

Surplus Energy Economics

How the economy REALLY works – Tim Morgan



#130: Grand Bargains, dangerous choices?

Posted on **July 2, 2018**

THE SHARED CHALLENGES OF CHINA AND DONALD TRUMP

One of the most ill-informed critiques of China says that, as a one-party Communist state, the government need take no notice of public opinion. The reality is quite different. It is that a ‘grand bargain’ exists between the state and the public. For their part, citizens accept the denial of certain rights which are taken for granted in many Western countries. In return, the government delivers steady improvements in prosperity.

There’s a striking parallel to this in the United States, because the presidency of Donald Trump is founded on a very similar ‘grand bargain’. Voters disaffected with a self-serving establishment have trusted Mr Trump to restore prosperity. Just like Beijing, he has to deliver.

It’s a measure of America’s political disconnect that, right from the start of his campaign, self-styled ‘experts’ dismissed Mr Trump as a “joke candidate” with no chance whatsoever of making it to the White House. This mis-reading of Mr Trump – and the consequent shock of his victory – was more than just wishful thinking. It was based on a misunderstanding of the central issue at stake.

This issue was, and is, *prosperity*. Whatever conventional economic statistics may say, Americans have been getting poorer over an extended period. This, plus anger at the perceived enrichment of a tiny minority, was the driver behind the Trump victory. It helped, of course, that his opponent seemed to many symbolic of an entrenched and privileged elite. Ultimately, though, “make America great again” translates as ‘make Americans prosperous again’.

In the same box

This interpretation puts America and China in the same box. Both are regimes whose imperative is *the delivery of prosperity for the average citizen*. In America, SEEDS analysis indicates that Mr Trump cannot deliver (and, in fairness, neither could anybody else), because trends that have made the average American 7.5% poorer since 2005 look irreversible. For China, average prosperity *has* increased – by 41% over the last ten years – but continuing to deliver has already become very hard indeed, and isn’t going to get any easier.

The parallel goes at least two stages further, the operative terms being *energy* and *debt*. Chinese energy consumption has increased by 46% over a decade (and it’s far from coincidental that prosperity has expanded by a similar 41% over the same period). But sustaining this critical growth-driver is looking distinctly problematic. Whilst China will seek out every oil supply deal it can get its hands on – helped, perhaps, by the mutual hostility between Washington and Tehran – switching towards coal seems the favoured strategy. America, too, may re-emphasise coal. In neither instance, though, is coal likely to be an effective fix.

Thus far, America has benefited enormously from the dramatic expansion in shale oil output. In this, the United States can be grateful for the irrationality of investors, who have been prepared to pour enormous quantities of capital into a sector which is, by definition, a cash-burner, never having covered its capital costs from operating cash flows *even when oil prices were well above \$100/b*. Tolerance of cash-burning is, of course, a direct corollary of ultra-cheap money.

The fundamental problem with shales is the ultra-rapid rate at which production from individual wells declines. This puts operators on a ‘drilling treadmill’ which requires ever more drilling just to sustain output, never mind increasing it.

It helps shales, of course, that investor generosity looks almost limitless. Anyone who can ignore the mismatch between record equity values and deteriorating

prosperity – and who can meanwhile buy in to the issuance of perhaps \$1 trillion of debt for no better reason than stripping equity out of corporate capital structures – isn't likely to balk quickly at cash-burning by shale companies. Even so, there must be limits to how quite much more capital shale drillers will be allowed to burn their way through.

Fortunately or not – and from what we can judge from their actions – America's military leaders seem more realistic, certainly where shales are concerned. Service chiefs, it seems, have never bought in to the “Saudi America” narrative of energy independence. The Navy's carrier groups, costly assets whose main functions include both power projection and the defence of seaborne energy supplies, have not been sent to the scrap-yards. Neither has America de-emphasised the policy importance of the Middle East.

Fundamentally, both Beijing and the Trump administration need to deliver prosperity – and energy is the greatest single threat to their ability to do so. The real issue here isn't just the maintenance of supplies, but cost. The relentless rise in ECoEs is felt first in the cost of essentials, not just energy itself but utility bills and all the other non-discretionary outlays which drive a wedge between income and *prosperity*. ECoE is the big problem, for Mr Trump as much as for Beijing.

Debt and self-deception

If energy is one problem facing both America and China, another is debt. More specifically, it's dependency on a *continuing* process of credit creation, a dependency which lies at the heart of the “monetary adventurism” which has characterised the economic landscape since the 2008 global economic crisis (“GFC I”).

Here, time-sequencing has differed between China and the United States. Between 2000 and 2007, America (and most other Western economies) went on a debt binge. In the US, and stated at constant 2017 values, debt grew by \$12 trillion over a period in which GDP expanded by only \$2.6tn. This – helped, of course, by acquiescence in increasingly dangerous practices – led straight to GFC I.

Prior to 2008, Chinese policy on debt had been fairly conservative. What we've witnessed since has been a truly breath-taking change. Stated at 2017 values, Chinese GDP and debt in 2007 were, respectively, RMB 37 trillion and RMB 60tn. Today, those numbers are RMB 81tn (a 120% rise in GDP) and RMB 251tn (a 320% leap in debt). Whilst GDP has expanded by RMB 44tn, debt has soared by RMB 191tn.

Even more strikingly, the rate at which China has been borrowing over the last decade has averaged RMB 19tn annually. GDP has averaged RMB 60tn over the same period. So, on average, *China borrows close to 32% of GDP each year.*

Nobody else comes anywhere near. America typically borrows 5.8% of GDP annually. That's more than twice the rate of the most optimistic interpretation of growth, so it's not sustainable, and highlights how much "growth" has been nothing more than the simple spending of borrowed money. But it's nowhere near the 31.8% of GDP borrowed annually by China since 2007. The global equivalent is 9%, but that, of course, is heavily skewed by China.

It has been suggested that China is throttling back on its propensity to pile up debt. There's limited truth in this, in that China borrowed "only" 30% of GDP last year, compared with 38% in 2016 and 35% in 2015. But the numbers continue to look bizarre, unsustainable, and – potentially – lethal.

The United States, meanwhile, looks increasingly likely to revert to pre-2008 borrowing patterns. The budget outlook is for much higher levels of annual borrowing by government, whilst there seems to be no end in sight to the irrationality of converting corporate capital from equity into debt, not to mention the continued willingness of investors to finance cash-burners.

(In fairness to investors, it should be recognised that ultra-cheap monetary policy has presented them with 'no good choices', only bad ones or worse ones).

Both public and private borrowing – and especially the latter – keep injecting yet more leverage into a system already awash with risk.

China – the *why*?

As we've seen, the sheer rate at which China borrows looks reckless in the extreme. But 'reckless' isn't an adjective that many would apply to the government in Beijing. Why, then, has China seemingly turned into a debt-junkie?

The answer lies in the prosperity imperative of the 'grand bargain'. For the average Chinese citizen, prosperity has three main meanings – employment, wages and household expenses (which include housing itself). Of these, employment

predominates. What this means for the government is that employment *must* continue to grow. It must grow at rates which not only exceed the rate at which population numbers are expanding, but must also increase at least as quickly as workers migrate from the countryside to the cities.

In stark contrast to Western profit orientation, this makes China a volume-seeker. If employment is the overriding objective, profit matters less. For businesses heavily influenced by state objectives, expanding employment (and hence growing output volumes) is an imperative, almost irrespective of profitability. An enterprise succeeds by this criterion if it grows employment, even if this achieved at a loss.

This shows up in the figures, where business has accounted for most (68%) of all of the RMB 191tn borrowed over the last ten years. Essentially, business has borrowed for the twin purposes of financing losses and expanding capacity. The latter, of course, has the by-product of depressing margins, often pushing returns on assets to levels well below the cost of capital. China is therefore in something of a vortex, where new capacity requires borrowing whilst simultaneously undermining the ability to service existing debt. An apparent effort to convert debt into equity failed pretty spectacularly, when it came close to crashing Chinese equity markets.

In one sense, this use of debt to sustain and grow volumes has a direct corollary in the West, where “zombie” companies have been kept alive both by ultra-low interest rates and by the willingness of banks to roll over (by adding interest to capital) debts which would otherwise have had to be recognised to be non-performing.

In another way, using debt to finance capital investment may seem very different from the West’s use of credit to bolster consumption. The difference narrows, though, when it is recognised that the Chinese version, too, uses debt to underpin the incomes of working people.

Moreover, the priority placed on volumes over profits has implications for trade, where Washington, at least, isn’t prepared to accept the continued influx of products seemingly produced ‘at a loss’.

Any way out of the box?

As we’ve seen, America and China are in the same box, both having an imperative need to deliver prosperity at a time when this is becoming ever harder to achieve.

In both instances, debt is simply a time-buying expedient, creating apparent prosperity in the short term, but at severe expense and risk to the collective balance sheet.

These debt-based responses are not just unsustainable but are highly risky, too. According to SEEDS, the sheer scale of indebtedness – and the truly shocking rate of ongoing credit dependency – puts China in the highest-risk category, along with Ireland, Britain and Canada. America's level of risk isn't quite so elevated, and it's no coincidence at all that the energy challenge, too, is less acute for the United States (for now, anyway) than it is for China. Another big difference is that China's ills are the product of circumstances, whereas much of the escalation in American risk is self-inflicted.

It's interesting to speculate on quite how far the parallel risks of America and China are recognised at the level of policy. From the Chinese side, we can be very confident that the energy challenge is recognised, and we can assume, too, that Beijing is well aware of the debt problem. Here, it cannot be emphasised too strongly that the issue isn't simply the absolute quantum of debt but the extent of *dependency* on the supply of credit continuing at quite extraordinary levels. (This is why SEEDS measures these two risks independently).

The combination of risk and sheer size must put China near the top of the watch-list for those monitoring the likeliest epicentre for the start of GFC II. Whilst we cannot rule out, for instance, market slumps in the United States, a property price crash in Canada, debt problems and instability in the Euro Area, and further rapid economic deterioration in Britain, the combination of energy and debt risk in China dwarfs these threats, serious though they are.

It is sometimes observed that China's banks are, in effect, under state control, as though this makes a potential rescue a simple and painless matter. In reality, the difference between the Chinese and Western positions is far less than it appears. Western governments, no less than Beijing, would have to stand behind their banks in the event of a wave of cascading defaults. It's pretty easy to envisage a Western government having to nationalise (by whatever name) a bank whose equity value has disappeared.

The obvious solution might appear to be for the Chinese government to simply take bank debt onto the public balance sheet. The snag is that this involves issuing RMB to the extent of the banks' uncovered liabilities. This reminds us of the

observation that, in the end, *the world's debt problem is going to turn into a currency credibility problem.*

The claim that money creation through QE 'isn't inflationary' rests on a narrow definition of inflation. If your definition of inflation includes only CPI, this assertion may be true. But, if it is recognised that asset price inflation matters at least as much as retail prices, QE has already been extremely inflationary. Using monetary issuance to tackle stratospheric debt levels and bloated banking systems cannot be undertaken without severe currency risk.

What we are left with is that, on a worldwide basis, we have compounded "credit adventurism" with "*monetary* adventurism" in trying to square the circle of deteriorating prosperity. The snag is that neither credit nor money can resolve a problem which has its roots in energy.

Ultimately, rising ECoE is making us poorer, and is doing so in ways that may not be acceptable politically, but which cannot, without grave and compounding risk, be wished or manipulated away with monetary tinkering.

= = = = =

SEEDS 2.19 China 030718