

Economic and Financial Newsletter

Quo Vadis?

*"How did you go bankrupt?" "Two ways.
Gradually, then suddenly."*

Chinese current affairs in historical and cultural perspective

Executive Summary

- Starting with its loss in the First Opium War in 1839, China went through what Mao later called the 'Century of Humiliation', when Western imperialist powers and Japan forced China to accept the Unequal Treaties, in which it lost, among others, Hong Kong and Macau. When Mao established the People's Republic of China in 1949 after winning the civil war, for some, this marked the end of the Century of Humiliation. To others, the end only came in 1997 with the handover of Hong Kong or in 1999 with the handover of Macau. But for many others, including Xi Jinping, the Century of Humiliation will only end with the reunification with Taiwan. The Century of Humiliation is deeply engraved in China's collective memory. Every attempt at foreign interference, like Nancy Pelosi's foolish visit to Taiwan, raises this memory and increase the probability of the island's annexation. Investors should keep this scenario in mind. In any scenario, deglobalization is set to go in overdrive because of mounting geopolitical tensions. Western companies heavily exposed to the Chinese economy, such as Apple, are very vulnerable.
- After 4 decades of liberalization, Xi Jinping is reversing China's capitalist tendencies. The CCP has tightened its grip on the private sector and it has destroyed its own (ed-)tech and gaming sector. Xi Jinping does not hide his basic communist ideas. He is an ideologue who tolerates the success of the private sector provided it does not get in the way of communist nirvana. He has installed a totalitarian regime which reverts to repression, censorship, propaganda and manipulation of official statistics. His extreme zero-covid policy, used to enforce total control over the population, has backfired and is leading to the biggest popular revolt since the student protests of 1989. China may be making progress on environmental issues, it has very poor governance, the G in ESG, which is another aspect investors should keep in mind.
- China's huge real estate bubble is deflating, dragging economic growth down for many years to come, along with waning foreign investment. This, together with China's evaporating labor force, which is set to drop from 900 million to below 300 million people, as well as declining productivity gains, will push China's economic growth rate to 2-3%, well below consensus forecasts until demographic forces push the growth rate below zero. "Gradually, then suddenly". China's growth miracle is over. The effects will send shockwaves through the global economy, reducing structural economic growth, creating a long bear market for commodities and deflation.
- Investors in Chinese assets are dancing on a volcano. Given its poor long-term prospects, investing in China should be opportunistic. The US remains the world's cleanest dirty shirt.

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As a reminder

The first edition of *Quo Vadis (He who controls Taiwan, controls the world)*, focused on Taiwan as the epicenter of geopolitical tensions of the future. The second edition (*Suicide by demography, Part I: Honey I shrunk the population*) focused on the demographic catastrophe developing in China. The mathematical conclusion was that China's growth miracle is over. The many reactions we received on this topic, the new US sanctions against China, Xi Jinping's power grab and the White Paper Revolution that put the flame in the wok, prompted us to delve deeper into China's eventful history in this edition to provide context to the latest and future developments.

Part I. A History of violence

1.1. The Great Leap into the abyss

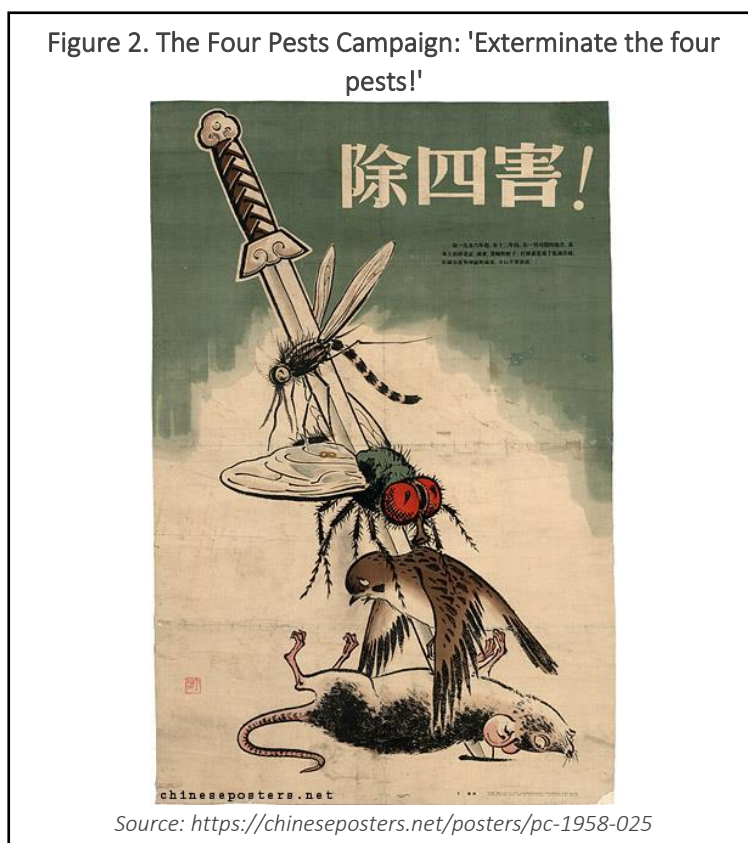
The Chinese state system is not easily defined unequivocally. Is it communism, or socialism or state capitalism or something else? In 1949, Mao Zedong rose to power. Mao was an ideological Marxist-Leninist who subjected China to a utopian communist regime under the control of the Chinese Communist Party [CCP].

Figure 1. Propaganda poster for the Great Leap Forward



With the Great Leap Forward (1958-1962), he wanted to use a planned economy to lift China from an impoverished agricultural country to a prosperous industrial nation. The intentions were noble, but the consequences catastrophic. The Great Leap Forward turned out to be a leap into the abyss and caused famine with the largest death toll ever in human history. The Four Pests Campaign, part of the program, was to blame. Mao considered not only rats, flies and mosquitoes a plague, but also sparrows because they ate too much grain and fruit. He mobilized the Chinese people to exterminate them.

Search-and-destroy



The population enthusiastically engaged on a search-and-destroy mission, shooting sparrows from the trees and from the skies with guns, bows and catapults. They banged on pots, pans and drums to keep the traumatized sparrows in the air until they crashed from exhaustion, at which point the poor birds were wrung off their necks. However, Mao had forgotten that sparrows not only ate grain and fruit, but also insects such as locusts. The latter could multiply unhindered and ate up the harvest. Between 15 and 55 million Chinese starved to death, partly because the government confiscated so-called surplus food, which it later stubbornly refused to distribute. Against their better judgement, that is. In 1959, Mao is reported to have said in Shanghai, *"If there is not enough food, people die of hunger. It is better to let half the people die so that the other half can eat"*. Thousands of cases of cannibalism were recorded. Desperate parents ate their own children, children ate their parents, corpses were dug up and thousands of passers-by murdered.

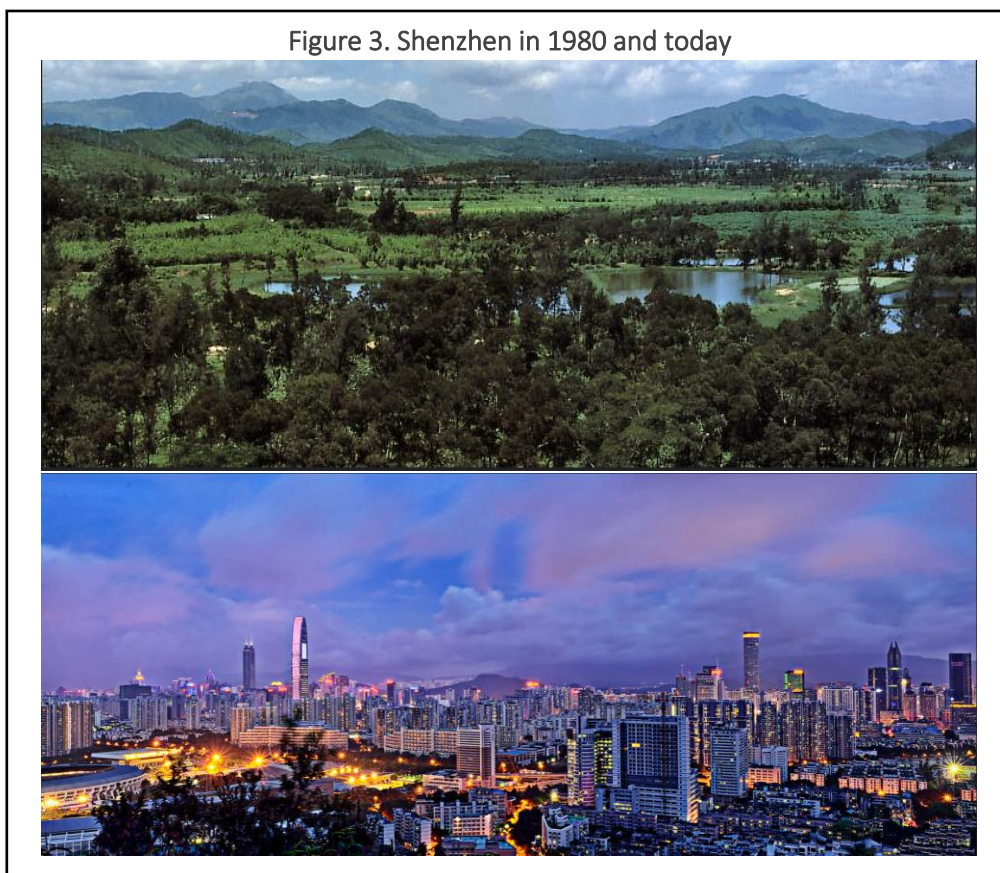
Mao stepped aside but returned to power in 1966, this time to impose his equally catastrophic Cultural Revolution. During the Cultural Revolution, Mao wanted to purge the country of the capitalist influences of the bourgeoisie that had allegedly infiltrated the government. Millions of Chinese were persecuted and killed. During this period, the infamous Gang of Four came to the fore. In 1976, shortly after Mao's death, the Gang was rounded up by the political alliance formed by Deng Xiaoping and, for understandable reasons, China was open to a new state system away from hopeless Maoism.

1.2. The China Model

The real Great Leap Forward may be credited to Deng Xiaoping. Partly inspired and perhaps intimidated by the resounding economic success of Singapore and the other Asian tigers, he introduced far-reaching economic reforms called "socialism with Chinese traits" or also "capitalism with socialist traits" or the "China Model". The key to the Chinese economic miracle lay in the decentralization of policies, starting with the abolition of collectivism in agriculture. Chinese farmers were given individual control over their production and profits, resulting in greatly increased agricultural output. Managers of enterprises were also empowered, with correspondingly positive consequences. Private entrepreneurship was encouraged by financial incentives, China invested heavily in education and allowed foreign investment. In a second phase, price controls were gradually removed and much of the state-owned enterprises were privatized. It became a huge social and economic success story that was only briefly interrupted by the conservative uprising that followed the quashing of protests in Tiananmen Square in 1989. Jiang Zemin, president of China from 1993 to 2003, who died on 30 November, also played an important role in China's success. In 2001, China joined the World Trade Organisation (WTO), providing additional economic momentum.

Deng may have been formally a communist, but he embraced economic freedom and acted as a wise manager. In many other countries, like Russia for instance, too rapid economic liberalization led to chaos and decline. Deng was smart enough to take a step-by-step approach, including experimenting with 'special economic zones' first. In the images below, you can see how Shenzhen, which first received special economic zone status in 1980 thanks to its proximity to Hong Kong, evolved in a few decades from a city of 330,000 inhabitants to a dizzying technological and financial metropolis of 18 million, China's own Silicon Valley. Without Deng Xiaoping, no China's rise to global economic power, no Alibaba or TikTok.

Figure 3. Shenzhen in 1980 and today



1.3. The Century of Humiliation

The biggest drug dealer of all time

Capitalism emanating from a communist party, like China's enduring adoration for Mao, leads to an odd mix that can only be understood from its historical context. The CCP and Mao are held in high regard in China - we abstract for a moment from the current White Paper Revolution to which we will return further - because they are still considered the saviors of the fatherland. China has a very eventful and traumatizing history even before Mao made a mess of it. In the 19th century, the country was besieged by foreign imperialist powers. Today, the United States dominate the world stage, but then Great Britain, surfing the Industrial Revolution, was the undisputed world leader, colonizing and terrorizing distant lands with her formidable British Navy. However, the British had lost out in the American Revolution, losing what was called British America, which made an end to the First British Empire. That, along with the cost of the many wars, had drained the British treasury and the country shifted its focus from America to the East to build the Second British Empire by military force. Nevertheless, the prosperity of the British people had improved substantially and, as prosperity always does, created a huge demand for luxury goods such as silk, tea and porcelain from China, which were paid for in silver. The British traders of the powerful East India Company, a commercial-military multinational and the equivalent of the Dutch East India Company, were in bad shape due to the cost of conquering the British East Indies. They had few goods to offer that were in demand in China, and China stubbornly refused to open its market. China thus built up a huge trade surplus with Britain, which was mirrored in a huge shortage of silver and huge frustration among the British. To turn the tide, the British devised a diabolical plan. Perhaps inspired by the British people's addiction to black Chinese tea - an average British family spent 5% of the family budget on it - they cultivated opium in the British East Indies with which they flooded the Chinese population via smugglers. Victorian Britain, where opium was incidentally an illegal substance, thus became without any doubt the world's biggest drug dealer. Opium addiction grew into a national epidemic in China, proportionally ten times worse than the current opiate addiction in America (based on the number of heroin users). When the situation got out of hand and the Chinese government cracked down on opium traders and seized large quantities of opium, British merchants protested vehemently at home. In a process of military escalation, for which the Chinese emperor was also responsible, they got the British government to launch a war campaign, starting the First Opium War (1839-1842), in which China lost disgracefully. Their wooden junks were useless against the British navy, which could deploy more manoeuvrable steel gunboats, and their bows and arrows and antique muskets were useless against modern British weaponry.

Looty

The First Opium War marked the beginning of what the CCP under Mao would later call the 'Century of Humiliation'. As the loser, China was forced to sign the so-called 'Unequal Treaties'. Under the 1842 Treaty of Nanking, it had to cede Hong Kong to Britain, open its internal market, allow opium imports and pay 6 million silver dollars as compensation. Other countries, such as France, smelt opportunity in China's military weakness and joined the British. During the Second Opium War (1856-1860), provoked by British wiles and pretexts, China again had to lose out. During the fighting, Lord Elgin, the British High Commissioner to China, ordered foreign troops to loot and destroy the Imperial Summer Palace, a complex of palaces and gardens where the Qing dynasty emperors conducted their state affairs. In addition to a treasure trove of Chinese art and artefacts, a little dog - a Pekinese in popular parlance - found on the estate, which may have belonged to the empress or her court, was whisked away to England by a Captain named John Hart Dunne as

a gift for Queen Victoria. The queen loved the little dog and named it Looty¹ (see inset with painting of the animal in question), referring to how it had come into British possession.



The naming, as well as the fact that cultural vandal Lord Elgin was hailed as a hero in England, illustrates the perversity of Western imperialism, which considered aggressing other countries normal. And the imperialists did not just kidnap doggies, countless Chinese were transported to the West as slaves, and almost half died in transit. Under new treaties, China again had to grant far-reaching concessions and cough up exorbitant reparations. America and Russia joined the pack to further corner China. China was forced to sign treaties with Russia, ceding 1.5 million square kilometers of territory in the North. And there was no end to the humiliations. China was also defeated by Japan in the first Sino-Japanese War (1894-1895), with Taiwan coming under Japanese colonial rule. When China rebelled against foreign colonialism

during the Boxer Rebellion in the late 19th century, eight countries, including the United States, Britain, France, Germany and Japan, conspired to put down the rebellion.

The alliance then imposed the Boxer Protocol, similar to the Treaty of Versailles, which condemned China to reparations greater than its annual tax revenues. The alliance even wanted to divide China into colonial pieces but fortunately it remained only bad intentions. In the Century of Humiliation, China nevertheless lost, in addition to Hong Kong, Taiwan, and large chunks of the North, Macau (to Portugal) and Zhanjiang (to France), among others, and was permanently besieged by Japan, the belligerent Prussia of the East, which occupied China during WWII, committing the most terrible war crimes. The opium trade peaked in 1906 when 13.5 million Chinese, out of a population of 400 million, were addicted. In 1907, Britain pledged to consider the opium trade illegal, but this did not end opium addiction.

Figure 4. Western imperialists try to cut up China



Source: <https://www.loc.gov/resource/ppmsca.28534/?st=image>

¹ "Friedrich Wilhelm Keyl (1823-71): Looty". www.rct.uk. Retrieved 2022-07-20.

As if foreign terror was not bad enough, China was plagued by internal instability and political violence. In 1911, the Xinhai Revolution ended the Qing dynasty and thus a period of more than 2,000 years of imperial rule. In early 1912, the Republic of China was proclaimed. In the interwar period, civil war raged off and on in the country, with the nationalists of the Kuomintang, led by Chiang Kai-shek, who dominated the Chinese political scene until the end of WWII, and the CCP fighting each other to the death. The civil war flared up again after WWII and in 1949 the nationalists were finally defeated by the CCP led by Mao, gaining control of mainland China, while the Kuomintang had to retreat into Taiwan.

There is no doubt that few other peoples in world history have experienced such humiliation and misery as the Chinese.

1.4. The Rebellion

Mad Nancy

It can be argued that the Century of Humiliation ended during WWII when Chiang Kai-shek denounced the Unequal Treaties, but since history is written by the victors, the view prevails that it was Mao who formally ended it by proclaiming the People's Republic of China in 1949. Mao also put an end to opium addiction. After all, he saw it as a symptom of the "Chinese Shame" of the Century of Humiliation. Incidentally, the interested reader will find here the historical roots of most Asian countries' crackdown on drug use and trafficking.

For some, the actual end of the Century of Humiliation came only in 1997 with the handover of Hong Kong or in 1999 with the handover of Macau. For others, including Xi Jinping, the Century of Humiliation will only end with the annexation of Taiwan. The Century of Humiliation is deeply engraved in China's collective memory. Every attempt at foreign interference raises this memory.

Figure 5. Chinese coolies (unskilled laborers) smoking opium



Source: <https://biblioasia.nlb.gov.sg/vol-16/issue-3/oct-dec-2020/opium-revenue>

Anyone who wants to understand the Chinese soul must know that China, more than anything else, wants to rise above humiliation. Something Nancy Pelosi - and with her many other US politicians - with her reckless visit to Taiwan either does not understand or simply does not care about. Any provocation by foreign countries rips open deep old wounds in China. Many economic and military conflicts have their origins in distant history. In the West, we sometimes tend to rationalize a country's actions too much economically and too little culturally-historically. And in the West - just look at the political mayhem during the Qatar World Cup - we have an unsympathetic habit of constantly lecturing the East based on the idea that our values are universal and therefore may be imposed on dissenters. By running over cultural sensitivities with our Western mud boots, we create a growing opposition in the East.

Face/Off

In China, as in many other Asian countries, it is also culturally very important not to lose face, especially in public. When a foreign power causes Chinese leaders to lose face, this, taking into account China's past history, takes on a special dimension. The 'face' (Miàn Zi (面子)) in China represents a person's reputation and feelings of prestige and this in various circles, public, professional and private. The face is an essential element in any social interaction. Chinese therefore consider it extremely rude to publicly reprimand someone, even if the person concerned is manifestly at fault, and feel deeply aggrieved when they are publicly looked down upon by President Trump, whom Covid called the "China Virus" or by reckless Nancy. However, Americans - like Europeans - are not known for their cultural empathy or respect for other cultures and value patterns, to put it mildly. The flood of US sanctions, criticism and needless provocation is riskier than what the West suspects. It makes the likelihood of concessions or even consultations with China ever smaller. Financial markets are also misjudging the risk, as evidenced by the lukewarm reaction to Pelosi's outing. The Quo Vadis edition around Taiwan argued that Taiwan's annexation is much closer than thought, among other reasons. Those who argue - in an attempt at Appeal to Authority - that Warren Buffett does not believe in an imminent incorporation of Taiwan because he has just taken a stake in TSMC, may note that Buffett too can be wrong from time to time, such as with his QE [quantitative easing] call on inflation, which he himself, by the way, admitted gracefully.

1.5. Back to square one

A new world order

Under Deng Xiaoping, China slid ever further towards the West and capitalism, but this trend has now reversed. Under Hu Jintao, who was CCP secretary-general from 2002 to 2012, a number of reforms were slowed down or reversed. The Great Financial Crisis of 2008-2009 was a gamechanger. China came through that crisis relatively unscathed, and saw in the same crisis the failure of the Western model. Since then, China has shaken off its follower mentality and is looking assertively into the world. China's new ambition is to develop its own model and establish a Chinese order in Asia. Since 2008, China has increased its annual military spending from \$62 billion to \$293 billion, narrowing the gap with the United States, which spends \$800 billion on 'defense' every year. China's assertiveness is part of the inevitable transition to a multi-polar world, with the East, Russia, China and Saudi Arabia in the lead, forming an economic and identitarian power bloc turning away from the West and Western neo-liberal values.

Carnage

But the real turning point in Deng Xiaoping's pro-Western policies is being propelled by Xi Jinping. Since Xi came to power in 2013, the CCP has tightened its grip on the private sector by a considerable margin, actively strengthening large public companies. Two years ago, the CCP decided to attack its own private (ed-)tech and gaming sector with repressive regulation. The market was totally surprised by this evolution, as witnessed by the carnage that followed in the stock market. The private education sector, for instance, was stripped of its right to make any more profits, and saw its value evaporate from \$100 billion to zero. The CCP's drastic action makes it clear that, despite all the liberalization, communism is never completely gone in China. The communist aspiration remains the nirvana where the country becomes richer, just like the West, but with wealth neatly distributed among the entire population. Xi Jinping does not hide his basic communist ideas. You only have to listen to his speeches to realize this. During a speech in 2012, when Xi

became secretary-general of the CCP, he said that *"We must not abandon Marxism-Leninism and Mao Zedong's thoughts. Otherwise, we will lose our foundations."* While Xi clarified that the road to communism is still long and that *"productive forces must be released and developed"*. In 2017, he said that *"The party, the government, the army, society, education, the north, the south, the east, the west and the centre - the party runs everything"*, what is now called the 'Xi Jinping Thought'. In short, the CCP has control over everything. This is not to say that he wants to destroy the private sector, but that every private enterprise is de facto controlled by the CCP and dances to the beat indicated by the CCP.

World record

At the 20th congress of the CCP, where the world record of simultaneous clapping of hands and staring rigidly in front of oneself when asked if there are any votes against were fervently broken, Xi Jinping seized absolute power. All opponents have been removed and what remained of checks and balances have been wiped out. You can argue about how capitalist or communist China actually is, but one thing is certain: China is now, as it was long ago under Mao, back to being a totalitarian state headed by an autocrat. Read along in Human Rights Watch's World Report 2022:

"With President Xi Jinping at the helm, the Chinese government doubled repression inside and outside the country in 2021. Its "zero tolerance" policy on Covid-19 strengthened the authorities' hand, imposing harsh policies in the name of public health.

Beijing's information manipulation has become ubiquitous: the government censors, punishes dissent, spreads disinformation and tightens the reins on tech giants. The once cacophonous internet is now dominated by pro-government voices reporting to authorities on people whose views they deem insufficiently nationalistic.

In 2021, the Chinese government insisted on more conservative values and narrowed the space for LGBT and women's rights - topics previously considered less sensitive. Beijing became less tolerant of criticism from private entrepreneurs. In July, courts imposed an 18-year sentence on Sun Dawu, an agricultural tycoon who supports human rights activists, for vague crimes, after handing down an equally harsh sentence to Ren Zhiqiang, an outspoken property tycoon...

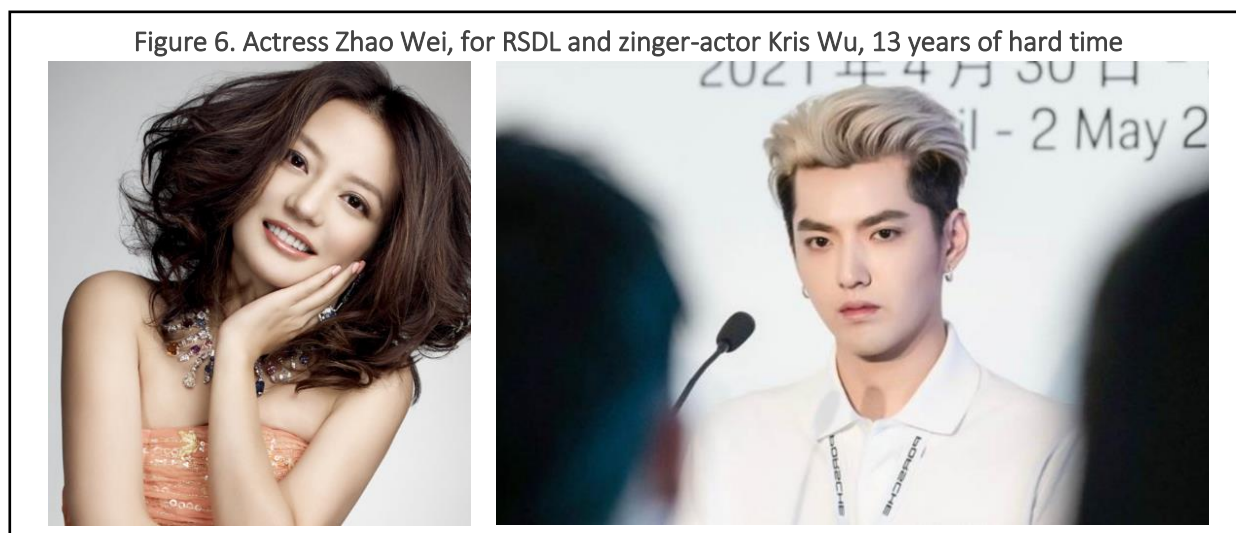
The authorities destroyed the protection of human rights and civil liberties in Hong Kong by labelling much of the peaceful behavior that underpinned life in Hong Kong, such as publishing news, as subversive. According to an April 2021 Human Rights Watch report, authorities committed crimes against humanity as part of a widespread and systematic assault on Uighurs and other Turkic Muslims in Xinjiang, including mass detention, torture and cultural persecution. Tibetans continue to suffer severe abuses, including harsh and prolonged detention for exercising their fundamental rights.

The Chinese government's record on rights and its "wolf warrior" diplomacy led to an increasingly negative image of the government in some countries abroad. New research by AidData revealed a \$385 billion "hidden debt" from developing countries to Chinese authorities...."

The big disappearing act

Individuals who dare to criticize the CCP are rounded up to be submitted to what is euphemistically called 'Residential Surveillance at a Designated Location' [RSDL], with 'training centres' operated by China's secret police. It sounds like a holiday but rather a horror holiday, even much worse than a holiday in Egypt. Professor Feng Chongji, a man speaking from personal experience, states that "the victim usually enters the isolation cell, is cut off from the outside world for a period of up to six months, during which the person is subjected to continuous interrogation, sleep deprivation and other forms of torture". The Act gives the state the right to keep the person's family in the dark about the detention and deny the person the right to a lawyer and visits. After a few weeks or months of intense re-education, the victims are released and – it's a miracle! – all of a sudden start singing the praises of the CCP. It does not matter whether you are famous or not, witness the disappearance of Jack Ma, co-founder of Alibaba, presumably because he had criticized China's financial system in a speech. Tennis star Peng Shuai, who had accused a member of the CCP of sexual assault, suffered the same fate. Being too famous makes the risk of disappearing even greater, as the CCP considers celebrity culture extremely threatening, as numerous celebrities, including Zhao Wei (pictured), one of China's most popular actresses with 86 million followers on social media, were able to find out. It is also notable that celebrities disappear

from the scene or go to jail at times when the CCP is under fire. The CCP uses them as lightning rods. This is also the case today. Kris Wu (pictured), a well-known Canadian-Chinese singer and actor, was charged with vice and tax fraud last year. On November 26, not coincidentally just as the White Paper Revolution was emerging, he was sentenced to 13 years in prison. Foreigners are not immune either. In 2018, two Canadians were placed in RSDL, presumably in retaliation for the arrest and deportation of a Huawei top executive. Half a million people undergo 'RTL', Re-education Through Labor, forced labor in other words.

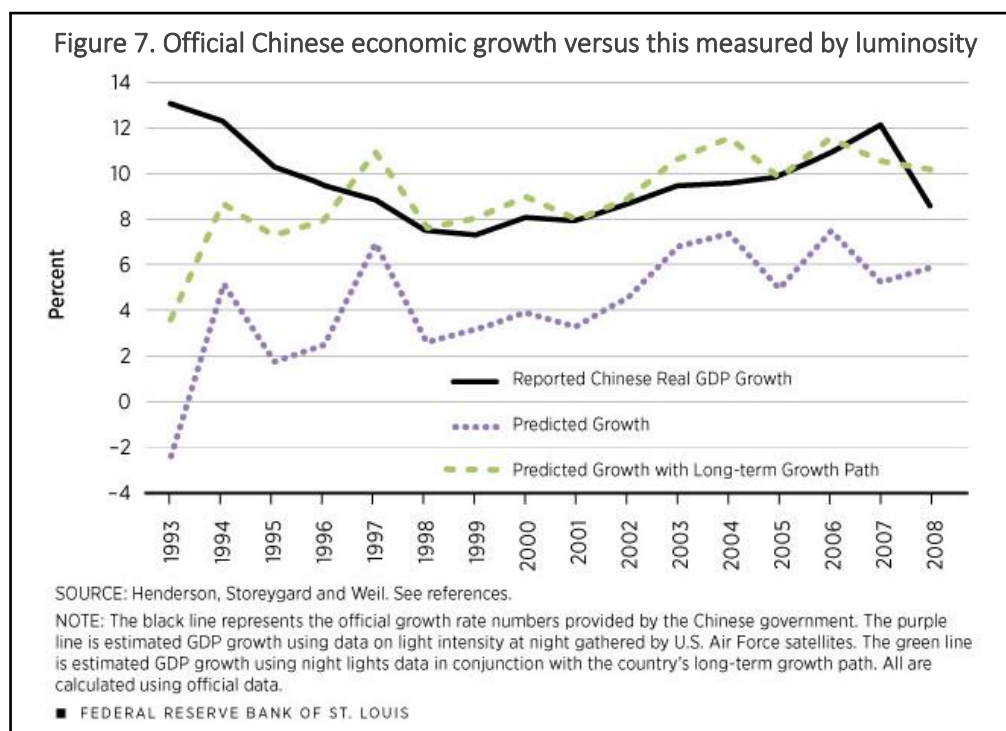


Just ahead of North Korea

The CCP also keeps the media, the internet included, under tight control. The Chinese people are not allowed to see anything that deviates from the Party's vision. The CCP, using US technology and US companies (e.g. Cisco's routers) by the way, built out the world's most sophisticated and comprehensive population surveillance device. You cannot move an inch in China without being watched by the Chinese government. The Big Brother cliché is often used to great effect, but in China it is a harsh reality. The Chinese government's tentacles also extend far beyond China. China has infiltrated foreign media and manages to influence (bribe?) some platforms like Youtube to remove sensitive content or minimize its visibility. Anyone who wants to set up a news service in China with private capital is in for a treat. It is forbidden to use non-public capital for the following purposes: financing news gathering, editing and broadcasting, investing in the establishment and operation of news organizations, or operating web pages, radio frequencies, television channels, newspaper columns and social media accounts of news organizations. According to the South China Morning Post, Chinese journalists must take a test on the Xuexi Qiangguo (學習強國)-app, which can be translated in two ways: "learning from Xi to strengthen the nation" or "great power of learning". The Xuexi Qiangguo features news reports, videos and documentaries on the president's communist ideology and is seen as the 21st-century version of Mao Zedong's legendary Red Book. To get press accreditation, they must demonstrate their ability to effectively propagate Xi's ideas. Censorship is the order of the day. According to the Press Freedom Index, China ranks a dismal 175th in terms of press freedom, lower than Cuba, Iraq and Somalia, for example, and still just slightly higher than Myanmar, Turkmenistan, Iran, Eritrea and North Korea at 180. The current riots are not only against the harsh zero-covid policy but also against censorship, symbolized by the white sheet of paper held in front of the protesters' mouths. Right now, stop-and-search teams of Chinese police on the streets and subways are snatching citizens' smartphones from their hands to check whether they can access banned foreign apps such as Instagram, Telegram and Twitter via VPN (Virtual Private Networks), charming.

Virtual reality

It is not only difficult for Chinese citizens to face the true state of the economy, it is equally difficult for foreign observers and investors and even the central Chinese government. Chinese official statistics are as reliable as a fox in a henhouse. Withdrawing bad economic reports, only to replace them with suspiciously rosy ones, is commonplace. And it is not just the central government that should be pointed at for manipulating data. China is a corrupt country, with individuals, regional and local governments making a sport of disguising the truth so as not to get the CCP all over them if they fail to meet the objectives imposed on them. Not to make things too bad, China's National Bureau of Statistics [NBS] applies downward corrections to local figures. In 2015, for example, the NBS published a GDP figure that was 7% lower than the sum of data inputs supplied by local levels. But even then, the corrected official statistics are suspiciously optimistic. The World Bank and the OECD have pointed out in the past that China's official statistics overestimate real economic growth (by e.g. 3.8% a year between 1986 and 1995). Economist Thomas Rawski points out that according to the official figures, China's economy grew by 25% between 1997 and 2000, while electricity consumption - on which there are reasonably reliable figures - fell by 13% over the same period, something that does not square with China's industrial nature. In an original approach, by relying on night-time light intensity in various industrial centres recorded by US military satellites, the economist trio Henderson, Adam Storeygard and Weil calculated that China's overall economic growth during the period 1992 to 2006 was not 122%, the official figure, but only 57%.

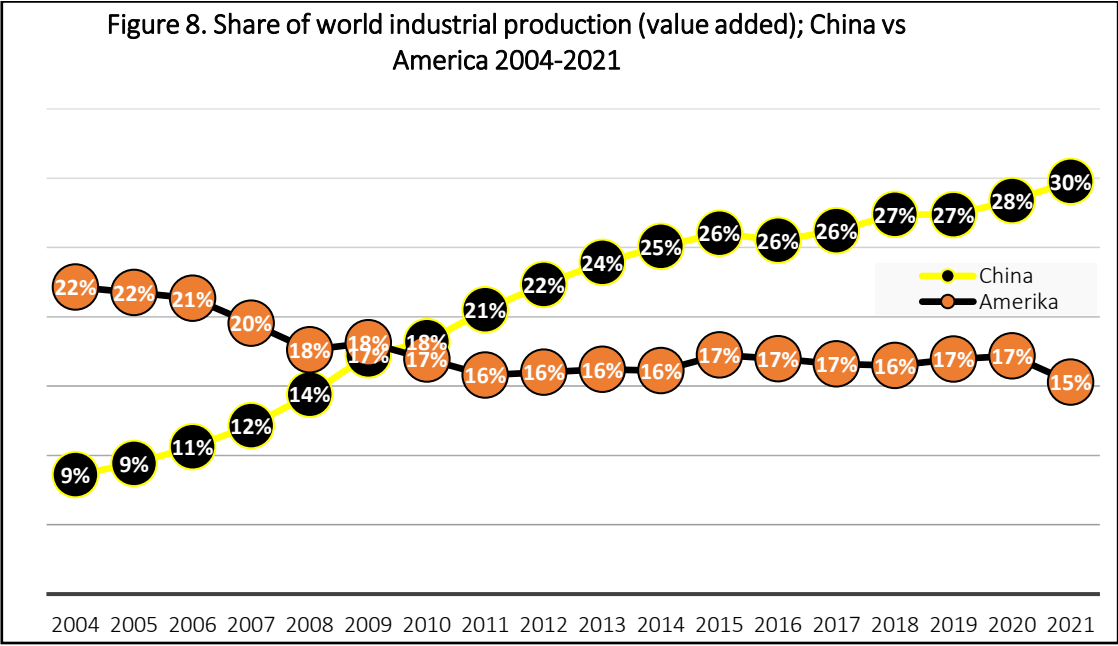


No one can deny that the Chinese economy has grown strongly, but probably much less spectacularly than thought.

As a matter of fact, official Chinese statistics are also becoming rarer. Not coincidentally parallel to the weakening of China's structural economic growth that has set in since Xi Jinping took power, the CCP has simply stopped publishing numerous economic indicators, especially on industrial production. Ten years ago, 40,000 statistics on industrial production were published annually, today only about 10,000.

Blunders

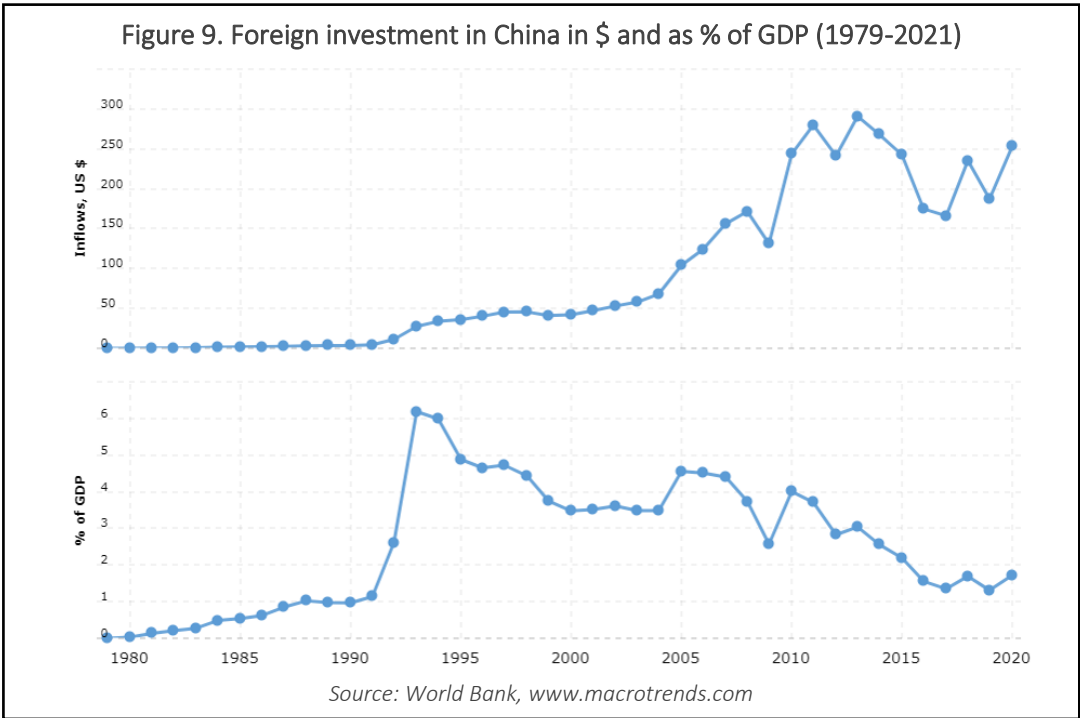
Too much power in the hands of one person does lead to mishaps in business and politics. On the economic front, Xi Jinping can boast a number of successes. Under his rule, China's economy has continued to grow. Despite harsh lockdowns, China has been able to strengthen its leading position as the world's factory. Measured by its share of world production, China overtook America in 2010 and the country continues on this momentum under Xi:



Source: World Bank

The country has also built a phenomenal transport infrastructure. Environmental pollution has been reduced thanks to massive investments in renewable energy and electrification, and extreme poverty has almost been eradicated (note, however, that a very large part of the population remains 'just' poor).

But alongside these successes, Xi Jinping also piles up the blunders. His ambitious Belt and Road initiative, the New Silk Road, has strengthened the supply lines of China's economy, but has also saddled many weak countries with debts they cannot repay. The property bubble (discussed below), already in place when Xi came to power, has continued to swell. With the already discussed attack on his own tech and entertainment sectors, he has shot himself in the foot. And his extreme zero-covid policies are not getting the virus under control and threaten to wring the neck of China's economy. Xi is balancing on a tightrope. His covid extremism is scaring off foreign investors, putting further pressure on economic growth. Foreign investors are also highly questioning an increasingly totalitarian regime that discriminates against foreign companies and their employees, the property bubble and debt problems. Since Xi's arrival, foreign investment has stagnated, and when expressed as a percentage of China's GDP, it shows a clear downward trend:



Source: World Bank, www.macrotrends.com

Some desperate energy-intensive European companies, think BASF, are still looking towards China, but America offers them an increasingly interesting alternative, thanks to substantially lower energy costs and generous subsidies. America First is back and many other countries. The EU is trying to follow the US example but will fail, as it did in its ill-considered energy policy.

White Paper revolution

Some see the zero-covid terror policy as a political move by Xi to reinforce his domestic authority. But this policy is having the opposite effect: Xi is losing face and gaining popular anger. The spark that ignited the popular anger is the same one that set fire to the apartment building in Urumqi (Xinjiang) on 24 November. The residents were trapped like rats because the door of their flat (the front doors open to the outside) was barricaded on the outside by local authorities with wooden and iron rods as part of the lockdowns. The fire brigade was unable to do anything as they failed to move the residents' cars in front of the building. The car batteries were flat, also as a result of the lockdowns. In the image below, you can see the water jet of the fire brigade falling down in front of the building.



Source: Associated Press

The fire was filmed by local residents and the videos with the residents' heartbreaking cries went around the internet. Popular anger only really ignited when the mayor issued a press statement in which he lied that the flat was in a low-risk[covid] zone and that the residents were free to leave their flat. The fire service lied along and pinned the blame on the parked cars and on the residents who allegedly lacked "self-rescue capabilities". The actual death toll may also be a lot higher than the official figure.

The local protests have gone national in no time. They are the largest protests in three decades and of the same scale as the 1989 student uprising, which was relatively easily quelled with brute force because the protests were concentrated in Tiananmen Square. The CCP is now throwing its police force into the fray to control the protests, but must now operate under the all-seeing lens of smartphones and the full attention of foreign countries. It is impossible to estimate what the outcome will be, but the people's victory against the world's most powerful repressive apparatus is not a foregone conclusion.

The G of ESG

Economic success in a context of striving for a communist nirvana, the destruction of entire sectors and companies, a totalitarian and autocratic regime, repression, censorship, non-existent press freedom, unreliable or missing information and statistics, ... The new China Model has become a contradiction. It has certain economic advantages over a Western democracy, for instance that you can implement public policies at a rapid pace, but it is not a model of

good governance (the G within ESG) aimed at creating shareholder value like the Anglo-Saxon one. Xi Jinping is an ideologue who tolerates the success of the private sector provided it does not get in the way of communist nirvana. This ideology conflicts with the creation of shareholder value. In an Anglo-Saxon capitalist system, an entrepreneur's success leads to shareholder wealth. Under Xi Jinping, shareholders - of both Chinese and Western companies operating in China - will end up paying a heavy price. Specific to ideology is that it takes precedence over any other rational consideration.

In investing, the E within ESG gets by far the most attention, but from a shareholder perspective, the G is at least as important. Poor governance has always been a good reason to avoid an investment. Those who nevertheless want to invest in Chinese stocks have a sword of Damocles hanging over their heads and should at least demand a hefty discount on valuation as compensation for poor governance. And that is not yet the whole story.

Part II. A Great Wall of bad real estate

Another reason to be suspicious of investing in China is the situation in the real estate market. Investing in real estate is deeply embedded in Chinese culture and is a strong status symbol there, not least for the male part of the population. In light of the law of large numbers, China has curiously more men than women (33 million) due to the mass abortion of female babies under the One Child Policy. Owning real estate increases the men's chances of marriage. Chinese citizens hardly invest in equities. Real estate accounts for 78% of their assets on average. The rest is held in bank accounts. Chinese real estate developers have cleverly exploited the real estate appetite of Chinese people by pre-selling projects years before they are completed. Buyers pay 30% of the purchase price upfront and then neatly pay off their mortgage loan every month for years before the actual completion. They are willing to do this because they assume prices can only go up. Thus, they hope to sell their investment at or even before completion at a profit. The real estate developers use not only their clients' advances but also a stunning amount of debt. Evergrande, China's second largest real estate developer, alone has more than \$300 billion in debt outstanding. The toxic cocktail of a narrative that prices can only rise, speculation and debt accumulation is characteristic of every bubble. Chinese real estate is undoubtedly the biggest Ponzi scheme in the world. The market value – or what should pass for it - of Chinese real estate is about \$55 trillion.

This town ... is nothing but a ghost town

Because property in China's big cities is prohibitively expensive, Chinese citizens mainly buy cheaper investment property in the suburbs and in medium-sized and smaller towns. Ghost towns have emerged in numerous places. The buildings in these ghost towns are of deplorable quality. The investors have no intention of ever living in them and do not even expect that others would live in them because they serve to be sold quickly anyway. Many are unfinished because, according to Chinese culture, it is bad luck to use an existing interior. The lousy quality of Chinese investment real estate, often no more than concrete skeletons, makes it extra shaky.

Figure 10. Image of a Chinese ghost town



Source: Image © Tim Franco, Flickr User shanghaisoundbites,
<http://www.timfranco.com/china/photographer/architecture/urbanism/spaces>

Here are some data to illustrate the real estate craze in China:

- the real estate industry accounts for 29% of China's GDP; this is more than double that of the West;
- until recently, China built 5 times as many houses and flats as America and Europe combined;
- by the end of 2021, 8.4 billion sqm (!) of real estate was under construction;
- more than 90% of new projects are pre-sold;
- between 50 and 100 million flats are empty today in China's ghost cities;
- in Shenzhen and Beijing, a flat costs more than 40 times the national income average; in the West, a level above 7-8 is considered a bubble level; mind you, the Chinese figure does get distorted by the wide income disparity in China. Big City slickers have much higher incomes than their less fortunate compatriots in smaller cities and rural areas.

This merry-go-round keeps spinning until a catalyst throws a spanner in the works. In August 2020, the government intervened to curb the building boom. Through the 'Three Red Lines', recourse to debt financing by construction promoters was curbed. This caused problems for the big developers, such as Evergrande, and indeed curbed speculation. Sales of new projects have fallen sharply and prices are starting to cool down. In the big cities, there has been a salami crash rather than a collapse, but in Tier 2 locations, the price drops have been much bigger. If the same problems had reared their heads in the West, the price drop might have been much bigger and faster. With us, news of problems can spread like wildfire, resulting in contagion and a rapid property crash. This is less the case in China. The property bubble has been around for at least a decade. The state media tries to silence the real estate problems to death in all languages. But the problems in the real estate sector are becoming too big and too widespread to ignore. Hundreds of thousands of Chinese citizens have gone on payment strike, refusing to pay their mortgage repayments. And the banks are powerless because it is impossible to seize a property that exists only on paper.

All CCP and RSDL

The property sector is the cornerstone of China's economy and this cornerstone is crumbling. The crash may be a crash in slow motion, but its long-term impact will be very painful. China's shaky banking system is also sharing in the debris. As always, it is very difficult to get reliable Chinese statistics, but with some detective work and a little arithmetic, you can make some reasonable estimates. Lei's Real Talk (available on Youtube, I strongly recommend it) does the math. Lei starts from the number of foreclosures in a metropolis like Hangzhou, published on Alibaba's website, which comes out to 50,000. Add another 20,000 from other websites and multiply by 230, the number of major cities in China, and you have 16 million foreclosures. Take conservatively 10 million foreclosures, multiply by 600,000 Rmb and you have 6 trillion Rmb (\$0.8 trillion). Add 4 trillion arising from undelivered projects and you have a total of 10 trillion Rmb (\$1.4 trillion). You end up with bad mortgage loans accounting for almost 30% of China's total mortgage debt, equivalent to almost 10% of China's GDP. This contrasts sharply with estimates by Western banks such as Citi, which put the percentage of bad mortgage loans at 1.5% instead of 28%. And Oh yes, the information on foreclosures can no longer be found on Alibaba's website. *All CCP and RSDL make Jack [Ma] a dull boy*, to paraphrase Jack Nicholson in *The Shining*.

When Chinese economic growth threatened to go under during the Great Financial Crisis, the central government launched an investment bonanza by instructing local governments to carry out major infrastructure works. Because of the centralization of their fiscal revenues with the national agencies, Chinese local governments set up about 10,000 special vehicles, the LGSVs, which issued Rmb 54 trillion (about USD 8 trillion, half of China's GDP) worth of domestic bonds to finance those major infrastructure projects. However, the cost of the debt is much higher than the local governments' recurrent receipts. To stay out of the red, local governments have sold huge chunks of land to real estate developers. Now that these are in trouble, besides the banks, local governments are also in trouble. And it is the massive infrastructure investment by these vehicles, along with the real estate sector, that has been responsible for a major part of China's economic growth since the Great Financial Crisis. China's real estate crisis, like all real estate crises, is seeping into the financial system. Not to mention the hidden and bad debts outside the real estate sector. A new financial crisis is emerging.

Dead cat bounce

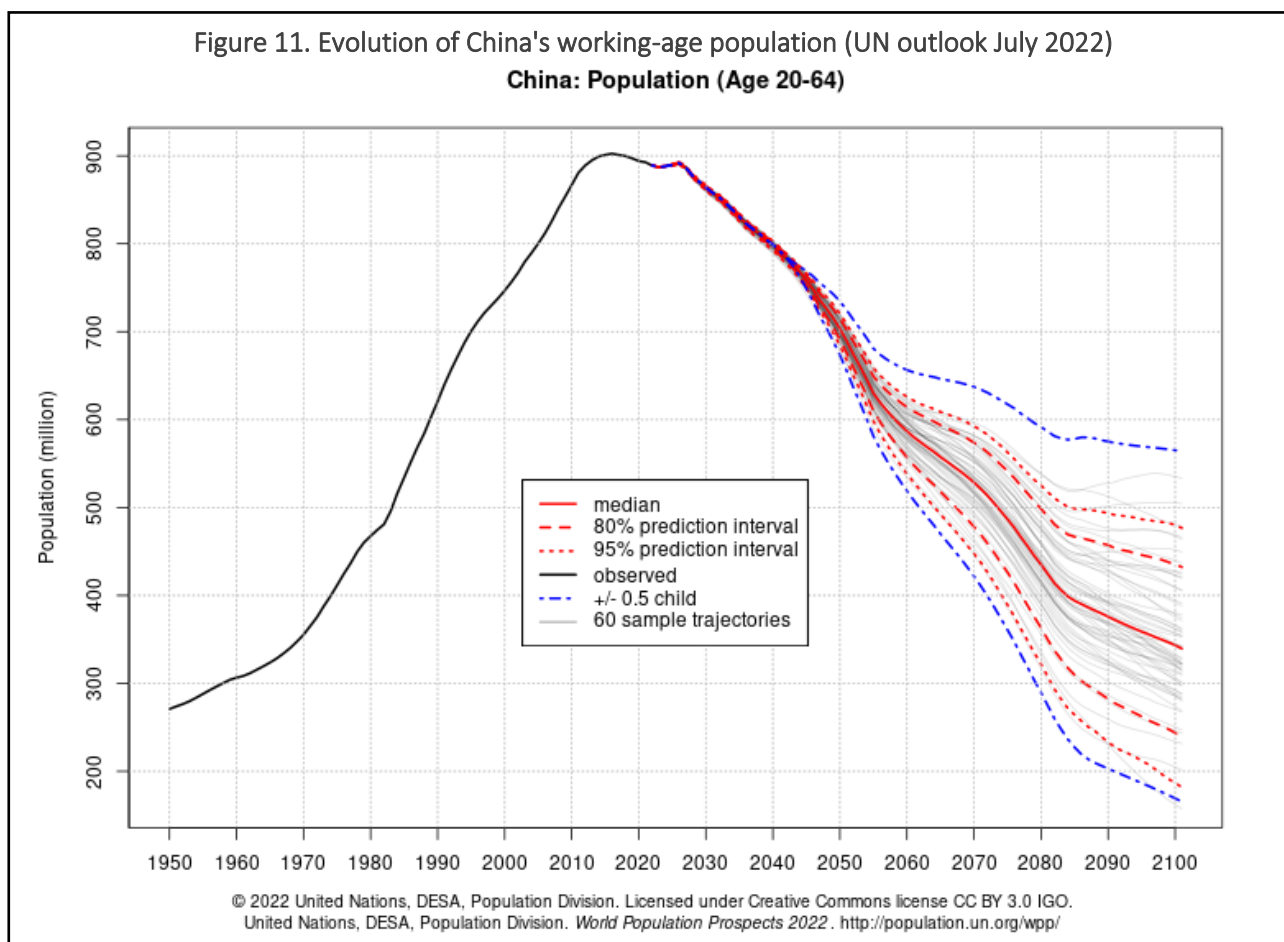
The CCP is concerned - rightly so - at the latest evolutions. With the situation spiraling out of control, it replaced the Three Red Lines with the 'Sixteen Measures' in mid-November, leading to a violent rebound in the share prices of Chinese property stocks. This year, the CCP is once again reverting to the recipe of debt-financed infrastructure works to keep the boat afloat. Never underestimate the power of the CCP to scoop the economy out of a difficult corner through interventions, but this only puts the problem on the back burner. Debt addiction, like drug addiction, is not remedied by taking on new debt.

Part III. More on demographics and productivity gains

Over the top

In the October 2022 *Quo Vadis*, we discussed China's catastrophic demographics and declining productivity gains. Both are explored in more detail here. In the previous edition, you found a graph illustrating the collapse of China's overall population. The evolution of China's working age population, which is most relevant to economic growth, is shown below:

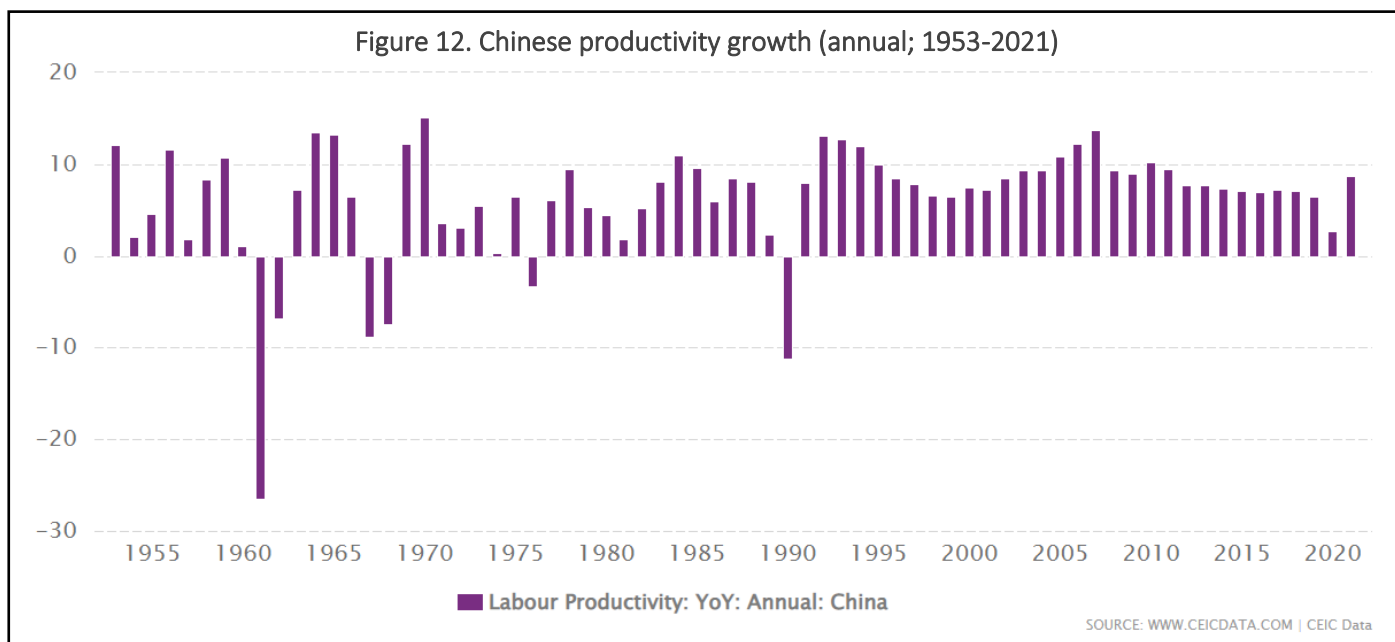
Figure 11. Evolution of China's working-age population (UN outlook July 2022)
China: Population (Age 20-64)



One picture says more than a thousand words. According to the UN, in its July 2022 demographic outlook, China's working-age population will fall from 900 million to just over 300 million. Bearing in mind that the UN's outlook is overly optimistic, particularly due to the hypothesis that the fertility rate (the number of births per woman) would recover from 1.15 to 1.6, and given the strong suspicion that the reality is worse than what the official population figures would have us believe, the working-age population may fall to below 250 million, barely higher than the US, for example (see below).

Fatal attraction

China's large productivity gains, the second driver of economic growth alongside labour population growth, are the fruit of rural flight to the cities, where productivity is 4 times higher. We know that China's urbanisation rate is some 65%. This figure may indeed rise even further. In the United States, for example, the urbanisation rate is 85%, in Taiwan around 80%. If we take Taiwan as a reference point, and taking past rates into account, some 200 million more Chinese could move to cities by 2040.



This will support productivity gains and thus economic growth, but at the same time (cf. Figure 11) the working-age population will fall by 100 million, possibly more. Moreover, the rural exodus also has a demographic downside. Life in China's big cities is so expensive that the fertility rate over there is only 0.7, well below the national average. Conclusion: the pace of productivity gains will inevitably slow down, and, together with the demographic collapse, undercut economic growth.

Nicking industrial secrets

Is there no salvation for China's growth problem? In theory, China could boost its economic growth by increasing its productivity gains through innovation.

China has long been unable to innovate on its own. The early stages of its economic advance relied mainly on cheap subcontracted production from abroad and on the Chinese interpretation of Copyright as the Right to Copy just about anything invented in the West, only to market it much cheaper, and often at inferior quality. Though morally reprehensible, it is not abnormal for an emerging nation to copy first before innovating. Western countries too once did it, albeit mainly by luring those responsible for a major innovation abroad. Even Steve Jobs and Bill Gates borrowed another company's innovation and then made it their own (Xerox's Palo Alto Research Centre, where the computer mouse, the GUI and the Windows principle, among others, saw the light of day). But that China is above average at nicking foreign industrial secrets is beyond dispute.

Although copying - "Theft Economics" in Donald Trump's franc parler – remains a persistently bad Chinese habit, China has now shown its ability to innovate on its own, as evidenced, for instance, by its honorable 11th place in the international innovation ranking, itself based on 80 indicators:

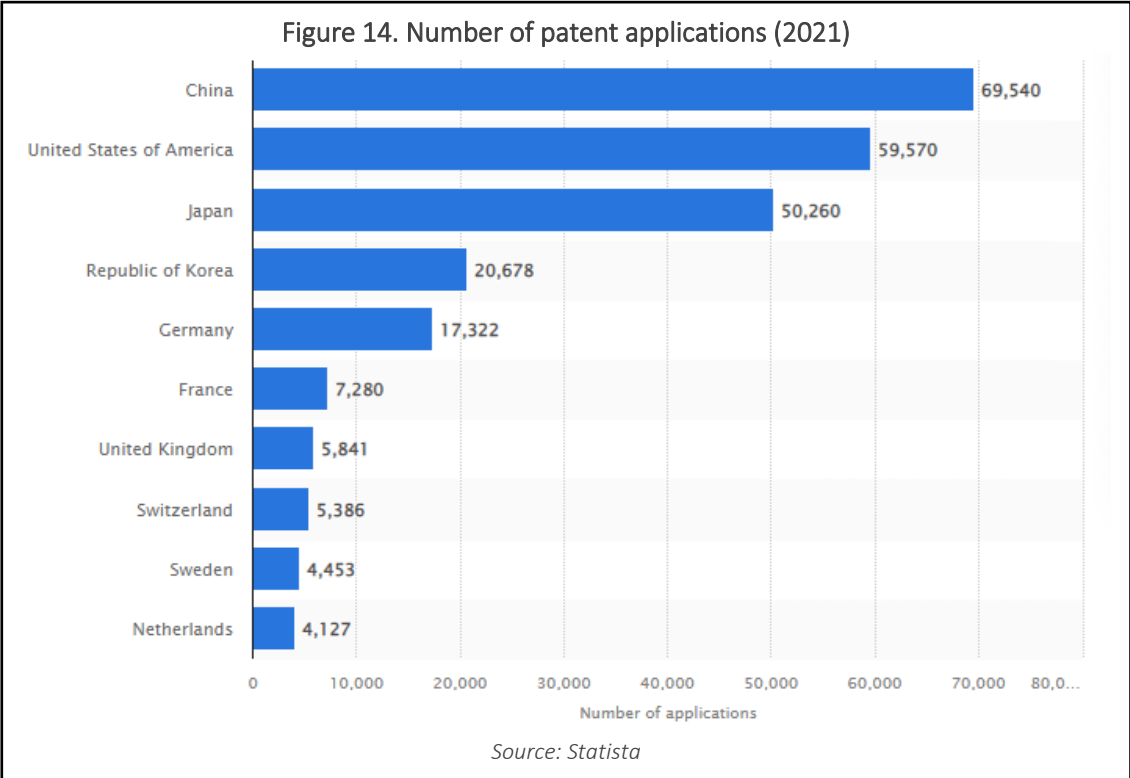
Figure 13. Global Innovation Index, 2021 ranking

GII rank	Economy	Score
1	Switzerland	64.6
2	United States of America	61.8
3	Sweden	61.6
4	United Kingdom	59.7
5	Netherlands	58.0
6	Republic of Korea	57.8
7	Singapore	57.3
8	Germany	57.2
9	Finland	56.9
10	Denmark	55.9
11	China	55.3
12	France	55.0
13	Japan	53.6
14	Hong Kong, China	51.8
15	Canada	50.8
16	Israel	50.2
17	Austria	50.2
18	Estonia	50.2
19	Luxembourg	49.8
20	Iceland	49.5
21	Malta	49.2
22	Norway	48.8
23	Ireland	48.5
24	New Zealand	47.2
25	Australia	47.1
26	Belgium	46.9
27	Cyprus	46.2
28	Italy	46.1
29	Spain	44.6
30	Czech Republic	42.8

Source: Global Innovation Index 2022, WIPO (World Intellectual Property Organisation)

Based on the number of patent applications filed, China even ranks number one:

Figure 14. Number of patent applications (2021)



This evolution shows that China is no longer just feasting on the innovations of others. The democratization of Chinese education has created a huge reservoir of people who score very high intellectually, as evidenced by the top scores in the PISA rankings that measure students' performance in reading, mathematics and science:

Table 1. PISA scores (2018)

	Reading	Maths	Science
OECD-average	487	489	489
China	555	591	590
Taiwan	503	531	516
Singapore	549	569	551
United States	505	478	502
Switzerland	484	515	495
Belgium	493	508	499
Russia	479	488	478

Source: OESO

So, no worries?

Nope. While China leads in terms of the number of patent applications, quantity is not always the same as quality. Many Chinese innovations bring modal rather than revolutionary improvements. Providing a special compartment with a specific temperature for ice cream in a refrigerator intended for the US market because US consumers do not like to wait is a meaningful innovation, but not the type that will fundamentally change the world. China may be able to develop innovative apps like TikTok, for example, but it is not able to develop the backbone behind the app: advanced microchips. An innovative application still remains an application, not pure innovation. In a previous Quo Vadis issue, we explained the importance of advanced microchips, called the 'oil of tomorrow' because they make all the difference in the realm of advanced weaponry, of supercomputers and of artificial intelligence. China is capable of innovation, but lags behind in terms of the technological innovations that really matter. Its chances of initiating a new industrial revolution to solve its structural economic growth problems are slim.

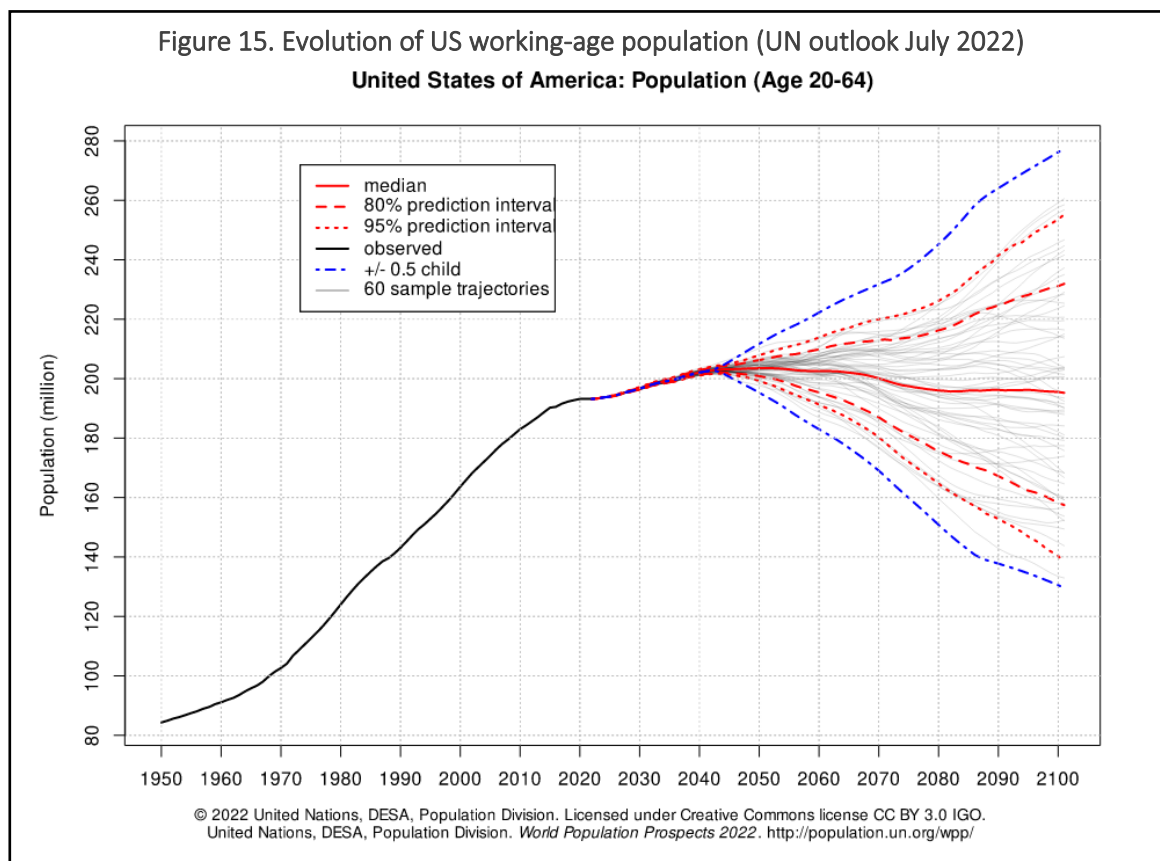
Part IV. Implications for investors

Hemingway's Law of Motion

The above analysis draws an ominous picture of China's economic prospects. The miracle years are definitely over. The world does realize that growth rates of 10%, as in the 2000-2009 period, are no longer possible. In the following decade, the growth rate fell to 7.7%. Perhaps because of the behavioral bias of anchoring (i.e. anchoring responses to certain reference points without really thinking), the consensus seems to assume that a growth rate of 5-6% in the current decade is quite feasible. In reality, growth will be much lower and gradually decline towards 2%, 3% a year at most if the Chinese government throws in a few more trillion of new debt. After 2040, along with the end of migration to the cities and with the evaporating labor population, growth will go into a steep decline. "Two ways. Gradually, then suddenly", was Mike's answer when asked how he had gone bankrupt (from Ernest Hemingway's *The Sun Also Rises*).

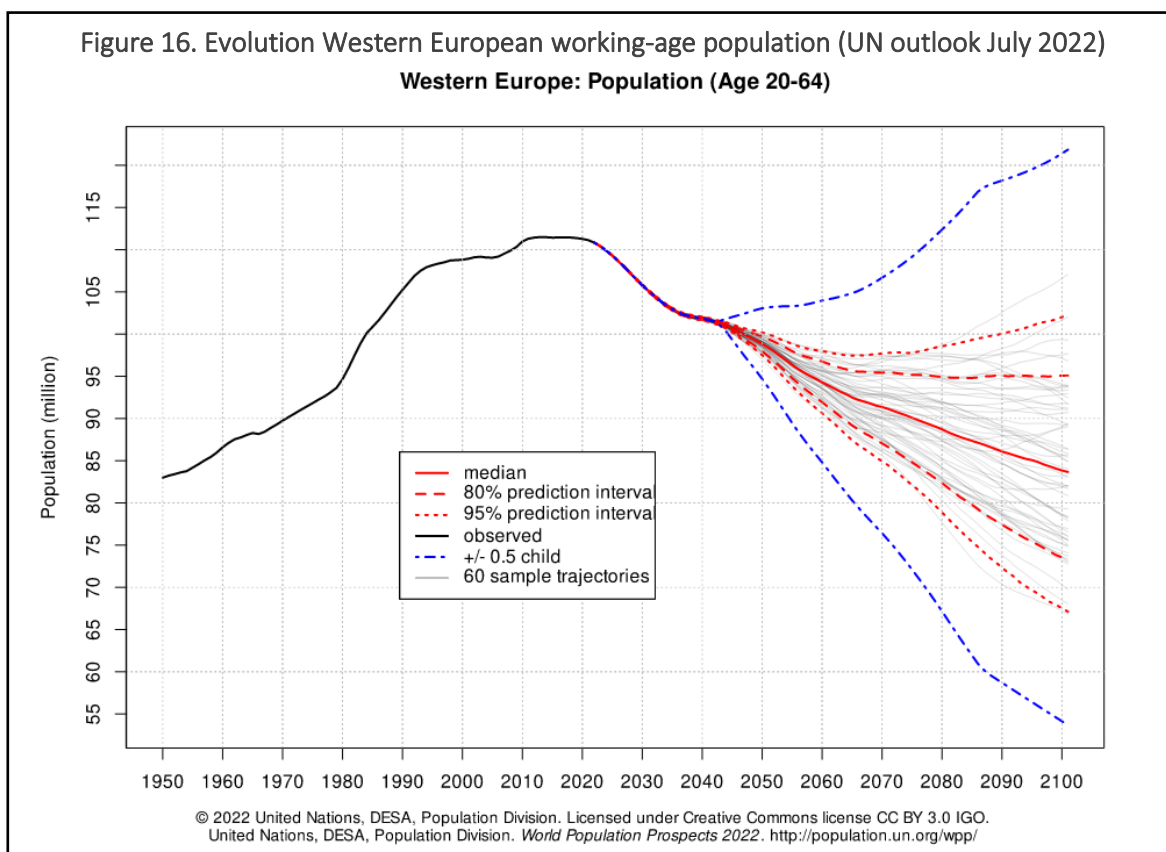
USA! USA! USA!

Investing is about making choices between alternatives. If we compare China, Europe, Japan and the US demographically based on working-age population, the US emerge as the clear victor. America's demographic outlook is totally different from China's, as the picture below shows:



Whoever said that the Chinese economy would soon overtake the US economy? Well, most economic think tanks (CBER, Oxford Economics to name a few), argue that the Chinese economy will rush past the US economy by 2030 and then build a big lead. Really? US GDP is \$25 trillion, China's (without adjusting for purchasing power parity) \$18.3 trillion. Assuming average real economic growth in the US of 2.5%, to catch up by 2030, China would have to grow by 7% per year in real terms and, to catch up within 10 years, by 6%. It's not going to happen. And if it did happen, it won't be for long. The US will remain on the economic throne, to the regret of those who envy it. Granted, if purchasing power differentials (the difference in living standards) are taken into account, China's economy, at \$27 trillion, is the largest in the world, but this is just virtual reality.

America's demographic outlook is also noticeably better than Western Europe's (and Japan's, of course):



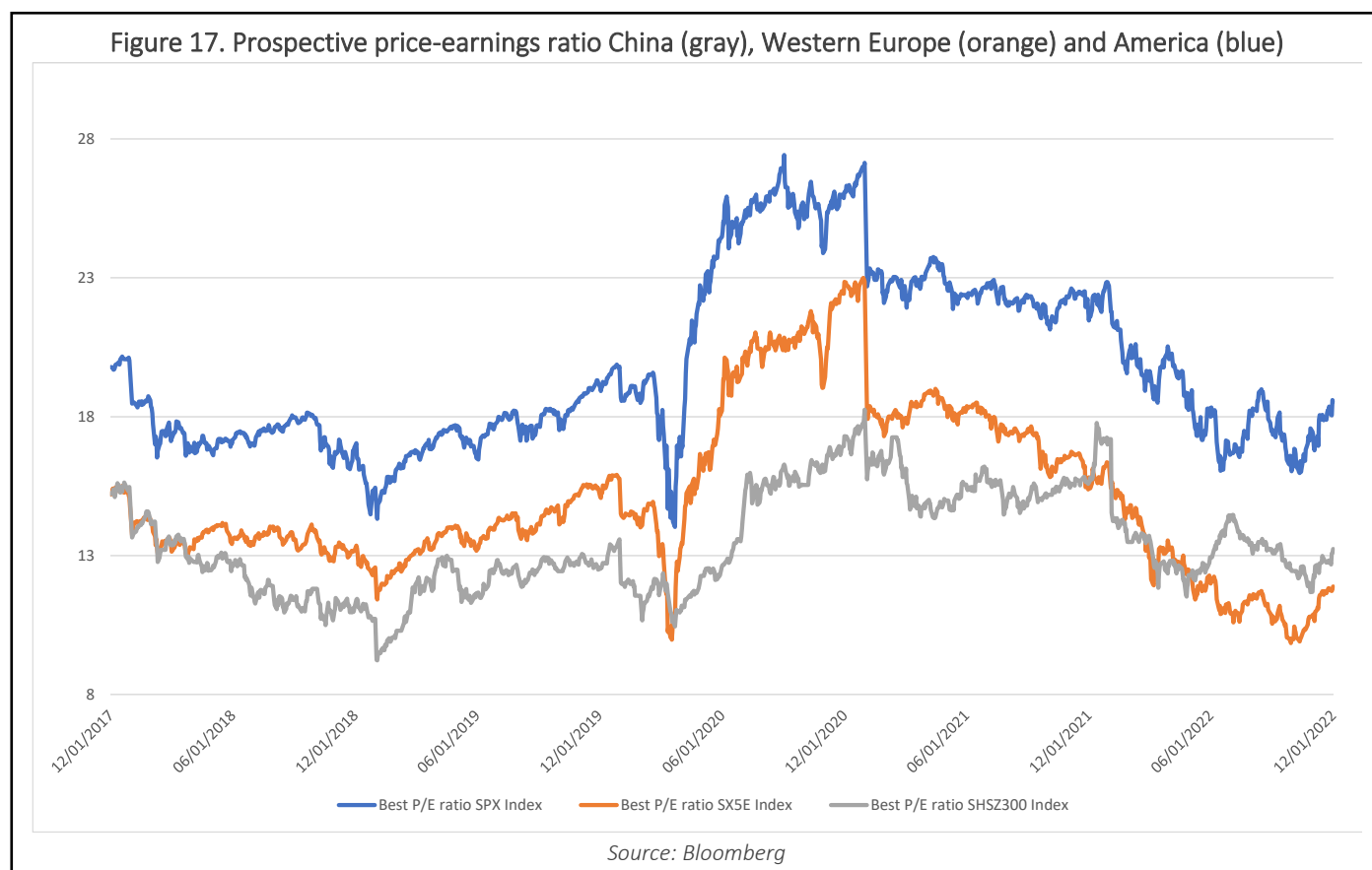
If we compare China, Western Europe and the US from a broader perspective, we get the following picture:

Table 2. Broad comparison China, Western Europa and the US

	China	Western Europe	US
Favorable demography	XXX	XX	V
Corporate governance (shareholder value)	X	V	VV
Democracy	XX	V	V
Innovation	V	V	VV
Impact annexation Taiwan	XXX	V	VVV
Energy cost	-	XXX	VVV
Energy independence	X	XXX	VVV
Monetary sovereignty and power	V	X	VV
Strength banking system	X	V	VV
Military power	V	XX	VV

Source: Eurinvest Partners Research

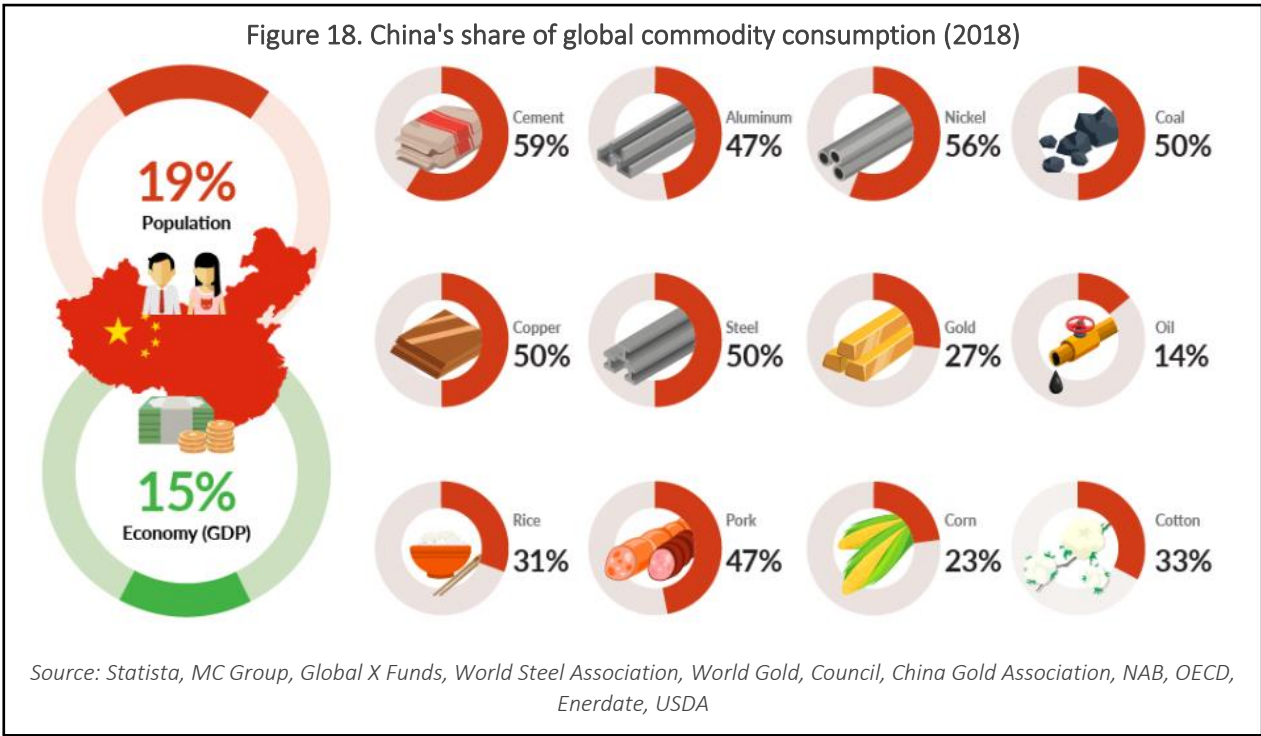
America remains the world's cleanest dirty shirt in the context of the new geopolitical and demographic realities. In the stock market, all roads lead to the US. That was true 15 years ago and it remains so today. The only thing playing in favour of the Chinese stock market - as well as the European one - is valuation:



Extremely negative market sentiment has pushed Chinese and European equities to very low levels and widened the gap with the US, albeit not as spectacularly as one might have imagined. In the short and medium term, a recovery in the Chinese and European stock market is quite possible, even likely, but in the long term, US assets deserve structural preference. It is not for nothing that Warren Buffett continues to invest mainly in America. Occasionally he invests in China, and now in Taiwan, but once he has made enough profits, he quickly leaves the building. The message remains that Chinese assets, including Taiwan and Hong Kong, are a death trap for long-term investors. Chinese assets are a tactical and opportunistic investment, not a strategic one.

Commodities

China stands out as the world's biggest consumer of commodities.



You would therefore expect to see a strong correlation between Chinese economic growth and commodity prices:

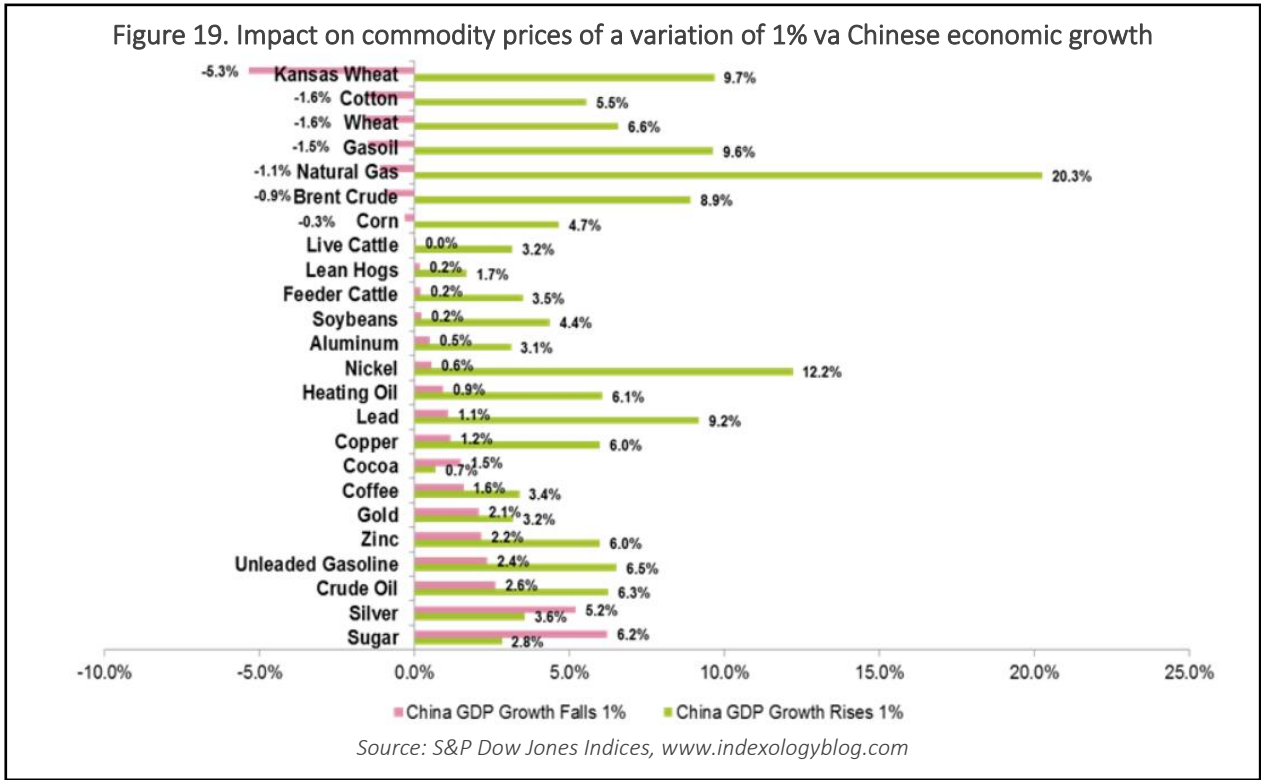


Figure 19 shows the variation in commodity prices relative to a 1% variation in Chinese economic growth. The result is strikingly asymmetric. All commodity prices rise sharply when the Chinese economy grows, but when Chinese economic growth falls, the (negative) correlation is much weaker. When Chinese economic growth falls, only wheat, cotton, oil and natural gas prices fall. But to what extent are these past findings still relevant for the future? The scale of the growth slowdown facing China is such that it will undercut the structural growth of the global economy. China has accounted for a third of global economic growth over the past 10 years. And even without China, the global economy can expect a growth slowdown due to terrible labor demographics in Europe and Japan. All in all, a context that is very negative for demand and prices of basic commodities. And by extension, structural deflationary pressures will follow.

Deglobalization

The first edition of Quo Vadis argued that the annexation of Taiwan might happen within the next 5 years. The White Paper Revolution reinforces this view as it is the ultimate lightning rod for Xi, should he need to save his skin. If and when this happens, deglobalization will reach warp speed. But even if this scenario does not materialize, growing deglobalization is a reality. Critical manufacturing is widely reshored. Numerous countries have enacted a Chips Act to get production of advanced chips on home soil. The West is working at breakneck speed to mine its own rare earths and to find alternatives. America is fully reindustrializing itself. The revolt at Foxconn is making Apple and the world face the fact that the success model of siphoning off all manufacturing to a faraway country has had its day. Especially when this distant country presents a huge geopolitical risk, such as China. Investors would do well to bet on Western companies benefiting from reindustrialization in their own region. They would also do well to shun companies that have bet heavily on China. Those who invest in China are dancing on a volcano.

Jan Longeval

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