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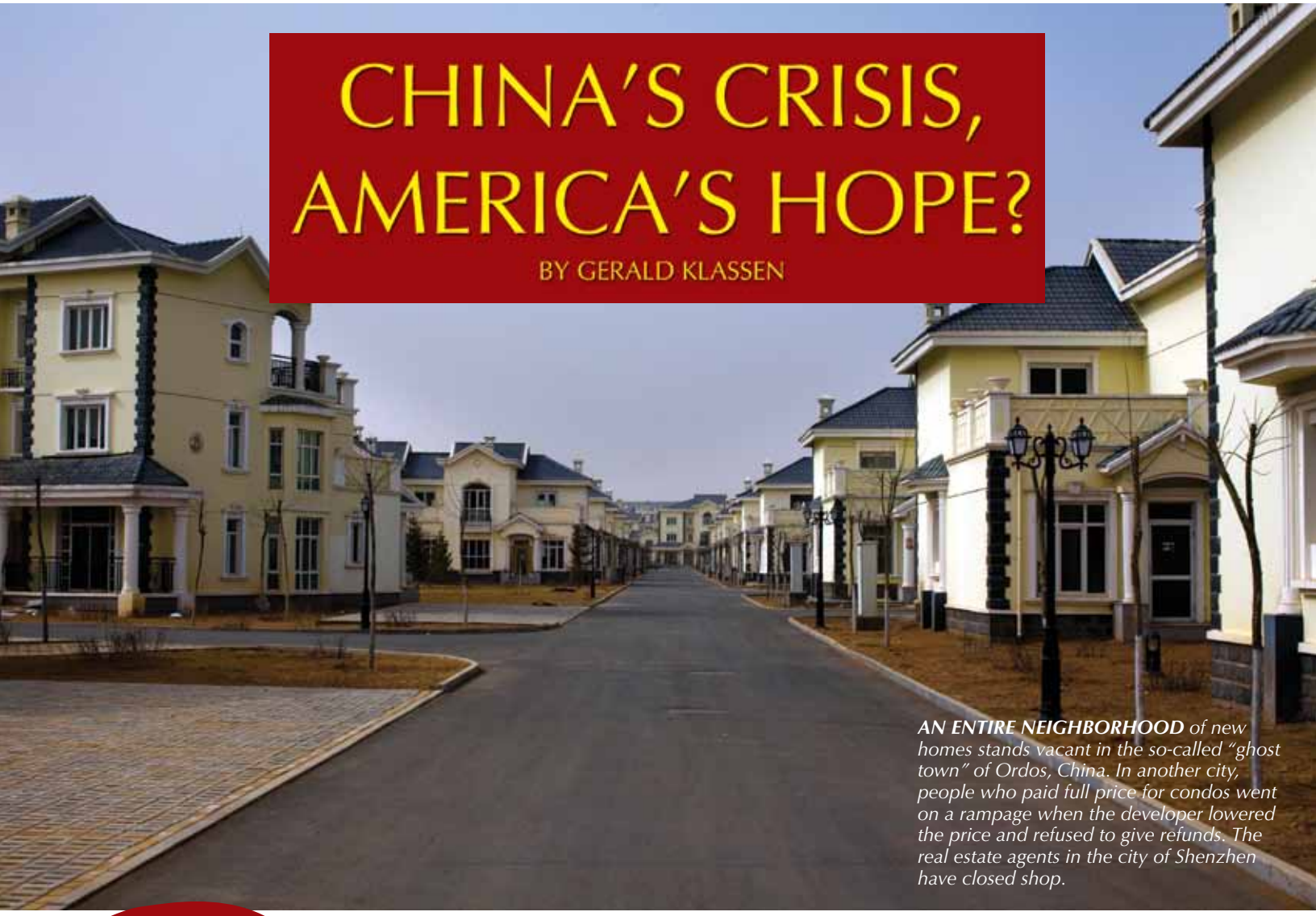
CHINA'S CRISIS, AMERICA'S HOPE?

BY GERALD KLASSEN



***AN ENTIRE NEIGHBORHOOD** of new homes stands vacant in the so-called "ghost town" of Ordos, China. In another city, people who paid full price for condos went on a rampage when the developer lowered the price and refused to give refunds. The real estate agents in the city of Shenzhen have closed shop.*

Recent signs of an economic slowdown in China have American investors concerned. The predominant hope has been that growth in Chinese consumer demand could lift developing world economies in this time of crisis.

But what if the Chinese economy is cooling? Could a "hard landing" in China erase potential for export job growth in the United States? How would a bursting Chinese real estate bubble affect the U.S. economy?

AT ITS NEW PLANT *in Victoria, Texas, Caterpillar will manufacture excavators previously imported from Japan. The cost advantage of manufacturing in Asia is rapidly shrinking, causing manufacturers to expand production in the United States.*

China holds significant sway over stock investor sentiment. Three days prior to the March 2009 U.S. stock market lows, China announced a massive four trillion yuan ($586 billion; 8.4 percent of China's 2009 GDP) fiscal stimulus package to spur economic growth. It also expanded bank lending by nine trillion yuan in 2009, representing a 30 percent increase in total banking system loans. The U.S. stock market immediately rallied with a meteoric bull run spurred by hopes that emerging economies would grow and increase demand for goods and services from U.S. companies.

In his January 2010 State of the Union address, President Obama set a goal of creating two million jobs by doubling U.S. export growth over the next five years. He did not lay out a detailed plan to accomplish this, but he started the National Export Initiative to help farmers and small businesses increase their exports. No doubt he was eyeing China as a major source of demand.

China's Economic Problems

Although there are significant differences between the Chinese and U.S. economies, China's recent economic downturn has much in common with the U.S. downturn of 2007–08.

China's economic growth has slowed for three straight quarters, and economists expect growth to drop below 9 percent for the first time since 2001. While that is strong growth by developed world standards, the Chinese believe the minimum GDP growth rate required to create sufficient jobs to prevent civil unrest is 8 percent. Rapid growth in Chinese cities, whether by private or public investment, is necessary to create new jobs for workers migrating from rural areas. Slower growth, they believe, will leave many migrant workers out of work and inclined to disorderly conduct. The coming year could test that theory.

The Chinese manufacturing sector is on the edge of contraction. The official purchasing-managers index fell to 49 in November 2011, matching the lowest reading since February 2009.

China's stock market is down 30 percent since May 2011 and 60 percent from four years ago. The Chinese National Social Security Fund (NSSF) has announced plans to spend ten billion yuan ($1.58 billion) to support stock market prices by purchasing local stocks.

Average property prices in China declined for the second straight month in November 2011. Prices of newly built homes in 49 of 70 medium-sized Chinese cities fell that month on a sequential basis, up from 34 cities in October.

Prices of new homes in major cities were down slightly compared with October 2011. As late as 2010, average home prices rose 12.8 percent year-over-year. The government is now working to support property prices. Roughly 25 percent of China's GDP comes from housing and related industries. Wang Tao, China economist at UBS, estimates new housing starts fell 2.2 percent year-on-year in October including housing starts by the government.

Falling property prices are causing wealth to fall in Chinese households. Approximately half of China's household wealth is tied up in property. In the town of Ordos, a symbol of China's property boom, most households own two or three properties, and many have seven or eight. Transaction volume in Ordos has plummeted, and prices have started to fall. Across China, growth in new housing starts is

close to zero, and one developer plans to slash starts by 40 to 50 percent in 2012. Nationwide, 3.6 billion square meters of property were under construction at the end of October 2011 compared with sales of 709 million square meters in the first ten months of the year.

Developers Feeling Crunch

Chinese developers are in distress. The Council on Foreign Relations reports that Shanghai developers recently slashed prices on their luxury condos by as much as one-third. Crowds of people who had bought apartments at full price converged on sales offices throughout the city, demanding refunds. Some of them went on a rampage, breaking windows and smashing showrooms.

According to property agency Homelink, new home prices in Beijing dropped 35 percent in November alone. Another property agency estimates that Beijing developers have 22 months of unsold inventory and Shanghai has 21 months.

Half of the real estate agents in the city of Shenzhen have closed shop. More than 100 local government land auctions failed last month, and Beijing land sale revenue was down 15 percent in 2011.

Chinese investors have been largely responsible for the recent run-up in real estate prices. Estimates of investor-owned vacant homes range from ten million to 65 million units. A significant portion of the 2009 bank-lending stimulus was used to develop new housing units.

Developers in many cities have stopped purchasing land at local government auctions. In the first nine months of 2011, land sale revenue in 17 of the top 30 cities declined, and in three cities, the fall topped 35 percent. Local governments depend on land sales to raise money for building the roads, schools, hospitals and other projects Beijing has directed them to construct. Falling land revenue will cause many local governments to default on loans they took out during the massive 2009 bank-lending stimulus. Credit Suisse estimates that loan losses at Chinese banks may be equivalent to 60 percent of equity capital if real estate companies and local governments fail to repay debts.

Capital is now flowing out of China as the prospect for the rising yuan relative to the U.S. dollar diminishes. The rush of capital into China contributed to real estate development and economic growth. The flow of capital out of China is placing a strain on property prices and reducing credit availability. The yuan recently declined against the U.S. dollar as the People's Bank of China allowed it to trade at the low end of its currency exchange rate band.

The fixed investment that has fueled economic growth is unsustainable. Fixed investment in China is forecast to reach 60 percent of GDP in 2011, up from 50 percent in 2010. No country has ever had more than nine years at 33 percent yet China is in its 12th consecutive year above this level.

Wage inflation is reducing China's manufacturing cost advantage. Many manufacturers can no longer absorb wage increases, so they are passing them along to buyers.

The Chinese export engine may have reached its peak. China is the world's largest exporter and accounted for 10 percent of global exports in 2009, up from 3 percent in 1999. From 1998 to 2008, China's exports grew at an annual average of 23 percent in dollar terms, more than twice as fast as world trade. If it continues to expand at this pace, it could grab one quarter of world exports (and many more jobs from other countries) within ten years.

That would beat America's 18 percent share in the early 1950s, a figure that has dropped to 8 percent since. As a comparison, the "miracle" economy of Japan (see "Land of the Setting Sun," p. 18) peaked with a 10 percent share of global exports in 1986.

Wage inflation is reducing China's manufacturing cost advantage. In November 2010, Dallas Federal Reserve President Richard Fisher made a speech in which he commented that the Chinese government was encouraging manufacturers to grant wage increases of 15 to 20 percent to "goose up" domestic spending. He also noted that Chinese manufacturers of low-tech products sought price increases of 30 percent over current levels to supply goods to U.S. importers for fall of 2011.

During the 2011 shopping season, U.S. consumers paid higher prices for Chinese-made goods. Retailers are having to push through higher costs for their imported goods to maintain profit margins. For example, 80 percent of U.S. shoe imports come from China. The Labor Department reported that imported-footwear prices were up 6.1 percent year-over-year in November. China accounts for 60 percent of imported furniture, and those prices were also up 6.1 percent. Eighty percent of imported luggage comes from China. Prices of imported luggage rose 8.3 percent year over year in November.

Higher prices for Chinese imports have contributed to rising consumer prices in the United States. In the past, Chinese manufacturers have been able to absorb wage inflation by accepting lower profits to keep export prices down. Many are reaching a point at which they can no longer absorb wage increases, so they are passing them along to buyers.

China's population is aging rapidly, and the reserve of future workers is declining. Those younger than 14 now make up 16.6 percent of the population compared with 23 percent ten years ago. Those older than 60 now account for 13.3 percent of the population compared with 10.3 percent in 2000.

LOGISTICS PLAYED *an important role in Caterpillar selecting Victoria, Texas, for its new facility. Having an advanced, integrated supply chain like those found in Asia will be key to attracting manufacturers to Texas. Rail providers like Kansas City Southern and Union Pacific will play important roles.*

An energetic, young workforce is necessary to keep wages low and power economic growth. The Chinese government's one-child policy is a threat to future economic growth. Japan exemplifies the challenges an export-led economy faces when the workforce is aging rapidly, and social policy prevents needed population growth.

History Repeating Itself

China's economic path over the past ten years and its impact on the United States share many similarities with the Japanese experience of the 1970s and 1980s but on a larger scale. For example:

- A long run of rapid growth in the export-led manufacturing sector preceded a property bubble in China as it did in Japan.
- Americans feared the rise of China's economic might just as they feared Japan's economic rise.
- U.S. manufacturing workers suffered most as their jobs were outsourced first to Japan and then to China.
- U.S. investors in emerging economies benefited the most from skyrocketing stock and real estate prices in Japan and then China.
- Rising wealth in Japan spilled over into acquisitions of U.S. real estate just prior to the bursting of the Japanese property bubble. Wealthy Chinese similarly have acquired significant amounts of U.S. real estate in the past few years.

U.S. politicians, gross domestic product and mortgage borrowers have all benefited from deficit spending as first the Japanese and then the Chinese used their profits from U.S. exports to purchase U.S. Treasuries and mortgage-backed securities.

Brighter Days for U.S. Commercial Real Estate

The imbalances that have existed during the rise of Japan and then China appear to be reaching their endgame. The widespread cost advantages from low wages and cheap currency have eroded on a large scale as reflected in rising U.S. import prices. There doesn't appear to be another large emerging market capable of the economic expansion achieved in both countries. So what happens next?

A clue to the answer exists in the relatively strong performance of the U.S. manufacturing sector during this recovery. While not earth shattering, U.S. manufacturing indices have performed well in the past two years. Importers are beginning to seek sourcing alternatives to China because the "Chinese price" is reaching parity with U.S.-sourced goods in some sectors. And U.S.-sourced orders mean shorter lead times, common business practices and better customer relationship management. The bottom line is that economic activity that was previously outsourced to Japan and China could be coming back to the United States.

This is great news for the U.S. commercial real estate community. As capital exits emerging markets and returns to the United States, it will be available to fund new factories, warehouses and transportation infrastructure needed to support a renaissance in U.S. manufacturing. As importers source more of their goods domestically, manufacturing workers may see an increase in employment opportunities.

Reversing the imbalance could also present a challenge to the U.S. economy via decreased funding for U.S. deficits. What happens if China needs to use 50 percent of its foreign currency reserves to recapitalize its banking system after the property bubble bursts? What happens when the flow of U.S. dollars to China and Japan slows as manufacturing moves to the United States and other countries? Who will purchase the U.S. Treasuries and mortgage-backed securities used to fund American consumerism?

The hope that President Obama and investors have placed on China fueling export-led U.S. job growth may be misplaced. Chinese wage inflation and the bursting of the Chinese property bubble may be the start of global rebalancing that produces domestically fueled job growth in the United States.

And that would give Americans real hope.

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THE TAKEAWAY

Some view the economic slowdown in China as a threat to the U.S. economic recovery. But it could be an opportunity for job growth in U.S. manufacturing and expansion in U.S. commercial real estate.

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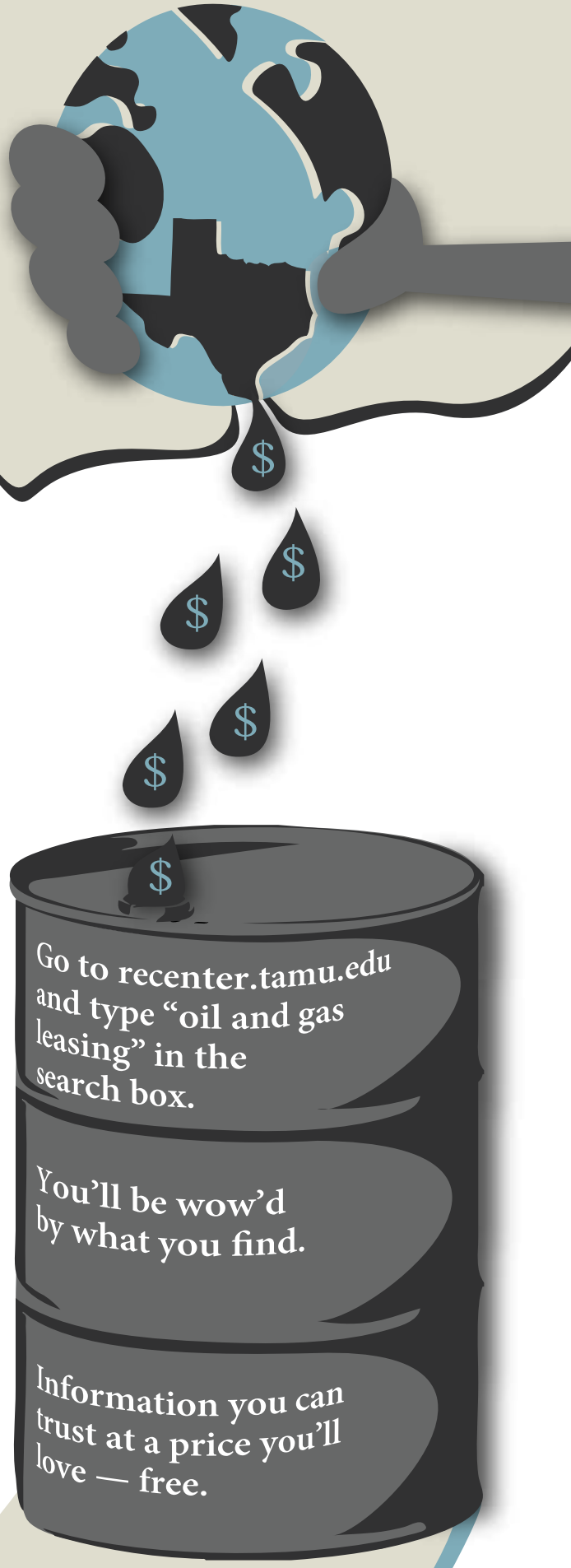
The oil and gas reviews are in!



Colossal!*

*Amount of oil and natural gas drilling in Texas.

Immense!**

**Amount of knowledge landowners need to negotiate an oil and gas lease.

Monumental!***

***Amount of oil and gas leasing information available on the Center's website.

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