COMPARING NEIGHBOURS

CHINA VS JAPAN

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BAILLIE GIFFORD

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Andrew graduated from the University of Edinburgh with a first class honours degree in Mathematics and Business Studies (BSc) in 2011. Upon graduation, he joined Baillie Gifford as an Investment Operations Graduate Trainee and completed a two year programme of secondments across the firm. He now works as a Client Service Manager in the Emerging Markets client team. Andrew is a CFA Charterholder.

COMPARING NEIGHBOURS – CHINA VS JAPAN

BY ANDREW KEILLER

By definition, miracles are extremely rare occurrences, but Asia has been fortunate enough to have been blessed by more than one economic miracle in modern times. The extraordinary development of China is the most current example, with Japan's post World War II revival being another from the recent past. As an emerging economy with rising household income, particularly in affluent consumers' pockets, China sits at the bottom of an opportunity curve, where the 'new economy' should produce an abundance of attractive opportunities for the growth investor. But one can easily temper enthusiasm by looking to modern-day Japan, where aggregate growth is now unremarkable and consumer spending is fragile, and wonder just how sustainable such 'miracles' might be.

Although it is becoming easier to argue against the use of GDP as a reliable metric, it is nonetheless striking that in US dollar terms, Japan contributed an impressive 16% to global GDP growth from 1960-1990, with China adding 2%. But the tables turned between 1990 and 2014, with China contributing over 17% to global GDP growth and Japan adding just over 2%. For the Land of the Rising Sun, the economic miracle of the 1960s–80s faded into the 'lost decade' of the 90s. At the current juncture, per-capita GDP in China is at a level similar to the mid-to-late 1970s in Japan, which was then at the height of its resurgence. So this would appear to be an opportune time to investigate the factors defining the flight path of these two Asian economies, to explore what happened to miraculous Japan and see if this might offer any insight into what may or may not be on the cards for China.

Let us consider four factors to precis this: financing, demographics, governments and technology.

Top Right – A Japanese Matsuri Festival.
© LightRocket/Getty Images.

Bottom Left – Man delivering supplies to Chinese restaurant.
© iStockphoto/ErmakovaElena.


浅草うまいもの会


広島風お好み

FINANCING

The parallels are clear between where China is now and where Japan was before its asset bubble burst: large debt, overcapacity in a number of industries and a lack of trust in the banks. We are seeing an aggressive expansion of (particularly the smaller) banks and increasing complexity of transactions involving debt in China. Reform and clean-out will be painful for the government. However, if we take a step back and look at the country's current predicament, there may be good reasons to suggest China isn't about to descend into lethargy in the way that Japan did in the 90s when its credit expansion caught up with it. At the consumer level, household debt to GDP in China is only around 40%, well below western levels. For reference, it was around 70% in Japan in 1990 and is just a little shy of that today.

For many, the path of credit growth is the biggest issue for China. Total social financing, a measure of credit that includes bank loans, the shadow banking sector and the domestic bond market, is around 260% of GDP in China today, compared to about 140% back in 2008. It appears that there is a big contradiction in overall Chinese policy at work here – is the main aim to keep GDP growth at the same rate as the recent past as the credit boom implies, or is it to concentrate on the sustainability of growth and undertake much needed structural reform as policy statements insist?

If it is indeed the more significant latter, it would be reasonable to suggest credit growth will be tempered in time; it is simply not sustainable to continue at the current trajectory for many years to come without a nasty ending. In Japan, debt to GDP is higher than in China, at over 400%, but there is a fundamentally important difference. The lion's share of the Japanese debt pile is public borrowing, so is controlled by the Bank of Japan which, has infinite money printing power, in theory. In China, it is corporates that hold more of the debt and the lenders are listed profit seeking banks. Many have rising levels of non-performing loans as fragile loans come under stress, and their ability to fund ongoing obligations via deposits certainly isn't infinite. As such, they are likely to need recapitalisation down the line, so equity issuance or government bailouts in the form of debt for equity swaps seem increasingly inevitable. We are seeing signs of this already as some Chinese banks funnel debt towards sister asset management companies.

In itself, the total amount of debt means very little unless you consider how well-funded the debt is. The funding side of the balance sheet looks reasonable in China. The gap between the asset side and the deposit side of the system isn't at crisis levels, with around $1.10 private sector credit per $1 of deposits in China. But it cannot keep widening as it has been. Perhaps a real crisis point might occur if the endless ramping up of the volume and complexity of bank assets relative to the supply of funding were allowed to combine for the next five years or so. We suspect it won't.

Stepping away from the Japan-specific comparison for a moment, we can also look at the role that foreigners might play in a liquidity squeeze. The capital account in China is relatively closed, i.e. foreigners play such a small role in funding Chinese banks that a withdrawal of foreign funding cannot trigger a meltdown. China is still a net lender overseas. It is interesting that in the best known examples of emerging markets crises in the past 20 years, it was the build-up of foreign liabilities in the financial system that eventually led to a collapse.

Ariel view of Marunouchi, Tokyo at night.

DEMOGRAPHICS

If you were to plot the age dependency ratio for China and Japan against each other from 1990 to today, you would get an X shaped graph. In 1990, Japan had a dependency ratio of 43% which has increased to 64% as the population has aged. Compare this to China, where the ratio has in fact fallen from 52% to 37% over the same period.

The ageing population trend that Japan has been through has clearly already started in China though, as the number of workers aged 16 to 59 dropped by a record 4.87 million in 2015 (China's National Bureau of Statistics). The government in Beijing is aware of the problem, ending 40 years of a one child policy last year, for instance. We can't pretend the demographic trend isn't becoming more challenging, but it is up to China to ensure that it doesn't grow older before it grows richer. The wealth trends in its favour, with all provinces in China expected to have at least a 40% middle income occupancy by 2020.

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Street in Kowloon, Hong Kong.


淘
金
沙
桑
拿
嘉多莉餐廳
馳名蒸鮮魚客家鹽焗雞
御藥堂
凱豪商業中
八方雲集
人民幣找換
機器補鞋

Chinese President Xi Jinping (right) welcomes Japanese Prime Minister Shinzo Abe to the G20 Summit in Hangzhou, China.

© Damir Sagolj/Reuters.

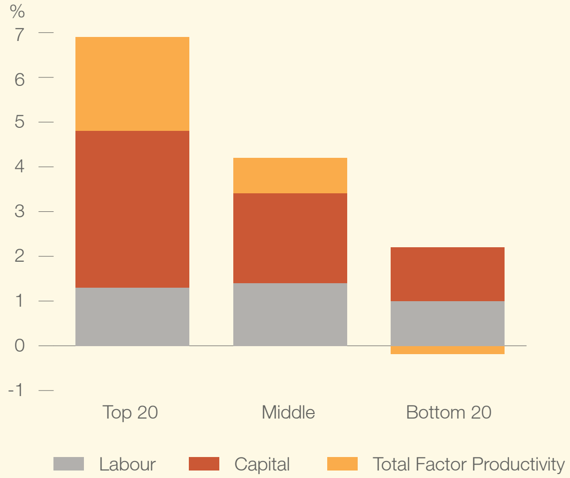
GOVERNMENTS (& BUSINESS)

Clearly, the vast differences in political systems could command pages of prose in itself. If we think about the relationship between the government and business though, there are broad parallels that can be drawn between Chinese SOEs and the Keiretsu in corporate Japan. Cynics don't find it too difficult to argue that both are compromised forms of corporate (mis)organisation which are mired in red tape and cannot operate freely, but which can't be transformed properly either.

Part of the rationale for listing many Chinese SOEs was to bring in more rational external shareholders. But, while the government retains control, most of these enterprises are politically-motivated policy instruments, rather than economically-motivated growth businesses. It is important to beware of generalisation, but being publicly listed requires them to fund themselves at a private sector cost of capital, yet operate with excess baggage such that they generate poor public sector-like returns. The public sector continues to suck up credit growth while failing to generate a decent return on it. As long as the SOE sector is inefficient, China and investors therein rely on the new economy for sustainable earnings growth.

The more that credit growth outpaces productivity growth, the trickier it becomes to avoid a bust, which is why productivity improvement will be crucial for China's predicament. As this chart neatly shows, total factor productivity has been a major swing factor in the growth of the best and worst emerging economies over the past 25 years or so.

Real GDP growth by contribution (pp, 1990-2014 avg)



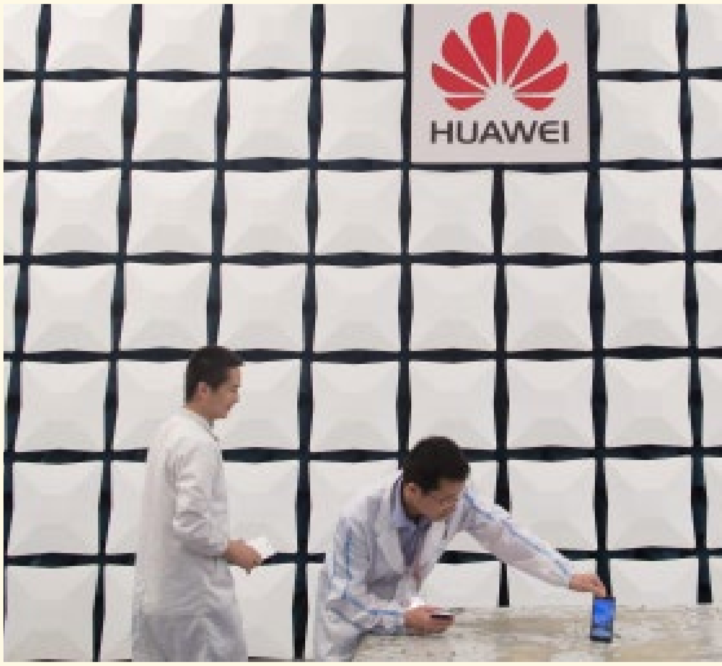
Source: EM Advisors Group.

Robots Manufacture Robots Inside Yasukawa Electric Corp.'s Robot Village.
© Bloomberg/Getty Images.

TECHNOLOGY

Productivity gains are a desirable part of the recipe for any business, but how to achieve them is the secret sauce. Over the next ten years, we expect technology and what emanates from it; networks, knowledge and efficiency – will be crucial. The Japanese have done a very commendable job in the automation/industrial robotics line of business, for example. Fanuc, Keyence and Yaskawa Electric are all global leaders in their respective fields. Probably the two most important traits that these businesses have in common are that they are R&D driven and are very willing to innovate. It's no coincidence that best in class Chinese technology businesses such as Ctrip, JD.com and Huawei, to name a few, share similar characteristics.

It is not just technology in its current sense that we are considering here, but also those that have yet to be dreamed of. Might schools use virtual reality to give children best in class education? Might all workplaces use social networks to improve information sharing? Might all production lines be fully automated? Might the advancement of technology be such that all cars use lithium ion batteries? Might social networks become the new search engines? Which companies will benefit most? These are the sorts of questions we consistently ask ourselves as investors in emerging markets. This matters now more than ever due to the change we are witnessing in the Chinese growth model. It is clear that more emphasis, at both the political and company level, will be placed on technology and software investment. This is crucial for China's future. We are confident that the business environment in China, particularly in the south, is fertile for technological innovation. However, it seems right to take this much further and to say that it will drive China forward as the world's best consumption story, and that the opportunity for significant growth in the best consumer businesses from here is monumental.



An engineer sets up a smartphone for testing inside a semi-anechoic chamber in the global compliance and testing center at the Huawei Technologies Co. campus in the Longgang district of Shenzhen, China.

© Bloomberg/Getty Images.

A Sunset view across the East China sea towards Japan.

CONCLUSION

Perhaps the biggest reason to suggest China won't 'do a Japan', or the key differentiator in China's favour, is that it has a potential growth rate – due to its current stage of development and trajectory – that is much higher than Japan's was when it hit its debt wall. Maybe China's real issue is not whether it will face a Japan-like bust or a financial crisis, rather whether it will successfully bridge the middle income trap. Chinese businesses such as Tencent and Alibaba, the likes of which China hasn't seen in its state-dominated past, give us good insight here. Unlike when Japan was at a similar stage of development, we can see that the new economy in China is developing with such dynamism and entrepreneurial drive that it is successfully moving from wage cost arbitrage and infrastructure build out towards genuinely innovative, service-orientated growth. This will provide the next leg of the country's evolution and leaves us with great optimism as active investors.

CURIOUS ABOUT THE WORLD

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