

China 2.0 = Consumption + Productivity

The Past – China Has Experienced Dramatic Results

The Chinese economy has been through a period of unprecedented growth over the past 20 years. Hundreds of millions of people have been lifted out of poverty and per capita income has grown at a pace never before experienced in an economy of this size. Many doubted the success, and yet the economy delivered.

The first phase of China's path to wealth was based on cheap labor, cheap credit and an investment wave in infrastructure. The result was the largest rural to urban migration in history. Literally hundreds of millions of workers benefited by moving from barely earning a living wage in agricultural jobs to jobs in low cost manufacturing. As many countries around the world outsourced low wage labor-intensive tasks, the Chinese economy was willing to fill the void with efficiently organized workers who appreciated wages that were low by developed market standards. This fueled a wave of growth that was, and continues to be, an important building block of the Chinese Miracle.

This success was achieved in many ways because of a methodical approach of a planned economy increasingly embracing free markets, where private investments in manufacturing and housing were met with fast-paced changes in regulations and bold infrastructure investments. The result has been a rapid rise of GDP per capital income in China, which now stands close to \$10,000.

The Present – Where China Stands Relative to the U.S.

China's GDP is approximately \$14 trillion. This is approximately two-thirds the size of U.S. GDP of \$21 trillion. China's economy is approximately 53% consumption as compared to the U.S., which is approximately 82% consumptionⁱ. Up until now, China has been dependent on exports for growth. The next phase, China 2.0, will be driven by domestic consumption. The stage is set. The government, realizing developed markets were slowing, especially in the wake of the Global Financial Crisis, focused on the next phase of growth – rising domestic consumption and productivity growth. Investments in healthcare, severance packages for workers in restructured industries and an expanding life insurance industry are paving the way for a decline in the savings rate, facilitating domestic consumption. Investments in infrastructure, and research and development in the healthcare, technology, and manufacturing industries have set the stage for higher value added products. Investments in education are designed to ensure worker skills improve. Combined, these initiatives put in place over the past several years set the stage for China 2.0.

Challenges, Concerns, Skeptics – A Fixed Mindset is a Difficult Thing to Change

There is much that could be criticized about the Chinese economy and many have done so for decades: it was supposed to fail, success was financed with debt, money was wasted on ghost cities, bridges were built to nowhere, pollution is out of control, and, surely, communism is the wrong form of government. China's success threatens so many of our Western beliefs about democracy, communism, human rights and freedom of speech that it is easier for the critics to conclude it will fail as opposed to understanding the factors that have propelled success. Many of the articles written about China are designed to provoke fear. Our sense is that the voices of the skeptics will be with us for years. Instead of allowing them to overwhelm our understanding of the progress made, we choose to focus on the evidence and continuously elevating our own awareness.

The Future

The continued success of the Chinese economy has many components, but one of the most important is the rise in productivity. While the government continues to reform by expanding health care, social security, deregulating as well as addressing the excesses of the past credit boom; heavy investments in education, intellectual property and in a digital economy are crucial to China's goal of obtaining sustainable growth in per capita income.

Today, with an aging population and wages that have risen from extremely low levels, the next phase of growth in GDP per capita is dependent on sustainable productivity and the gradual shift into producing higher value added products and services. Strong investments in capital goods need to be matched with enough quantities of skilled workers in order to sustain productivity growth.

The government seems to be prepared for this next wave with massive investments in education, alternative energy, infrastructure, technology and healthcare that will continue transforming the economy. These investments will have two major impacts. The domestic economy will be less dependent on importing high value added goods from developed markets in several industries, and China expects to move up the value added curve in terms of exports. In the years ahead, low-end manufacturing will be outsourced primarily to South East Asian countries with similar models as China.

Evidence

We will continue to monitor developments in China from multiple sources. Official data provided by the Chinese government, information from the IMF and the World Bank, company reports and audited financial statements of Chinese as well as western companies in addition to first-hand information of interviews with management teams and business people. In our view, we must be open to multiple inputs to determine if the progress we have witnessed so far continues. In the end, we want to continuously evaluate if the mission to improve productivity, produce higher value added products and increase domestic consumption progresses in the years ahead.

"The fools may be dancing but the greater fools are watching"

Author unknown



Tom Masi
Portfolio Manager



Nuno Fernandes
Portfolio Manager

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ⁱ World Bank: Final consumption as a percent of GDP.