China Economic Prospects: A Brighter Future When You Dig a Little Deeper

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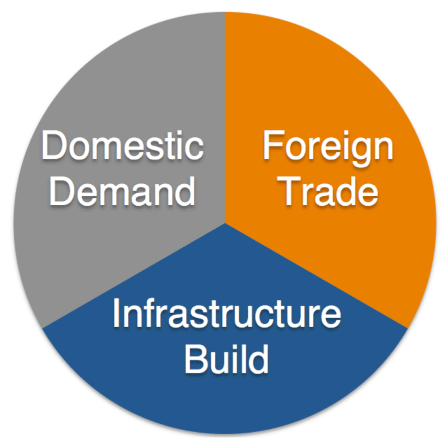
Mike Corkran has 30 years of international and China operating experience, including line operating responsibility for integrated manufacturing businesses in China. Prior to founding China Centric in 2003, Mike served as President of North American & Asia Pacific for RELTEC, a NYSE-listed telecom equipment manufacturer where his responsibility included the start-up and management of five manufacturing businesses and two development centers in five different Chinese cities. In addition to his extensive China experience, Mike has held various marketing, financial management, and general management roles and assignments, leading teams of up to 5,000 people and generating up to USD 1B in revenues. Mike earned a B.A. degree in Economics from Dartmouth College and an M.B.A. from the University of Rochester.

Search the web today and you find a wave of articles fearing the global economic effect of a sustained China economic slowdown. There is no doubt that China's growth rate has slowed to below 7% and may slow more in the near term. However, China's demographics and economy suggest a very different story about the near and medium term prospects for China's economy. Today, China is and will most probably remain the fastest growing large market in world for the foreseeable future.

Making decisions on general facts and averages can lead you to make bad decisions. You can drown in a lake with the average depth of six inches that has parts that are fifty feet deep. If you can't swim and choose to walk across that lake based only upon that true average statistic, you are taking a big risk. Basing China business decisions on broad general trends is faulty because the component stories of what is actually taking place within the three major segments of the China economy are quite different. Peel the onion and you get a clearer picture of China today and the implications for the future.

The graph in the top right depicts the three major sectors of the China economy and the sections that follow discuss China Centric's analysis of the different stories and outlook for each one.

China GDP Segments

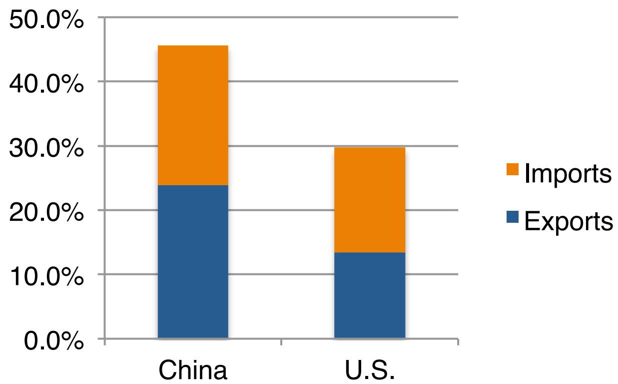


Graphic is not intended to imply relative segment contribution

Foreign Trade

In recent years, the surge in domestic demand has seen foreign trade (imports and exports) decline in its relative impact on China's overall economy. But the fact remains that China's foreign trade has continued to grow and is a far more significant influence on China's overall economy than it is for the United States. China's exports and imports each represent a significantly higher percentage share of GDP. Together, exports and imports summed to a total equal to 45.6% of China's GDP in 2014 compared to just 29.8% for the U.S., according to the CIA Fact Book.

Foreign Trade Significance to National Economy



Source: CIA Fact Book 2014

Weak economic growth in recent years for China's three largest export markets – United States, European Union and Japan has been a drag on China's export growth that is hurting the overall GDP growth rate of China. For the first half of 2015, the Ministry of Commerce of the PRC reported overall exports grew by only 1%. This was largely due to weak growth of China's major trading partners. When any country depends heavily on foreign trade, that country is at the mercy of the economic health of other counties. For the past 6-7 years the U.S., Europe and Japan have experienced growth rates lower than their historic averages. The slow down in relative export growth rates of China's exports to these key markets is arguably the single greatest driver of the overall reduction in GDP growth rates from low double-digit percentage gains to the 6-7% range today.

One great fallacy is that China is losing its competitive edge in exports. No country will ever be the most competitive source of all products and commodities. However, if China were no longer competitive, its exports would be declining relative to other countries. This is simply not happening. China remains the world's largest exporting region, 39% greater than #2 United States, 46% greater than #3 Germany and 217% greater than #4 Japan.

It is unreasonable to expect China's exports to grow dramatically faster than the economies of China's major trading partners on a long-term basis. It is also not reasonable to expect a relative decline in China's exports as China's overall technology base and manufacturing sophistication continues to improve in higher value export products. The most probable expectation is that China's exports – the foreign trade engine of GDP contribution – will settle into a growth pattern of between 1% and 5% annually depending on the strength of China's major trading partners. There may be annual "blips" due to currency valuations, but China can be expected to remain the world's largest exporting economy.

Infrastructure Build

According to the World Bank, capital formation including public and private infrastructure development and construction has been pretty steady at about 45% of GDP since 2010. There is no other major country in which infrastructure build is a greater part of the country's GDP than China.

Country	Infrastructure Build as a % of GDP
China	45.3%
United States	18.5%
Japan	21.0%
Germany	19.8%
United Kingdom	16.2%
India	31.0%

Source: World Bank (average of available years 2010-2014)

Infrastructure expansion has to be planned and executed years ahead of actual need. Plans must be based on expected growth nationally and regionally. If the planning assumptions turn out to be wrong – and they always are to some degree – the result is an over or under-supply of infrastructure. Until 2014-5, the prevailing assumption was that China's GDP would grow at ~8% through the remainder of the decade and infrastructure plans and programs were based on this general demand expectation. With actual GDP growth underperforming to expectations – but still remaining comparative high on an absolute basis by international standards – the result was an unavoidable oversupply of infrastructure nationally.

In 2014, realizing the relative slowdown of GDP growth, China policy makers took deliberate steps to slow infrastructure expansion to soak up the excess capacity. This slowdown had significant impact on overall GDP growth momentum because of the heavy contribution of infrastructure build on the overall economy – 45.3% of total GDP in 2014.

More recently in 2015, China has relaxed these constraints and it can be expected that infrastructure expansion will progress at a faster pace in 2016. The relaxation is probably partly a national economic stimulus and partly due to the judgment that the excess capacity has been reduced. Unlike the developed economies of the West, where ubiquitous modern infrastructure is the norm, China's infrastructure is largely primitive in comparison – and especially away from the developed coastal cities. Whereas Western countries engage primarily in incremental infrastructure expansion and maintenance, China is in the process of building a complete modern national structure where none existed. This need is enormous and the time horizon for this demand will stretch well into the next decade.

The drag on China GDP growth that resulted from the deliberate throttling back of infrastructure programs in 2014 appears to be ending with aggressive national expansion initiatives announced this summer. In 2016, it can be expected that this economic segment will rebound to its contribution levels to GDP experiences in the 2010-14 years.

Domestic Demand

Demand inside China has remained the most significant engine of growth for China's GDP and all signs point to continued momentum. Consumer demand has grown by 10% or greater on average annually throughout the decade and yet household consumption as a percentage of GDP lags the developed economies.

Country	Household Consumption as a % of GDP
China	36.8%
United States	68.7%
Japan	60.8%
Germany	56.1%
United Kingdom	64.8%
India	57.0%

Source: World Bank (average of available years 2010-2014)

It is estimated that ~400M Chinese live in families with the purchasing power equivalent of $50,000 (USD). That's a middle class larger than the entire population of the United States. However, there are still ~1 billion Chinese who have not yet approached this middle class status. China's economic policy is clearly to drive expansion of domestic demand to lessen relative dependence on the health of foreign economies (trade) and infrastructure build to create a healthier economic balance. The shift in development emphasis from the coastal regions to inland provinces will drive investment and domestic consumer demand in these areas. The outlook for a vibrant and rapidly growing consumer economy is excellent and the experience of the past decade is solid supporting evidence.

"The Demise of the Chinese Economy is Greatly Exaggerated"

No economy is immune to the business cycle, and that includes China. However, the gloomy media reports painting a picture of a China free-fall remain grossly overstated. Careful consideration of the facts and actual trends of the three main segments of the Chinese economy paint a picture of an economy in transition, a transition that will be less dependent on foreign trade. Domestic demand growth will play an increasingly important role in China's future economic growth with infrastructure expansion fueling economic development of inland provinces where the next decade of economic expansion will be centered. This domestic demand growth reinforces the market opportunity for foreign companies targeting China as the fastest growing large growth market.

China will remain the world's largest exporting country for the foreseeable future, but export growth % will probably be less than historical levels.
China's infrastructure build can be expected to regain momentum in late 2015 and 2016.

How all of this shakes out is uncertain, but a China whose GDP grows in the 6%-8% range is far more likely than lower growth. This is clearly lower than the 10%+ rates of the pre-2010 era, but still the fastest growing large market in the world. Just consider how we would react if the U.S. economy was growing 6%-8% annually. I suspect we would either be dancing in the street with joy or be petrified about the prospects of hyper-inflation.

Where else in the world can a company find the absolute size and growth potential offered by China? China will have cycles, but those cycles can be expected to be growth cycles on a steady upward economic climb.