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China: The Hazards Of Mental Models

- Investors have relied on several mental models when approaching China. All of these have substantial shortcomings.
- As a consequence, reactions to events and data are colored by confirmation bias, and schizophrenic market reactions.
- The key takeway for investors is that it is no longer appropriate to think of Chinese economic policy in the simplistic way that has been helpful in the past.
- In Xi's China, policy will be clouded by complex tradeoffs and policymakers will inch forward with incremental experiments.

The field of "neuroeconomics" tries to explain why investors rely on mental models, rather than formal logic, to understand and predict economic phenomena. The bipolar nature of consensus views on China's economy make it is an obvious case study in behavioral economics. This is not the place for such a study.

Foreign investors have typically used simple mental models of China...

In this report we unpack the various assumptions underlying the five broad mental models commonly applied to China. All five have a grain a truth to them, but none offer a base from which effective forecasts or investment strategies can be launched. We then offer some an alternative framework for understanding how Chinese policymakers approach economic issues, along with the implications for investment strategy.

...Each of which carries a grain of truth...

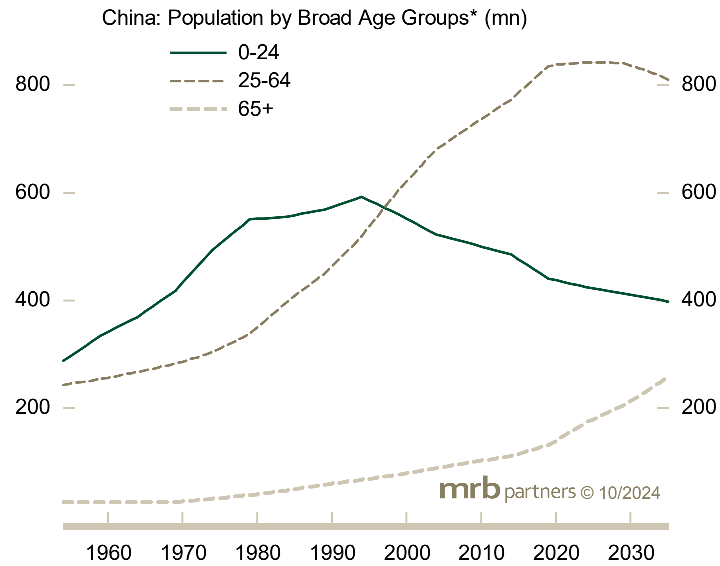
...but none of them offer an appropriate investment framework

1. How Not To Think About China's Economy

We have identified five common mentals models used by foreign observers, whose use causes their interpretation of the latest news item or data release to be colored by their prior assumptions. Thus, investment strategies end up being driven by confirmation biases. Even investors who pride themselves on being contrarians cannot escape, for just because one mental model is "wrong", it does not imply that its opposite is "correct"!

1A. *Demographic Decline And "Japanification"*

Chart 1 Population is Aging And Declining



* Source: UN Population Division

Yes, China's population is falling, and it is aging (**chart 1**). And yes, the starting point for China's demographic decline coincided with an asset bubble. The parallel with Japan's pre- and post-1990 slump and population decline therefore has some initial appeal.

But this model is an imperfect one. China's per capita income, urbanization rate and productivity levels are substantially lower than was the case in Japan in the early 1990s. There is still considerable catch-up potential, as well as opportunities for profitable fixed investment in China[1]. Research and development spending in China remains high, as does the process of upgrading its manufacturing sector. Even the urbanization process has not been exhausted.

Furthermore, China has an enormous pool of human resources in high-value fields of technology and has developed a world-class manufacturing supply chain that is the foundation of its powerful and competitive export sector. It has already successfully transitioned away from low value-added manufacturing and should be able to repeat this feat in the future.

Focusing on demographics offers little insight for a economy where there is still massive upside potential for sustained growth in per-capita income

In other words, China's ***per-capita income still has room to grow substantially***, creating the precondition for a substantial increase in its domestic demand over the next decade.

1B. *Hayek/Minsky Credit Cycle*

China's rapid economic growth since the mid-1990s followed an earlier debt crisis. As state-owned enterprise (SOE) debts were unwound, a new credit cycle took hold and propelled two decades of astonishing credit-led growth. Total debt[2] to GDP exceeded 300% of GDP in mid-2024, and there is plenty of evidence of wasteful investment in fixed assets and housing (**chart 2**). Furthermore, the GDP deflator is flat to negative, indicating that *prima facie*, there is some support for a classic debt deflation as predicted by the Austrian school.

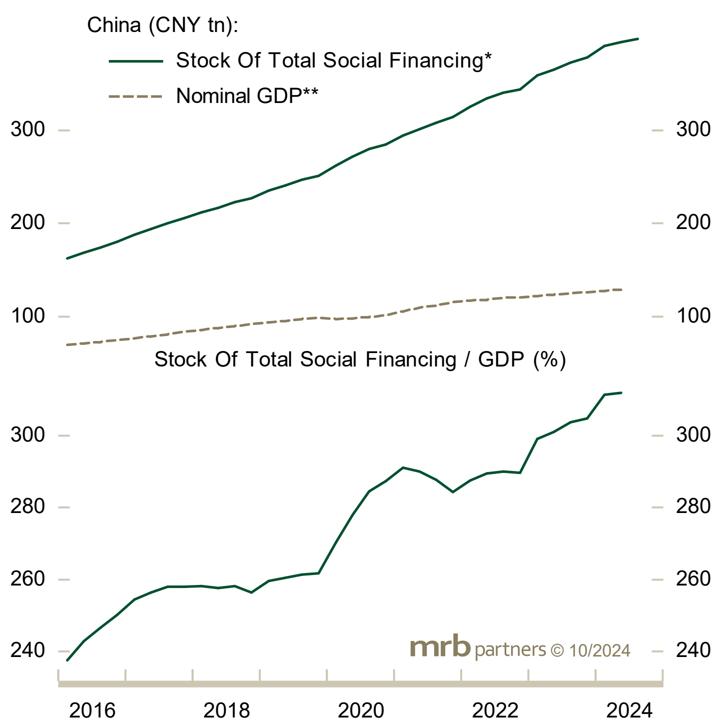
[1] **MRB:** "*Making Money During China's Demographic Decline*", March 21, 2023

[2] Using the measure for aggregate social financing, not simply central government debt.

But this mental model has its limits because it fails to recognize that the commercial banks are overwhelmingly controlled by the government, and the central bank has no independence. In effect, the banking system cannot act as the transmission mechanism that would generate debt deflation. Loan delinquencies are highly selectively applied, there is massive regulatory forbearance and "zombie corporations" abound.

In effect, ***the credit mechanism is a branch of fiscal policy***. Given that China has its own currency and an only partially open capital account, the central government has virtually unlimited scope to counteract debt deflation pressures. The political determination to do so is strong, because the legitimacy of the Chinese Communist Party (CCP) is based on a social compact whereby it delivers a rising standard of living in return for limited political freedom.

Chart 2 Total Debt Levels Are High



* Source: People's Bank of China
** Source: China National Bureau of Statistics

1C. *Schumpeterian Creative Destruction*

The notion of "creative destruction" does have some appeal in describing a Chinese economy characterized by rapid technological progress. Much of the manufacturing sector based on cheap labor and exported goods that was established in the 1990s and 2000s is obsolescent. China is now at the global cutting edge in solar, wind, battery and electric vehicle technologies where it is a dominant global producer (**chart 3**). The investment strategy arising from this mental model is a simplistic sector rotation out of declining sectors (and the banks, on whom they rely) and into the emergent technologies.

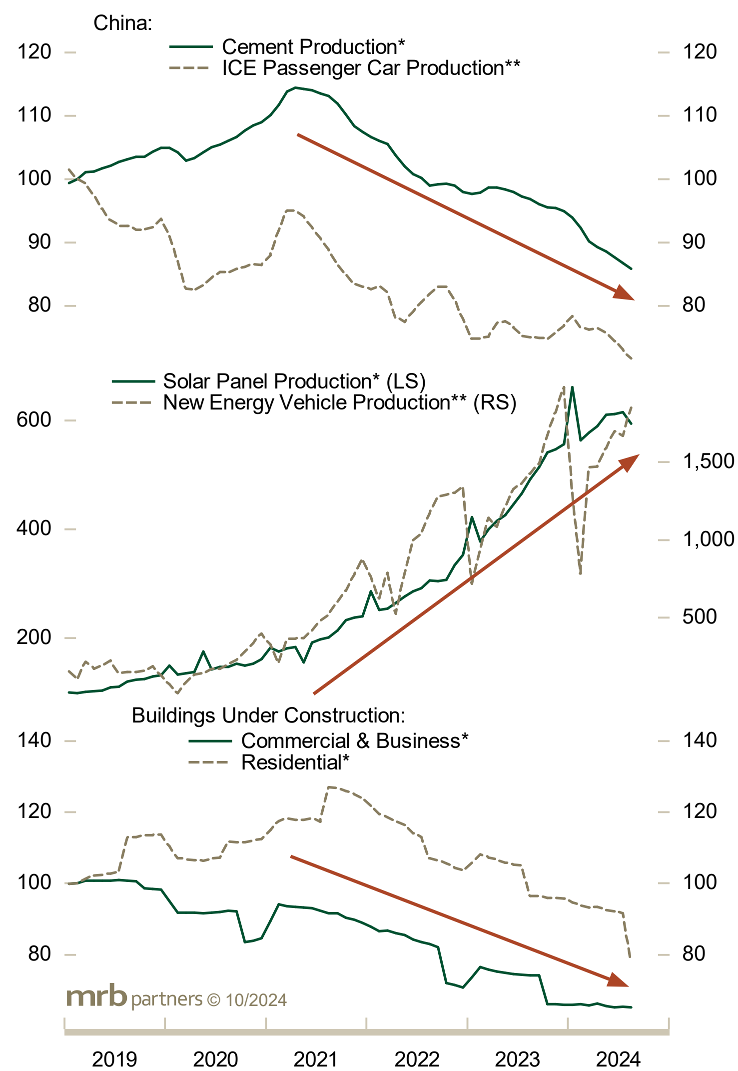
The standard "Austrian" approach looks for debt deflation after excessive credit growth…

…which is short-circuited in China by the fact that bank credit is effectively a branch of fiscal policy

However, the pitfall of this mental model as applied to China's version of capitalism is that the latter only selectively permits annihilation of sunset industries, and at the same time, its industrial policy preselects the scope for sunrise industries. ***Neither is the "destruction" complete, nor is the "creation" unconstrained.*** The entire process is driven by domestic political priorities, involving the primacy of the ruling party and Xi Jinping's dominance of the latter. In effect, the sunset industries can continue to generate positive cash flows while the emergent industries can be plagued by over-capacity and razor-thin margins.

1D. *Standard Business Cycle*

Chart 3 Divergent Manufacturing Trends



* Rebased; source: China National Bureau of Statistics
** Rebased; source: China Association of Automobile Manufacturers

China has witnessed several pronounced business cycles over the past decades. Its large export manufacturing sector was exposed to sharp declines/recoveries in global aggregate demand such as 2008's global financial crisis and the COVID pandemic. The amplitude of its domestic cycle was even stronger, driven by stop-go housing sector policy, with several housing bubbles pricked by tighter monetary conditions, before a rapid reflation of the bubble as policy was relaxed.

Thinking of China's current sluggish growth as primarily a business cycle problem is associated with some major cognitive dissonance: it makes for an exaggerated expectation of a policy "bazooka" to re-ignite growth because it fails to appreciate the structural change that has already occurred and will continue to play out, which implies a falling GDP growth rate (**chart 4**). In other words, ***policymakers see the current subdued growth trajectory as a feature, not a bug***. Policy interventions are mostly to contain risk, rather than to launch the next boom, albeit market reactions to the former can be schizophrenic[3].

Past cycles have been driven either by global events (GFC, COVID) or by stop-go policies to either inflate or deflate a housing bubble

At the same time, as is common across all economies, it is always dangerous to assume that structural impediments to growth preclude cyclical economic growth. China's economy faces significant long-run challenges, and its leadership is not obsessed with short-term growth stimulus, but this will not prevent near-trend growth over the next 1-2 years, and perhaps beyond.

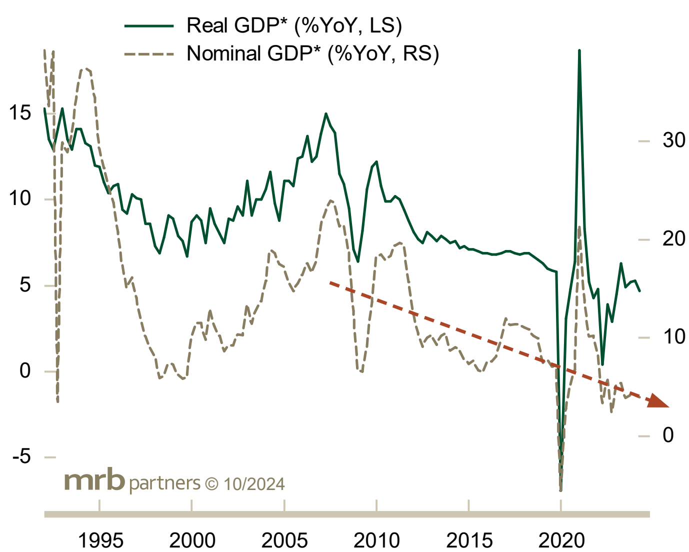
1E. *Marxist/Populist Redistributive Policy*

Most of the reasons why the forementioned mental models have limited applicability relate to the fact that China is only a partly capitalist economy. Some argue that it

[3] **MRB***:* "***China: PBoC Fires Its Bazooka, Banks Will Suffer The Collateral Damage***", September 27, 2024

should be analyzed as if it was pursuing a Marxist, or at minimum, populist economic policy. After all, Xi Jinping is closely associated with a "common prosperity" agenda, and prior to the effective shutdown of the housing market the official mantra had been "*housing is for living in, not for speculation*". Add to this the fact that Marxist theory and "Xi Jinping Thought" are obligatory parts of school curricula, and the ruling CCP has direct control over organs of government as well as the armed forces.

Chart 4 Long-term Downtrend In Underlying GDP Growth



* Source: China National Bureau of Statistics

But this approach also fails, because Xi Jinping's economic policy platform is anything but communist: he is an arch fiscal conservative and believes that market mechanisms play an important role in setting prices as well as allocating capital. Furthermore, the tax system is not particularly progressive for a "communist" economy.

Decades of fiscal repression mean that the primary available path for household capital accumulation has been via the housing market. Even though every urban household was given title to legacy homes left over from the Maoist era (which can be viewed as progressive), there is no property taxation, which means that the subsequent very substantial gains in house prices, accruing to the wealthiest, are left untouched. Direct fiscal transfers to the household sector are very limited, and where they exist (e.g. via the social safety net) are highly skewed in favor of urban (i.e. richer) households.

It is too glib to reduce the Chinese economy to that of a badly-managed populist or socialist behemoth…

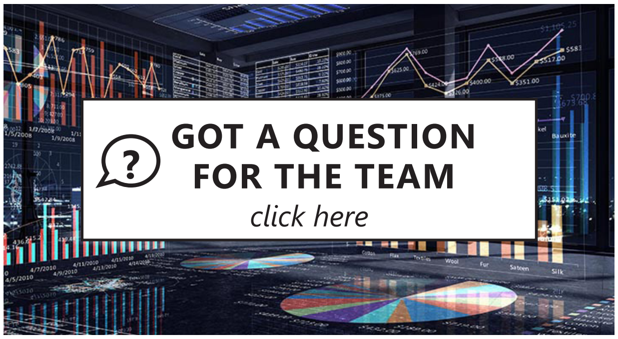
Nor has the crackdown on the housing market since 2022 been progressive in nature. It is resulting in significant wealth destruction for the wealthy multiple homeowners but is not directly helping the plight of the bottom quartile of the population, who see no benefits from the decline in urban house prices. ***Robin Hood may be robbing the rich, but he is not helping the poor.*** Policymakers remain stubbornly resistant to any notion of "helicopter money" or large-scale direct fiscal transfers to the poor[4].

… because Xi Jinping's policies are fiscally conservative and depend on a functional market pricing mechanism

2. Foxes, Not Hedgehogs, Run Economic Policy

Ever since Deng Xiaoping consolidated power in the early 1980s, the single-minded pursuit of economic growth was the central feature of CCP policy. Deng's famous

[4] There have been several instances of direct transfers to the poorest, but they have always been very small and limited in scope.



remark that *"it doesn't matter if a cat is black or white, as long as it catches mice"*, relegated ideology to the back seat and his market reforms raised the prospect for China's economic development to converge on the path of those already traced by Japan, Korea and Taiwan. Most investors believed that it should follow that the achievements and challenges experienced by these economies – including period asset bubbles and debt crises - would be replayed in China. Herein lies the root cause of the discredited mental models discussed above.

China's breakneck economic growth masked the fact that, despite elaborate five-year plans, neither policymakers nor economic agents had any certainty about the speed, trajectory and modality of growth, nor were there any pre-defined guardrails, both in terms of the triggers for counter-cyclical economic management or in the balance of economic power between the public and private sectors.

China's breakneck pace of growth in the past masked the fact that neither policymakers nor economic agents had any certainty about the speed, trajectory and modality of growth...

In other words, nobody knew beforehand how China's large domestic savings surplus would be intermediated, the role of capital (and housing) markets in allocating those savings, or the balance between fixed and productive asset creation. Nor was the commitment to "economic opening" ever translated into concrete targets for the opening of the capital account, the flexibility of currency and interest rate management, or how much inflation/deflation was tolerable.

In the Xi Jinping era, lip service continues to be paid to the pursuit of economic growth, but with a tectonic shift in focus in favor of income distribution and the primacy of CCP. Tellingly, in the aftermath of the state-directed crackdown on property developers in 2021, there has been no coordinated fiscal response to soggier economic growth, such as occurred in 2009 and 2015. With slower economic growth, the ambiguities inherent in Chinese economic policy have become apparent, while policy responses appear "behind the curve" and at best tentative. What most investors miss is that ***being tentative is inherent to Chinese statecraft.***

..."crossing the river by touching the stones" was, and remains, the core principle

"*Crossing the river by touching the stones"* is a Chinese folk saying that justifies pragmatic incrementalism, i.e. taking a step, pausing and evaluating, then proceeding. It can also be used to mean to prioritize stability or adopt a rigorous analysis in the face of change. Because of its common usage and its ideological elasticity, it was widely used to describe policy during the Maoist and Dengist eras, as well as in Xi's ideological environment.

While not a directly analogous concept, there is some echo of this in the proverb that "*a fox knows many things, but a hedgehog knows one big thing*" which is extended to the observation that people can be divided between those whose beliefs are guided by a single defining idea (hedgehogs) and those who rely on multiple experiences and for whom a central causal relationship can never be relied on (foxes)[5]. ***The mental models used by most investors in China are built by "hedgehogs", whereas Chinese policymakers are quintessentially "foxes***."

That is not to say that there are no over-arching policy goals. Xi's China aspires to be the world's largest economy, a military hegemon at least on a par with the United States and remain under the absolute control of the CCP. It wants to be richer, but with an outsized benefit accruing to the lowest income quartiles, with economic growth driven by strategic industrial sectors capable of being globally competitive and an expanding base of domestic consumption.

"A fox knows many things, but a hedgehog knows one big thing"...

...The mental models used by most investors in China are built by "hedgehogs"...

...Whereas Chinese policymakers are quintessentially "foxes"

A concise translation of those aspirations into concrete policy proposals is anathema to the vulpine instincts of the Chinese policymaker. Therefore, statements from the various organs of government will remain as densely written and anodyne – and essentially unhelpful to investors – as they ever were. However, the following framework may be helpful for contextualizing Chinese economic policy in the Xi era:

- Fiscal policy will remain cautious (and probably tight) as the central government pursues a policy of deleveraging local government balance sheets. Over time, the central government's debt will rise relative to GDP, while local government debt will decline.
- The credit impulse will remain negative, or at best neutral. Fixed asset investment will no longer be the primary driver of economic growth.
- Monetary policy will remain reactive and the PBoC's role will continue to diminish. Currency management and bank regulation are already largely determined elsewhere, while the PBoC will be relegated to an implementer, rather than an architect.
- The CCP's social contract is focused on income distribution. Success will be measured by the ability to deliver better economic outcomes to the least affluent. By extension, any discontent amongst the top 1% will be ignored, if not punished.

[5] In the Eurocentric context, this can be traced back to Aesop and Erasmus but similar stories exist in the folklore of many other cultures. Isiah Berlin was responsible for popularizing the idea that there are essentially two ways (fox-like and hedgehog-like) of approaching problems.

- Absolute CCP control should be understood as central control. Local governments will not be able to build independent sources of tax revenue, such as by introducing property taxation[6].

- The goal for the housing sector is to limit economic risks and improve access for low- and middle-income households. It is not to stimulate another round of house price appreciation.

- SOEs will take the lead in implementing industrial policy and employment creation. This does not preclude support for start-ups in strategic sectors, but with SOEs dominating the venture capital ecosystem.

- There will still be plenty of room for the private sector to expand, especially in strategic sectors. However, the source of funding for private firms will no longer be heavily reliant on foreign investors, whether in public or private markets.

China's economic policy in the past could be reduced to a single-minded dash for growth…

…Whereas the policy dashboard today comprises a bewildering array of knobs that may (or may not) strengthen, or attenuate, growth vectors

For the foreign investor, the implication of this framework is that there will be no "hedgehog theme", to justify long-term buy-and-hold positions in China, despite the fact that ***GDP growth and per capita incomes will be rising steadily and that China will continue to outgrow developed market economies***. There will undoubtedly be plenty of cyclical investment opportunities for Chinese assets, particularly when they are cheap, when momentum is recovering from a period of softer economic data and/or when global trade is in a solid expansion phase.

China's economic growth since the early 1990s has been simple: become the workshop of the world and build world-class infrastructure. Henceforth it will be far more complex: encourage mass market (as opposed to luxury) domestic consumption, highly focused technological development and the selective growth of export champions.

In pursuit of such growth, the simple policy dashboard of the past (with toggle switches for fixed asset investment, financial repression and export subsidy) has been superseded by vastly complex policy trade-offs. A few on/of switches have been replaced by a bewildering array of knobs that may (or may not) strengthen or attenuate growth vectors. These will be used gingerly and experimentally, which will often give the impression of policy paralysis. Investors will respond to this uncertainty by demanding a significant and structural valuation discount on Chinese assets.

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[6] There have been various pilot projects testing the implementation of a property tax in recent years. None have gained traction.

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