



# Ted Scott on the wire

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## China: Can it learn the lessons from Japan?

### Summary

- **A credit explosion triggered an asset bubble in Japan in the 1980s**
- **There is some evidence of a bubble in the real estate market**
- **The Chinese economy remains over-dependent on exports**
- **Unlike the Japan of the 1980s, China is still emerging**
- **A stronger renminbi can allow the economy to rebalance**
- **The economy is being well stewarded and a slump similar to Japan's is unlikely**

### Introduction

In November I wrote a note examining whether China was a potential bubble that could burst. China has become increasingly integral to the global recovery story following the credit crunch, especially as some developed economies are showing signs of fragility as they have continued to be weighed down by the size of their debt burden. Last year I concluded that the scepticism about China's economic miracle was largely misplaced even though certain risk assets were clearly overvalued. In this piece, I revisit the doubts harboured about the Chinese growth story but with particular reference to what happened in Japan two decades ago.

Many bears of China have drawn the analogy of the Japanese growth story in the 1980s that resulted in the bubble bursting in 1990 and subsequently a protracted period of deflation and recession. The note looks at the similarities and contrasts between the two countries and asks what lessons the Chinese authorities can learn from Japan to avoid a similar fate.

### What happened in Japan?

Despite the appearance of a vibrant modern economy the story of the last two decades has been one of almost uninterrupted woe. During the last 20 years the economy has grown at an annual rate of just 1.1% as it has lapsed in and out of recession.

Once the bubble burst in 1990 deflation took hold and has retained its vice like grip ever since, despite efforts by the authorities to reflate the economy, including the Japanese version of quantitative easing. Over the period, government debt has shot up from 13% to 115% of GDP reflecting the deterioration in state finances at the same time as the private sector savings have increased. This has made it more difficult for the authorities to generate growth when it has been desperately needed and throughout the two decades interest rates and bond yields have remained at extremely low levels without sparking recovery. The problem has been exacerbated by an aging population that is an increasing burden to the state and the working population.

It is this collapse in the economy and, more importantly, the failure to emerge from the deep seated recession which followed, that bears of China feel could happen there. The boom in Japan was centred on the commercial real estate sector (CRE) and in the years 1985-91 prices on average rose five-fold. Although residential prices also increased fast it only accounted for a relatively small part of the credit growth that had fuelled the real estate bubble. The genesis of the boom was the Plaza Accord in 1985, whereby leading industrial nations agreed to revalue the yen, which like the Chinese renminbi, had been kept at an artificially low level to help the export industry. Once the yen rose (it doubled in value against the dollar in the following three years) the export sector slumped and the authorities responded with an aggressive monetary policy including low interest rates. The excess liquidity that was thus created was directed into real estate and other assets such as equities and marquee works of art.

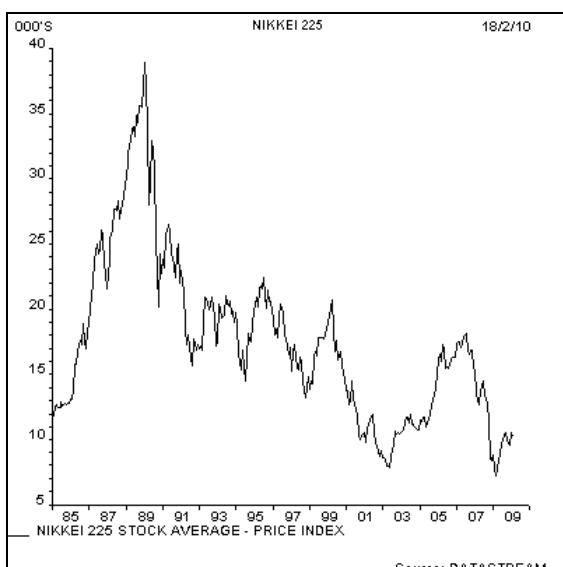
The valuations for Japanese assets reached ludicrous heights as investor mania took hold. Perhaps most famously in 1987 a price of \$39.7m was paid for a Van Gogh painting that more than trebled the previous record price paid only two years before!





Good but worth \$39.7m in 1987?

The cost of land also sky rocketed with prices peaking in 1989 in Tokyo at approximately \$1m per square metre. To give you some idea of the extent of the investor fever, in 2004 prices of prime property in Tokyo's financial district were less than 1% of their peak in 1989! Meanwhile the total market capitalisation of the Tokyo stock exchange was briefly higher than Wall Street as the price earnings ratio peaked at an average of about 70 xs. It was not uncommon for companies to be rated on over 100x the price earnings ration (PE) multiples and there was talk of a new paradigm in an effort to justify the absurd valuations. Inevitably, not only have share prices fallen to reflect the end of the boom but there has been a savage de-rating of the Japanese stock market. By October 2008 the index plunged to a 26-year low.



### What are the similarities to China?

Some of the above has hallmarks of what is going on in China today. The boom in Japan was based on the easy availability of credit and aggressive monetary policy and the growth in bank lending, especially in 2009, is a characteristic of China's growth story. Furthermore, asset bubbles are beginning to or, depending on your point of view, have emerged as evidenced by the strong performance of the stock market and residential real estate markets. China is also an export led economy which, like Japan, has seen the creation of a large trade surplus and accumulation of foreign exchange reserves (currently estimated at \$2.4 trillion). This has enabled the government to sponsor an aggressive expansionary monetary policy with relative impunity. By this I mean that, in response to the global credit crunch, the Chinese authorities could not only lower interest rates and increase the money supply (as has happened in the developed economies) but also licence a massive increase in bank loans to fuel an infrastructure boom. Unlike their counterparts in developed economies, China has a public sector balance sheet that can afford the expansionary programme. It is this that has been responsible for much of the growth in the Chinese economy in the last year and is a cause of concern for those who believe that China is creating a bubble.

In 2009, it is estimated that bank loans expanded by 31.7% and much of the credit was directed to infrastructure spend such as roads, bridges, airports and public buildings. Investment represented some 47% of GDP last year, which is well above the rates for a developed economy. There has been some justifiable criticism that the economy is imbalanced as a result. In a developed economy like the UK or US, consumption represents up to 75% of GDP and while consumption can be encouraged it cannot be controlled like government spending that has been responsible for so much of the incremental growth during the recession.

Last year China posted GDP growth of 8.7%, an incredible performance when one considers that the UK shrunk by -4.8%. Growth accelerated during the year as the aggressive policy measures took effect and by the 4<sup>th</sup> quarter the economy was growing at an annualised rate of 10.7% compared to near 6% at the start of the year. China, being a command economy and under the control of the State, has a growth target of 8% for 2010, the same as last year, and over the last 10 years has averaged GDP growth of 9%. To some extent, China has become the growth engine of the world. With the developed economies only tentatively emerging from recession, China is by far the fastest growing major economy and is now on the verge of overtaking Japan as the world's second largest economy after the US.



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Any growth story of this scale and over such a short time frame is going to have bumps along the way, especially in the context of the biggest global recession since the 1930s, but this is different to saying it is a bubble such as Japan experienced in the late 1980s. Bubbles are only obvious in retrospect and, as stated above at the time there were plenty of analysts strongly recommending Japan as the preferred region for investment. Opinion is more divided this time with regard to China so the section that follows will analyse some of the doubts surrounding the growth story.

## Is the Chinese economic miracle sustainable?

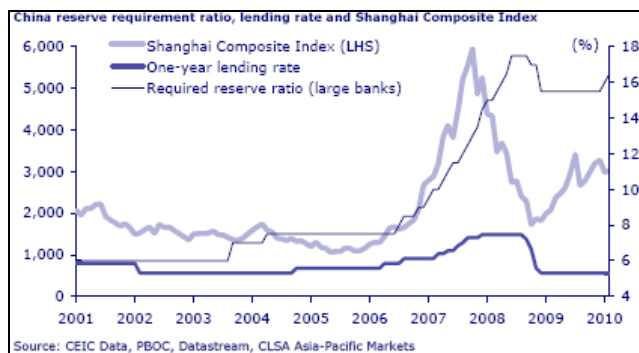
In order to answer this I will address the main areas of doubt that have been directed at China's economic policies and their consequences.

- **Growth has been based on an explosion of credit, just like Japan in the 1980s**

This has been increasingly the case with the 31% expansion in bank lending last year and a further acceleration in January 2010 which registered a larger increment in bank lending than in the three previous months combined. Since 2004 the gap between the rates of growth of credit and nominal GDP (excess credit) has increased, particularly last year.

This has raised fears of inflation and over-heating but the Chinese authorities are well aware of the risks and have already taken action.

The reserve requirements for banks have been raised twice by 0.5% so that for large banks it is now 16.5% and the authorities have indicated that further increases are likely on a monthly basis. Treasury bill yields were also raised slightly. The chart below shows the reserve requirement together with the official interest rate and the stock market index. It shows that reserve requirements still remain relatively high compared to the ultra loose policy prior to 2007 and the lending rate remains unchanged despite the rise in the required ratios.



The moves spooked markets that have increasingly perceived China as the engine for global growth, but it also shows the resolve of China to engineer a sustainable growth path. The target for bank lending is 17-18% growth in 2010 and the authorities had become alarmed that it was growing too fast and want the banking sector to spread its lending more evenly over the year.

There is little sign of incipient inflation yet; in January the consumer price index (CPI) rose to 1.5% and most of the rise came from food. However, inflation is a lagging indicator and is a dragon that is difficult to slay once it takes hold. Therefore, the measures to increase bank reserves are a prudent response to rapid economic recovery last year based on the huge growth in bank lending and the money supply. Also, they reflect the authorities' desire to sterilise (neutralise) the inflow of US dollars as a result of the recent rise in exports to the USA. The authorities are not yet ready to raise interest rates and so the shift in monetary policy is likely to be a gradual one. The preferred method of monetary tightening is through directed lending and lending quotas before raising interest rates. At present, growth in the economy is consistent with an annual rate of well above 10% compared to the target of 8% so the authorities are likely to continue to clamp down on bank lending.

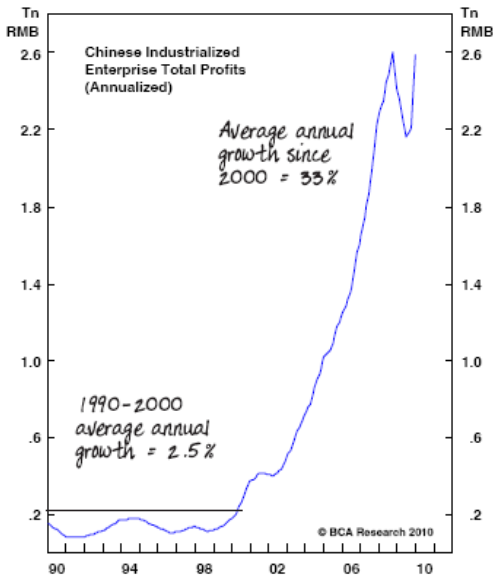
- **There is increasing evidence of asset bubbles emerging**

Although the CPI has barely moved into positive territory some assets have registered substantial and, in the view of some, unsustainable gains. Like Japan, real estate and equities have been amongst the main beneficiaries of the rise in asset prices. Looking at equities first, the market is on a PE of about 28x following last year's rise. This sounds high compared to developed markets (the UK is on about 13 xs by comparison) but this is below China's long run average and much lower than the average multiple of over 70 xs for Japan in 1989. A higher valuation for Chinese companies should be expected not only because they are growing profits at a much faster rate but also because the Chinese economy is functioning much better than its western counterparts. The following chart shows the acceleration in profit growth since 2000 compared to the decade previously.





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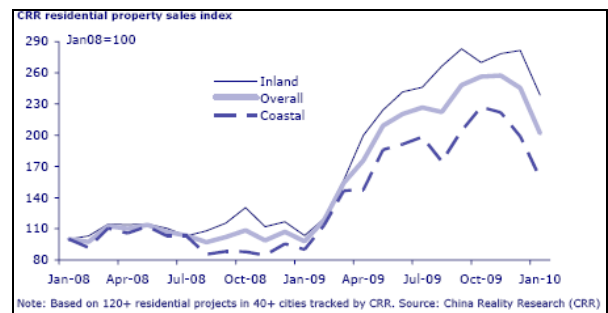


Last year there was clear evidence of excessive speculation in the stock market and it is healthy that it has consolidated in recent months (see the chart relating to the reserve requirements above showing the Shanghai Composite Index), partly in response to the signs of monetary tightening. The recent announcement that Anthony Bolton from Fidelity wishes to run a Chinese investment trust because he sees the country and its companies defining the future for the next generation, is a further endorsement.

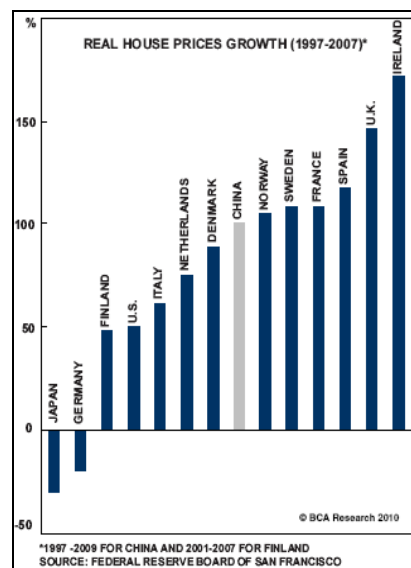
In the real estate market there is, however, more evidence of a bubble, albeit on a regional basis. The boom in property prices has been concentrated in large urban areas such as Beijing and Shanghai; for instance last year the average price of real estate rose from R10000 to R18000 per square metre in Shanghai. For the country as a whole, the average house price divided by average income is 10 xs which sounds high compared to western markets. In the UK it peaked at about 6.5 xs in 2007 during the housing bubble compared to a long run average of less than 4 xs. (In Japan it got to 18 xs at the peak that required some buyers to take out 100 year mortgages!)

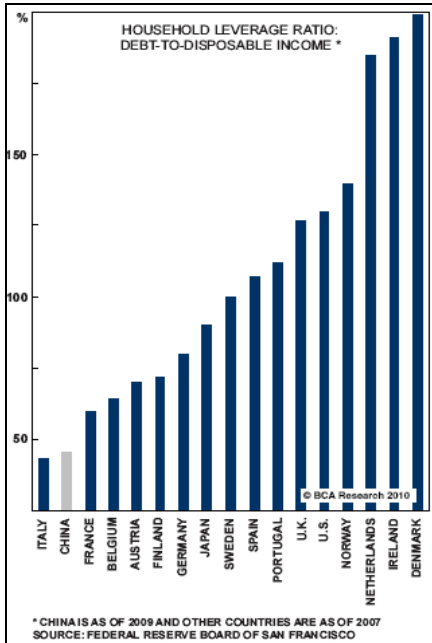
To understand the housing market in China it is necessary to consider the demographic change that is unfolding as part of the industrialisation of the country. China is still essentially a poor rural nation with a vast population of some 1.4 billion that is undergoing rapid urbanisation. This involves mass migration from the countryside to the cities and part of the infrastructure investment has been in preparation for it. The urban buyers generally have much higher incomes than those

working in the countryside and unlike in the UK, and many other developed markets that have experienced a boom and bust, most of the buyers are not heavily indebted. In fact, it is estimated that about 25% of buyers pay cash and total household debt is around 35% of disposable income compared to 130% in Japan in 1989. There is already evidence, as with the stock market, that some of the froth has come out of the housing market. The chart below shows residential property sales and is a positive development as the authorities will be reluctant to target the real estate sector as it may jeopardise recovery.



While there is evidence that for some urban areas prices have run too far, too fast, for the market as a whole there is much less evidence of a bubble. The chart below shows that property prices have risen 100% in real terms since 1997 but that is less than in many Euro economies including the UK where they rose by 146%. The second chart shows that the leverage taken on by households has been fast but again not excessive.



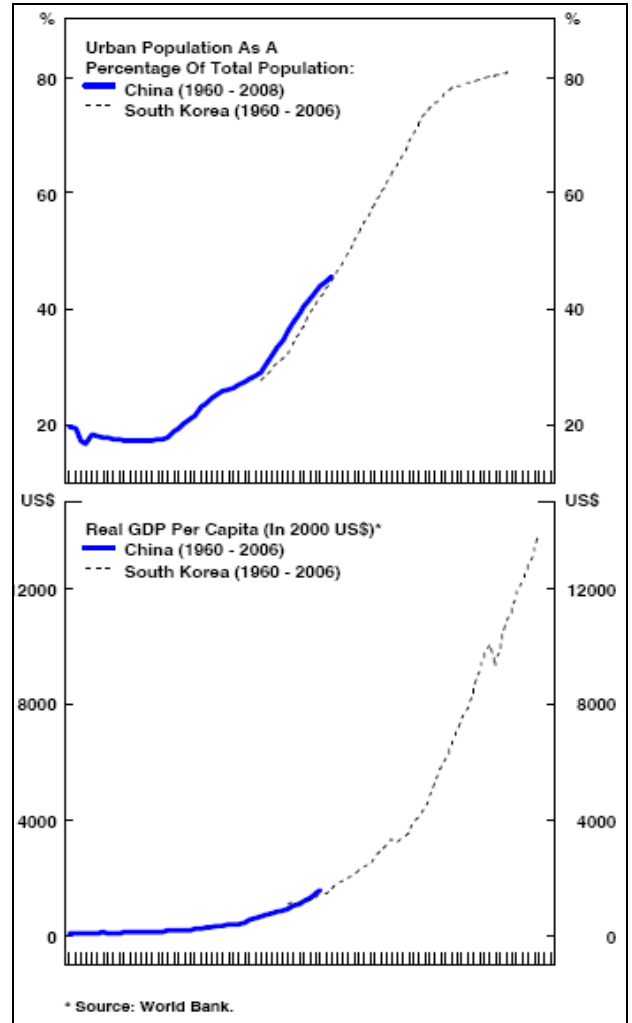


In conclusion, I would say the boom in the Chinese residential housing market has a lot more substance than the equivalent surge in CRE in Japan in the late 1980s. On a national basis there is little evidence of a bubble emerging and much of the housing boom is being financed by savings, which is a lot less dangerous than credit.

- **There has been overinvestment leading to an imbalanced economy**

Much criticism that has been directed at the Chinese growth story has been that it is dependent on State spending and bank loans that are also policy driven. In 2009, 47% of GDP came from infrastructure spend and it has led to over-capacity in some industries such as steel and cement. Clearly, this partly reflects the downturn in global demand as a result of the recession, but there are valid concerns that the economy is becoming too dependent on government spending. In contrast, the consumption represents a relatively small percentage of GDP at around 35% compared to double that in developed economies. In the longer term, China needs to raise the share of GDP represented by consumption, but in the near term could the lack of consumer demand lead to over-heating?

Part of the reason for the high level of public spending, aside from generating jobs and growth, is to prepare for the urbanisation of Chinese society. The following charts plot the urbanisation and the GDP per capita of China against South Korea in earlier decades and they show a similar trend.



Urbanisation requires many projects to build airports, bridges, roads etc. and it is important to remember how populous China is. Although it has about the same land mass as the US, it has about 13x the population at the time the US was going through its own industrial revolution a century ago. Although many of the projects will not be profitable and will result in bad loans for the banks, they will collectively bring significant economic benefits; in this respect they are similar to the rail road companies in Britain that powered our industrialisation but for the main part were a bad investment.

As regards the imbalance in the economy, it is true that it is over-dependent on the export sector and the public sector. However, consumption is growing rapidly but given the size of the population and the fact that the majority of Chinese are still poor with a low per capita income, it is going to be a transformation that takes years, if not decades.



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The government has encouraged greater consumption with various incentive programmes for consumer durables. At present, the household savings ratio is 25% in China compared to 5-6% in the UK and US because of job insecurity and the lack of a social security system. That is also gradually changing and in 2009 expenditure on healthcare and education rose by 48% and 25% respectively. As average incomes rise, combined with a more embracing social security system, so the Chinese will spend more and this is already happening.

A key difference from the Japanese bubble is the demographic profile. China today is an emerging economy whereas Japan in the late 1980s was a fully developed economy with a rapidly aging population and labour force, which shifted the burden of paying for the expensive social security system to future generations. In China, the labour force is forecast to grow until 2016 and GDP per head is a lot lower than Japan. This better balance to the economy as it grows means that China is much less susceptible to a bubble than its neighbours.

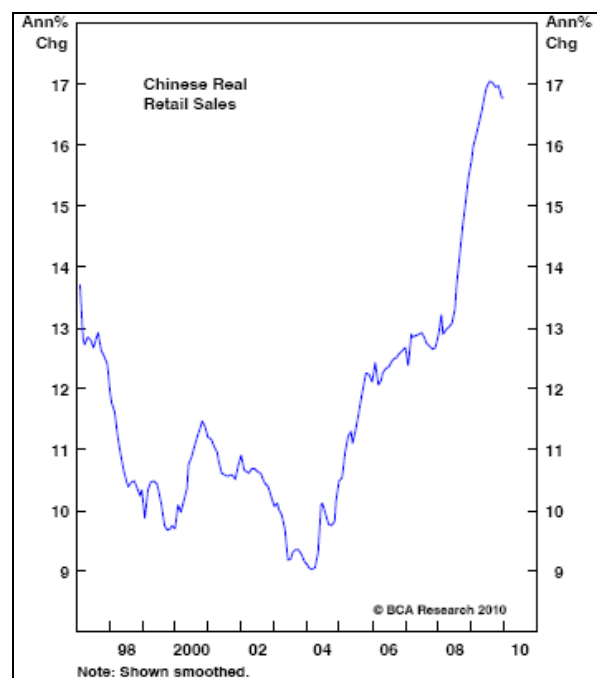
- **The exchange rate is artificially low**

The issue of the renminbi (R) being pegged to the dollar has been a source of international tension for some time and, with the onset of the credit crunch, trade relations have deteriorated further. While the growth in Chinese exports has helped drive its own economy and created huge foreign exchange reserves, the reverse is true of the importing countries, especially the US, which has accused China of effectively stealing its jobs. The size of the forex reserves is indicative that it has kept its exchange rate down more than any other country in the history of international trade. The weakness of the R is effectively shifting the burden of adjustment of the global financial system and its relative competitiveness to other countries and is a form of covert protectionism.

Until the credit crunch took hold the relationship suited both countries as the forex surplus was largely invested in US treasuries and helped fund the US trade and fiscal deficits. With the US now trying to repair its own balance sheet while growing the economy it needs its export sector to be strong, something the artificially weak R makes much more difficult to achieve. The problem for China is that it does not want the R to appreciate and precipitate an export slump, as happened in Japan after the revaluation of the yen in the mid 1980s.

While the Chinese authorities do not want to risk derailing the recovery with the export sector being such a large part of the economy, a compromise must be found. The R did undergo a partial and gradual revaluation from 2005-08 but this had the effect of attracting hot money and raising inflationary pressures, something policy makers will be keen to avoid. It could be that a one-off hike in the R would be the answer as it would circumvent the problem of speculative hot money being attracted by a gradual rising exchange rate.

The steady increase in domestic consumption (see chart below) will also lead to a substantial rise in imports, which will reduce the trade surplus and the accumulation of forex reserves.



Thus, over time, the problem will resolve itself and at present it is happening at a fast pace because of the relative weakness in demand for Chinese exports. Nevertheless, with the recoveries in developed economies proving so fragile, China must play a proactive part in the adjustment process that necessitates revaluing the R sooner rather than later.



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### Conclusion

In my view the fears that the Chinese economy is overheating and that bubbles are emerging are largely unfounded. Indeed, the Chinese state model of centralised capitalism has proved much more successful than the liberal democratic model favoured by developed markets in the last 10 years. The authorities have managed the economy astutely and, as with previous crises, notably the Asian crisis of 1997; they have accelerated and applied the brakes at what has proved to be the right time. The response to the global credit crunch last year was an aggressive one and now the growth targets have been achieved, monetary restraint is beginning to be implemented.

The above piece addresses the issues that have most often concerned observers of the Chinese growth story. The analogy with Japan is an unfair one and despite the similarities with respect to the rapid growth of credit and liquidity there are fundamental differences not least on a demographic basis that are strongly in China's favour. As with any economy there are bound to be policy mistakes, but China appears set fair for several more years of rapid growth that will be an essential contributor to a more widespread recovery from the recent recession.

**Ted Scott**  
**February 2010**

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