Chris Horan, Financial Advisor

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RSP Reminder

The deadline for 2004 RSP Contributions is Tuesday, March 1st, 2005. The limit is $15,500 for the 2004 tax year and for 2005 it rises to $16,500. (Please call Barb McKenzie to make arrangements!)

Your personal limit is on your Notice of Assessment from your 2003 Tax Return; your contributions to-date are on your Assante RSP statement.

Phone Reminder

Please note that we now have direct phone lines so rather than go through reception, call us directly at:

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China: Dragon Awakening?

China has been getting a lot of attention recently. This newsletter will try and summarize some of the major issues and estimate their impacts for investors. The essay also builds on my last newsletter, 'Myth of Offshoring' (please email or call me if you'd like a copy)

China's transition to the modern world began with the leadership of Deng Xiaoping in 1978. Deng liberalized trade by dropping import tariffs to the lowest in the developing world, encouraged foreign direct investment, and began the infrastructure projects such as the Three Gorges Dam and the modernization of the cities. These policies have resulted in economic growth of over 9% per year, a rate triple that of the developed economies.

Even with such rapid growth, China's economy is still only 1/10th that of the United States. Because China's economy is spread over its population of 1.3 billion people, China's income per person (Gross Domestic Product or GDP to economists) is only US $900 today, compared to US $22,000 for Canada or US $35,000 for the United States.

However, the immense population means that even with such low income per person, China now ranks as the 6th largest economy in the world, ahead of Italy and almost 50% larger than Canada, at current exchange rates. If you adjust exchange rates to account for different buying power between countries, (known as Purchasing Power Parity or PPP) China is the 2nd largest economy in the world today, and its income per person is about 1/8th the US).

China is the world's 1st or 2nd (to the US) largest consumer of steel, copper, coal, lead, zinc, aluminum, and cement. China consumes 40% of the coal and 30% of the steel produced in the world today. China's oil demand has doubled over the past 10 years, was up 15% in 2003 alone, and is now second only to the US, as reported in the Economist's 'World in Figures'. China's foreign trade increased 40% in 2003 alone, according to Goldman Sachs.

So China is already a very large beast even though its income per person is very small. When you modernize a very large population from a very low starting point, the numbers really do boggle the mind.

For instance, China's income or GDP per person is now about 1/8th that of the US (at PPP). If China's GDP per person were to increase to just ½ of America's, and it took the next 50 years to do it, the *annual* increase would be the equivalent of the entire Canadian economy. That's like adding a whole Canadian economy to the world every year, for the next 50 years.

Or take oil consumption: South Korea's energy consumption per person today is about half that of the US. If China's energy consumption per person were to rise to South Korea's levels, the *increase alone* would be greater than the entire annual oil consumption of the US today.

Growth of this magnitude is entirely plausible: it would require an annual growth rate of about 5%, which is only about half China's growth rate of the last decade or so. South Korea and Taiwan each maintained annual growth rates of 8% for 40 years, according to The Economist.

The really exciting part of all this is that China could boost world economic growth from its long term average of about 3% per year to 4% /yr. This may not seem like much, but it would double world income in only 18 years rather than 24.

This will be a good thing. Like any modernizing economy, China will sell us low-priced, labor-intensive goods, and will buy higher value goods and services from us.

The Economist estimates that if China grows at 8% per year and its income distribution across its population remains similar to today, by 2020 China will have 100 million households with income equivalent to Western Europe. So they'll be able to afford a few Porsches.

Canadian consumers will also benefit from lower prices in labour-intensive goods, like clothing and furniture.

The real question is: will China stay on the modernization track?

My view is that the cat is out of the bag: the Chinese won't go back to the rice paddy, after they've seen gay Shanghai, (to borrow the old expression). Enterprise and commerce seem to be well-established behaviors in Chinese culture.

The current Chinese leadership has quickly adopted economic policies that are very open to international trade and domestic commerce. The result will likely be rapid modernization and growth.

In my opinion China probably won't fall into the chaos that has consumed Russia. The reason is in history: the Chinese have 2000 years' experience with a highly competent bureaucratic class that kept things humming as the emperors came and went. Russia has no such experience.

However, it won't be smooth sailing. China will not be immune to recessions, for example. The Chinese authorities are talking today about slowing down the growth – who knows if it will be a hard or soft landing?

The Chinese do not have a banking system to allow capital to be invested efficiently. They also lack a legal system to back up agreements over long periods of time. Banks, contracts, patents, and private ownership are keys to long term progress.

Our modern economy is a fantastically complicated mechanism that has taken hundreds of years to develop, and you can't just start one up with a wave of your (Communist) hand.

There will be social and political strains as well. Enterprise and commerce are driven by individual decisionmaking, which in turn encourages personal liberty. Individuality and liberty are not things that Communists do well.

So the long term success of China is not assured. One well-known manager of an emerging markets fund said, emerging countries 'may go back where they came from'.

So, although there is the potential for a virtuous circle, in my opinion, there are many uncertainties, and we should be careful not to indulge in growth fantasies. The tech bubble taught us that lesson (again).

Specific impacts to Canadian investors will likely include continued strong demand for our natural resources. Because we are a resource-exporting nation, our currency will continue to be strong. One very good benefit of a strong currency is that interest rates can stay lower than they would otherwise be.

My advice is to not go changing your portfolio mix all around to try and capture the various 'China themes'. My client portfolios have already been positioned to benefit from the long term global growth that China may contribute to. For example, we have been adding resources funds to client portfolios for several years now, so we've captured much of the short term impact already.

The broader point is that we should have confidence in our economic future. The successful modernization of China will drive growth globally through trade. Trade with other nations is proven by history as the route to improved standard of living for all who participate.

Growth and progress improves our standard of living, which provides the means for us to do more research, reduce disease, improve our environment, and contribute to those less fortunate than ourselves.

We should invest, as always, by searching the world for value, buying confidently when optimism is at its lowest, and not being caught up in the fads or panics of the day.