Letter n°68

What to think about the Chinese economy and market after the 20th Congress? (2)

"Nothing constant except change" Chinese proverb.

China has experienced tremendous development over the past 30 to 40 years and this Chinese proverb sums up the evolution wonderfully.

For example, what was Shenzhen 30 years ago? A small fishing port, what is it today? A city of 15 million, a Special Economic Zone, one of the most innovative cities in the world.

From this economic take-off, many expected a shift towards democracy. This was a fatal mistake because, on the contrary, the communist flame was rekindled at the recent 20th Congress of the CCP.

Today, two points stand out: the perception of a risk to be averted and a certain skepticism to overcome.

- ***The seeds of deflation***:

At a time when inflation control is shaking Western central banks, the risk of deflation threatens the Chinese economy and some figures attest to it: at the end of October, there were still 230 million people confined and a rebound of the epidemic was reported in Guangzhou. For the first time since 2019, exports fell in October by 0.3% due to lower sales of durable goods. Exports to the United States fell by 10.9% and to Europe by 7.9%. Imports also fell by 0.3%.

- ***Objectives that seem ambitious*** :

Xi Jinping's stated goal is to double GDP by 2035 but China's growth, for the first time since 1990, is lower than that of its Asian neighbors.

1. The economic angle:

- ***The initial goal set by Deng Xiaoping***:

Deng Xiaoping had wanted to create a socialist market economy, that is, an economy without interference by the Communist Party in private enterprises, an economy allowing private enterprises to flourish, an economy offering the possibility of personal enrichment, an economy encouraging companies to invest abroad to consolidate their positions.

Implicitly in recent years, and explicitly in the recent 20th Congress, Xi has put a stop to these strategic lines.

Yet the success has been spectacular. GDP has increased 15-fold since 2000, a year before China joined the WTO. In many sectors, China has established dominant positions as world leaders. For example, in the financial sector which is key to the development of an economy. According to Forbes in 2020, two of the world's top six banks were American, the other four were Chinese. And in many other sectors, from the traditional cement industry to the advanced solar or battery sectors, the dominant players are Chinese.

Although China intends to become the world's leading power in the coming years, in terms of GDP per capita, it will remain a middle-income country and will have the greatest difficulty in joining the club of rich countries. Out of just over 190 countries, it is ranked 74th in the world, far behind the United States which ranks fifth.

- ***The primacy given to state-owned enterprises***:

This is one of Xi's stated priorities and in recent years the grip on the private sector has been strengthening. Already in 2019, takeovers of listed private companies by state-owned enterprises had reached $20 billion but since then the trend must have continued.

The biggest borrowers are now public companies as credit to private companies has dried up in recent years.

The profitability of private companies has been affected and this is something to watch out for because private companies in recent years accounted for 60% of GDP and, according to McKinsey, 87% of employment and 88% of exports. At the same time, state-owned enterprises, traditionally less profitable, are not improving their situation.

Overall, despite some monetary easing, credit dynamics remain weak.

- ***Worsening debt***:

While the central government remains moderately indebted, the country's overall debt, the sum of public debt, provincial and local government debt, household debt and corporate debt, is almost three times the GDP, a high percentage especially if we rightly consider China as an emerging country.

Government debt is officially at 20% of GDP but according to the IMF at 70% with bad debts probably equivalent to a quarter of GDP.

Corporate debt, $20 trillion, has quadrupled in a decade and today, with excessive debt, the IMF estimates that one in ten companies is at risk of bankruptcy.

In 10 years, household debt as a percentage of GDP has risen from 30% to 60%.

Local governments have $4.5 trillion in debt.

In a context of structurally weaker growth, debt management is proving difficult as evidenced below by the real estate debt.

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

The infatuation of households with real estate has resulted in record debt. According to the BIS, Bank for International Settlements, between 2009 and 2019, China accounted for 57% of the $11.6 trillion in additional real estate debt in the world against 19% for the United States. 96% of urban households, according to statistics from the Chinese central bank, own at least one home compared to 65% in the United States.

It's a short step from infatuation to excess and in 2017, according to the China Household Finance Survey, 21% of urban housing, or 65 million homes, were empty. Today, with the scale of the real estate crisis, the figure is higher. According to Capital Economics, the empty homes (30 million owned by developers and 100 million owned by individuals) could house 340 million people.

Rental yields in large cities, 2%, are lower than bond rates.

Empty homes and low yields are all reasons to affect household confidence because, according to China Guafa bank, 78% of Chinese household wealth is in real estate against 35% in the United States. A wealth estimated by Goldman Sachs at $52 trillion, twice the American wealth.

What are the prospects? Supporting this sector, which has long contributed to 15% of GDP growth, is difficult. Betting on continued growth in urbanization to absorb the stocks of empty housing is risky because the rate of urbanization, which has risen from 50% in 2011 to 64% today, is high. Counting on the creation of a "bad

bank" to house the bad debts of the banks and thus clean up the banks' balance sheets is a hypothesis that is less credible every day because the idea has been mooted for months and the government has not taken it up.

In 2021, almost all homes were sold before construction but due to the lack of money, developers are unable to complete millions of homes and many borrowers are refusing to repay. China Evergrande, an iconic company among struggling developers, still carries $300 billion in debt.

- ***The difficult stimulus***:

The growth target of 5.5% in 2022 will not be met.

Industrial production over 8 months is up by only 3.6%. Retail sales in September rose by only 2.5% due to persistent lockdowns. The manufacturing PMI in October is below 50 like the non-manufacturing PMI.

The outlook is poor but the government is not considering a substantial stimulus package. All measures combined, lowering interest rates, liquidity injections, infrastructure plan..., the total spent since the beginning of Covid is less than 4% of GDP. Nothing compared to the 13% spent in 2009. For their part, Chinese banks are reluctant to lend and demand for consumer credit is sluggish.

- ***The hope of an increase in consumption***:

The household savings rate is traditionally high, 23% of GDP, and some deduce a potential for consumption.

But this ignores the confidence of households which has been undermined by the high level of youth unemployment at nearly 20%, it underestimates the difficulty of finding work for the 10.7 million university graduates each year; it ignores the low unemployment benefits; it ignores the current difficulties of employment for the 280 million migrants (from the countryside to the cities), the Hukou, who are deprived of compensation; it neglects the costs of education and health, and the need to compensate for the low level of pensions.

As long as the welfare state is underdeveloped, it would be futile to expect massive transfers from savings to consumption.

2. The business angle:

- ***The benefits of openness***:

An important point to bear in mind is that China's success owes less to the strategy followed by the CCP than to its entry into the WTO, the World Trade Organization.

From the 1990s and especially since the early 2000s, China has re-entered the international game and has been the great beneficiary of globalization.

First, China attracted international investors because its market is large and its labor costs were low. Second, it became the workshop of the world and re-exports were the main engine of growth. Finally, it accumulated trade surpluses and this led to a stock of foreign exchange reserves of more than $3 trillion, the largest in the world.

Recently, China has once again been able to take advantage of the stimulus packages adopted in OECD countries after the Covid crisis. Its exports of durable goods increased significantly and this was again the engine of growth in a context of weak domestic demand.

In 2021, China accounted for 15% of global exports ahead of the United States 7.9%, Germany 7.3% and Japan 3.4%.

- ***Vigilance in opening up***:

Certainly, China has multiplied free trade agreements, with 26 countries, and this covers more than a third of its trade, but if China has sought to attract foreign capital, it has always known how to protect sectors deemed key.

Foreign investment is aimed at securing access to raw materials, agricultural land, technologies and strategic locations.

The authorization of foreign investments in China is regulated. One example, among others, is the financial sector. Despite their efforts, according to the People's Bank of China, foreigners have only 1% of the Chinese banking market and 1.5% of asset management.

Another example is Apple. Although the firm achieves a significant part of its turnover in China (20%) and recently manufactured almost all its products there, in order to gain access to the Chinese market it had to agree to remove a large number of applications (access to foreign media, etc.) and even went so far as to approve an application against Uighurs!

Switzerland has done well. It is an important partner after Germany and the United States and before France and Italy. In 2020, Swiss exports reached almost CHF 15 billion. 1050 Swiss companies are active in China.

- ***The impact of increased sanctions***:

If relations between the West and China were to worsen and trade between the two blocs were to shrink, the loser would a priori be China, but the analysis is not so simple because there are multiple overlaps.

Of course, China is dependent on imports of sophisticated goods from the West that it cannot produce. Certainly, if the borders were to close, it would lose an outlet for its exports while the West could source from countries like Vietnam or Bangladesh. Admittedly, China is more dependent on international trade than Western countries: if the volume of imports of OECD countries from China is equivalent to 3% of OECD GDP, this represents 9% of China's GDP.

But China is also the workshop of the world. According to Allianz, $3.4 trillion of Chinese production serves global value chains, far ahead of the United States, $1.8 trillion, and Germany, $1.4 trillion, especially in telecom equipment, IT, automotive and metallurgy, sectors that account for half of world trade.

The United States has a trade deficit with China of $245 billion over the first 7 months of the year and it has 276 critical dependencies (products of which the country is a net importer and for which China accounts for more than 50% of supplies).

The big Western companies are trying to reduce their dependence on China - Apple in India for its smartphone as Amazon for its Fire TV, Microsoft in Vietnam for its consoles as Samsung for its chips - but this takes time and does not always delight the firms.

Meanwhile, Huawei will invest €200 million in Alsace to set up a 5G factory with 300 employees but it remains banned in Great Britain and the United States, the American bet being that Huawei will be unable to hold its technological edge in 5G. Recently, Biden has restricted US sales in the A.I. and semiconductor sectors, and this is proving more problematic for China.

To sum up, the political postures in China and the United States may sometimes be martial and abrupt, but the economic reality remains one of mutual dependencies and reciprocal interests in pursuing cooperation.

- ***The loss of momentum of the Silk Roads***:

The Silk Roads involve 150 countries and according to the Bank of International Settlements, $930 billion has been spent in the last 10 years but only $28 billion in the first half of 2022.

They have a strategic aim to extend China's influence in the world, an economic aim to open up China's western provinces and a commercial aim to sell its products.

Notwithstanding these aims, China needs a return on its investment and this is problematic because many countries are weakened by debts contracted for the realization of projects often disproportionate to their financial capacity. China holds 20% of Africa's debt and the ability to repay is uncertain.

A quarter of China's debtors are close to default and are asking for rescheduling. Montenegro could not repay the Chinese-financed highway and feared it would have to give up land to China. Others deplore unfinished or poorly targeted work, for example, the port of Hambatota which still does not receive cargo ships.

The blows to Chinese expansionism, cloaked in the terminology of the Silk Roads, are multiplying.

In Europe, Lithuania has left the 16+1 group in Eastern Europe and Estonia could do the same. Portugal now refuses to sell its ports to the Chinese. Italy refuses the sale of a semiconductor company. Germany did the same last week.

In the emerging world, Tanzania, Pakistan, Bangladesh and Egypt have suspended projects and Nigeria wants to renegotiate.

China lends with conditions, which the Paris Club does not do. After a total of $460 billion in loans between 2008 and 2019 from the Eximbank and the Chinese Development Bank, or as much as $467 billion from the IBRD, there is a drying up of loans from these two banks, $75 billion in 2016, $4 billion in 2019.

3. **The stock market angle**:

The Chinese market has a domestic market with A-shares and an offshore market with H-shares of companies listed in Hong Kong or the United States. Similarly, the bond market has an international segment of $700 billion fueled by state-owned enterprises and companies active in real estate and a domestic segment of $16 trillion fueled mainly by government bonds.

On a positive note, the delisting of Chinese companies from the US seems to be less of an issue and an agreement with the US authorities seems to be in view.

Another positive point is that lockdown measures will be eased sooner or later and this should be conducive to a resumption of consumption and production in factories that are currently closed.

Lastly, after the decline of the last two years, the market is not expensive but it is true, investors, worried about the excesses of the regime, are at best waiting, at worst, worried.

On the negative side, Hong Kong, a market recently at its lowest since 2009, a GDP down 4.5% in the 3rd quarter, a strict Covid management that has left its mark, less attractive because of the increased influence of Beijing, nearly 120,000 departures in the first half of 2022 and therefore a real estate crisis after, and admittedly, a strong inflation of prices since 2003.

Technology stocks were once attractive because China is at the forefront of e-commerce, with online shopping accounting for more than half of China's retail trade compared to 15% in the United States. But the government is increasing the Communist Party's oversight of private groups. Tencent, number 2 in mobile payment with WeChatPay behind Alipay, as well as NetEase have been hampered in their video game launch and group chairmen like Jack Ma are disappearing. In other segments of technology, China is finalizing the development of an airliner equivalent to the Boeing 737 and Airbus A320 but it does not yet have efficient engines. It also has success in space by landing a rover on Mars in 2021.

Conclusion: "***He who acts, acts on something on which he cannot act" Zhuangzi, Chinese thinker of the 4th century BC.***

- ***Growth is structurally weaker*** and, despite a still exceptionally high fixed capital formation, double that of OECD countries and more than 43% of GDP, in infrastructure and construction, returns will decrease, investment often unproductive because much overcapacity and debt have been accumulated in recent years.

- ***Technological autonomy is far from being achieved:*** the stated objective of producing 45% of China's semiconductor needs by 2025 seems out of reach because the country currently produces only 5% of its needs and US sanctions are holding back component sales.

- ***Exports will remain the main engine of growth,*** as evidenced by the trade balance, +57% over 8 months, and China will therefore hesitate to antagonize the West on issues such as Taiwan.

- ***The real estate crisis is far from over:*** the outstanding real estate loans are estimated at $6.8 trillion. Nearly one-third of home loans are considered bad debts. Housing starts decreased by nearly 40% over the first 8 months and sales by nearly 30% over the same period. The policy of lowering interest rates is thwarted by the depreciation of the currency against the dollar.

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