China Plays The Long Game While The U.S. Blows Bubbles

China is taking multiple actions to boost productivity and sustainably strengthen its economy. If successful, China's efforts come at the expense of the U.S. and other western nations that are not as willing to stress the benefits of productivity.

We abhor communism in part because of its economic shortfalls and restrictions on basic human rights and freedoms. However, communist rule has a benefit. In China's case, the government can take actions without broad government approval, regardless of what its people think. Today, it is using its authoritarian power to better the economy and raise collective prosperity. Some of the productive actions they are taking are much more difficult for democracies to accomplish.

We do not advocate communism. Far from it, in fact. That said, we hope our leaders are paying attention to the economic substance of the actions China is taking. If we are correctly reading China, and if they can avoid a revolution, China is taking steps to reform its economy, possibly making it the world's largest economy.

If the U.S. and other countries sit idly by, we may look back at today as a turning point in global economic affairs. The U.S. does not have to cede economic growth. But they must readapt capitalistic logic, which, ironically, China seems to be slowly grasping.

Productivity Drives Economic Growth

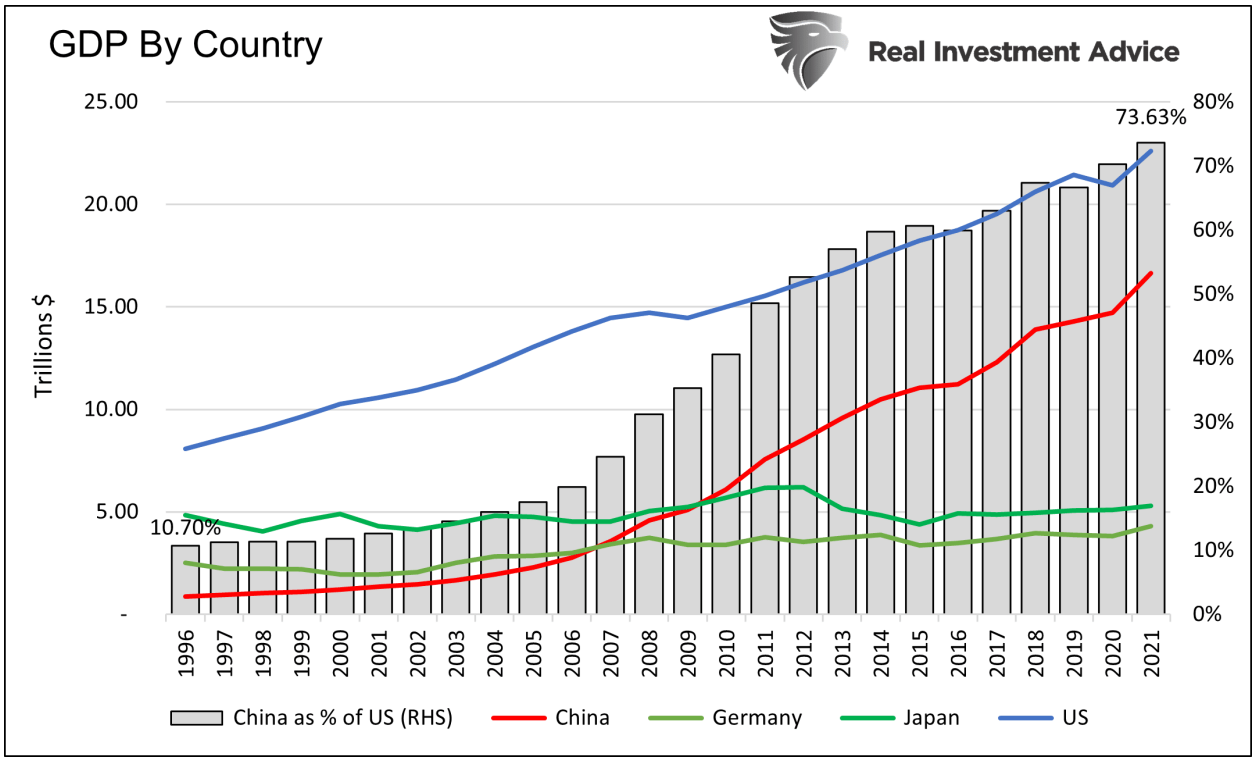
Economic growth is a direct function of productivity, which measures the amount of leverage an economy can generate from its two primary inputs, labor and capital. Due to the limited nature of both labor and capital, they are not dependable to produce economic growth over extended time frames. Productivity growth allows an economy to get more growth with the same or less labor and/or capital.

China has grown extensively on the back of a massive population that was living in poverty. They leveraged their massive population with the extensive use of natural resources and financial capital. It has served them well thus far, significantly boosting economic activity and the prosperity of their people.

China finally realizes productivity growth is vital if they are to continue to grow.

China's Bump in the Road

China's economic objective is to surpass the U.S. as the world's economic leader. The graph below shows China is on the road to meeting its goals. China's economy now dwarfs those of Germany and Japan, the third and fourth-largest economies.



China's economy grew sharply by allowing capitalism to creep into their society and economy. Becoming the world's factory and global exporter increased the wealth of the nation's populace. Consumption followed. Their vast supply of natural resources, massive government spending, consumer borrowing, and debt, fueled the demographic fire.

Unfortunately for China, much of the easy growth is behind it. Their double-digit growth from 2000 to 2010 is now half of what it was and trending lower. They still exploit natural resources and their billion-person population for economic growth, but the rewards are diminishing.

Financial capital, specifically debt, has been used extensively and, in many cases, non-productively. The benefit is economic growth, but it comes at a dear cost. Leveraged growth backed by non-productive investments leaves little cash flows to pay for existing debt. Instead, more debt is required to make interest payments and repay debt. As the scheme enlarges, financial resources are unavailable for productive uses.

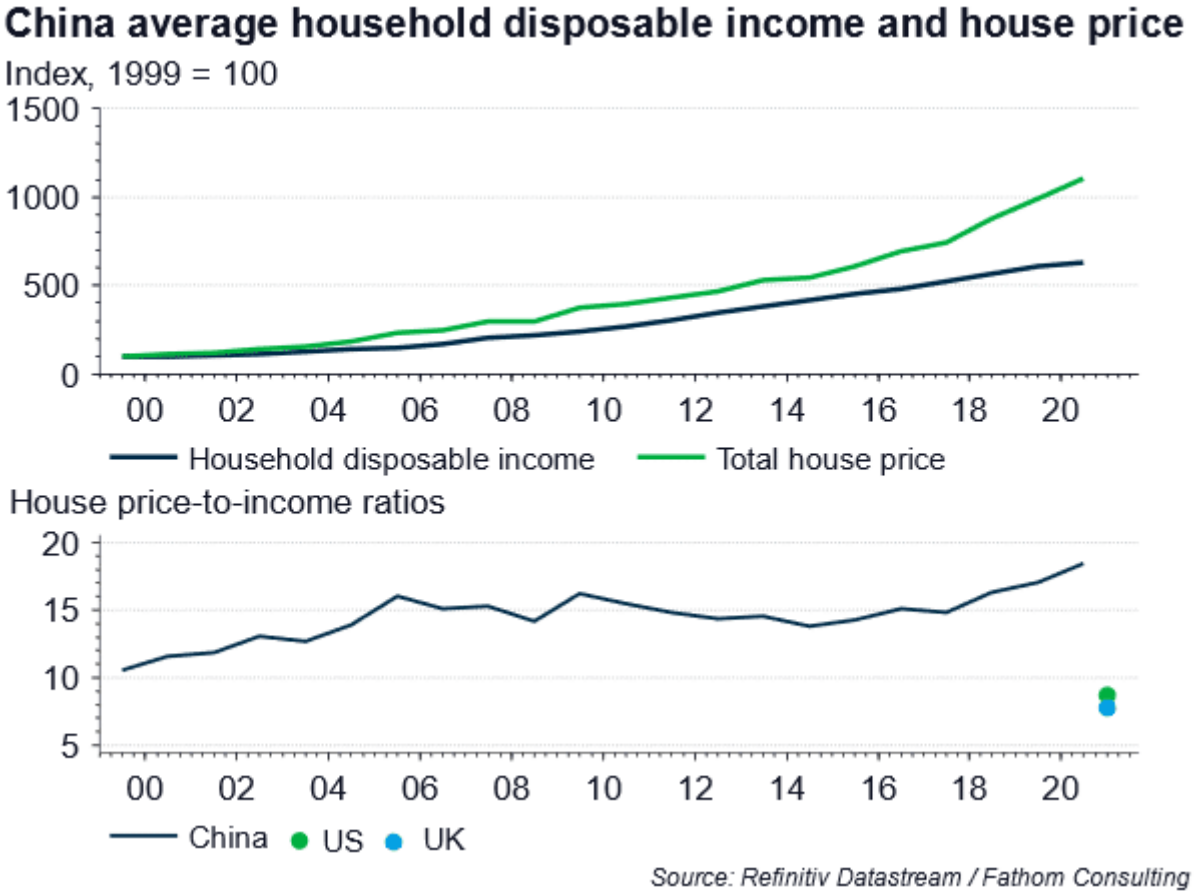
Per the Economist: "*The World Bank calculates that, since 2008, China's total-factor productivity (TFP)?the amount of GDP growth that cannot be explained by capital or labour?**has grown by just 1.1% per year, less than a third the rate of the previous three decades**. That is still double the level in America over the same decade. "*

Evergrande

The failure of Evergrande highlights China's growing problem. Seemingly out of nowhere, a company with a history of profits is near default. Overleverage and overbuilding, coupled with obscenely overpriced assets drove those profits. As we learn, Evergrande's scheme and similar actions of other companies are unsustainable.

We recently shared a Twitter thread from **@INArteCarloDoss** **to help** RIA Pro **readers understand the situation. Here is the** link **to the thread. The important takeaway, Evergrande's demise is primarily due to new leverage rules designed by the government to curb real estate speculation.**

If you want more information and shocking video evidence of China's burgeoning property bubble, please watch this dated but poignant short 60 Minutes episode- LINK. The graphs below provide further context.



Finding Religion

China is coming to grips with the limits to growth under the current system. **They seem to recognize productivity gains are the key to leveraging their economy to meet their growth goals.**

There are many ways to improve productivity growth. In China's case they are extending their reach toward unproductive activities occurring in business and personal arenas.

Consider just a few of their recent actions:

- Create "3 red lines." These are leverage rules to curb real estate speculation
- Limiting daily usage of Tik Tok and other social media sites
- They are banning children 18 years and younger from video gaming Monday thru Thursday. They also limit such activities to one hour on weekends.
- Making crypto mining and transactions illegal
- Halting investments in real estate-based private equity funds.

Further, China is now allowing business and personal financial failure. As we see with Evergrande, China is watching bankruptcies and bond defaults that it would have backstopped in years past. **Their goal is to reward capital allocations to more productive manners and punish unproductive investments.**

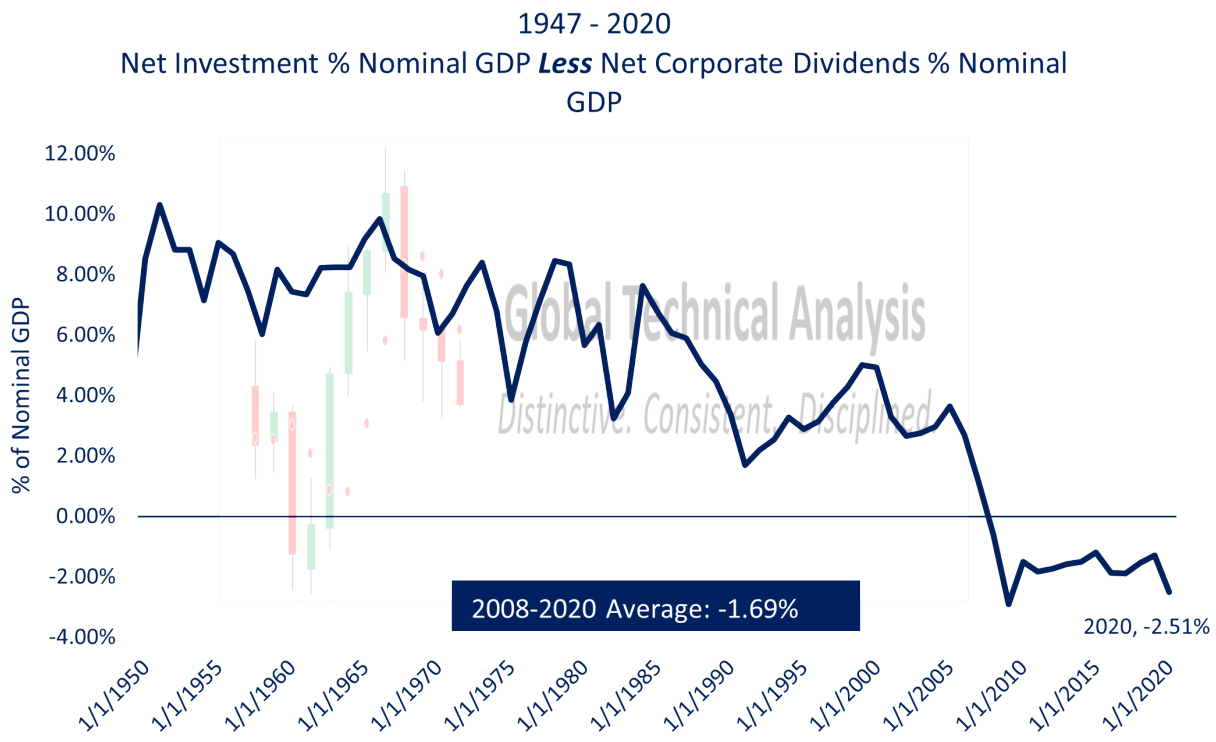
China is also investing heavily in infrastructure, schools, 5G, and ensuring they can domestically produce national security priority goods such as semiconductors. The list goes on and is expanding seemingly daily.

Comparison to the U.S.

Stanley Druckenmiller once said, "**We should try capitalism for a change**."

Capitalism allows for business and personal financial failure. It enables borrowers and savers to set interest rates. Capitalism incentivizes productive uses of its resources. **The U.S. may be capitalist in name but not in its actions anymore.**

As a result, economic growth is trending lower, and the gap between the rich and poor is widening. Infrastructure in the U.S. is aged and in desperate need of replacement. Capital is chasing speculative investments. Innovation and productivity are occurring, but they are far from a priority. The graph below tells the pathetic story well.



Buybacks and Dividends

For the better part of the last five years, S&P 500 companies have given back to investors via dividends and buybacks about 100% of their earnings.

Why not? Executives are paid handsomely to boost share prices today, not to be more productive and profitable in the future. Further, near-zero interest rates allow executives to borrow to pay dividends and buy back shares.

The Federal Reserve indirectly promotes such activity. They feed speculators with liquidity and backstop markets. They enable gross misallocations of capital.

The government seems unwilling to prioritize the virtues of productivity. Pushing productive measures involves taking hard and politically unpopular steps, such as we see in China. Allowing failure and popping speculative asset bubbles, for starters, is necessary albeit painful.

It's hard to get elected when markets are down, and confidence is poor. China's leaders have no such problem.

Summary

The thousand-plus words in this article could easily be 500,000. We only touch on the tip of the iceberg.

Making this article difficult to write is that China seems to understand the value of productivity. At the same time, the U.S. is floundering, using debt and monetary tomfoolery to keep asset bubbles afloat despite betraying long-term economic growth.

Wall Street and investors cheer markets higher. The Federal Reserve bolsters speculation as the means to meet their employment and price objectives. Leadership on both sides of the aisle prefer to spend like drunken sailors, favoring reelection over what is best for the nation. The media willingly goes along with all of it, unwilling to ask difficult questions or call anyone out.

It's time to pay attention to China before they eat our lunch!