts for the greater Asian market, but mostly to tap into the fastest growing car market in the world.

As the Chinese economy grew, so did the demand for cars. Wildly optimistic sales targets were projected for the Chinese markets as Chinese consumers experienced the glorious



sense of freedom and status that the private car offers.

There are 1.3 billion people in China but comparatively few own cars. Thus, on paper at least, the potential Chinese car market is huge. However, China is one of the most densely populated countries on the planet and no one seems to have worked out exactly how these millions of extra cars are going to fit down the already-overcrowded Chinese roads, let alone park.

Strange bedfellows

There are three concepts that are almost totally missing from the Chinese language: Intellectual Property, Human Rights & Value for Money. If the multinational carmakers had contemplated these three omissions, they might have saved themselves a lot of grief.

When the Western carmakers wanted to set up shop, the Chinese government insisted that these foreign carmakers went into 'partnerships' with local manufacturers. Most of these partnerships were with China's 'big three' car companies, which between them make over 50% of China's cars:

• **Shanghai Automotive Industry Corporation (SAIC)**, partnered with Volkswagen & General Motors,

• **Dongfeng**, partnered with Honda, Nissan-Renault, PSA Peugeot Citroën, and Kia,

• **First Automobile Works (FAW)** partnered with Mazda, Volkswagen & Toyota.

However, there are lots of minnows as well: there are a total of 150 licensed carmakers in China, but just 20 of them account for 95% of sales.

A number of other Chinese industrial companies have started building cars independently of the Western carmakers: BYD, Changfeng, Geely, Chery, Great Wall & Hafei Motor.

It didn't take long for China's true intentions to become clear: Chrysler-Daimler, for example, set up a Jeep manufacturing plant in China, only to discover a short time later that the locals had set up a copycat plant around the corner making – you guessed it – exact copies of the original at a substantially reduced price.

The plant was closed after ChryslerDaimler protested, but you can be sure that another one quietly eased into production somewhere nearby. And that incident was just the tip of the iceberg.

At a German car show recently, rumour had it that some Chinese car companies would be barred because the models they were offering were blatant copies of Western vehicles. When the show opened, most of the Chinese copy cars were still there. A spokesman for the manufacturer said: "Maybe they want to block the Chinese cars in Europe, but BMW is also trying to sell cars in China, and now the Chinese people are beginning to think, what can we do in China also? I think it is not good for BMW and it's not good for the competitive market."

At this point, many Western carmakers probably got their first real understanding of how little intention the Chinese have of playing 'fair' by Western standards. As long as Western carmakers are operating within China, the Chinese will set their own rules. The message from China that came through that incident was: "Don't try and stop us selling our copies of your cars in the West, or we'll stop you selling your legal ones in China." The threat wasn't quite that blatant, but the underlying warning was pretty clear.

Other Western carmakers have already tried appealing to China's hopelessly corrupt legal system, and lost. No matter how blatant the copy, Chinese courts, by and large, don't enforce copyright lawsuits from Western carmakers.

The bottom line is that the Chinese, culturally, don't share the West's concepts on either human rights or intellectual property. The Chinese see

Great Wall Motors shows off its fleet
(police escort not included with vehicle)

no shame in copying a Rolls-Royce; quite the opposite, they see it as an accomplishment. “See! We copied a Rolls-Royce, therefore we have acquired the status of a Rolls-Royce.”

Not quite, at least not yet. Chinese car makers also don’t understand the Western concepts of quality or value for money, but they certainly understand the importance of price. This probably means that all or most of China’s Western car partnerships are going to end in tears for the Western partner.

China’s car market is close to becoming the largest in the world, and Chinese car companies have begun exporting their models to the West. At present many Chinese cars are something of an automotive joke, but there was a time when cars from Toyota were something of an automotive joke, too.

In five years time China will have no need for the Western carmakers at all. Whether the Chinese throw them out gradually or suddenly, the end result will be much the same. The Chinese probably won’t have to throw out the Western carmakers at all: the Western carmakers will simply withdraw voluntarily because they can no longer compete with their Chinese rivals who are selling copies of Western models for two thirds of the price.

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The great Chinese bubble

There’s always a time in an economic boom when it seems natural and inevitable that it will go on forever. People with easy money in their pockets assume the boom will be permanent, because they’d like it to be so. Historically, it’s always around this time, when the economic bubble seems to be an unstoppable force, that it suddenly bursts, taking the dreams of its investors with it.

After the bubble bursts, the same economists who hailed the bubble a few months earlier, now duck for cover, unwilling or unable to take responsibility for the chaos they helped create.

The modern China that Westerners see on television is a world of bustling, prosperous cities and Chinese millionaires in Rolls-Royces. These tv programmes somehow miss that fact that the Chinese economic boom exists only in the cities, and even then only for the minority that have benefited from it. The Chinese boom has largely passed over the majority of the Chinese population who live in rural areas.

Even in the cities, most Chinese still live in poverty and most private cars in China are sold as semi-luxury items – proof of economic success in a country where the average factory wage is US$225 a month. If that figure seems low, the average rural wage is about $100 a month.

We talked to an accountant who has extensive dealings with China. These were his words of caution:

“It frightens me that Westerners are so gullible where China is concerned. They take Chinese government economic statistics as gospel, then they arrive starry-eyed in Shanghai and get a guided tour of a few select businesses and believe that these businesses represent the strength of new China.”

Shanghai–based Andy Xie, one of the few economists who accurately predicted the economic bubbles that triggered both the 1987 Southeast Asian financial crisis and US subprime financial crisis of 2008, described China’s economic policy as a ‘giant Ponzi scheme’.

For those that don’t know it, a Ponzi scheme is a fraudulent investment operation that offers high returns to investors. The first wave of investors are given high interest rates, which are paid for with the money invested by the next wave. As the news gets around, more and more investors pile their money into this miraculous money-making scheme. Each new wave of investors pays the interest on the previous waves. In the end, of course, the whole scheme collapses.

In 2007, the sub-prime mortgage bubble burst in America, triggering an economic crisis and a sudden plunge in imports from China. This, in turn, triggered a rash of bankruptcies in China, but these were mostly among independent entrepreneurs. As in America, the rogues who caused the crisis largely escaped the consequences of it. Most large companies in China are run by the government or by businessmen with strong links to the government. Thanks to government bailouts, these businesses were largely protected from China’s economic difficulties.

Thus, flush with government money and under heavy pressure to keep the economy rolling, Chinese steel mills kept pumping out steel and Chinese car factories kept pumping out cars, whether they had customers for these products or not.

During 2009, China’s state-controlled banks loaned out over US$1.27

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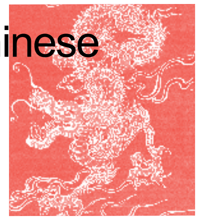

trillion in order to stimulate the economy. Many analysts warned that too much of that money was going to people who might not be able to pay it back and was ending up in stocks and real estate, but these analysts were largely ignored.

To those with eyes to see it, the 2009 Chinese bubble was exactly the same scenario as the sub-prime mortgage crisis that crashed the US economy a couple of years earlier. For example, in 2009, mainland Chinese property values soared by a staggering 73%. Was this sustainable? Of course not. Even the Chinese government was scared, but it was more scared of what would happen if it didn't spin the economy into bubble mode.

Chinese Premier Wen Jiabao, doesn't seem to believe Chinese official statistics, either. In early September of 2009, the day before the official statistics showed that Chinese retail sales had surged 15.4% in August, the Premier described the Chinese economy as " unstable, unbalanced and not yet solid ... we cannot and will not change the direction of our policies when the conditions aren't appropriate".

News of a recent rush of new car sales in China should be treated with suspicion, because it's not uncommon for Chinese businessmen and bureaucrats to heavily exaggerate sales, while unsold vehicles gather dust in some Shanghai warehouse. Also, every car sold this year is one less car to sell next year, and the easy loans that made this year's sales possible have yet to be repaid.

China's two top banks recently started to rein in credit in an effort to halt excessive speculation, but their efforts may be too little, too late: China's bubble may deflate or burst; in the end, the outcome will be much the same.

As soon as the everyday Chinese realise their economy is in trouble, private car sales will grind to a near halt overnight. The massive Chinese car industry, which currently relies on local sales for its survival, will fall into crisis. So will the steel mills that supply these car companies. So will the Australian mines that supply the iron ore to China. So will small countries like New Zealand, which rely heavily on both the Chinese and Australian economies.

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Since the end of World War II, the world's economy has enjoyed an unprecedented period of sustained economic growth. Most people, including most economists, now regard this style of economic activity as normal and correct. History suggests otherwise: economic growth in the last sixty years has been the happy exception to a very grim economic rule.

Most people don't want to consider what will happen when – as has always happened throughout history – this endless growth goes into reverse.

If any nation can survive economic downturn, it's China. The Chinese may crave economic growth, but they are a nation of hardworking survivors and pragmatists. If times go bad they will simply revert to more conventional forms of commerce, transport and farming. It's difficult to imagine large numbers of Americans swapping their cars for bicycles anytime soon, yet many Chinese still own the bicycles they grew up with. It would not take much of an economic shock to switch Chinese car owners back to two wheels.

Then China will slowly and painfully continue on its path to the top. China's second economic boom is likely to be far slower and more sustainable, with less of an emphasis on vodka bars and Mercedes Benzes.

If China can avoid disintegrating internally after an economic crash, it will eventually recover, but the Chinese people, once burned, will be twice shy •