China: land of opportunities

Deirdre Keown

In 2005, PortfolioConstruction Forum's publisher, Graham Rich, and Think Global Consulting created the Think Global BRIC Study Tours – highly tailored, week-long study programs, designed to give participants vital on-the-ground exposure and materially increase their understanding of each BRIC market and its role in portfolio construction.

The first BRIC Study Tour was to China in April 2006. I attended the second tour in October 2006. Here's a synopsis of our first day.

We flew into Shanghai on a Sunday evening. I don't know what I expected, but it wasn't that the airport would be more modern than Sydney's, that we would breeze through customs in under five minutes, travel into the city on the world's fastest train at just over 300 km/hr (to save energy, it doesn't run at its 430 km/hr maximum speed after 6pm), and arrive at a modern luxury two-year-old hotel. We could have been in any modern city in the world – in truth, it was a bit of an anti-climax.

Monday, we were up early to travel by bus to our venue for the day, a restored Chinese building in the old French concession (finally, something that looked like we were in China), for a day of briefings on China's economy, business environment and social structure by those who live and work there. We had an incredible calibre of speaker:

~ Christopher Wright, Austrade Shanghai's senior trade commissioner, on China's economy past, present and future;

~ Clinton Dines, head of BHP Billiton China, on the BHP story in China (unfortunately, Chatham house rules prevailed for this session);

~ Richard Williamson, Commonwealth Bank's general manager of Asia strategy, on China's financial services sector; and,

~ Wang Yong, assistant editor-in-chief of *Shanghai Daily*, on how the Chinese live.

The first thing everyone tells you about China, once they realise you're new to it, is that it's BIG; that you'll find it impossible to get your mind around the numbers.

There are 1.4 billion people, including 700 to 800 million peasants. Actually, this became a running tour joke – every speaker during the week gave us an estimate of the number of peasants, but each estimate was different. In the words of one tour member, "Is it 600 million, 700 million, 800 million, 900 million – really, what's a few hundred million people either way?"

And what exactly is a peasant? In China, any farmer is a peasant. Yes, for the most part, they're poor, but even the wealthy ones are called 'peasants'.

More numbers. Fourteen million engineers, 600 cities (33 are home to over two million people). Over 35,000 kilometres of highway has been laid in the past 10 years, and another 85,000 will be laid in the next 30 years, all part of China's planned expressway network to connect all cities with populations of greater than 200,000.

I heard this at the start of the week-long tour, and I didn't really believe it. But I did by the end of the week. One of the key lessons I took away with me from the tour is that China thinks long-term. It really does have 30-year plans for just about everything.

As one speaker put it later in the week: "Western governments plan to the next general election. China's officials plan for the next 30 years (because there are no elections)." And the 30-year plans get implemented on schedule. I came away understanding that there's nothing like a benevolent dictatorship to get the job done!

All that concrete had me wondering whether there would be any green left in China. The consensus across all the week's presenters was that the environment is a very real concern to the Chinese Government, albeit only a recent one. As with anything it turns its mind to, there is a robust plan to reduce environmental damage.

Back to the big numbers. Each year, China brings on "a UK and a bit" of power, as one speaker put it. Some 70 per cent of China's power is currently coal generated, complemented by gas and hydro.

In the next decade, coal generation is expected to account for 60 per cent (on a growing base, keeping in mind the rate of urbanisation), with natural gas and nuclear energy picking up the slack (the plan includes 32 nuclear power plants).

However, it's not possible for China to concentrate all its energy in just coal, gas or nuclear plants, because it would exhaust the worldwide supply of the raw ingredients! So in the next decade, China will bring on more energy in each area – water, nuclear, wind, gas, coal, and so on – than the rest of the world combined.

One number that's not big is the number of lawyers (many would say this is not a bad thing) – just 120,000 for a country of 1.4 billion people.

"The legal system has good architecture but poor implementation," one speaker opined.

And of course, the economic numbers are big.

Gross domestic product (GDP) has grown at 8 to 10 per cent per annum on average through the 1990s and 2000s. Exports are growing at 25 to 35 per cent per annum. There was a lot of discussion around this by tour delegates, particularly the threat posed if the US economy comes off the boil. However, as one speaker noted, China's exports are well diversified and what is exported is low value. If the US economy slows, the US consumer will still shop at the low value end of town.

Another natural question was how much of GDP growth is dependent on foreign investment. One speaker noted that domestic demand is such that if all foreign investment pulled out, China's GDP would fall by only about 1 per cent per annum.

Another question was, 'Is growth sustainable?'. We asked this again and again during the week. Not one person we spoke with doubted that it was (and they weren't all bulls, some were decidedly bearish about other issues).

One presenter recommended we think of China not as an Asian tiger, but in the same light as the US in the 1880s and 1950s – going through a massive economic revolution fuelled by industrialisation, urbanisation, and the emergence of a middle class.

There was a lot of focus on the urban/rural wealth inequity.

Austrade's Christopher Wright put up an interesting chart, showing the gap is closing slowly. Following 74,000 protests by the people in 2004, the gap halved in 2005 – not by halving anyone's income, rather than as a result of urbanisation.

This was a shock – I'd thought protesting was a one-way street to prison in China. But apparently protests are very common. It's the topic that's the issue – economic protest is allowed. Political freedom, choice, elections and human rights remain strict no-go areas.

As expected, the Central Party has a 30-year plan to reduce this urban/rural divide.

In 2004, 80 per cent of households were 'poor', defined as earning less than 25,000 yuan per annum. This is about $4,166 per annum.

Only 10 per cent of households are currently 'upper middle class', earning 40,000 to 100,000 yuan ($6,666 to $16,666 per annum).

By 2025, poor households are expected to be just 10 per cent of the population, with the upper middle class at 60 per cent and lower middle class at 20 per cent. The mass affluent (earning greater than 100,000 yuan) will be just under 10 per cent.

Another myth dispelled during our first day was that China is only a manufacturing success story. Wrong again – there is a growing services sector. The financial services market is growing twice as fast as the rest of the world, and by 2020, will be larger than Germany's.

China is already the world's largest consumer of international education, and the world's largest telecommunications market. By 2020, it is expected to be the world's largest tourism destination, and the fourth largest source of tourists.

In the afternoon, Richard Williamson gave a detailed overview of the financial services market.

Once again, the numbers are huge. China's banking assets are over four times the size of Australia's and only marginally behind those of the UK. The banking industry is critically important – banking assets form 77 per cent of the country's financial assets, and the industry has undergone rapid reform in the past several years.

Interest rates are low, as a way of subsidising Chinese corporations. However, retail mortgages are still very profitable at around 400 basis points (compared to 100 basis points in Australia). The problem, Williamson explained, is that the Chinese pay off their mortgages too quickly – in around three to five years! They do this by saving more than 50 per cent of their salary. Internet banking has not yet taken off, as the infrastructure is not yet robust enough to support it.

There are four distinct tiers of bank: the big four state-owned banks; 12 joint stock banks; 111 City Commercial Banks; and 39,000 credit co-ops (38,000 of which are rural based). That's 40,000 banks in total, an impossible task to regulate. It's a market ripe for consolidation, encouraged by the Government, which fears social unrest in the event of bank failures. Estimates are the number of banks will fall to around 2,000 in the next decade.

The credit card market is small, at just US$700 million, but this is growing at such a rate that China will be the fourth largest credit card market in non-Japan Asia in 2006.

Share market capitalisation is only just behind Australia. Total debt securities are 50 per cent higher than Australia, and about half of the UK.

However, the life insurance and funds industry is fledgling. At around $180 billion, it is well down on Australia ($1,000 billion). The current environment is dominated by local players. The top five fund managers are all local and relatively young, having started in 1998-99. These five control over 45 per cent of funds under management (FUM), but between them offer just 47 funds.

While the industry experienced strong growth between 1999 and 2001, Chinese investors tried to stage early fund IPOs, causing FUM to halve very early on. As a result, since 2002, fund managers have stopped offering closed-end funds.

It's expected that the Chinese fund market will grow with the development of a healthy internal stock market, something that is a key priority for the Government.

Since 2005, commercial banks have been allowed to set up funds management entities, and the regulator has recently approved the establishment of the first fund distribution company, which will only provide advisory and sales services to investors.

The regulator has also begun to allow qualified domestic institutions to invest in overseas markets, enabling greater diversity of fund offerings.

Finally, we were amazed and delighted to hear that "tax is almost voluntary" in China. Private tax collection is around 2 per cent, and while the corporate tax rate is 30 per cent, it drops considerably to 15 per cent if you set up business in a special economic zone such as Pu Dong (an area across the river bank in Shanghai). And, we heard, corporate tax is totally negotiable for local companies!

Of course, by now, we were all considering moving to China.

It was left to our last presenter of the day to bring us back down to earth.

Wang Yong is assistant editor-in-chief of the *Shanghai Daily*. He opened by explaining that he wanted to show us "the other China". His numbers were also big.

He estimated there are 900 million peasants at present. Six million migrate to the cities every year for jobs, and over 40 million have left the land in the past 10 years.

In the next five years, a further 15 million will move to the cities. However, there are not enough cities to absorb the flow, and as fast as housing and other infrastructure is being built, it is not fast enough to keep pace.

The environment has been neglected in favour of fast development. The land is very dry in many parts, with drought caused by land clearings and diversion of rivers. What water remains is often tainted – some 70 per cent of lakes and rivers are seriously polluted, with the resulting loss of bird life, and 400 million people do not have access to clean water.

The Yangtse, which 10 years ago was very clean, is now green, and at the current rate will be ruined within 10 years. Many trees near rivers have been chopped down by peasants to earn money to live, exacerbating the drought conditions and pollution (the Government has responded by paying the peasants to protect the trees).

Despite this gloomy picture, Wang Yong was clearly of the view that the Government will succeed in tackling the environmental problems, now it has committed to do so.

Am I convinced of the strength of China as an investment story? I think so, at least for the next 20 years while the Chinese people are focused on working hard to increase their wealth and their wealth continues to improve.

Yes, there will be stresses and strains on the system in the meantime, and bumps along the investment path. But ignoring China in constructing portfolios would be madness. How you access that investment story is the key challenge – but that's a topic for another day.

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