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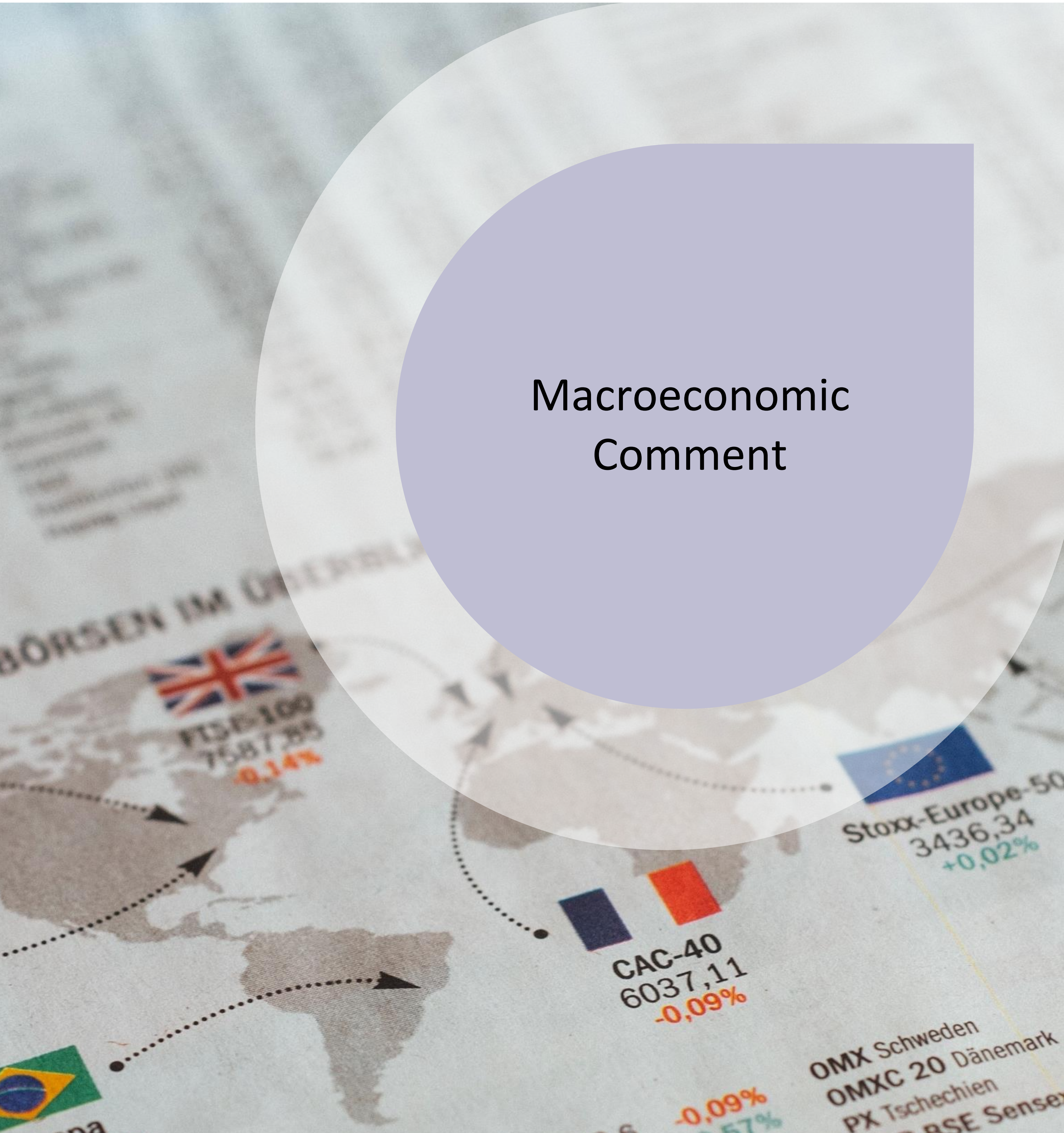
Macroeconomic Comment



Global economic turndown and China in crisis

August 25, 2023, Peter von Elten

The US is experiencing surprisingly robust growth despite interest rate hikes and a frail global economy. On the other hand, Europe's economy continues to weaken, evidenced by a renewed decline in the Purchasing Managers' Index for the industrial and services sectors. However, the greatest uncertainty is currently emanating from China. Its export engine has begun to sputter due to a cooling global economy, coupled with several home-grown and structural burdens.

It is not a shock that China, after enjoying a rapid rise over three decades, is set to grow more slowly in the future simply because of its current economic size. It is crucial to assess the extent to which the current slowdown in growth is cyclical in nature or is caused by structural changes. Even if China's economy should fall below the government's growth target of 5% this year – to be expected with the current status quo – the nation's contribution to the global economy will remain vital. Hence, the focus of this commentary lies on the particular challenges China faces today and in the future.

The middle income trap – This refers to when a nation can neither keep up with low-wage countries in terms of price nor catch up with highly developed countries due to its relative prosperity. Coined by researchers at the World Bank, the phenomenon of the "middle income trap" describes the frequently observed economic development of emerging countries that, after an impressive rise, experience a structurally induced plateau of growth. China has a GDP per capita of app. $13,700 (Source: IMF) and has therefore reached a level of development that meets the criteria of the middle income trap. The factors outlined below – demographics, productivity, partial deglobalization, debt, and geopolitical changes – suggest that China will struggle to escape this trap.

Demographics – China's state-imposed one-child policy was in effect for 35 years and has caused a massive and unprecedented demographic problem. This makes its impact difficult to assess. The shrinking and aging of its population in the coming decades will prove to be even more severe than what Japan has displayed. There are further similarities to Japan's economic developments: At the end of a long and impressive economic rise, when Japan was at an operational and technological peak, came a turning point in its population development. In 1990, the bubbles in Japan's real estate and stock markets burst. The following decades found Japan struggling with the consequences of a vast aging population and economic deflation that continually flared up. It would be imprudent to extrapolate China's current deflationary trends as a longer-lasting phenomenon or to equate its severe real estate crisis with Japan's developments. Yet, by the time

Japan reached its turning point in demographic and economic development, it had already achieved a much higher level of prosperity than China today.

Productivity development – In the last decades, China has achieved exceptionally large productivity leaps by retraining its workers from agricultural to industrial, as well as through automation and digitization. In addition, it has benefited from economies of scale made possible by a large, state-controlled domestic market. However, lately, President Xi Jinping has not only tailored the party to his own liking, largely stripping it of power, but he has also perfected control mechanisms that surveil all areas of life and work – a feat almost unimaginable in the West. Productivity development is likely to bear the costs of this surveillance state. It is doubtful whether innovation can come to fruition in this kind of climate. Moreover, its separation from the US, currently the most important export market, will put a strain on further productivity development, given trade restrictions on both sides and China's efforts to achieve extensive self-sufficiency across all sectors.

Partial de-globalization and bloc formation – Globalization and China's entry to the World Trade Organization (WTO) over 20 years ago have played a major role in shaping its rapid growth trajectory. However, its free trade is restricted by its growing conflict with the US regarding nothing less than a new world order in which both powers claim economic, military, and geopolitical supremacy. China now exports more goods to emerging markets than to the US, Europe and Japan combined. Through a series of initiatives, China aims to significantly increase the influence of the "global South" on the world political stage, such as in the UN, at the expense of the West. These strategies include the Silk Road Initiative and the planned expansion of the BRICS bloc (Brazil, Russia, India, China, South Africa). To document its claim to global leadership, China recently launched three further initiatives (Global Development, Global Security, Global Civilization).

Real estate crisis and debt – For a long time, China has managed and driven its economic growth with debt-financed infrastructure measures and by boosting its real estate sector. A few years ago, the government called for a shift in the economy toward more services and consumption. However, the twin disasters of the COVID-19 pandemic and the real estate crisis have led to significant costs for citizens. These costs have yet to be compensated by the state. Further, considering a limited state pension and health care provision, restrained consumption continues despite China's citizens retaining high savings. The real estate crisis is putting considerable pressure on growth and is driving up the debt of regional governments to dangerous levels. As this sector contributes app. 25% of China's gross national product, heavily indebted regional governments have significantly strengthened their budgets through land sales to real estate developers and taxes from construction activity. Yet, the largest real estate developers are currently in crisis, such as Evergrande (a debt mountain of app. $340 billion, with a loss of over $80 billion in the past 2 years) and Country Garden (almost $200 billion debt). These firms are dragging many other construction companies into insolvency and are now also endangering selected financial institutions in the shadow banking sector. So far, the government has responded with moderate interest rate cuts. Most observers assume that the state will have to take much stronger countermeasures to prevent the crisis from escalating.

Conclusion – The transformation of the Chinese business model toward higher-value services and production, as displayed by the dynamic development of its automotive industry, is in full swing. However, structural challenges are likely to affect growth forces for much longer, making it more challenging to escape the middle income trap.

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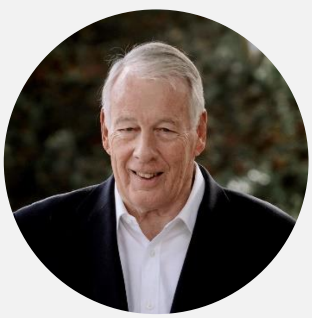

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Further-more, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

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