

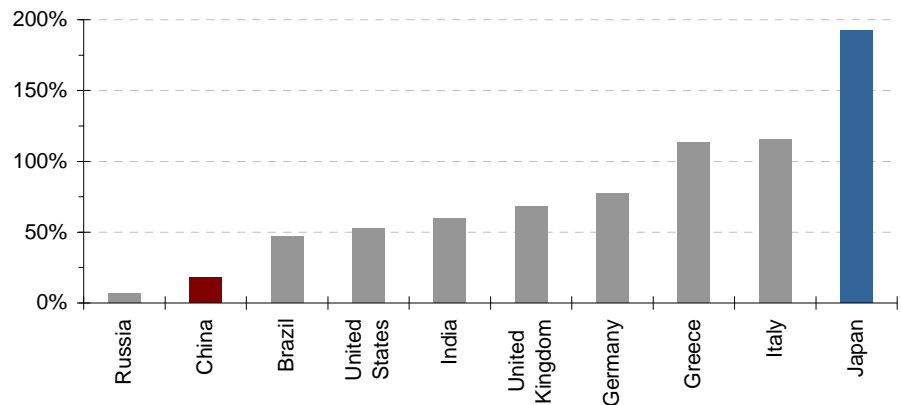


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Last month I was in Japan, where I lived for over three years at the end of the extraordinary 1980s boom. One reason was to see what parallels can be drawn between its bubble and the situation in China today. As the bubble burst, Japan's economy stagnated and has not since regained anything like its earlier lustre. The stock market plunged from December 1989 and remains around 75% below its all time high.

A key difference between the two is that debt was, and remains, far greater in Japan than in China. In Japan, corporates built up debt, but it was the government that was particularly extravagant. Government debt rose from 50% of GDP to 70% during the 1980's – but is now 200%. In China, despite pockets of local government debt, overall public sector debt remains insignificant, at a mere 18% of GDP, while private sector (personal and corporate) leverage is also low by international standards.

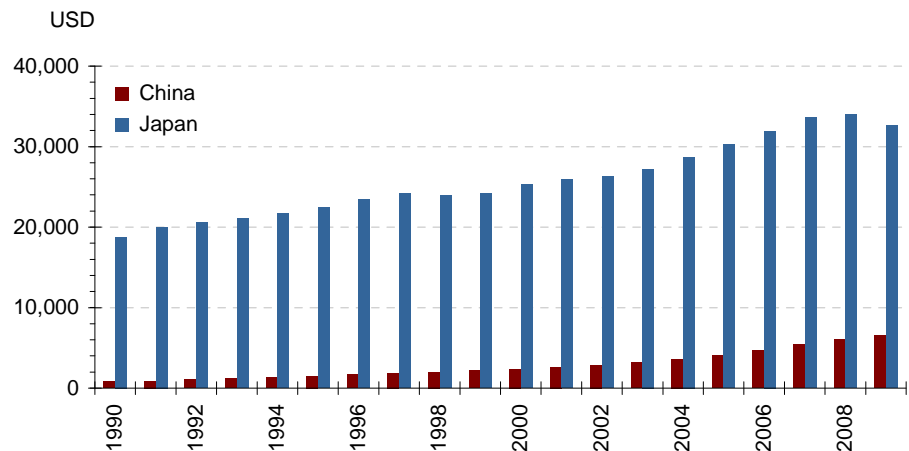
2009 Public Debt (% GDP)



Source: CIA World Factbook

Another important difference rests on the degree of wastefulness of government spending. Despite three decades of breakneck growth, China today remains a relatively poor country. Japan in the 1980s was one of the world's richest countries and its per capita GDP is now \$32,000. By contrast, China's per capita income is below \$7,000.

GDP per capita (USD purchasing power parity)



Source: IMF World Economic Outlook

Why does this matter? Much of the present concern about China's economy, like that of Japan before, revolved around high and potentially wasteful levels of government investment, especially on infrastructure. However, given its stage of development, China has needed, and continues to need, infrastructure spending. On my visits to China over the years, I have come across, for

example, a vast greenfield development - to which I have later returned to find a flourishing commercial community. This is typical in a high growth economy. With 45 cities with a population over 2 million, each with their own traffic concerns, demand for underground railways is expanding.

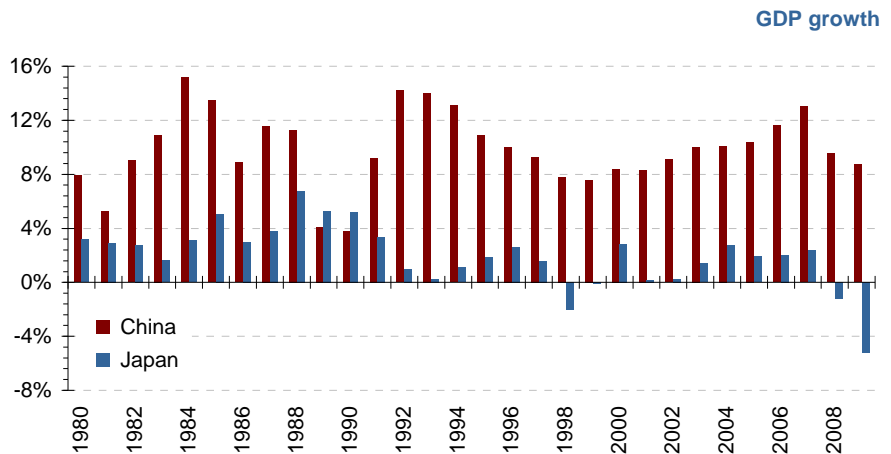
Before



After



China's economy has grown at 9.8% per annum for the last ten years. Its current position is thus more analogous to that of Japan in the booming 1950s and 1960s, when the famous bullet train was first built, rather than in the bubble economy of the late 1980s, a decade in which the economy grew at an annual average of 'only' 3.9% in real terms.

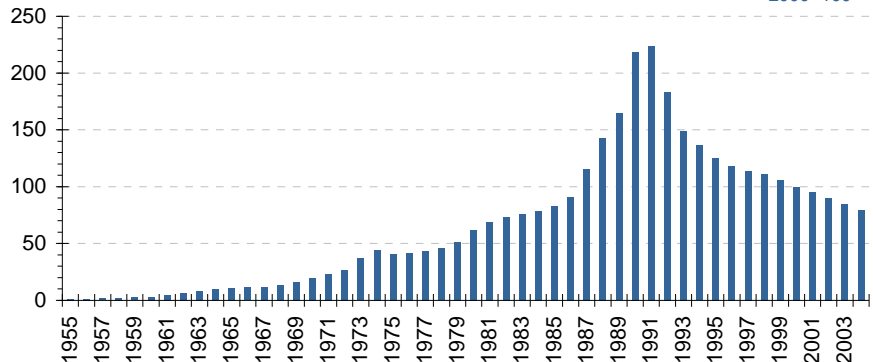


Source: IMF World Economic Outlook

The other main difference for investors is valuations. Put simply, we do not see a bubble in Chinese equities, nor property. At its 1989 peak, Japan's Nikkei Stock Average traded at a Price-Earnings ratio of above 60, compared to less than 15 times in the case of the Hang Seng China Enterprise Index today. The same applies with property, where the threefold rise in Chinese house prices in the last decade merely matches a similar rise in incomes - unlike Japan in the 1980s when urban land prices leapt over 230%, in which time Japan's economy grew, in nominal terms, by an impressive, but not comparable, 83%. (Bloomberg)

**Japanese Urban Residential Land Prices (6 major cities)**

2000=100



Source: Ministry of Internal Affairs and Communications

China, therefore, is likely to be a high growth economy for some time to come, at least until its per capita wealth levels start to approach the likes of Malaysia, Thailand or the less wealthy EU countries. And equity valuations suggest that the market is reasonably valued. Chinese equities should be a core part of investors' portfolios for many years to come.

Finally, to return to Japan. In some ways, its current problems appear modest. It remains a prosperous, orderly society with low levels of unemployment and other measures of poverty. A consequence of a high savings rate is that interest rates have remained low and so the huge and increasing levels of government debt have not been too much of a burden. Looking forward, however, it is an economy in transition. As the population ages – 36% of the population will be over 65 by the middle of this century - those leaving the workforce start to spend instead of to save, removing the major prop to the bond market, so the cost of funding the massive debt burden will become crippling. The country's woes are only just beginning.



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