# Americas CIO View

## A brief history of China's 40-year economic expansion

### China has not had a recession in 40 years: it will not let tariffs cause one now

The intensifying trade conflict between the United States and China is becoming a matter of national pride and economic-policy resolve in China. We doubt a grand deal that quickly lowers tariffs comes at the G20 meeting at the end of June. However, over the coming year, we believe that China's economy, listed-company's profits and its currency will prove to be much more resilient than most investors expect against tariffs, owing to how important China sees its need to transition its economy further away from exports and investment spending to domestic consumption. The trade conflict brings more urgency to China's leaders in achieving this desired transition. We think history marks 2019 as the year China launches a consumption-led economy.

### China's 40-year expansion with four key stages from: 1979, 1989, 1999, 2009

We think it helps to understand China's economic-policy responses in process to this trade conflict by reviewing the four stages of China's economic expansion since 1979. We think these four stages can be marked, albeit imperfectly, by four key years. After decades of post revolution economic decline and then brutal years of a crushed economy and high inflation in the 1970s, it became clear that China could no longer afford to sacrifice the economy in pursuit of ideology.

In 1979, China's leader Deng Xiaoping launched reforms permitting some entrepreneurship and free trade. As Americans understand that "only Nixon could go to China[1]," in 1972, it is similar that only Deng could sprinkle in some capitalism. These reforms brought some relief to China's masses in the 1980s, but living standards lagged versus neighboring nations better linked to the west with trade. Those aware pushed for more change.

After 1989, China's leadership made economic-growth priority one to ensure stability. In the 1990s, China aggressively pursued an export-led economy. Presidents Bush and Clinton promoted trade with China, granting favored-nation trading status while prodding reforms. This trade helped China industrialize and slowly amass a saving pool that it would deploy to fund investment. Growing trade, which fed a captive savings pool that was directed via command-credit policies toward industrialization and urbanization, was recognized as a powerful and transformative economic model.

In 1999, the United States and China struck an agreement to win U.S. endorsement of China joining the World Trade Organization (WTO). This agreement called for more free trade and more

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**In a nutshell**

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- China's 40-year expansion with four key stages from: 1979, 1989, 1999, 2009



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[1] It is a reference to President Nixon's efforts to establish a direct diplomatic relation with the People's Republic of China.

privatizations and a flood of state-owned companies listed shares. Global trade and financial expertise came in from Hong Kong after the handover from Great Britain in 1997 and quickly the Guangdong province became an export manufacturing juggernaut and Shanghai a world-class financial city. After the 1999 accord and the formal inclusion of China into the WTO in 2001, the economic model of exports to build a savings pool to fund industrialization and urbanization went into hyper drive and China boomed.

In 2009, the global financial crisis erupted, causing slack-foreign-export demand. China's policy response was to aggressively tap into its now relatively massive saving pool to ramp up a faster pace of urbanization and infrastructure investment. This investment spending, made the already in process shift from being an export led economy to an investment led economy decisive. Construction or Fixed Asset Investment (FAI)[2] surged from 2009 to 2014, but it became clear that the investment had to be slowed to prevent excess in property development from threatening decent enough returns on such projects to service the underlying debt. From 2014 through 2019 to date, China has dramatically slowed its FAI and associated credit expansion. FAI was running near a 30% year-over-year growth rate in 2009 and is now down to 6% growth. This huge slowdown in investment and gross-domestic-product (GDP) growth from a 10% to 6% trend without slipping into recession or a surge in unemployment is a very impressive soft landing.

In 2019, the Trump administration substantially escalates U.S. tariffs on imports from China effective June 1. This began in 2018, but more selectively and at lower rates. China is much less sensitive to exports, especially to the United States, than in decades past, but it is now acting to accelerate its transition to a domestic-consumption-led economy. These actions include lower value-added taxes (VAT), more social spending, likely selective easier credit conditions and more credit directed toward households. Because China's listed companies are tilted more towards domestic consumption than exports we expect continued healthy earnings growth from most China listed companies. Whereas we expect S&P 500 earnings-per-share (EPS) growth to slow to 2% in 2019 and 2020 if no relief from tariffs is in effect.



[2]Fixed Asset Investment is an expenditure by government and business sectors on buildings, engineering, construction and machinery and equipment.

## Glossary

### Earnings per share (EPS)

**Earnings per share (EPS)** is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

### Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

### G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

### Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

### Inflation

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

### Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

### State-owned enterprise (SOE)

A **state-owned enterprise** is a legal entity that executes commercial activities on behalf of an owner government.

### Value-added tax (VAT)

A **value-added tax (VAT)** is a consumption tax that is collected based on the incremental value added in each stage of production (as opposed to a sales tax where only the final consumer is taxed).

### World Trade Organization (WTO)

The **World Trade Organization (WTO)** is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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