



“The Times They Are a-Changin’”

There is much debate about the focal point of Bob Dylan’s 1964 epic tune “The Times They Are a-Changin’.” Some have characterized it as a protest vehicle filled with calls for revolt, amid the backdrop of political and racial upheaval that marked the 1960s. Others, including Dylan himself from time to time, have downplayed those interpretations and focused more on the tune itself and the feeling it evokes, rather than a specific message embedded therein. Perhaps the true strength of the song is in its ability to have meaning across groups and ages – such that hippies of the 1960s and Republicans of the 1990s each felt equally at ease in using its lyrics to define their movement.

Whatever Dylan’s purpose at the time, I think it’s relatively safe to say that he didn’t have economics in mind at the time he penned the song. Nevertheless, I keep returning to it when thinking of global financial markets today. In the third quarter of 2007, we witnessed many notable financial market events – the near collapse of shadow financial systems, widespread liquidity injections by central banks, sharp currency depreciations, AAA-rated bonds trading at 85 cents on the dollar, and a run on banks. Each of these ills occurred in so-called developed economies, not in the *emerging* economies that usually are associated with such crises. In fact, in developed economies, investors and corporations were rumored to be turning to emerging-economy agents for financial support during this time.

How times have changed. EM countries, through their current account surpluses, now constitute the bulk of the world’s net *savings*. Work done by the PIMCO Emerging Markets forum team suggests that emerging market economies accounted for 70 percent of the incremental increase in global *consumption* denominated in U.S. dollars in 2006. And the most recent World Economic Outlook produced

by the IMF highlighted that, for the first time, two emerging markets – China and India – are making the largest country-level contributions to global *growth*. But with these positive changes in EM have come imbalances that threaten to derail the high-growth, low-inflation period the global economy currently enjoys.

What are the prospects for investing in emerging markets as the developed world backdrop clouds over? The natural place to begin to look for an answer – and a new anchor for the global economy – is China.

My former, and soon to be new colleague, Mohamed El-Erian, used to describe China as a country whose development was bi-polar, part resembling Europe and part more akin to Africa. The future reconciliation of this dichotomy, within a country that holds the world’s largest population, makes China a keystone to the global growth story. Our most recent assessment visit to the country offered a fascinating on-the-ground perspective of this evolution, with both encouraging and worrisome signs. Our key take-aways from meetings with members of the private and public sectors, in both the more developed coastal cities and the developing hinterland, include:

- 1) The urbanization movement in China is still nascent and provides a platform for rapid long-term growth, particularly in consumption;
- 2) Wage pressures in China’s manufacturing sector seem to be a non-issue;
- 3) The focus of Chinese policy continues to be managing overheating risk, rather than mitigating downside risk from a U.S. spillover;
- 4) The twin bubbles in equities and coastal real estate are a natural result of foreign exchange policy that has pumped liquidity into the system and produces misallocation of resources;

- Asset bubble risks (point four) do not seem to be large enough yet to derail momentum from the other supportive factors (points one through three).

“Gather Around People Wherever You Roam...”

Key among the secular trends in China is the massive urbanization movement that has been promoted by the government and influences economic policy. As Table 1 below shows, developed countries tend to run urbanization rates of between 65 percent and 90 percent, with Japan at the low end of this range and Korea, the U.S. and the U.K. each above 80 percent.

China’s urbanization rate stands at roughly 44 percent today. Government officials indicate that their goal is to increase urbanization by one percent each year to a long-run target of 70 percent. These numbers are staggering when put into perspective. Consider that:

- China’s current population (at 1.3 billion) is four times that of the U.S.;
- China has 24 provinces with a population of at least 20 million people, while the U.S. has only two states (California and Texas) that fall into this category;
- China’s most populous city (Chongqing at 31 million people) is four times more populous than New York City and is considered in many circles within China to be a “second tier” city¹;

- the targeted one percent increase in the rate of urbanization per year (for the next 20 years) would mean 13 million new city dwellers a year, more than a new New York City population injection every year.

This increase in urbanization should have some meaningful effects on the consumption dynamics in China. The service sector, though already constituting roughly 70 percent of new employment in China, should continue to grow in its contribution to GDP from roughly 40 percent today to a number closer to the world average of roughly 50 percent over time. This should continue to support urban residents’ per capita income, which was 3.3 times that of rural residents in 2006. Generating sufficient, stable long-term growth to create the jobs necessary to employ this massive influx of workers each year is an obvious challenge. Estimates are that each one percent of growth per year produces roughly 800,000 new jobs in the Chinese economy – meaning that the economy needs to grow at double digit rates to generate the jobs needed each year from this move to urbanization. Suffice to say, these types of numbers are not lost on Chinese policy makers.

“The Loser Now Will be Later to Win...”

How to generate the employment and rapid growth necessary from the dynamics above? Well, one way is to pursue a mercantilist strategy that keeps export industries competitive through an undervalued exchange rate.

Comparison of Urbanization Trends (%)

Year	China	Korea	Japan	U.K.	U.S.	Thailand	Malaysia	Philippines	Indonesia	India
1950	12.5	21.4	34.9	79.0	64.2	16.5	20.4	27.1	12.4	17.3
1955	14.2	24.4	38.9	78.7	67.2	18.0	23.4	28.7	13.5	17.6
1960	16.0	27.7	43.1	78.4	70.0	19.7	26.6	30.3	14.6	18.0
1965	17.6	32.4	47.4	77.8	71.9	20.2	29.9	31.6	15.8	18.8
1970	17.4	40.7	53.2	77.1	73.6	20.9	33.5	33.0	17.1	19.8
1975	17.4	48.0	56.8	82.7	73.7	23.8	37.7	35.6	19.3	21.3
1980	19.6	56.9	59.6	87.9	73.7	26.8	42.0	37.5	22.1	23.1
1985	23.0	64.9	60.6	88.6	74.5	28.1	45.9	43.0	26.1	24.3
1990	27.4	73.8	63.1	88.7	75.3	29.4	49.8	48.8	30.6	25.5
1995	31.4	78.2	64.6	88.7	77.3	30.3	55.6	54.6	35.6	26.6
2000	35.8	79.6	65.2	88.9	79.1	31.1	60.8	58.5	42.0	27.7
2005	40.5	80.8	65.7	89.2	80.8	32.5	65.1	62.6	47.9	28.7
2006	43.9									
2010E	44.9	81.9	66.8	90.1	82.3	34.0	71.8	66.4	53.7	30.1
2015E	49.2	83.1	68.2	90.6	83.7	36.2	75.4	69.6	58.5	32.0
2020E	53.2	84.2	69.8	91.1	84.9	38.9	78.1	72.3	62.6	34.4
2025E	56.9	85.2	71.7	91.6	86.0	42.2	80.2	74.6	65.9	37.3
2030E	60.3	86.3	73.7	92.2	87.0	45.8	81.9	76.7	68.9	40.7

Source: BOC International, Population Division of the Department of Economic and Social Affairs of the United States Secretariat

Table 1

This strategy, however successful in the short term, can produce some major economic distortions and foster a misallocation of resources – but we'll get to this later in more detail. For now, let's just focus on whether Chinese firms can compete without the subsidies afforded by an undervalued currency, which is a natural question that arises when considering the scope for future exchange-rate movement. The answer depends, in part, on China's ability to increase the productivity of its workers, with figures suggesting gains in this area of 19 percent per annum from 1999-2006. Another part of the answer stems from the current wage differential Chinese firms enjoy.

On the latter point, we found little evidence from our trip that wage pressures are an issue in China. On the contrary, managers we met with in Chongqing indicated a continued abundance of available workers both at the unskilled and university graduate levels. To frame the point from a wage perspective, we surveyed a steel producer and an auto parts manufacturer and came away with the following information:

- New employees at the university graduate level generally receive wages of \$130-200 USD equivalent a month, while unskilled rural workers generally get paid \$80-120 USD equivalent a month.
- Housing is subsidized, in some cases through a program whereby the employee is compensated for 50 percent of his housing expenses (a modern two bedroom apartment in Chongqing rents for roughly \$70 USD equivalent a month – split among two employees each receiving the 50 percent subsidy would mean net monthly \$17 USD equivalent in rent per occupant). In other cases, companies offer low-cost housing onsite that costs roughly \$1.50 USD equivalent a month.
- Ten years ago, Chinese wages were roughly one quarter of today's levels, and five years ago compensation was around 60 percent of today's level – indicating annual wage increases of roughly ten percent. Even so, hourly wages today for a new university graduate in the manufacturing sector come out to be roughly \$1.25 USD/hour, with unskilled labor earning just up \$0.75 USD/hour.

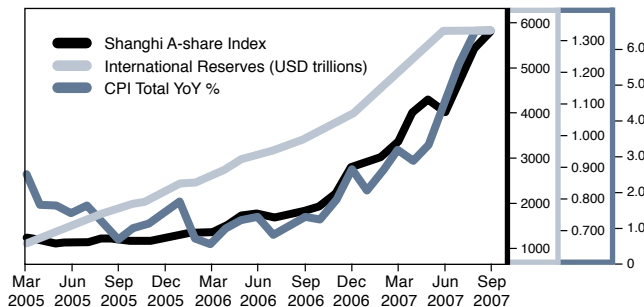
With relatively low wages, abundant labor and healthy productivity, threats to China's competitiveness appear to be a long way off.

“The Waters Around You Have Grown...”

What about the potential for economic distortions or misallocation of resources? As the Chinese economy accelerates, with real GDP registering 11.5 percent growth in the third quarter of 2007, signs of the abundance of liquidity are everywhere in China. As illustrated in Chart 1 below, consumer price inflation has picked up substantially, and asset price inflation has been notable with stock markets and real-estate prices soaring. At the same time, international reserves have hit uncharted territory as the trade balance and current account record massive surpluses. With real interest rates on deposits still substantially negative and inflation picking up, it's no wonder that money is pouring into equities, sending Chinese stocks up 170 percent on the year, pushing P/E ratios above 40 times, and catapulting five companies into the top ten of the world's largest in market value.

Policymakers have continued to implement a wide array of tightening measures to safeguard against overheating. Reserve requirements on the banking system have been raised nine times, and by a cumulative 500 basis points in the last 18 months², while the one-year lending and deposit rates are up roughly 125 basis points over that same time period. To alleviate asset-price inflation pressures, the government has employed administrative hurdles in the real estate market, searched for an equity pressure-release valve in the equity markets in Hong Kong, set up the China Investment Corporation to diversify reserve investments³,

Chinese CPI, Reserves, Equities



Source: Bloomberg

Chart 1

and attempted to alter the competitive balance of various export industries through changes in taxes. These measures, however, have had limited success.

“The Slow One Now Will Later Be Fast...”

What to do? It is becoming increasingly clear that a faster pace of appreciation of China’s currency – yuan (CNY) – is a necessary and appropriate policy response. China’s economy has shown no ill effects from the 10 percent CNY appreciation since the July 2005 de-peg, with growth and trade significantly stronger now than two years ago. Furthermore, market expectations are already in place for an additional seven percent CNY appreciation over the next 12 months, and conversations with technocrats suggest that the private sector is comfortable with accelerating the 5.5 percent appreciation seen over the last 12 months. From an economic perspective, a stronger CNY would help reduce the trade surplus, ease pressure on inflation, mitigate speculative purchases of onshore assets, help the central bank gain monetary credibility, foster proper allocation of investments, stimulate domestic demand, rebalance the economy, and disarm protectionist tensions with the U.S. and Europe (the latter a growing concern, given that EU is now China’s number-one trading partner and the CNY has significantly depreciated against the euro over the last year). At the same time, the sterilization costs of heavy currency intervention will grow as interest rates in China rise, while those in the U.S. fall⁴. Finally, any concerns of a growth slowdown from the stronger CNY easily could be offset by expansionary fiscal policies, particularly targeted infrastructure and social investment.

Bottom Line

The Chinese economy is anchored by powerful urbanization trends and still-supportive labor dynamics that suggest continued strong growth over the long term. At the same time,

the secular decline of the USD – called for by PIMCO, and a major story in financial markets over the past two years – is set to continue due to large deficits in both the U.S. fiscal and current accounts, weakening growth dynamics in the U.S. and deteriorating interest-rate differentials. The brunt of the USD decline has, thus far, been borne by the euro, as its standing as a true floating currency in the developed world has made it the de-facto release valve in the global economy for USD pressure. Massive intervention from China has suppressed the appreciation of its currency, and of others in the region, as it sets the bar for competitive foreign exchange policy in Asia.

The times, however, have changed. China’s own interests are now aligned with an accelerated pace of currency appreciation, and we expect the CNY to advance at a rate consistent with or exceeding the seven percent implied by the currency markets today. This argues for shifting exposure away from the Eurozone, over time, and to Asia, as a stronger CNY clears the way for further advances in non-Japan Asian currencies. Furthermore, it argues for increasing allocations to emerging-markets assets, as the strong pace of global growth – anchored increasingly by China – should assume a more stable and lasting dynamic as global imbalances unwind.

Michael Gomez
Executive Vice President

¹ Chinese cities are considered tiered, based on per capita income, with Tier 1 considered high income (roughly \$4,200), Tier 2 middle income (roughly \$1,700) and Tier 3 low income (roughly \$1,100).

² The increase in reserve requirements has not been binding to this point as bank’s reserves are still generally above these newly mandated levels.

³ Creating China Investment Corporation in and of itself does not alleviate asset price inflation, but may reduce the cost of sterilization.

⁴ For more information on emerging markets reserve accumulation and the costs thereof, please reference Paul McCulley and Ramin Toloui’s November 2007 Global Central Bank Focus entitled “Perils of Plenty: Can Foreign Reserves Grow Forever?”.

The products and services provided by PIMCO Canada Corp. are only available in provinces or territories of Canada to investors who are accredited investors within the meaning of the relevant provincial or territorial legislation or rules and in certain provinces, only through dealers authorized for that purpose.

Past performance is not a guarantee or a reliable indicator of future results. Investing in non-U.S. securities may entail risk as a result of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets. Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

This article contains the current opinions of the author but not necessarily those of the PIMCO Group. Such opinions are subject to change without notice. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. © 2007, PIMCO. EMW043-110207

P I M C O

PIMCO Canada Corp.
120 Adelaide Street West
Suite 2005
Toronto, Ontario
Canada M5H 1T1
416-368-3350