

# China's Place in the World

THE OPPORTUNITIES AND IMPLICATIONS OF ITS RISE

JANUARY 2019



# *“To get rich is glorious.”*

*—Deng Xiaoping*

Leader of the People’s Republic of China, 1978—1989

After Chairman Mao’s death in 1976, Deng led reforms that opened China to foreign investments and instituted economic policies that propelled China’s growth forward. These changes helped transform China into the economic powerhouse it is today.

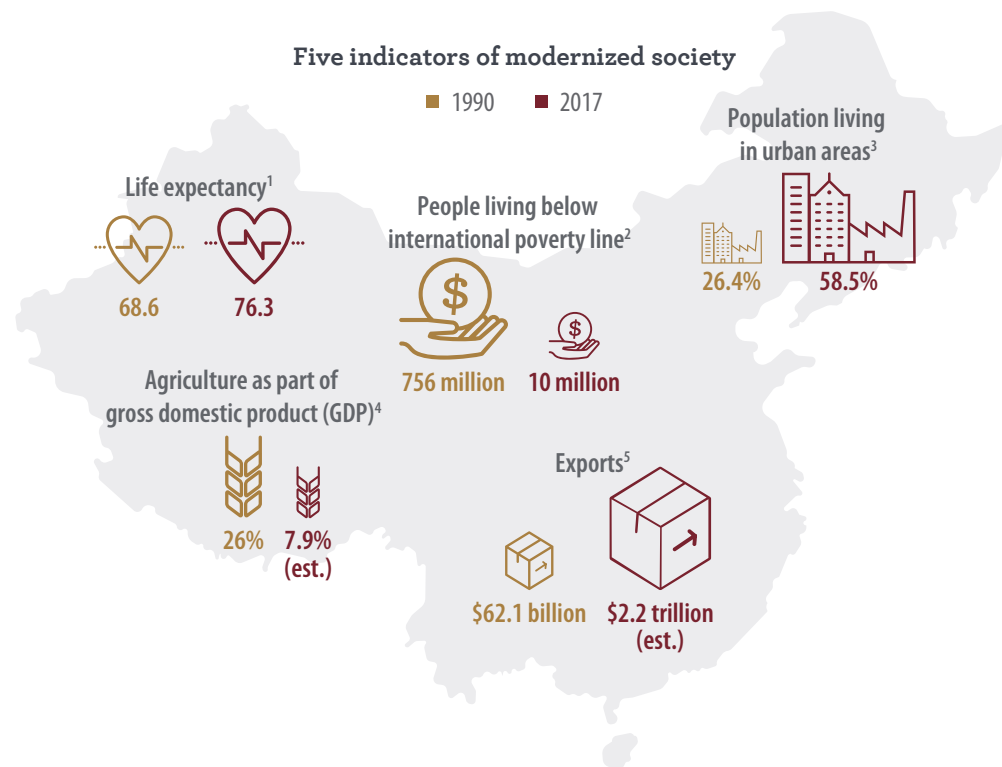
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# China rising

The 2018 trade dispute between the U.S. and China highlighted concerns about China’s increasing global prominence—and prompted questions about the country’s motivations as it advances. We believe that China primarily wants to reduce poverty and increase social well-being for its citizens, but growing the Chinese economy also has implications for China’s international trade and political relations. As China’s economy and global influence advance over the coming years, we anticipate long-term investment opportunities and risks in China, including those that arise as China’s relations with the West evolve.



1. National Bureau of Statistics of China, 2018 China Statistical Yearbook, December 2018

2. World Bank, Poverty and Equity Data Portal, December 2018. International poverty line represents a value of \$1.90 per person per day.

3. National Bureau of Statistics of China, 1999 and 2018 China Statistical Yearbooks, December 2018

4. Central Intelligence Agency, The World FactBook, December 2018

5. Central Intelligence Agency, The World FactBook, December 2018

## Key questions we answer in this report

What is China’s economic strategy?

Could China’s currency displace the dominance of the U.S. dollar?

When will China’s wealth equal that of the U.S.?

What investment opportunities and risks could China offer?

# What does China want?

## 2018 United Nations Human Development Index

### Ranking

1. Norway
13. U.S.
19. Japan
86. China
130. India
189. Niger

The Human Development Index is a composite index focusing on three basic dimensions of human development:

- the ability to lead a long and healthy life, measured by life expectancy at birth
- the ability to acquire knowledge, measured by mean years of schooling and expected years of schooling
- the ability to achieve a decent standard of living, measured by gross national income per capita.

Source: Human Development Report Office, 2018

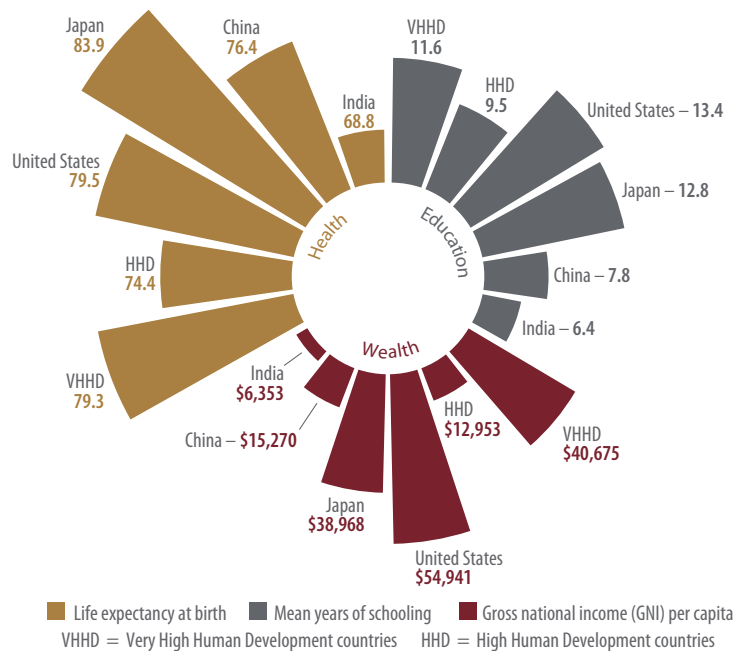
## The dream of a prosperous society

Looking at what Beijing has communicated through its five-year plans, centennial goals, and other policies over the past 40 years, we believe that China desires to increase its level of development in order to “build a moderately prosperous society in all respects” by reducing poverty and increasing economic opportunities for its citizens.

While the country has grown considerably over the past few decades, China has a way to go to reach its development goal of a moderately prosperous society. According to the 2018 United Nations (UN) *Human Development Report*, mainland China ranks 86th out of the 189 countries tracked by its Human Development Index (HDI). The HDI measures progress in a country’s education achievements, health outcomes, human security, and income, among other metrics. Out of the organization’s four-tiered ranking system, China falls into the *High Human Development* category, which is second from the top.

## By many measures, China is still a developing economy

Within the *High Human Development* category, China ranks well for life expectancy at birth and gross national income per capita but below average for mean years of schooling.



Source: United Nations Human Development Report, 2018. Note: The UN’s four categories of development are LHD = Low Human Development, MDH = Medium Human Development, HHD = High Human Development, VHHD = Very High Human Development.

## The task ahead

The level of China's growth and economic achievement over the past 20 years has been phenomenal, but China still faces a long road to catch the most developed countries. China ranks 86th in HDI, but the U.S. stands at 13th and places in the UN's top category of *Very High Human Development*, along with other countries like South Korea, Japan, and Singapore, as well as the region of Western Europe. Other infrastructure-related measures of economic development tell a similar story. For example, China has approximately the same land mass as the U.S. and four times its population, yet, according to the CIA World Factbook, the U.S. has 40% more road miles, 2.4 times the number of railroad tracks, 11 times the number of paved airports, and over 20% more of its population living in urban settings.

These statistics are not intended to discount the progress made in China's economy. Rather, these measures suggest that despite the absolute size of its economy and population, China still has a way to go to achieve its goal of a prosperity level that is comparable with that of more advanced economies—which is why continued economic development is a top priority for leaders in Beijing. We believe that China's steps to raise its standard of living could produce new investment opportunities.

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## Comparing populations

### China

1.38 billion

### United States

329 million

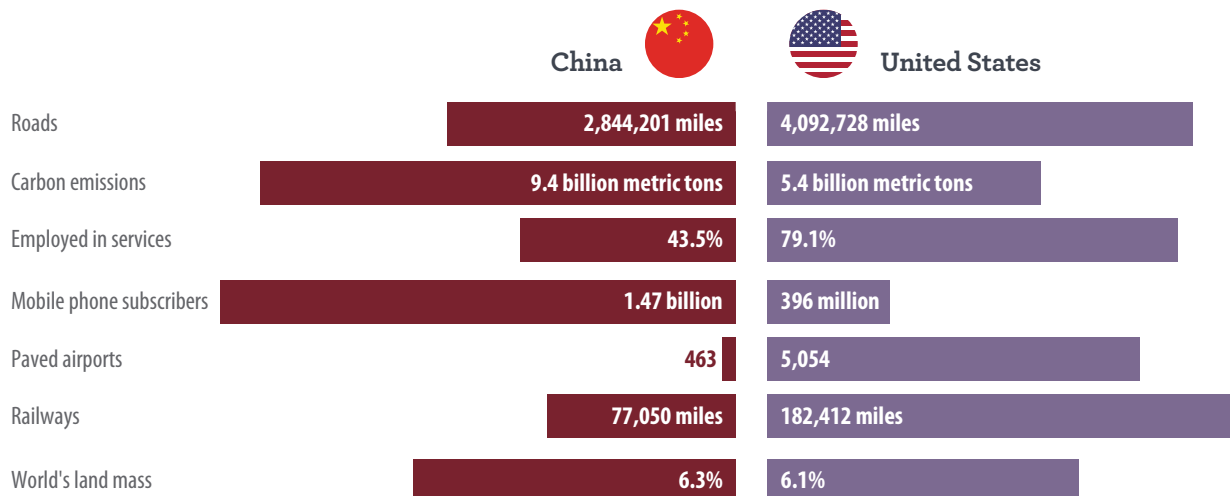
Source: Central Intelligence Agency, The World Factbook, December 2018

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## China's current infrastructure development lags that of the U.S.

Measures of infrastructure development suggest China must develop further in order to reach its desired level of prosperity.



Source: Central Intelligence Agency, The World Factbook, data as of 2017

# How is China developing its economy?

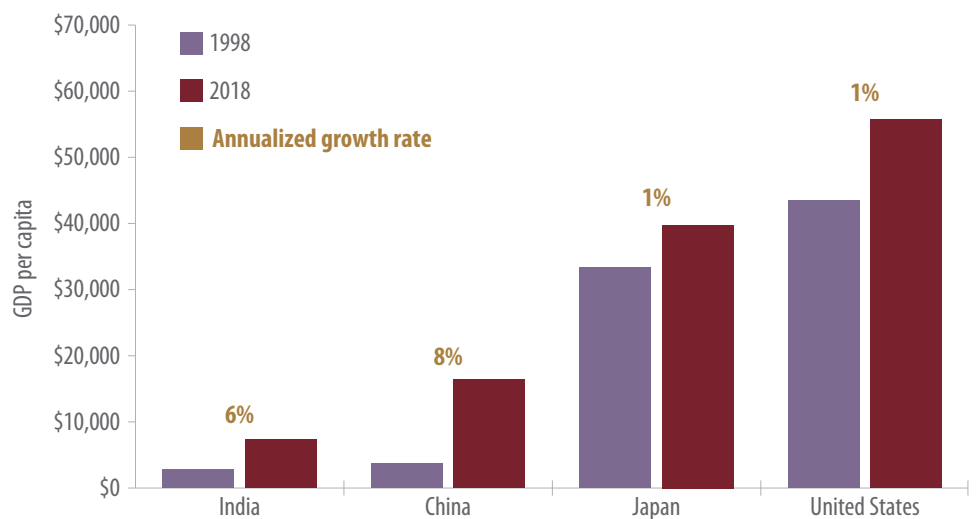
## The initial boom

As noted earlier, the magnitude of China's development over the past 20 years has been remarkable. In a relatively narrow span of time, 24% of China's population left rural homes to take advantage of growing economic opportunities in the cities. During this same period, the share of the population living in extreme poverty fell from 40% to less than 1% as per-capita wealth increased at an average annual rate of 8.4% per year.

What contributed to this rapid increase in economic development? We believe that a transformational part of China's economic growth was established in the late 1970s following *opening up* reforms spearheaded by Chinese leader Deng Xiaoping. This initiative accomplished two important ends: It allowed foreign firms more direct access to China's markets through joint ventures, and it enabled an inflow of fresh capital and expertise shared through these multinational partnerships. China's admittance to the World Trade Organization (WTO) in 2001 further fueled its advance. Entry to the WTO lowered barriers for Chinese exports and brought with it the financial capital needed to fund a construction boom that propelled China into the middle-income, *High Human Development* country that it is today.

## China's economic wealth has grown rapidly over the past 20 years

China's income growth rate has outpaced that of other major economies, even as its gross domestic product (GDP) per capita remains below that of other major economies.



**Source:** International Monetary Fund, January 4, 2019. GDP per capita at constant 2011 prices and purchasing power parity. Average growth rate equals average annual compound rate of growth in GDP per capita.

## The next stage

What policies do we believe that China's leadership has in store for the next phase of its long-term development? From our vantage point, Beijing is implementing policies aimed at pivoting the economy away from investment and manufacturing-oriented growth and toward innovation and services-oriented growth. As part of this process, China has signaled a desire to make its economy less reliant on the foreign commercial partnerships that once helped propel its development, as well as give more preference to domestic innovation and industry as primary drivers of the Chinese economy. This is the essence of the "Made in China 2025" initiative.

At the same time, a plan known as the Belt and Road Initiative serves as a means to build trade routes necessary to secure the resources needed for domestic manufacturing and to feed an increasingly affluent population. It is the effects of these policies—a potentially diminished foreign commercial presence in China and increased global resource competition—that have arguably fueled the recent trade dispute between the U.S. and China. Ultimately, while we believe that China's economic pivot is likely to pose a number of challenges for Western policymakers, it also should provide opportunities for outside investors.

## What is the Belt and Road Initiative?

Sometimes called the new silk road, China's initiative will create a "belt" of overland routes and a "road" of maritime routes.



Source: Wells Fargo Investment Institute, December 2018

## Made in China 2025 highlights



### Innovate and localize

- Increase homegrown technology
- Use onshore global supply chains

### Substitute

- Reduce reliance on foreign high-value goods
- Increase domestic consumption of homegrown technology

### Increase global market share

- Develop market-leading technologies
- Acquire international brands to increase market share

# Opportunities and challenges in China's next phase of growth

## Risks of excessive lending

In some situations, excessive lending can contribute to unproductive borrowing. This is reflected in anecdotal stories about empty high-rise buildings with no inhabitants, or accounts of materials-oriented state-owned enterprises seeking governmental financial assistance because of overproduction.

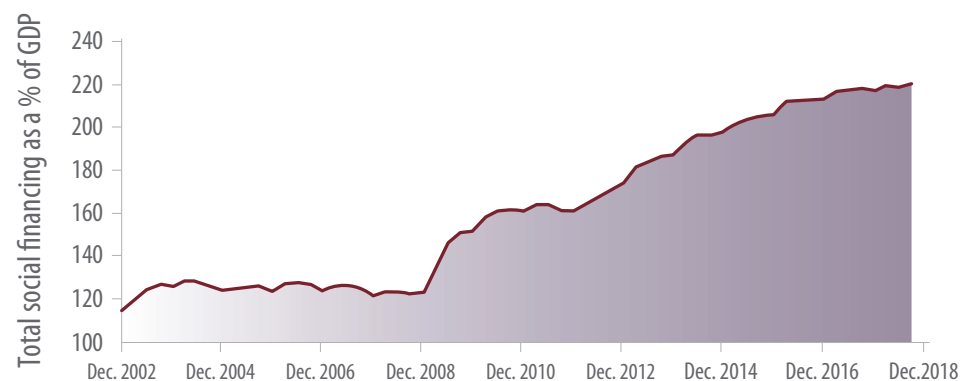
## The overhang of excessive lending

China's investment-led growth has resulted in a major expansion of lending activity. This can be seen in the People's Bank of China's monthly estimate of total social financing—a figure that includes bank loans, corporate debt, initial public offerings, and special purpose bonds issued by local governments. This data is watched closely by investors because it provides an indication of just how much capital is flowing into the financial system. Total social financing ballooned between 2002 and 2018; the government tends to increase lending during times of stress to help support economic growth rates. Should higher tariffs have a meaningful impact on China's growth rate, we likely would see the government respond through an increase in total social financing levels.

Today, policymakers are working to address these excesses. However, they will need time to correct the problems and transition toward the country's innovation and consumption-oriented development goals. At the same time, the risk remains that Beijing's plan to close unprofitable businesses could create stress in the financial system, which will have to deal with the debts of these companies. Much of this credit risk lies with the banks, which remain the main sources of capital. Yet a financial system disruption is not part of our base case. China's government has been backstopping its financial system for several years. In addition, we believe that Beijing's easing of restrictions on foreign investors and encouraging their greater use of China's equity and debt markets should direct capital toward profit-making businesses.

## Loans to China's private sector ballooned after the global financial crisis

China's total social financing measure encompasses all of the country's loans to the private sector. Chinese policymakers have increasingly relied on credit to drive domestic economic growth since the global financial crisis in 2008.



Sources: Federal Reserve Bank and People's Bank of China, January 4, 2019



## China seeks solutions in the capital markets

Policymakers in Beijing are increasingly encouraging international participation in the country's debt and equity markets. To this end, in 2014, the Shanghai-Hong Kong Stock Connect program was launched, which for the first time allowed some direct foreign ownership of mainland Chinese stocks. The following year, Beijing allowed direct foreign access to mainland China's stock and bond markets, a move that encouraged further capital inflows.

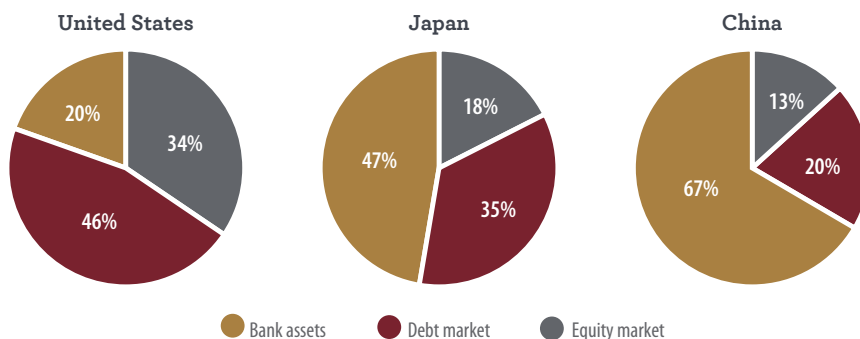
Policymakers then eased restrictions on the yuan (the country's currency) in 2015, allowing the value to be more market-driven. This was done, in part, to allow the yuan to join the International Monetary Fund's (IMF) special drawing right (SDR) currency reserve basket. The effort was successful—the yuan entered the IMF currency basket as of October 1, 2016.

We believe that China will continue to look toward the capital markets to provide opportunities for foreign investors. Additional capital inflows can help policymakers address excesses in China's lending system while supporting the country's economic pivot toward a service- and consumption-oriented economy. These opportunities for investors do not come without risks—capital markets in China remain subject to government capital controls. These controls, which include tightened restrictions and regulations on overseas corporate investments and on Chinese citizens buying foreign currencies, are designed to support the yuan and limit the ability of capital to flow freely out of China. Investors should remain cognizant of these risks, but we believe that the investment opportunity that China presents outweighs these concerns.

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## China's securities markets are small relative to those of other major economies

China has significant opportunity to rebalance from bank lending toward its securities markets, a rebalancing that is likely to provide continued opportunities for foreign investors.



# What does China's rise mean for the U.S. economy?

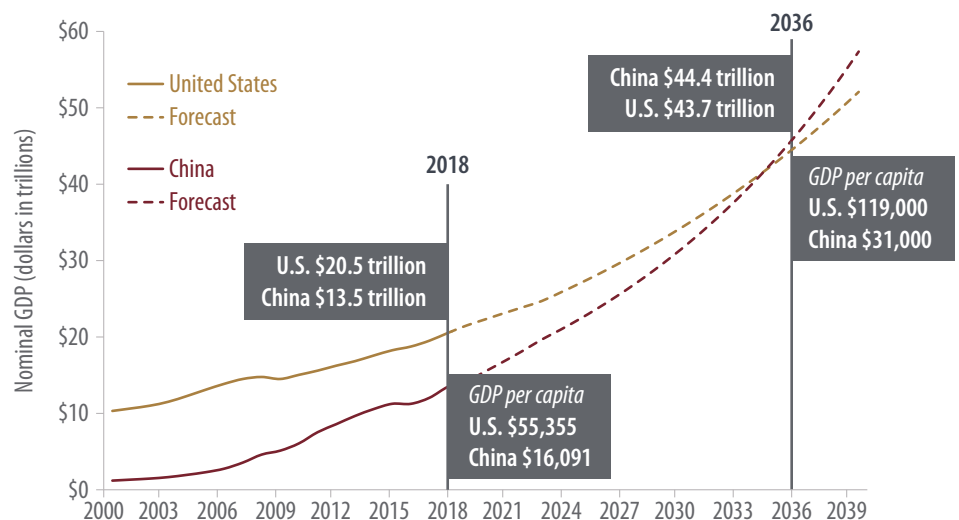
## When will China's wealth equal that of the U.S.?

China's remarkable ascent over the past 20 years has prompted some investors to question when (not if) the country's economic and financial prowess will surpass that of the U.S.—and what such an achievement might look like. Assuming that the current pace of economic growth in China evens out at a nominal level of 6.5% (compared with a long-term average of 15.0%), we estimate that the size of the Chinese economy could match that of the U.S. in as little as 18 years. Yet, on a per-capita basis, China's wealth would continue to lag that of the U.S.

This is because China's population is expected to remain nearly four times the size of the U.S. population into the foreseeable future, meaning that an equivalent amount of national wealth in China would be spread across a larger number of people. Policymakers are nevertheless working on closing that wealth gap by encouraging economic growth in wealth-generating sectors of its economy, and this is where we see opportunity for investors. While it may take many years for China to close the income gap, we believe that this pivot toward services and consumption-based growth may be the key to increasing the country's per-capita wealth as new firms enter the market to address the leadership's policy direction.

## The absolute size of China's economy is likely to surpass that of the U.S. before its per-capita wealth does

China's nominal GDP could match that of the U.S. in as few as 18 years, but it will likely take longer for per-capita wealth to catch up.



Sources: Wells Fargo Investment Institute and Bloomberg, as of October 19, 2018

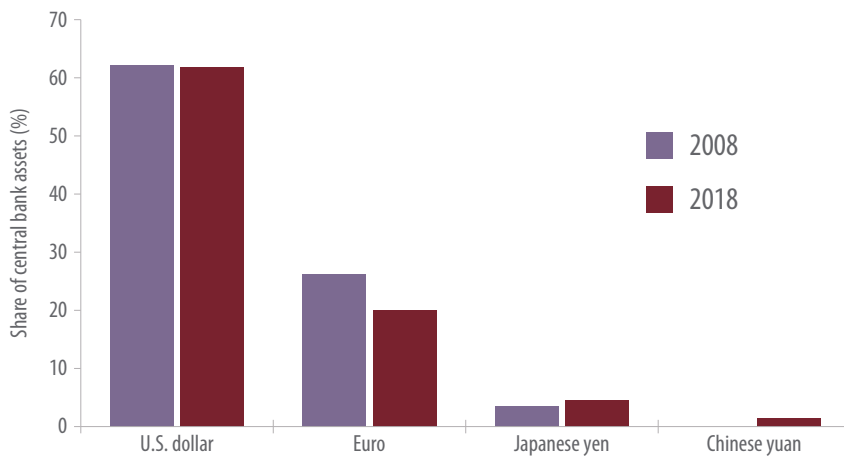
## When will China's currency overtake the U.S. dollar?

When the IMF added the yuan to its SDR currency basket in late 2016, some investors worried that the U.S. dollar's dominance as a reserve currency would soon end. However, we believe that the yuan's inclusion in the SDR currency basket is only the first step in a long process toward a wider international role for the Chinese currency.

We believe that the yuan's still-low utilization as a trade, savings, and payments currency—and its limited institutional adoption—likely will hinder its long-term prospects as a dominant global store of value. However, this view is subject to change as Beijing expands foreign access to its financial markets, a process that is likely to evolve over many years.

## Use of the yuan as a reserve currency by central banks remains low

Yuan-denominated assets on central bank balance sheets are increasing but lag assets denominated in the U.S. dollar and the euro.



Sources: Wells Fargo Investment Institute and Bloomberg, as of January 4, 2019

## What is an SDR?

The IMF's special drawing rights (SDRs) are used by global central banks and some select financial institutions as a reserve asset, but the usage is limited. Indeed, the size of IMF SDR reserve assets relative to total global reserve assets is small. According to the IMF, the SDR is "neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members."

## What is the effect on global relations?

Global supply chains have relied heavily on Chinese production, while shipping lanes near China are critical to the free movement of goods across the globe. China's rise is leading to increased competition with global powers—both economically and militarily. Trade tensions, cyber hacking, and military expansions in the South China Sea (see chart below) are some of the visible confrontations that are affecting global relations and represent risk to investors.

Historically, the United States, while preparing for a rise in Chinese military capabilities, has maintained a cooperative relationship with China that has benefited both countries economically. At the same time, China has been *biding its time* as it awaited continued economic development and technological advancement that would allow it to better compete. With the renewed focus on trade disparities and China's efforts to control the South China Sea, we may be seeing the start of a transition in which China and the U.S. have a more competitive relationship.

Increased competition also could have profound effects on China's neighbors and cause stress for Japan, Taiwan, and other key Asian economies. While we view these risks as limited in the near term, global investors should look to diversify their investments across spheres of influence. We believe that such diversification merits an emerging market allocation in many of our strategic asset allocation models.

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## Disputes over territory in the South China Sea are sources of diplomatic and military friction

Shown on Chinese maps since the 1940s, the “Nine-Dash Line” marks the boundaries for the waters, islands, and reefs within the South China Sea where China and its neighbors compete for sovereignty.



# What these developments mean for investor portfolios

## Expanded opportunities in China's equity markets

Changes in China's economy and financial markets are likely to affect investment portfolios that are simply maintaining a diversified allocation to emerging markets. This is because index providers have gradually increased China's relative weighting in their investment benchmarks as the size of the country's capital markets and available investments expanded.

For example, in 2018, equity index provider MSCI decided to add more Chinese companies to its Emerging Markets Index, taking it from 100 to more than 400 names. Such changes not only have increased investors' exposure to China but also have given investors access to more companies—such as retail and technology firms—that better represent China's changing economy. We expect inclusion of additional Chinese companies to the MSCI Emerging Markets Index in the future should China continue to further deregulate and open its capital markets to foreign investors.

Our expectation is that portfolio allocations to emerging markets have the potential to increase investor returns. The majority of our asset allocation models recommend an allocation to emerging market equities—an asset class that includes China. While emerging market returns have lagged domestic returns during the current economic cycle, we do see emerging market economies offering investors better return opportunities going forward.

## China's increasing weight in emerging market indices

**2018:** 31.1%  
**2008:** 15.9%

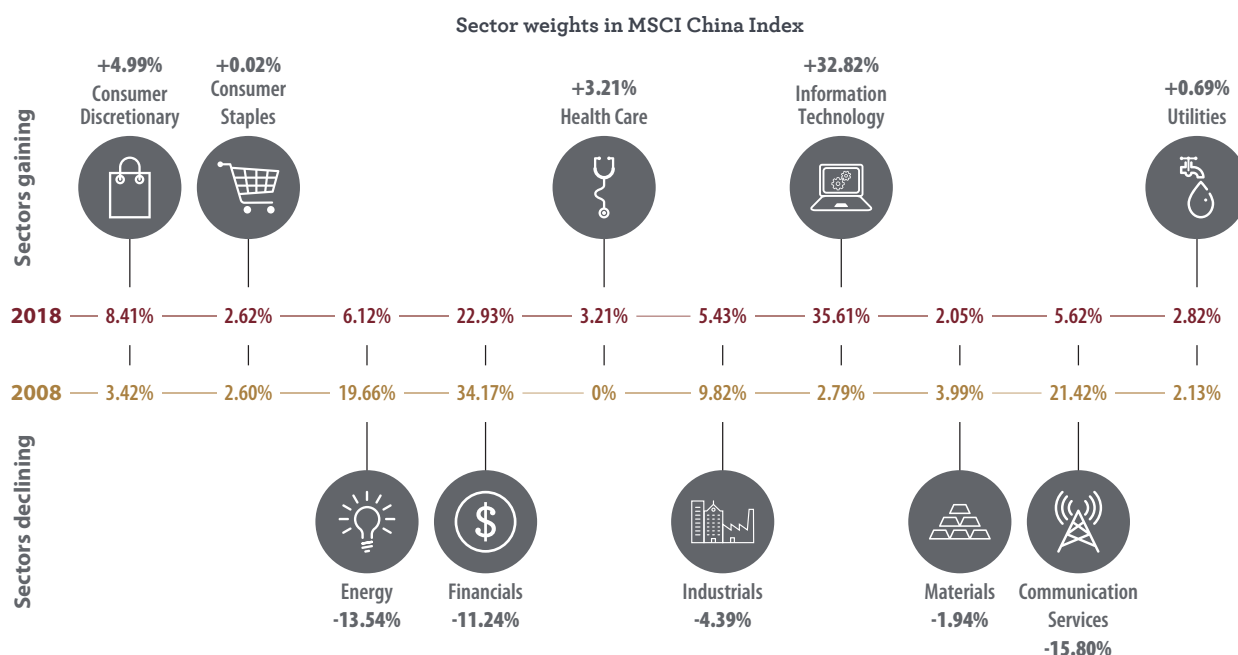
China's weighting in the MSCI Emerging Markets Index has almost doubled in the last decade. MSCI indices are commonly used benchmarks for global markets that are closely watched by investors. The MSCI Emerging Markets Index has more than \$1.8 trillion in assets benchmarked to it.

**Sources:** eVestment, Morningstar and Bloomberg, as of June 30, 2018, reported on September 30, 2018.

MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index designed to measure equity market performance of 24 emerging market countries.

## Growth in China's capital markets has meant changes in index structures

The increases in the Information Technology and Consumer Discretionary sectors highlight some of the changes in China's economy.



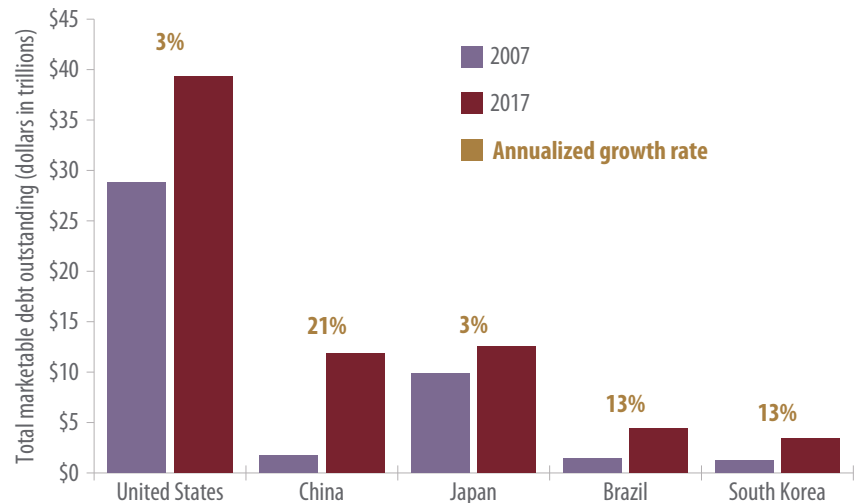
## Impacts and changes in China's debt markets

China's emergence also is having an effect on the fixed-income markets. In March 2018, Bloomberg announced that it would add yuan-denominated government and state-controlled bank securities to its Bloomberg Barclays Global Aggregate Bond Index (the Index represents the global investment-grade fixed-income markets); the addition is scheduled to be phased in over a 20-month period beginning in April 2019. As a result, China's weighting in the Bloomberg Barclays Global Aggregate Index is projected to increase from less than 1.0% to approximately 5.5% of that index. Given the number of portfolios that follow the Global Aggregate Index, most fixed-income investors are likely to see their exposure to China increase.

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## China's debt market is now among the largest in the world

After a decade of double-digit growth, China's supply of marketable debt is now approximately on par with that of Japan.



Sources: Wells Fargo Investment Institute and Bloomberg, as of October 19, 2018

## Investor implications

In our view, investors who wish to benefit from China's desire to "build a moderately prosperous society in all respects" could effectively do so through a diversified allocation to emerging market assets. The diversified approach offers two potential advantages. First, as China broadens its trade relationships, emerging European, Asian, and Latin American markets should benefit. Those markets are likely to provide raw and intermediate goods to Chinese markets and are positioned to buy more products via China's expanded trade routes. Second, a diversified exposure should blunt some of the risks of investing in China as a single market. As China continues to grow and to liberalize its capital markets, global investors will not be able to ignore the country's influence.

## Author



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