Letter 47

What about the Chinese shadows?

"The perfect traveler does not know where he is going; the perfect contemplator does not know what is before his eyes."

Chuang-Tzu

- Like the contemplator described by ***Chuang-Tzu,*** let us recognize the difficulty of deciphering China's prospects. Modesty is essential and we will proceed methodically, firstly, in the first part, a presentation of the cyclical slowdown, then in the second part, the examination of the causes of a structural slowdown and finally, in the third part, the modalities of a reorientation of the growth model.

But let us start with three points:

- ***The undeniable successes:*** twenty years ago, when China joined the WTO, the World Trade Organization, China's GDP was $1.3 trillion and that of the United States $10.6 trillion, today, it is $14.3 trillion compared to $21.4 trillion for the United States.
  Twenty years ago, GDP per capita was $1,000, today it is $10,000. This is an unprecedented performance, even if the current figure remains one-sixth of US GDP/capita.
  China has taken advantage of trade liberalization to become the world's leading exporter with $2.5 trillion, or 16% according to Eurostat, the 3rd largest importer with 13.1% of the world's total, behind the EU 13.7% and the United States 16.1%. China, like the Americans, has more than 120 of the world's 500 largest companies.
  Gradually, China is trying to promote domestic consumption and thus, the share of exports in GDP, 35% in 2010, is now at 20% and the trade surplus has fallen from 10% of GDP in 2007 to 1% today.

- ***The emergence of structural problems:*** we think of ageing, overcapacity in many sectors, overinvestment in infrastructure (8% of GDP/year), the very high number of empty homes, the high debt of developers, the indebtedness of the provinces, the situation of state-owned enterprises, the criticisms aroused by the Silk Roads, and the barriers erected by the United States and Europe against Chinese trade practices. Americans and Europeans denounce the size of the trade deficit with China, $255 billion for the United States, $180 billion for Europe, and they deplore the cost in industrial jobs of Chinese competition, 600,000 in the United States between 1999 and 2011 out of the 12 million currently employed.

- ***The brakes on stimulus measures:*** before Covid, China contributed to 35% of global growth, today it contributes 25% and tomorrow, less because, according to the OECD, the Chinese real estate crisis could cost 2 points per year to Chinese domestic demand, and thus 0.4 points to global growth.
  China can, as in 2008 and 2014, lower interest rates and increase infrastructure spending, but it is stymied by the debt burden, mainly from provinces, local authorities, and businesses.
  As a result, we will no longer see the double-digit growth rates of the last thirty years.

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The economic slowdown:

- ***The deterioration of the indicators:***

The PMI reflects a contraction in manufacturing activity for the 2nd month in a row. The decline was due to power cuts, shortages of certain components, rising material costs and a slowdown in the real estate sector.

In November, amidst a regional lockdown, the Caixin manufacturing index recorded a slight dip to 49.9, indicating weak demand, declining purchasing power and worsening employment with the unemployment rate recently up to 5%. Car sales have been declining for the past six months.

In November, industrial production increased by 3.8% year-on-year and retail sales fell to +3.9% year-on-year. These figures are weak compared to China's history.

More fundamentally, business investment in machinery, which had long been growing by 20 to 30% annually, has been expanding slowly since 2015.

Finally, in the 3rd quarter, real estate sales fell by 12% year-on-year and, in September, 27% of land auctions failed to find buyers. Housing starts over the January-October period fell by 7.7%.

The slowdown in real estate is an upstream threat, for example for steel as 50% of production is used in the construction sector. Another example is iron ore whose price has fallen 50% since the end of July and the share price of Vale, a major producer, has fallen.

- ***Late payments or defaults by several real estate developers:***

The sales value of the top hundred real estate developers are down 37% year-on-year according to China Real Estate Information Corp. And this is one of the causes of the sector's difficulties.

The first consequence is that unpaid real estate debts have reached nearly $15 billion since the beginning of the year.

Secondly, banks could be weakened because bad debts as a percentage of outstanding loans, currently at 1.7% and lower than the 3.5% observed in 2006, could worsen and because the sector's debts are underestimated: part is accounted for in "joint ventures" with options to sell their stake to developers and the outstanding "junk" loans are approaching $200 billion.

The third consequence is the difficulties of many developers:
Evergrande, the 2nd largest property developer with a turnover of $78 billion is struggling with $90 billion in debt, 40% of which is due in less than a year, $20 billion in foreign debt, and $300 billion in commitments. *Kaisa Group* has an international debt of $11 billion. Both have formally defaulted on credit terms.
Evergrande is restructuring because the company failed to sell its Property Service division to Hopson for $2.6 billion and thus no longer able to meet its debt maturities. The government has asked the owner of Evergrande to use his assets to reduce debts.
Huarong is expected to receive $6.5 billion in capital from state institutions after recording $16 billion in losses in 2020.
Modern Land, a real estate developer, did not honor the payment of a due date. *Fantasia*, specializing in luxury real estate, and *Sunshine 100* are also in turmoil and have defaulted.
The debt of the developers is the subject of various evaluations, $2.8 trillion according to Morgan Stanley, $5.2 trillion according to Nomura, both very high figures that do not take into account off-

balance sheet and "shadow banking" which is difficult to assess. Only 5% of this outstanding is in the form of bonds in $, the rest in the form of bank loans, pre-sale or supplier credits.

- ***Stimulus measures:***

The Central Bank has just lowered reserve requirements to stimulate the economy. This is the second time this year that this measure has been taken, given the scale of the property crisis and the slowdown in the economy. This decision will inject nearly $200 billion into the economy. Other actions are expected such as lowering interest rates or providing aid for the financing of infrastructure.

The structural slowdown:

- ***The real estate crisis:***

If real estate contributed about 2 points of growth each year, today it takes away more than 1 point and in the coming years, it will be the same because residential construction is expected to decline. The real estate sector, according to ***Krugman,*** accounted for nearly 30% of GDP, according to other estimates 14% and according to Goldman Sachs 23%. So be careful with these various figures, but even the lowest is significantly higher than the figures recorded in other countries.

Many households affected: in recent years, Chinese households have invested most of their savings in real estate. Not only is the ownership rate 90%, which is high based on international standards, but a number of urban households have several apartments intended for rent where some of which are empty.

Unsold stocks: residential investment accounted for 11% of GDP in 2020 against 6% at the peak in the United States in 2006 and 7% in Japan in 1988. Nationwide, the number of empty houses is estimated at 70 million, and the number of houses under construction at approximately 100 million. Real estate inventories would represent 18 months of sales, a less problematic level than in 2015, but the rate of urbanization is higher.

A real estate bubble: the value of real estate assets would reach $62 trillion (according to China Real Estate Information Corp), the equivalent of more than 4x GDP, or even, according to other estimates at $80 trillion, or 6x GDP, compared to $34 trillion in the United States, or 1.5x GDP.
The most conservative estimate is equivalent to 7x the Chinese stock market capitalization against 0.7x in the United States.
The price of housing in Beijing is more than 25x the average annual disposable income compared to 7x in New York.

- ***Aging:***

Like Japan in 1990, China is facing aging but the standard of living per capita is much lower, 1/6th of the American against 4/5th for Japan at that time.

Low birth rate: since 2013, there has been a drop in the number of marriages, from 24 million per year to 14 million. The promotion of the two-child policy in 2016 was not successful. Only 12 million births in 2020 against 17.5 million a few years ago, that is a fertility rate of 1.3/woman, far from the 2.1/woman needed to replace generations.

The cause: one of the reasons is the weakness of social protection, that is to say the cost of education, the weakness of pensions, the low level of health expenditure (less than 8% of GDP compared with 15% in Europe and 18% in the United States).

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The consequence: the population is aging rapidly. The Chinese population pyramid is that of Japan in 1992 and in 2035 it will be that of Japan in 2018. The median age, close to 40 years, is now higher than in the United States and by 2050 will be that of Europe, at nearly 48 years. The number of people over 65 is expected to double from 150 million to 300 million within 20 years.

Thus, logically, the active population has been declining since 2012.

- ***Corporate debt:***

Corporate debt has exploded in recent years, from 95% of GDP in 2008/2009 to 160% of GDP today.

The reorientation of the growth model and the closure of the country:

Export remains a key variable and China has been able to take advantage of the Covid crisis to increase its market share in global manufacturing production from 25% to 30%.

- ***Reorientating the model:***

Overinvestment: China has built nearly 19,000 kilometers of high-speed rail lines in the past five years and has a network of 38,000 kilometers, equivalent to two-thirds of the world's total. It has opened 10,000 kilometres of motorway every year since 2011 and has added some 40 airports in the last five years. It has also invested heavily in 5G.

Over-indebtedness: these exceptional developments in terms of the speed of deployment were made at the cost of a problematic debt for many public companies and local authorities and in defiance of profitability calculations.

Accusations of dumping: China is the EU's largest trading partner. But the EU has a trade deficit of €180 billion and is organizing itself to react. Chinese FDI in the EU + UK, following a peak of €44 billion in 2016, has steadily declined to €12 billion in 2019 and €6.5 billion in 2020 as the Brussels Commission's controls are better coordinated.
The European Union accuses China of dumping and imposes, for example, taxes between 20 and 45% on Chinese exporters of fibre optic cables.
The main entry point for Chinese goods is the port of Athens, which is two-thirds owned by Cosco. Traffic has increased six-fold between 2009 and 2018. Negotiations with the Italians for the ports of Trieste and Genoa have been abandoned.

The new priorities: officially China wants to depend less on exports and more on the domestic market, less on investment in infrastructure and real estate and more on consumption or a few priority sectors.
Although the country's growth is tending to slow down to around 5%, it is holding steady in the priority sectors: in September, the production of robots was up 35% over 1 year, and semiconductors up by 19%. Electric cars (BYD the leader, but also NIO and Xpeng) and autonomous vehicles are two other favored sectors and 1/5th of the cars sold are 100% electric. In electric batteries, a sector closed to foreign competition, CATL is the world leader ahead of South Korea's LG and another Chinese company, BYD.

- ***Closure:***

The economic angle: the Americans, yesterday under President Trump and today with President Biden, have been working to limit Chinese access to technology and research with the exclusion of Huawei from the US telecommunications market, the closure of a Chinese consulate in Houston and the distrust shown towards Chinese students in US science universities as emblematic examples.

The Chinese took the ball and ran with it and leveraged Covid to close their borders. Academic exchanges with other countries and the dissemination of information by journalists on subjects deemed sensitive have been curtailed.

In several sectors, such as finance or healthcare, the establishment of foreign companies is difficult and limited.

While state-owned enterprises (SOEs) now account for only 25% of GDP, the influence of the Communist Party in private enterprises has recently increased.

At the same time, a new data security law makes it difficult for foreign investors to obtain information on economic activity in different sectors. Transferring data out of China is now illegal if national security is compromised.

In the long run, we can expect a ban on the use of American software in China.

Also, the management of the epidemic has seen a halt in the flow of tourists and business travelers between China and the rest of the world. According to information from the Chinese Civil Aviation Authority, 50 million people entered or left China in 2019, while there has only been 1 million this year over 8 months.

The stock market angle: Beijing wants to gradually ban Chinese companies operating in technology sectors from being listed outside China. Initially, the ban affects new companies not yet listed, but this measure could be extended. U.S. stock market authorities have also reacted and are now demanding more information from Chinese companies.

The political angle: China has a bad memory of the concessions it had to make to the great powers and the intervention of eight enemy armies in 1900 to put an end to the Boxer Rebellion. Nor has it forgotten the abuses committed by the Japanese in Manchuria in 1931. Today, it is asserting itself, opposing itself and imposing itself.

Arms spending: in 2020, according to SIPRI, the Chinese budget, $250 billion, represented a third of the US budget, $770 billion. India, Russia, Japan, came behind with budgets respectively of $73 billion, $62 billion and $49 billion. In terms of number of nuclear missiles, China, 320, is far from Russia, 6300, and the United States, 5800, but in terms of conventional armament, fleet of boats in particular, China is approaching parity, although with less sophisticated equipment. Internationally, China is studying the establishment of a military base in West Africa, in Equatorial Guinea.

The United States did not discover the Chinese threat with Trump: the Quad, an agreement with Australia, Japan and India, was initiated in 2007 and aims for freedom of navigation in the South China Sea and, to this end, the Americans have increased their presence.

Japan has had China as its main trading partner since 2003 but it has been increasing its military spending and has bought 105 F35 from the Americans in 2020 because since 2010, tensions have been rising around the Senkaku Islands, administered by Tokyo since 1895, but previously Chinese and claimed by Beijing since 1970.

India counts China as its 2nd largest trading partner after the United States but opposed it in Ladakh in 2020 and is increasing its military spending.

Australia, in 2020, for the first time increased its military budget to 2% of GDP and in 2021 signed a contract with the Americans for nuclear-powered submarines.

The Taiwan question: a major issue for the stability of financial markets, Taiwan is trying to reduce its dependence on China but more than 40% of its exports, more than a third of its investments abroad, and more than 400,000 Taiwanese are in China.

A blockade could be decided because Taiwan imports 60% of its food products and 90% of its oil but a blockade of the Strait of Malacca could be established by the Americans in retaliation because 50% of the oil used by China and many of its imports go through this route. But the failure of the blockades in history makes this option unlikely.

To retake Taiwan, the military action would be the most plausible, but the Americans and their regional allies retain superiority, and in the eyes of the Japanese, the Taiwanese lock is an essential protection to guard against a Chinese naval attack.

Beyond that, the vigor of Chinese nationalism on this issue should be weighed against American pride and credibility as an ally in Asia and the world. For the Americans, letting go of Taiwan would mean the loss of their status as a power and the end of NATO, even if it is not involved in this region.

In the hypothesis of a nuclear escalation, the scenario is no clearer because the American advantage is undeniable, but the Chinese would keep the possibility of a second strike on an American city.

In short, the future of Taiwan will depend very much on the evolution of the pro- or anti-Chinese sentiment of the Taiwanese population and the Chinese will not fail to work the issue, to maintain a climate of insecurity, to multiply the dissemination of false information to try to win over a majority of the population to a rallying point. ***"Winning without fighting"*** is one of the principles set out by ***Sun Tzu.***

China, apart from the border confrontation with Vietnam in 1979, has no military experience and any unfavorable outcome to a conflict would undermine the party's monopoly of power granted since 1949.

The South China Sea: it is a sea the size of the Mediterranean. In 1974, during the fall of Saigon, China seized the Paracel Islands, in 1988, China took several islets in the Spratly archipelago from the Vietnamese and militarized them. In 2012, China took the Scarborough Lagoon north of the Spratlys from the Philippines and, in the China Sea, it has built artificial islands equipped with ports and airstrips.

- ***The impact on innovation:***

The United States and China are erecting technological barriers: on the one hand, Chinese telecommunications companies, ZTE and Huawei for example, are excluded from the American market, on the other, in China, some US technology icons, such as Twitter, Facebook, Google, YouTube have been kept out. China is gradually favoring its players, Huawei, Tencent, Alibaba for the cloud and promoting NeoKylin as an alternative to Windows as an operating system.

The technology ecosystem consists of universities, mobilizable capital, a legal framework, and even incentives. The United States, along with Israel, is the paragon, Europe is waking up, China is losing ground because the Communist Party is more intrusive in companies, the pressure on US-listed companies is more significant, the criticisms addressed to the leaders and their wealth are more acute.

In the US this year, 384 technology companies passed the $1 billion mark, in Europe 98, in China only 26, according to Atomico's calculations. Thus, the United States has 1178, Europe 321, China 300.

The same trend can be seen in the financing of these companies. In the first 9 months, venture capital attracted $110 billion in Europe, but only $45 billion in China, according to Atomico.

***Conclusion* :**

- ***From a military point of view***, the Americans are well aware of ***Sun Tzu's*** words which permeate Chinese culture: ***" The enemy advances, we retreat; the enemy camps, we harass; the enemy tires, we attack; the enemy retreats, we pursue".***
  Thus, the Americans aim to preserve their superiority, have a network of allies that China lacks and each Chinese offensive move only succeeds in inciting the actors of the Pacific, Japan, Australia, India, to increase their military effort.
  However, the risks of war over Taiwan, the Senkaku Islands or navigation in the South China Sea cannot be ruled out because a possible incident during an air incursion can get out of hand.

- ***From an international angle***, China is retreating but it is difficult to accept the parallel with the closure of China in the aftermath of Admiral Zheng He's expeditions to the African coast in the early 15th century. China lost a lot in that closure and would lose more today because, since joining the WTO in 2001, it has benefitted greatly from trade with the rest of the world and exports still represent 20% of GDP.

- ***From an economic point of view***, the period of overinvestment is over. If, according to the IMF, China has accounted for 28% of world growth and if real estate has accounted for nearly 30% of this growth, then the slowdown in this sector is weakening 9% of world growth. China's GDP growth could thus fall to 3-4% in 2022.

- ***From a trade point of view***, if China needs globalization, American companies are still interested in this market of 1.4 billion; The Europeans trade a lot with China and depend on it for essential metals such as magnesium, tin, and zinc.
  But the West will be increasingly intransigent in the fight against the dumping of Chinese companies, in the surveillance of Chinese investments and they will try to counter the Chinese on the Silk Roads by alternative financing offers, such as the €300 billion plan for Africa.

- ***From a monetary point of view***, the dynamism of exports, +22% over 1 year, facilitates the appreciation of the Yuan, which is at its highest against $.

- ***From a technological point of view***, the Americans have the advantage and their more open system to foreign talent, to the financing of venture capital... will help it to maintain a lead in innovation.

- ***From a stock market perspective***, the Chinese market was the best of the major markets in 2020, the worst in 2021. Today, it is much cheaper than the others, and it should benefit from stimulus measures but the political contingencies, prevalent in recent months, unfortunately require caution and vigilance.

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