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CHINA: THE GREAT DISRUPTOR OF OUR TIME

As China's economic development enters a more sophisticated and mature phase, it is beginning to challenge many of the status quos that have been taken for granted since the middle of the 20th century. With its large domestic market and huge savings pool, China does not simply follow the rules. China and its companies are becoming increasingly competitive, disrupting many long-established norms by leveraging various competitive advantages such as economies of scale, product differentiation and erecting higher barriers to new entrants.

I have previously written about investing in China and why it is crucial that investors take a balanced and comprehensive long-term investment view (see 'Capitalising on the Pacific Decade: Taking the long-term view on China'). As each year passes, I become more convinced that China is the great disruptor of our time and that its companies are quickly becoming competitive threats in many industries. In our view, investors can no longer afford to ignore China and the influence it is having on global markets.

China's economic rise differs from other Asian nations

China joined the World Trade Organisation (WTO) in 2001, marking the start of closer integration into the global economy and leading to years of explosive GDP growth. Between 1999 and 2013, China GDP grew by 8 times. In 2000, there were 25 million families in the middle income bracket in China; now there are 250 million, a tenfold increase[1]. China's economic success since 1980 parallels similar growth stories of Asian economic achievers, such as Japan, Korea, Singapore and Taiwan. The abundance of cheap labour drives export-oriented manufacturing. Very high savings rates generate a large pool of investment capital, while financial repression with regulated low interest rates, a managed undervalued exchange rate system and capital controls all favour reinvestment of that capital in the domestic economy. Other factors that contribute to early success are land subsidies, lax environmental regulations and labour laws favouring manufacturers.

However, there are increasingly noticeable differences between the success stories of Asia's economic achievers and China's trajectory. In our view, this may result in a higher likelihood of global industry titans emerging from China than we have seen with other Asia Pacific nations.

China's aggressive infrastructure investment has led to increased efficiency in manufacturing, transport and the logistics required to move goods to overseas markets. For example, China's national highway system grew from 5,000km in 1997 to 112,000km (half of the US's inter-state system) by 2014. Shanghai, which in 2000 was the 19th-largest port in the world, now houses the globe's largest container port, bigger than the next six countries combined. This increase in infrastructure has also promoted urbanisation, providing the labour to feed China's growth. Going forward, China is championing the 'One Belt One Road' initiative, which involves financing infrastructure in 65 countries in order to improve trade throughout Asia, Africa and Europe. Together these countries account for 60% of the world's population, giving rise to the possibility of even greater global trade ties and economies of scale.

In addition, the sheer size of China's domestic market dwarfs other nations. The US's large domestic market is one reason often cited for the dominance of American enterprises since the mid 20th century. In terms of economic development and gaining advantage from economy of scale, size does matter. By tapping the immense domestic consumption market, Chinese companies are emerging as global competitors in many industries, especially as GDP per capita rises above the USD 12,000 hurdle which enables many middle income consumers to afford cars and larger purchases. Given the size of the market, there is also fierce competition among domestic players. This assists the best companies in honing their skills to achieve dominance on the national stage before they emerge to compete on the global scene. This domestic competition is what assisted US companies to grow into multi-nationals in the last century.

China also pursues an industrial policy which is inherently anti-competitive towards foreign makers in favour of domestic companies. This is not a new concept, of course. All Asian countries have practiced something similar in the early years of industrialisation (e.g. car imports, protection of key industries, capital controls). However, the difference is that China is quite explicit about its mercantilist and protectionist tendencies. What is unique to China is that by taking advantage of the size of its domestic market at the same time as being protectionist regarding that market, in many cases it has formulated its own unique standards to create further barriers to entry—e.g. the bankcard monopoly in UnionPay, the TD-LTE telecom standard championed by Chinese makers and internet censorship. With such tactics, China either blocks out global competitors or forces them to compete according to China's own rules.

Competitive barriers are erected in two ways. Firstly, explicit trade rules or alternative standards for an industry are set up to disadvantage foreign players; secondly, national champions or self-selected domestic players are bestowed with competitive advantages to succeed in the domestic markets. By the time other nations complain about it, it's already too late.

China is the great disruptor of this century

At their heart, we believe that China’s many anti-competitive policies are designed to challenge the status quo established by the US as it expanded its sphere of influence following World War II. With initiatives such as the Asian Infrastructure Investment Bank (AIIB), ‘One Belt One Road’, Regional Comprehensive Economic Partnership (RCEP), and the leadership role it is taking on climate change, China's geopolitical ambitions are very clear.

China is not afraid to challenge the US and the many status quos it has established in various industries because of its size, ambitions and abundance of capital. Furthermore, the country's lack of a past economic model and relative freedom from established interests that the government needs to protect or placate, enable it to leap into the latest innovation. This 'leapfrog effect' may explain why smartphones are supplanting landlines faster than in any other country. With its population of 1.4 billion, China has the largest internet user base in the world. This base enables the emergence of domestic smartphone brands, taking market share from Apple and Samsung. We are seeing similar swift take-up in internet adoption, e-commerce, artificial intelligence (AI), fintech, online payments, big data and other disruptive technologies.

In fact, it would seem that the Chinese government encourages adoption of new technologies because Beijing views technological disruption as an opportunity for a rising young economy like China to supplant the existing world order. This has seen China substantially increase its research and development (R&D) spending over the past 15 years, with JCI[2] noting that China’s R&D budget is now 75% of that of the US, rising from only 12% in the year 2000. In our view, one area to watch in this regard is electric vehicles (EVs). China may be instituting the highest regulations for EV production for all of its domestic auto makers among the global markets (just as the US is retreating from the Paris Accord). While a few Western governments continue to argue over the existence of scientific proof about climate change from fossil fuels, Beijing is already envisaging the day when the majority of cars in China will be electric and emission-free. With that forward-looking focus, China may be sowing the seeds to help it become a major auto exporter in the world (as well as batteries and renewables).

Investors cannot ignore the increasing influence of China

China’s economic rise has, up until now, largely followed an expected pattern, especially after joining the WTO and the rapid globalisation from free trade. However, due to the size of its economy and different philosophy from the US, China is the first economic power big enough to start threatening the status quo. In challenging the Asian Development Bank (ADB) over infrastructure lending to Asia, the International Monetary Fund (IMF) over the reserve currency status, or regional influence over its ‘One Belt One Road’ plan, China has proven to be much more audacious, innovative and future-focused than many expected. Its diplomacy, political ambitions and industrial policy (China 2025) are all coherently articulated and mutually reinforcing.

What are the implications for investors? If China successfully leaps over the 'middle income trap' and is able to push its GDP per capita to the minimum level required for an OECD country, then China’s middle income consumer segment would be 2-5 times that of the US and EU markets combined. If the ‘One Belt One Road’ initiative is successful, Asia will constitute 50% of the global middle class by 2020 and 66% by 2030[3].

Even on a more conservative assumption, it is clear that the Chinese consumer will become an increasing target for global brands, while Chinese brands will become increasingly influential outside the domestic market. As China's consumers begin to influence the tastes of everything from cars to movie-making to food production, the biggest producers of consumer-oriented goods will likely be forced to adapt and cater to this immense market.

Up to now, China’s influence on global investors has concentrated on macro factors, especially in the commodities sectors. This new thesis is that, with China being the great disruptor in many industries, its influence on the supply and demand of consumption patterns will begin to exert influences at the microeconomic level. For stockpickers, therefore, not following China may pose a real risk in the future. Many currently unknown companies in China are quickly becoming competitive threats in various global industries. Even if they don't care to invest in China, any globally minded investor should be aware of Chinese competition and prepared for China's disruption in many industries.

1. Gavekal Research, ‘Growth Slows, Affluence Accelerates’
2. JCI Insight, ‘Globalization and changing trends of biomedical research output’, https://insight.jci.org/articles/view/95206/table/2
3. OECD Development Centre, ‘The Emerging Middle Class in Developing Countries’ by Homi Kharas

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