

The China boom has a long way to go

Oliver's insights



Key points

- Like all emerging countries, China faces risks and speed bumps that make for an occasionally volatile ride.
- However, its rapid growth is sustainable for years to come and this creates big opportunities for investors.

Introduction

Over the last 25 years or so, China's economy has grown by over 9% per annum. China's transformation is without precedence in that it is dragging over a billion people out of near subsistence conditions into the modern world over just a few generations. Past rapid development phases, such as the industrial revolution in Europe, the US in the nineteenth century and Japan and then Asia over the last sixty years involved millions not billions of people. Sceptics naturally argue that China's rapid development is unsustainable and will end in a bust. Our view remains that China's rapid growth is sustainable and has a long way to go. This will create enormous opportunities for investors with exposure to China.

Long-term drivers look sustainable

China is following a development path traversed by many countries before it. Having got the fundamentals right – the shift towards a market economy, growth friendly economic policies and a focus on economic development – China has been pushed on to the conveyor belt of growth. This is being propelled by a range of considerations, all of which are intertwined and are sustainable for a long time to come.

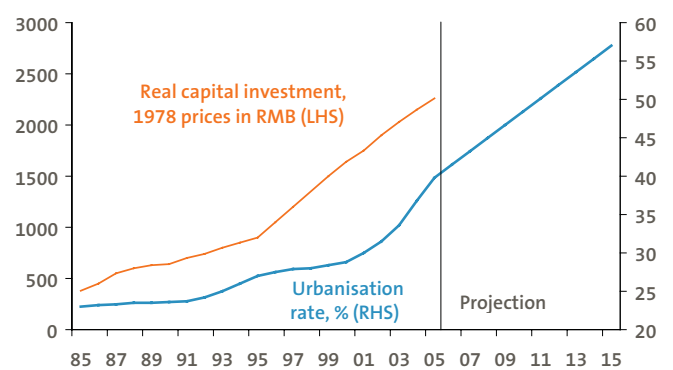
Firstly, China is experiencing very strong productivity growth on the back of rapid privatisation, labour market and industry liberalisation resulting in intense competition and the application of new technology. In many ways China's economy is more competitive than many developed capitalist economies in the sense that many industries operate in near perfect competition with multiple producers. For example, there are approximately 800 iron and steel firms in China. This results in a highly competitive and highly productive market place.

Secondly, China has huge competitive advantages built around low unit labour costs and scale advantages. While wages growth has picked up in some areas, for example, around the Pearl River delta in Guangdong province, it is coming from a very low base.

An average unskilled factory worker earns around a dollar an hour in China compared to around A\$15 an hour in Australia.

Thirdly, rapid urbanisation is sustaining investment demand, contributing to surging productivity growth [taking workers off farms and putting them into factories with machines is an easy way to boost productivity] and keeping labour costs down via a continuing supply of cheap labour. Over the last five years the urban population has grown by about 100 million. This has taken the proportion of the population living in urban centres to about 40%. This is still low by Asian standards and is extremely low compared to rich countries where urbanisation is above 90%. Over the next decade this is likely to rise by more than 200 million to around 57%.

Rapid urbanisation is a strong driver of growth in China



Source: Goldman Sachs, AMP Capital Investors

Fourthly, consumer demand is surging in response to rising affluence. This is a normal phenomenon and the relatively low level of per capita consumption of 'things' like living space and cars suggests it has a lot further to go.

China has a long way to catch up to rich country consumption

	China	US
Cars [per 1000 people]	7	475
TVs [per 1000 people]	365	837
Living space [sq feet per person]	73	718
Electric power [kw hrs per person]	964	12322
Mobile phones [per 1000 people]	128	451

Source: Fed Reserve of Dallas, AMP Capital Investors

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Fifthly, China is investing in new capital at a rapid rate and this is also contributing to productivity growth. Investment is running at over 40% of GDP [although there is reason to believe that this is somewhat overestimated] and while there has been a need to slow it down recently the indications are that it will remain very strong:

- Ongoing urbanisation will continue driving strong demand for new infrastructure – see chart above;
- China's capital stock relative to its population is very low compared to developed countries;

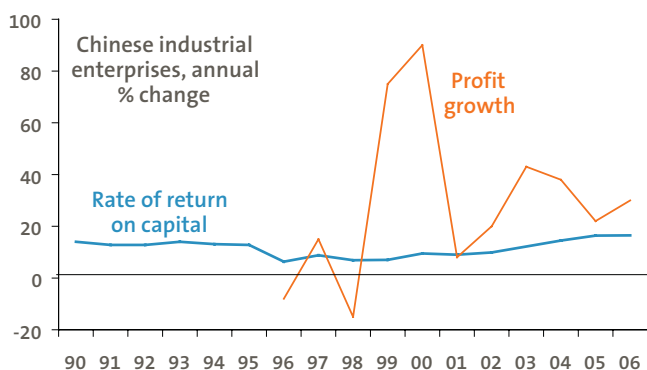
China's capital stock per person is relatively low

	Capital stock per person in \$US, in 2004
US	\$152,367
Japan	\$158,352
China	\$4,164

Source: Fed Reserve of Dallas, AMP Capital Investors

- While many fret that China has been over-investing, **corporate profit growth in China remains very strong** [running at 30% in 2006] and the rate of return on capital is solid and has improved since the late 1990s despite the surging capital stock. This would suggest that while China may experience periods of excess capacity in some industries, in aggregate it is not in fact over-investing as illustrated in the following chart.

Strong profit growth and return on capital



Source: Thomson Financial, AMP Capital Investors

- Finally, corporate investment is mainly financed by retained earnings and most companies have only moderate gearing levels.

China's growth can remain strong for a long time

The fact that China is coming from such a low base for average income levels indicates its rapid growth phase can continue for several decades before it runs out of puff. At market prices GDP per person in China is about \$US2000 per annum. Adjusting for purchasing power this is about \$US7000. In Australia it is about \$US32,000 and about \$US42,000 in the US. This would suggest China can average very strong growth for a long time before it catches up to rich countries. If China were to grow at 8% per annum in real terms, it would take 30 years to catch up to Australian per capita income levels.

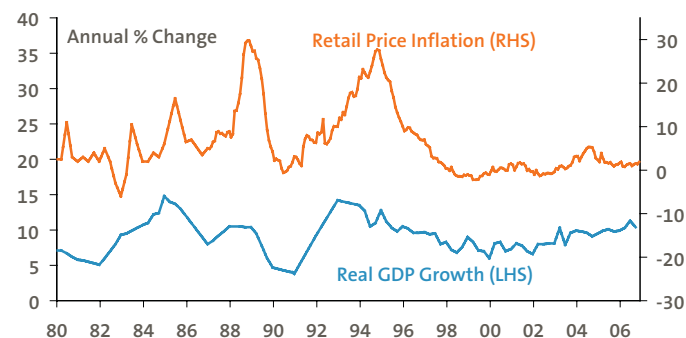
No signs of major problems ahead

The main concern in 2006 was that China's growth had become just a bit too strong [at 11.3% for the year to the June quarter] and too skewed towards investment. This saw the authorities raise interest rates and introduce other measures to cool the rate of growth in investment. However, recent indications are that growth in investment has slowed towards a more sustainable pace and GDP growth has come off the boil.

What's more, the normal indicators of impending trouble in emerging markets remain benign in China's case:

- Inflation is low and since the mid 1990s there has been a dramatic improvement in the growth/inflation trade-off in China, i.e. higher growth and lower inflation. Better economic management has also meant that economic growth has been far more stable in recent times compared to the 1980s and early 1990s.

An improved growth/inflation trade-off



Source: Thomson Financial, AMP Capital Investors

- The current account is in surplus – as opposed to a deficit. While this is causing conflict with the US, China is defusing the issue by allowing a gradual appreciation in the Renminbi. The combined trade surplus and managed exchange rate is likely to see further increases in banks' required reserve ratios to ensure money supply growth does not get out of control.
- China is not reliant on foreign capital inflow. In fact, the rest of the world is reliant on Chinese capital outflow!
- China's foreign exchange reserves are very strong at around \$US1 trillion.
- The currency is undervalued and is likely to appreciate gradually over time [around 5% per annum].
- While property prices are up strongly in some cities, in aggregate Chinese property prices have been rising at a slower pace than nominal GDP, in contrast to the US, Australia and the UK in recent years. In other words, China does not have a generalised property bubble.

China faces environmental problems and political risks but they are not enough to derail its strong growth prospects.

Conclusion

As with all emerging countries, China faces risks and speed humps that make for an occasionally volatile ride. However, the rapid industrialisation phase in China's development has years to run and this will create big opportunities for investors with exposure to China, whether it's indirectly, e.g. via commodities, or directly, such as via Chinese shares.

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¹ Purchasing power parity adjusts for spending power.