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China's economic growth engine is in a period of transition

Christina Chung, Senior Portfolio Manager at RCM, a company of Allianz Global Investors, gives her outlook on the future of China's economic development:

- **Exports will return to positive growth following the sharp contraction in exports over 2009**
 - **Private consumption has huge growth potential during 2010**

Infrastructure spending underpins economic growth

"With China's economy growing at close to a double digit rate versus about 1-2% growth rate for Japan, China looks set to catch up and overtake Japan to become the second largest economy globally very soon. Assuming that the global economy will grow at a slow rate, exports will not be a key contributor to economic growth in 2010. However, following the sharp contraction in exports over 2009, we should see exports return to positive growth, although at a much subdued pace. The growth driver should come from continued fiscal spending on multiyear infrastructure projects.

Private consumption is a steady performer but takes time to become key growth driver

"Private consumption has huge growth potential and should mean steady growth on the back of rising household income, increasing urbanization and selective policy support. But, the transformation from export-led to consumption-driven growth will be a multi-year process requiring policy reform to enhance social security levels. Per capita GDP grew by 10 times over the past 30 years versus 4.5 times in the US over the same period. If per capita GDP grows at a similar rate over the next 10 years, China's per capita GDP will exceed US\$10,000 by 2018 or about the level of the US in 1978. As an example of rapid growth in private consumption, automobile sales in China have risen sharply and exceeded the US in 2009.

Positive demographic trends

"China will be in a demographic sweet spot over the next five years with a rising share of the population at working age. More people will work, save and consume. The ageing population will become a challenge in the longer term and the Chinese Government may soon need to review its 'one-child' policy. The education standards of the Chinese workforce is also expected to improve over time with the government aiming to increase education expenditure as a percentage of GDP to over 6% by 2010, and over 7% by 2020, versus about 3% in 2001.

Policies to increase consumption

"Policy measures will aim to promote medicine and health system reform with RMB850 billion fiscal funds on health reform for 2009-2011. Another area of focus is efforts to improve retirement insurance and the social safety net and these include setting up a retirement insurance system to cover migrant workers, increasing the benefit payment to enterprise retirees and enlarging the coverage of unemployment insurance.

Financial reform facilitates the development of the services industry

“We expect a gradual opening of the domestic A-share markets to foreign participation through the Qualified Foreign Institutional Investors scheme as well as a relaxation of the Qualified Domestic Institutional Investors scheme that allows Mainland Chinese to invest overseas. This year saw a significant reform by allowing the Renminbi to be a settlement currency for trade in selected cities including Hong Kong.

Policy measures to enhance technology

“Through various tax incentives for industries such as IT, logistics, machinery, automobile and renewable energy, the government aims to enhance technological development. Research and development spending in China is increasing at a rapid rate but it still lags behind most global peers. Chinese exports have taken significant global market share in low-end consumer products in the past 10 years, however, China needs to move up the technology ladder to produce higher valued added exports. In particular, in the area of machinery and equipment, China has the potential to gain global market share.

Gradual shift in corporate culture

“The open door policy has transformed a socialist, planned economy into a capitalist, market economy with the bulk of China’s industrial output now derived from foreign-invested and private enterprises. Companies have also started to provide management incentives to drive corporate profitability. This is a very positive development for equity investors as it aligns shareholders’ interests with that of managements.

Equity market capitalization to GDP ratio is still reasonable

“The current equity market capitalization to GDP ratio is still well below the peak levels seen in Japan in 1989 and the US in 1999. Assuming the ratio remains unchanged and as the Chinese economy expands at a much faster rate relative to other global economies, we would expect China’s market capitalization to grow significantly over time. Chinese equities are still under-represented in global equity indices. For instance, China only accounts for a mere 3% of the MSCI World Index although China is already the world’s third largest economy. It is noteworthy that the market capitalization of the A-share markets is about twice the size of H-shares and Red Chips listed in Hong Kong and the A-share market capitalization is not captured as the A-shares are still effectively closed markets. The non-convertibility of the Renminbi is another problem. While we do not expect global equity indices to reflect the A-share market capitalization anytime soon, we would expect a gradual increase of China weighting in global equity indices, as the A-share markets gradually open to foreign participation, an increase in dual listings between A-shares and H-shares with the latter being captured by global equity indices as well as a faster rate of expansion in market capitalization reflecting the stronger relative economic growth of China. Global liquidity flow also favors China as capital is usually attracted to countries with undervalued currencies.”

- Ends -

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Photographs

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http://www.rcm.co.uk/press/04_fundmanagers.html

Awards

- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, Co-CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.
- Allianz RCM Global EcoTrends Fund named winner Best Climate Change Investment fund 2008, by Holden & Partners/ Incisive Media.

About RCM (all data source: RCM as at 30/09/09)

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