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Goldman Sachs Asset Management

Viewpoints

FROM THE OFFICE OF THE CHAIRMAN

CHINA, CHINA, CHINA.

Last Friday, July 1, was the 90th anniversary of the Communist party in China (CCP or CPC as it is now sometimes known) and the government celebrated with quite a fanfare. Not for the first time, I spent quite a lot of time pondering China, its likely future, and its impact on the rest of us.

This is my 30th year in this wonderful business. So, I have been looking at the world professionally for a third of the CCP's existence. For the first decade, I rarely thought about China or their economy. I first visited Beijing in 1990, the year after the Tiananmen Square uprising, some 21 years ago. I have been there endless times since. The change has been remarkable. I recall that there were very few Western hotels to stay at in those days, perhaps the China Wall and the St. Regis. I remember visiting the Badaling section of the Great Wall. At that time, the last third of the journey was essentially on a dirt track and it seemed like quite an adventure. The car I was being driven around in was a rarity on the roads. The biggest challenge facing the driver was avoiding the thousands of bicycles and numerous cart bikes. These days, Beijing's ring roads effectively spread as far as that part of the Wall. And, for a couple of years now, China has become the world's largest auto market.

When I joined GS in 1995, things had already started to change pretty dramatically, and I had developed a regular dialogue with those responsible for foreign investments. Nonetheless, looking back, according to data I can find from the GS ERWIN website, their economy was about $ 350 bn in size at the time. Ironically, this is about the same size as Greece today. Over my near 16 years at GS, China has already overtaken Japan, and this year, its US$ value of GDP will probably grow to above $ 7 trillion. So, in my life at GS, China will have created another 20 of itself. As an aside, as I keep telling people, this is why I can't get too excited about Greece's problems and the world unless it were to lead to substantial contagion. This year alone, China will create $ GDP of more than 3 times the size of Greece, and its import growth is likely to be as big as the entire Greek economy.

Of course, in my old life as Head of GS Economics as well as in my new one as Chairman of GSAM, I am at the forefront of those that have suggested China is likely to become the world's biggest economy, probably sometime in the second half of the next decade. Let me just emphasize at outset that, in my old and current life, I have always been at pains to point out that I have only ever said China could be the biggest economy in the world by 2027, not that it will.

Despite the fact that the country is led by a single party, which holds Communist virtues, if China tracks even close to its current path, then it will become the world's biggest economy in another 16 years or so, with a lot of profound relevance for us all. In fact, the big picture BRIC projections that the GS Economics department undertakes, is currently assuming that China will grow by around 8 pct over this period, which is markedly less than the past 10, 20 and indeed 30 years, which astonishingly has been more than 10 pct on average.

This week, the China Daily, often regarded as the voice of the CCP, has some remarkable facts and figures about their achievements, as well as many interesting statements about their style and aspirations for the future. As also reportedly said by President Hu at the official celebration of the anniversary on Friday, the China Daily includes lots of references to promoting the "socialist market economy" and "social democracy". According to the weekend FT, President Hu mentioned the word democracy 32 times in his speech. That said, most political observers don't expect any radical changes to the form of governance in the near future.

It is a remarkable irony and perhaps the greatest global contradiction of our current lives that the nation that is being driven by a single party can be expected to successfully become so large and much richer. By 2050, the last formal GS BRIC 2050 projections imply Chinese GDP per capita in excess of $50,000, above most countries today, although importantly not as wealthy as most Western economies will be in 39 years. Already contradictions abound. Some studies already claim China has more than 1 million millionaires, which for a nation with an average wealth today of around $6,000, is quite remarkable. The 2011 Forbes study of the world's billionaires concluded that China has just over 300, and in fact, one more than in all of Europe. Some people I know in Hong Kong think that there may already be more billionaires in China than in the US.

So what can go wrong? A large part of me often thinks something is bound to go significantly wrong at some stage, as that seems to happen eventually to every country. That being said, when I focus on the populist views of many, I am frequently comforted by the fact that Chinese policymakers worry even more than everyone else does about their challenges. This comforts me, as usually one should worry a bit more when policymakers don't.

Against this background, I do find myself thinking that once China has reached an urbanization rate of close to 70 pct, some of the populist concerns might be more relevant. I often think that urbanization has been a huge driver of economic growth throughout history and many underestimate its simple powers. According to recent data I have seen, China is currently around 52 pct urbanized. This means that they have plenty still to go and this may disguise some of the ultimate inevitable problems. I have – before anyone sends them to me – seen non-Chinese studies that claim true urbanization is already much higher, but I tend to believe the independent views of the likes of the OECD.

Of the populist concerns, I think urbanization reduces their immediate relevance. The two most common concerns are excessive investment as a share of GDP, and an aging work force. Both of these are problems for China, but only once urbanization is near complete, in my view.

In any case, the 12th 5-year plan, already mindful of both these – and many other – problems is oriented towards boosting the role of personal consumption as a share of GDP. The success of this policy, in particular, is likely to be specifically the most important thing for the rest of us. That's because, if they succeed, the power of their consumption will help to support many of our economies. Of course, as I often write, the evidence of this is only too clear to me already. Just this week, as Premier Wen visited Europe, it encouraged me to check into German export trends with China one more time. This followed news that they had agreed bilateral trade deals in excess of £10 bn with Germany (about 10 times more than the UK agreed!). At the end of last year, China had moved to be Germany's 7th largest export market, and is not far behind the next few. Unless something very odd happens in coming months, by the end of 2011, there is a decent chance they will become Germany's 3rd largest export market, just behind the US, while a bit further behind France. It is possible that, by 2012, and likely by 2013, that they will become the number one export market for Germany. As another aside, this has rather large ramifications for the European Monetary Union, which, as I wrote last week, suggests that the EMU's problems won't get any easier with time.

As another aside, Dirk Schumacher, the GS German economist, told me this week, Germany is already exporting more to all of the BRICs together than to France. This is in stark contrast with the UK, where Ministers focus on the fact that we supposedly export more to Ireland than to the BRICs. I suspect the UK export mix has already changed beyond this, but this demonstrates how far it has to move.

Amongst other "problems", let me briefly deal with four: the one child policy, inequality, house prices and inflation.

As far as the one child policy is concerned, in some urban areas, it already doesn't really exist, as anyone who visits prosperous coffee shops in fashionable parts of Shanghai and elsewhere can see. This is a deliberate experiment, as is the permission to have a second child if your first is a girl.

The inequality issue does strike me as a major policy challenge, especially if the CCP wants to uphold its exact ruling structure as they are inconsistent with its just restated goals. Eventually, those millions not sharing in the China boom, especially at times when inflation becomes an issue, will protest sufficiently to cause problems. Once more, policymakers are more than aware of these problems.

This is why the inflation challenge is currently so important in China and why it was so interesting that ahead of his European visit, Premier Wen appeared to express some confidence that inflation is not going to remain a major problem. I share the views of many forecasts in China and overseas that the second half of this year will see CPI heading back towards 4.5 pct and lower next year. If it doesn't, this will be quite an issue.

The house price issue is amongst many that are relevant and related to the inflation and inequality issues, but of course, it has its own importance too. China would have considerable economic and social turmoil if it really did end up with the kind of property bubble bursting that so many Western economies have experienced. I recently discussed the topic with a Japanese policymaker who is widely regarded as amongst their foremost experts on China and has analyzed the topic. Given that country's past property problems, his general sanguine stance was most interesting. I also happened to meet one of China's leading property business people in London this week and she also seemed quite sanguine. I often reflect back on a trip I made to Beijing in September 2009 when, at the end of a luncheon speech to some mid level policymakers, three of them approached me and asked whether I was worried about a Chinese property bubble. After jokingly replying "I am now", I realized after that, in fact, I could interpret this as a sign that policymakers were highly likely to introduce policies to stop the sharp price rises, which they have done.

I am sure that something will go wrong eventually, but I am not sure what. The weekend FT piece has a wonderful quote from its author Jamil Anderlini who describes the CCP as more like the world's largest Chamber of Commerce, rather than the world's biggest political party.

INVESTING IN CHINA?

Linked to the obvious contradiction to many Western minds, the idea of investing in China just simply doesn't seem attractive. I encounter this frequently in my new life, especially with quite conservative investors and notably in the US. Many reasons are often cited. I recently met another Pension Fund CIO who is not allowed to invest in China as his trustees believe they take American jobs. He asked me what I thought he should do, and I joked, "Get another job." Others simply believe that China will never allow foreign investors to make money. And finally, some cite the fact that the Chinese equity market is the weakest performer of the four BRIC markets since 2000 as evidence, despite the fact that China has created the fastest-growing GDP. This is an interesting fact. It is also true, as two recent GSAM Monthlies showed, that the Chinese market has vastly outperformed the US markets over the past decade. And, most importantly, unlike many other Western and truly still emerging markets, its correlation to the US major markets is quite low.

If China does get close to the 2027 matching of the US, we will all be investing more there, whether we like it or not. Whether it will be indirectly through Western companies taking the exposure for us, or directly in more developed local markets, we shall see. I suspect both.

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