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Joerg Wuttke, Member of the stars International Board, gave an exclusive interview to Mark Dittli, Editor in Chief of "Finanz and Wirtschaft", 27 May 2017.

China risks a Japanese scenario

Joerg Wuttke, the former president of the EU Chamber of Commerce in China, issues a stark warning about the health of the Chinese economy.

Whatever happens in the second largest economy of the world has global repercussions. The dreaded scenario of a hard landing, a sudden drop in the Chinese economy, have so far been averted; the economy grew a respectable 6.9 percent during the first quarter of 2017. But **Joerg Wuttke, one of the most clear-sighted experts on China, is worried. "Growth still hinges on the old tool box of infrastructure investment, with a rapid increase in debt", says Wuttke, the long term president of the EU Chamber of Commerce in China, who has lived in the country for more than three decades.**

Dittli: Mr. Wuttke, what is your assessment of the Chinese economy?

Wuttke: It's moderately fine. We have been seeing a pick-up in the past few months, driven by a fiscal and financial stimulus. But the growth is still based on the old recipe: infrastructure investment. If you look beneath the surface, you see two big problems: First, needed reforms of the state-owned enterprises is not going anywhere. There are huge overcapacities in the system. Second, there is a massive mountain of debt on the Chinese economy. In a normal economy, we would have seen a financial crisis by now.

Why is that pile of debt so dangerous?

The state-owned enterprises (SOE) are massively indebted, and now we see a rise in private household debt, driven by real estate prices. The total debt in the Chinese economy now reaches roughly 267 percent of GDP, with a significant acceleration in the past few years. You can look at Japan, the U.S. or Southeast Asia: A similarly big and fast buildup of debt has historically always led to a financial crisis.

Most enterprises and all the banks in China are owned by the state. Doesn't that fact itself prevent a financial crisis?

Yes, that's possible. The system won't explode like it did in Korea or Thailand in 1997. The ultimate owner is always the state, hence there is no widespread loss of confidence. Nevertheless do I see huge problems in the Chinese banking sector. Not so much with the big four banks, they manage their risks reasonably well and don't have the worst balance sheets. But many local and regional banks are in a horrible condition. China's financial system is in urgent need of reforms. The new man tasked with that job, Guo Shuqing, is a thorough reformer. But his challenge is huge, and I don't see him succeeding without some collateral damage.

And what about SOE reform?

I see many initiatives and new rules, but hardly any progress. Chinese steel overcapacities are still around 300 million tons, and the situation in sectors like cement, glass or coal is similar.

Many steel mills have been closed in the past twelve months. Is that not enough?

No. Most mills have only been mothballed, they could re-open at any time. That is not a solution. Sick, overleveraged companies should vanish from the market, but local and provincial governments with their protectionist mindset prevent that from happening.

You mentioned in an interview last year that there are tens of thousands of zombie companies in China, being kept alive by the government. Is that still the case?

Yes, no change there. The central government is thinking in terms of quota, not in terms of markets. With that policy, Beijing is punishing the healthy, well-managed companies, because the sick ones are kept alive.

If those zombies were left to die, millions of workers in poorer regions of the country would lose their jobs.

Yes, it would indeed be millions.

Can the central government even allow that to happen?

It must. The longer Beijing drags its feet, the bigger the bang will be some day in the future. Chinese politicians more and more resemble Western politicians: They are very risk-averse and think short term. But they have a role model: Prime minister Zhu Rongji has shown the way in the late Nineties. He sacked 24 million workers in underperforming industries. That was during the Asian crisis, China was a lot poorer then, suffering from double digit inflation. And still, Zhu pushed through an important

SOE reform and built up the financial system. He was a true genius. Zhu Rongji put China back on track. If the central government waits much longer now, I see the risk of a Japanese scenario, with a long period with very low growth.

You paint a very bleak picture of the Chinese enterprise sector. But what about companies like Alibaba and Tencent, which have established themselves globally?

The Chinese enterprise system is deeply divided. On side we see the highly leveraged, deeply inefficient SOE. They don't care about markets or customers, but a lot about subsidies. On the other side are a few very clever, highly successful entrepreneurs like Jack Ma of Alibaba or Robin Li of Baidu with a very impressive track record. Those are the role models the government should learn from. But they always revert back to their central planning thinking and push money into new infrastructure investments.

What's wrong with further infrastructure investments?

Every airport in China is better and nicer than Frankfurt or Zurich, every city hall is oversized, they have libraries without books, opera houses without performances. How many more airports and congress halls do they want? Of course, this creates demand for steel and glass, but many of these investment projects are economically useless. They just perpetuate overcapacities and damage the environment further.

The EU Chamber of Commerce in China has very vocally criticized Beijing's "Made in China 2025"-strategy. Why?

The aim of the strategy is to readjust China's economy into sectors with higher value-added content. That in itself is not a problem. But we criticize the central planning approach, with subsidies, forced mergers, the protection of SOE and the creation of disadvantages for foreign companies. Beijing uses the wrong tools, creating overcapacities and not necessarily better companies. I fear that "Made in China 2025" will cost a lot and end in tears.

But is that strategy not comparable with the "Industry 4.0" approach that the German government is championing?

No, that's completely different. Industry 4.0 is a bottom-up strategy, with companies and research institutions in the lead. The budget by the German government is a meagre 200 million Euros. China uses a top-down approach, with a budget of 300 billion Dollars over five years. This is nothing less than a restructuring of the entire Chinese industry.

And you fear that they want to create huge global champions?

Yes. This is the first internationally aimed ten year plan of the Chinese central government. It's full of the genes of the central planners, who think they can identify where to invest and set targets for the market share of indigenous Chinese companies in various industries. Just imagine if the German government would order its companies to achieve a certain market share by 2025. That would be absurd. But that's exactly what Beijing is doing.

What about Western companies that are active in these industries that are identified in the 2025-plan. Do they face more risks or more opportunities?

At first, they will see opportunities. Chinese companies that aim to be global champions in certain sectors first need technology and good suppliers. But it can turn dangerous. The plan does not only call for "Made in China", but "Made by Chinese in China", which could mean that foreign companies are pushed aside. Just look at what happened in wind and solar power: The central government has decided on a grad plan, unlocked huge sums of investment, and a few years later the rest of the world is drowning in overcapacity.

Is an acquisition like the Swiss agrochemical company Syngenta part of that master plan?

That remains to be seen. But ChemChina, the buyer of Syngenta, is a state-owned behemoth with a massive pile of debt on its shoulders. We shall see if this was an entrepreneurial decision or a political move.

The 19th congress of the Chinese Communist Party will take place in fall. Do you expect president Xi Jinping to step up economic reforms in his second term?

I hope so. During the first five years of Xi's term we have seen big reforms in the areas that were most important to him: the army and the secret service. He needed to control the guns. Now I see the possibility that a new government crew could start working on true economic reforms starting March 2018. The big question is if Xi succeeds in assembling a good team for the second half of the game.

Xi Jinping is the most powerful president China has seen in decades. Why should he not succeed?

Xi has amassed a lot of power, but he is no dictator. China has a very complex governing system. Xi knew he needed to control the army and the secret service and that he needed to sharpen ideology within the party. He is very conscious about the fall of the Soviet Union: Xi knows that the Soviet Union collapses because of a lack of ideology and that the regime in the end was swept away by the army and the secret

service. I hope that now, when he has consolidated his power base, Xi will work with a new government – there are rumors of a new prime minister – and push through much needed economic reforms. Xi Jinping must succeed in bringing China back on track. The world cannot afford a derailment of China.