Chapter 1

The Corleones Meet Confucius

The Chinese Mirage of Miracle Expansion

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In *The Godfather II*, Michael Corleone consults his advisers in his Lake Tahoe mansion following an unsuccessful assassination attempt against him. The young, powerful Don Corleone considers the likelihood of insider help in the plot, from within the Corleone family organization. Michael counsels:

All our people's loyalty is based on business; and on that basis, anything is possible.

Whether a crime family, a company, or an ordinary family, if the organization's central binding ethos is money, then the flow of capital must not cease or the organization splinters quickly. It is not an absurd

analogy to compare the motivations of the members of the Corleone family to the majority of the citizens of China. That is, like the Corleones, China is not truly a family. It is not even truly a country. Instead, China is more like a group of countries—a vast collection of disparate, and often confrontational, cultures, languages, and histories. And since the reforms of Deng Xiaoping, the glue that binds the amalgam together is not ideology but commerce. George Friedman, political scientist and founder of the private intelligence corporation Stratfor, correctly postulates:

China is held together by money, not ideology. When there is an economic downturn and the money stops rolling in, not only will the banking system spasm, but the entire fabric of Chinese society will shudder. Loyalty in China is either bought or coerced. Without available money, only coercion remains.[1]

Like the Corleones, the Communist Party that controls China faces a daunting task: trying to purchase the loyalty of the Chinese masses. Consider that the Party must simultaneously balance China's fierce pace of growth, manage the world's largest-ever migration of people (from western China to the coast), steer all industrial policy, and—perhaps most dauntingly—allocate capital effectively. And the Party must manage these myriad tasks while maintaining a system of tyrannical oppression of thought, communication, religion, assembly, and even reproduction.

That repression should soon become far more apparent, once the flow of credit slows. Already, Chinese authorities are quickly tightening monetary policy—that is, restricting the availability of credit—to stem the impending threat of food inflation that imperils the still-poor masses, especially in the western interior lands. As credit recedes, coercion must rise, otherwise Beijing relinquishes control. As Michael Corleone knew, when buying loyalty becomes impractical, force becomes indispensable. Corleone had his henchmen; the Chinese have the People's Liberation Army.

In this chapter, I detail the inherent contradictions and attendant dangers endemic to China as presently structured. Further, I make the case that China's fierce expansion is unsustainable, representing an economic mirage, analogous to Japan of the 1980s and a similarly dangerous investment. I maintain that, far from presenting a credible threat to American supremacy, China will in fact be fortunate to even maintain itself as a unified state.

Exposing the Myth

Despite the myriad risks relevant to China, it represents perhaps the most widely held fallacy of our age. The herd is, indeed, stampeding into China. Western companies and western capital flow torrent-like into the Middle Kingdom, ignorant of Chinese history (and Japanese recent history) and cavalier about partnering with Beijing. Instead, the West beholds a near-unanimous belief that China is an unstoppable force of progress and modernization, an economic miracle before our eyes. Moreover, asserts conventional wisdom, China will soon threaten, and assuredly surpass, the economic, political, and military primacy of the United States. In fact, many on Wall Street expect that growth in China will miraculously lead the global recovery out of the depths of the credit crisis of 2008. Instead, I assert that China presents the most stark single risk to the global recovery. Far from being a locomotive leading a global resurgence, China instead hangs like a Sword of Damocles over the world economy.

But, rather strikingly, the bullish view on all things Chinese traverses wide swaths of our society. The vision of China that has been successfully sold to the American public by the media and Wall Street is a carefully orchestrated, well-honed machine with brilliant top-down control emanating from the allegedly wise, forward-looking leaders in Beijing. In this mien, we Americans supposedly look foolish by comparison, with our diffused and democratic power structures. America is inefficient, goes the thinking, while China presents a model of twenty-first century progress through a controlled, almost scientific approach.

In reality, a better analog for comparison is not some well-oiled machine, but instead a wild, dangerous bucking bull. And Party leaders in Beijing, in stark contrast to the image of wise, measured seers, are instead like a cowboy riding a bull, losing control but desperately trying to stay on. Bull riding is a sport far better reserved to American cowboys than Chinese leaders, and the bull that is China's internal situation will soon buck the rider into a painful dismount. Nevertheless, from Wall Street research departments to Ivy League academies to Main Street, the assurance of China's ascendancy reigns nearly unchallenged.

The Gallup Poll asked Americans, "What country has the world's largest economy?" In 2009, respondents placed America and China at a tie. In February 2011, an amazing 52 percent of Americans named China as the largest economy in the world, with only 32 percent naming the United States.[2]

In reality, America is, by a giant margin, the largest economy. According to the International Monetary Fund, the 2010 GDP of the United States was $14.62 trillion, compared to China's $5.75 trillion. Further, given China's far larger population, the per capita gap is even starker, with China's per-person GDP at $4,000 versus America's $47,000.

Lately, when watching business television, talking to economic consultants, or reading the financial media, it has become rare to hear anything but almost reverential descriptions of China. In fact, analysts trip over themselves competing to make even grander predictions about China's potential and growth. The seduction of the simplicity of top-down, command economy is presently capturing the imagination—and the capital—of much of America's elite.

A similar movement occurred in the 1980s when Japan was, according to the American media and cognoscenti, about to economically swallow up the United States. Instead, Japan now finds itself staring at a third consecutive lost decade, as we examine in the next chapter. But while history may not repeat, it sure seems to rhyme. Today, what multinational company CEO does not pin his growth strategy on emerging markets in general, and on China specifically? The chorus is loud and far too self-assured about China's growth prospects.

As an example, I recently went to a dinner attended by large asset managers in New York City at Sparks Steakhouse, a popular restaurant for traders and bankers in midtown Manhattan. As we dug into very American-sized giant steaks, the China praise was effusive. Of the six men seated at the table, I was literally the *only* one whose children were not taking Mandarin! When a wave becomes that unanimous, we're surely on the edge of sustainability. I modestly suggested that perhaps Spanish would represent a much more important language for America, given our southern border and the demographic trends within America itself. My suggestion was met with polite but dismissive interest.

We will examine later in the book why Americans (and Westerners broadly) mistakenly so fear and respect China. But first, it's vital to examine the growth-killing hurdles facing China.

Adam Smith's Revenge: The Folly of Central Planning

In *The Wealth of Nations*, Adam Smith extolled the wondrous, surprising harmony of the "invisible hand," the collection of millions of individuals, businesses, and interests naturally aligning into efficient channels of commerce, spurred by the dynamic forces of supply and demand, and compelled to creative action by the profit motive. He warned against central planning, the idea that government can and should determine an overarching economic policy for a country, and insert policy into the affairs of commerce. Instead, he argued for the unpredictable elegance, the surprising harmony of a society's combined collective genius, propelled by countless individuals acting in self-interest. His warnings to politicians arrogant enough to attempt to manage the affairs of millions stands the test of time, and it powerfully indicts the Chinese Communist Party bosses of 2011. He warned against central planning, which he described as:

The statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[3]

Regarding Adam Smith, hedge fund titan and China bear Jim Chanos noted on CNBC: "Adam Smith is going to get his revenge in China."[4]

Despite endless examples of the folly of central planning—from Stalinist Russia to 1980s Japan to the U.S. government's mortgage agency debacles—politicians, media, and investors continue to fall for the alluring myth of central planning. Human nature seems almost perversely drawn to such schemes, wanting badly to believe that councils of wise men can effectively direct economies and whole societies. Resisting this temptation, and standing aside of, or even against, the herd can be lonely, but also safe and profitable. For example, not following the crowd onto one side of the deck of the *SS Eastland* would have precluded personal disaster.

In the case of China, the herd, after all, is ignoring voluminous historical evidence to the contrary, and betting massively that the Party in Beijing can, in the face of history and against all principles of free markets, hit a hole-in-one and successfully commandeer a statist, quasi-capitalist economy of 1.3 billion people. Such an autocratic approach to money and markets leads, inevitably, not to sustainable growth and lasting wealth, but rather to cronyism, bubbles, and severe misallocations of capital.

In fact, China appears to be moving even more forcefully toward state control, emphasizing (unsurprisingly) its state-controlled businesses now that the global economy has so slowed. Michael Wines noted in the *New York Times*:

Once eager to learn from the United States, China's leaders during the financial crisis have reaffirmed their faith in their own more statist approach to economic management, in which private capitalism plays only a supporting role.[5]

In fact, of the 100 largest publicly traded Chinese companies, a grand total of *one* is not majority owned by the state. In an even more brazen display of cronyism, of the 129 major state enterprises, more than half of the chairmen were appointed by the Communist Party.[6] Can any investor honestly believe that those appointments are based primarily on merit?

The very definition of capitalism is the *private allocation of capital*. So in reality, China's economic model is not capitalism at all, but rather a command economy attempting to meet the supply/demand needs of other capitalist economies. The capitalist aspects of Chinese society, therefore, are not free or fair, but instead represent, in the words of eminent Chinese economist Wu Jinglian, "capitalism of the rich and powerful."[7]

Such cronyism naturally leads to ineffective resource allocations. For example, China keeps on massively investing in auto production despite the fact that, at present, global auto production capacity stands at 86 million vehicles per year, with present projects expected to expand that capacity to 100 million by 2015. And yet, presently the world is only buying about 55 million new vehicles per year.[8]

And how about bridges for those cars? Apparently bridge builders in China operate a very effective political action committee. Consider that the United States, roughly the geographic size of China, maintains 450,000 usable bridges. By comparison, China presently has 500,000 bridges, after building 15,000 per annum for the past 10 years, even though the United States has *five times* more rivers than China. And the United States has *five times* more cars than China. And already China has a comparable number of expressways to that of the United States.[9]

Speaking of bridges, there was in July 2011 a truly tragic accident in Wenzhou in eastern China, in which two high-speed trains collided

near a bridge over the Ou River, killing 40 people and hospitalizing 192 more. The crash was, I believe, perhaps symptomatic of the dangers of such rapid, top-down directed industrialization. Even more telling, though, was the Chinese official response to the disaster. Rather than conduct an open, serious inquiry into the causes of the tragedy, the Chinese government quite literally buried large portions of the train carriages, thereby preventing any real forensic type of analysis. This reaction stands in utter contrast to the reaction to tragedies in the West. Granted, America's obsession with litigation would have likely meant trial lawyers at the site concurrent with paramedics; this is an unwelcome reality of American life. But on the very positive side, had the accident occurred in the United States, the analysis of its causes and possible preventions would be thoroughly, openly evaluated.

But in China, the first priority of the government is never the safety of the people; instead the goal is growth, and growth at all costs. The need, therefore, for endless Biblically sized infrastructure projects in China, based on capacity and real demand, becomes spurious. But the political need for such projects, to employ the migrating masses and line the pockets of connected interests, is undeniable—and dangerous.

Ghost Cities and Construction Cranes

One rather frightening place those cars and bridges can reach is the Ghost City of Ordos. The original old Ordos lies on top of one-sixth of all the coal reserves of China. So despite its remote location near the Mongolian border, Ordos prospered. Its citizens produced about three times the national average GDP of China, ranking it only behind Shanghai and ahead of Beijing. Ordos became known as China's Texas.

But, unsatisfied with its natural resource-based achievements, the Party determined that a massive planned city, a "new Ordos City," must spring up from the desert. So 30 minutes away from the old Ordos, a giant monument to the folly of central planning emerged:

The Kangbashi district began as a public-works project in Ordos, a wealthy coal-mining town in Inner Mongolia. The area is filled with office towers, administrative centers, government buildings, museums, theaters and sports fields—not to mention acre on acre of subdivisions overflowing with middle-class duplexes and bungalows. The only problem: the district was originally designed to house, support and entertain 1 million people, yet hardly anyone lives there.[10]

But Ordos (shown in Figure 1.1), while notable for its massive scale, does not at all represent an exceptional story of following the Chinese model. Rather, bridges to nowhere and ghost towns are quickly becoming the norm as China struggles to spend its massive $585 billion stimulus. That stimulus, by the way, compared to the size of China's economy, dwarfs America's similarly ill-conceived attempts at stimulus. But in the Chinese version, GDP becomes not the result of a vibrant model but instead the very model itself. That is, growth, at any cost, and in spite of any waste and irrespective of profit margins, becomes the overarching goal. Cash flow, not profits, becomes king. Because, like the Corleones, Beijing needs to purchase the peace.

A more bizarre ghost city has sprung up much nearer to Shanghai, called Thames Town. Built to replicate a British country village, Thames Town looks eerily like a theme park homage to Britain, complete with a replica church and fish and chips shop. The only problem is that, similar to Ordos, no one lives there. The quaint English village is empty.

Tadashi Nakamae, perhaps Japan's preeminent global strategist, has endured a front-seat view of the failures of Japan's central planning. Nakamae specifically cites the massive overcapacity of industrial production in China. More frighteningly, he posits that China continues

Figure 1.1 Ghost City of Ordos
SOURCE: Huai-Chun Hsu.

to expand capacity, even though final demand is slowing, internally and internationally. But again, the Chinese manager answers not to an American-style board or investor base but, in reality, to the Chinese government. He surmises that China will "continue down the reckless path of adding capacity by mass overproduction not driven by market demand but by administrative edict."[11]

Such administrative edict created an Ordos-like boondoggle much further south of Mongolia—the New South China Mall in Dongguan on the southeast Chinese coast (see Figure 1.2). It stands as the largest mall in the world, with capacity for an astonishing 2,350 stores and a replica of the Arc de Triomphe. But the New South China Mall is also notable for something embarrassing: It is 99 percent empty.

Figure 1.2 But Where Are All the Shoppers?

Just before the mall debuted, the *New York Times*, in hagiographic praise all too common from the Western press, hailed the Mall as proof of China's "astonishing new consumer culture" and noted "there is no end in sight—and no evidence that China's long boom is likely to suffer anything more than a modest slowdown."[12]

Instead of "no end in sight" inside the mall, there are in fact, no *people* in sight—no shoppers, no workers. Indeed, China now claims 7 of the 10 largest malls in the world. But one stark, remarkably inconvenient truth remains: that Chinese consumers represent only 36 percent of GDP. Compared to the 50+ percent for India and 71 percent for the United States,[13] can this relatively small consumer appetite really satiate the über-ambitious plans of the Chinese government?

But despite the obvious failures of projects like Ordos and the New South China Mall, the pace of construction, at the behest of the

government, actually quickens monthly. At present fixed asset investment represents an almost unbelievable 70 percent of GDP. By comparison, at its peak, U.S. construction only comprised 16 percent of GDP.[14] For this reason, Jim Chanos labeled China "Dubai times 1000."[15] At its peak, Dubai saw 240 square meters of property development for every $1 million in GDP. In urban China presently, the ratio is four times as high. Chanos expounds, "We've seen this movie before." From Dubai to Thailand during the Asian crisis of the late 1990s, to Tokyo circa 1989, "this always ends badly."[16]

And the evidence mounts that Chinese real estate valuations have reached unsustainable levels. For example, housing prices in the United States peaked nationally at 6.4 times average annual earnings. In Beijing, the present multiple is 22 times. In prestige cities like London and Los Angeles, the figure in 2007 at the highs never exceeded 10 times, yet Shenzhen housing presently trades at 25 times.[17]

As further evidence of the massive infrastructure bubble—despite a global glut of capacity, after financial crisis—consider China's present cement consumption. China produces more cement than the rest of the world's countries combined. Its estimated spare capacity exceeds the total cement production of India, the United States, and Japan combined. And perhaps most telling, proportionally it's now consuming roughly the same amount of cement per person as Ireland and Spain in recent years—countries that were poster children for excessive construction bubbles.[18]

Global companies have been far too willing to jump headfirst into the warm waters of Chinese expansion. For example, Vale, the giant Brazilian iron ore producer, boasted that because of Chinese demand, it now commands the second largest fleet of ships on earth, outside of the U.S. Navy.[19]

Consequently, global investors need to avoid, or short, companies with too high an exposure to Chinese construction and real estate. For example, global metals, shipping, and steel names all appear vulnerable to the inevitable retrenchment in Chinese construction. Especially dangerous are companies with a heavy Asian-Pacific emphasis, such as

Australian metals play BHP Billiton, the American Union Pacific railroad with its heavy dependence on west coast United States to Asia transit, and the aforementioned Brazilian giant, and surface competitor to the U.S. Navy, Vale.

China Too Crowded? Not for Long . . .

One reason the pace and scope of construction are untenable is that China has a serious population problem. Only, it's not the population problem the world expects. The actual, undeniable problem is not that China will have too many people, but rather *too few.* To be more specific, there will be too few young people. And of particular importance, there will be precariously too few young women.

The disastrous decades-long one-child policy, combined with increased longevity, has induced an aging of the Chinese population that stands unprecedented in history. For example, China first reached 1.2 billion people in 1994. Twelve years later in 2006 it hit 1.3 billion. Adding another 100 million people, to reach 1.4 billion, will take an estimated 20 years from then, until 2026, when China's population will peak and start descending.[20] Even worse, because of rapid aging, the labor supply of China will peak in 2017.[21]

The population will peak, because of declining birth rates, well below population replenishment. In 1990, Chinese women averaged an above-replacement 2.2 births. By 1995, that average fell to 1.8 births per woman. Today, the average Chinese woman has a fertility rate of only 1.6. The migration of hundreds of millions of people has sparked far lower reproduction. First, because in urban factory lifestyles, children become an economic burden, as opposed to rural subsistence farming where children provide valuable, free assistance. And second, because this mass migration has also separated literally millions of families, with one or both parents living near the coast working, while children (usually child, in the singular) reside in the peasant west, often in the care of grandparents. As evidenced by Figure 1.3, families spread

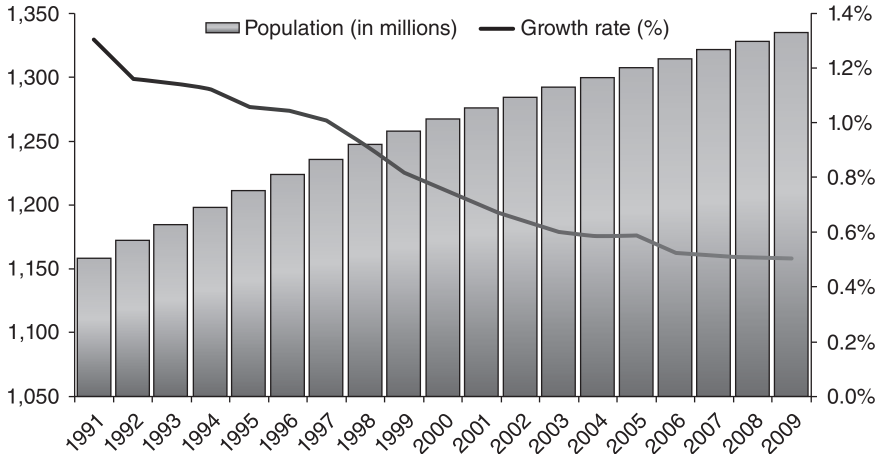

Figure 1.3 China's Population Trends and Growth Rate, 1991 to 2009
SOURCE: Starmass International.

across China are simply not having multiple children, as romantic as the prospect of industrial dormitory residences might seem.

In contrast, the United States still averages more than 2.1 births per woman and, combined with steady immigration, keeps the total U.S. population growing far into the future. China's National Population and Family Planning Commission claims to have prevented 400 million births through the one-child policy. The Commission is now reversing itself and allowing second births in five provinces. This new policy is expected to be rolled out nationwide by 2014.[22]

But demographics are troublesome. Once births decline precipitously, the problem becomes quite literally terminal; that is, reversing the aging, declining population would require multiple births per woman on a scale beyond reasonable probability.

This decline in births and coming dearth of young workers arrives at a most inopportune time. China has thrived for a decade on the mass influx of migrant, cheap labor from the interior west of the country, but since 2005 this flow of eager, cheap labor is declining. Credit Suisse notes in its 2011 report "China: Turning Point of the Labour Market"

that "in 2010, factories suddenly noticed that it had become much harder to find workers, and a 30 to 40 percent salary increase was almost a must if they were to have any chance of capturing those still interested in working in the coastal areas." China has not prospered through creativity and innovation, as we will examine in coming pages. Instead, it has seen rapid growth as the world's factory and smelter. It has become the toy factory for every Wal-Mart shelf in the United States and a low-end foundry for India. But China's greatest asset—abundant, cheap labor—is dissipating as it reaches the "Lewis point" where the surplus of agricultural labor tapers off. The Lewis Turning Point was first expounded on by Sir Arthur Lewis, a Nobel laureate economist who concluded that developed countries see fast wage growth once the free flow of workers from the countryside to the city's industrial centers abates.[23] As evidence of China reaching the Lewis point, executive Bob Rice of the U.S.-based Master Lock Company recently stated that, because of rising Chinese wages and inferior productivity, "I can manufacture combination locks in Milwaukee for less of a cost than I can in China."[24] Years of rising wages have taken a toll and eliminated the only real Chinese advantage, which was seemingly endless cheap labor. Goldman Sachs's chief economist in Hong Kong, Helen Qiao, points out that, for a full decade, real wages in China have advanced on average 12 percent per year.[25]

The demographics, meaning fewer young, productive, affordable workers, guarantee that China will continue to lose this comparative advantage. And more broadly, such a decline in the young, productive segment of any society will surely restrain growth going forward, whether in China or elsewhere. If the past is prologue, which it normally is, then China is in for particular trouble. The Chinese baby boomers (born 1955 to 1965) have closely matched the "footprint of the Chinese economy—the production boom of the 1990s, the housing boom of the 2000s and the recent consumption boom."[26] But as this bulge of boomers enters their fifties and the one-child generation ascends, Chinese growth will recede, especially compared to the United States.

Accordingly, investors will, in coming years, be well advised to avoid multinationals that bet too heavily on the much anticipated enormous Chinese consumer class. Specifically, consumer discretionary names, particularly those with an Asian focus, should be avoided—or shorted. Companies like Tiffany and Coach should be especially burdened. The herd is promising a market in scope and depth that will dwarf the U.S. consumer appetite. But such promises ignore the harsh realities of Chinese demographics. When I was young my mother warned me against doing dumb things simply because the crowd was doing it, especially the cool kids. Similarly, capital will be wise to avoid too much Chinese exposure just because Tiffany and Coach promise a yellow brick road (or Chinese Wall) to riches. In point of fact, China's consumer appetite is actually declining as a percentage of its GDP, and rather precipitously so. As China ages and the Chinese save ever more, mindful of a dearth of social programs for the elderly, the long-promised mass Chinese consumer market becomes far less likely. Specifically, for 2010 the consumer made up only 36 percent of total Chinese GDP, the lowest on record since the market reforms 30 years ago, and off from 46 percent just 10 years ago.[27]

China is not, of course, alone among nations in facing a declining and aging population. Italy, Spain, Russia, and especially Japan face similar, if not worse, scenarios. But compared to the United States, which stands alone among industrial societies growing in numbers, China represents a poor investment. We will discuss this key advantage of America much more in the final chapter. But suffice it to point out that investments are based on growth—growth of incomes, numerical population growth. China's population is about to crest, meaning that growth is already tapering off and will soon result in outright declines in the number of people. Such a recession of people does not bode well for long-term capital growth.

One final point on demographics: The male/female mismatch represents a truly unprecedented, and perhaps very volatile, wild card in analyzing the future of China. Due to the one-child policy and mass

abortions of girls, the ratio of male to female births has climbed to 119 to 100. In some rural provinces, the ratio is 130 to 100.[28]

If I am even partially correct about a Chinese economic slowdown, what ramifications will result from this macro gender imbalance? In general, this book seeks to use the lessons of history to gain some reasonable divination of future trends. For example, studying Chinese history reveals the fissures among the ethnic groups that make up China. And similarly, studying 1980s Japan (which we will examine in Chapter 2) provides an analog for the command cash-flow-centered economy of present-day China. But there is literally no comparison for this present Chinese gender imbalance. Many societies have witnessed a dearth of males, especially following brutal wars, but a dearth of young women? If the economy does splinter, what will become of young, unattached, unemployed men? The honest answer is "I don't know," but I doubt the outcome will be pleasant. The idea of undomesticated single males fighting over resources and wives does not engender optimism, but rather suggests a future of strife and instability.

In many years, considering all the missteps of the Chinese government, I suspect that in retrospect this gender imbalance issue will stand out as the most damaging. It may well become a most egregious example of the pernicious unintended consequences of the visible hand of government, especially a government like China's that operates in opacity.

Big Brother's Watching: Censorship and Secrecy

In 1984, the singer Rockwell released his hit song "Somebody's Watching Me" and bemoaned the lack of privacy and concurrent unease at being watched. Well, Rockwell would not enjoy living in China, because Big Brother is indeed watching. For example, recently China's Internet censors filtered and blocked Chinese surfers from

seeing the name of the U.S. Ambassador to China, John Huntsman Jr. His offense was appearing, very inconspicuously, as an observer at a McDonald's gathering of Chinese youth concerned about human rights.

On the topic of censorship, consider that China has a mind-boggling 457 million Internet users. Of that total, only an estimated 700,000, or less than 2 percent, use Facebook, which is largely blocked.[29] Compare that total to the United States, where more than one out of three Americans (of any age) is on Facebook. And Facebook is hardly unique. China blocks Google, YouTube, Twitter, and anything it deems critical of the Communist Party.

The 2010 Nobel Peace Prize winner, Liu Xiaobo, knows all too well the sting of Chinese censorship. For writings considered subversive to Beijing, he was arrested in the middle of the night in 2008, tried in secrecy, and sentenced to 11 years in prison where he sits still, even after winning the Nobel Prize.

This lack of transparency represents not just an affront to human rights, but a very real, tangible impediment to a flourishing, lasting economic growth model. True capitalism requires openness in many forms. It particularly requires the openness of information, so that actors can create and capital can seek the best possible allocations. Without unfiltered information, the process of capital allocation is, at best, inefficient and, at worst, fraught with danger.

Moreover, a culture of secrecy and obfuscation bleeds into commercial sectors as well. For example, recently many Chinese firms have achieved pseudo-legitimacy by listing shares on the Nasdaq in the United States. Using a tactic known as a reverse merger, these companies have bought American shell companies that have a stock listing but insignificant remaining businesses. After changing the name, these Chinese firms instantly achieve American publicly traded status. Since they're foreign firms, the United States allows them to pass audits in their home country. But what kind of audit standards exist inside China? Given the utter lack of transparency, and the blatantly political nature of the Chinese business model, does anyone believe

that the Chinese audits compare well against the standards of the U.S. equivalent?

An example is Fuqi, the Chinese jewelry maker. It is listed on the Nasdaq, trades almost 500,000 shares daily, and at one point boasted a market capitalization value of nearly $1 billion. But in March 2010, Fuqi was forced to admit that it over-reported earnings for 2009 and would have to restate them. As of March 2011, Fuqi still had not filed any new statements and the stock is presently 80 percent off its peak. RINO is a similar story. The Chinese environmental firm was delisted from the Nasdaq after admitting to the SEC that it lied about customer contracts. RINO also secretly lent its CEO $3.5 million, without any loan agreement.[30]

In 2011, a similar but much larger fraud story played out surrounding Sino Forest, a Chinese timber play based in Vancouver, Canada, and traded on the Canadian exchanges. Journalists and investors uncovered huge discrepancies in the amount of land and timber Sino Forest purported to own versus publicly available information from Chinese local governments as well as other forestry companies. Once this alleged fraud was uncovered, the shares predictably careened lower, losing about $750 million for hedge fund titan John Paulson. The China myth, it seems, has taken in even the world's most sophisticated investors. In total, Sino Forest sold about $1 billion in bonds, and insiders sold another $1 billion in shares to investors. With both the shares and bonds close to worthless, hedge fund manager John Hempton notes that Sino Forest represents "probably the largest straight theft in human history."[31]

This lack of transparency endemic to China has already produced serious losses for investors, and undoubtedly the pace and scope of such financial machinations will expand greatly in coming years. Growth covers up myriad problems, misdeeds, and scams. But as the saying goes, "When the tide goes out, you discover who's swimming naked." When Chinese growth slows, as appears to already be happening, then I am convinced the scale and audacity of corporate dishonesty, Party graft, and dirty dealing will truly astound the Western investor.

No H-P Garage

But the worst ramification of the lack of transparency is the concomitant lack of innovation. Creative successes require the fertile soil of openness to grow. Leonardo da Vinci thrived not in a closed society of repression and control, but rather in a Renaissance era abounding in inquiry, fostering a flourishing of commerce, arts, learning, and exploration. The control exerted by Beijing compels just the opposite result: a stifling of creativity and encouragement of conformity.

Even further, this rigid top-down control demands growth at all costs, including flouting internationally recognized protections of intellectual property and copyrights. Consider Zippo, the iconic lighter manufacturer. Since 1937, Zippo has proudly produced its lighters at its only plant in Bradford, Pennsylvania. Every Zippo comes with a lifetime guarantee, "Always works—or we fix it," and for free. The trouble in recent years is that Zippo produces 12 million lighters per year, but receives countless malfunctioning fake lighters for repair (which it won't work on) that have been made in China. Chinese production of "Rippos," as the real company calls the fakes, has reached 12 million per year.

Perhaps more disturbing is China's consistent abrogation and lack of intellectual property standards. For example, the Business Software Alliance, an American industry group that includes Microsoft, Intel, and Apple, said that as of 2008, 80 percent of all software used in China is pirated, costing the industry $6.7 billion in lost revenue. China is the second largest PC market in the world, after the United States, but only the tenth largest PC software market. Regarding counterfeit goods seized by the U.S. Customs and Border Patrol, a General Accounting Office report detailed that from 2004 to 2009, China and Hong King accounted for fully 84 percent of all seized counterfeit goods. For comparison, the next worst offender, India, managed a paltry 2 percent of all seized goods. As critical as I am about the Chinese model, one thing they seem to have mastered is stealing America's creations. From

tobacco to pharmaceuticals to software, China's recklessness with intellectual property and patents is proof of its inherent lack of both contract laws and creative innovation.

Clearly most of China's manufacturing is properly licensed and legal. But even its legitimate industry mostly follows a cut-and-paste recipe, wherein it takes the products and processes of other economies and replicates them more cheaply using seemingly ever-abundant low-cost labor. Sometimes, it "takes"—as in steals without permission—as with Zippo. Most of the time it "takes"—meaning licensing and manufacturing legally and ethically—but nonetheless, only as a lower cost producer that adds little to no product value outside of cheaper labor. . . . And, it should be noted, when I say "takes," as in the case of Zippo, I literally mean without permission or licensing. The cut-and-paste process can, and surely has, produced incredible near-term income. It does not, however, present a model for sustainable, long-term growth. For example, China now produces more cars than any other country. But its contribution to auto design is negligible.

Long-term growth requires, above all else, innovation. First, because eventually the comparative advantage of cheap labor dissipates as wages rise, as is already occurring in China. And second, the ideas and products that truly create new wealth always emanate from great thinkers motivated by large profits, rather than by simply lowering production costs. So far, China has completely failed to move up the value-add design chain. And why? Are the Chinese not smart enough? Of course they are, but the economy and, indeed, the whole society suffocate under the repression of intolerance, central command, and censorship.

The danger of a lack of innovation is evident when we compare salaries of unskilled workers to those of university graduates. In 1998, China announced plans to bolster college attendance. Consequently, the annual number of graduates rose from about 800,000 per year to almost 6 million. But, in contrast to unskilled factory workers who easily find jobs in the East, these legions of university graduates struggle to find work. The *New York Times* has observed:

The supply of those trained in accounting, finance and computer programming now seems limitless, and their value has plunged. Between 2003 and 2009, the average starting salary for migrant laborers grew by nearly 80 percent; during the same period, starting pay for college graduates stayed the same, although their wages actually decreased if inflation is taken into account.[32]

These young workers struggle, and the educated classes perversely see relative wages declining—the exact opposite phenomenon evident in the United States. In China, the more educated the worker, the more depressing the opportunities, because China as a nation has failed to progress to higher-value businesses, a bitter outcome of a void of innovation. In China, stories of wealthy, well-connected contractors using Party-issued permits to build new high-rises abound. And loyal provincial officials share in the spoils of dreary textile mills producing basic products for the West at low cost. But very much lacking, despite 30 years of growth, are analogs to the Hewlett-Packard garage, where David Packard and Bill Hewlett launched their eponymous firm and spawned the entire Silicon Valley boom.

China has failed to so advance because its political and societal constraints on innovation preclude a true flowering of ideas and creativity. Watching the creative destruction of capitalism is not always pretty, and in fact is sometimes downright painful to those afflicted by change. But the inevitable and undeniable truth remains: Creation and destruction work wonders. Societies grow rich by allowing outliers to solve problems and create whole new businesses.

Moreover, the lack of transparency and void of innovation encourage all manner of inefficiencies. For example, China is already the world's second largest energy user, nearly matching the total energy consumed by the United States. But since its GDP is so much smaller, its energy used per unit of GDP ratio is only about one-third of the

U.S. level. And why? Mainly because state-owned enterprises pay little, or even nothing, for electricity. Are you a bit more willing to let the hot water run on and on in the shower of a hotel room or club locker room? Probably yes. On a much larger scale, the politically connected managers of Chinese factories often see little reason to conserve energy. In fact, they're so willing to "let the hot shower run" on China's cement producers, for example, that they use 45 percent more electricity per ton of output than comparable production elsewhere.[33]

Simply put, China is not a driving force of creative innovation. And without innovation, its growth prospects diminish greatly as its society ages and it loses the easy comparative advantage of endless free labor. But really, this void of innovation is not surprising. Rather, it directly flows from the folly of managing a country of 1.3 billion people with a small, secretive collection of allegedly omniscient overlords. As the great Austrian economist Friedrich Hayek remarked:

If the human intellect is allowed to impose a preconceived pattern on society, if our powers of reasoning are allowed to lay claim to a monopoly of creative effort . . . then we must not be surprised if society, as such, ceases to function as a creative force.[34]

Lasting growth requires innovation. Innovation requires openness. But China rejects these principles and will eventually reap the bitter harvest of a misguided and insular model. As we will examine in the concluding chapter of this book, America represents the near polar opposite of all these trends that so afflict China.

If China Catches a Cold, Who Else Will Start Sneezing?

First, it's important to note that, although the media and Wall Street research communities remain uniformly ebullient on China, actual

capital might already be recognizing some of the risks I am detailing. For example, in 2010, a red-hot year for global equities in general, the S&P 500 Index climbed 13 percent and the German DAX rose 15 percent, but China's Shanghai Composite actually *declined* 14 percent. China's Shanghai markets are largely closed to foreigners, though, and are very volatile. Nevertheless, Chinese investors appear to be less willing to eat their own cooking than Western observers are. Even looking at the FXI I-Shares ETF, which trades in the United States and largely replicates the Hong Kong stock market (in U.S. dollar terms), from the beginning of 2010 through the first quarter 2011, FXI returned 7 percent gains versus the S&P's 19 percent gain over those same last five quarters.

Outside of China, the pain should be particularly acute for Australia, which has enjoyed a bit of a miracle growth cycle of its own recently, courtesy of China. Australia functions largely as "China's quarry" by sourcing the iron ore and copper necessary for the massive industrial projects of China. Largely due to exports to China, Australia has thrived in recent years even as the rest of the world peered over the edge during the 2008 credit crisis. In fact, as American housing craters with seemingly no bottom (see Chapter 4), Australia's property markets remain red-hot and its currency trades, as of March 2011, at a fresh 29-year high. But even a modest slowdown in China could quickly imperil the Australian expansion. That expansion Down Under appears very vulnerable, with Florida and Nevada 2007 types of real estate speculation. A study by *The Economist* recently found the Australian housing market almost 60 percent overvalued, the highest on earth (just above Hong Kong) based on price to income ratios and compared to similar rental rates.[35]

As such, I advise avoiding companies with too much Australian exposure, such as BHP Billiton. And for the more speculative and strong-stomached, shorting the Australian dollar via futures, spot FX markets, or the ETF EWA may pay handsomely.

Here in the United States, look to avoid or short the most China-centered companies, names like Caterpillar, General Motors, Union

Pacific Railroad, and United Technologies. But perhaps the simplest and safest way to play a China bubble bursting is to own U.S. Treasuries. A 2 percent yield on 10-year notes might not seem very appealing, but a volatile breakdown in China would send the world into further deflationary pressures. Since the collapse of Lehman Brothers and the credit crisis, the Federal Reserve has rightly been fearful of stubborn disinflationary, if not deflationary, pressures on the economy. As housing prices fall and wages stagnate, structural lower prices beckon. If China, with its massive existing overcapacity, starts to tank under a mountain of bad internal debt, then its only last-ditch hope will be to flood the world with cheap goods, even far below production cost. Such a scenario is frighteningly deflationary. And in that scenario, the world would run to the relative safety of the U.S. Treasury market.

While on the topic of Treasuries, it is worth mentioning that the media, like so many things China-related, completely misunderstand the dynamics of the United States-China debtor-creditor relationship. Yes, China owns a massive amount of Treasuries. And yes, the American government debt problem could spiral out of control if budget changes are not enacted. But who really has the bigger problem, America or China? The notion that China could sell Treasuries wholesale is absurd, as they would immediately realize massive losses for themselves by moving such a giant position quickly. No, the truth is that the Chinese have the problem regarding Treasuries. They are astutely concerned about the debt addiction of the federal government. But since a giant borrower always actually calls the shots to the creditor, it is simply the perverse reality of large-scale indebtedness. To put the situation in everyday terms, if you owe me $100, then it is your problem. If you owe me $1 million, then it is my problem. And the reality is that the Chinese have no alternative deployment for the massive amounts of cash flow they are presently generating from the United States. European sovereign issues weigh heavily on any Euro currency denominated bonds, and Japan's debt woes make the American situation seem downright frugal (as we will discuss in coming pages).

But America will hardly escape unscathed. Quite the opposite, in fact, given how much the developed world, America and Europe, have bet on China as the herd has rushed headlong into the Middle Kingdom. Far too many Americans have been seduced by the stunning scale and near-term efficiencies of economic dictatorship. Indeed, America's large companies, and billions of dollars of investment capital, have bet massively on China, believing the hype generated not just by Beijing but also by Wall Street and the media.

No matter how badly the West wants China to "thread the needle," the Chinese miracle will be revealed as merely a mirage. Central planning failed in the Soviet Union and it failed in Japan. Nor will it succeed in China. And when it unravels, Beijing will turn ever harder, like Michael Corleone, toward force and coercion. Because, like Corleone, the endgame for Beijing and the Party is not capital, but rather power. For now, capital suits the power calculus of the Party and so it dutifully pursues a quasi-capitalist policy of export industry. Once the breakneck pace of growth slows, the government will revert to its more Maoist tendencies toward insularity. Indeed, as Jim Chanos predicts: "Adam Smith is going to get his revenge in China."