

# The Investment Case for China

Part of Warren Buffett's success has been his ability to read the general picture of the American economy and reduce Berkshire's equity holdings when the market seemed overvalued. Nowadays with the globalisation of the financial markets it seems not unreasonable to look at what is happening in other major countries. One such is China.

Anyone considering investing in that country would do well to read two recent books on it, namely: *The Chinese* by Jasper Becker (published 2000) and *The China Dream* by Joe Studwell (published 2002).

Studwell's book describes how over the years the enormous prospect of well over a billion consumers has been a dream for businesses in the developed world. However, such enterprises that have been tried have invariably fared badly because they ignored one simple fact – in general, the Chinese are extremely poor and have no money to spend beyond what is needed to survive. Becker reports that a Gallup poll conducted at the end of 1999 found that urban Chinese account for 70% of the country's wealth, with a mean annual *household* income of £1,700. The annual average income of rural *households* was £600. An article in *Fortune* of March 11<sup>th</sup>, 2002 reported that one Japanese company, Omran, pays assembly line workers in China, mostly young high school educated women *less than* £850 a year. Their counterparts in Japan earn at least ten times more and are more expensive to get rid of.

The following summarises Studwell's book:-

“In more recent times, international business has moved to make use of this cheap source of labour as well as the industriousness and adaptability of its people. Anyone, who buys a pair of shoes, an item of clothing, toy, electronic goods and much more, faces a high probability that their purchase was processed in China.

This is not as beneficial to that country as might be expected. The designs for these products are invariably produced abroad. Prototypes are made in Hong Kong and elsewhere and tenders for manufacture are sent to mainland based factories. When the contracts are awarded, the machinery and materials for making the goods are generally sent to China from abroad. The difference between the value of goods imported and then exported as finished products is only 25%. For this industry to be a true benefit the 'added value' needs to be developed enormously. This is not likely to happen in the very near future.

More problematical is the larger state controlled part of the economy. China is a command economy with a closed financial system. In general, money must be kept in the country. Other than holding cash, there are only three avenues for the population to put their savings into. These are: state banks, Government bonds and state owned enterprises on the stock market, all of which are controlled by the Government and the Party.

Funds are made available from the Government for state owned enterprises which are controlled by state employees, be they part of the beaurocracy or the Party and which almost always perform badly and should be closed down. But instead, they are repackaged and merged with other larger state enterprises with fresh injections of grants. Bankruptcies on any major scale are not acceptable as they would show the system is not working. The Party and the Government have remained in denial about the depth and seriousness of the problem in the state sector. Lying and concealment are such a way of life in the beaurocracy that it is easier to pretend than to confront reality. But pretence changes nothing.

Despite consuming most of China's finances and credit, in the late 1990s, the state sector profits had fallen to zero.

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Edward Steinfield, an associate professor at the Massachusetts Institute of Technology, in a study in 1998, concluded that the state sector is not only dying, it threatens to bring down the whole economy. Another study by Nicholas Lardy, an American economist who was the most active and influential foreign researcher of China's financial system in the 1990s, stated that when a country becomes highly indebted, its solvency depends on its ability to keep servicing its debts. On its current rate of creating bad debt the study estimated that the state will be insolvent within the first decade of the new century.

Stan Fulton, a financial systems specialist working for the World Bank, after three years in the field to assist the Chinese Central Bank with prudent supervision said, 'It's not a banking system. It's a state collection system for people's deposits and a state planned redistribution system of these deposits'. He found that 70 – 80% of loans to be non-performing.

By the late 1990s, the most famous living economist of them all, Milton Friedman, was exposing the Chinese charade more explicitly. After visiting the Pudong New Area in Shanghai ,he said, 'the city is not a manifestation of the market economy but a monument to a dead pharaoh on the level of the pyramids.' (Deng had recently died in 1997)."

No one can say how and when it will all played out, but Studwell's and Becker's books clearly spell out the risks for those contemplating investing in China. Neither can it be said what the long term effect of such a massive transfer of manufacturing to that country will have on the global economy in the long term.

Notwithstanding the above, the present attractiveness of the private export sector of the country for foreign companies is undeniable. In the short term, it seems that when assessing non Chinese manufacturing companies for investment, one message from Studwell's book might be to take into consideration to what extent they are taking advantage of the current benefits of this cheap and efficient resource. But how one can justify this on moral grounds would be another question, given the level of poverty and the working conditions the Chinese people are having to endure.

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