

Among emerging markets, China holds a particular place. It represents by itself more than a third of emerging markets GDP. It is half the economic size of the U.S. but is growing 3 times faster. China already commands a dominant position in many markets either as a client or a supplier.

The second particularity is that for centuries, it was the dominant world economy, even ahead of Rome at the peak of its power. Rare foreign travelers like Marco Polo marveled at its fabulous wealth and technological advance. At the end of the 18<sup>th</sup> century, around the birth of the United States, it is estimated it represented a third of world GDP and a population of nearly 300 million, equivalent to the U.S. today.

The 19<sup>th</sup> century brought catastrophe with the Opium War of 1839. During that period which the Chinese refer to as "the hundred years of national humiliation", China would collapse at the hands of colonial powers. This nation would not regain its sovereignty until the advent of Communist China in 1949. Consequently, while most countries accept the post WWII world order, China often does not. In many ways, clocks stopped in Peking in 1839. In the Eastern China Sea, significant tension can arise over territorial claims dating back to the 19<sup>th</sup> century. For instance, China does not consider Okinawa as Japanese or never thought of Tibet as an independent country. Vast territories of the rich Russian Far East or Mongolia were once part of Imperial China. When it comes to the reunification of Taiwan, the question is not if but when. Hopefully it will be done peacefully in a form similar to Hong Kong or Macao.

China is profoundly resentful and suspicious of outside powers, especially Japan. Official Chinese statistics for the 1937-1945 Sino-Japanese War are 20 million Chinese casualties and 15 million wounded. Highly nationalistic and convinced of the superiority of its civilization, it does not take too lightly to receiving advice from what it considers lesser civilizations. Because of its own experience it is always highly reluctant to intervene in other countries. This often puts it at odds with other members of the UN Security Council, the self-appointed policeman of the existing world order. But every indication points to the fact that China is intent on regaining its preeminent position which, if there was any doubt, is clearly stated in its name, the Middle Kingdom.

Imperial China was for centuries a centralized political entity with an effective government and a large administration of highly educated civil servants. Communist China is also a command and control economy. The role of the State and consequently the position of the Party are central to every important event. Communism, as a term has lost most of its significance. After all Tian Gong, Heavenly Palace, the name of the Chinese space station, sounds more imperial than revolutionary. Today's ideology has very little to do with Marxist-Leninist theories. Long gone are the days of the Great Leap Forward, the Cultural Revolution and every other foolish economic idea that went with it. Considering the values that are expounded by the leadership, in many ways Confucianism would probably be more fitting than Communism: paternalistic leaders, respect for the elders, education and knowledge. Rabid anti-imperialism has been replaced with the early reemergence of Chinese imperialism and a profound desire to regain what it considers its rightful place.

The communist party has 82 million members. It is as large as the population of Germany. It is run like a very large corporation where new members are recruited straight out of school and then progressively

given ever larger responsibilities. Rising to the top requires many years of successful experience. While the leadership is not elected as it would be in the case of a democratic society, its members are co-opted among their peers. So while not democratic, the system is nevertheless perceived as relatively fair where experience and competence are rewarded. However one notable exception is the children of former leaders, the princelings, who have leveraged their family connections.

Recognizing that the breakneck growth of the last 30 years has brought major imbalances the new leadership of Xi Jinping, president in place for the next 10 years, is intent on rebalancing the economy. Consumption represents a third of GDP (USA two third) compared to 45%, 20 years ago. This rebalancing will particularly benefit service sectors, small to mid-size companies and impact large state owned enterprises (SOEs). Considering the size, 1.3 billion people, and complexity of this economy, this project will take many years and bring many challenges.

China is still an emerging economy, with 600 million Chinese living at the UN poverty level (\$2 per day) in regions with very limited infrastructure. The present five year development plan lists the construction of 20,000 apartments per day, an airport per month, miles of highways, railroad tracks, hospitals; all in the name of the largest urbanization program ever seen. Even the Ming emperors who built the Great Wall would have been impressed.

To help promote economic growth, the government has controlled and subsidized for years the price of many basic inputs like credit, water, electricity, oil, gas, freight. This has brought significant imbalances and high levels of waste and pollution.

SOEs which control half the economy particularly benefited from this situation. For instance, they have privileged access to cheap credit while smaller companies have to go around the official banking sector and access credit through what is called the shadow banking system. Access to cheap credit enabled excessive investment in uneconomic projects while more dynamic and profitable parts of the economy were deprived of credit. The government through the Bank of China has started the process of rebalancing the financial sector. The two key elements are: bringing the cost of credit to market rates and bringing greater transparency and order to the shadow banking system without killing it. After all this unregulated system provides credit to the more dynamic and entrepreneurial parts of the economy. SOEs pay very little taxes and, therefore, have vast resources to pursue projects of sometime limited value. By reforming the tax system the government intends to redirect these resources towards projects that benefit the overall population like healthcare or social security. This in turn will encourage private consumption.

Another aspect of the reforms includes a big clamp down on corruption. Anger has long been mounting over the preferential treatment of princelings, corruption scandals, and illegal farm land seizures. Officials will no longer be allowed to personally benefit from their position and control over vast segments of the economy. This anti-corruption drive has already affected the consumption of luxury goods, often used as gifts to corrupt officials. Ostentatious display of wealth has become politically dangerous. The clamp down on land seizure will slow unnecessary real estate development and redistribute wealth more fairly.

In the 50's, to control immigration to cities, China instituted a registration system, the hukou. As part of this system, social benefits were tied to the county of origin. Therefore about 140 million migrant workers are denied access to benefits like schools for their children and are forced therefore to leave their family behind. The reform of this extremely unpopular system is now a priority. It should bring great benefits in terms of labor mobility, decrease the need for excessively high savings rate of migrant workers and encourage private consumption.

Finally it is also important to recognize that China is already in many fields a highly developed economy. For instance, in terms of technological advancement, it is the only country with its own space station and launchers. It is the largest car market in the world, the largest steel producer and the largest importer of many commodities. Alibaba, well ahead of Amazon, is the largest internet based retailer in the world. China holds the largest amount of foreign reserves, U.S. treasuries and will soon hold the largest gold reserves.

While all these changes have created a lot of uncertainties we see these reforms favorably and believe they will be particularly beneficial for the companies we invested in. The emergence of a Chinese consumer is already bringing great benefits to many companies not only in China, but also globally.

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