

## **China pays dearly for its political mistakes**

**The financial circles are realizing belatedly the weaknesses of the Chinese model, which I have been denouncing for a decade. Although China initially caught up economically, its development is now hindered by its political missteps.**

For over 10 years, I have been writing increasingly skeptical articles about the "Chinese miracle," drawing on my areas of expertise: demographics, economic development, and communism, which I have experienced in several countries.

I have notably highlighted the debts incurred in exchange for fake assets, such as housing construction when there are fewer and fewer young people to occupy them, or redundant infrastructure, temporarily delighting builders. I suspected that these debts would surface someday...

But until the pandemic, the growth appeared so strong that my warnings fell on deaf ears. Afterwards, everyone thought things would return to normal.

### **The financiers are finally discovering the reality of China**

But today, the financial world is shaken with Chinese stocks at their lowest since 2019 and the bankruptcy of Zhongzhi, the largest private financing institution. Economists are discovering the obvious, and on December 5, 2023, Moody's downgraded China's economic outlook to "negative."

The delay in this realization, in my opinion, stems from the fact that many experts primarily focus on analyzing financial data, whereas these data often only reflect underlying "physical" movements.

Let's start with the negative trend that should have clearly alerted them: demographics.

### **A belated realization of demographic decline...**

Any sensible person could have foreseen, from the inception of the one-child policy, that we were heading towards a major demographic problem.

President Mao was alarmed by the rapid growth of the Chinese population and made the same mistake as our "degrowth" proponents today. Namely, that reducing births too much condemns the elderly to abandonment, due to lack of children or caregivers.

This not only affects today's elderly but also the elderly of tomorrow, which means everyone.

The one-child policy was implemented in 1979, following pressure for birth control that began in 1970. However, it took more than 40 years and the 2022 census for President Xi to realize, far too late, the ramifications of this policy. It was too late because there was already a decline in the number of parents.

We have here a primary "physical" cause of the fragility of Chinese growth.

The government is now aware of this and is increasing the use of robots to compensate for the lack of manpower.

For now, the robots are coming from Germany and are producing electric cars that are undermining the German industry. However, many jobs or functions cannot be automated.

The directive to allow families to have 2 or 3 children instead of just one still leaves in place this all-powerful birth control administration, which is highly representative of the authoritarianism of the regime.

Until now, no autocrat had dared to dictate the behavior of families.

### **... ant its consequences on real estate**

It was evident that the decrease in the number of children and adults, but not of the elderly, would decrease the final demand for housing.

The phenomenon was masked for some time by urbanization, but much less than one might think.

Indeed, a good portion of migrants to the cities are housed in makeshift shanties, or even within the enterprises themselves: cities are jealous of their privileges, and internal passports prevent rural migrants from benefiting from their schools and housing.

The construction sector has also been favored by forced population displacements, for example, on the occasion of the immense lake created by the Three Gorges Dam, but these are punctual phenomena limited in time.

Finally, speculative demand (buying a home to resell without living in it), which inflated demand, inevitably runs into reality due to the lack of final buyers. Especially since the government, deeming this speculation unhealthy, discouraged it, which precipitated the crisis.

Thus, the main developers went bankrupt, leaving hundreds of thousands of unfinished or unoccupied homes, and destroying the savings of many individuals.

Furthermore, the abrupt decline in this very material-intensive activity, particularly in reinforced steel bars, has repercussions on the entire industrial production, retrospectively revealing a part of it as artificial... This did not prevent China from inflating its growth figures and boasting them as an illustration of its power, then attempting to offload the surplus through the famous "Belt and Road Initiative".

Ultimately, despite the numerous incentives taken by Beijing to boost sales, they plummeted by 35% in December 2023 compared to the previous year.

## **The induced debts**

### **The bankrupt of the giant Zhongzhi**

Let's go back to the case of Zhongzhi. This Chinese giant in "shadow banking," i.e., entirely private as opposed to state bank services, was one of the main wealth managers in the country: it is said to have had around \$140 billion in assets at its peak.

Today, we discover that it is indebted to the tune of approximately \$64.4 billion and in default. It is one of the most serious bankruptcies in China's history.

Zhongzhi collected savings from businesses and households to lend them again and invest in real estate, as well as in stocks, bonds, or commodities. (see Rachel Cotte's article in Les Echos dated 5/1/23).

This is a normal function in a market economy where housing and infrastructure are supposed to be saleable or profitable, but not when it involves a speculative bubble or redundant infrastructure, politically decided due to grandiosity or simply cronyism between party decision-makers and entrepreneurs.

I'm not sure if the corresponding debts have been accounted for in China's national accounts, but it's far from certain. With this bankruptcy, another part of the population's savings will disappear.

### **Local government debts**

In addition, there is growing concern about the debts of local governments, which, until

now, have been repaid by converting agricultural land into developable land and pocketing the profit.

As a result, any decrease in the construction of housing or buildings in general prevents them from repaying their debts.

Of course, these local governments will turn to state-owned banks or the government itself. But, in my opinion, the destroyed value will eventually make itself felt in the economy in one way or another.

And to these debts are added subsidies to companies deemed strategic, or simply favored by the Party. This allows them to break into markets by undercutting prices: see, for example, the case of solar panels yesterday, and today that of electric cars.

If the West benefits from these bargain prices, it is unfortunately at the expense of its domestic industry.

## **The return of party control over businesses**

I briefly return to my article explaining that party cells within companies have been ordered to reactivate and participate in management, including the selection of leaders, even in foreign companies.

The tightening of Party control seems to me a fundamental point, affecting not only China's attractiveness but also indirectly the freedom of technical debates, and thus innovation, despite massive subsidies to generate it. In state-owned enterprises, any manager gaining a certain level of prominence casts a shadow over the Party, or even the president, and disappearances have become common. The first highly publicized case was that of Jack Ma, but there have been many others since then. There have even been "accidents" abroad.

## **The disillusionment of foreign investors**

In the business world, which wields political power in all Western countries, but particularly in Germany and the United States, China is first and foremost an irreplaceable market and an efficient subcontractor.

Hence, there is pressure on the political sphere summarized by the sentiment: "Let politics not hinder our business!" I am not only referring to large industrial groups, but also to numerous financial advisors advocating for investing in Chinese stocks, i.e., financing the country's growth.

This is bad advice: Chinese stock markets have been declining for several years!

Worse still, Western investments have mitigated losses for Chinese nationals and have thus partially paid off the regime's debts!

This fascination of Western investors with Chinese markets is, of course, a geopolitical mistake, but it also signifies that they have been relying on financial results that did not fully account for reality.

### **A painful awakening**

The business world has evolved somewhat recently, recognizing that the efficient Chinese subcontractors were becoming dangerous competitors, and that the political stability in China, long touted, now translates into a party's stranglehold on foreign companies, and a health policy that has banned the stay of foreign executives and leaders in China.

As a result, multinational corporations have begun to shift their expansion projects to other countries such as India or Indonesia, or even Mexico. Or, in particularly strategic cases, to the United States.

### **The case of Taiwan is instructive**

Initially, entrepreneurs from the island, aided by the language community, invested massively in China and significantly contributed to its development.

At that time, I even remarked that Taiwan "had won the war" by combining their skills with the low wages on the mainland. Now, Taiwanese feel trapped and are starting to invest elsewhere.

All these issues have repercussions on the Chinese currency. The Yuan is relatively weak compared to the dollar (0.14 compared to often 0.16 over the past three years) and, above all, is not fully convertible, probably to complicate capital flight from wealthy Chinese.

This non-convertibility is also a weakness: if Russia exports more oil and gas to China, it will only be able to use its yuan to buy Chinese goods or those from a country with a deficit vis-à-vis China: there are some, but it also depends on whether they don't use the dollar and whether their goods are of interest to Russia.

While with dollars or euros, you can buy anything, anywhere.

## **The most serious issue in the long run: intellectual closure**

This growing awareness, albeit relative, within the business world will further isolate China.

The requirement for everything to align with "Xi Jinping Thought" and the dismissal of any "Western values" as decadent or anti-national will stifle intellectual debate, including in terms of technical advancement.

The decline in demand for English language learning is an indicator in this regard.

The reminder to every Chinese citizen, even those of Western nationality, of their duty to spy, and the resulting distrust it creates, also contributes to intellectual closure.

While this closure may only have indirect and long-term consequences, I believe they are significant even if they do not directly reflect in financial indicators.

### **As a conclusion**

I don't deny the real and significant development of China, but I believe it's the normal catch-up of a powerful country, as happened from 1945 onwards with Japan, Germany, and South Korea.

My opinion is that this development has been overestimated and, more importantly, it relies on causes that no longer exist today, such as demographic growth and openness to the world.

I am struck by the gap between the geopolitics and the economic perception of China by the financial circles or the passion of entrepreneurs for the Chinese market.

As a geopolitician, I worry about anything that demonstrates China's strength, while the financier and entrepreneur worry, on the contrary, about all signs of weakness.

In the short and medium term, these financial ups and downs result notably in the disappearance of part of household savings. This will weigh on future demand and could potentially lead to political movements.

From this, I deduce that China will not surpass the United States anytime soon!

Yves Montenay

