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INVESTMENTS

The Rise of China: An Eyewitness Account

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OVERVIEW

- China has changed dramatically over the last 60 years.
- Even with tremendous economic growth, the Chinese government has been careful to avoid a bubble forming.
- The government is unlikely to reduce credit availability extensively, so as not to hamper its growth rate targets.
- The Chinese people have worked hard, saved and suffered, and they have succeeded in creating a much better China today. But the job is not over.

FLASH INFO

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On October 1, 2009, China will celebrate the 60th anniversary of the founding of the People's Republic of China.

THEN AND NOW

Since the 1960s, Hong Kong has been like a home to me and in the frequent visits I made to China things have changed substantially, particularly from the days of the Cultural Revolution. I feel very excited to be a witness to this kind of dramatic change. Twenty years ago, I remember being in Beijing and noticing its very high pollution. That has changed because the Chinese are beginning to clean up their environment by moving or closing smoke-emitting factories and introducing a number of other pollution-control policies. The other big change from those times is that in those days we could cycle all over cities like Shanghai or Beijing, since there were very few cars at that time. Now, it's just the opposite—there are far more cars than bicycles. That gives some indication of how things have changed and how the standard of living in China has changed over the years.

TREMENDOUS GROWTH

China has witnessed tremendous growth so far—for example, despite the global economic slowdown, according to the International Monetary Fund, the Chinese economy is expected to grow by 8% in 2009. With such strong economic growth coupled with money supply growth of around 20% on an annualized basis, there is naturally the potential for bubbles to form in any kind of market, whether it is the property market or the stock market.

Indeed, the stock markets in China have risen substantially this year and are much more expensive than some other markets in the world, but I believe they are not exceedingly so. The government is quite aware of the possibility of overheating and has been watching the situation carefully. From time to time, when the markets appear to be getting out of hand, the government takes certain measures to prevent a stock market bubble from forming, such as increasing the stamp duty or restricting capital going into the market.

The same thing is true of the property market. There may be some signs of overbuilding in certain areas, but the Chinese people's desire for homes or apartments and their desire to upgrade their living standards means that there is likely to be a continuing demand for good housing. For example, up to now, real estate development has been concentrated in coastal cities such as Shanghai, Shenzhen and Guangdong, but now the activity is moving inland to cities like Chongqing. Many of these inland cities need substantial infrastructure, including subways, roads, power stations, parks, and adequate housing. The building of this infrastructure is well underway as witnessed by numerous construction sites.

In terms of industrial production, many industries in China currently have excess capacity, and some of that capacity—approximately 10% of total capacity—will probably count as wasted capital. This is particularly true in the construction, mining, machinery and automobile industries. Nevertheless, I believe a number of companies in these sectors will continue to grow and stay profitable, and could even purchase other companies that have excess capacity. Meanwhile, I see the strongest growth in extractive industries such as oil exploration and production as well as in the consumer products area.

Recently, talk of the Chinese government looking to reduce credit availability to prevent overheating led to concerns that such policy tightening measures might have an impact on short-term growth prospects. If the Chinese government decides to reduce credit availability extensively, that will certainly have an impact on growth in the country. As I mentioned before, China is looking at about 8% growth this year, and its government wants to maintain this high growth rate going forward. So I doubt that the Chinese government would restrict credit too much, because this would have an impact on the growth rate. I believe that while the Chinese government will be careful to prevent bubbles from forming, it probably would not want to reduce economic growth by restricting credit availability too extensively.

DEPENDENCE ON THE U.S. CONSUMER

Some investors may express concern that China's exports are significantly dependent on the U.S. consumer, and that China may therefore be impacted by the economic slowdown in the U.S. However, of China's total exports, the percent going to the U.S. has decreased substantially over the last decade and is now around 18%¹, while their exports to other parts of the world are increasing as we speak. Europe is one big market for Chinese goods, but emerging markets are also rising in importance.

In an extreme scenario, if the U.S. consumer stops buying absolutely and does not import from China at all, China of course will be affected, and during the recent financial crisis, we've seen some of that impact. But the numbers clearly indicate that China's exports are not totally dependent on the U.S. consumer—by a wide margin. Recent numbers indicate that exports to the U.S. from China are beginning to recover.

In addition, I believe the domestic consumer in China will increase in importance as exports decrease in importance, when it comes to contribution to total gross domestic product (GDP). The country has a huge population of over

one billion people, and I don't see any substantial reason why China cannot sustain high economic growth led by the growth of domestic consumption rather than export-led consumption.

CHINA'S SUCCESS

Today, China is widely viewed as an economic success story, and in my opinion, the reason for this success is really with the Chinese people. They have worked hard, saved and suffered difficulties since the Revolution. Now they have risen from those problems and challenges, and I believe they have created a much better China than we saw in the past.

I continue to believe that the investment prospects and long-term outlook for China are excellent for a number of reasons. (1) Chinese leadership is intelligent, resourceful and enlightened, with an interest in maintaining growth with a better standard of living for all Chinese; (2) that leadership has the organizational skills and policies capable of ensuring that China continues to achieve the highest GDP growth of any major country in the world; (3) China has the financial resources to undertake this gargantuan task with the world's largest store of foreign reserves; (4) China has one of the healthiest banking systems in the world, where most individuals have little borrowings; and (5) inflation and interest rates in China remain relatively low, while investment in infrastructure continues to boom.

Meanwhile, China is also playing the role of a significant importer in the global market, particularly when it comes to natural resources and commodities. The buying of natural resources not only caters to growing internal demand in China, but also serves as a hedge against dollar depreciation. I believe that the Chinese will continue their policy of accumulating foreign exchange reserves but may do so at a slower pace than before.

The new credit facilities extended by the government over the past year will probably be used by households to improve their standard of living—poorer households are likely to spend it on disposable products and appliances, while wealthier households are likely to purchase cars, new apartments and houses, and education for their children. But we must remember that the job of increasing disposable incomes is not over. There is still a lot to be done in terms of raising the standard of living—particularly in the rural areas—and also confronting the new and different challenges that come with an industrialized society.

¹ Source: National Bureau of Statistics of China

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