# What is happening in China?

In recent years, we have witnessed profound transformations in China with significant changes in economic policy and increased state intervention. As we will discuss in this letter, the reaction of the political leadership to important global events of the last few years appears to be the driving force behind this dynamic. The intensity of the recent changes also has a lot to do with the fact that we will have a busy political calendar in 2022, culminating with the twentieth congress of the Chinese Communist Party (CCP) in October/November. It should be noted that changes in the main political leaderships occurs during this forum, such as the commanding heights of the Communist Party and high-ranking positions in public administration.

China has appeared in our previous letters several times. In 2007, we wrote in our 8th letter about its emergence as an economic power and highlighted the historical issues that have shaped China's political-institutional organization and economic development model. We already wondered at that time how other powers in the West, particularly the US, would react to the rise of China - a nation with quite different characteristics and values. The most unequivocal answer to this debate came at the end of the last decade with the beginning of the trade dispute between the US and China when Donald Trump entered the White House.

Another recurring theme is the coexistence between a market economy and lack of political freedom - unusual in this scale and magnitude. We do not intend to answer this complex question here, but we point out the millennial tradition of Chinese culture with the centralization of power in imperial dynasties. Confucianism with its emphasis on the welfare of the people - which should be the goal of a virtuous ruler - also helps to explain this point.

The first part of this letter discusses present day China and raises some important considerations on how the country arrived at its current stage of development. In the second segment we interpret the main recent events, explaining slogans such as "dual circulation" and "common prosperity", which are increasingly common in political leaders' public statements.

## The China of today and the path taken

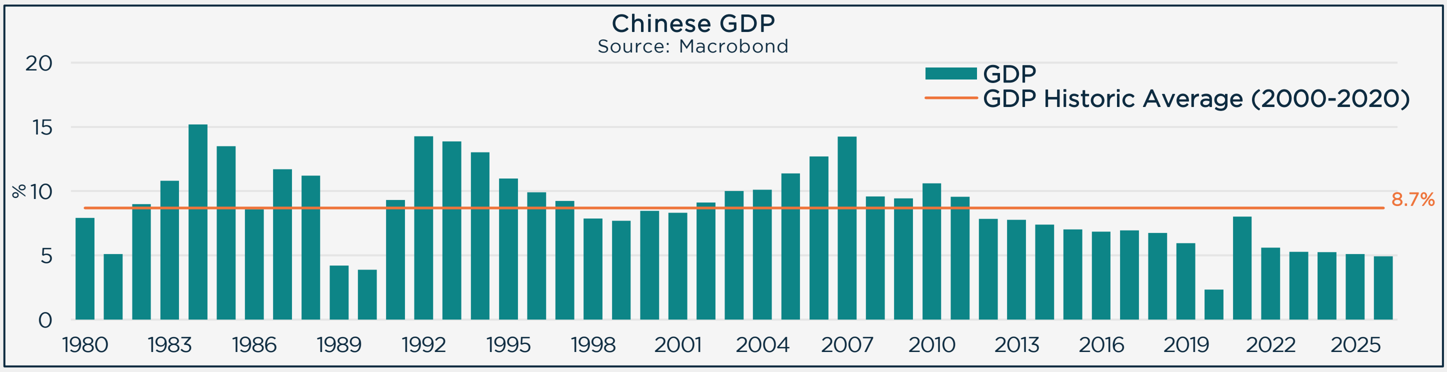
China is a country full of contrasts and paradoxes and therefore very difficult to fit into general classifications. Is it a developed or an emerging country? Does it have a capitalist or a socialist economic system? How can it call itself the People's Republic of China if it is not a democracy with rulers elected by popular vote? How does it intend to make its currency a secure means of exchange for international transactions while maintaining capital controls?

According to World Bank data, China is the second-largest economy in the world measured in current US dollars, with a GDP of approximately $15 trillion, and the largest economy in the world adjusted by purchasing power parity. It is seen as a middle income country, with per capita income of around US$ 10,500.

China is also the most populous country in the world with almost 1.45 billion people. In May of this year, it released the results of the census carried out at the end of 2020. The census showed that the population was aging rapidly and has a low fertility rate: 264 million people are over 60, which represents the equivalent of another Germany being added to this group in the decade. The fertility rate of 1.3 children per woman is low and comparable to that of Japan[1]. It is worth noting that these numbers were worse than the authorities had expected after they announced the end of the one-child policy in 2015, and they suggest that the nation is probably very close to peak population.

The political system is not that of representative democracy but is dominated by a single party, the CCP, which has 92 million members and celebrated its centennial this year. Political governance in China was the subject of our 12th letter[2]. Xi Jinping is the general secretary of the CCP and highest political authority in the country. He began his term in 2013 and successfuly eliminated the two-term limit in early 2018, indicating that he would continue to run the nation after the end of his second term next year, and thereby becoming the longest-serving leader in the position of general secretary after Mao Zedong and Deng Xiaoping.

The accompanying graph shows the growth rate of China's GDP since the 1980s. The average growth rate between 2000 and 2020 was extremely high, amounting to 8.7% per year. We can clearly observe a drop in the growth rate, and the IMF estimates that growth will be close to 5% for the next few years.




1 https://www.economist.com/finance-and-economics/2021/05/13/chinas-census-shows-its-population-is-nearing-its-peak
2 "China's Governance and Political Institutions", read more on our website turimbr.com

The strong economic growth after the 1980s came from the "reforms and opening up" process implemented by Deng Xiaoping, who took command of the CCP after the death of Mao Zedong. We highlight the economic opening with the insertion in global supply chains, benefiting from an enormous wave of cheap labor that migrated from the countryside to the city[3]. As far as capitalism and market economy were concerned, Deng Xiaoping made his famous comment in the mid-60s before assuming power that it did not matter what color a cat was, as long as it catches mice. This was a harbinger of his pragmatism. He then created the concept of socialism with domestic characteristics to hallmark the Chinese model of development. The current Chinese model is also known as a form of State Capitalism[4]. Under this system, although there is a vibrant private sector, the State plays the role of the main economic player and owns large companies in strategic sectors.[5]

There should be a greater participation of spending rather than investment in the internal absorption (sum of investment and spending) over time and as per capita income increases. However, this process is gradual, and in the meantime the government uses state investments in infrastructure and credit markets through controlling stakes in the largest banks as levers for economic policy.

It was generally accepted until recently that the CCP's permanence in power depended on maintaining high rates of economic growth. However, with the obvious decline in productivity as rural-urban migration slows as well as decline in the overall labor force sustaining double digit growth becomes much more difficult, and pursuing robust economic activity at any cost creates enormous distortions. The main issue is the excessive debt burden that economic analysts have expressed concern for over many years, such as shadow banking, local government liabilities and the real estate market.

China's political leadership reacts relatively quickly to the changing winds of the global economic and political landscape. Many observers point out that speed of implementation is a major advantage of systems that are marked by a more top-down hierarchy. Following the major global financial crisis of 2008, the authorities became aware of the vulnerability of relying on external demand and funding for trade flows. In response, they boosted the domestic economy through the credit markets with a focus on investments in infrastructure and construction. However, this model also seems to have become exhausted as evidenced by the large increase in the leverage of the economy.

American rhetoric towards China changed radically with the election of Donald Trump, who had promised to reduce the bilateral deficit with the country which reached almost $375 billion in 2017[6]. The imposition of tariffs on Chinese exports starting in 2018 escalated into a trade conflict with the ensuing "eye for an eye" type measures.

The changing mindset of American politicians and society towards China became patently obvious and highlighted the existence of a political-ideological conflict, commonly referred to as the "New Cold War", that went beyond trade issues. The Chinese response came in the form of the slogan "Dual Circulation". Internal Circulation refers to domestic demand and external circulation to external demand. In this sense, dual circulation is a way of prioritizing domestic sources of growth further but without giving up exports as an important part of progress. What most alarmed the Chinese government in this trade conflict was not the levy of tariffs, but the restrictions imposed on Chinese companies. This was particularly notorious in the case of Huawei, one of the world's largest telecommunications equipment companies was banned from buying high-tech chips from American companies, on which it was heavily dependent. As a result, national security, which was already an important goal, became a matter of survival.

The Covid-19 pandemic which broke out in the Chinese city of Wuhan paradoxically had a much greater effect on other countries than in China itself. The authorities' zero tolerance stance towards the virus, with very strong restrictions on mobility, proved to be a successful strategy in stymying the numbers of cases and deaths. After a sharp contraction, the Chinese economy was the first to recover to levels of late 2019, and it was the only major economy to show growth in 2020 (+2.3%).

The pandemic also had the extremely important effect of changing the mix of aggregate demand in the world, with a redirection towards consumer goods at the expense of services. And China, as an important production platform, benefited strongly from this shift.

With growth well sustained, we can state that the Chinese government felt comfortable enough to tackle other more structural problems. The general pattern of action is that whenever economic growth is comfortable, the focus shifts to strategic issues, risk management, and addressing economic and financial imbalances that could threaten social stability and national security.

One example was seen earlier this year when Xi Jinping declared that extreme poverty had been eradicated, pointing out that almost 100 million Chinese had been lifted from this condition in the eight years of his term of office. This allowed his government to sign off on another of its key goals. Efforts are now being focused on the quality of growth rather than the quantity, attacking problems such as income inequality, pollution and environmental damage, and excessive leverage. This is the starting point that explains recent events.

## The 14th Five-Year Plan

Inspired by the Soviet model, China has laid down the leadership's strategic direction and concrete objectives for the country's economy for the next 5 years since 1953. The most recent was announced in March of this year, and the biggest difference to prior plans is the absence of a specific goal for economic growth. In our view, this is a strong suggestion that economic growth is no longer the most important variable. However, Xi Jinping mentioned in 2020 that he hoped to

*3 A good summary on the different phases of China's development can be found on chapter 4 of the book "The Great Demographic Reversal" and also this RBA's text.*
*4 Foreign Affair Articles: State Capitalism Comes of Age and We're All State Capitalists*
*5 "Brazil's Economy and the Washington and Beijing Consensuses", read more on our website turimbr.com*
*6 Federal Reserve, Did the U.S. Bilateral Goods Deficit With China Increase or Decrease During the US-China Trade Conflict?*

double the size of the economy by 2035, making China a "moderately developed country". This implies an average annual growth rate of 4.7%, a rate more in line with estimates of what the country's potential growth could be.

The other guidelines of the plan are aligned with the long-term goals of self-sufficiency and sustainability[7]. We would highlight the encouragement of industrial innovation in the technology, new materials, electric and intelligent vehicles sectors along with the intermediate goals that would allow China to achieve its stated goal of becoming a carbon-neutral nation by 2060.

## The Anti-Trust Campaign and "Common Prosperity" Slogan:

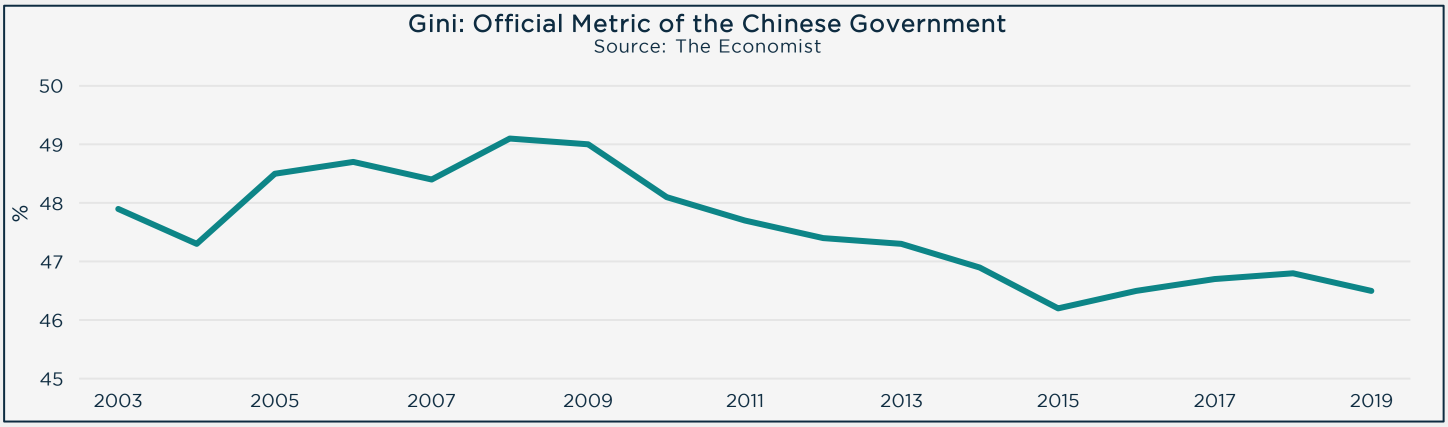
Chinese regulatory agencies in the anti-trust area have gained muscle since the end of last year. In early November of 2020, the listing of Ant Financial's shares, the fintech arm of the tech giant Alibaba, was blocked. In December, the State Administration for Market Regulation (SAMR) launched a broad investigation into Alibaba's practices. Other Internet platforms also started being investigated in the following months, which led to fines and prompted changes in behavior. In July, it was Didi's turn, the "Chinese Uber," to suffer punishment by the Cyberspace Administration of China (CAC) a few days after its IPO in New York. The reason this time was the company's failure to comply with the data security law that had been enacted the previous month. Also in July, a fatal blow was dealt to a part of the private afterschool education sector that was banned from making profits. In this case, intervention was aimed at curbing the practice of private tutoring of children attending public schools. The authorities claimed this put too great a financial burden on parents and widened the inequality since those who could afford it would have a better chance of doing well in the Gaokao (a kind of Chinese university entrance exam).

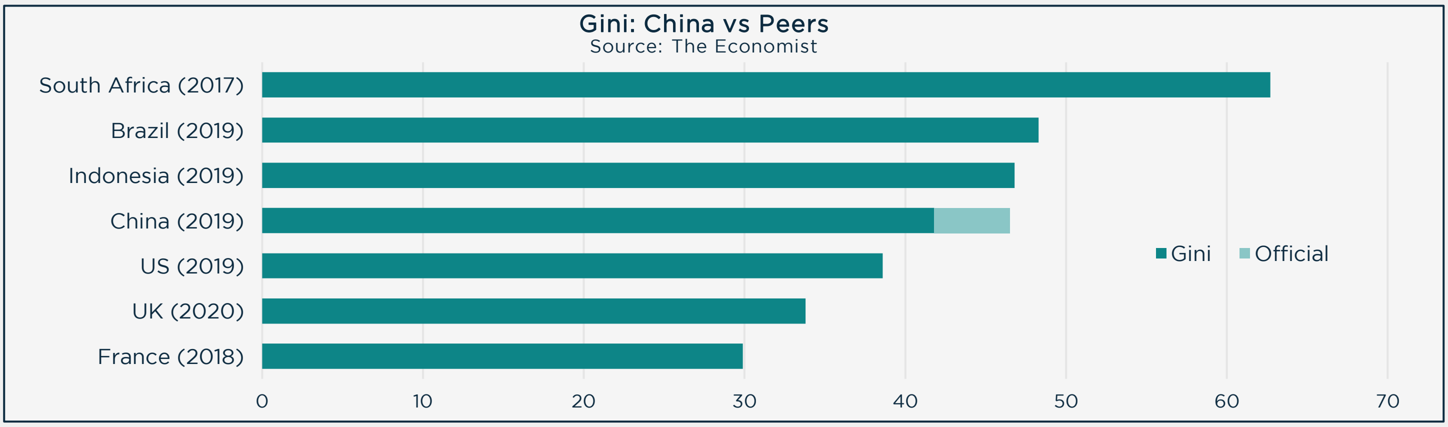
Why did the Chinese government toughen the rules and impose penalties to sectors that have been so successful and dynamic in recent years, and that attracted large amounts of capital to the economy?

The answer to this question lies in the slogan that has increasingly figured in Xi Jinping's speeches and the state media - "Common Prosperity" - which we can literally translate as "prosperity for all". The Chinese government has always been concerned with social stability and reducing income inequality, and now this seems to be the top priority on their radar. However, this slogan is far from new and first appeared in a series of articles in the People's Daily newspaper as early as 1953.

In the early 1980s, Deng Xiaoping said that the nation should let "some people and some regions get rich first" in order to give impetus to an economic development that would eventually benefit everyone. The goal of "Common Prosperity" is to reduce income and wealth disparity.

The following graph compiled by The Economist shows that although the Gini coefficient is falling, it is still high and even higher than that of the USA and other OECD countries. (0 is perfect equality and 1 total concentration).




7 https://research.nus.edu.sg/eai/wp-content/uploads/sites/2/2021/03/EAIC-26-20210311-1.pdf

The Zehjiang province (where Alibaba's headquarters are located) was chosen as the test bed for a set of measures related to this goal. The government wants to encourage a better distribution of what it considers the three forms of income created by economic activity: the first distribution refers to the macroeconomic components of income, i.e. wages and profits; the second distribution refers to those arising from fiscal policy, i.e. taxation, transfers and subsidies; and the third distribution refers to philanthropy.

While leading a meeting on the topic, Xi specifically called for a "reasonable adjustment in excessive income and encouraging high-income groups and enterprises to give more back to society". Heeding to his words, companies such as Alibaba and Tencent have since announced big donations and investments in social causes.

There is already speculation about what the next steps will be. The possible introduction of a real estate property tax is currently grabbing the headlines with the announcement of pilot projects along these lines.

## The Evergrande case

As we write this, the situation of the construction giant Evergrande is the most recent case in the papers, but it is actually a reflection of a well-known issue that has been around for a long time. We have been faced with the prospect of bubbles in the Chinese real estate market several times over the past few years, and have read about ghost towns and empty developments even before the 2008 crisis. In 2017, Xi Jinping said that houses were for housing and not for speculation. To reduce the leverage of the real estate sector the government introduced the three red lines policy last year which would put a limit on builders based on three debt indicators. But this led to highly levered construction companies, such as Evergrande, finding it difficult to access credit markets. The solution was to speed up the sale of assets to generate revenues, but the lack of confidence in the sector caused a collapse in sales, against a backdrop of increased prospects of default on their obligations.

This self-induced problem is causing a sharp drop in a key sector. It will have a negative effect on the economy, but we believe that the likelihood of it becoming an event that will cause a systemic financial crisis in China and globally is low. The authorities have levers to contain the negative impacts on other sectors, and the president of the Chinese central bank recently said he was confident that the risks were manageable and that systemic risks could be avoided.

However, until early November, the absence of broad monetary stimulus measures (such as cutting interest rates) indicates a willingness to sacrifice short-term growth to offset bigger problems down the road.

## Is it still worthy investing in China?

There are basically two different ways of looking at these transformations. The first and more pessimistic one is that Xi Jinping is engineering a turning back to the Maoist roots, concentrating power with a nationalist discourse against Western capitalism, indicating only the beginning of a new model that will reduce the private sector. This is because, from his point of view, the private sector has become too powerful and threatens the CCP's enduringness. This would be a huge setback for China and the world.

A more optimistic view is that the authorities are addressing the excesses of capitalism, albeit in their own way, such as inequality of income and opportunity, pollution, and excessive debt, sacrificing short-term objectives to avoid greater long-term risks to society. Which is to some extent the key challenges faced the world's major economies.

The increased activism and interference of the state raises concern, and we are alert to it. The risk is to undermine the entrepreneurial spirit that is the main factor in generating innovation, value and wealth. Nevertheless, we do not believe that the Chinese leadership has this intention.

From a practical point of view, as the world's second largest economy and main trading partner to most other developed and emerging countries (including Brazil), and with a middle class with great consumer potential[8] and larger than the entire US population, ignoring China does not seem a reasonable option to us when we consider long-term global portfolio allocation.

As with any risk asset, the calibration of the size of the overall exposure is fundamental. Moreover, we also know that good opportunities always appear at times of volatility and change.

*8 2020 China Consumer Report - McKinsey &Co*

# An optimistic view of the future

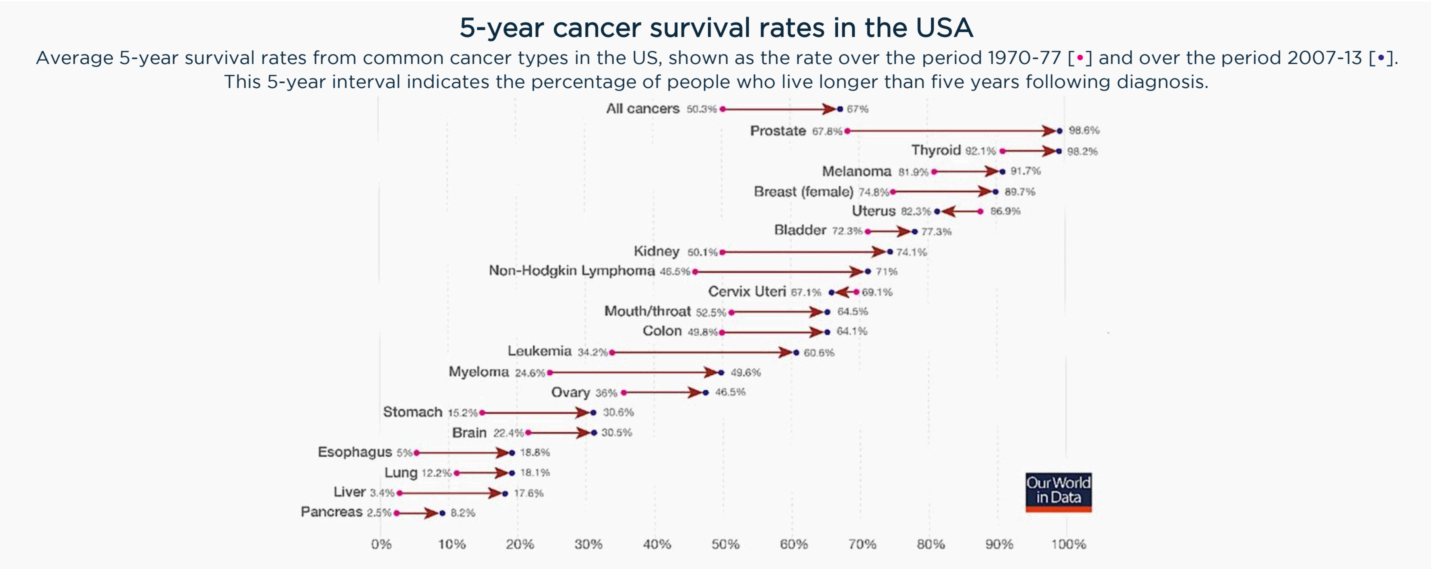
Despite the recent events, humanity has evolved year after year and has accumulated a number of admirable achievements that support a positive outlook for what lies ahead. A movie often tells a story better than a photograph, so it's worthwhile giving a brief rundown of the important milestones before discussing the future.

Society has developed in various aspects since the second industrial revolution. Two of these stand out to us as being the most remarkable: the continuous increase in 1) life expectancy, and 2) disposable income.

The improvement in life expectancy is not only impressive for its growth, but also when considering the setbacks we faced along the way, including two world wars, two pandemics (Spanish flu and Covid-19) and a global financial crisis (2008).

The causes for improved longevity are varied and it's extremely challenging to establish a precise causal relationship. However, we are certain that combination of widespread access to basic sanitation, vaccination, improvements in nutrition, the development of new drugs (e.g. antibiotics) and socio-economic advances were fundamental in achieving this result.

With the subject of health still in mind and faced with a public health emergency, reviewing a few data points is extremely interesting. Although the Spanish flu and Covid-19 are not directly comparable due to their biological differences and historical context, it is worth putting into perspective their relative numbers. Whereas the Spanish flu killed between 1-5% of the world population[1], Covid-19's toll is expected to amount to less than 0.10%[2], at least a 10x better outcome than the worst pandemic of the last century. Although the comparison is not entirely fair, when we look at the broader trends we see there has been clear progress in several areas, including a 15-percentage point increase in the survival rate for cancer in the United States over the last 30 years, shown in the graph below.



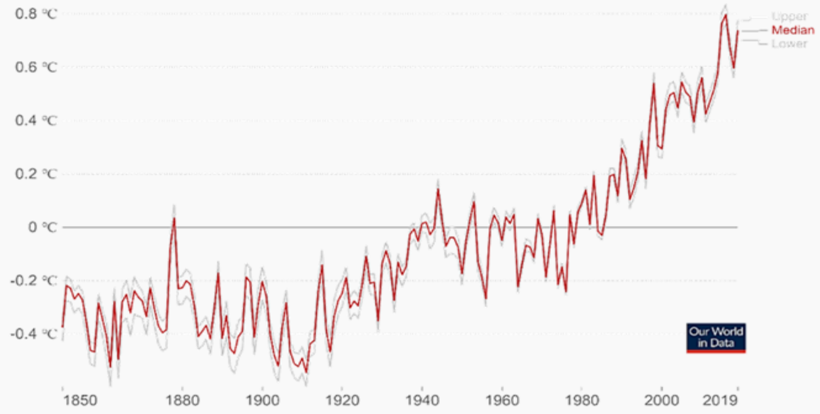

Another achievement worth celebrating is not just the impressive reduction in extreme poverty ($1.90/day), but also the significant increase in those who earn more than $10/day. At the beginning of the 20th century approximately 75% (1.3 billion people) of the world population lived in extreme poverty, whereas today this figure is approximately 10% or 733 million people[3]. Globalization combined with improvements in logistics were paramount achieving these results.

Looking at what is being developed and put into practice makes us even more excited about the future. The most remarkable innovations include clean energy, artificial intelligence (AI), the Internet of Things (IoT) and 5G. Clean energy is important not only because of its positive environmental impact, but also because it should enable lower marginal energy costs in the future. In terms of the other technologies, we can reasonably predict their impact will be positive and significant in terms of improving productivity and social inclusion, although very challenging to put forth a precise estimate of their real effect. One of the most serious externalities of economic growth has been the significant increase in $CO_2$ emissions and global warming, for which coal and petroleum are the main culprits[4].

1 https://ourworldindata.org/spanish-flu-largest-influenza-pandemic-in-history
2 https://covid19.who.int/ and https://www.census.gov/popclock/
3 https://ourworldindata.org/extreme-poverty
4 https://ourworldindata.org/emissions-by-fuel

**Global average temperature anomaly**

Global average land-sea temperature anomaly relative to the 1961-1990 average temperature.




We believe that the challenging transition of the energy matrix generates a substantial need for investment in addition to the greater operational complexity inherent to the intermittent nature that wind and solar generation impose on the system. However, the reduction of the cost of generating power plus the increase in productivity of clean energy will likely address part of the investment problem. And the improvement and development of lithium batteries is the probable solution to the system's irregularity.

Speaking of batteries, we should touch on terrestrial mobility which is responsible for 12% of global emissions[5]. Electric cars are much more efficient than the internal combustion engines, and fuel consumption is 3x lower[6]. Therefore, the continued fall in the cost of batteries, which represents approximately 30% of the final price of the electric vehicle[7], should serve as further propellant in gaining share in global vehicle sales from the current level of 7%[8] .

AI, IoT and 5G are examples of technologies that are still very much under development but that have transformational features and with very uncertain effects.  Nonetheless, a few studies have attempted to estimate the magnitude of the repercussions of these technologies. McKinsey has estimated that AI will boost productivity by 1.2% a year, adding $13 trillion to global GDP by 2030[9]. In a nutshell, AI is the software element while IoT and 5G are the hardware and infrastructure components that will allow for a symbiotic relationship to reach full potential.

Perhaps the chatbot is the most obvious and palpable AI we experience today on a regular basis, which serves as a good example of the direct benefits and potential uses. In most initial interactions with customer support departments we are now dealing with algorithms and robots, and no longer human agents. These chatbots are able to carry out the first filters and can solve the most common problem or requests without human intervention. Two benefits are immediately apparent, i) productivity increase when measured in service hours per person and ii) availability of partial service 24/7. The further development of this technology could encompass even more complicated uses in medicine, for example, with increased productivity and access to healthcare for a larger number of people through telemedicine.

If the previous example looked at AI for language and communication, another field where AI has evolved is visual detection. Perhaps within a few years object and facial recognition through smart cameras should allow for automated driving (e.g. Tesla) and in-person shopping without the need for human and physical means of payment (e.g. Amazon Go).

Finally, IoT and 5G should enable productivity gains in virtually every industry. At the end of the day this could bring greater capacity, higher speeds and lower latencies in data transfer over current technologies, expanding the use of automation in increasingly complex activities that will culminate in Industry 4.0.

Productivity gains and resource allocation optimization are inherent to these technological developments (lower marginal cost of energy, AI, etc.). As a result, these effects have improved social inclusion and deflationary impacts which should fuel the virtuous circle which lies ahead for the world.

Humanity has achieved extraordinary things to date despite the challenges we have faced along the way. Geopolitical (e.g., wars, deglobalization), health (e.g., pandemics), financial (e.g., debt, bubbles) and climate risks will always exist, and it is crucial that they be monitored. However, technological progress shows such promise that it will likely allow society to amplify the gains achieved so far and, perhaps on an even greater scale. As a result, we remain optimistic for what the future holds, even acknowledging the likelihood of black swan events.

*5 https://ourworldindata.org/ghg-emissions-by-sector and https://ourworldindata.org/co2-emissions-from-transport*
*6 https://www.fueleconomy.gov/ (Tesla Model 3 vs. Corolla)*
*7 https://www.bloomberg.com/news/articles/2020-12-16/electric-cars-are-about-to-be-as-cheap-as-gas-powered-models*
*8 https://www.woodmac.com/press-releases/electric-vehicle-sales-to-vault-over-6-million-in-2021/*
*9 https://www.mckinsey.com/featured-insights/artificial-intelligence/notes-from-the-ai-frontier-modeling-the-impact-of-ai-on-the-world-economy*