Morgan Stanley

INVESTMENT MANAGEMENT

BIG PICTURE
China's Past, Present and Future

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China's economy has undergone a remarkable transformation over the past 70 years, catapulting the country from its predominantly rural roots to a vibrant, urbanized industrial powerhouse. After the communists took control in 1949, the state exercised tight control over the economy. It was only after a series of transformative reforms initiated in 1978 that an entrepreneurial spirit was unleashed and propelled the country to become the world's second-largest economy, with an annual growth rate that soared from 6.5% for the first 30 years to nearly 10% for the last 40.

Today, China faces binding constraints including unfavorable demographics, elevated debt levels, a productivity slowdown and rising income inequality, all at a time of rising geopolitical tensions. President Xi Jinping's measures to reassert state control in economic planning mark a significant departure from the previous four decades of reforms and signal a shift away from the reform-driven tailwinds for private enterprises. The introduction of these new controls comes at a crucial time. Western governments and businesses are actively exploring alternatives to their Chinese suppliers to mitigate risks associated with relying on a single country. The tensions between the West and China have worsened due to Beijing's increasing assertiveness on the global stage, including its efforts to control key technologies, its military expansionism and its territorial claims over Taiwan.

This paper takes a closer look at China's past, present and future, its transition from poverty under Marxist policies to a global powerhouse today, and its ongoing attempt to navigate the complex intersection of economic, technological and geopolitical realities to achieve its goals.

Past

1950s

After winning the civil war in 1949, Chinese Communist Party (CCP) leader Mao Zedong implemented a centrally planned economy modeled after the Soviet Union, with a focus on heavy industries and rapid industrialization. This included collectivizing the majority of the country's farms into large cooperatives or communes and directing massive investment into iron and steel production. Additionally, millions of farmers were reassigned to join factories making heavy machinery. This came at a great cost. The Great Leap Forward (1958-1961), a campaign aimed at rapidly industrializing China, resulted in a severe famine from 1959-1961 that claimed the lives of millions of people due to mismanagement, forced collectivization and flawed agricultural ideas.

1960s

In an effort to mitigate the impact of the famine, the government mobilized millions of workers from urban areas to reinforce the agriculture sector and allocated new machinery to modernize farming methods. However, the economy suffered another downturn in 1966 when Mao launched the Cultural Revolution to eliminate "bourgeois" elements within the CCP and weed out challengers. The turmoil led to widespread chaos and stalled economic growth. Although Mao declared an end to the Cultural Revolution in 1969, its impact lasted into the next decade.

1970s

The Cultural Revolution was a disaster. Mao consolidated his power and maintained his grip on the party leadership until his death in 1976, but the period of political upheaval proved damaging to the economy and hindered growth. After Mao, the pragmatic faction of the CCP quickly gained dominance and abandoned Soviet-style economic planning. Starting in 1978, Deng Xiaoping—who had succeeded Mao—initiated free market reforms, including dismantling state ownership and controls, promoting industry and encouraging private businesses.

1980s

Deng took steps to improve China's living standards. The country's per capita income was just $156, much lower than major economies like Japan, which had a per capita income of $8,000. Deng initiated market reforms, loosened state controls and offloaded non-essential state-owned enterprises (SOEs). His policies encouraged private farmers and entrepreneurs to set up their own businesses. China's new economic strategy was modeled after the high-savings, high-investment and export-driven playbook of countries like Japan and South Korea.

1990s

The reforms paved the way for China's emergence as a manufacturing hub as it opened its economy to foreign investment. Thanks to its vast low-cost workforce, the country was well positioned to become the world's leading exporter, as globalization went into overdrive. Building on Deng's legacy, President Jiang Zemin continued to liberalize the economy in response to the Asian Financial Crisis in 1997 by selling, merging or closing down the majority of SOEs, which contributed to a significant reduction of the state's share in the economy—coming off from 75% in the 1980s to 40% currently.

2000s

In 2001, China took a significant step forward by joining the World Trade Organization, which enabled it to increase its share of global exports from 4% in 2000 to 14% by 2015. The boom in exports was accompanied by a real estate investment bonanza driven by housing reform, privatization and urbanization. The privatization of China's housing market allowed households living in state-owned housing to purchase their homes at prices far below market value, which contributed to a rapid increase in homeownership.

To address the impact of the Global Financial Crisis (GFC), Chinese authorities introduced the largest stimulus package in the world, close to 13% of China's GDP, to boost demand. At the peak of the crisis, China's contribution to global growth increased from 25% to 40%. These measures helped cushion the impact of the global recession and maintained China's economic stability.

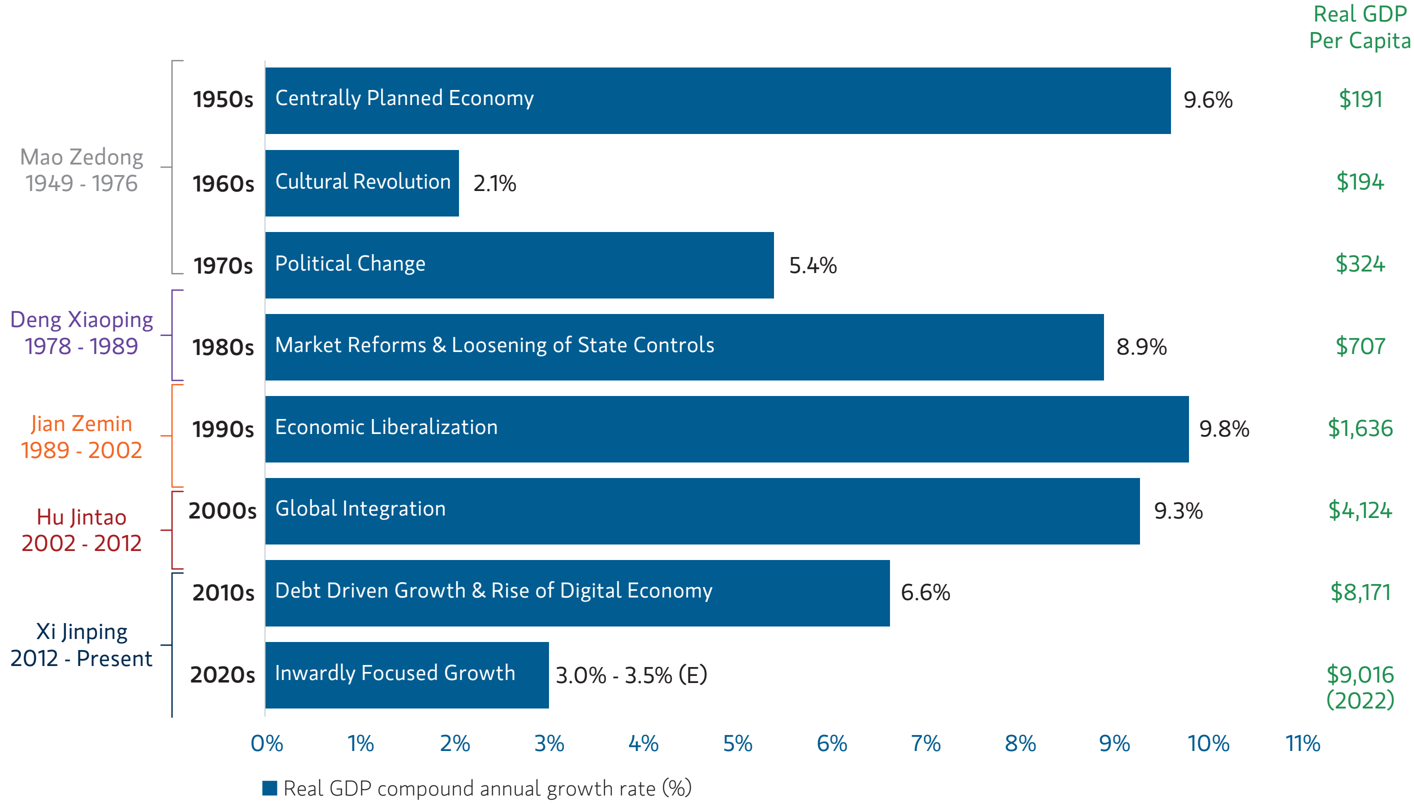
2010s

The spectacular post-GFC economic growth was primarily fueled by debt, with substantial investments in infrastructure, a real estate boom and an expansion of bank and non-bank (i.e. shadow banks) balance sheets. Investments reached 45% of GDP and residential and ancillary activities climbed to 25% of GDP. While traditional lending in China had come from state-controlled banks, less transparent alternative lending sources like trusts, policy banks and wealth management products emerged, leading to high-risk loans to meet the growth-at-all-costs initiative by the government. China's debt-to-GDP ratio

DISPLAY 1

China's Decades of Unfettered Growth Stalls

China's post-war GDP compound annual growth rate and real GDP per capita by decade



Source: Haver Analytics, MSIM EM Research

increased from 203% in 2009 to 296% in 2017. This boom in debt levels was accompanied by the rapid growth of the shadow banking sector, which grew from $80 billion in 2008 to almost $9 trillion in 2018.

Concerned about the highly-leveraged state of the economy in 2017, Xi's administration shifted its focus to lowering systemic risk by reducing debt levels and deleveraging balance sheets. China's trifecta of overinvestment, overleverage and overproduction contributed to a slowdown in the economy. In addition, the country's average income had reached the middle-class phase, a point when "miracle" economies have historically slowed. Another driver of growth was also coming off. China had reached its Lewis Turning Point, the structural change from an excess supply of labor to one of labor shortage, which can lead to rising wages and slowing growth.

If the previous decade had witnessed the last surge of China as the world's factory (China 1.0), the 2010s ushered in the rise of digital China (China 2.0). Just as the export-, manufacturing- and credit-fueled growth engine showed signs of fatigue, the digital revolution, in the form of consumer internet platform giants that offered shopping, entertainment, mobile banking and other e-commerce services, took center stage. These platforms became the driving force behind China's economic growth with the digital economy growing to 40% of China's GDP compared to just 5% a decade earlier.

Beijing prioritized investments in innovation, R&D and domestically driven growth. This effort was given further impetus with the launch of the "Made in China 2025" plan, which aims to modernize the country's manufacturing in key sectors, focusing on areas such as robotics, automation, aerospace and electric vehicles (EVs).

Present

China's economic growth in the 2010s, fueled by robust exports, significant borrowing and extensive government investments, created imbalances within the economy. These imbalances manifest as excess capacity, real estate, income inequality and elevated levels of debt. As Beijing's trade dominance expanded, it also led to an increased scrutiny of its export agreements.

The onset of the present decade was marked by the global outbreak of COVID-19 and strict lockdowns to curb the spread of the virus. Beijing's focus further turned toward stabilizing the domestic economy to mitigate the impact of the pandemic.

Since Xi assumed power in 2012, he has consolidated his control over the country, becoming China's unchallenged leader. Although in his first five-year term Xi embraced market economic policies, in recent years he has pushed for greater state control over the economy, a marked move away from Deng's reformist agenda. Xi has emphasized the role of the Party Congress, where he has solidified his control and its decision-making processes. Additionally, he has launched a widespread anti-corruption campaign targeting both high-level officials and local civil servants.

In addition to dealing with political challengers, Xi has taken steps against technology and online education entrepreneurs. He has also introduced policies such as increasing the minimum wage and land reform, both to address income inequality, which had widened during the high-growth years. Similarly, the government recently introduced regulatory scrutiny of several sectors of the economy. These measures have contributed to heightened uncertainty surrounding "China Inc." and the country's economic future.

These concerns were reinforced by China's underwhelming and uneven post-pandemic recovery. While consumer spending in services has led to a bounce in GDP growth, investment remains sluggish. We believe the government does not have the appetite to engineer an across-the-board real estate recovery and is instead trying to rightsize the sector. Structural factors such as changing demographics, slowing income growth and an unwinding of the speculative excesses that built up over the past 15 years have set the property market on a downtrend trajectory. Youth unemployment remains a worry at 19%—about 12 million graduates enter the job market every year and need to be employed.

China was successful as a command economy because economic actors had always responded to policymakers. If the government announced it was time to buy property, people lined up to do so, and when it announced a fiscal stimulus, the private sector doubled down. The private sector has grown to contribute to 60% of the country's GDP, 70% of innovation, 80% of the urban workforce and 90% of new jobs. With two years of the COVID-19 lockdown, political ideological shifts and mark-to-market losses in property and equity markets, economic actors are no longer reacting with the same enthusiasm as in the past. Currently, the private sector is lacking confidence and animal spirits.

Stimulus Tank Near Empty

Despite the economy's challenges, monetary policy remains highly accommodative. Interbank markets are well supplied by liquidity and the growth of money supply is double that of nominal GDP growth. The government has room to further cut the Reserve Requirement Ratio to add additional support to the economy.

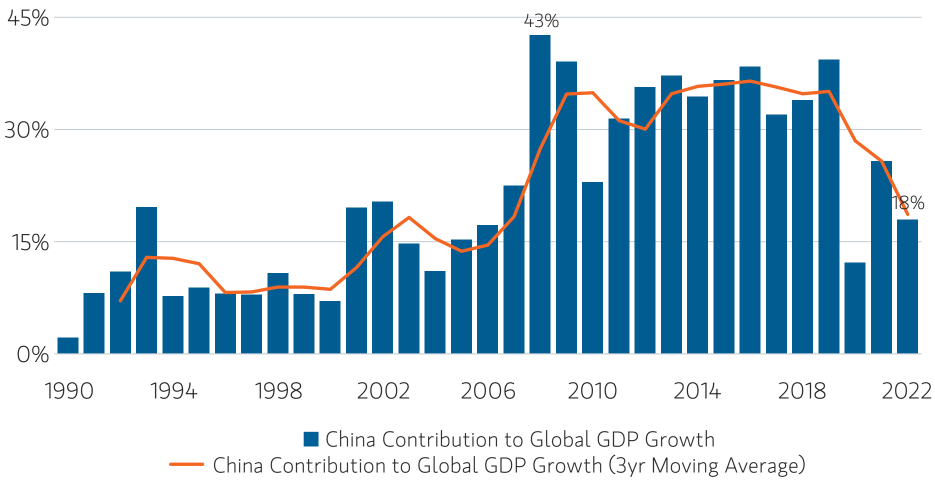
However, the fiscal impulse has weakened compared to previous years, primarily due to the lack of meaningful fiscal stimulus from the local government financing vehicles. In the past, China channeled fiscal policy through these but now local governments are burdened by high debt of 55 trillion renminbi (RMB) on their collective balance sheets and face rising interest costs and declining cash positions. For the moment, local governments have resorted to swapping their short-term, high-interest-rate borrowing for longer-tenor, lower-interest-rate bank loans. However, this is not a long-term solution as it simply shifts the burden to banks. Additionally, while local government financing vehicles have increased their debt liabilities, their revenues have actually decreased since 2021, primarily due to a reduction in land revenues—a significant source of local government finances. To address this issue, a restructuring and write-off of this debt is necessary.

The disruption of the real estate money-making machine has exacerbated the problem. Traditionally, land sales, property development and infrastructure projects formed an interconnected financial triangle. Local governments recouped significant income from land sales to property developers, who borrowed heavily to build new developments. Local governments then used the proceeds to fund infrastructure projects. This mutually beneficial relationship meant that local governments had strong incentives to push up land prices sold to property developers. To curb property speculation and deleverage the sector, Beijing introduced policies such as limiting credit to developers and making it harder to obtain mortgages. These controls have hurt land sales which, in turn, will put constraints on future infrastructure projects.

DISPLAY 2

China's Contribution to Global GDP Has More Than Halved Post its GFC Peak

Year-on-year contribution to global growth



Source: Haver Analytics, IMF, MSIM EM Research

High Debt, Low Growth

China's significant debt burden at 351% of GDP has been a major concern to the government. Beijing has managed to avoid a debt crisis through a combination of closed capital accounts, current account surpluses, a high domestic savings rate and a command economy. While there have been bankruptcies and restructuring in the last few years, the authorities have reacted quickly to create the necessary liquidity to prevent a crisis from developing. The government has focused on deleveraging balance sheets and reducing systemic risk since 2017 by introducing measures that enabled them to control defaults and liquidity and manage the excesses.

Although liquidity issues have been addressed, the structural issues remain at large. China is now facing a "growth crisis" rather than a "financial crisis."

Importantly, nominal growth has fallen off, accompanied by a lack of inflationary pressure, and it is becoming clear that the currency is no longer going to provide support. Although China enjoys a trade surplus, the RMB has not been strong enough to offset the interest rate differential with the U.S. Rising geopolitical tensions curbing foreign investment should also prevent currency appreciation.

The central government's leverage ratio is relatively low, indicating there is room for more policy stimulus to support economic growth if necessary. But there is a limitation to relying on the "old recipe," namely using infrastructure and housing investments to revive the economy. For sustainable growth, public investment will need to focus on upgrading services to address social needs.

As China turns inwards, the country's contribution to global growth has fallen off. Beijing's share of global growth peaked at 43% during the height of GFC but more than halved to 18% last year *(Display 2)*.

New Tech Ecosystem

China's technological advancement continues to make strides despite encountering obstacles in developing a domestic semiconductor infrastructure. Although the country is the world's biggest producer of greenhouse gases, Chinese companies are leading the way in renewable energy equipment, including solar cells and batteries for EVs and utility grids. China is also a global leader in 5G and in the production of lithium-ion batteries.

The recent Shanghai Auto show was an eyeopener for European carmakers. While some American and German carmakers remain players in China, the French and Korean companies have exited. China's EV offerings are 30-50% cheaper than competitors

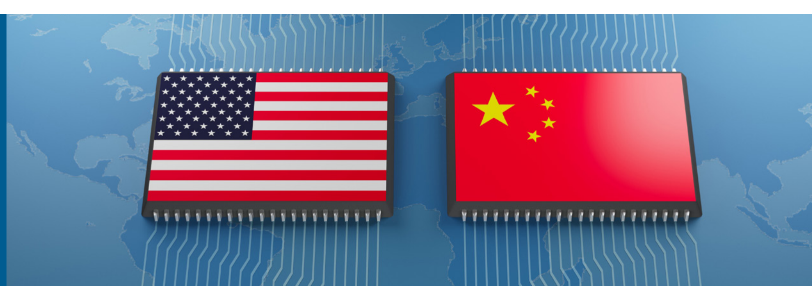
DISPLAY 3

U.S. versus China: Hi-tech Clash

Each country dominates in different sectors

U.S. Leads In:

- AI
- Advanced semis
- Quantum computing
- Space launch systems
- Video games



China Leads In:

- 5G
- Renewable energy
- EVs and batteries
- Social media apps

While the U.S. leads in AI, advanced semis and video games, China excels in 5G, renewable energy and electric vehicles.

and the country dominates the EV infrastructure space, controlling 77% of battery production and 54% of all EV manufacturing. Their share in mining and processing battery components also remains high. At a private meeting, one European trade official said "It is better to win with the Chinese than to lose competing against them."

Some Western Internet firms have left China due to strict regulatory control. Within the telecom space, Chinese companies are actively pushing out foreign competitors in the 5G market. Two Scandinavian telecom giants had 30% of the 5G market five years ago, but today one has a 1.5% share, the other a mere 0.2% share. For Xi, this trend of indigenization—relying on homegrown champions—will continue in industries like semiconductors, EVs, green technology, AI and automation.

Future

China has set ambitious economic, technological and geopolitical goals for this decade, but faces constraints.

Overinvested, Oversupplied, Overleveraged

China faces high levels of debt, excessive investment, declining productivity and growing inequality. Policymakers have been playing "whack-a-mole" to curb high debt levels. Their solutions to handle overindebtedness end up addressing liquidity issues and not the structural ones which require restructuring or a write-off in debt. Problems have been transferred from local banks to local governments and larger, healthier banks. Maintaining centrally-planned growth targets further complicates the overindebtedness. Although a shift in focus from investment to consumption can contribute to rebalancing, it may not lead to higher growth.

Geopolitical Muscle Flexing

Five years into their trade war, the U.S. and China now view each other as national security threats and economic competitors. The strategic focus is on resiliency rather than efficiency.

China's emphasis on national security prioritizes areas like cybersecurity, self-reliance in sectors like food, energy and semiconductors and strengthening relations with other members of BRICS (Brazil, Russia, India and South Africa). China has engaged in diplomatic efforts in Central Asia and the Middle East, encouraging talks between Saudi Arabia and Iran, participated in multilateral agreements such as the Regional Comprehensive Economic Partnership (RCEP) in Southeast Asia and sought to improve security relationships with Japan and South Korea. China's outreach is part of a broader strategy to keep the U.S. off balance. China has also tried to mend relations with European countries, but Beijing's support for Russia's war against Ukraine is hindering those efforts. China's rhetoric has recently shifted from "decoupling" to "de-risking and de-escalation," reflecting a desire to avoid another "Trump Trauma" in light of the upcoming U.S. elections.

The future of Taiwan remains the key geopolitical question. Beijing has conducted military exercises and amplified its rhetoric surrounding the island's future. In our opinion, the likelihood of China invading Taiwan is very low. Beijing stands to lose a substantial amount (at least $1 trillion reserves in U.S. Treasuries could be sanctioned) at a time it faces looming domestic challenges. European companies, like a large Dutch semiconductor equipment maker, have also made significant investments in Taiwan. A Chinese attack on Taiwan would lead to the closure of the Straits of Korea/Japan, disrupting semiconductor trade and effectively signaling the end of globalization. All of this makes China's invasion of Taiwan an extremely low probability event.

Tech Rivalry

Semiconductors, the most traded goods globally, are at the heart of the U.S.'s efforts to hobble China's technological advancement. Last October, Washington imposed stringent multilateral export controls on high-performance semiconductors to China. It also convinced other key players like Japan and the Netherlands to restrict exports of manufacturing equipment for chips, especially those that have military applications or are used in AI and cloud computing, two tech areas where China is lagging. So far, Beijing's response has been limited to a surgical strike against a single, large U.S. semiconductor manufacturer and curbing exports of rare earth metals used in advanced semiconductors, rather than a full-fledged retaliation.

On the other hand, most of the semiconductors manufactured in China fall into the "lagging" edge or mature mode category, which actually have a wide range of applications including automotives, robotics, medical devices, appliances and computers. Building a foundry in the U.S. is 30-55% more expensive than a similar one in China.

The U.S. will continue to ratchet up its rhetoric and China has limitations to retaliate. But, given the complexity and intricate linkages of the semiconductor ecosystem, a complete decoupling will be difficult.

China's muscular foreign policy has strained relations with Western nations, allowing countries like India, Indonesia, Mexico, Japan, Taiwan, South Korea and Japan to benefit. Supply chain diversification away from China is an observable trend, as measured by the decrease in the percentage of total U.S. imports from China since the pre-pandemic era. Although this shift may not happen on a large scale, incremental relocation of certain components to "friendlier" shores is already taking place—and will likely grow.

Is China Investible?

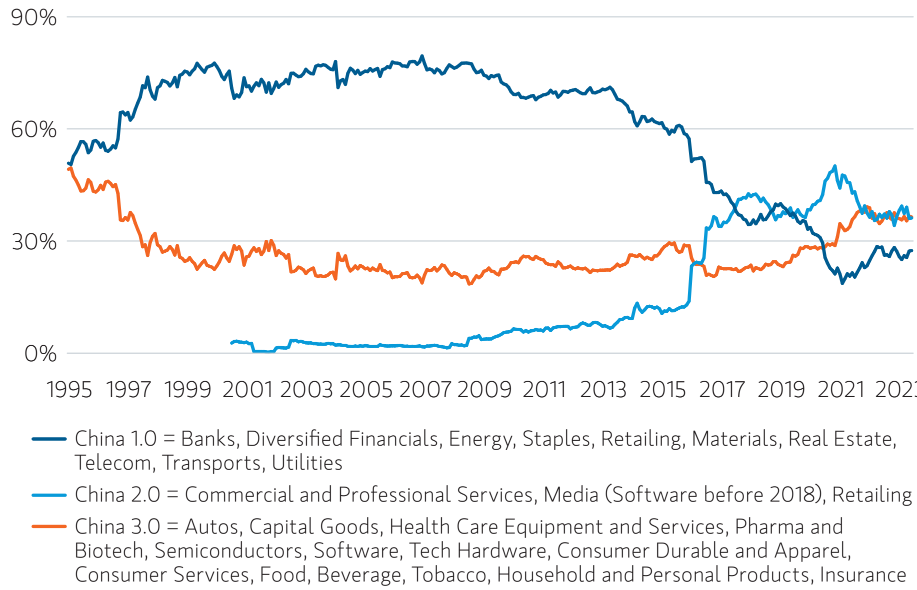
Yes, but very selectively, in pockets of growth aligned with the government's focus on the next generation of new science-based industries. We call this China 3.0, and it includes semiconductors, AI, quantum computing, green tech, biotech and high-end manufacturing, as well as consumer sectors like sports and tourism *(Display 4)*. Xi is advocating for self-reliance in tech and less dependence on the U.S. to localize supply chains. Last year China's National People's Congress approved a plan to spend $1.4 trillion over the next six years to build 5G wireless networks, create smart cities and integrate AI networks to accelerate progress in smart manufacturing. Being on the right side of government policy will be a necessary, but not a sufficient condition for creating shareholder value.

In March 2023, the state-owned asset regulator called on SOEs to align themselves with the nation's economic and political agenda and prepare to compete with multinationals from advanced economies. It is safe to conclude that China's groundbreaking research in semis will be conducted in stealth, away from the gaze of the rest of the world, and will likely not be for the benefit of shareholder maximization.

DISPLAY 4

China 3.0 Is Only a Third of the MSCI China Index

China market share by MSIM classification



Data through: May 31, 2023

Source: MSIM, Bloomberg, Factset, Global Insight

The path forward may lead to the creation of mega-cap conglomerates, a similar approach to the Korean model of developing national champions, like what we saw with chaebols. In South Korea, some large chaebols have close ties with the government and are regarded as key drivers of economic growth. Beijing may adopt a similar economic model in which businesses operate with the blessing of government planners and the state facilitates the creation of new national champions.

Moving forward, it will be tougher for foreign companies to conduct business in China. The recent counterespionage law puts China's security services in charge of cracking down on threats posed by American firms. Any foreign data gathering in China—print, electronic or oral—can be categorized as "espionage." One of China's biggest financial information providers has blocked some users located outside of the country from accessing its data.

Given excessive pessimism, there could be short-term tactical opportunities in Chinese public and private markets. However, lower growth and rising risk premiums in Chinese assets may lead to a secular derating of overall assets and reduced capital flows. Creating national champions may not be enough to get foreign investor interest back. We believe on the one hand Xi needs to focus on policies that reignite animal spirits to revitalize the private sector and stimulate growth. On the other hand, he should temper his inwardly-focused policies and reduce his rhetoric on territorial disputes over Taiwan. Rather than looking to Mao, he should follow in the footsteps of Deng and his market reforms.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. **Asset allocation/Diversification** does not protect you against a loss in a particular market; however it allows you to spread that risk across various asset classes. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. The **commodities markets** may fluctuate widely based on a variety of factors. These include changes in overall market movements, domestic and foreign political and economic events and policies, war, acts of terrorism, changes in domestic or foreign interest rates and/or investor expectations concerning interest rates, domestic and foreign inflation rates and/or investor expectations concerning inflation rates and investment and trading activities of mutual funds, hedge funds and commodities funds.

DEFINITIONS

Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period. **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. It includes all private and public consumption, government outlays, investments and net exports.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of 23 emerging markets.

The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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