

Corporate Network

China: the way forward

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Why China attracts . . .

- **1.3 bn people (some 250 mn urban dwellers, expanding middle class); 9.6 mn sq kms**
- Year after year of 7-9% growth, in 2004 even faster
- Political stability
- A fairly consistent policy direction
- Inexpensive, highly trainable and huge labour pool
- Good infrastructure on the coast: ports, roads, rails, municipal highways, electricity, telecoms
- More than 20 years of opening, capped by a 15-year struggle to meet WTO entry demands
- **plus** China opened early, while it had an air of mystery and the opening door was a surprise, a novelty

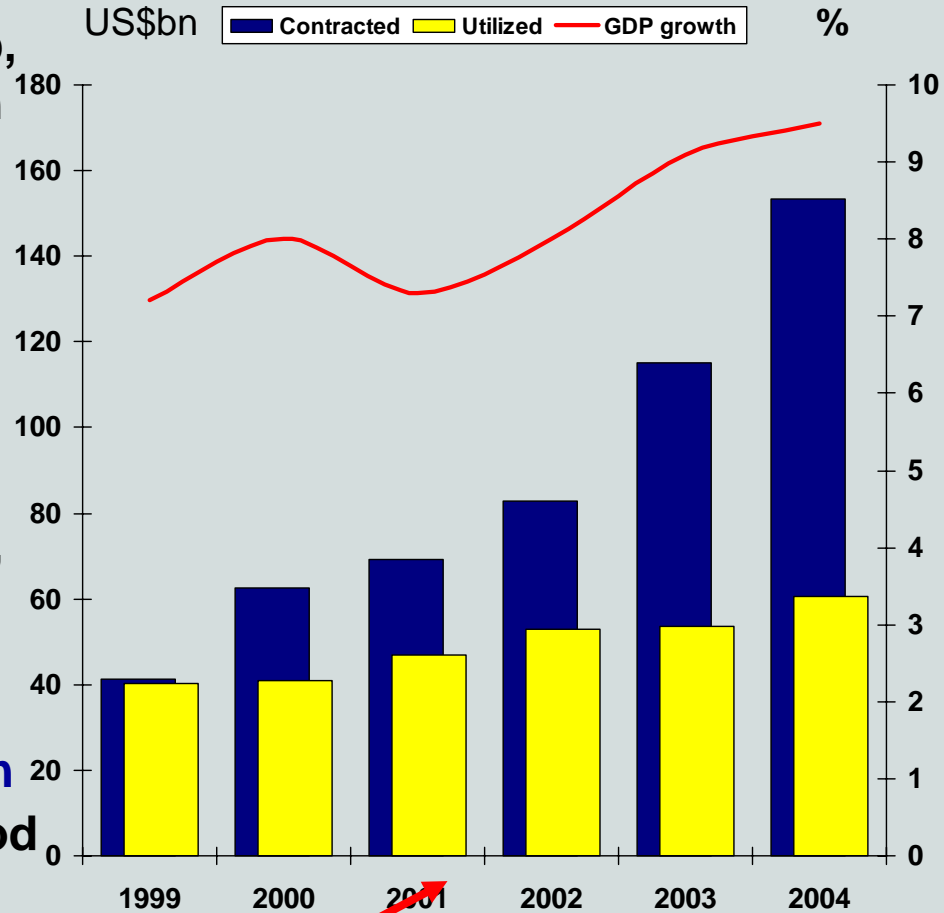
Investors continue coming: look for a 10% leap in 2005 as a more level playing field beckons

2002: despite global economic slump, the WTO aura sparked a 12.6% leap in FDI: **US\$52.7bn**

2003: a still sluggish world economy and SARS slowed investors' trek—FDI grew only 1.4%, to **US\$53.5bn**

2004: anti-job export sentiments in investors' home countries and power, other shortages in China had little effect—FDI grew 13% to **US\$60.6bn**

2005 Expect Up about 5% to **US\$63bn** as Jan-May totals lag same 2004 period by 13%



China entered WTO Dec 11th 2001

. . . and why China threatens

Troubling to some but exciting to many:

- The **speed of China's forward movement**
 - an average annual 8.6% growth over past 10 yrs ('95-'04)
 - an average annual US\$51bn in FDI over the past 5 years
 - third largest trading nation, after the US and Germany
- Its **share of world production**
 - 12.7% of goods and services (EU 15.7%, US 21%, India 4.8%)
 - world's largest (or 2nd largest) producer of such items as:
 - coal zinc tin lead wheat rice mobile phones colour TVs
 - world's 4th largest carmaker
- Its **appetite**
 - buys 20%-25% of many commodities (iron ore, chromium)
 - the world's 2nd largest oil importer

All of this spells opportunities—and growing global clout

How China compares

	China	India	Russia	US
Population	1.3bn	1.1bn	144m	293m
of world pop	20.4%	17%	2.3%	4.6%
Land area (sq km)	9.6m	3.3m	17m	9.4m
GDP (US\$)	1.6trn	677bn	582bn	11.7trn
of world GDP	4.0%	1.7%	1.4%	29%
GDP per head (US\$)	1,130	630	4,050	40,047
GDP growth	9.5%	6.5%	7.1%	4.4%
Exports as % of GDP	40%	16.1%	37%	10%
FDI (US\$bn)	60.6	5.8	11.7	115.5

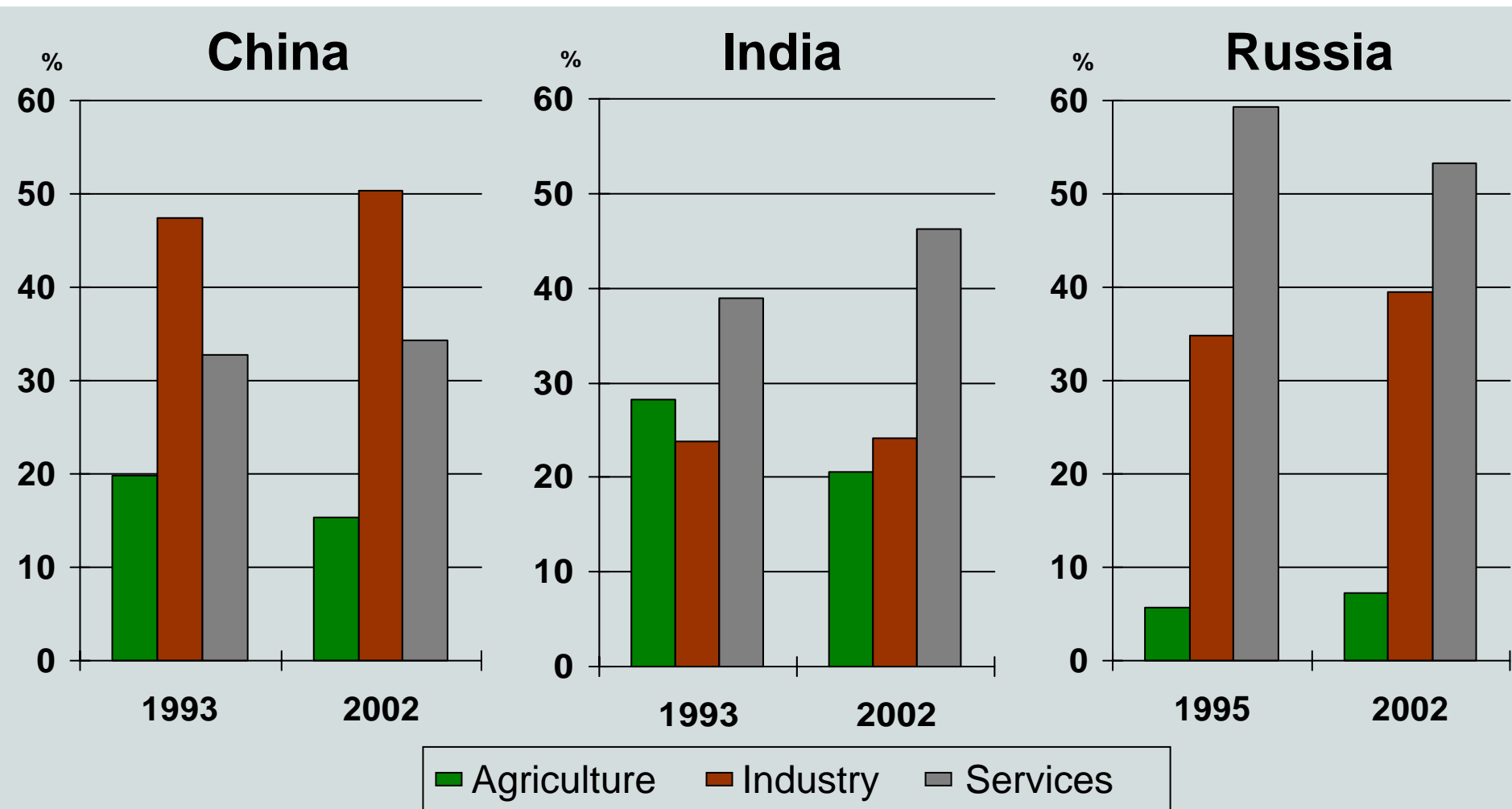
Data are for 2004

Source: EIU

Economist Intelligence Unit

The
Economist

Components of GDP



Source: EIU

China: the economy and politics

Slowing economy, more market options, and the push to grow

How do you solve that equation in 2005?

- Understand that “slow” doesn’t mean “stop” –and some sectors will slow more than others

Note: Watch whether Beijing yields to pressure to relax restraints

- Know that inflation is falling—raising prices won’t be easy

Note: Food has been inflation’s main source, by far

- Understand leaders’ growing confidence—despite clumsy handling of Zhao death

Note: Hu’s been quietly building support in the provinces

- Concentrate on managing growth—both corporate expectations and on-the-ground realities

What will *not* happen in the next 18 months

- No hard landing—that is, growth that dips below 7%
- No physical hostility toward Taiwan—or anyone else
- No one-shot revaluation of the renminbi—but a widening of the band
- No likely let-up in China's push to export—but a slower world economy buys somewhat less

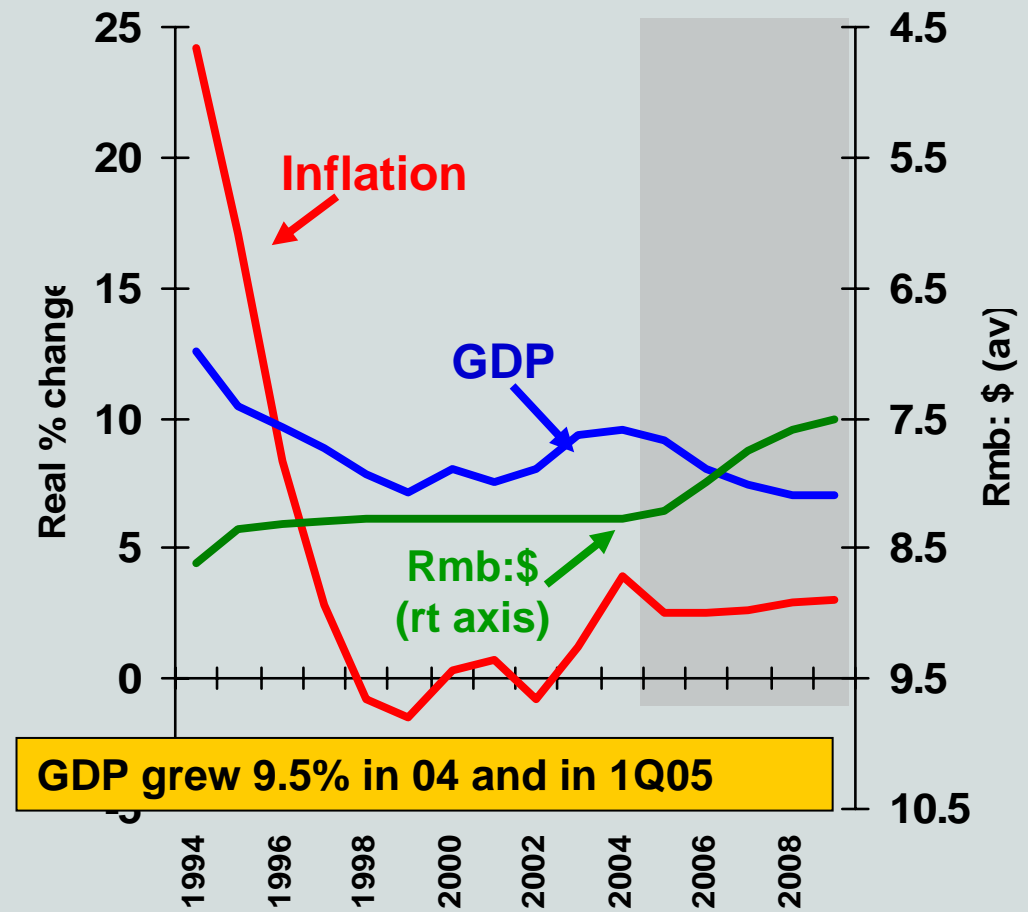
China: growth outlook

Cooling is the current challenge

The economy grew a warm 9.5% in 2004 but will cool somewhat to 9.1% in 2005, cooler still in 2006 (8%)

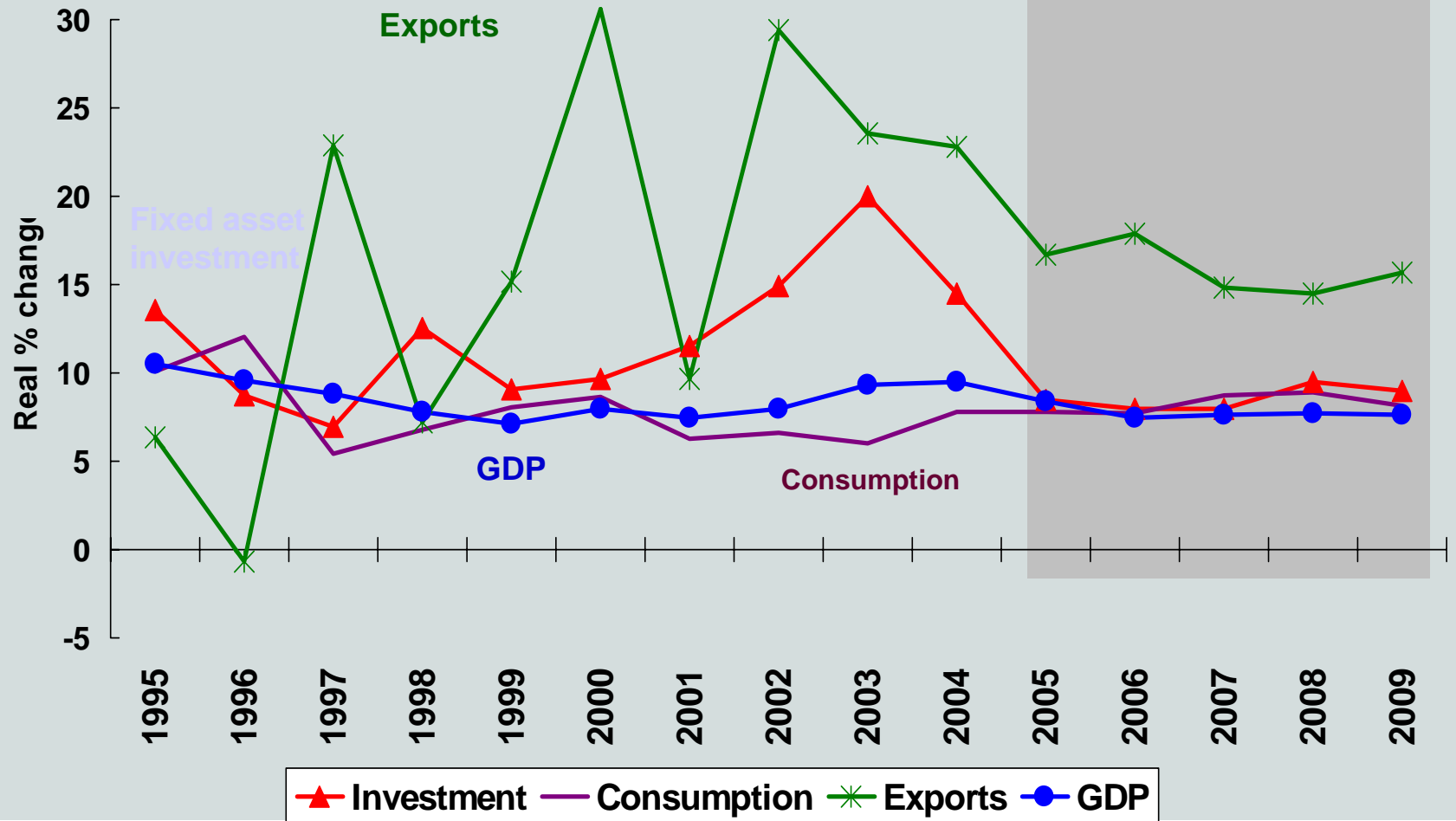
The pace has been slowed somewhat by Beijing's clamps on lending to hot sectors and halting of some investment projects

The new upward trend in prices continued in 2004, rising 3.9%, but will moderate in 2005 as food supply brightens. Inflation will 2.2-2.4% in the 2005-08 period, 3% in 2009



Source: Economist Intelligence Unit

China: growth drivers (year-on-year % change)



Source: Economist Intelligence Unit

Cooling will continue in 2005. . .

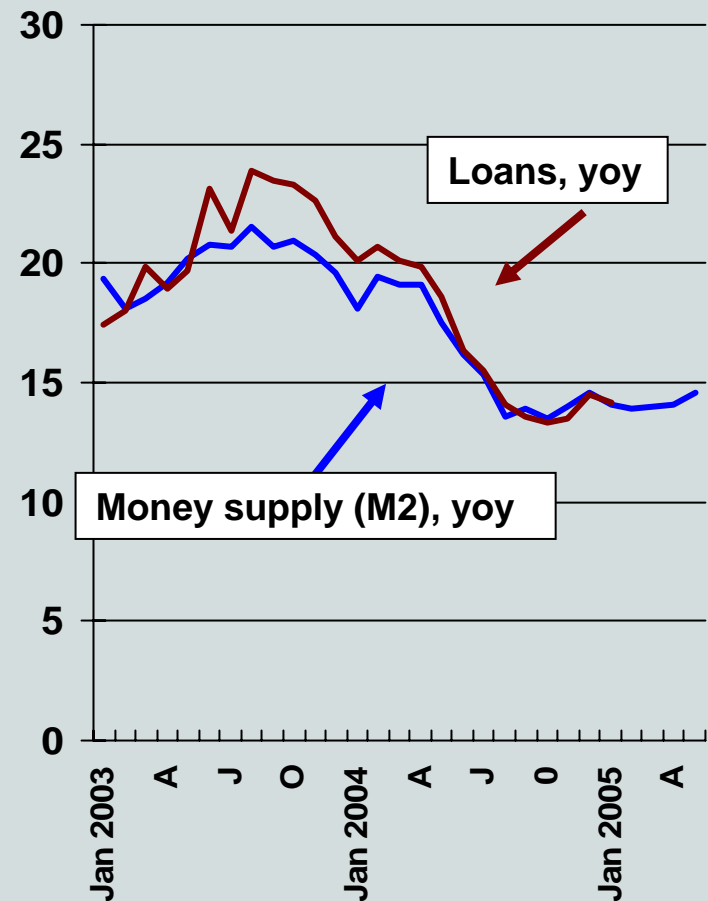
IF Beijing resists pressure to relax restraints

The authorities' moves to cool

- halting lending to some sectors
- raising reserve requirements
- raising interest rates

were to get a grip on the economy and on the banks—before sectoral overheating could cripple the economy and to ready banks for '06 market opening

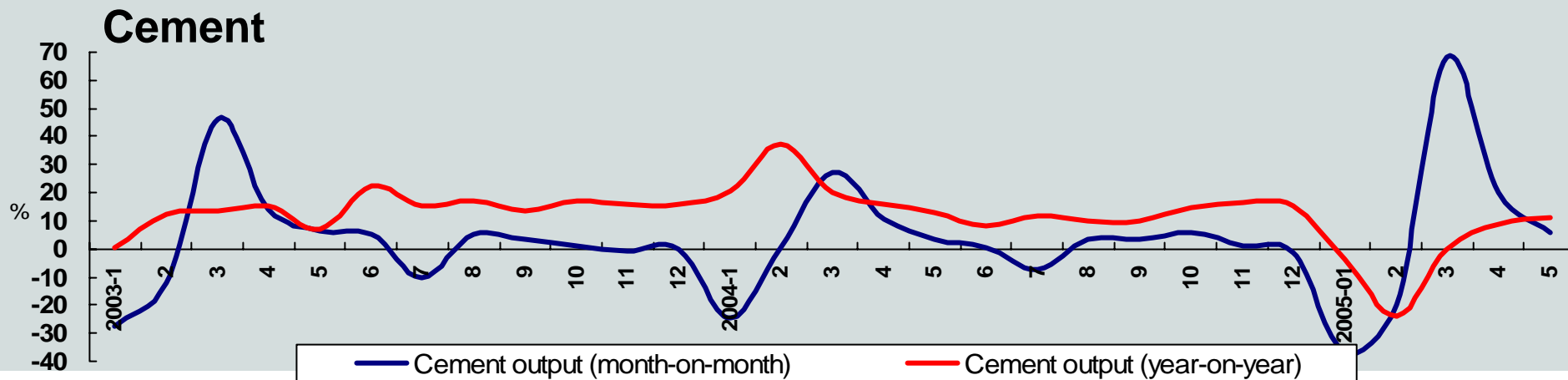
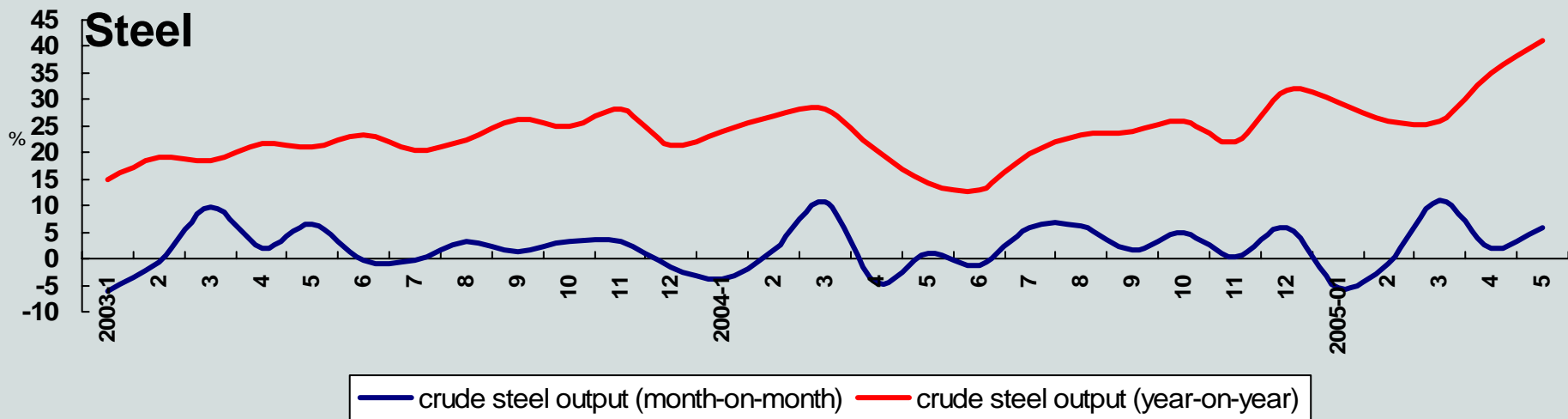
But pressure will mount in 2005 to relax curbs on construction/major projects as pro-growth local officials fear unemployment, social discontent



Source: CEIC, govt statistics

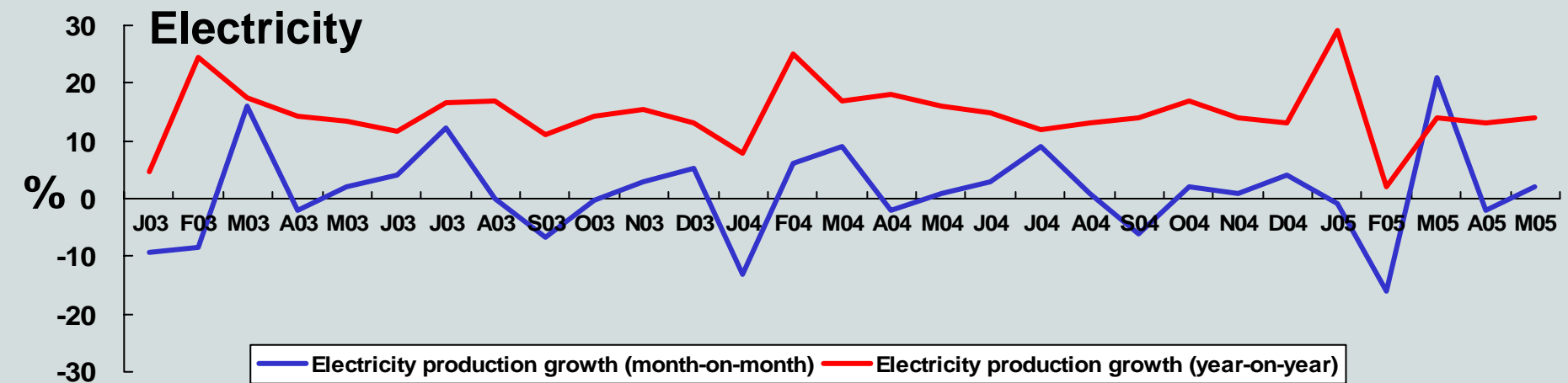
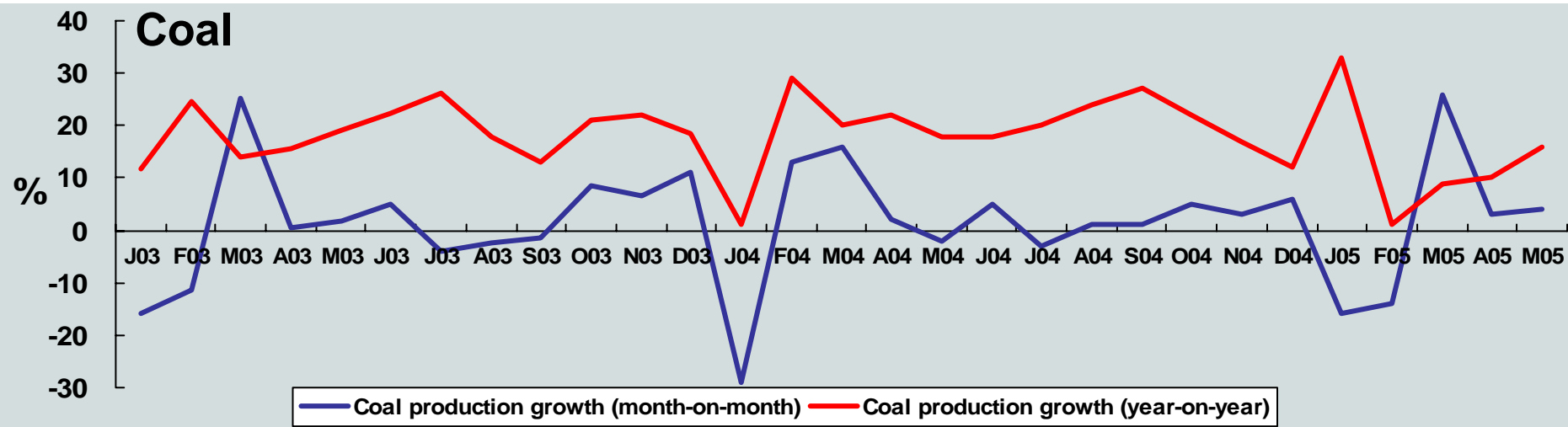
Official pressure on hot sectors is showing uneven results . . .

Steel, cement (mom,yoy growth, Jan 03-May 05)



But these need encouragement . . .

Coal, electricity output (mom, yoy growth, Jan 03-May 05)



Source: CEIC

The automotive industry: how makers view the market

We surveyed 299 automotive industry companies in China in February 2004. We found that:

- Only 30% of them expect the market to grow by more than 20% a year in the next five years
- Yet 44% plan to increase their capacity at that rate
- If the demand forecast is right, capacity will exceed demand by an even greater degree than it does today
- Joint ventures were the most optimistic about the market and their own capacity plans
- More than half of respondents expect between 4 and 6 major OEMs will dominate the industry five years from now
- More than 90% see less than eight leading firms

Note: 299 companies were surveyed, of which 57% were purely domestic Chinese firms, 43% were Sino-foreign joint ventures.

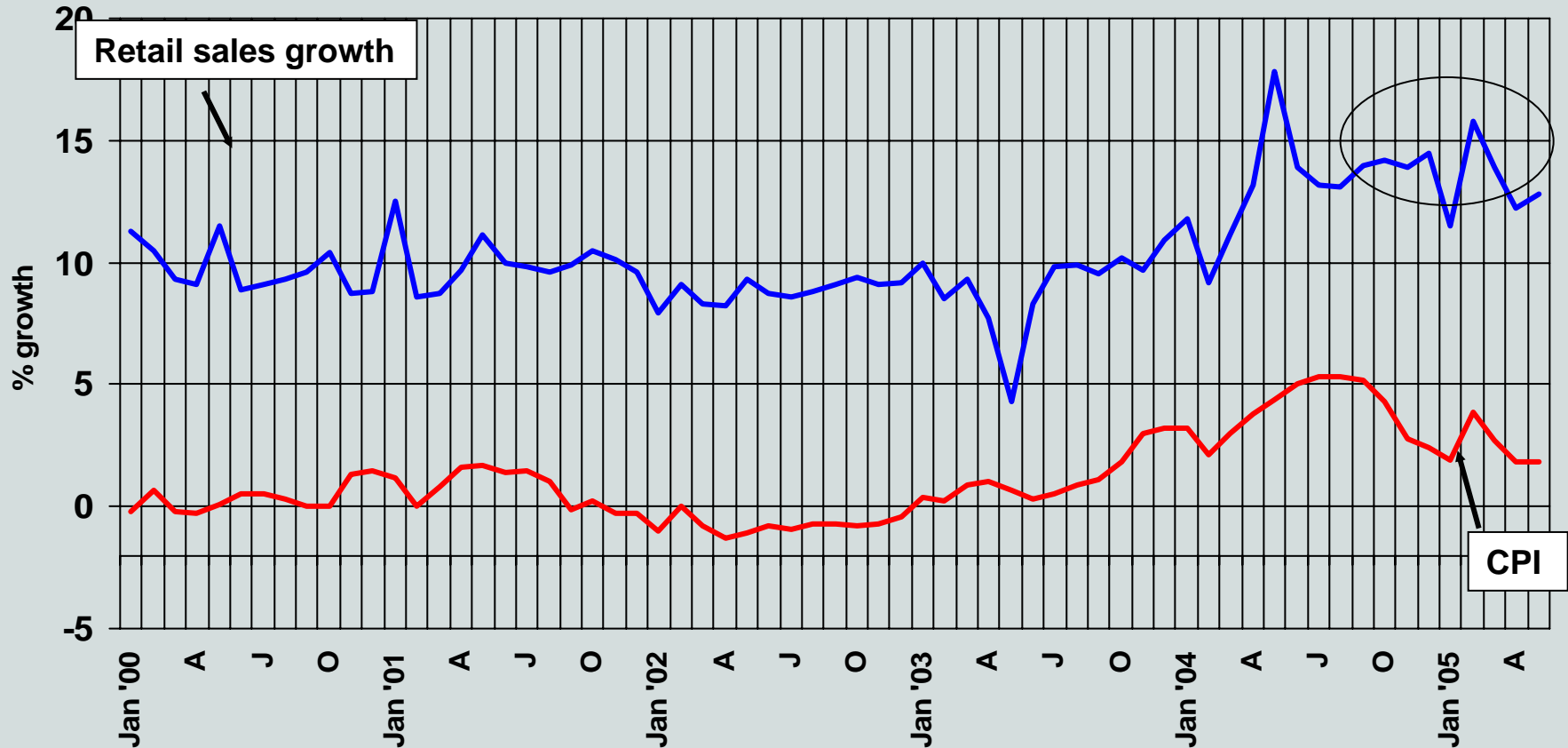
The automotive industry:

state of the market: slower sales, excess capacity

- Car **sales growth slowed** dramatically in 2004:
2002 up nearly 55%
2003 up 80%
2004 up 17% (1H04 up 37.7%, 2H04 up 7.3%)
- Car **prices fell** (VW's Jetta fell from Rmb150,000 to Rmb100,000 in late 2004)
 - ➔ **Imports** are cheaper as tariffs fall (Jan 05 fell to 30%; Jan 06 to 28%, July 06 to 25%)
 - ➔ **Over-capacity** in the industry (the government predicts capacity will exceed demand by 100% in 2007)
- Huge **unsold inventory** at end-2004: 300,000 cars

Consumer spending

(monthly growth, yoy, Jan 2000-May 2005)

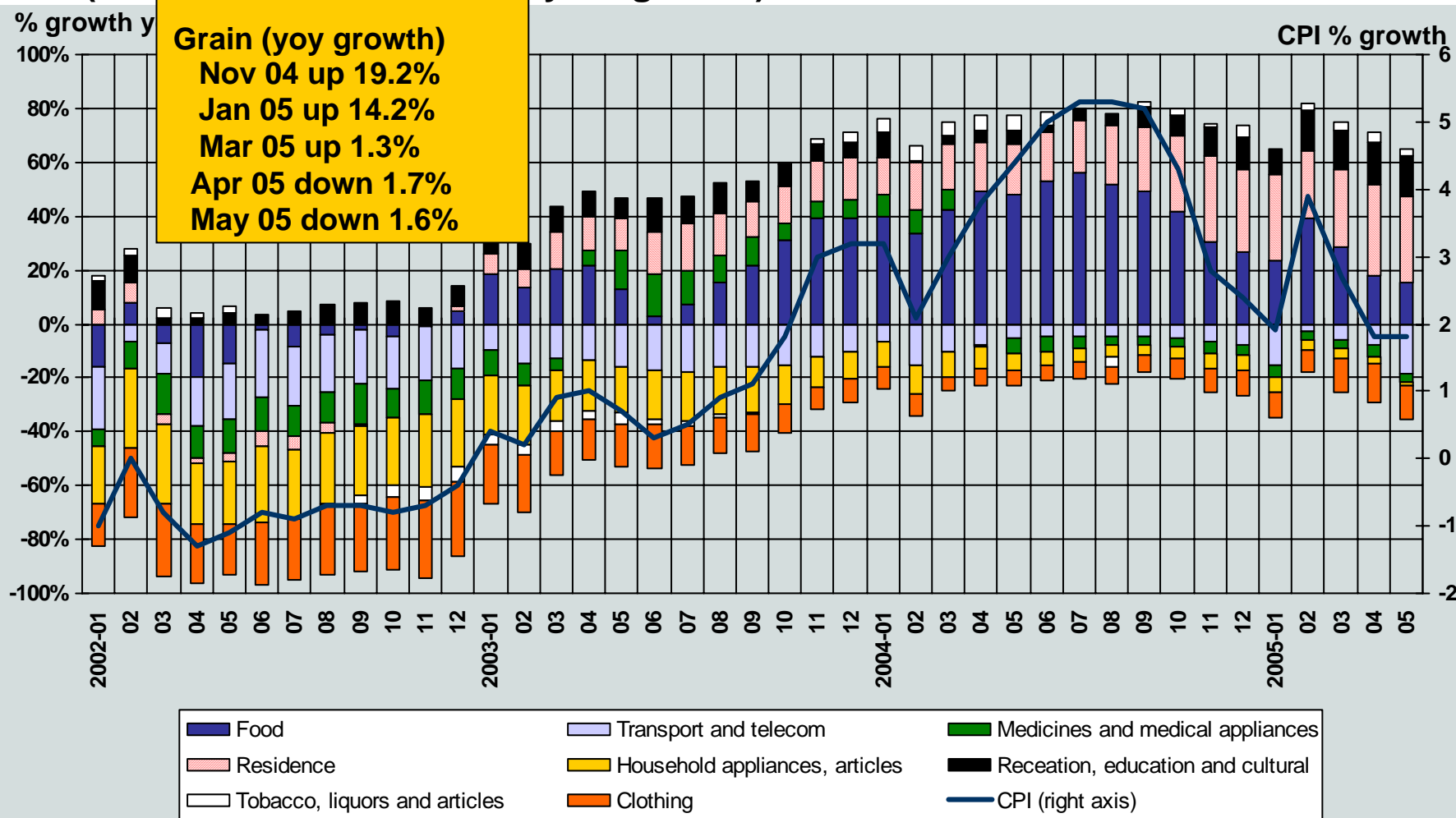


Source: CEIC

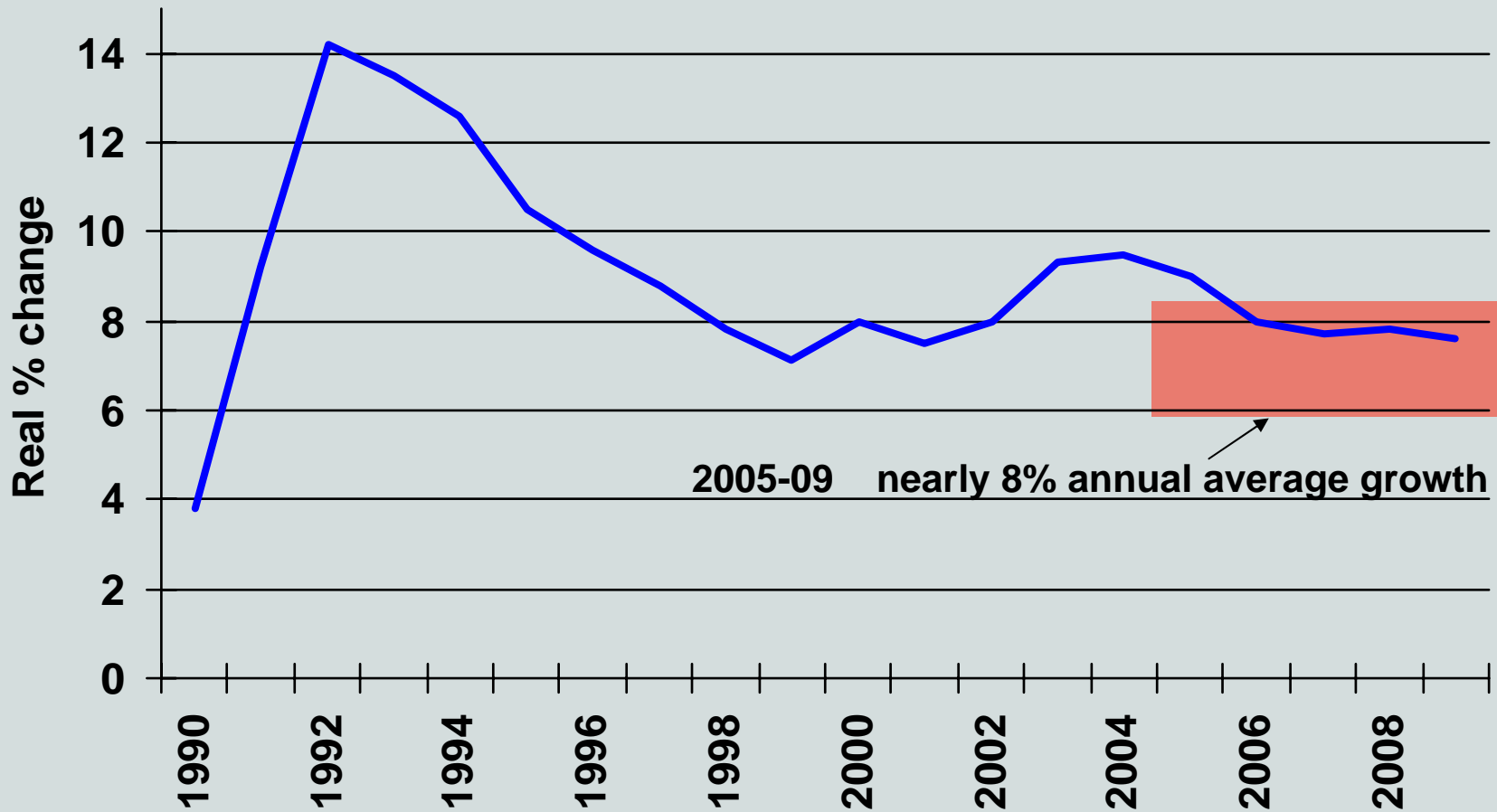
CPI and components, 2002-May 2005

Annual CPI: 2002 -0.8, 2003 1.2, 2004 3.9

(monthly figures, year-on-year growth)



China: growth outlook



Source: Economist Intelligence Unit

Can China maintain this amazing growth?

China can maintain an average 7-8% growth over the next decade if its leaders

manage several issues well:

- Energy—its own and other people's (imports)
- People
- Infrastructure
- Social inequalities (narrowing the rural/urban and coastal/inland gaps)

and change the weight of the drivers of growth

- Decrease dependency on exports
- Increase private consumption

Political risk

but

- Political leadership change has become virtually seamless
- China is at peace with everyone, even a shaky one with Taiwan
- Income gaps could spark unrest

Critical to investors, the Party has demonstrated:

- The political will to pursue modernisation and globalisation—the top leaders have bought in
- Conduct of a modernisation process that necessarily began with Deng Xiaoping and was implemented enthusiastically by Zhu Rongji, who ran the economy from 1993 to 2003
- A willingness to subordinate ideology to economic development
- An understanding of the need to create a well-off society and narrow the urban-rural income gap

China is under international pressure:

- TO:**
- Revalue the renminbi and rethink its export strategy
 - Show restraint toward Taiwan: the cross-Strait flights and KMT visits are encouraging but the anti-secession law is troubling
 - Refrain from proliferating nuclear technology

BUT China's **ability to resist such pressure grows** as its economic clout and strategic importance grow.

AND China is critical in some of the world's big dramas (North Korea, the war on terror, its veto in the UN Security Council) and a major holder of US debt

The RMB: no one-shot revaluation coming

Most critics want a one-time appreciation, then a float

Will China yield to this pressure? **NO**. It feels it needs

- Continued export success
- More time to reform the banking sector

What China will do: widen the band in which the Rmb trades allowing gradual appreciation—but no one-shot revaluation

China may also peg the currency to a basket of currencies including the Euro and the yen, instead of simply the dollar

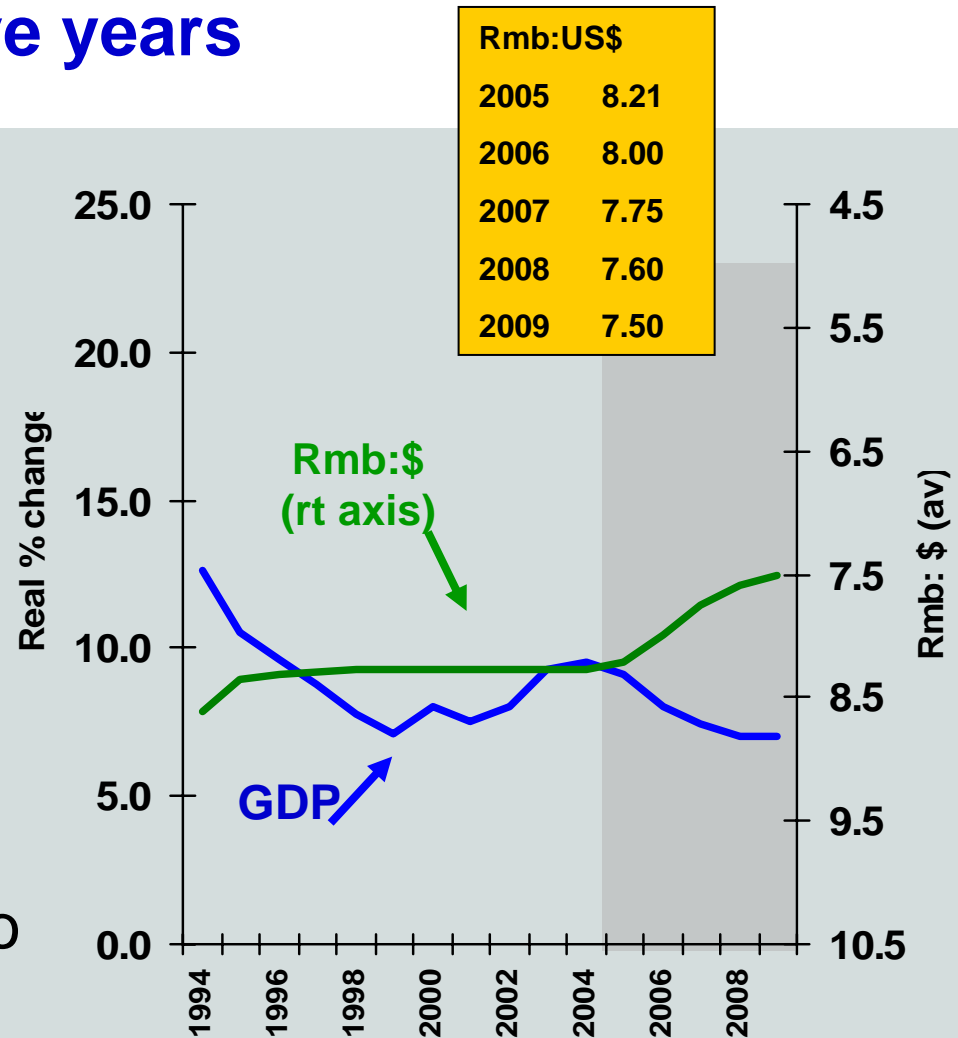
RMB: gradual rise in five years

- These moves will achieve modest appreciation (only about 9% over five years)

but

they will not come near to revaluing the currency 10-20% as some critics demand

- Don't expect the currency to be freed for at least the next five years



Source: Economist Intelligence Unit

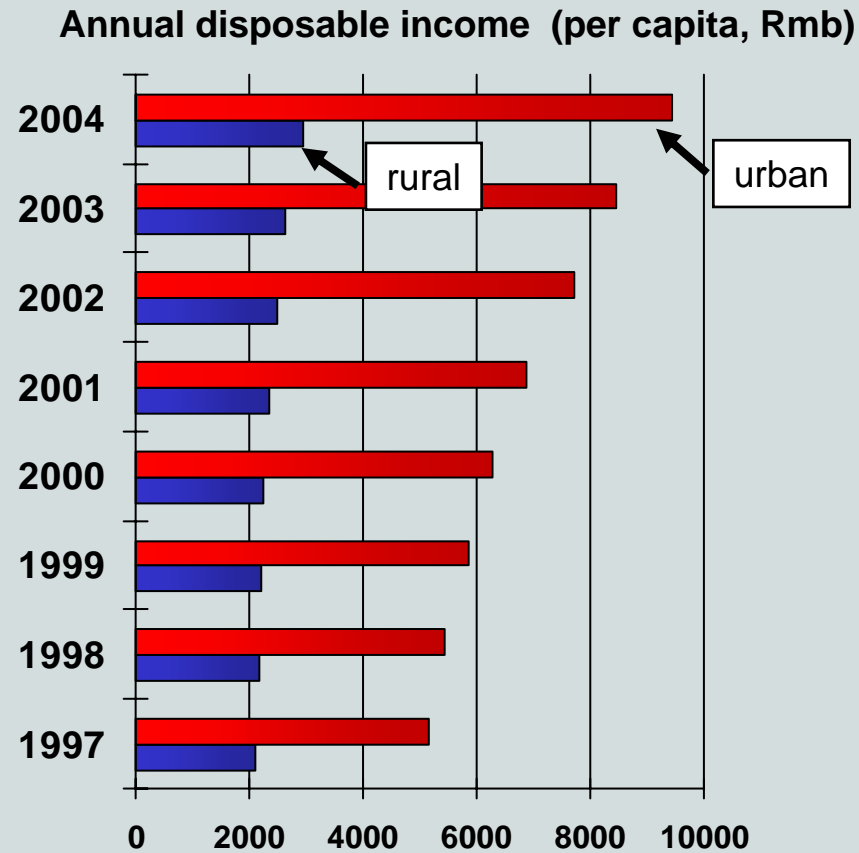
**Key issue for the central government
and for firms:**

**Narrowing the urban-rural and
coastal-inland income gaps**

A critical issue for the Hu-Wen leadership: **agricultural restructuring and narrowing the rural-urban income gap**

The leadership must:

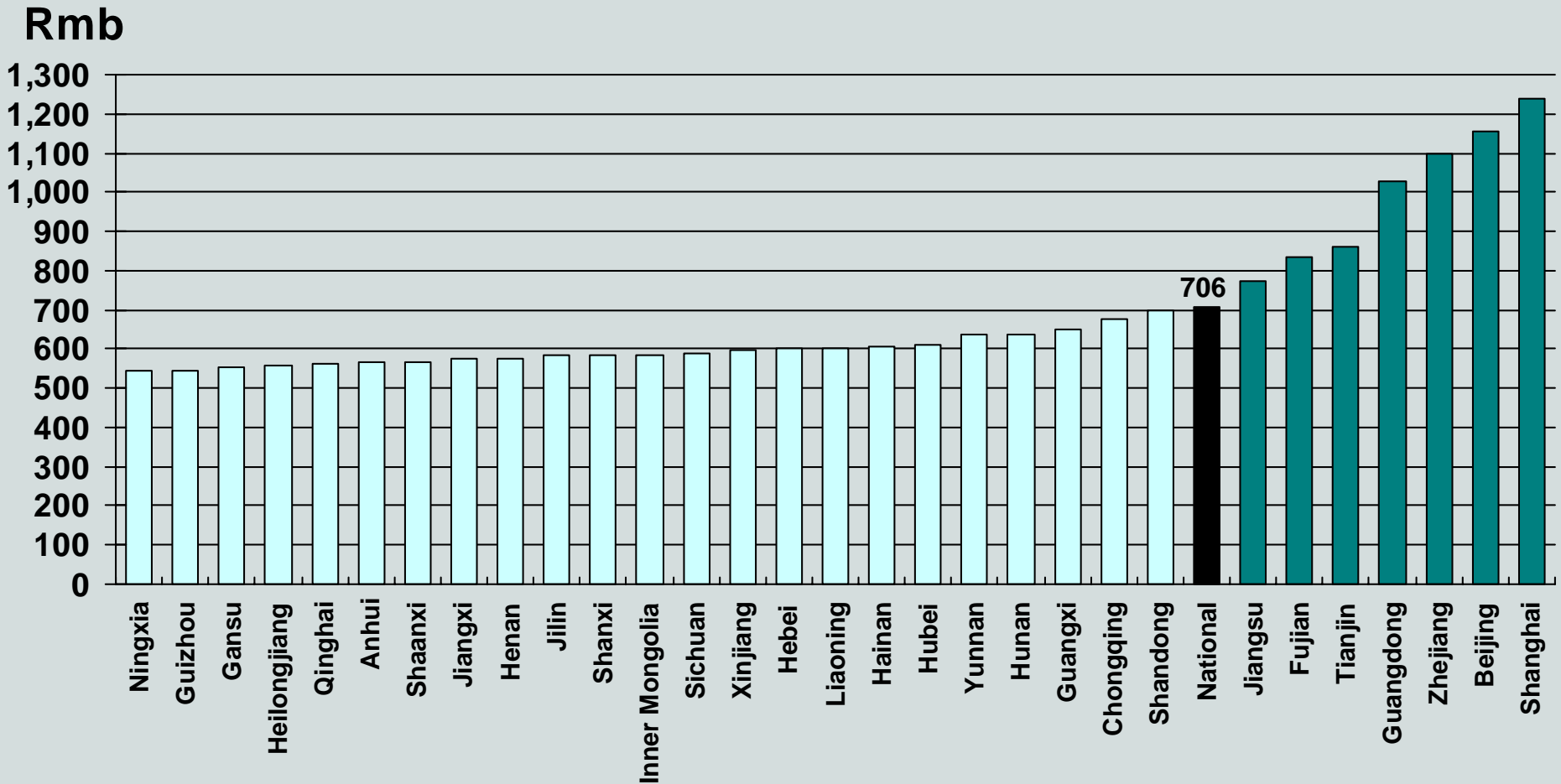
- Restructure the sector as agricultural imports increase (China's ag trade deficit 2004: US\$5.5 bn)
- Stem the flow of farmers to major cities but encourage satellite towns; prepare for inevitable urbanisation
- Narrow the urban-rural and coastal-inland income gaps. (Urban incomes are 3 times larger than rural ones.)



Source: National Bureau of Statistics

Coastal-inland gap: inland provinces lag

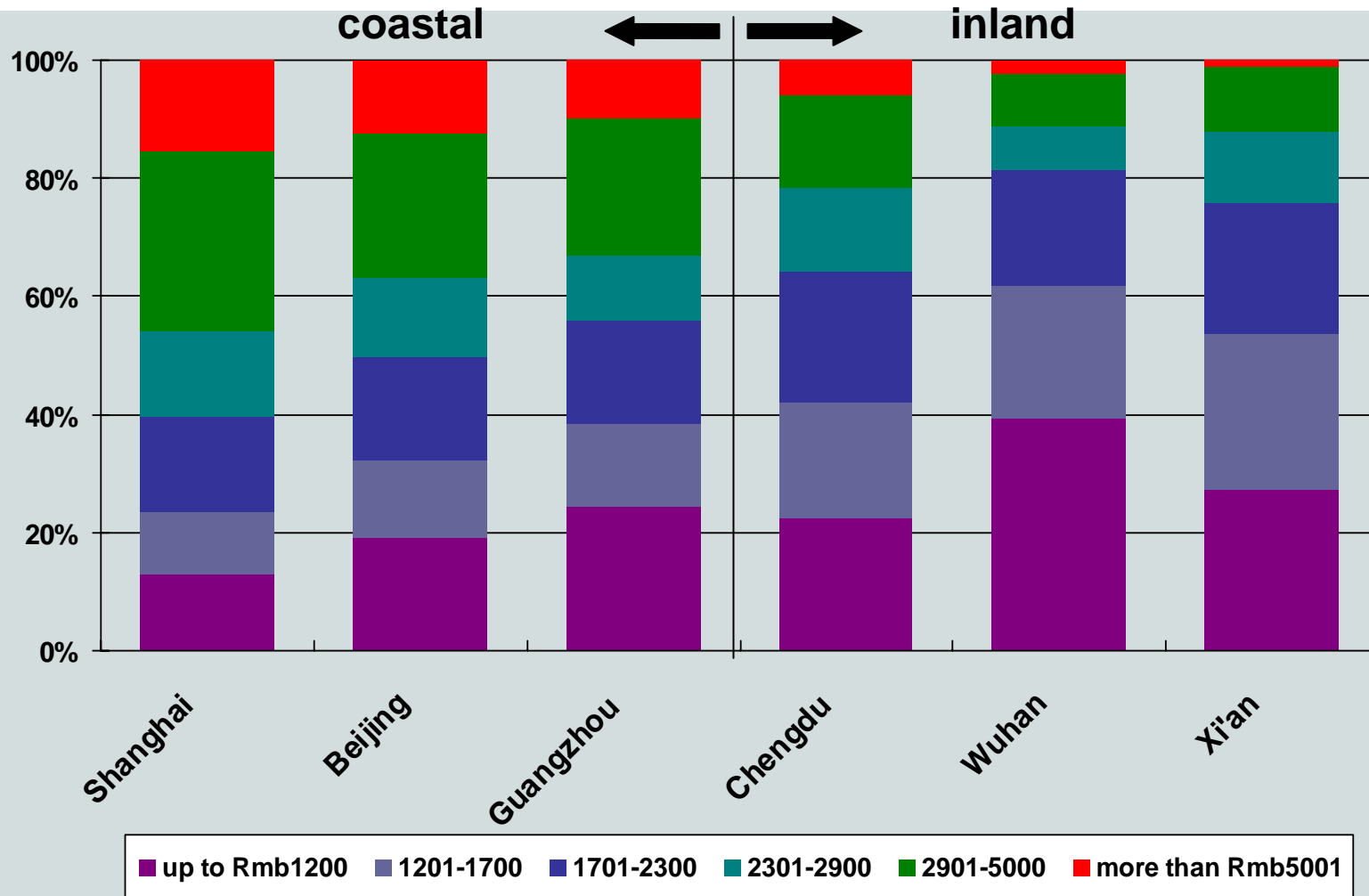
(average disposable income, per month, per capita, 2003)



Source: CEIC

The coastal-inland gap

(Household income, monthly, by major city, 2003-04)



Source: IMI, 2003-04

Growing the middle class

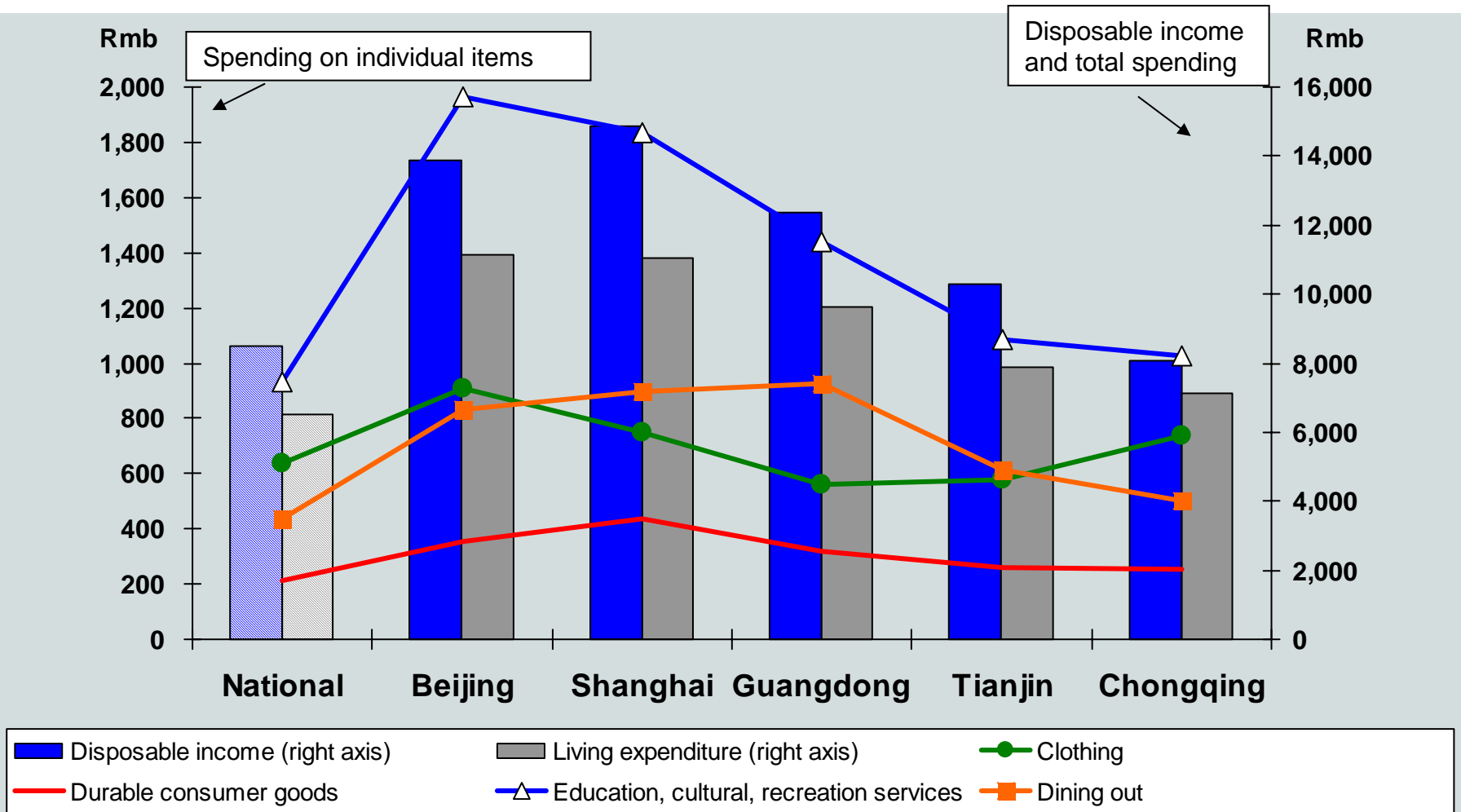
To ensure its continuing existence, the Chinese Communist Party wants to create a well-off society

Today, some surveys show, 50% of China's people consider themselves "middle class"

According to a Chinese Academy of Social Science study:

- 19% of the total population—250 m people, 49% of urban households—are middle class
- Middle-class households are those with total assets of between US\$18,000 and US\$36,000
- By 2020, China's middle class will increase to 40% of the population

Consumers: disposable income and expenditures, 2003 (per year, per capita)



Source: National Bureau of Statistics

The operating environment . . .

Fulfilling promises: the first three full years of compliance (Jan '02 - Jan '05)

WTO-related disputes will be common but several market opening measures have been taken. China promised that, **by end-2004**:

- Foreign banks would be doing RMB business with PRC companies (and by end-2006 with individuals), no geographic limits
- Manufacturers would be enjoying trading rights (the ability to import parent and other products, export)
- Retailing, wholesaling and overall distribution would be under companies' control

Trading and distribution rights:

Companies are right to question Beijing's intentions

→ WTO-compliant and an apparent breakthrough . . .

Administrative Measures for Foreign Investment in the Commercial Sector (effective June 1 '04, more liberalisation Dec 11)

Four commercial activities are covered:

- wholesaling
- retailing
- franchising
- commission agency

All companies will be able to import products, sell and distribute them (as well as ones they make in China)—at wholesale or retail

→ . . . but now what?

Implementing rules—critical guides to what can and cannot be done—were expected by end-2004 but they have not yet appeared

. . . what growth requires of companies

For investors:

Growth requires . . . structural changes

Operating structures in China are changing again.

Over the next 12 to 18 months, widened trade and distribution options will require deciding:

- What functions to retain and what to farm out (the options for 3PL providers are widening)
- Where to centre in-house trade and distribution functions
 - + amend a current operation's business scope or
 - + create a new FICE (foreign-invested commercial enterprise) or
 - + turn an existing venture into an FICE

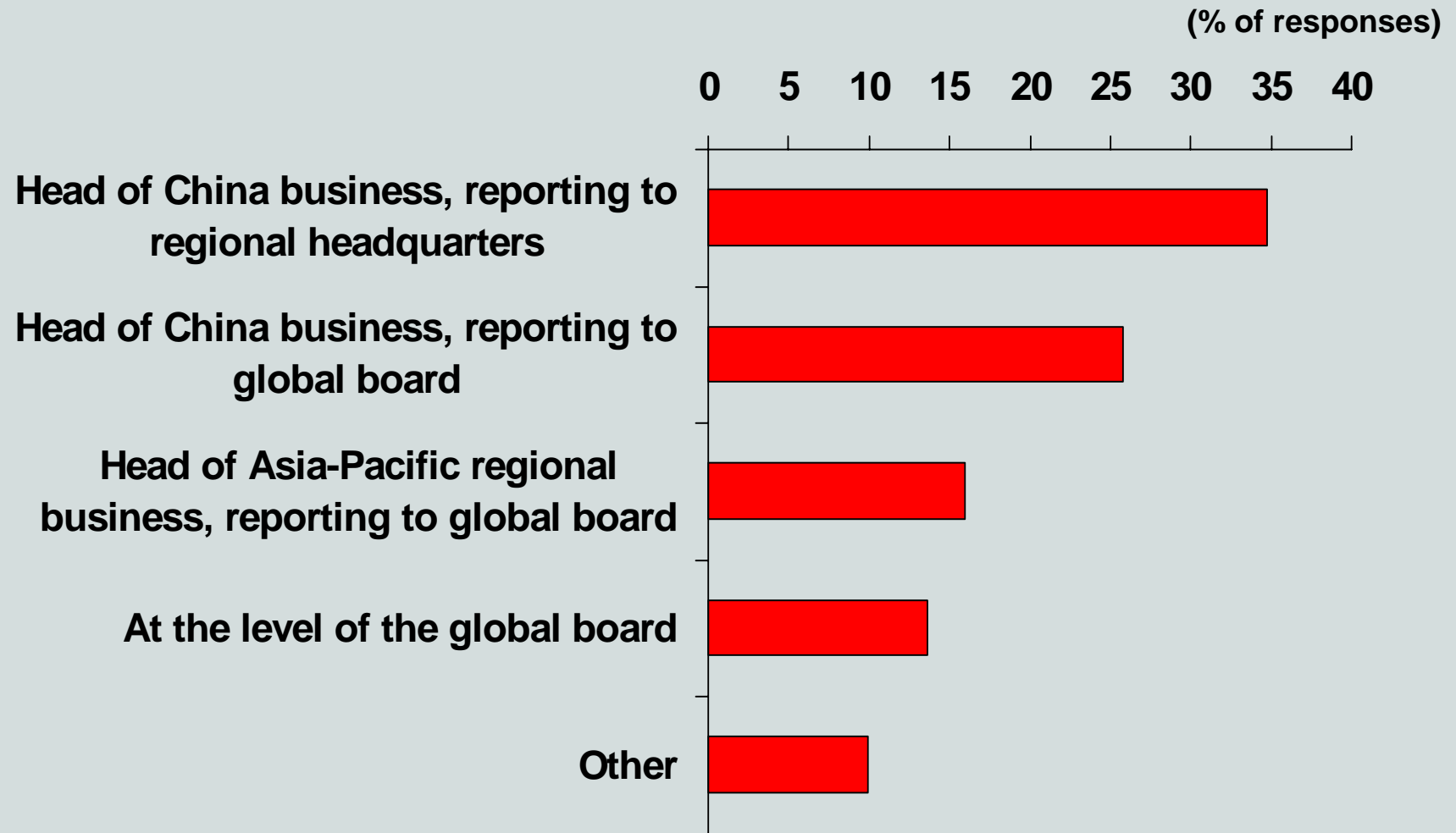
Time for lawyers, accountants—and hard thinking

Growth requires . . . corporate relationship changes

Corporate relationship changes will reflect China's growing importance to global turnover

- China will be run like Japan, as a separate, complex entity requiring a manager's sole focus. (The Greater China concept is fading.)
- China heads will report directly to corporate HQ
- Shanghai will become the functional centre (often China headquarters)

We asked companies in April 2004:
Where does the China CEO sit, in the global decision-making structure



Source: Chart by Chris Nailer, Australian National University, from the survey in *Coming of Age: Multinational Companies in China* (Economist Intelligence Unit, June 2004); 217 respondents

Growth requires . . . deepening local ties

Local government power is widening

Over the next 12 to 18 months, companies will be forced increasingly into the arms of local officials.

- Approval power is going downward
- Some apparent contradictions can put companies in the middle:

Beijing's need to control local-level industrial capacity-building

versus

its allocation of more approval power to local levels and provinces' desire to attract foreign capital, expand their tax base

Companies must consider placing government relations managers in provincial capitals/cities—as well as in Beijing

Growth requires . . . an R&D presence

Despite flawed intellectual property rights protection in China, an R&D presence may be necessary for more than simply R&D

R&D centres:

- Allow companies to take advantage of China's talent pool in sciences and engineering
- Increase the weight of a company's presence and demonstrate yet another level of commitment
- Allow companies to do pure research and/or China applications

Protect IP by doing simply part of the research in China, integrating it with the rest elsewhere, and limiting number of people with access to parts of the process

A possible brake on companies' growth: an anti-monopoly law

Anti-trust legislation

- the anti-monopoly sentiment may already be present in some sectors, bureaucracies, locations
- anti-monopoly legislation is being prepared
 - in draft since March 2004
 - possible passage by NPC Standing Committee in 2005 for enactment in 2006
 - may well be used against domestic SOE monopolists as well as large foreign firms

What could slow China's forward momentum—and seriously discourage investors?

What could **slow** China's forward momentum . . .

Situations that could **slow China's forward-moving train**—but not necessarily reverse it:

- War—civil; with Taiwan; or with other states
- Repeated terrorist incidents
- Social unrest that is co-ordinated
- Inability to secure sufficient energy resources
- Banking system collapse
- World-wide recession or, worse, depression
- Rapid increase of HIV/AIDS-infected people

. . . and seriously **diminish its lustre** with investors?

- Serious social deterioration (e.g. urban crime, vandalism, ineffectual police force, over-stretched social services)
- Acts of corruption affecting everyday life
- Rapidly escalating wage rates
- Expropriation or nationalisation of property
- Domestic politics in investor nations or international anti-globalisation activism that forces investors to refrain from showy investment projects—even in China

China's lustre dims—but investors do **not** retreat

None of these events **occurring alone** would be powerful enough to cause firms to divest and leave, though one or another might take the gloss off of China as an investment site.

Two of more of these events occurring simultaneously would certainly dim China's lustre—and cause some firms to leave.

Still, participating in satisfying the needs and desires of 1.3 bn people in a vast land would remain a powerful attraction that, to many companies, would be worth almost any risk.