

Investment: think China, not Japan

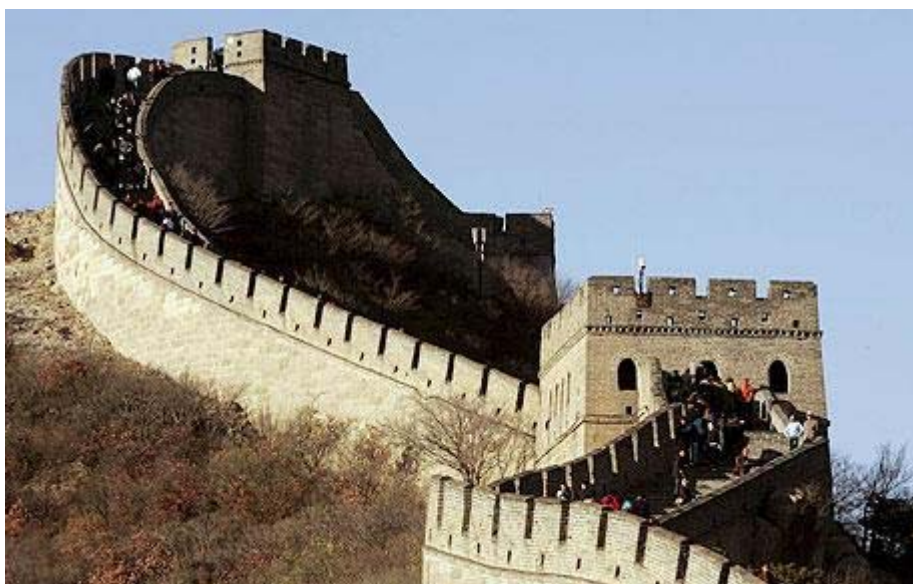
Fundamentalist view: Before the end of this year, China will become the world's second-biggest economy, replacing Japan about 10 years ahead of schedule.

By Professor Shujie Yao

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This should ring alarm bells for traditionalist investors.

Traditional thinking is that China is an emerging market economy – usually a small, high-risk part of investor portfolios; Japan the stable, mature economy worthy of significantly greater exposure.



'At times like this China's political structure has economic advantages. If the Chinese government wants a major road built, work will start straight away' Photo: EPA

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But this turnaround in the global gross domestic product (GDP) league tables should also, arguably, trigger a turnaround for many investors. First, China. There is no doubt China has been hit by the global recession.

Exports fell for the sixth month in succession in April, the Shanghai Stock Exchange suffered worse drops than most other leading world stock markets in 2008, when it fell by 65pc although it has recovered since, and GDP growth has slowed from double figures in 2007 to a likely 8pc this year.

But Beijing's recent 4,000bn Renminbi (£385bn) economic stimulus package, worth 13pc of GDP for various infrastructure projects, as well as increased bank lending will have an impact faster than similar plans elsewhere.

For all the criticisms of China's political structure, at times like this it has its economic advantages. If the

Chinese government wants a major road built, work will start straight away. If it needs the banks to lend, they do.

Two years ago I was worried that rising food and commodity prices could act as a drag on China's economic progress. The recession has brought these prices down – and that is helping China's recovery and growth.

The recession is also leading to a painful but necessary economic shake-up within the country.

Manufacturers of cheap goods are going out of business because of the collapse of the export market, and that is leading to the demise of inefficient businesses and a drive to move Chinese manufacturers up the technological ladder.

Finally, the crisis is helping to remove regional inequalities that were threatening China's growth and political stability.

The drop in exports is encouraging manufacturers to move their businesses from coastal regions to the interior to cut costs and satisfy domestic demand and that is helping to correct some regional imbalances.

This raises a crucial point for Western investors. China – as the markets have shown in the past year – is an integral part of the global economy. Those who argued that when America sneezes the rest of the world no longer catches a cold, were wrong.

But China is not as dependent upon exports as other countries – or as much as it was. This is not a cold that is sending the country staggering to its bed.

The consumer economy is broadening and as the population ages excess household savings will be spent. China can sustain its own endogenous growth, so it will emerge stronger from the recession.

Japan, on the other hand, looks fragile. Government debt stands at about 200pc of GDP. Japanese interest rates are very low, 10-year Japanese Government Bonds yield just 1.4pc, so you might say this isn't too much of a problem.

But follow the maths: debt at double GDP financed at 1.4pc takes 2.8pc of GDP every year just to pay the interest and keep debt stable – and that assumes the annual current budget is in balance.

Like most others, Japan's current budget is in deficit, by about 7pc of GDP. The deficit is increasing, even before its recent stimulus package. All of this adds to overall borrowings, which would be fine if the economy were sufficiently strong to keep debt under control.

The snag is that Japan has not grown at 2.8pc for decades and there is no realistic prospect of it doing so. Japan appears to be in a classic economist's "debt trap"; a state in which the ratio of debt to GDP can never fall. If it were a business, it would be deemed insolvent.

Exports and industrial production have imploded; even with some recovery later in the second half the economy is likely to contract by 5pc this year (and that's being kind). For most countries this road leads to hyperinflation and a trashed currency.

For the Japanese economy to implode is surely beyond imagining. But it is far from impossible. The logic is simple, yet none of this seems to be on anyone's agenda. Let's hope I am wrong but plan for if I am right.

Stock markets may be bumpy, but any "long-term growth" investor without a chunky exposure to China, and still preferring Japan, is driving while looking through the rear-view mirror, not the windscreen.

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