

CHINA » The diversification of China's trade and industry and rebalancing of its economy will ensure sustained, rapid growth

Expect plenty more growth

main points

» China's annual GDP growth came in at 10.7 per cent for 2006

» The most recent Chinese GDP numbers prompted a number of commentators to suggest the economy is beginning to overheat and growth will slow significantly

» The International Monetary Fund predicts China's GDP will once again grow in the double-digit region in 2007, estimating a 10 per cent rise

» A Goldman Sachs Brics report claimed China's economy would become the world's second largest by 2016, and eclipse the US by 2041

» In 2006, China's total volume of imports and exports reached \$1.76trn, a year-on-year growth of 23.8 per cent



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The fall in China's market at the end of February did not come as a surprise to many investors. Indeed, such corrections are often an inherent part of investing in global emerging markets. China still has good investment potential and in fact, the correction in the market could provide a good buying opportunity.

At the end of January, it was announced that following strong gross domestic product growth in the fourth quarter of 2006, China's annual gross domestic product growth was 10.7 per cent for the whole of last year. Not only was this growth stronger than widely expected, it represented the country's fourth consecutive year of double-digit GDP growth.

Overheating speculation

When investors are faced with such a rapidly rising economy, the natural conclusion can be "have I already missed the boat?". Indeed, the publication of the most recent Chinese GDP numbers has already prompted a number of commentators to suggest the economy is beginning to overheat and growth will slow significantly. There is also a school of thought which says if the US significantly slows this year, China will too. But going into 2007, the International Monetary Fund predicts that China's GDP will once again grow in the double-digit region, and estimates a 10 per cent rise. This compares with its 2.7 per cent estimate for GDP growth in Britain this year, and 2.9 per cent in the US.

The importance of China in the world economy was brought to the attention of the investment world following the publication of a Goldman Sachs Brics report in 2003. The report claimed China's economy would

become the world's second largest by 2016, and eclipse that of the US by the year 2041.

However, China's growth story began in the late 1970s. In 1978, under Deng Xiaoping, the government opened the country up to the world market through the introduction of several reforms. Since then, China's GDP has increased tenfold and in 2006, measured on purchasing power parity basis, it stood second only to the US as the world's largest economy. China's entry into the World Trade Organisation in 2001 proved a watershed, as it opened up the market to foreign investment. In 2006, China's total volume of imports and exports reached \$1.76trn, a year-on-year growth of 23.8 per cent. Exports continue to outpace imports, with the trade surplus reaching a record \$49bn in the third quarter of 2006, up from \$29bn in third quarter of 2005.

The countries China exports to have also become more diversified. While North America and the European Union are its main export destinations, exports to Latin America, Africa and Eastern Europe are rising more rapidly. Total exports to the traditional key destinations rose by 20 per cent year-on-year between January and August 2006, while exports to the rest of the world expanded by 32 per cent. If this carries on, the diversification maybe able to reduce China's exposures to downturns in particular markets, including that of the US.

The main area in which China has thus far grown most strongly is manufacturing. Machinery production grew by 22 times from 1998 to 2002 as China became the world's workshop. To fuel this expansion, about 20GW of electricity generating capacity was added annually, equating to installing Holland's entire power system every year. From 2000 to 2004, almost one-third of the world increase in oil consumption came from China.

During the 1990s, China also became the world's leading exporter of office machinery, IT and telecom equipment, and the country now ships about 80 per cent of the world's notebook and desktop computers. It has also become the world's third-largest market for semi-conductors, with demand reaching \$37bn in 2005.

In addition to manufacturing, fixed assets investment has been vitally important in the China growth story thus far. It is estimated that last year, gross fixed investment represented 44.3 per cent of the country's GDP. Not surprisingly then the more bearish commentators may point to a recent slowing in fixed asset investment as a sign of economic weakness. Growth slowed from 31.3 per cent in June 2006 to 24.5 per cent at the end of December, on a year-on-year basis.

Rebalancing the economy

This slowdown may actually prove to be more beneficial to the economy than harmful in the long-run. This is because it shows the Chinese authorities are starting to be successful in their attempts to try and rebalance the economy. While there is still a divide between urban and rural households, the income of both rose last year and employment recorded a large increase. The per capita disposable income of the urban population rose year-on-year by 12.1 per cent, while the per capita net income of the rural population rose 10.2 per cent year-on-year.

Despite the rises in income, the savings rate in China also remains high. To address this, the Chinese government has made rebalancing the economy and striving to achieve a harmonious society key economic policy objectives. By 2020, the government aims to narrow the urban-rural

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and regional development gaps, improve income distribution, increase employment and establish a social safety network across both the urban and rural areas. To meet these targets, fiscal policy will be key, with the government planning to spend more on health, education, social security and the promotion of innovation. By doing this, the government will bolster domestic consumption and make the Chinese economy less dependent on production, investment and exports. Indeed the growth in China's middle class may be vital to this potential increase in spending. There are now some 300m middle class people in China, with the income per head increasing to \$3000. This birth of a middle class is leading to booming demand for everything from cars to homes and jewellery. Indeed it is predicted that by 2025 China will buy more cars than the US and it is now already the world's largest consumer of platinum.

If the government does manage to rebalance, the concerns of the many people who are pessimistic about China's long-term growth story may be alleviated. Not only would it make growth less intensive in energy, raw materials and resources, it would make the country less capital intensive which would allow it to grow with lower savings. There are already some early signs that rebalancing progress is being made. Consumer indicators reveal that retail sales have picked up, with growth of 13 per cent in the third quarter of 2006.

In addition to a potential increase in consumption, China looks set to become the second largest spender on research and development in the world, according to a recent report from the Organisation for Economic Cooperation and Development. The nation now has the second highest number of researchers in the world, at 926,000, compared with more than 1.3m in the US. Perhaps as a result of this, the things that China manufactures are increasingly moving up the value chain. From low value-added items such as toys and textiles, Chinese companies are now involved in the manufacturing of high quality goods such as Apple's iPod. China now also produces 90 per cent of the world's DVD players. As a result, while it is true that many Western companies outsource their production to China as a result of the cheaper labour, the country's investment in technology is indicative of the economy becoming increasingly sophisticated.

Under the spotlight

China will also be thrust into the global spotlight next year when Beijing hosts the 2008 Olympic Games. Some 22 venues are being constructed and the city's rail network is to be extended by 148.5km. Roads are being installed and revamped and Beijing's airport is also being redeveloped. All this construction work requires energy and raw materials. Consequently, the earnings outlook for Chinese energy companies continues to be positive, with oil and gas demand looking likely to stay high. With the Chinese government offering incentives for companies to produce cleaner energy, growth in this sector looks set to be positive.

For investors new to China, it would be easy to listen to the bears who claim that after its rapid rise and recent wobble, the economy is set to overheat. However for those who can see the bigger picture and realise the economy is moving away from just being about manufacturing, the rewards may be significant. The Chinese stock market has already begun to make a modest recovery since the correction, confirming that most investors believe economic fundamentals in China remain in tact.

Growing bigger: China's growth has a long way to go

