CIARDI CIARDI & ASTIN

Emerging Economies: Mid Life Crisis or Why I Can't Have My Growth Now

by

Paul L. Sloate

Chief Executive Officer

Green Drake Partners, LLC

September 11, 2013

The Emerging Economies, the economic sprinters of the past 30 years, now represent over 50% of the Global Economy. While some look to this past record as an indicator of what the future holds, these countries' current position in the global economy and their stage of development would indicate otherwise. For economies built on Export Growth and Infrastructure development, this will represent wrenching change. And with the Emerging Economies warring amongst themselves over the share of the global economic pie they each possess, a stalemate is developing that will likely severely constrain their collective growth. Thus, these countries must rely on internal growth to drive their economies, unlike the past. With underdeveloped Consumer markets, they will face difficult choices and a long period of adjustment. Given this reality, we see Developed Economy and Emerging Economy growth rates converging over time.

We will highlight China as the poster child for these issues. However, the issues China faces apply to almost every other Emerging Economy, such as Indonesia, Malaysia, Brazil, India, …, which has built its economic growth using a Mercantilist economic policy. China confronts huge challenges in transforming its economy. Gross Fixed Capital Investment represents a full 48% of its economy. This is well above the typical peak of 35% for a Developing Economy and compares to more mature Asian economies, such as South Korea, where the ratio is 25% or less. While we do not expect China to reach South Korea's level in the next 5 years, a drop to 35% would be reasonable. Despite the reality of massive overinvestment occurring in its economy, China continues to grow its Fixed Asset Investment (FAI) over 20%. With Government at 19% of GDP and Consumption at only 33%, we wonder who will buy the goods that such massive investment will produce? While China possesses a major middle class, given the vast size of the economy, the average citizen cannot afford to buy many of the goods it produces, such as TVs or washing machines. Even if they can afford these goods, they cannot afford the electricity to run them. Thus, even though China theoretically possesses the populace to absorb its goods, the reality of income levels for the average family prevents them from moving up the income spectrum rapidly enough to absorb this additional capacity. With a minimum growth target of 7% for its GDP, this leaves China with a quandry. China must invest the equivalent of over 40% of US GDP to prevent its FAI from falling. If it does this, it will create more goods than its populace can absorb. Thus, to maintain its GDP growth targets, it must continue to increase its exports at a rapid rate or displace imported goods.

There is only one major problem with this strategy. China's Emerging Economy and Developed Economy trade partners have begun to lose patience with it. We will use Aluminum as an example of the structural issues facing large parts of the Chinese economy. Our tale starts in Indonesia, which is a major Bauxite producer, the raw material for Aluminum. Two years ago, Indonesia passed a law ending Bauxite exports for Aluminum smelting, requiring the processing to occur in Indonesia. Why did Indonesia do this? China was the major destination for the raw material which it then sent back to Indonesia in the form of finished products containing processed Aluminum. In other words, China treated Indonesia as a colony, using classic Mercantilist economic policy to capture all Value Add for itself. This might make economic sense if China were a global low cost or even medium cost producer of Aluminum. However, China is neither. In fact, it is a high cost producer. The key to economic aluminum production is low cost electricity, something clearly lacking in China. This makes this a very curious proposition based on the facts. However, it appears normal market signals do not matter here. Despite this key fact for locating Aluminum smelter capacity, China currently stands as the largest producer of Aluminum in the world, at over 30% of global production, and continues to grow its production rapidly. China, which has grown its Aluminum production every year for the past 15 years at 12% to 30%, except for 2009, will grow its production 11% this year followed by 10% in 2014 and 7.5% in 2015. Despite this economic reality, China continues to produce large amounts of Aluminum, losing money in the process, with the government clearly subsidizing production. They do this to feed their vast manufacturing machine, whose goal is to export goods and collect hard currency.

On the import side of the equation, China's government recently proposed banning low quality and/or high sulfur Coal imports, mainly originating in its Emerging Economy brethren, such as Indonesia and Vietnam. These imports grew 30% in 2012, as low cost inputs into the need to produce power. This displaced Chinese Coal production, as the cost of moving the Coal from where it was mined made these imports an attractive economic proposition. Such a ban would eliminate over 90% of Indonesia's Coal exports to China, despite its much lower production costs. (We note, this will also have an impact on the US, who is a major coal exporter globally.) Mexico recently complained to China over its exports to that country. While Mexico opened its economy to goods from China over the last decade, which now total $57 billion, Chinese imports from Mexico total a paltry $6 billion. This is despite cheaper production in Mexico for many goods than in China. Mexico recently imposed anti-dumping duties on exports of Chinese Steel Pipe for the oil industry. As China already has a major dispute with the US over Electric Steel, this is no surprise. We would note production of Steel is electricity dependent, just like Aluminum. Brazil also complained about China recently and its refusal to open its borders. This partially led to Brazil imposing 65% Domestic Content requirements on all goods. (We would note that Brazil is equal opportunity when it comes to trade disputes. It has fought with both Argentina and Mexico recently, as well.)

While China's average tariff has declined to only 10% over the past 15 years, China imposes a VAT of 5% to 17% on all imported goods, driving the average total import tax to 15% to 27%. In addition, the average tariff rate covers up wide variations in duties that lead to protections for China's industry while encouraging imports of raw materials. For example, food tariffs range from 12% to 27% while oil imports only face a 5% tariff. Footwear and apparel duties are 13% and 16%, respectively, as China wants to protect its domestic apparel food chain. Most manufactured goods face double digit tariffs, with some extremely high. For example, Passenger Vehicles face a 25% import duty. They also face a Gas Guzzler tax that can turn a $25,000 import at the dock into a $63,000 retail sale. We note that this analysis excludes the targeted investigation of non-Chinese companies operating in China. The purpose of these investigations clearly is to hamstring foreign competitors, such as Danone, Tetra Pak, Merck, Corning, and Yum Brands, as they compete highly effectively against domestic Chinese companies. We note, despite China growing to be the #2 Economy in the world, the WTO continues to consider China a "non-market economy", enabling China to sidestep rules that apply to Developed Economies. We wonder how much longer this charade will continue, given China's role in the global economy.

On the Developed Economy side, Chinese trade frictions continue to grow. Fighting with your major customers is never a good thing. And that is what the Developed Economies are, China's major customers. They have begun to respond to China's actions to continue to grow at their expense. Over the past two years, Europe imposed anti-dumping tariffs on steel wire, aluminum foils in rolls, aluminum radiators, ceramic tableware, oxalic acid, and solar panels produced in China. China, to protect its high cost chemical producers, recently imposed tariffs on Toluidine, a necessary chemical to manufacture dies, among other things. The major manufacturers of this chemical are European. We note this is similar to tariffs, put in place several years ago by China, for chemicals necessary to produce polyester staple that goes into clothing. To further send a message to Europe, China continues to threaten to impose dumping duties on imports of luxury cars and wine from the EU. We find it hard to understand how bottles of Chateau Lafite-Rothschild or cars such as BMW or Mercedes-Benz are being dumped in China. The net result of these trade frictions is that Chinese exports to the EU are down over 8% year-over-year and European exports to China are under pressure.

Things are not much better for China with the US, with disagreements escalating. Most major manufacturing plants, today, are highly automated with little labor input. And with the rise in China's labor costs, most high labor content goods have migrated to other Emerging Economies, such as Thailand and Vietnam, over the past five years. Given that China no longer relies on cheap labor to drive its exports and its high cost energy position, its ability to produce manufactured goods more cheaply than the US is highly limited. This realization has led the US to impose anti-dumping duties on numerous products including steel wire, electric steel, cylinders, wheels, aluminum extrusions, wood flooring, bricks, paper, tires, and citric acid. There is also pressure for the government to impose duties on auto parts and solar panels. The outcome of such policies is quite predictable: a 5% year-over-year decrease in exports to the US from China in June.

The impact on global trade of such trade disputes is clear. Global trade, which grew at a 7.6% compound growth rate from January 2002 until December 2007, grew at only a 1.8% compound growth rate since January 2011, after the snapback from the global recession. For economies built on ever growing trade to drive economic growth, this creates a fundamental problem with the Developing Economy growth model. In addition, the Law of Large Numbers stands to significantly impact these economies. Growing from 10% to 20% of a market feels great. Growing from 20% to 40% of a market feels good. But growing rapidly, once you are 50%+ of a market, is impossible. You are the market. And your growth is equivalent to the overall growth of the market. That is where China and its Emerging Economy brethren stand today.

The implications of this new reality are significant. First, Gross Fixed Capital Investment growth must decelerate significantly for China and all the Emerging Economies. When this deceleration occurs, it will produce feed back into the domestic economies for these countries, as a fall in demand for capital goods and investment into new plants. Second, many of these Emerging Economies are Commodity sensitive, producing copious quantities of raw materials to feed the global industrial machine. They benefitted significantly from the rapid global demand increase for raw materials in the 2000's, driven by the outsized Fixed Capital Investment into industrial plant to support export growth. Fixed Capital Investment growth is 15x as commodity intensive as growth in Consumption. With Consumption growth playing a more critical role in the Emerging Economies, commodity producing countries will experience slowing commodity demand growth and less need to invest to increase supply through new mines and processing facilities. This slowdown in growth also will impact commodity pricing negatively, lowering trade surpluses and ultimately the investment into new rail and port facilities, providing further negative impacts on the rate of economic growth. One need only look at what is occurring in Australia to view the future of many of these economies. Given this economic reality, we see the Emerging Economies facing a Mid-Life Crisis as summarized in the phrase "Why I Can't Have My Economic Growth Now".

Paul Sloate is Chief Executive Officer for Green Drake Partners, LLC. Green Drake Partners serves High Net Worth Investors, Family Offices, and Independent Registered Investment Advisors, providing them Investment Services, Economic Analysis, and Strategic Advice. More information about Green Drake Partners can be found at their website at www.greendrakepartners.com or by contacting them in Wayne, PA at 610-687-7766.