

Don't be taken in by the 'Chinese miracle' myth

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12 Jul 2010

It is hard to resist comparing the extravagance of the Shanghai World Expo, which ends on October 31, with Moscow's attempts to showcase the greatness of the former Soviet Union in years gone by. In the case of the USSR, such exhibitions were a triumph of style over substance. Similarly China observers would today be entitled to ask: what will be left once the great show is over?



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Just a few years ago, people were questioning what confidence foreign investors could possibly have in Chinese macro-economic statistics and GDP in particular. Despite subsequent attempts to get rid of the vestiges of central planning, reported GDP in China does not yet appear to be achieved as a result of market forces, but rather a target ordained from above, Soviet style, that everyone scrambles to reach.

While travelling in China, Professor Milton Friedman spotted scores of builders working on a new road, moving earth with shovels instead of modern machinery. When he asked why more modern equipment was not being used, he was told it was all part of a "jobs programme" to keep employment high in the construction industry. The logic was that if workers used tractors or modern road building equipment, fewer people would end up with jobs. Even today, levels of automation still lag western economies, by some margin.

China has enjoyed phenomenal growth from three key drivers: the migration of the rural population to cities, better education and the deployment of capital. Even if these do generate positive results in the short to medium term, they cannot go on indefinitely.

Capital deployment into non-economic projects is one of the most worrying factors. Fixed-asset investment has grown so much that many infrastructure projects have created ghost cities, empty shopping malls and unoccupied buildings. State-owned enterprises are being progressively privatised, often through sale to private equity sponsors, offering limited partnerships attractive turnround

opportunities. But, to this day, 50% of industrial output still comes from poorly managed state-owned enterprises.

After the US caught a cold in 2008, the Chinese authorities could no longer count on their booming exports to sustain economic growth so they threw everything they could at the economy to avoid a large increase in unemployment which would have almost certainly created massive social unrest.

One of the reasons behind the 32% drop of the Shanghai Composite index over the past year – and a 60% drop from its peak – is that the Chinese authorities have been taking bold steps to contain an explosion of credit. But with only mixed results so far.

Residential property prices continue to defy gravity, with one apartment in Shanghai recently selling for a record-breaking \$45m. Apart from stocks, there is not much else that locals have the opportunity to invest in and that helps fuel property price increases with ever greater velocity.

Commercial real estate offers an even more worrying story. Vacancy rates are running around 20%. Visitors to Shanghai and Beijing have noticed that new office space is still being added at breakneck speed.

Last but not least, China is struggling to secure access to the natural resources it so badly needs to support its growth.

Despite major farmland investments in Africa and extensive purchases of hydrocarbon assets across central Asia over the past few years, China still needs to do more: a lot more. Access to water will be another critical issue, with some Indian observers pointing to a rising risk of conflict with India over Himalayan water.

It is only fair to add that China is travelling hopefully – in a direction very different to the old Soviet Union. Astute investors stand to make great returns.

But there is always a risk that any country in the midst of a change will revert to type in times of hardship. And don't be fooled by talk of the "Chinese miracle". It does not exist.