

# China: A giant in transition



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## Introduction

For most of the past 40 years, investors, policymakers and interested observers have become used to the idea of China as a fast-growing, emergent economy, well on its way to achieving middle-income status, with every hope of continuing along a path of resounding economic success.

Recently, however, a different story has surfaced. This one portrays China as stumbling badly, weighed down by long-term challenges related to excess debt and investment, an aging population, the end of globalization, and the adoption of policies inside and outside China that may frighten off investment and consumption.

In our view, the truth about China is neither as optimistic as some had earlier believed, nor as pessimistic as is currently fashionable. Rather, the central narrative is one of China in transition. China is shifting from an economy underpinned by extraordinarily high and probably unsustainable rates of savings, investment and debt accumulation to something else.

Such a transition is not easy, but it is also not unusual. At similar stages of their development, other countries, including the United States, Japan and various successful East Asian economies, witnessed something similar.

Our aim in what follows is to better understand how China is in transition and offer some insights about how investors should anticipate change. Whether investing in China directly or into themes that are linked to China's economic prowess, the set of opportunities and risks related to China investment strategies is fundamentally shifting. What has worked in the past may not be so fruitful going forward. But fresh opportunities are also arising.

## The middle kingdom evolution: What's shifting beneath the surface?

The days of supercharged Chinese real gross domestic product (GDP) growth are a thing of the past. That is partly because of simple arithmetic. Compound growth is easy for small economies, but impossible for large ones. And China has become very large. Depending on the metrics employed, it is either the largest- or second-largest national economy in the world.

Slower growth is also partly fundamental. China faces large imbalances in savings, investment and credit allocation that will need to be unwound in the years to come. Those imbalances will weigh on private sector demand.

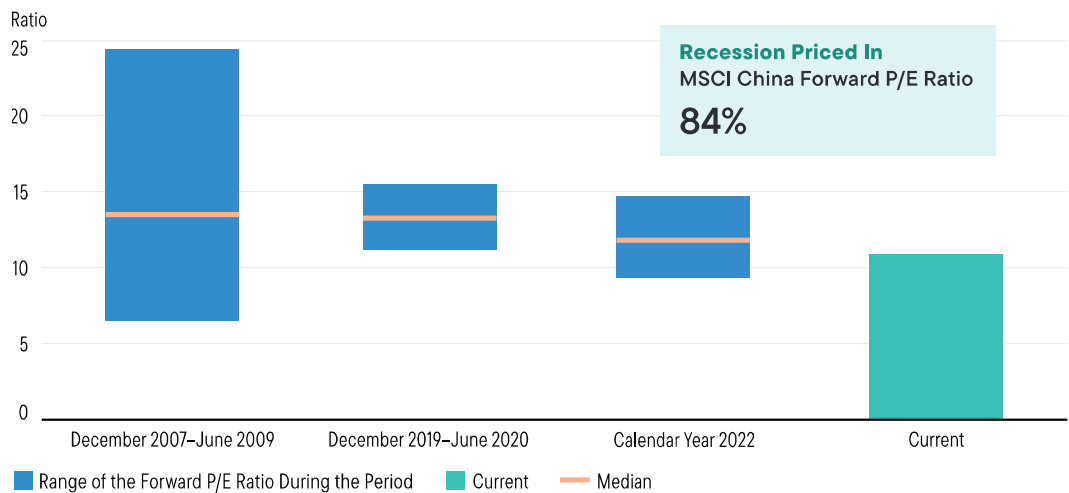
China's population is rapidly aging, and its labor force growth is stagnant. There is a strong likelihood that the number of able-bodied workers will shrink China's economy for at least a generation. And, like all economies these days, China will have to make do without the tailwind of ever-expanding globalization, a phenomenon that has stalled over the past decade.

But investors should guard against excessive pessimism. China's more than four-decade long story of unprecedented economic success is based mostly on its adoption of a market-driven economy,<sup>1</sup> which remains intact as a source of dynamism, innovation and opportunity. China has vast and still-untapped human capital resources, capable of producing a highly trained and motivated workforce. China also offers an enormous domestic market, which creates strong incentives for investment, distribution and innovation.

### Recession Priced in for China's Equities is High, While for Fixed Income, it Differs Across the Yield Curve

#### Exhibit 1A: China Equity: Forward Price-Earnings (P/E) Ratio During Previous Market Stress Periods vs. Current Forward P/E Ratio

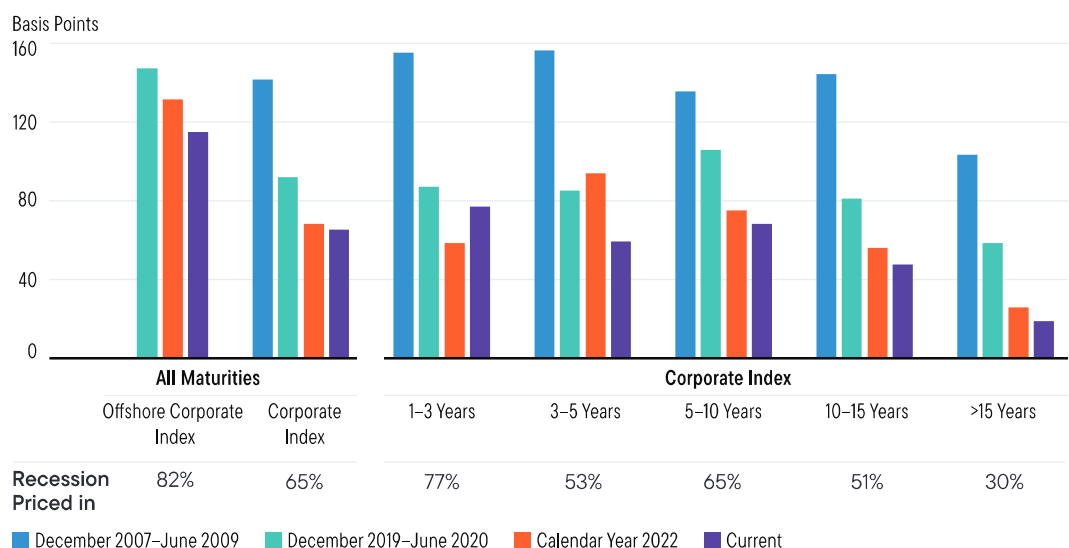
As of September 25, 2023



Source: MSCI Indices. Bloomberg. Analysis by Franklin Templeton Institute. Important data provider notices and terms available at [www.franklintempletondatasources.com](http://www.franklintempletondatasources.com). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** There is no assurance that any estimate, forecast or projection will be realized. The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 717 constituents, the index covers about 85% of this China equity universe.

#### Exhibit 1B: Credit Spreads During Previous Market Stress Periods vs. Current Credit Spreads

As of September 25, 2023



Source: ICE BofA Indices. Macrobond. Analysis by Franklin Templeton Institute. Indexes used: ICE BofA China Offshore Corporate Index. ICE BofA China Corporate Index. ICE BofA 1–3 Year China Corporate Index. ICE BofA 3–5 Year China Corporate Index. ICE BofA 5–10 Year China Corporate Index. ICE BofA 10–15 Year China Corporate Index. ICE BofA 15+ Year China Corporate Index. Important data provider notices and terms available at [www.franklintempletondatasources.com](http://www.franklintempletondatasources.com). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

The legion of critics that has sprung up in recent years underestimate these pillars of China's development story, and are quick to point out China's challenges but reticent to see its strengths. In our view, despite the enormity of the challenges it faces, China is well-positioned to adapt and prosper over the medium term.

To be sure, it is possible to overstate China's challenges. Much of China's growth this century has come from unsustainable levels of debt-financed investment and a gross misallocation of capital. To be fair, at similar and even more advanced levels of development, the history of all successful economies has chapters like what confronts China today. It is not an exaggeration to conclude that excesses are the unavoidable consequences of capitalism—and the operative word here is capitalism.

China's excesses are not merely the mistakes of central planning. Rather, the hopes and dreams of ordinary Chinese citizens primarily drive the high savings, high investment, and heavy borrowing that characterize its economy—and they pay the consequences. However, the Chinese are not intrinsically different from people everywhere who marshal their resources to build better futures for themselves and their families.

Four decades ago, China's great innovation was the establishment of property rights and the right to trade them—what we otherwise call a market-based economy. In this context, property rights refer to the fact that individuals can freely exchange most goods and services. So long as those conditions remain intact, China is likely to adapt and adjust to today's challenges and remain on a trajectory of rising living standards.

### **Decoding China's success**

Over the past 500 years, there has never been a case where a country or region has enjoyed sustained increases in living standards without a market-based economic system. Crucially, markets are nothing more than the exchange of property rights, which means that a necessary condition for a successful market economy is the recognition of, respect for, and protection of property rights.

The provision of property rights is often thought as enshrined in Western-style democracy, but that is not necessarily true. Other political systems may offer strong property rights and protections, as has historically been the case elsewhere in East Asia, for example.

The critical feature of property rights is not their legal foundations *per se*, but rather, a sense of social trust that they will be respected and enforced. Widespread infringements on property rights typically characterize failed economies. Indeed, failed states are most often characterized by significant and widespread infringements on property rights, for example via crime, expropriation, corruption, indifference, or persistent inflation.

It is no coincidence that China's remarkable economic success of the past four decades began with Deng Xiaoping's assurances in the late 1970s<sup>2</sup> that first farmers, and then urban dwellers, could own property and prosper from it. Successive Chinese leaders have only reinforced that central tenet of market capitalism.

China is not a purely capitalist economy. Nor is the United States, Japan, the European Union or even other successful Asian economies. But in China, the vast proportion of what is produced and sold reflects market forces. Prices, not planners, dictate how much is produced and what is consumed.

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**China, in other words, is not “trade dependent.” Like all countries, it will grow more slowly if globalization is turned backwards, but de-globalization won’t impair China’s ability to grow via its large internal market.**

First-time visitors to China often find the grandeur of its cities and their gleaming infrastructure impressive. The scale of what has been built is breathtaking and, for many, seems only possible under the guidance of central planning. True enough, few cities anywhere in the world were built without considerable government guidance. But the rapid emergence of Chinese cities where once there were only fields is primarily about marshalling the vast resources of a market economy, not the by-product of central planning.

Economic success is also dependent on scale. Access to customers, suppliers, resources and labor is required. It is well-known that China is not self-sufficient in many natural resources, including crude oil or natural gas. But it does enjoy scale in other dimensions.

For one, China has an enormous domestic market. It is worth recalling that exports make up about a fifth of China’s economy.<sup>3</sup> That’s larger than the comparable figure for the United States,<sup>4</sup> but not by much. The other four-fifths of China’s economy is domestic, which alone is the second-largest national economy in the world. Accordingly, producers and consumers in China enjoy a vast market of diverse goods and services. Big markets create big opportunities and therefore provide strong incentives to innovate and to deliver products to meet large demands.

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Over time, growth of income per capita is linked to the growth of productivity. Productivity growth in China has been weak in recent decades.<sup>5</sup> But that is partly a global disappointment, shared with most advanced and emerging economies.

But there is a Chinese angle as well. Although urbanization reflects a massive shift in resources from agriculture to manufacturing (initially) and services (subsequently), the construction of homes, of itself, represents a form of investment that does not directly yield higher output. Once built, an apartment produces nothing, whereas a factory does.

Moreover, while throwing vast amounts of capital and labor into new enterprises—such as building cities—creates jobs and boosts living standards, it can also lead to a gross misallocation of resources.

In the history of successful high-income countries, there are times when resources are grossly misallocated into property, almost always accompanied by poor lending practices. Japan experienced a massive property bubble in the late 1980s and early 1990s, with loose monetary policy, speculative lending, and land hoarding providing fuel. In the early 2000s, Canada, the United Kingdom, Ireland and Spain witnessed property booms amid high household debt, low interest rates and lax regulation. What followed was the global financial crisis—albeit first triggered in the United States with sub-prime mortgage loan defaults. One could argue China is experiencing something similar today.

But neither the financial speculation that engulfed Europe, the United Kingdom, or the United States at comparable times in their industrialization and urbanization, nor episodes of spectacular defaults of railroads, industrialists or farmers, permanently derailed their development. Capitalism, as economists from Smith to Keynes to Minsky have pointed out, is seemingly incapable of avoiding excesses.<sup>6</sup> But if properly managed, those occurrences are not sufficient to long forestall the journey to higher living standards.

## China's hurdles: unmasking major challenges

The largest imbalance today in the Chinese economy resides in the excess debt-financed investment in real estate. Over the past four decades, as hundreds of millions of Chinese left rural areas and flocked to cities in search of work, the property sector rode a wave of low-cost finance and encouragement from the authorities to supply the boom in Chinese urbanization.

As noted, borrowing has played a big role. A 2019 People's Bank of China survey estimated that for Chinese urban households, the value of their property represented 59% of their total assets, while mortgage loans stood at 12% of total assets.<sup>7</sup> This was considered noteworthy at the time, because the figure for mortgage loans as a percentage of total assets was close to the levels in the United States in 2008—on the eve of the subprime mortgage crisis. Similarly, property value as a percentage of total assets was close to the levels in Japan in the 1980s before its property bubble burst.<sup>8</sup>

A 2022 Caixa Bank report<sup>9</sup> estimated that the cumulative significance of housing and all the related inputs accounted for 30% of Chinese GDP, well above the headline 7% for real estate. (An earlier study by K.S. Rogoff and Y. Yang came to a similar conclusion.<sup>10</sup>) The difference is due to the collateralized activities of housing and real estate, such as capital goods, real estate services, basic metals, electrical equipment, finance, and legal services, etc.

However, extreme financial stress—akin to what occurred in the GFC—is unlikely. The reason is that Chinese savers have little reason to fear for the safety of their bank deposits. China's regulators and central bank ring-fence the financial sector, and China's considerable financial resources, including central government borrowing capacity and even the country's sizable foreign exchange reserves, act as a backstop. China has adopted free-market capitalism across much of its economy, but finance is different. Success is encouraged, but system failure is to be avoided. Widespread bank runs remain highly unlikely in China's financial system.<sup>11</sup>

Accordingly, a sudden stop due to a freezing up of credit markets is improbable in China. Instead, the process of unwinding excess investment and bad lending is apt to be gradual, for better or worse. Most probably, the drag that policies of gradualism create will likely present growth headwinds lasting for the remainder of this decade, if not longer.

China's second major challenge is an aging population. China's labor force has already stopped growing and will shrink over the coming several decades.<sup>12</sup> Arithmetically, stagnant labor-force growth shifts the burden for achieving sustainable economic growth to investment and productivity. At a macroeconomic level, however, it is unlikely that China can increase the share of investment in its economy, which has averaged 43.4% of GDP over the past two decades, from 2003–2022.<sup>13</sup>

Another challenge is the perception that China's government is becoming less market-friendly, especially over the past decade. Anti-corruption drives and the extreme lockdown response to the COVID-19 pandemic are cited as evidence that economic freedoms may appear to be diminishing. If so, such policies could cast a pall over investment and consumption.

Markets can remain functioning when risk can be approximated, but can be impaired if uncertainty prevails. Whether grounded in constitutions, precedent, law, custom or political culture, confidence in the sanctity of property rights is vital to sustained economic success.



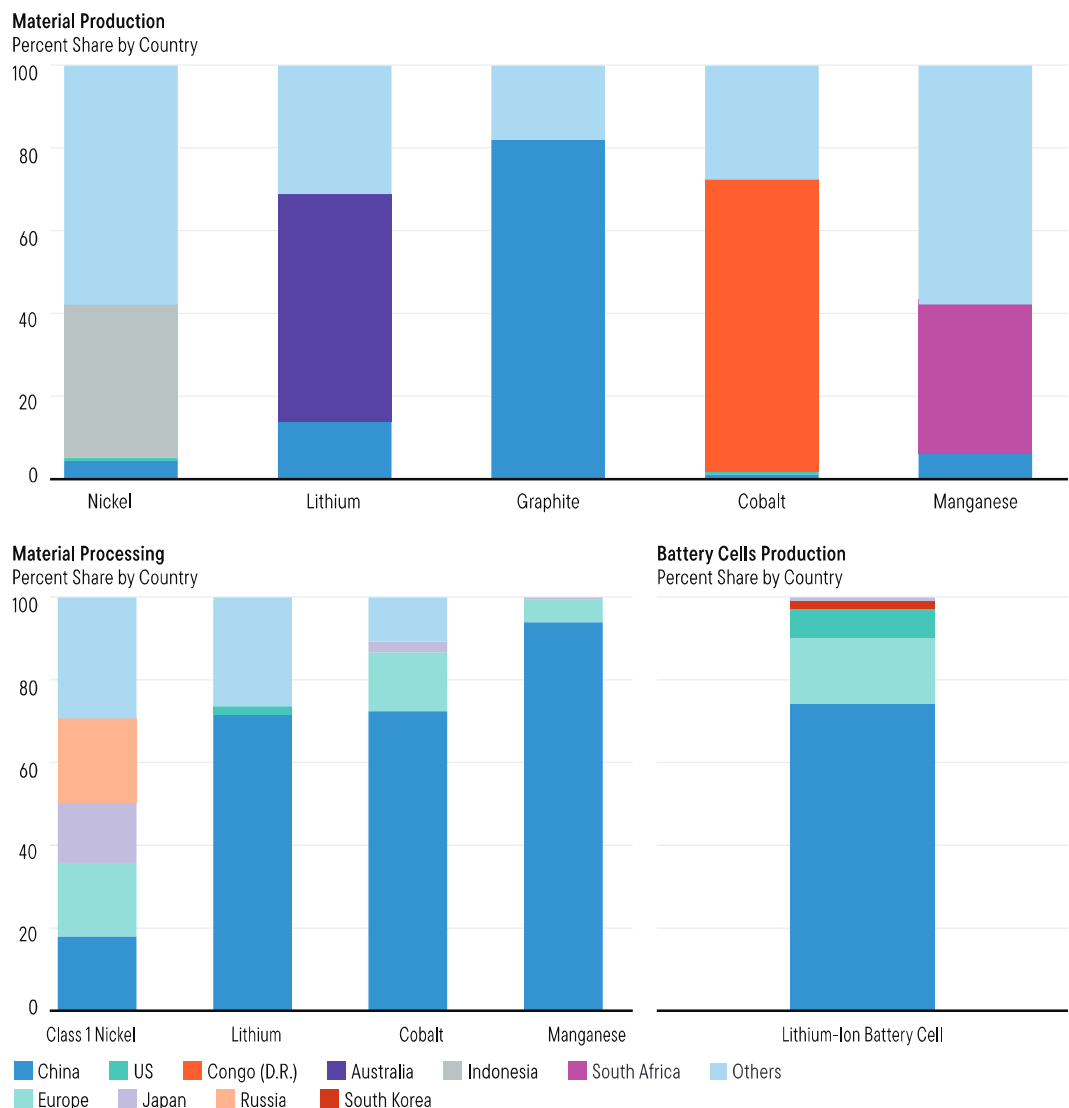
## Unleashing the dragon: Exploring opportunities

As China pivots away from an over-reliance on urbanization and unsustainable increases in private sector indebtedness, it must also find growth strategies compatible with other transformations underway. For now, globalization has peaked. The collapse of faith in unfettered free trade, outsourcing and long supply chains are likely to remain realities that will confront China and its robust traded-goods sector. Although China no longer runs large trade surpluses, it is nevertheless true that the world is less willing to absorb surplus Chinese production in ways possible during China's early "take-off" stage of development. Strategic rivalry will constrain China's access to some areas of advanced technology. And like every other country, climate change and environmental degradation are confronting China.<sup>14</sup>

Simply put, China's growth model must adapt. And China is pivoting. Examples include China's recent strong advances in the development and production of alternative energy (especially solar) and electric vehicles. China is also at the forefront of other industrial and commercial adaptations of key technologies, including artificial intelligence (AI), robotics, big data and machine learning.

### China Dominates Global EV Battery Supply Chain

#### Exhibit 2: Geographical Distribution of the Global EV Battery Supply Chain

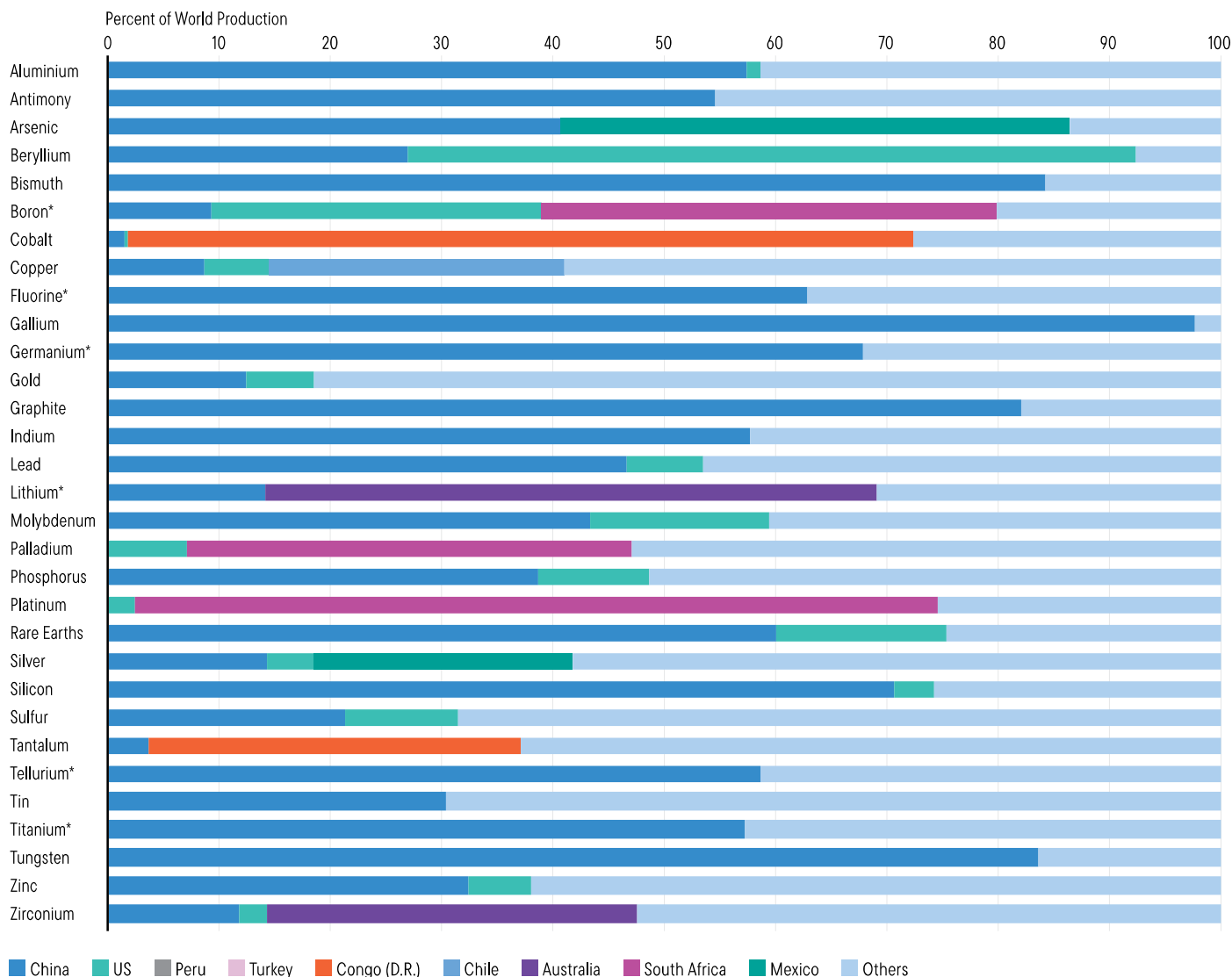


Sources: US Geological Survey 2022. Bloomberg NEF. Franklin Templeton Institute. Material production refers to mining; figures are 2021 estimates. Material processing is based on refining production capacity; figures as of 2021. Battery cells refer to lithium-cell manufacturing capacity by region of plant location; figures as of 2022 (facilities commissioned up to May 2022 included).

## China is Leading Global Production of Raw Materials Used for Chip Production

### Exhibit 3: Primary Production of Raw Materials by Country

As of 2021



Source: USGS. Based on 2021 estimates

\*United States data for germanium, lithium, tellurium, titanium is not disclosed, and data for fluorine is not available, hence share of United States in the total production is included in "Other." Boron data for the United States is not disclosed after 2005, hence 2005 figure was used.

China's supply-side must also adapt to changes in demand, above all within China's domestic market. Consumption excluding housing accounts for a smaller share of final demand in China than in higher-income economies but is likely to grow over time (in part simply reflecting a necessary decline in investment share of GDP). Recent trends within China, as well as the experience of other countries at similar levels of per-capita income, suggest that consumer spending will continue to shift from necessities and basic goods (food, housing, transportation) to discretionary outlays and services (such as travel or personal care, but also healthcare and financial services). Insofar as services are among the least globally traded items, Chinese firms that serve those faster growing areas of consumption are likely to emerge as major employers and creators of wealth.

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**Given China's slowing labor force growth, education services as well as labor-saving automation will be in demand.**

Moreover, China can improve the quality of its labor force via increased education and training.

As of the 2010 census, 74% of Chinese workers aged between 18 and 65 were without secondary schooling, representing some 500 million individuals.<sup>15</sup> According to World Bank data, the relatively few countries that have successfully migrated since 1960 from the middle- to high-income status, such as South Korea, Singapore, Israel, and Ireland, had in common high levels (over 70% of the population) of secondary education achievement. Given China's considerable resources, already-high levels of literacy (above 95%), improving the quality and productivity of its labor force appears possible.

Similarly, corporate investment spending is likely to change in China. Business services, including marketing, branding and financial services, are apt to be growth areas. Given China's slowing labor force growth, education services as well as labor-saving automation will be in demand.

Just as the path from agrarian to industrial society was well-trod by other countries before Deng Xiaoping pursued that same journey for China, so too it will be for China's transition to a lower-savings, lower-investment, higher-consumption, and more service-oriented economy in the decades ahead. It is already happening, albeit gradually. From a low of 34.6% in 2010, private consumption has risen by nearly four percentage points as a share of GDP to 38.2% in 2021.<sup>16</sup>

The fact that consumption, as a share of GDP, remains well below norms of other higher-income economies poses both a challenge and an opportunity. As various studies have shown, increasing consumption, which implies some decline in household savings rates, probably requires the broadening of China's social safety net, with more financial assurance regarding the provision of education, healthcare, and retirement benefits.<sup>17</sup> Those are stated ambitions of policy, though there may be implementation lags.

Consumption may also rise in areas of non-durables, which typically are less credit-driven. Based on data from other countries at similar levels of development, the demand for (and provision of) healthcare, education, financial and lifestyle services is apt to be some of China's most rapid rates of growth of consumption in the decade to come.<sup>18</sup>

Investment in higher-value-added manufacturing is also well underway, as evidenced in China's advances in motor vehicles, solar, and engineering sectors.<sup>19</sup> Several factors buttress China's potential for growth in other areas of value-added manufacturing. These include the large number of "STEM" graduates,<sup>20</sup> including in engineering, its established access to global trade and finance, its history of inward technology transfer and its ability to offer large economies of scale in production and demand to various industries.

### **How should investors judge opportunities and risks in China?**

In short, pessimism that China might get stuck in a middle-income debt trap appears exaggerated. China faces challenges but has extraordinary potential. It has a dynamic and innovative private sector, access to skilled labor, and is well established in the global trading and financial systems. Its odds of overcoming its challenges are greater than many think.



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**A China in transition away from investment encumbered by mounting loan losses is unlikely to see the rapid growth rates for basic materials, other commodities and energy.**

During China's rapid ascent into the world economy in the 1990s and early 2000s, the prevailing investment wisdom could be summed up as "buy what China buys, sell what China sells." China's voracious appetite for energy and raw materials, underpinned by rapid industrialization and urbanization, meant that investors could happily seek out opportunities in global mining and energy production. China's increasing dominance of low value-added manufacturing meant that global investors shunned those same industries in the West on account of low-cost competition.

Selling to the increasingly affluent Chinese urban middle class was another favored strategy. European and US consumer brands coveted brand-conscious Chinese consumers, with investors in hot pursuit.

Going forward, the investment landscape will likely change, in our view. A China in transition away from investment encumbered by mounting loan losses is unlikely to see the rapid growth rates for basic materials, other commodities and energy. To be sure, China's absolute levels of demand probably won't fall off a cliff, but the period of rapid growth has already come to an end. Similarly, as Chinese consumers become more sophisticated and, like higher income households worldwide, shift their preferences to services, brand buying habits will switch.

As overall consumption rises as a share of GDP and as the consumption of services becomes more important, growth opportunities will become more apparent in sectors such as insurance, wealth and asset management, pension services, education, travel, personal care and new commerce.

Similarly, business spending needs are shifting. Bricks, mortar, glass, steel, and heavy machinery will remain in demand, but are unlikely to be high growth areas. Instead, business services including consulting and financial advisory services, information technology, AI, big data analytics, and the design and implementation of robotics are areas where investors should anticipate higher growth.

In short, there is every reason to believe that China remains an investment opportunity, both within China and with companies that offer products and services that address China's shifting spending habits. In other words, made in China, for China.

### **Conclusion: Underestimate China at your risk**

China's growth disappointments in the past five years have understandably raised questions about its long-term economic dynamism. Some of that is mere extrapolation of the recent past into the future. But it is also true that China is confronted with a multi-year adjustment to a misallocation of resources in property construction, with a corresponding increase in bad debt. Unwinding those excesses is apt to be a drawn-out process, one that may act as a drag on domestic growth for years. The slowing pace of globalization and a backlash against China's exports (as well as restrictions on high-tech exports to China) are further hindrances to growth.

But the underlying dynamism of China's domestic economy remains intact. Gone are the days where Chinese entrepreneurs produce based on global demand and trends but are now trend leaders. It has and will continue to spur innovation and create new growth and investment opportunities. It is likely that government policy will aim to boost consumption's meager share in national income. Chinese consumer fundamentals, needs, and tastes continue to evolve. Accordingly, China is likely to offer astute investors fresh and exciting avenues for growth.

Equally, investors must also adjust to new realities. Global investors are emphasizing the importance of being on the ground with the right partners to navigate the rapid changes and identify the right opportunities. Owing to its sheer size, legacy imbalances, an aging population and slowing globalization, it's unlikely China's economy will return to its high growth era of past decades. Just as important, the sources of growth will shift away from what worked (construction, infrastructure, expansion of large-scale, low value-added manufacturing) into new areas of innovation, healthcare, renewable energy and industries that serve the local consumers.

Given China's considerable engineering skills, its access to global markets, finance and know-how, its dynamic domestic sectors economy, we believe it is well-positioned to meet the challenges that new technologies, climate change and a stagnant pool of labor pose.

## China's transition through the lens of coffee culture

### **The China that was: Starbucks' foray into a land of tea drinkers**

In the early 2000s, the successful foray of Starbucks into China represented the Western corporate perception of China as a vast, untapped market. China's entry into the World Trade Organization in 2001 marked a significant phase of globalization and economic openness, which contributed to the rapid urban and economic transformation, thereby creating a burgeoning middle class with a penchant for global brands and products. Despite China's deep-seated tea culture, Starbucks, symbolizing modernization, and global connectivity, thrived, epitomizing the shifting consumer preferences of China's youth population.

### **The China that is: The emergence of Luckin Coffee amidst economic shifts**

Present day, China's exponential growth is giving way to more sustainable, albeit slower, economic progress. This shift is characterized by the aging of the population and stagnant labor force growth, highlighting the need for innovative business

models and products to stimulate economic activity.

Luckin Coffee's emergence epitomizes this shift. Offering affordable, convenient coffee options primarily through a takeaway model, Luckin Coffee reflects China's growing inclination towards efficiency, technological integration, and innovation in business models, resonating with the lifestyle of the contemporary Chinese consumer.

### **The China that will be: Leader in innovation marrying tradition**

Ahead, China's trajectory is set to harness the synergy between dynamism, innovation, and its rich cultural heritage. This prospective phase is represented by the emergence of the "sauce flavored Latte"—a collaboration between the entrepreneurial venture Luckin Coffee and a traditional local company Kweichow Moutai. This encapsulates the essence of China's future—a global leader adept at integration of ancient traditions with technological advancements.

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## Definitions

The ICE BofA China Offshore Corporate Index tracks the performance of CNY denominated corporate debt issued in the Chinese domestic bond market. Qualifying securities must have at least one year remaining term to final maturity, at least 18 months to final maturity at point of issuance, a fixed coupon schedule and a minimum amount outstanding of CNY 500 million. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Contingent capital securities ("cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Securities in legal default are excluded from the Index.

The ICE BofA China Offshore Broad Market Index tracks the performance of publicly issued CNH denominated government, quasi-government, corporate and collateralized debt. Qualifying securities must have at least one year to maturity at time of issuance, at least 18 months to final maturity at point of issuance, at least one month remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of CNH 500 million. Contingent capital securities ("cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Synthetic bonds (denominated in CNY but settled in another currency), CDs, retail deals, equity-linked securities and securities in legal default are also excluded from the Index.

## Endnotes

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## WHAT ARE THE RISKS?

**All investments involve risks, including possible loss of principal.**

**Equity securities** are subject to price fluctuation and possible loss of principal.

**Fixed income securities** involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Low-rated, high-yield bonds are subject to greater price volatility, illiquidity and possibility of default.

**International investments** are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

The government's participation in the economy is still high and, therefore, investments in **China** will be subject to larger regulatory risk levels compared to many other countries.

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