

# China's ascent towards global leadership

Implications for Pacific investors

August 2020





Let China sleep. For when  
she wakes she will shake  
the world.



Napoleon Bonaparte

China's economic transformation has been described as one of the greatest economic miracles of the 20th century but the journey is not over. This article examines the next phase of China's economic development and investigates implications for capital markets and whether Australia and New Zealand can continue to benefit economically from China's rapid ascent as a global superpower.

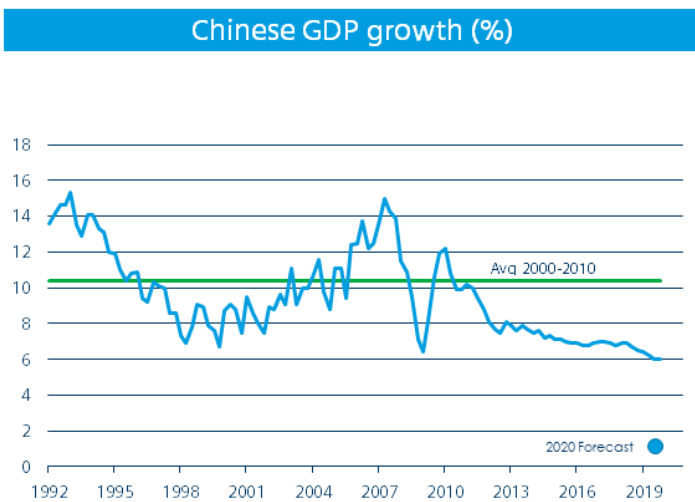
# China's economic journey

The Chinese economy has evolved significantly over the past 42 years since Deng XiaoPing pursued 'reform and opening up' initiatives back in 1978. The Chinese economy has modernised and transformed from a rural/ subsistence economy to an intermediate and upper-end manufacturer with a modest consumption base. China's per capita income has risen significantly since the 1980s, with over 750 million people lifted out of poverty.

In recent years, China's economic growth has slowed from an average of 10%, from 2000 to 2010, to around 7% in 2015 and more recently to 6.0% in 2019 as shown in Chart 1. Many commentators have pointed out this signified the end of China's growth miracle. While headline growth is a key measure of an economy's rate of progression, the contribution and composition of growth are equally important to consider.

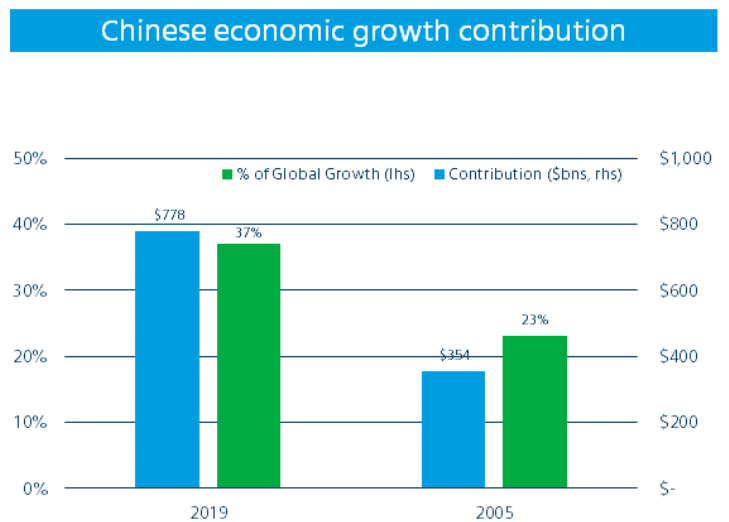
In terms of contribution, the Chinese economy is the second largest in the world with a base value of \$12.6trn (USD, 2019). As shown in Chart 2, growth of 6% last year resulted in a raw contribution of \$778bn, which was equivalent to around 37% of global GDP growth.

Chart 1



Source: Bloomberg, IMF, Mercer

Chart 2



Source: Bloomberg, IMF, Mercer

In terms of composition, growth drivers across the Chinese economy have shifted profoundly. In the early 2000s, investment and manufacturing sectors of the Chinese economy represented around 60% of total growth. As capital deepening reached capacity, it was evident that further growth in investment would only result in diminished returns. The painful lesson from Beijing's stimulus package during the global financial crisis outlined the pitfalls of increased investment across the manufacturing and construction that exacerbated overcapacity issues. This would eventually sow the seeds for China's current growth strategy.

# A "New Normal" for Chinese growth

As early as 2015 Chinese policy makers discussed a "new normal" for the Chinese economy. This focused on enhancing growth quality over quantity. Domestic consumption would play a key role for the Chinese economy and the government enacted a raft of policies to support household consumption including changes to the taxation system and to allow more foreign firms into the domestic market.

Chart 3: Chinese Economy Pivots Towards Consumption Growth



From 2015 consumption as a share of the total growth became the biggest driver rising steadily from 42% in 2008 to 53% in 2019. China's domestic consumption has also benefited from rising incomes. While the nationwide per capita income stood at \$11,000 (USD) in 2019, across Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) per capita income reached around \$23,000 (USD), which is closer to levels enjoyed across advanced economies. Rising incomes have supported the Chinese middle class boom, which has transformed trends in global consumption with Chinese consumers becoming an everlarger share of global purchases in luxury products, motor vehicles, education and tourism.

# East vs West: from domestic manufacturer to global competitor

China's export and investment led growth model worked well over the 2000s by boosting profits for western companies, which in turn supported growth in domestic income. The recent embrace of internal consumption helped to further balance out traditional growth drivers and to support new industries. As a manufacturer, China's share of the value chain was only ever going to be so large. Faced with an ageing demographic, policy makers soon realised that to achieve "developed" status, China's growth model had to focus on generating higher value by moving up the value chain towards an innovator, or risk being held in the middle-income trap. This gave rise to the Made in China (MIC) 2025 blueprint.

MIC launched in 2015 with one core purpose, which is to transform China from middle to high technology manufacturing. The plan calls for ten strategic sectors to be co-developed with the state which includes: 1) information technology such as artificial intelligence, Internet of Things and semiconductors; 2) robotics;

3) green energy; 4) aerospace; 5) ocean engineering; 6) railway equipment; 7) power generation; 8) new materials; 9) medicine; and 10) agricultural machinery. At a time when China's economy slowed, embracing such emerging industries and technologies was considered crucial to sustain and upgrade growth.

China's industrial policy has been impressive and has strengthened under President Xi. The Made in China 2025 policy is but one component of China's innovation-driven development, which largely complements China's existing strengths in infrastructure. China's innovation strategy has produced some success and China is now home to a number of national champions that supply the global market. The most widely known company is Huawei, which currently holds the most significant amount of patents across core 5G processes and is currently the world's largest supplier of wireless technology. Aside from Huawei, there are also Chinese equivalent companies to some of the largest and strongest companies in the West. See table below:

Table 1: Chinese equivalent companies in the West

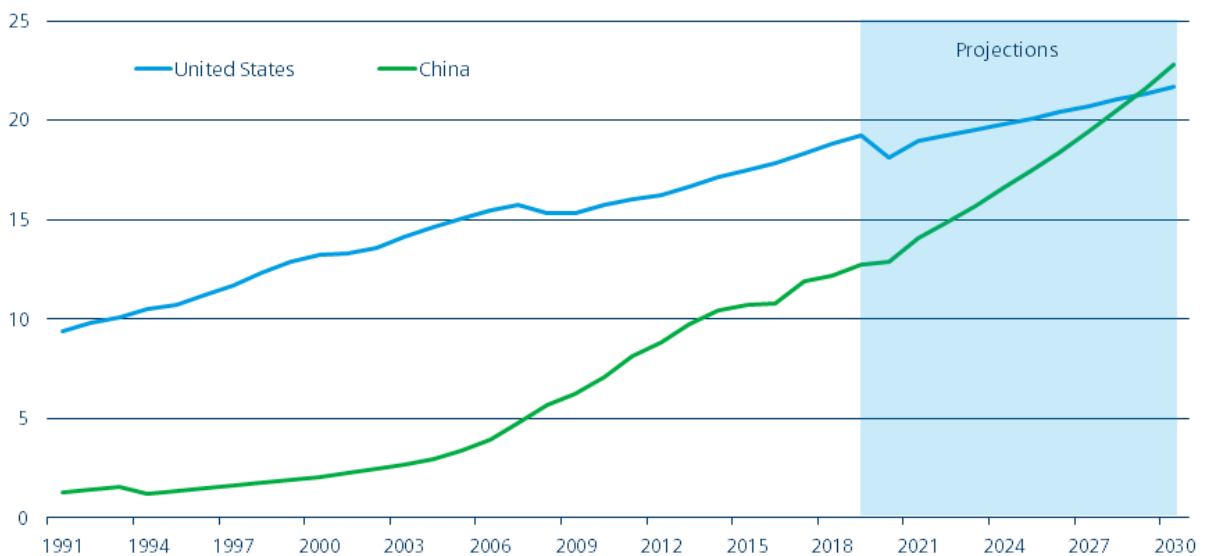
Western national champion	Sector	Eastern national champion
Cisco	Telecommunications	Huawei
Tesla, Inc.	Electric vehicles	BYD Auto
Amazon, Ebay	E-commerce	Alibaba, JD.com
Netflix	Online entertainment	iQIYI
Facebook	Social media	TikTok

China's rapid modernisation and technologically driven growth strategy has been met with increased anxiety from the US and other Western nations. The reaction from the US was partly due to the many years of significant under-investment in essential infrastructure and in new wireless technologies. There is concern that China's objective towards high-end manufacturing implies an ambition not only to catch

up to other advanced economies but also to surpass and displace them in a dominant position. The Chinese economy is already the world's largest in purchasing parity power terms but trails behind the US when measured in US dollars. Using growth projections from the International Monetary Fund, China will surpass the US sometime over the next ten years.

Chart 4: China's economy will soon outpace the US

**United States vs China total economic size (\$USD Trns)**



Source: Bloomberg, IMF, Mercer

Increased competition for economic and technological dominance has resulted in a tit-for-tat economic confrontation between the two nations. Recent examples include the US China trade war, export bans across key US products and delisting of Chinese companies from US stock exchanges. Rising economic tensions have also accompanied rising geopolitical tensions. China's Belt and Road strategy to build infrastructure and to enhance trade and investment opportunities across the Middle East, South East Asia, Europe and Africa has also been in conflict with US foreign policy interests. The global outbreak of the Coronavirus has seen Chinese

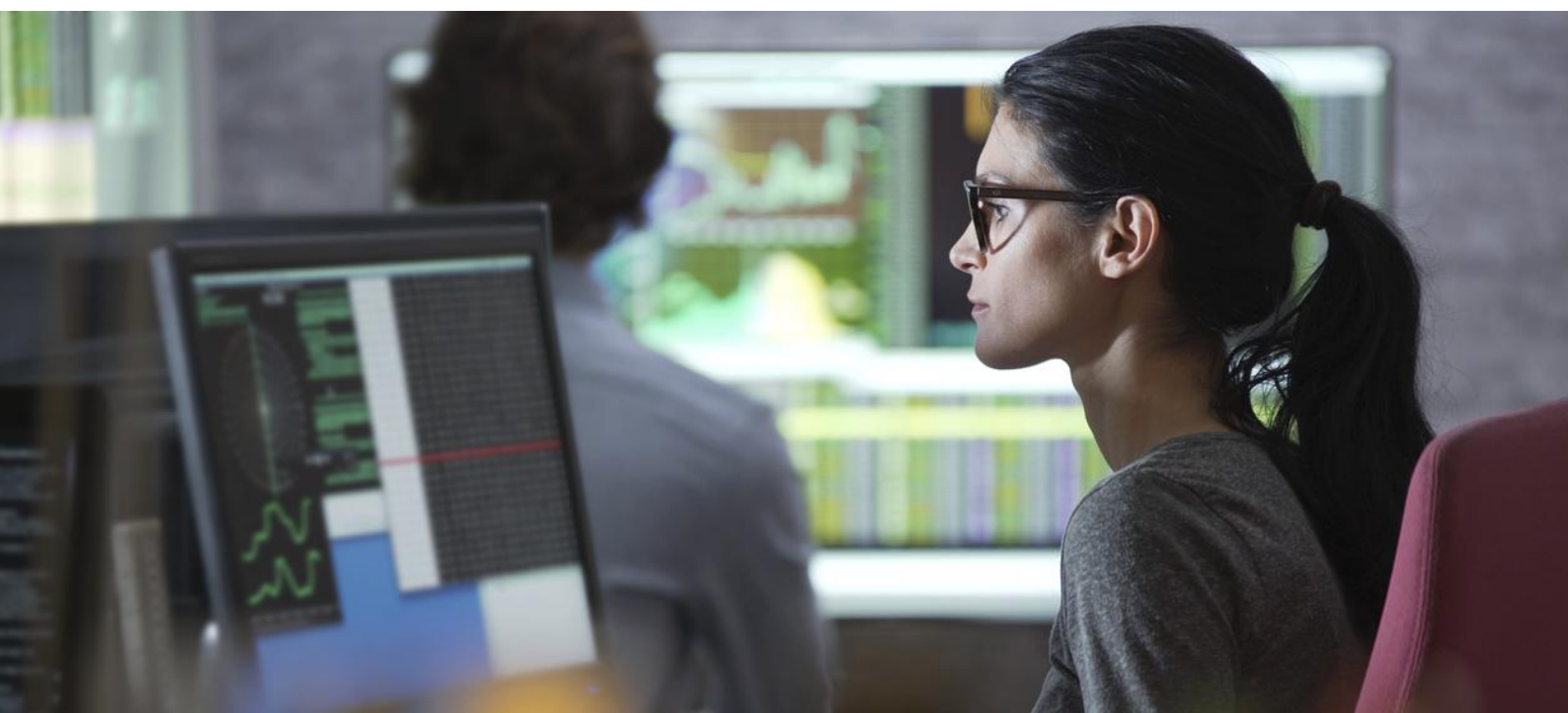
policy makers double down their strategy to drive internal growth and to strengthen indigenous technological capability, which will further decouple the two nations in selected sectors.

The battle for global dominance and the return of China as the centre for global economic growth and technology will mark the biggest change in the world order over the coming two decades with far reaching implications for trade, investment and politics.

# Investment implications

The battle for global dominance has a number of investment implications.

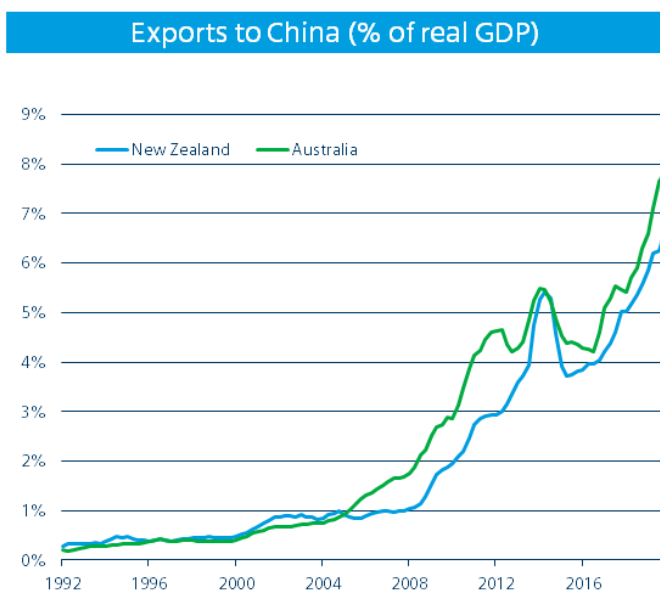
- The recent passage of the Holding Foreign Companies Accountable Act will give the US greater scope to delist Chinese companies from US equity bourses. As a response, a number of Chinese companies have taken up listing on the Hong Kong market and are considering other international exchanges such as London.
- The impact of rising technological competition has resulted in the recent creation of the STAR index in July 2019, which is China's Nasdaq style science and technology innovation board which aims to increase public funding for enterprises with core technologies. A dedicated exposure in domestic Chinese A shares will provide investors with diversification and scope to benefit from alternative risk exposures and uncorrelated risk premiums.
- The longer-term implications for China's capital market is to increase two way fund flows and to facilitate greater foreign participation across domestic equity and bond markets. Examples are increased index inclusion of Chinese stocks and bonds in global indices such as MSCI Emerging Markets and WGBI.
- Direct incentives to lure foreign investors include further liberalisation of the Chinese Stock and Bond Connect programs. For the Renminbi (RMB), the goal is to achieve a reserve currency status. While the global use of the RMB is still low relative to the US dollar, promotion of the RMB in China's Belt and Road program for trade and further capital market liberalisation will likely result in increased usage through time.
- Changes in global geopolitical order will inevitably result in increased market volatility. Investors need to be aware of these trends and consider increasing diversification across sector and geography as it becomes difficult to predict winners or losers in this environment.



# Can Australia and New Zealand Continue to Benefit Economically From China's rise?

China's rising economic prosperity has benefited major trading partners such as Australia and New Zealand in the past. China is currently Australia's largest trading partner and two way trade flows between the two countries reached \$177bn (USD) in 2019. As the most successful trade relationship, Australia enjoys a strong trade surplus with China and the value of Australian exports to China as a percentage of GDP stands almost at 8%. In New Zealand the relationship is also strong with exports representing around 6.5% of GDP. Australia's trade is predominately concentrated in minerals and resources, which represent around 72% of the total mix whereas a larger composition is in agriculture across New Zealand.

Chart 5: Exports to China as % of real GDP

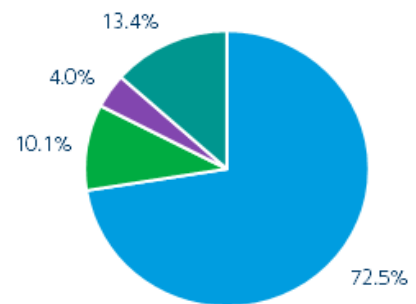


Source: Bloomberg, DFAT, Statistics NZ

Chart 6: Export composition to China

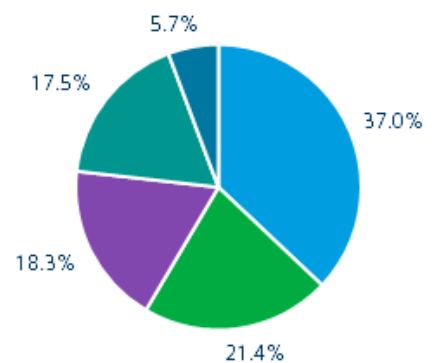
## Export composition to China

Australian exports to China (Major sector)



■ Minerals ■ Agriculture ■ Manufacturing ■ Services

New Zealand exports to China (Major sector)



■ Dairy ■ Meat Products ■ Travel Services  
■ Wood ■ Cereals

Source: Bloomberg, DFAT, Statistics NZ

With the Chinese economy entering into a period of rising internal consumption, this export mix will no longer be sustainable. Nevertheless, Australia and New Zealand are still currently in a strong position to capitalise from rising Chinese consumerism given comparative advantages in agriculture and tourism.



# Recent trade developments

While the trade flows between China and Australia have grown strongly in recent years, bilateral relations have worsened and more recently, China imposed export bans on Australian products such as beef and barley. Understanding the exact reasons for these bans is complex, due partly from China's increased purchase commitments from the phase 1 trade

agreement with the US. There are also concerns about the potential impact on iron ore, tourism and education if relations continue to deteriorate. From this perspective, it remains clear that reaping longer-term economic benefits from bilateral trade with China will require a more careful balancing act going forward.

## Conclusion

China is here to stay as the new regional superpower and her economic strength will only grow through time. China's ongoing economic rise will challenge the balance of power in Asia Pacific and rules of engagement and reciprocity will need to adjust to this dynamic. Investors need to be aware of these trends and also the associated capital market volatility. Having said that, with China following its own distinct path into the future, opportunities in Chinese stock and bond markets will continue to provide a source of diversification for investors.

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\*\*As at 31 December 2019.

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