

I have for several years already argued that China is a "Potemkin village", all front & little of any substance behind it, and a "giant with feet of clay" (Daniel 2 : 31-33), and that its leadership is fully aware of this, with its & aggressive international stance driven by its perceived need to 'make hay while the sun shines' .

As a result of the decades-long one-child policy, its population size is now plateauing [& rapidly aging, with few outsiders realizing the speed at which this is taking place – according to China's National Bureau of Statistics (NBS), the number of workers in its 16-30 year age cohort declined from 42% to 34% in just four years (2010-2014)]. The resultant rise in the "aged dependency ratio" will increasingly become a 'boat anchor' on its GDP trend growth rate.

While Beijing now has woken up to the long-term deleterious effect of this policy, its efforts to reverse it faces serious headwinds. One is the apparent reluctance of women of child bearing age to have more than one child. Two, worse still, after decades of girl baby infanticide, there is a relative shortage of breeding age females which will make it more difficult to ratchet the current 1.66 fertility rate (up 11 basis points from its 1998 low) not just to the usual 2.1 replacement level, but to the higher level needed to play 'catch up'. Three, even if the regime were somehow able to miraculously pull this off, the payoff would not come for at least two decades, while in the meantime the growing number of children in its society would increase the overall "dependency ratio" & require a great deal of, in the short-term non-productive, investment in their future.

Another consequence of the one child policy-driven girl baby infanticide phenomenon is the growing number of testosterone-laden young males, tens of millions of them, unable to find female partners who may, as a result, start behaving in asocial ways that will negatively impact on social stability. This has been accentuated by the fact that the scarcity of marriageable-age women has driven up the 'price' they & their families can extract from potential suitors (in this context it was interesting to note that a Chinese university professor recently suggested the time had come to start thinking of young men "sharing a wife" & that young Chinese males are said to have started travelling abroad, to Japan, Korea, Vietnam & even Ukraine, in search of bridal material & that some entrepreneurs have launched international match-making services).

According to the NBS, in 2014 there were 274MM 'migrant workers' (i.e. 36%) in a total work force of 770MM, and of the former 168MM (60%) were "long distance migrants". This has resulted in an estimated 60MM "left-behind" children (in six provinces with a total population of 350+MM over 50% of all rural children fall into this category) who will be under-educated & traumatized by the experience to the point where in their adulthood their potential contribution to the nation's economic wellbeing will be negatively affected by their lack of education & their inadequate levels of social-, emotional-, & behavioural adjustment.

Another phenomenon that may affect the future quality of China's work force is the "Little Emperor Syndrome", that of the children in the new middle class one-child families that have been coddled & spoiled by their parents to the point where as adults they may have a hard time dealing with adversity (the Robert Ford/'affluenza' phenomenon).

Since the turn of the century, much money was invested in China in ‘heavy industry’ & ‘ghost cities’ that are likely to become “stranded assets”, & hence a potential ‘drag’ on economic growth, in the years to come, if the government were to be successful in shifting its economy from an investment-, cum export-, led one to one that is consumer spending-driven. One interesting aspect of this is that Beijing seems to expect to fill these ghost cities with the hundreds of millions of people it plans to ‘urbanize’ in the coming years; for this may endanger its food self-sufficiency objective : China is the world’s largest rice producer (accounting for roughly one-quarter of the global total), rice accounts for almost half of its total grain output & has become of growing importance in its people’s diets, but growing it is very labour-intensive (with possibly only limited, if any, scope for mechanization. Furthermore, if Beijing’s objective, for social stability reasons, is to have the rural population share to a greater degree than it has hitherto in the benefits of economic growth, the incentive for rurals to move into the cities is likely to be reduced.

Next is the state of health of China’s financial system. The following provides an overview of the evolution of its Debt/GDP ratio this century :

	2000	2007*	2Q/14
Total Debt/GDP ratio	121%	158%	282%
Of which :			
Household	8%	20%	38%
Financial Institutions	83%	72%	125%
Non-financial corporations**	7%	24%	65%
Government	23%	42%	55%

*Prior to the onset of the Great Recession.

**Including the shadow banks.

The McKinsey Institute (see below) calculated global debt CAGRs during the 2007-2014 years; they are shown below alongside the comparable numbers for the Chinese economy :

	McKinsey	China
Total	5.3%	8.6%
Household	2.8%	9.6%*
Financial Institutions	2.9%	8.2%

Corporations	5.9%	15.3%
Government	9.3%	3.9%**

*The logical outcome of, if not a prerequisite for, the shift to a consumer spending-driven economy.

**While this means that the government is well-positioned (as McKinsey points out below) to orchestrate bailouts, this would involve, as it did in the US in 2007/2008, a downloading of the cost of private stupidity onto the public purse.

Beijing's response to the Great Recession was massive stimulus & an extremely lax monetary policy (the volume of bank loans outstanding went up 32% in 2009 & 20% in 2010, vs. an annual average growth rate of 15% during the preceding decade). So the Chinese banking system is now not just plagued on a concurrent basis by weak corporate earnings growth & the economic slowdown but by a legacy of excessive exposure to real estate & generally deteriorating asset quality, and by increasing numbers of non-performing loans & diminishing capital cushions. Worse still, while prior to 2007 virtually all lending in China had been done by heavily-regulated, mostly state-owned banks, since then a growing amount of it has been done by "shadow bank" entities that are lightly regulated, if at all, whose financial durability ranges from occasionally OK to mostly awful. And, while during the 6½ year period ended June 30th, 2014 the overall Debt/GDP ratio, i.e. the degree of leverage in the Chinese economy, almost doubled, from 158% to 282% (i.e., at an 8.6% CAGR), that of the corporate bond component thereof almost tripled & grew at a CAGR nearly double that (15.3%) – so it's not surprising that last October 24 Yi Gang, Vice Governor of the central bank (the People's Bank of China), was quoted in the media as saying that it was looking at leverage levels in the debt market. On top of all this, one study found that as of the end of 2014 over one in four domestically-listed firms, had a ratio of EBITDA over interest expenses of < 1, i.e. their operating cash flow was insufficient to serve the interest on their debt. Finally, to make the system potentially still more vulnerable, there has been a great deal of 'mismatching', both by financial intermediaries borrowing "short" & lending "long", and by corporations borrowing cheaply in US dollars without having US dollar cash flows so that the current US dollar strength vis a vis the yuan is costing them dearly. As the McKinsey Institute puts it in a February 2015 report entitled Debt and (not much) deleveraging "three developments *in China's debt run-up* are potentially worrisome : half of all loans are linked, directly or indirectly, to China's overheated real estate market; unregulated shadow banking accounts for nearly half of new lending; and the debt of many local governments is probably unsustainable." (while it goes on to say that Beijing has the capacity to bail out the financial sector, it warns that going forward the challenge will be to contain future debt increases without (*further?*) putting the brakes on economic growth).

Earlier generations of Chinese, like our own forefathers, were not stupid: they settled in areas with the greatest agricultural potential, i.e. with the best soil. This means that in China, as elsewhere, industrialization & urbanization have caused much of the most productive farm land to be blacktopped. In addition, shortsighted soil management practices have led to salinization & desertification [the Gobi Desert is said to have grown in size by 52,000 sq. kms (roughly 4%) in just the five years ending in 1999]. As a result the amount of productive farm land in China has

shrunk to a level that is approaching what Beijing deems the minimum required for a reasonable degree of food self-sufficiency, **and** its average food production capacity has declined.

As a result of its decades of untrammled growth, China is now a country where one cannot breathe the air, drink the water, or eat the food (I mentioned in Gleanings a year or so ago the case of one district so replete with chemical plants & their toxic effluent that local farmers won't eat the food they grow, and, while the long-term public health effects on those who do consume it can only be guessed at, they will likely prove costly in the years to come). And the triple whammy effect of this may not prove a good foundation for the world power status that Beijing is claiming (a claim that it has so far succeeded in the world accepting at face value).

Your point about the real & potential outflows of financial & human capital is also relevant; for this creates a risk that in the years ahead the Chinese economy will be 'hollowed out'.

We both know the history of China has largely been one of warlords. And since the death of Mao it seems to have increasingly "regressed to that mean", with the central government having less control over local governments than normally associated with a dictatorships. So Xi's war on corruption is a misnomer; in reality this designation is just a fig leaf to obscure the nature of its real target, increasing the power of the central government in the hope this will enable it to better deal with the economic, political & social hurdles in his country's, & system's, path.

All of the above are among the considerations seemingly justifying the designation of calling Xi's China a "Potemkin Village"