



Letter n°89

Is the Chinese crisis comparable to the Japanese crisis of the 90s? (1) Four similarities

"He who knows others is wise; he who knows himself is enlightened" Lao Tzu.

Shared historical characteristics:

These two countries had in common calligraphy, Buddhism, and Confucianism, which were imported from China to Japan. Both countries were also closed off from the outside world for a long time before becoming economic powers in the second half of the 20th century.

China had suddenly closed its borders after several expeditions led by Admiral Zheng He, a eunuch of Muslim origin, along the African coasts between 1405 and 1433, which was several decades before Vasco de Gama's arrival in India in 1498.

Japan was forcibly opened up after the visit of American Commodore Perry in 1853, who sought to establish commercial relations between the two countries. The ruling Shogunate fell, and in 1868, the Meiji era, known as the "enlightened rule", began. The capital was relocated from Kyoto to Tokyo.

- *Historical conflicts between the two:*

In the last 150 years, the two countries have fought twice, first in 1894 and then again in 1931.

In 1894, Japan defeated China and signed the Treaty of Shimonoseki, forcing China to cede Taiwan and withdraw from Korea. This victory marked the success of a modernized Japan, later admired by Sun Yat Sen, the first President of the Chinese Republic in 1912, who tried to transform China.

Starting in 1931, Japan invaded Manchuria and achieved several victories. By around 1937, the Japanese had control over Manchukuo and the Nanking-Shanghai region.

- *Chinese successes that are reminiscent of Japan's:*

During the 40 years prior to Covid, China's average GDP growth, according to the IMF, was 9.4% per year, compared to 4% per year between 1949 and 1978. This growth contributed one-fifth to the rest of the world.

In 1980, China's GDP per capita was at 2% of the American level, and today it stands at 29%. In 1977, China accounted for no more than 0.6% of global trade, while in the year 2000, it represented 10%, and today, it's at 18%.

This performance is reminiscent of the "Japanese miracle" of the 1950s and 1960s when growth sometimes reached 12% per year.

Chinese industrial production is 10 times greater than that of India and 50 times greater than that of Vietnam, its two main competitors in Asia.

- *China's current slowdown is reminiscent of Japan's from 1990 onwards:*

In both countries, Japan from 1990 and China more recently, the slowdown occurred after a real estate crisis.

Since then, Japan has experienced low growth, and many are concerned about similar prospects for China.

In this Letter 89, we can draw a parallel between the causes of the slowdown in Japan in the past and in China today. However, in Letter 90, we will see that differences prevail, often to the detriment of China.

The real estate crisis:

Real estate, including public works, constituted 30% of China's GDP in recent years, a percentage higher than that of other major countries, and probably slightly less than 30% of bank loans.

Today, the sector is in crisis and two indicators reflect this:

Firstly, there are alarming figures concerning Chinese property developers who are currently in default. This is the case with the largest among them, Evergrande, which carries debts estimated at \$320 billion. The same goes for Country Garden, with \$180 billion in debts. The list could go on with many more names, but Chinese authorities appear incapable or unwilling to find a solution.

The second indicator is the percentage of unsold new homes, estimated at one-third.

Let's look at the consequences and prospects, and assess the risk of a systemic crisis.

The immediate consequence is that Chinese households are restricting their consumption spending because they are indebted to the tune of 110% of gross disposable income. This level encourages many to deleverage since the debt is often associated with the purchase of a now depreciated property. Debt service represents 30% of their income, and 80% of their savings are invested in real estate.

A delayed consequence of this debt is that the number of marriages has never been lower, and as a result, the birth rate is unlikely to rebound.

The prospects are not promising. Clearing the unsold housing stocks will take time as 80% of Chinese people are already homeowners and rural-to-urban migration is tapering off.

Nevertheless, similar to Japan in the early 1990s, the risk of a systemic international financial crisis is moderate because the debt is held by local investors.

International trade tensions:

Once again, the parallel with Japan is tempting. Let's recall the Japanese commercial breakthroughs in consumer electronics in the late 1980s, the uproar in Hollywood when Sony acquired an American studio, and the commotion caused by the influx of Japanese VCRs in France. In Europe, as well as in the United States, tariffs and import restrictions served as barriers.

The situation is similar today with China. Donald Trump sounded the alarm, implemented tariff sanctions on numerous products, and Biden has maintained, and in some cases expanded, these measures. In the United States, containing Chinese influence is one of the few subjects of consensus between Republicans and Democrats. In turn, Europe, which was long open to free trade and the entry of Chinese products without restrictions, is alarmed by a trade deficit, reaching nearly €400 billion in 2022. It is concerned about the future of its automobile industry and the 12.7 million jobs in the sector and is now considering erecting trade barriers.

After dealing with steel and textiles, recent tensions have revolved around solar panels and the automobile industry. Due to extensive subsidies, China has developed a comparative advantage that could weaken European manufacturers. For example, the Chinese group BYD is a source of concern as it is highly competitive in the entry-level car market.

Demographic decline:

- *The beginning of the population decline:*

For many years, Japan's demographic decline has been a concern. Japan, like China, is losing 850,000 people per year, but its population is ten times smaller. That being said, the situation is quickly worsening in China. The problem has emerged more recently but is a source of worry.

While China's growth benefited from an influx of rural laborers between 1980 and 2000, demographic decline is now a hindrance to growth. In recent years, the number of children per woman has dropped to 1.1, a figure slightly lower than that of Japan, despite the abandonment of the one-child policy for women.

- *The ageing and expected decline of the population:*

China's median age, currently 38 years compared to less than 33 for India and Indonesia, will increase rapidly. According to the Shanghai Academy of Social Sciences, the population is expected to decline from 1.4 billion to 1.24 billion by 2050. It would then represent only 14% of the world's population, down from 22% in the 1980s, trailing behind India at 17% and Africa at 25%. Furthermore, by 2100, the Chinese population is not expected to exceed 585 million.

Another delayed consequence is that over 20% of the population will be over 60 years old by 2025 and over 30% by 2035. According to the United Nations, 40% will be over 65 years old by 2100!

- *The contraction of the working population:*

This decline will soon lead to upward pressure on wages and is one of the reasons for a loss of economic competitiveness. The United Nations anticipates a 10% contraction of the working population by 2035 and nearly 30% by 2050.

In the meantime, China will need to compensate for the decline in the working population by rapidly transferring people still engaged in agriculture to the industry and services sectors. This is because, similar to Japan, there is a shared reluctance to open up to immigration. The substitute for this decline will, therefore, be a substantial increase in the retirement age.

- *Mismatch in job supply and youth unemployment:*

Despite the demographic decline, youth unemployment rates are rising. The government, concerned about social repercussions and potential unrest, has decided not to publish these statistics. So, the last known percentage, officially 21.5%, will be used as a reference, but the reality is much worse. The problem is persistent because there is a mismatch between the increased qualifications of young people and the needs of the job market, leading to around 25% of graduates being underemployed.

Due to limited pension systems, Xi's dream of compensating for declining exports with robust consumption growth will not materialize. The concept of the "Silver Economy," popular in Western countries, will remain empty words in China.

The difficulty in restarting:

Since 1990, Japan has struggled to revitalize its economy. Since the Covid crisis, the Chinese government appears to be unable to chart a path of strong growth.

Xi's stated goal of achieving a 5% GDP growth this year seems difficult to realize, and the government is finding it challenging to stimulate the economy.

- *The monetary tool:*

It is not much of a recourse. It's difficult to significantly lower interest rates because they are already low and well below rates on the US dollar. The central bank is limited to ineffective reductions of 0.10%, but each time this happens, the Yuan is weakened. The image of the Yuan as an alternative to the US dollar is penalized, and bank profitability is reduced.

- ***The fiscal tool:***

With the announced issuance of €130 billion in bonds, the government is resorting to this tool. However, it falls far short of the 13% stimulus plan in 2008, as the country has to settle for this plan that is equivalent to 0.8% of GDP since the budget deficit is already high, and, as we will see, the debt burden is substantial for an emerging country.

In summary of this first part, the common factor is the real estate crisis. Demographic decline affects both economies, but in 1990, it was not yet a problem in Japan.

Let's now examine the differences. Japan was not hampered by ideology as is the case in China with Xi Jinping. Japan enjoyed a much higher per capita standard of living than China does today, and on the international stage, Japan had to manage trade tensions but not political tensions. In contrast, China holds a much more prominent position in the world in certain sectors.

Conclusion: *"It will take 35 years for China to become a great power, but it is on the path" de Gaulle.*

Perhaps this statement by General de Gaulle at the end of his life was inspired by observing the Japanese miracle in the 1950s and 1960s. The Chinese miracle has happened, but today, like Japan in 1990, China faces obstacles.

- ***The difficulty in restarting:***

Will there be a robust stimulus plan like in Japan in mid-1992? At that time, a stimulus equivalent to 6% of GDP led to an 80% stock market rebound. This seems unlikely because it's challenging to rely on already high levels of debt.

As a consequence of 30 years of stagnation and currency weakening, Japan's economy has been surpassed by Germany for the third place in the world this year.

- ***The situation in China appears to be more challenging than Japan's after the bursting of the real estate crisis in 1990:***

At that time, tensions between Japan and the United States were only economic, the Japanese standard of living was higher, the population had not yet declined, and the regime was not autocratic.

China is currently facing deflation, a contraction in exports, a record youth unemployment rate, poorly controlled debt, a persistent real estate crisis, and an alarming level of pollution as the country accounts for 31% of greenhouse gas emissions. Between 2017 and 2021, these emissions increased by over 10% while they decreased by more than 10% in the European Union and 6% in the United States. By 2025, China's greenhouse gas emissions will represent 35% of the global total, compared to 23% for the United States, Europe, and Japan combined.

- ***The Chinese slowdown is occurring earlier than Japan's in 1990:***

The Chinese slowdown affects a country with middle income, while the Japanese slowdown had affected a high-income country.

The slowdown is problematic for China because the income per capita based on purchasing power parity, while it did grow significantly since 1980 (when it was only 2% of US income), is still only at 28% of American income in 2022.

Geneva, 2 November 2023

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