China: Japan 1970 Development, Japan 1989 Debts

With the formal abolition of the political cycle,[1] Xi Jinping has definitively made himself personally responsible for "The Great Rejuvenation of the Chinese Nation." There is of course no problem with this since in his New Era Xi is "backed by the invincible force of more than 1.3 billion people, [he has] an infinitely vast stage of our era, a historical heritage of unmatched depth, and incomparable resolve." Nevertheless, personal responsibility can be a double-edged sword. Whisper it quietly but what if, for whatever reason, things start to go awry?

With the formal abolition of the political cycle, Xi Jinping has definitively made himself personally responsible for "The Great Rejuvenation of the Chinese Nation."

If you are a believer in the infallibility of the Communist Party, then there is no need for you to read on further. If, however, you faintly detect some potentially sizeable inconsistencies in Xi's stated reform aims, then execution risk seems to be, in fact, rather real. Especially since growth targets, contrary to the expectations of some, remain unmolested at around 6.5% for 2018.

Potentially sizeable inconsistencies in Xi's stated reform aims imply that execution risk might be rather real

Beijing's real tolerance for deleveraging and pain remains the salient cyclical variable to monitor near-term and for what it is worth, I continue to hold the view that the degree of pain that can be handled is probably "not very much." We are already seeing signs of an emergent near-term growth slowdown stemming in part from the lagged effect of tighter credit. However, it is the interaction with Xi Jinping's other stated structural policy aims that makes me question the Party's resolve, for as I noted towards the end of last year in "Party Fears Two":[2]

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I can think of few if any significant episodes of de-leveraging that did not deliver at the very best a period of significantly slower economic growth, and at worst, major financial dislocations. Can China buck this trend? Perhaps it can. Can it avoid at least the former if it is simultaneously reducing excess capacity, making a major push to clean up the environment,

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[1] "During consultations and surveys at the grass-roots level, many regions, departments and members of the party and the public have unanimously called for the rules on presidential term limits in the constitution to be revised." National People's Congress Secretary General, Wang Chen, assuring the delegates that the decision to scrap term limits was in response to overwhelming demand from the grass-roots. He was clearly persuasive since out of 2,964 ballots cast, 2,958 were in favour, three abstained, one was deemed invalid and just two brave/foolhardy/misguided delegates dissented. One assumes that at best they are probably not invited back in five years' time. "Just when I thought I was out, they pull me back in."

[2] November 22nd 2017.

promoting policies to reduce inequality, and asking private business and civil society to come more under the Party's purview? This would be a tremendous achievement of navigation and adroit-bordering-on-infallible management. At the very least I would not bet on this being a smooth progression…. Should trade wars and sanctions escalate and/or the Chinese economy slow meaningfully further from here, then the temptation to dial back on regulatory restraints and to re-open the credit taps will surely rise. I remain of the view that medium-dated shorts against the dollar on the CNY and/or the KRW provide some relatively cheap tail hedges.

Notwithstanding my growing medium-term concerns about the direction China seems to be going in, I have never been in the immediate collapse camp. Indeed, I have been rather cheerful cyclically – not just on China but the whole region – for the past couple of years. Such optimism though has been partly predicated on China's unwillingness to "eat [cyclical] bitterness" with its reversion to credit pumping type in late 2015 and the economy's resultant re-re-balancing act.

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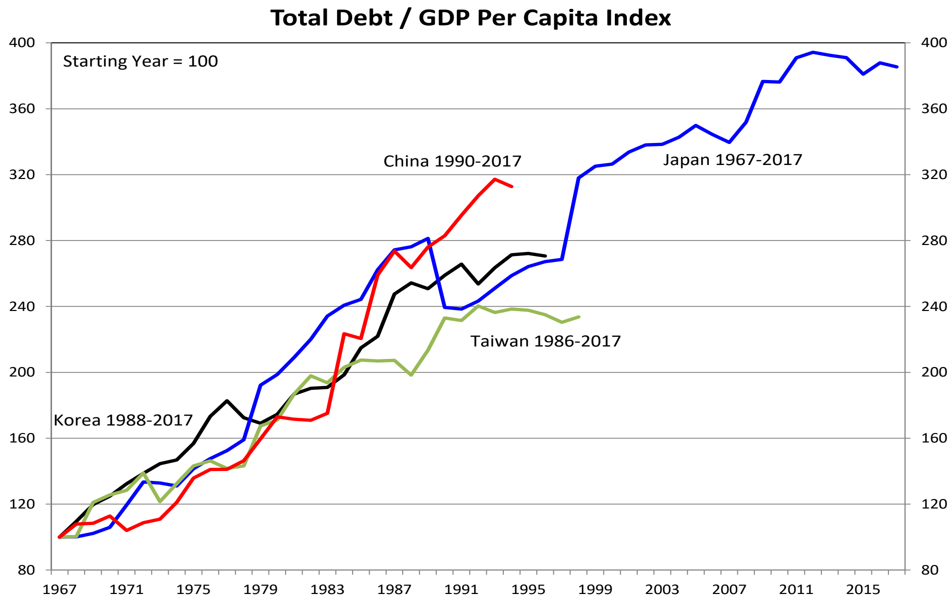


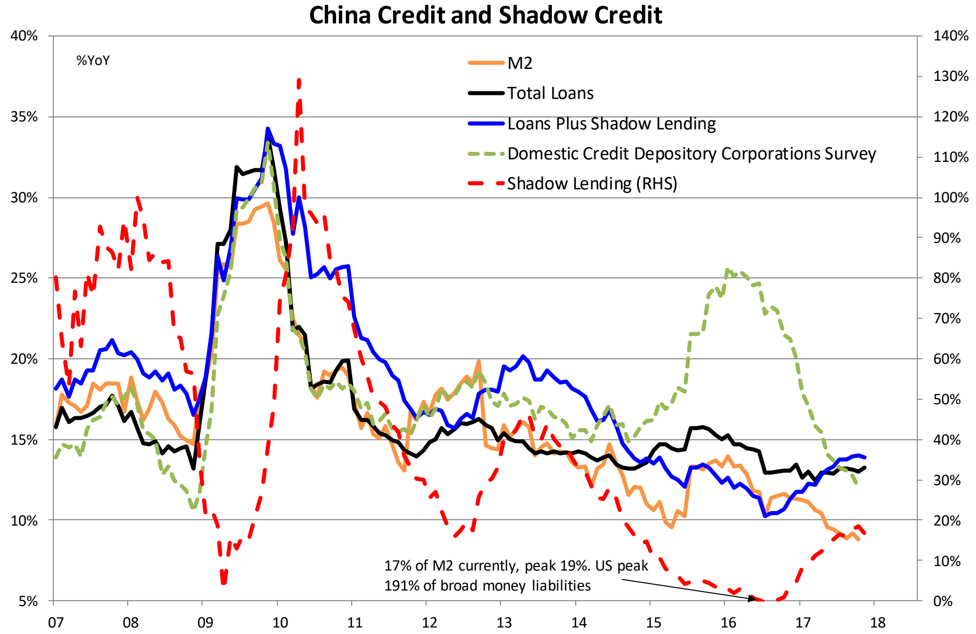
Nevertheless, this most recent episode of monetary incontinence has propelled debt ratios beyond those racked up by Japan in 1989 but at a stage of development more akin to Japan's in 1970 (the chart above incorporates both variables). Economic growth can be delivered by employing an increased quantum of different factors of production (land, labour and physical capital), improving the productivity of these factor inputs, and finally by leveraging the heck out of them. In the immediate decades

Debt ratios now exceed those racked up by Japan in 1989 but at a stage of development more akin to Japan's in 1970

following the introduction of the Open Door Policy in 1978, China was exceptionally successful in delivering on the first and second of these paths. The last decade has seen far more of a focus on #3.

This recent and arguably historically unprecedented (in a major economy) accumulation of leverage is the subject of today's structurally-focussed missive. The charts and narrative that follow say nothing about the timing of any denouement. However, bills have to be paid eventually or inflated/defaulted away and it is seriously debatable whether China has either the accumulated wealth or the social fabric to manage a Japanese-style internalised deflationary adjustment. Moreover, unlike Japan and its army of patriots who repatriate funds at times of national stress, the PRC's citizens are historically far more likely to rush in the opposite direction. I struggle to see how the RMB can be a strong currency over time.

The charts and narrative that follow say nothing about the timing of any denouement



Recent efforts to prevent credit excesses from worsening further should be applauded and I, for one, have been surprised that the regulatory-induced slowdown in money and the broadest measures of credit charted above has hitherto left the real economy largely unmolested. I still believe that the lagged impact of this monetary tightening will make itself increasingly felt

Recent efforts to prevent credit excesses from worsening further should be applauded

as the year progresses, especially as the Trump administration appears to have lost all patience with Beijing[3] and is now firmly on the trade warpath.

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[3] I recently attended a meeting with a DC insider, held prior to the President's announcement of his steel and aluminium tariffs, where our interlocutor said that the only real question was whether policy actions would be "significant or huge." The US, rightly or wrongly, is not alone in its assessment of China's trade and investment practices and its perceptions of a lack of reciprocity and sincerity in negotiations. It is troubling that the messenger is so flawed and his style hardly lends itself to coalition building, but none of this means that his message is entirely wrong. Trade in physical goods and the trade team's misguided focus on bilateral deficits is currently taking centre stage. (Trump remains very much a fan of the views of "My Peter" Navarro. Although Navarro has largely kept a low profile in recent times and left the public engagements to the far more politically experienced Robert Lighthizer, he apparently remains very much in a position of influence.) Nevertheless, some of the most radical changes being considered, and in many cases already being implemented, are in the investment sphere (again the US is not alone here) – not only inbound but outbound as well.

In the context of the recent National Defence Strategy paper which labelled China as a revisionist power and a strategic competitor in all spheres, military and economic, the Committee on Foreign Investment in the United States (CFIUS) is considering major changes under the sponsorship of https://www.cornyn.senate.gov/content/news/cornyn-feinstein-burr-introduce-bill-strengthen-cfius-review-process-safeguard-national to adapt the CFIUS regime to what is perceived to be the new national security reality. This in turn long pre-dates Trump and is a function of a decade of, as the US sees it, Chinese bad behaviour ranging from cyber security, to theft of intellectual property, to forced technology transfers, to its activities in the South China Sea. Senators John Cornyn (R-TX) and Dianne Feinstein (D-CA) are traditionally considered free traders, but in tandem with the Chairman of the Senate Select Committee on Intelligence, Richard Burr (R-NC), they are envisaging a regime of review which also encompasses the granting of study and work visas to those deemed likely to facilitate technology transfer overseas. Moreover, PE/VC investments, even by third country partners with Chinese investors will be scrutinised more, as will JVs in third countries where again there is a risk of IP leakage and technology transfer. Robber Baron America was often equally guilty of such practices as this article makes abundantly clear http://foreignpolicy.com/2012/12/06/we-were-pirates-too/ but since Trump and his acolytes do not readily do irony – the maid presses his shirts doubtless – this line of argument is not likely to sway many opinions in Washington.

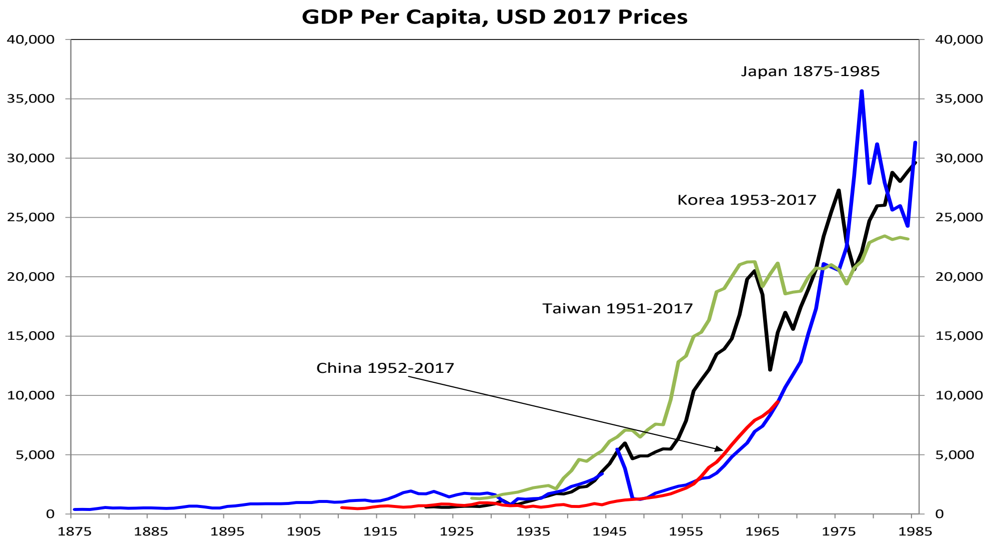
China: Japan 1970 Development, Japan 1989 Debts

We shall see what transpires, but for now, let us focus on some funky long-term charts. In many cases, I have employed multi-decade and, in some cases, multi-century time series for Japan and overlaid them with similar series for Korea, Taiwan and China at similar stages of development. As I mentioned earlier, such analyses offer little help with immediate timing but I believe the stories they relate are compelling ones.

The media may be awash with stories of wealthy Chinese investors buying up global assets….

The media may be awash with stories of wealthy Chinese investors buying up global assets and driving up prices in markets ranging from residential property in major global cities, to robotics and biotech companies, to English football teams (good luck with the last of these). Nevertheless, although a small percentage of 1.3 billion people translates into a large absolute number of rich punters, China remains overall a rather poor country with millions and millions who still have very little and still live precarious lives. Less precarious than in the past in many cases, but precarious nonetheless.

…. yet China remains overall a rather poor country with millions and millions who still have very little and still live precarious lives

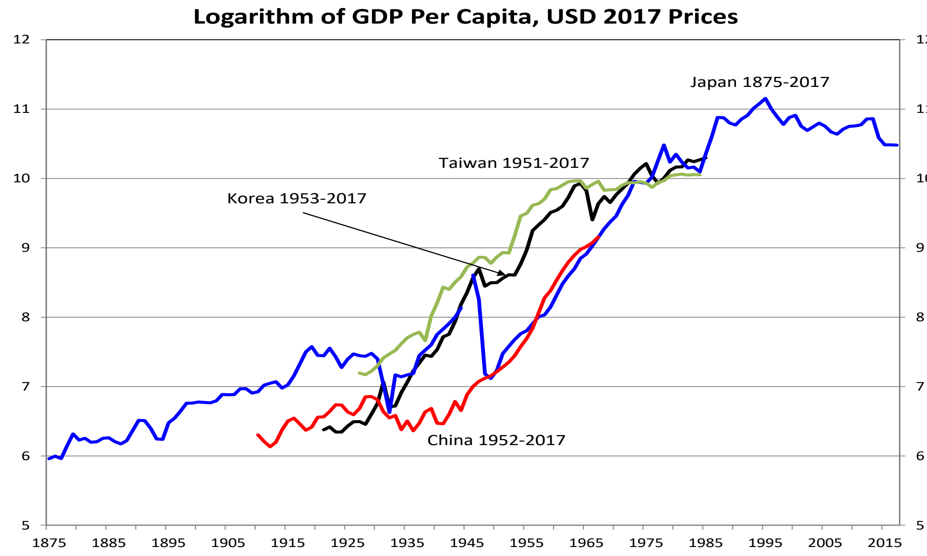


In constant US dollars, as the chart above illustrates, Chinese per capita incomes are only at levels achieved in Japan in 1967, and in 1986 and 1988 in Taiwan and Korea respectively.[4] Considering such measures on a log scale (overleaf) can help with this visualisation process.

Chinese per capita incomes are only at levels achieved in Japan in 1967

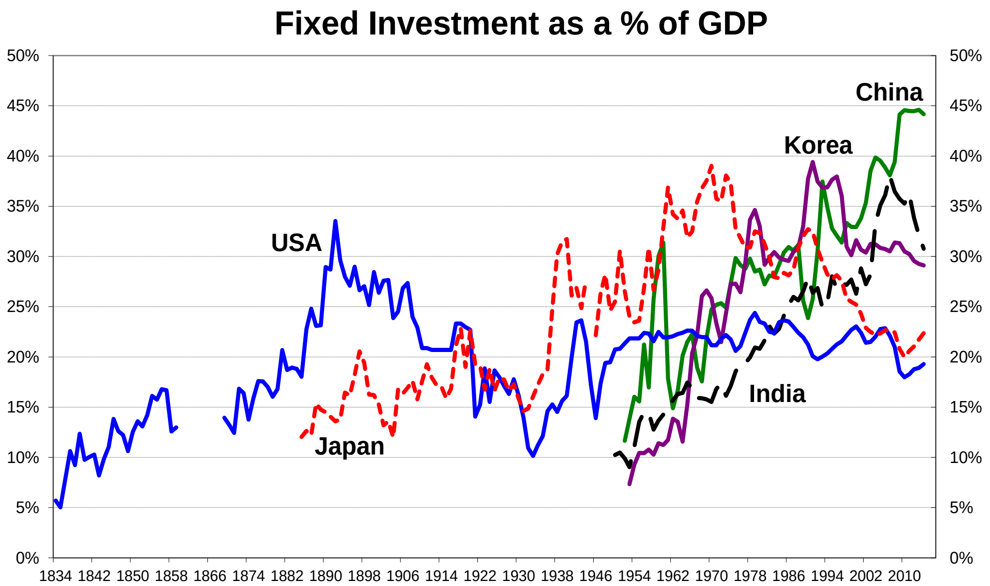
[4] I am no real fan of PPP or purchasing power parity adjusted GDP income measures since I have yet to meet anyone who pays for an international transaction in a PPP dollar. In any case, though I would gladly be disabused of the notion, I suspect that PPP estimates for 1875 Japan are likely to be elusive.

China: Japan 1970 Development, Japan 1989 Debts



I have written at length about capital stock measures in the past.[5] There is little doubt that China's investment rate over the last decade has exceeded previous peaks sustained by other Asian growth successes, and it is very likely cyclically over-invested. (The resultant excess, often state-subsidised capacity is a contributor to trade tensions as well as being one of the imperatives behind the Belt-Road Initiative.)

China is very likely cyclically over-invested



[5] Please get in touch should you wish to see the anthology.

China: Japan 1970 Development, Japan 1989 Debts

Nevertheless, despite this torrid rate of capital accumulation, China's capital deepening progression has, arguably, decades still to run. GDP growth should be thought of as a country's P&L while its capital stock represents its non-financial balance sheet position. In the context of its neighbours' experience, China is somewhat further up the capital accumulation path than its income measures might suggest, but not wildly so.

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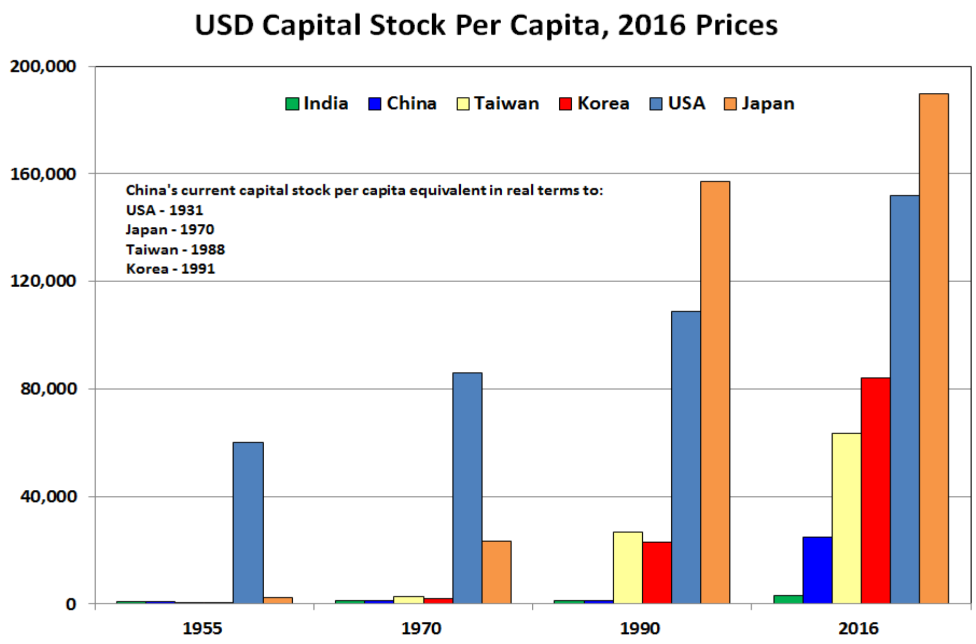
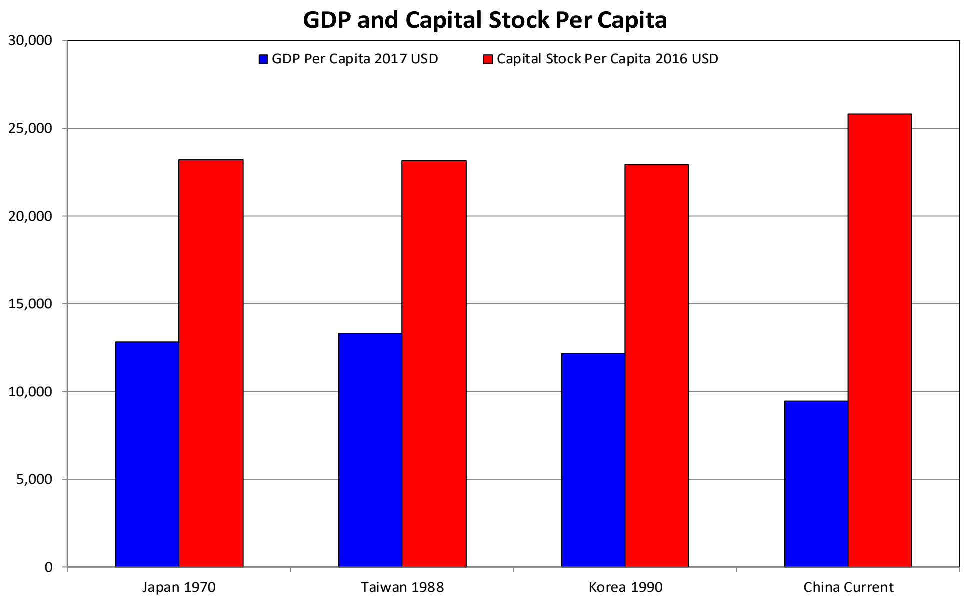
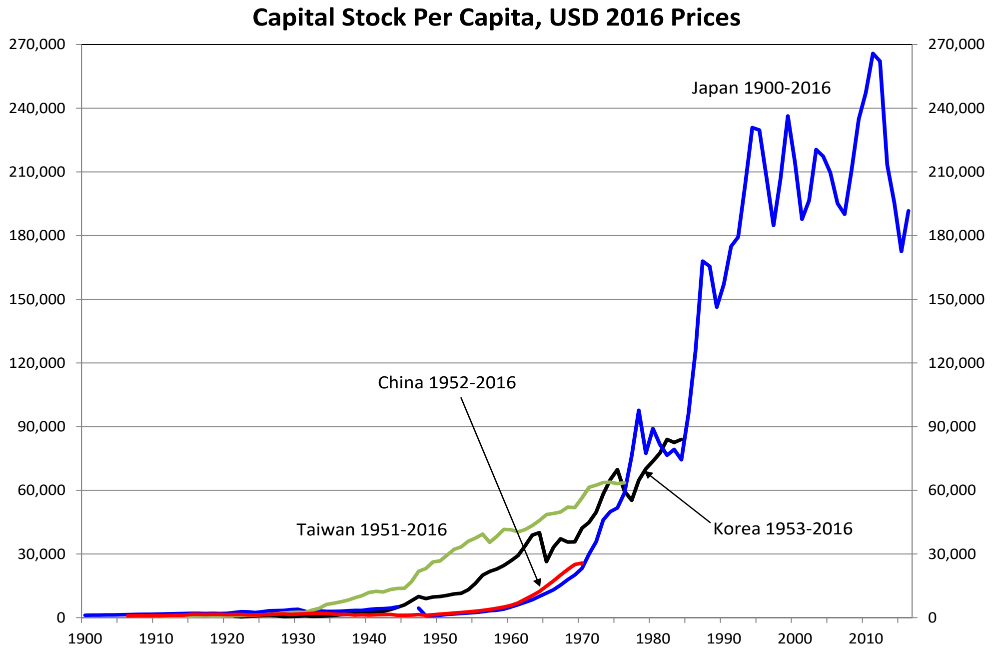




China: Japan 1970 Development, Japan 1989 Debts

What do we mean when we talk about a country's capital stock? It is the sum of a country's produced physical assets, tangible and non-tangible,[6] plus non-produced assets such as land and mineral resources. I choose to exclude non-produced assets from my measures since a) China does not provide us with official land[7] and untapped mineral deposit valuations and b) land values especially can vary wildly from country to country, and from time period to time period. (Recall, for example, the old saw about the land around Japan's Imperial Palace being worth more than the whole of California just before the bubble burst.) Again, China's scope for further physical capital accumulation is very apparent from this time-series chart.

GDP growth should be thought of as a country's P&L while its capital stock represents its non-financial balance sheet position



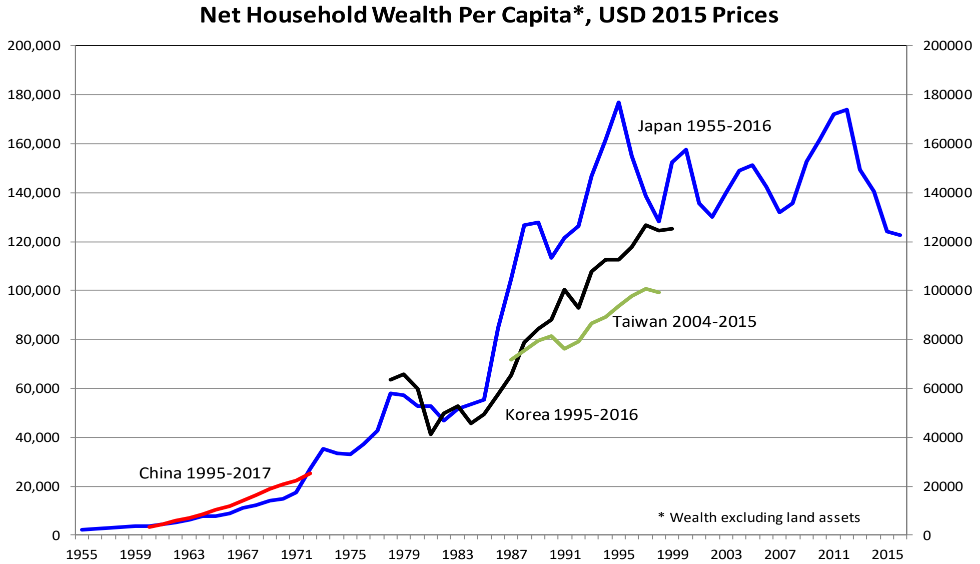
[6] Tangible assets are in practice far easier to measure though the valuations applied can be subject to debate. Valuing intangibles is a far more challenging exercise that is increasingly taxing statisticians as they try to adapt national income accounting and productivity measures for a post-industrial world. China is clearly investing heavily in its own intangibles but since no official measures are available it is hard to fathom their share in total investment. One can fairly assume though that richer and more developed countries should have a higher proportion of intangibles in the total and for contemporary Japan, Taiwan and Korea, these represent 3-6% of the fixed asset stock and 20-25% of the fixed asset flow.

[7] A politically sensitive subject in any case in a socialist paradise.

China: Japan 1970 Development, Japan 1989 Debts

To physical capital we can then add net financial assets to build out the full national balance sheet, otherwise known as national wealth. The adding in of financial assets offset by national debts does not materially change the story of China still being a relatively poor country, as illustrated below, by the comparison of developments in *household* wealth over time.[8]

National wealth measures also suggest that China remains a relatively poor country



As noted earlier, although China has rapidly accumulated a pretty sizeable pot of real and financial assets, real wealth is only built up by being a rich country for decades on end, if not centuries. Just as fast growing early-stage companies can run into balance sheet problems if hit by an income or payments shock that can be absorbed by an older venture with a far deeper reserve of retained earnings, so poorer countries can find themselves going bust far more quickly than their richer counterparts if faced by similar disruptions. Japan was financially capable (and had the right social fabric) of stewing in its own juices for decades whereas Korea has blown itself up (and rebounded) spectacularly multiple times since the mid-1990s. Similarly in Europe, France and Italy felt rather less immediate pressures to change than did their Spanish, Portuguese, Irish and Greek counterparts in the single currency. Which of these outcomes is preferable probably depends on which generation one asks.

Real wealth is only built up by being a rich country for decades on end, if not centuries

[8] This picture of relative poverty would not change significantly if one were examining the whole economy rather than just the household sector. However, there are significant gaps, inconsistencies and time lags in the Chinese data series for other major sectors which make construction of a meaningful time series for total national wealth rather problematic.

China: Japan 1970 Development, Japan 1989 Debts

China's potential vulnerability comes from both its relatively shallow pool of national retained earnings and the debts it has incurred in its breakneck quest for growth; debts ahead of those racked up by its neighbours at a similar stage of development. In the upper chart below I have re-appended my total debt-per capita GDP index chart while the lower chart just looks at total debt as a percentage of GDP. For "fun" I have incorporated the contemporary China series twice, overlaying both Japan's pre- and post-war experiences.

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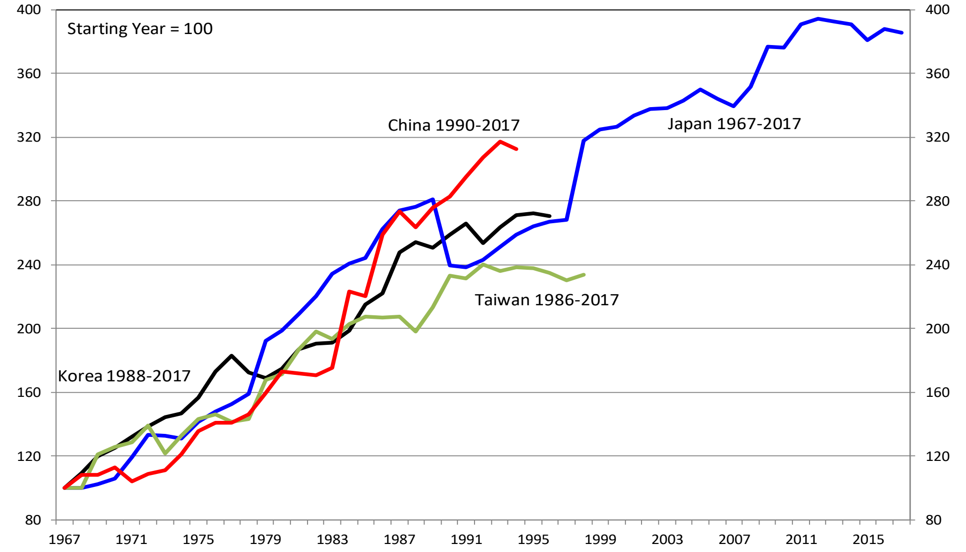
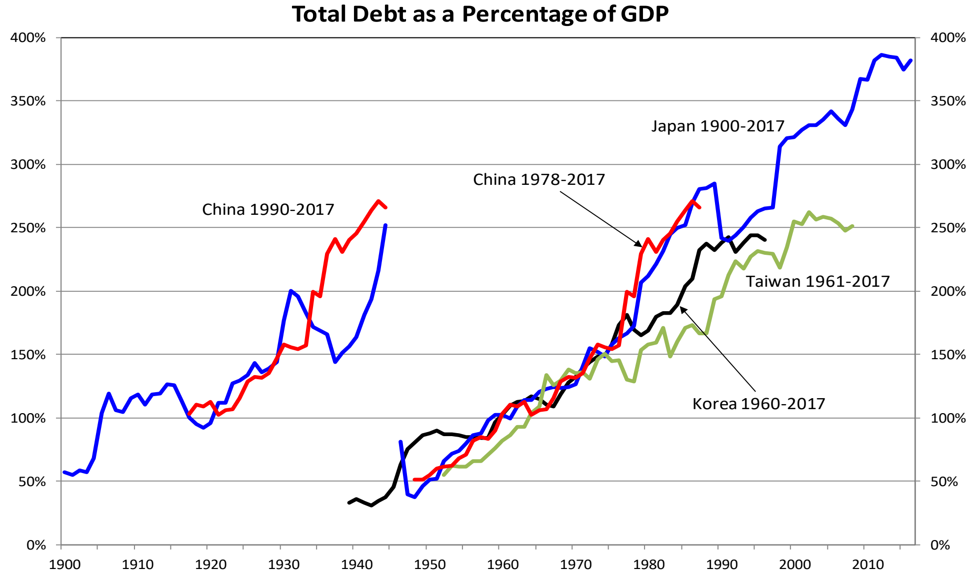
Total Debt / GDP Per Capita Index



Total Debt as a Percentage of GDP



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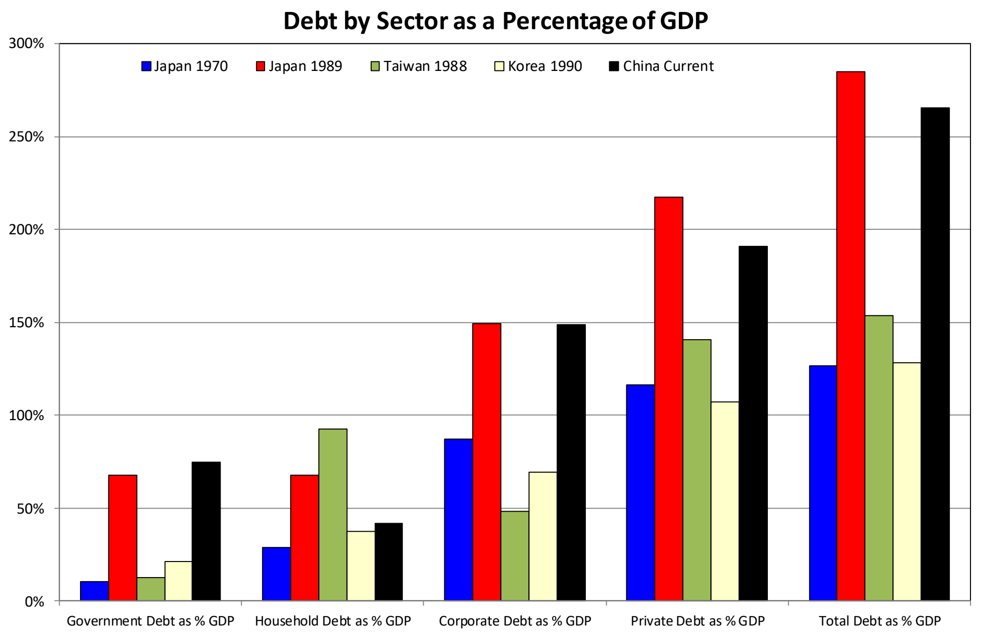
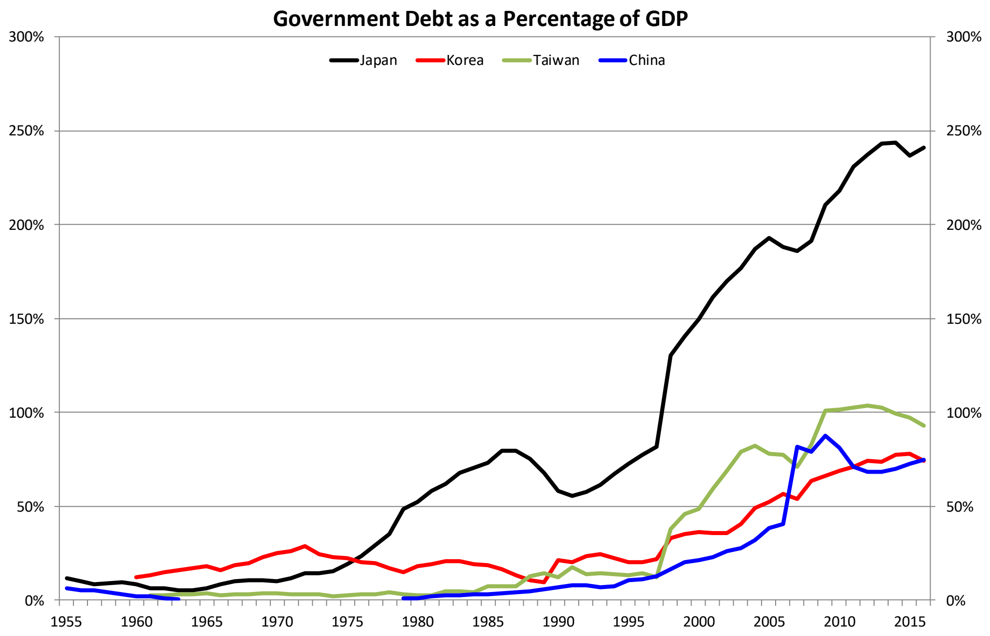
The bar chart below pulls together the various sectoral debt piles across equivalent stages in economic development. The line charts that follow plot these sectoral trajectories over time.





China: Japan 1970 Development, Japan 1989 Debts

You might note that Taiwan has generally had a far higher level of household leverage over the decades while conversely its corporate indebtedness has tended to be lower. This is largely a function of industrial structure since Taiwan has a far greater confluence of successful, smaller entrepreneurial companies which can often be classified as household entities. China is far more akin to Japan and Korea where larger enterprises predominate and SMEs are often emasculated.

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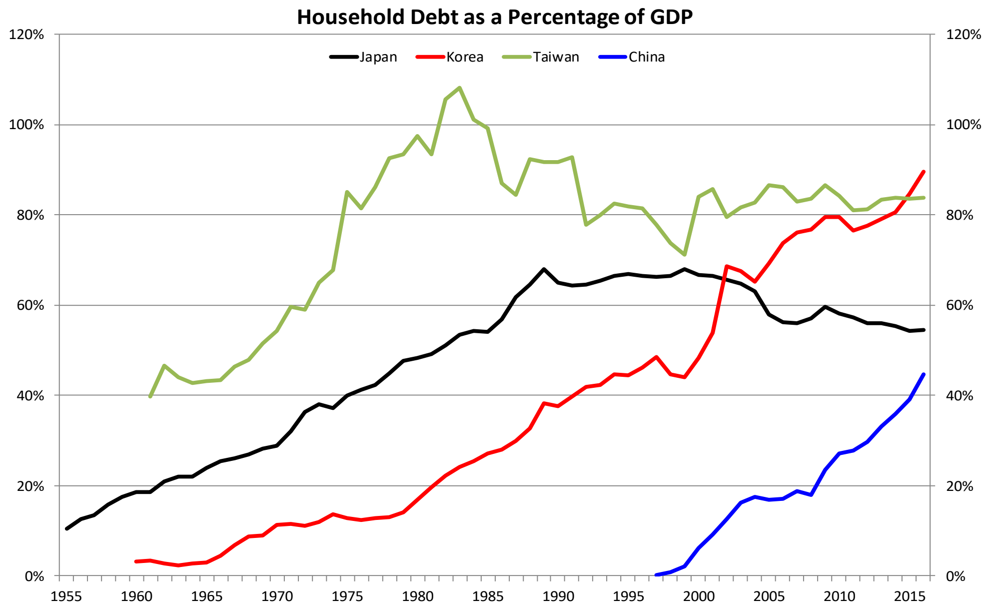

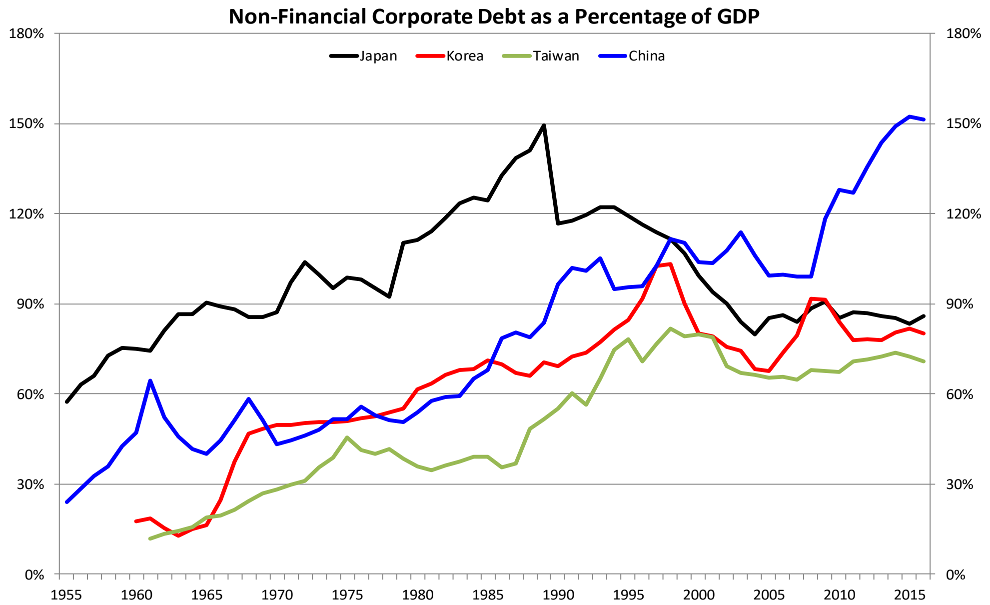

China: Japan 1970 Development, Japan 1989 Debts

Finally, given north Asians' love of property, we should consider both its share in total assets and its affordability. It is in Taiwan, closely followed by Hong Kong, where the least affordable property markets are to be found, and where (arguably inflated) property assets comprise the biggest share of gross household assets, a third and two-fifths respectively. While affordability is considerably less stretched in Japan and Korea, property assets also account for around a third of household totals. Chinese property affordability has been improving overall but in absolute terms it remains above Japanese and Korean metrics. Meanwhile, thanks to the shallowness and casino-like properties of its financial markets, property assets comprise around half of household totals.

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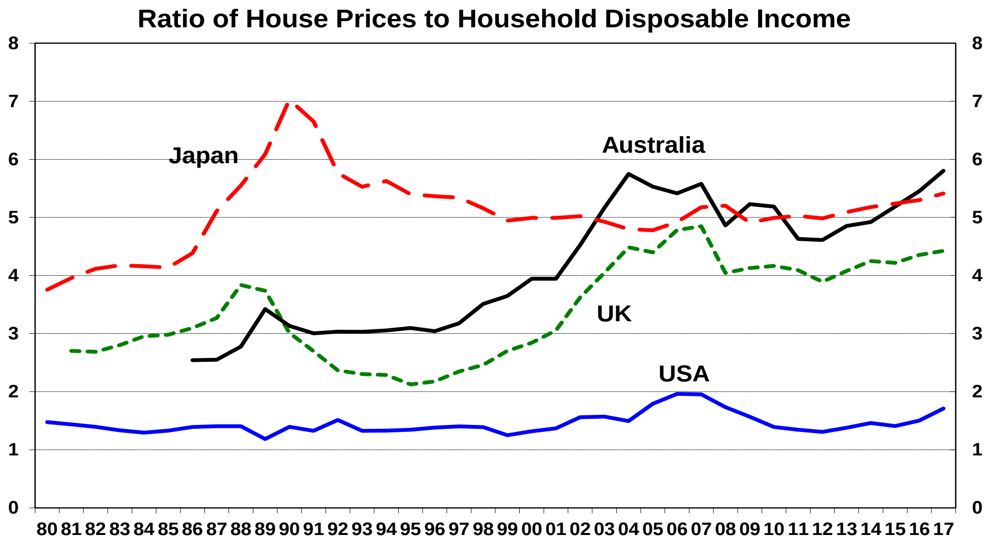

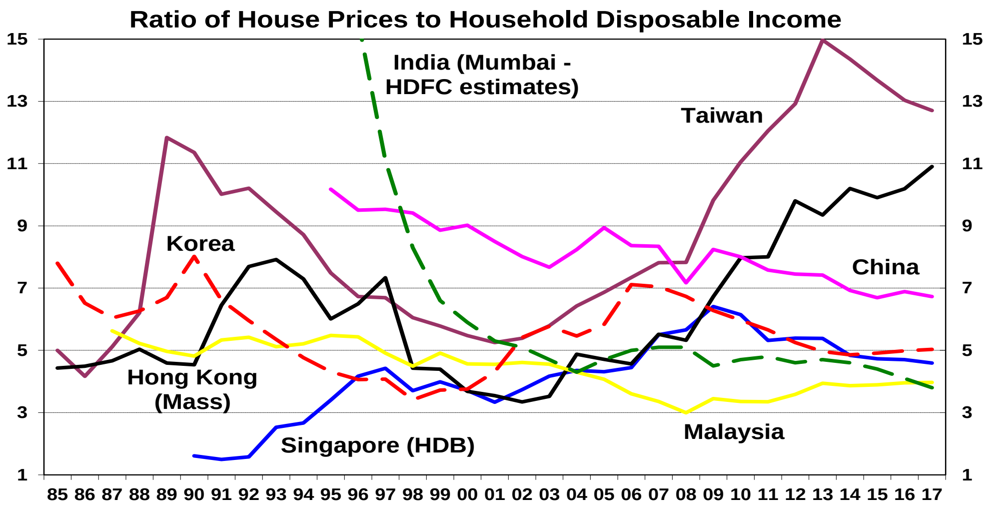

China: Japan 1970 Development, Japan 1989 Debts

National aggregates can disguise significant regional dispersion as our final two charts illustrate. It has rarely been as expensive to own a house in the cities where most people want to live. Nevertheless, given China's still relatively low levels of household borrowing (refer back to Page 12), the major credit risks would seem to reside in the corporate and quasi-government sectors.

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