Economist Intelligence Unit
The Economist

Corporate Network

China: the business outlook

Part two:

The economy: trends and threats

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Contents

China: economic outlook – strategic (1)

- The rate of growth of China in the last 25 years has been the most rapid and sustained in human history
- The city of Chongqing is growing 8 times faster than Chicago in 1850-1900 (the fastest growing US city)
- China's economic development has gone through these stages since 1949:
  - Decay and collapse from 1949-1979
  - Reforms from 1979; rapid growth in agriculture and then industry
  - Economic bust in 1988-89; renewed pick up in 1990s
  - Downturn in 1998-2000 in the wake of the Asian crisis
  - Booming growth 2000-2008
  - Outlook of 10% growth per annum for next 5 years

China: economic outlook – strategic (2)

- China needs to create 24mn jobs each year just to stand still on employment
- 20% of the world's population finds itself on 7% of the world's surface
- Even when China grows at 10% it only creates 20mn jobs
- Little wonder that the regime wants big growth and is irritated by advice to revalue currency which could threaten this growth
- Job creation is a key driver to the economy
- In order to create 24mn jobs (just to stand still on employment) China uses the following model:
  - creates jobs in manufacturing for exports
  - subsidises this production by keeping utility and input prices down for factories

China: economic outlook – strategic (3)

- This entails endless output which:
  - boosts commodity prices
  - clogs the global logistics network
  - produces so much output that even western consumers may become satiated
- Exports will lag one day and are doing so to the US in 2007-08
- China (and India) has to stimulate larger domestic consumption
- This would better balance the global economy
- There are early signs in 2007-08 of this happening
- As the US economy slows and US consumers buy less (a little less anyway), domestic sales in China rose proportionally
- But this is still early days

China: economic outlook – strategic (4)

- If Chinese and Indians do consume more at home, this eases global trade balances
- But it brings negative consequences in its wake
- Chinese and Indians now eat more like two meals per day than one meal a day which sustained them for the last 100 years
- This is excellent news for these people
- But it helps to hike global inflation in 2007-08 as food prices shoot upwards
- It is worth remembering that until 2000 global commodity prices were sluggish
- It has taken China (and other emerging markets) about 5-7 years to drive the oil price through the $100 barrier
- And now food inflation follows

China: economic outlook – strategic (5)

- There will be no big economic policy shifts in 2008
- The regime wants to direct more funds to social welfare and the peasantry
- With the 2008 Olympics, there will be no "rocking the boat"
- Hu Jintao and Wen Jiabao want to tackle poverty and corruption
- But not enough money is getting allocated to the regions because Beijing does not trust local leaderships to spend it properly
- It fears corruption and siphoning off of funds
- Estimated that corruption costs the economy at least $125bn (some 10% of GDP)

China: economic outlook – strategic (6)

- One major problem is that the central government can’t control the economy:
  - exports are still surging
  - over-investment continues
  - colossal amounts of energy are wasted
  - environmental damage is close to catastrophic in many parts of the country
  - corruption is entrenched at all levels of administration
- The banks were in a big mess by the end of the 1990s—cleaning them out and recapitalising them and making them fit for western investors has cost $250bn!
- … enough to build 10 Three Gorges dams (not that you would want to do that)

The economic outlook – key trends (1)

Key indicators

	2007 e	2008 f	2009 f	2010 f	2011 f	2012 f
GDP (% real change pa)	11.4	10.1	9.6	8.9	8.4	8.3
Consumer prices (% change pa; av)	4.8	3.5	3.6	3.7	3.8	3.8
Budget balance (% of GDP)	0.2	0.1	-0.2	-0.3	-0.1	-0.1
Current account balance/GDP	11.3	10.9	10.5	9.8	8.6	7.3
Commercial bank prime rate (%; year-end)	7.6	8.1	7.8	7.6	7.8	7.8
Exchange rate Rmb:US$ (av)	7.61	7.08	6.82	6.55	6.3	6.08
Exchange rate Rmb:¥100 (av)	6.45	6.6	7.09	7.01	6.86	6.62

The economic outlook – key trends (2)

Market outlook

	2007 e	2008 f	2009 f	2010 f	2011 f	2012 f
Population (m)	1,323	1,331	1,337	1,342	1,351	1,360
Nominal GDP (US$bn at market exchange rates)	3,315	4,081	4,855	5,733	6,716	7,846
Nominal GDP (US$bn at PPP)	11,401	12,835	14,405	16,091	17,873	19,834
GDP per head (US$ at PPP)	8,620	9,640	10,780	11,990	13,230	14,590
Personal disposable income (US$bn)	1,397	1,694	1,985	2,326	2,718	3,183
Median household income (US$)	2,880	3,410	3,920	4,500	5,140	5,880
Private consumption per head (US$)	906	1,110	1,310	1,540	1,820	2,140

The economic outlook – key trends (3)

- The general economic outlook for China is good:
- Average annual GDP growth has been 11% for the last three years
- The authorities will continue to push for growth at about 10% The massive economic growth is sustained by:
  - High savings
  - Resulting in high (if inefficient investment)
  - Openness to trade
  - Good education levels
  - Reasonably good infrastructure
  - Strong productivity growth (which cushions impact of pay rises)

The economic outlook – key trends (4)

- Most of the threats to the economy come from over-heating
  - China is the fastest growing major economy in the world, growing at almost three time's global average
  - Private consumption is rising at about 8% a year
  - Driven by some of the highest real wage growth in the world
  - Real wages have risen by an average 11.5% in recent years
  - And will continue to do so in 2008-12
  - These rises have been bolstered by strong productivity rises

The economic outlook – key trends (5)

- But it is likely that unit labour costs will accelerate in 2008-2012
- Which explains in part why some export prices have started to rise slowly
- This, combined with domestic credit expansion, of 18-20% per annum will ensure maintained strong GDP
- This is unavoidable when government consumption and fixed investment sectors will also be growing at 9-11%
- GDP per head (at PPP) will rise from $6,000 in 2004 to $11,000 in 2009
- Real disposable income is rising at 7-8% per annum
- Therefore personal disposable will double from one trillion dollars in 2005 to two trillion in 2009

The economic outlook – key trends (6)

- Imbalances are cause for concern
- Need to rein in capital spending and investment—results so far not too good
- Reason may be that regime will accept above optimum growth rather than below optimum
- GDP will remain strong in the next three years averaging about 10%
- Bank lending in 2007-08 is still (too) high
- Authorities try to combat this with higher reserve requirements
- And the renminbi is allowed to appreciate slowly
- Government brings in the Big-4 banks to advice them on lending policy

The economic outlook – key trends (7)

- There may be some slight slow down after the Olympics
- The biggest risk is that a slow down coincides with a sustained rise in inflation and the authorities rein in the economy too much and GDP growth collapses to 5-7%
- This is an unlikely scenario though:
  - China's reserves topped one trillion dollars in 2006 and will reach two trillion in 2009
  - The regime can always pump prime any down turn
  - They can always reflate fairly quickly any popped bubble
- Thus the negative scenario is only a 15% probability

The economic outlook – key trends (8)

- China also has highest savings ratio in world (40% of GDP and 25% of household incomes)
- The high rate is due to:
  - repressed savings i.e., people had nothing to spend the money on, which is good news for western consumer goods companies because things are changing now
- The high savings ratio also stems from the population’s need to cushion themselves against further deterioration in the provision of state social security
- In other words, they may not plan to spend a good part of this
- Also China needs better social services and people would be willing to use their savings on them

The economic outlook – key trends (9)

- China needs more domestic consumption and relatively fewer exports
- This switch could come about by investing less in US treasuries and using these funds on social spending
- This would in turn make the US dollar weaker which would curb some Chinese exports to the US
- Which is what the Chinese regime wants: fewer exports, more consumer spending in China
- If health and education was provided in a better fashion, people would be willing to direct some of their savings to paying for such services
- This was/is a good strategy but a little more risky now that inflation has popped up

The economic outlook – threats (1)

Inflation

- The biggest economic threat to China and the world is Chinese inflation
- If China started to export noticeably more inflation, then the global economy would wobble
- At the start of the decade China had serious concerns about deflation, not inflation
- Consumer prices did pop up a bit in 2004 but came down again in 2005-06 to 2-3%
- But inflation rose sharply in 2007 to 6% at year-end (average 4.7%)
- At the start of 2008, there were announcements that price curbs would be imposed on some food products

The economic outlook – threats (2)

- The good news is that inflation is driven by food and energy prices, i.e. top-line inflation
- Pork prices (a key consumption indicator) rose 50-60% and edible oil prices were higher by 25%
- The government tried to curb prices with a combination of:
  - four interest rate hikes
  - seven rises in bank reserve requirements
  - the renminbi was allowed to strengthen somewhat
- But these combined steps didn't have much impact
- The good news is that while top-line inflation was touching 6% end-2007, labour-productivity was holding up fairly well
- And strikingly core inflation was barely 1%

The economic outlook – threats (3)

- Which indicates how competitive pricing in other sectors, apart from food, keep prices down…
- …as do government energy and housing subsides
- As pig and other animal stocks are restocked, some/much of the inflationary pressure will ease
- The cyclical fall of food prices from the high base of 2007 will also put downward pressure on the inflation figure
- As the dollar remains weak in 2008, the pressure to let the renminbi rise a bit faster will increase
- This too will curb prices

The economic outlook – threats (4)

- But sustained high demand and global food trends will ensure that inflation stays at about 4% as an average in 2008-2011
- The risk could be on the upside, hence the state administrative measures
- One can rest assured the state will pull out all the stops to keep inflation under control
- It is their number one economic priority
- They want to avoid any reruns of 1989 and Tiananmen Square

The economic outlook – threats (5)

Revaluation

- Chinese authorities will do little in the way of further revaluation:
  - it does not benefit China
  - it heightens the risk of sabotaging the weak Chinese banking system
  - it can upset agricultural prices
  - in any case, China is definitely not the root cause of the US trade deficit
- Renminbi rose to 7.33 to the US$ at the end of 2007
- But will only rise to 7.0 by 2008 and to 6.0 only by 2012
- Full currency liberalisation is at least 5-8 years away

The economic outlook – threats (6)

<u>Over-capacity</u>

- Fixed investment accounts for 45% of GDP and is rising at 12% per annum
  - This investment is incredibly inefficient: to generate 1% of GDP growth, China invests $5—one of the worst ratios in world
  - The good news is that if over-investment was critical, then Chinese company profits would be falling, but they are rising
- 100mn people are employed in the textile industry on operating margins of 3-5%.
- Any strong appreciation of renminbi could hit this sector hard as could western protectionism

The economic outlook – threats (7)

Banks and non-performing loans (NPLs)

- The situation is better than some years ago:
  - NPLs are officially 7% of GDP, but probably more like 15%
  - But reforms in banking sector mean the chance of a crash is much lower
  - 3 out of 4 main banks listed overseas and were recapitalised with $60bn and downsized dramatically. ICBC alone sacked 200,000 staff in 5 years up to 2006
  - End of 2006 Chinese banks opened to foreigners under WTO but the Western share is still only 3.5%

China: the assembler of the world (1)

- China is bound into a sophisticated, pan-Asian production and supply chain
  - Western companies are investing in non-China Asia to supply China from there
  - And SE Asian economies realise that trying to compete with China for most FDI is a lost cause…much better to act as suppliers into Chinese production
  - Investing outside China but within the region also spreads corporate risk in case of any crisis in China
- Often though China ends up as the bolt-on assembler
- To make a toy, the plush fabric comes from Korea and the voice chip from Taiwan and the assembly is made in Shanghai
  - If a Barbie doll retails for $22, China gets about 35 cents

China the assembler of the world (2)

- In other words, made in China, not by China
- Another example is IT:
  - In 2004, 8 out of 10 exporters to set up in China were Taiwanese firms to which Dell, Apple and HP outsource
  - These Taiwanese companies “sell from China” because low wage costs mean that each machine costs $25 less
- China produces about 70% of the world’s computer boards
  - 55% of DVD players
  - 30% of PCs
  - 25% of TVs
  - 25% of car audios
- But the work down in China – parts assembly then shipment – rarely qualifies for more than 10-15% of the sales price

R&D in China

- The US spends 3% of its GDP on R&D while China only spends 0.8%
- And the US gets a better return (22%) added to the value of product under development
- Whereas value add to product in China is only 5%
- China gets IT by buying it, copying it or encouraging a partner to transfer it as entry price into China market
  - Motorola has 19 R&D centers in China ($300mn investment)
  - Microsoft Beijing R&D staff number is 250 people
  - Siemens invested $225mn in R&D in China since 1998

China buys the world (1)

- Today the great Chinese takeover of global economy is only in initial stages, but will accelerate
- Eventually US and EU will have to put their trade relations on a more plausible footing
- The current phase of derogations and postponements of WTO criteria is embarrassing and farcical
- In time the developed markets are going to either adapt or set up protectionist barriers to keep the Chinese out
- This latter option is worse than the first, very painful one
- But the world is changing and we are seeing the first stages of China's rise as an economic competitor
- The US is not accustomed to this and does not like it

China buys the world (2)

- Hence the US reaction to the proposed acquisition of Unocal by China’s CNOOC
- Or why several potential Chinese acquisitions have failed as white knights appeared on the scene
  - as in the case of the targeted US white goods company Maytag
- US business leaders tend to support Chinese acquisitions because they themselves want to do the same in China
- And they know they are vulnerable to accusations that the US does not support a global, level playing field
- China, like the US, is trying to secure oil sources
- And is aiming investment at the US (mostly failed so far), Canada and Kazakhstan

China buys the world (3)

- China has also invested and even tried to take a lead in Africa
- Where it has proven more willing to work with regimes with questionable human rights record
- For example, China is the biggest foreign investor in Zimbabwe and Sudan ($8 billion in Sudan with a 41% stake in the national oil consortium and the construction of a 900-mile pipeline)
- But it has widespread investments on the continent
- Deal to purchase 30,000 barrels of crude from Nigeria with investments in railways and rural telephony systems
- Oil pipeline construction in Libya
- Purchase by China of 25% of Angola's oil in exchange for credits for road, railway and electricity generation

China buys the world (4)

- In next 10 years more attempts by US and EU to amend WTO rules to curb Chinese exports
- Will use a variety of tricks to curb Chinese acquisitions
- But inevitably Chinese investment will arrive
- Unless free trade is dumped (15% chance), increased levels of Chinese investment and larger market shares for Chinese products are unavoidable
- Same applies to some Indian products later
- Expansion is part of a global strategy
- Which in the domestic sphere also seeks to create national champions…
- …in order to reduce its dependency on foreign technology

China buys the world (5)

- Chinese companies in value-added sectors have come to depend on foreign technology…
- …and have failed to develop their own
- When the Chinese do go shopping abroad it is possible that they will pay too much for their acquisitions…
- …due to their inexperience and cash-richness
- Much like Japanese companies did in the 1980s
- Chinese buyers rightly want to buy into US/European management techniques…
- …as well as distribution systems and, once again, technology

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