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Perspectives

Japan's Loss, China's Gain



A recent article published by BCA Research* is entitled "China's Race against Japan". What race? Japan and China are like two elevators going in different directions. Japan is heading from the ground floor into basement, and the only question remaining on the minds of onlookers is how many underground levels there are. China, somewhere near the 30th floor, is racing up towards the 100th floor viewing-platform.

Despite the poor choice of a title, the BCA's piece is highly informative and its conclusions are accurate. Among the key observations are these:

- China spends with the intent to transform itself, while Japan spends so that it can resist change.

- China has checked deflation, the economy is surging and the pace of reform is quickening. Japan is in its 12th year of stagnation with prices spiraling lower.

- China's industrialization could be one of the most important events in [contemporary] history.

China the regional powerhouse

The manifestations of what my friends at BCA Research are saying are everywhere. The US trade deficit with China is now larger than that with Japan. And within Asia, Beijing's leadership is even harder to ignore: Asian exports going to China are now 50% higher than those destined for Japan! What's especially intriguing about the two countries' evolution is that their problems are very similar. Both China's and Japan's economy are plagued by chronic over-capacity in the manufacturing sector and price deflation. Tokyo's and Beijing's bureaucrats have a history of interference in the business sector (which has caused corporate inefficiencies) and reluctance to discipline the banking system (which has led to a mountain of bad debts). And because corporations are poorly run and banks untrustworthy, savings rates are sky-high.

*BCA Research Inc., www.bcaresearch.com

Yet, despite these handicaps, China's government has been aggressive in reining in its bureaucracy. State enterprises have been eliminated and the private sector has been allowed to prosper. This has surprised some Westerners. But, in the end, why wouldn't the military and civilian leadership support business, when every general and politician has his hand in the till of free enterprise?

In Japan, in contrast, the government has talked reform but done its utmost to maintain the *status quo*. Time after time, the authorities have propped up a sick system by massive spending on largely unnecessary infra-structural projects. The reason for this is equally simple: the ruling Liberal Democratic Party is so dependent on kickbacks from the construction industry that it prefers to build bridges to nowhere than to get the economy back in order.

Two types of corruption

In simple terms, then, the only difference between a crooked Chinese leadership and its corrupt Japanese counterpart is that Beijing's bosses have a direct incentive to see free market principles succeed, while Tokyo's chiefs are motivated to keep it from succeeding.

Moreover, China, in its quest for regional dominance, has other advantages over Japan. One key plus is its virtually unlimited supply of cheap labor. Its cheap exports have not only secured China a rapidly growing market share, they've also strengthened the country's fiscal position and boosted its foreign exchange reserves. Japan's much higher wage structure, on the other hand, leaves it hopelessly uncompetitive. To counter the problem, foreign competition is being limited, despite the fact that Japanese consumers are screaming out for inexpensive imports from other Asian nations. The result is that domestic consumption seems stuck in an irreversible decline; in the absence of attractively priced goods, the Japanese prefer to save.

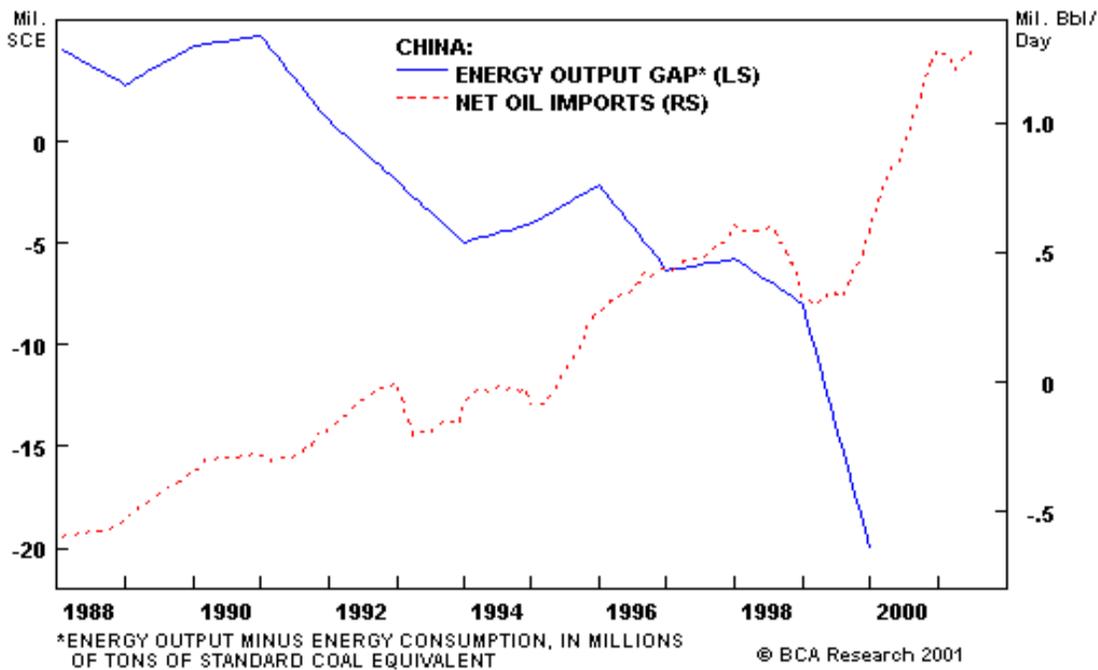
In short, China is rapidly progressing on every front, while Japan, saddled with its 15th prime minister since 1997, is going nowhere. China's pending entry into the World Trade Organization and its hosting of the 2008 Olympic Games will only intensify the trend. Which is not to say that China doesn't face significant challenges of its own. One key financial test will be the need for China to open its stock market to foreign capital. At the moment, foreign exchange controls and a variety of investment restrictions for different stock classes make it difficult to participate in Chinese equities and have caused significant distortions in valuations. Price/earnings ratios are in many cases so inflated that they remind me of Japan's "bubble days".

Some of the better informed analysts predict that the *renminbi*, China's currency, will become fully convertible within five years and that a centralized Chinese stock market, based in Shanghai, will be fully accessible to international investors.

Environmental, social challenges

China's most daunting challenges, however, are social and environmental ones. The country's natural resources have been degraded at an alarming rate, which has led to a rapid deterioration of the environment. Contrary to popular opinion, China is poor in resources, at least when measured against its vast population base. The Chinese government has repeatedly expressed concern about the ailing environment and resource depletion and has even instituted remedies, such as a nationwide ban on logging. However, critics point out that legislated safeguards are more frequently broken than observed. Still, the surging economy and the recognition that the local supply of commodities is finite, guarantee that China will demand an ever-greater part of the world's natural resources.

Commodity imports to explode



Socially, China faces a major test, as well. The gap between rich and poor is growing at a frightening rate, as disenfranchised rural populations see their urban counterparts prosper. Within the urban context, too, there are tensions. Tens of thousands of employees have been let go from eliminated state enterprises; they see young entrepreneurs make more money in a week than their loyalty earned them in a year, and they resent it.

These, and other problems (such as the one-party political system and the fact that many local governments wield far too much power) suggest that the new China is still a very risky place. “It is not surprising,” say the people at BCA Research, that there are plenty of pessimists and China bears.” Even so, the BCA analysts are optimistic, as am I. The country’s record of overcoming adversity is astounding: in just a few years, China has had to overcome a massive leadership struggle, an economic crisis that gripped all of Asia, broad government corruption and massive layoffs at state-owned enterprises. Logic would suggest that future crises should be easier to overcome, mainly because a large number of Chinese people have seen their fortunes raised and look towards the future with confidence. The BCA’s researchers feel that, from this perspective, the advent of the Beijing Olympics must not be underestimated. For the Chinese, the event will be synonymous with stepping onto the world podium. “This will help unite the people and allow the government to undertake extremely painful reforms without jeopardizing the underlying economy.”

Geopolitical balance to change

One of the most ignored aspects to China’s ascent and Japan’s decline is how they’ll affect the current geopolitical balance. At the moment, China and Japan are deeply suspicious of each other, as are China and the US. Yet the existing axis between the US and Japan no longer works. The US is justly disappointed with Tokyo. Even though many of the corrupt “arrangements” that have led to Japan’s problems were actively encouraged by General McArthur’s administration at the end of World War II*, Washington is frustrated by its partner’s inability to change. The latest Japanese Prime Minister, Junichiro Koizumi, has promised major changes but, ironically, if his reforms are implemented at this time, they will only plunge the country into deeper crisis.

*For a complete background on Japanese post-war history, read my review of “The Yamato Dynasty” in **Cavelti’s Library**.

A shift in existing trans-Pacific ties is clearly ahead, and how things play out is to a large extent up to the US. Corporate America understands that China is the rising star and Japan a power in decline. But the US government is stuck with the mission to de-emphasize its historically strong relationship with Japan without jeopardizing regional stability. There are elements in the US foreign policy platform that suggest that Washington understands the complexities of the challenge. The decisions to allow China into the World Trade Organization and to support its Olympic bid are among them. But other US policy components are troubling, none more so than the repeated calls for a stronger Japanese military.

In the end, it may well be political considerations that will decide exactly how economic issues between China and Japan will evolve. And US decision-making may be pivotal. Given America's generally poor grasp of foreign policy issues, that is a troubling thought! □

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