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# A Tale of Two Cities, Washington and Beijing, July 18

## ~Why is Mr. Xi making a series of bad measures?

As the U.S.-China confrontation has sharpened, world affairs appear to have begun to revolve around two elliptical poles, the two political leaderships of Washington and Beijing. In last week's political events between the two major powers, both countries presented their policies based on the premise of a confrontational relationship.

### In the U.S., the trends appear toward Unity Under "Trumpism"

The Republican Party convention was held in the United States until July 18, and Trump, who had risen from a previous assassination attempt, was enthusiastically elected as the next presidential candidate. Within the Democratic Party, it is hard to deny the aging of President Biden, and there is a growing movement to withdraw the nomination of Mr. Biden, who was outnumbered in the presidential debate. The odds of a Trump victory have increased significantly. Trump's biggest agenda is MAGA, the key to which is to restrain China from challenging U.S. hegemony. In his acceptance speech, Trump sealed his previous attacks on Democrats and called for unity of the American people. Trump has put forward deterrence against China, including the revocation of China's MFN status and a 60% tariff on imports from China. Thus, contrary to the poor performance of the current Biden administration in the election campaign, the U.S. economy is strong, with nearly full employment despite a seemingly wild 5% interest rate hike, stock prices at all-time highs, and a policy option to cut interest rates sharply and immediately if the economy shows signs of slowing down.

### China, under the dictatorship of Mr. Xi is making a series of bad measures

In China, the other superpower that is vying for global hegemony, the 3rd Plenary Session of the 20th Central Committee, a meeting held once every five years to decide important economic policies, was held until July 18. The agenda included growth policies centered on state-owned enterprises, accelerated domestic production of advanced technologies such as semiconductors in the face of intensifying confrontation between the U.S. and China, and measures on real estate and finance. The "Chinese-style modernization," a unique development model that sets China apart from the U.S., Europe, and other countries, was touted, but without specifics, giving a glimpse of the limitations of economic policy under the leadership of the Communist Party.

Unlike the U.S., China's economy has been experiencing worsening difficulties: CPI is almost zero year-on-year, PPI has been negative since 2023, and the economy is in a state of deflation. The National Bureau of Statistics announced on July 15 that real GDP grew 4.7% y/y in the April-June period, slowing from 5.3% in the January-March period and below the government's annual target of 5%. However, this is still too high to be consistent with the 28% y/y contraction in real estate sales in the January-May period and the 2-3% y/y increase in retail sales, a measure of consumption. The Chinese Statistics Bureau did not hold its customary press conference when announcing GDP this time." The question is how China is achieving 5% growth despite the many headwinds, from the collapse of real estate investment to a declining population. The actual growth rate is probably lower than this, maybe significantly lower," the WSJ noted. If China has begun to engage in statistical falsification, no one may ever know the actual state of the economy.

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## **Denial of the status quo, stopgap measures, and postponement of the problem**

It is clear that China is in the same long-term economic difficulties as Japan, with the bursting of the real estate bubble and the fall into deflation. Although the Three-China Plenum statement clearly stated that “China will firmly implement policies to reduce key risks in real estate, local government debt, and small and medium-sized financial institutions,” there is no concrete plan for this, suggesting a continuation of the same series of stopgap measures and postponement of problems that have been used in the past.

In the first place, the Xi Jinping administration has denied the existence of bubbles by regulating real estate prices to curb price declines. In the case of Japan, land prices have bottomed out after falling 80% from their peak, but housing prices in China have fallen only about 10%. Therefore, in terms of both statistics and corporate finances, non-performing loans on the scale that occurred in Japan have not occurred at all. As a result, de facto bankrupt companies such as Evergrande Group and Country Garden Group are being kept alive through lending only for survival.

Not surprisingly, real estate transactions have plummeted due to the prevailing perception of continuous declining housing prices. In order to stimulate real estate demand, the government has lowered loan interest rates and down payment ratios, extended loans to real estate agents for the completion of uncompleted properties for which payment has already been received, and purchased unsold housing stock and converted it to public housing. With rising job insecurity and a growing sense of uncertainty about the future of real estate prices, people are forced to cut back on consumption, which is leading to further economic contraction. In China, where social insurance and pensions are underdeveloped, the only thing that ordinary people can rely on is their savings.

## **Patients cannot tolerate surgery, or the Communist Party cannot perform surgery**

During the process of the collapse of Japan's real estate bubble and the disposal of bad loans from 1990 to 2003, public opinion was critical of the injection of public funds and this delayed financial structural reforms and led to a prolonged economic stagnation. In contrast, there was an expectation that China, being a dictatorship, would be able to quickly resolve its bubble economy. However, China has been postponing a series of problems, which is not the case in Japan. What is the motive for the Xi administration to continue to take such irrational and ill-advised measures? First, the disease may be so serious that patients cannot tolerate the surgical procedure. In Japan, real estate lending peaked at about 20% of GDP. In the case of China, however, the outstanding debt of the regional government financial vehicles (RGFV) alone is 53% of GDP, which is far higher than Japan's level. Furthermore, local governments have earned more than 40% of their total income from the sale of land use rights, which have soared in price, and have used this as a source of funds for fixed asset investment and industrial subsidies. If land prices are allowed to fall and revenues from land sales decline sharply, local government finances will become untenable. The only option would be to maintain real estate prices that have skyrocketed to levels higher than during Japan's bubble period.

The second possibility is that the Communist Party system is not compatible with capital discipline. Japan's financial reforms began with a fair real estate price assessment based on the cash flow of the property and the cost of capital. China, however, does not have the practice of valuing investment projects by cost of capital. In a party-led administration where arbitrariness is the norm, it would be impossible to make the government follow the discipline of capital. In other words, there is no choice but to keep the zombies alive.

## **The “New Quality Productive Forces” will further isolate China**

In this way, the real estate bubble will become a chronic disease, and the patients will have no choice but to continue their slow decline. The answer to this question by the 3rd Plenary Session of the 20th Central Committee is that China will continue to dominate the global market with its “new quality production power,” including solar panels, EVs, and other high-tech and green industries, which are overwhelmingly competitive. But that is a policy rejected not only by the Biden administration but also by Trump and Europe. Criticism against China will increase, and China will have to be further isolated.

The tale of two capitals on July 18 illustrates the overwhelming advantage of the US.

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