Letter n°90

Is the Chinese crisis comparable to the Japanese crisis of the 90s? (2) Five differences

"Hide your ambitions and disguise your claws." Deng Xiaoping.

This was the motto of the Chinese leader, who was responsible for China's take-off after the Mao era. This had been the approach of the Japanese in the post-war period. However, this is no longer the policy pursued by Xi, and this is one of the major differences between Japan and China.

In this Letter 90, we will analyse the Chinese political hardening, the political tensions it has generated internationally, and then delve into more economic aspects, such as the difference in the standard of living in favour of the Japanese, the weight in international trade in favour of the Chinese, the faster increase in debt in China compared to Japan, and finally, the weaknesses of the Chinese stock market and currency.

China's political tightening: a handicap for China.

This is perhaps the most significant difference compared to Japan, and it's not in China's favour.

Culturally, China is deeply influenced by Confucianism, and Confucian thinkers have always believed in the primacy of authority over freedom.

The problem lies elsewhere. Xi, despite the painful experience of re-education camps between the ages of 15 and 22, alongside his father, a Red Prince who was a victim of the Cultural Revolution, is entrenched in communist ideology. He constantly seeks to strengthen the control of the Chinese Communist Party (CCP) and its 95 million members over the country and private enterprises.

During the last Congress in November 2022, Xi side-lined proponents of a liberal approach to favour population control, promote state-owned enterprises over private ones, and strengthen the CCP's grip on private companies.

Leaders of technology companies are restrained, some disappear, others face corruption charges and imprisonment. The government has acquired "golden shares" in technology companies to exert better control over them.

Xi believes that real estate should not be an instrument of speculation, which likely explains the government's reluctance to assist the sector's players.

Additionally, there are concerns about the regulatory environment, weak governance, including corruption and the rule of law. Many also raise concerns about cybersecurity threats.

These are all limitations of a communist capitalism model very different from the Japanese capitalist system.

In summary, these factors have the potential to discourage innovation and impede potential growth, and they also contribute to tensions with the United States and Europe.

International political tensions: a hindrance for China.

- ***Decrease in FDI (Foreign Direct Investment):***

As a consequence of political tensions, American foreign direct investments in China in 2022 fell to $8.2 billion according to Rhodium. In the second quarter of this year, FDI, at $4.9 billion, reached the lowest level since 1998 and decreased by nearly 90% compared to the previous year.

Simultaneously, Chinese investments in the rest of the world have decreased by 18% in a year and 25% compared to the peak in 2016. Chinese investments in G7 countries account for only 18% of the total.

- ***U.S. desire to reduce dependence on China:***

U.S. imports from China now account for only 13.3% of overall U.S. imports, down from 21.6% in 2017.

The U.S., Dutch, and Japanese governments have agreed to limit the sale of high-precision semiconductors to China.

China remains highly dependent on Western countries, which it criticizes. Approximately 40% of Chinese exports go to the United States and the European Union, and over 50% of Chinese imports come from the West.

Trade with the European Union reached $850 billion in 2022, but due to the significant trade deficit of €400 billion in 2022, Europeans are acting by imposing import tariffs on many products subsidized by the Chinese. Wind energy is one example, and recent challenges faced by companies like Siemens Energy or Vestas make a strong case for such measures.

- ***Chinese dependencies:***

Regardless of the circumstances, China cannot do without the outside world. While it accounts for 18% of the world's population, it has only 9% of arable land and 6% of water resources. China is, for example, highly dependent on soybeans, with a self-sufficiency rate of less than 20%. Other cereals could also be mentioned.

In terms of energy, China imports over two-thirds of its oil needs and nearly half of its gas needs.

In 2020, far from covering 70% of its semiconductor needs, as it had aimed, China had only reached 6%.

- ***Growing difficulties of the Silk Roads:***

Since 2013, China claims to have invested nearly $960 billion in Silk Road projects, but recently the amounts have greatly decreased, reaching $85 billion in 2016 and $5 billion in 2021. In 2016, China lent $28 billion to Africa; in 2022, this figure did not exceed $1 billion because many countries are unable to repay. Overall, China had to reschedule or restructure $240 billion.

To counter the Silk Road initiative, the Americans have launched "Build Back Better World," and the Europeans have initiated the "Global Gateway," with the idea of creating a corridor between Europe, the Middle East, and India. However, the announcements are too recent to evaluate their implementation.

The difference in standard of living: advantage to Japan.

In the early 1990s, according to the World Bank, per capita income in Japan was $30,000. Today, in China, it stands at $12,850, and income inequality is among the highest in the world, with the country having over 560 billionaires with over $2 trillion in wealth.

The bursting of the bubble in Japan in the early 1990s affected a country with a high per capita income for a developed nation. The situation is quite different for China, which is ranked 77th in the world in terms of per capita GDP, falling into the category of middle-income countries.

There are legitimate concerns about China getting stuck in the middle-income trap like others before. The per capita income barely exceeds one-fifth of the American standard of living, and it's challenging to envision China catching up. Therefore, China will struggle to lift the 400 million people still below the poverty line.

In China, the share of consumption in GDP, at 38%, is substantially lower than in Japan, and it is difficult to expect a rebalancing of the economy towards this sector.

Weight in international trade: **3 advantages for China.**

- ***China, as the world's no. 1 exporter despite a loss of competitiveness:***

Like Japan in 1990, China relies heavily on foreign trade. In 2022, exports reached $3.6 trillion, imports were $2.7 trillion, and China's trade surplus accounts for 2% of its GDP. Its trade surplus with the United States alone amounts to $440 billion.

China accounts for 14% of global exports, surpassing the United States at just over 8% and Germany at over 6%.

Chinese companies continue to benefit from bank loans at preferential rates and the size of the domestic market to establish their competitiveness. However, cost competitiveness has declined as wages are now at least twice as high as in Vietnam or India.

More than Japan, China is exposed to sanctions and the relocation of investments by multinational firms to countries like Vietnam, India, and Bangladesh.

It's worth noting that while China's coastal regions lose competitiveness, mainland China competes with Vietnam and Mexico. Since 2018, exports from 15 mainland regions have increased by more than 90% to reach $630 billion, exceeding India's $425 billion, Mexico's $590 billion, and Vietnam's $345 billion in exports.

Another significant point is that the exports from these Chinese provinces have grown faster than those of these countries. Since 2018, Indian exports have grown by 41%, Mexican exports by 43%, and Vietnamese exports by 55%. Coastal regions continue to export $2.7 trillion in the last twelve months.

- ***A domestic market that remains attractive:***

The Chinese market continues to hold appeal, and American companies as diverse as Starbucks, Ralph Lauren, or McDonald's are expanding their points of sale. In 2020, Apple produced more than 40% of its products in China and aims to reduce this percentage to 30% by 2024, but it will still be significant.

Similarly, Germany conducts €300 billion in trade with China and has no intention of losing its positions. Notable examples include Volkswagen and other automobile manufacturers.

The willingness of Western companies to reduce their dependence on the Chinese market encounters challenges such as inadequate infrastructure in India, a lack of qualified personnel in Vietnam, and lower productivity in Mexico.

- ***Leading positions in sectors of the future:***

China possesses one-third of global solar capacity, accounts for 75% of the world's solar panel production, and is the global leader in wind energy.

Currently, nuclear power contributes only 3% to the electricity production, while coal makes up 60%. However, by 2030, China is expected to build 17 nuclear power plants and will have the world's largest capacity in this sector.

In many sectors of the future, China holds dominant positions. This is evident in electric cars, as Chinese manufacturers outsold their Western counterparts in China in the first half of the year for the first time.

China also has a strong presence in high-speed trains (having the world's largest network), batteries, and electric vehicles.

China is not hesitant to use means of pressure as well, as seen in its intent to restrict the sale of two essential metals for semiconductors, gallium and germanium, of which it produces 80% of the global supply. This could also be the case for various rare earth elements.

Worsening debt: **China's weakness**.

The IMF has recently highlighted the risk of over-indebtedness, as the total debt has increased from 180% of GDP to 300% of GDP in 15 years, a trend considered unsustainable in the long run.

In this context, corporate debt is high, amounting to 1.5 times the GDP, and household debt is growing, reaching 60% of GDP.

Additionally, there is the public debt, which is challenging to assess. Officially, public debt has increased from 56% of GDP in 2018 to 82% of GDP in 2023, marking a significant deterioration. However, it's important to consider off-balance sheet debt at the local government level. Public debt is, in fact, estimated to be 95% of GDP, while in Japan it was just a little over 60% of GDP in 1991.

In some cities, interest payments on loans consume three-quarters of budget revenues, and there are difficulties in paying public servants' salaries.

The off-balance sheet debt of provinces is estimated by the IMF to be $8 trillion, and according to the IMF, provincial debt reaches $10 trillion.

A reassuring point, similar to Japan, is that China's debt to the outside world is low. Nevertheless, in the event of an internal crisis, China may need to sell Treasuries or other assets.

The stock market and currency: China's weakness compared to Japan.

The Chinese stock market:

It has never reached the highs of the Japanese stock market. Let's remember that in 1990, for a brief moment, the Japanese market capitalization had surpassed that of the American market. Today, there's no such comparison with China. American market capitalization accounts for 60% of the MSCI World, while Chinese market capitalization is modest and has decreased by 40% since its peak in February 2021.

Clearly, investors are cautious about the influence of the Communist Party, even though the Chinese market is attractive in terms of valuation.

The motto:

The Yen is indeed a weak currency today, with 150 Yen to $1, but it was around 76 in 1994 and again in 2011/2012. The Yuan is not convertible and has already weakened against the dollar.

Conclusion: ***" If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat." Sun Tzu***.

More so than for Japan in the early 1990s, Chinese ambitions face the power of the United States:

- ***China, unlike Japan, has a political ambition:***

Japan was content with technological dominance, while China goes further and aims to shape the world. It has systematically engaged in institutions created by the United States and the West and currently leads the FAO, the United Nations Industrial Development Organization, and two other organizations out of fifteen.

- ***China, more so than Japan, will remain an industrial power:***

Even in difficult times and despite Western countries' efforts to reshore, a study by the Centre for Global Development suggests that China is expected to continue concentrating over 40% of the world's industrial employment by 2050. China can exert leverage with rare earth minerals, of which it currently controls 80% of the production. China is heavily investing in space, artificial intelligence, and other cutting-edge sectors.

- ***China, unlike Japan, is up against American power:***

By 2050, China's population will shrink by 150 to 200 million, while the U.S. population will grow by more than 20 million. To counter China, the United States is exploiting its strengths: energy independence while China will remain highly dependent; the $ as an international currency which still accounts for 90% of foreign exchange transactions, 60% of foreign exchange reserves, 50% of commercial invoices and 40% of international loans, while the Yuan is not convertible. According to WIPO (the World Intellectual Property Organization), the United States remains the 2nd most innovative country while China is only 10th. The U.S. retains the first place for soft power, universities, and the military. NATO was recently enlarged and invited Australia, New Zealand, South Korea and Japan for the first time. The Quad does not contain any defence cooperation, but includes the latter four countries, the U.S. and India.

Far from catching up with the United States, China is expected to show slightly lower nominal growth than the United States this year.

Therefore, the preference will continue to lean towards the American stock market, driven by innovation and abundant capital, over the Chinese market, which is more opaque and uncertain.

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