thebigpicture

guideposts for the private investor

Week Commencing 29 September 2003

CHINA: STILL HEADING UP

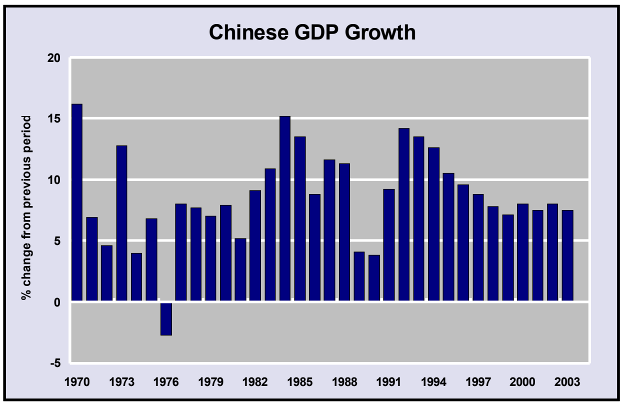
China remains on track to achieve its long anticipated potential. It is set to overtake the USA as the world's largest economy in little more than a decade. However, some anxieties are emerging: are gains coming at the expense of others?

China burst onto the business scene fifteen years ago when investors began to recognise the size of its potential market and the business opportunities it represented. Companies were expected to be transformed radically by the chance to participate.

As so often happens, anticipation ran too far ahead of short-term reality. Any company without a China strategy was thought likely to be a financial laggard. So, managements were pressured to respond to the perceived China opportunity.

The anticipated transformation of business, however, did not eventuate.

- The competitive environment within China made it difficult for companies to establish themselves profitably. They had to contend with emerging Chinese companies. But more than that, the influx from outside China created competition for market share which had no parallel anywhere else.
- Despite some conspicuous examples of how Chinese people were beginning to embrace consumerism, notably in Shanghai, generally low incomes limited how much western companies could gain by supplying sophisticated consumer products.
- Although committed to economic development, Chinese authorities were not necessarily committed to the longer-term success of western companies. Admission of foreign businesses was a quick way to rebuild plants which were not up to scratch by western standards or to gain access to technology. For the longer term, Chinese authorities ensured that their own national enterprises were also being fostered even at the expense of western companies being able to establish themselves profitably.
- Some local business practices posed cultural and commercial obstacles for western companies. Failure to protect intellectual property rights was one and, although the experience varied, examples of official and business corruption created uncertainty.



From the viewpoint of foreign investors, these pressures meant that the China story was too frequently of the horror genre and not the intended fairy-tale.

From demanding a China strategy, shareholders switched tack. They began to demand an exit strategy. Shortly after, and having learned little from the earlier experience, the revolution in information technology was thought to represent better value than anything China had to offer. Any company without an e-strategy was thought likely to be a financial laggard. And so, the cycle contin-

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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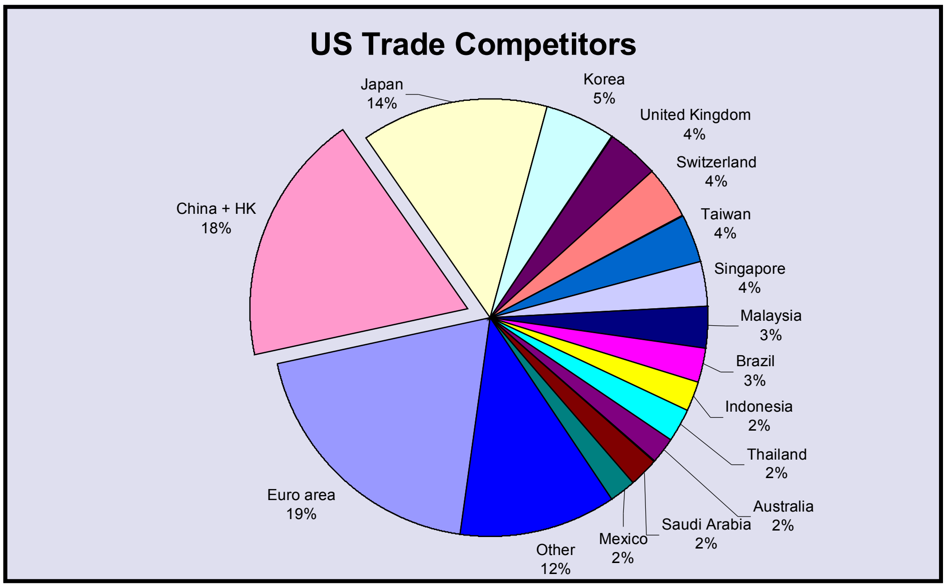
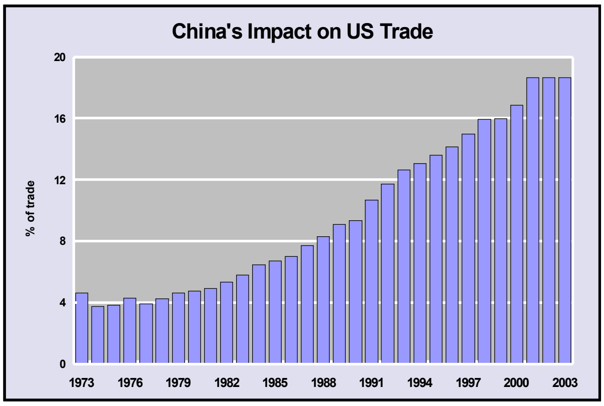
The Weekly Chart Spot



Source: US Federal Reserve Board

The importance of China in the trading performance of the USA has been rising consistently for the past thirty years. One indicator of this trend is China's weight in the trade weighted index of the US dollar calculated by the Federal Reserve.



The Fed's weights take account of trade between China and the USA as well as the extent to which companies from China compete in third markets with US companies.

China and Hong Kong currently account for 18.6% of the markets in which US companies compete. Their importance has risen from 4.6% thirty years ago.

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China: Still Heading Up cont'd

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and yuan depreciation against the yen.

Japan has an added fear. Its low domestic inflation rate is reducing the capacity of its companies to rebuild their profits. China's low inflation rate is not helping.

China's authorities have been able to achieve the highly prized double: high growth and low inflation. Since hitting 17% in 1995, China's inflation rate has fallen to under 1%.

With continuing productivity gains and ample excess capacity throughout the region, the outlook is for continuing low inflation and continuing pressure on Japanese corporate profits.

From the Chinese perspective, however, ongoing internal adjustments are just too great to react to what their officials perceive as a short-term view. The growth in China's urban population (and the migration of rural workers to the cities) represents a political as well as economic challenge which goes to the heart of the system of government.

To be able to accommodate the population shift will require growth to run at close to 8% for the foreseeable future. Exports will be a central part of this outcome. Those in charge might recognise the inevitable abandonment of the peg but will be reluctant to take the initiative if it can be avoided.

CHINA: STILL HEADING UP CONT'D

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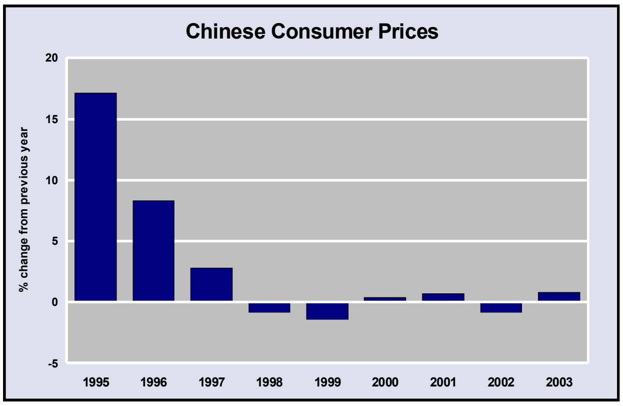
Meanwhile, despite disillusionment among investors, the basis of the China story was actually intact:

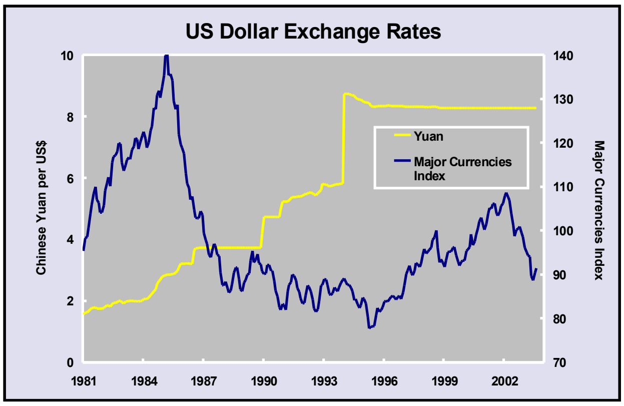
- a very large population base;
- a powerful government strongly committed to economic development;
- rising domestic affluence fostering a growing market for higher value consumer goods;
- a relatively low cost and disciplined workforce with which to attract foreign investors;
- macro policy settings which offered a relatively benign business environment; and,
- progress toward membership of the World Trade Organisation.

The underpinnings of the China story became more apparent in the late 1990s when other Asian economies showed that they were not as stable in their politics and that there were still structural flaws in their growth.

China's share of foreign direct investment increased as its regional rivals lost some of their edge. Foreign direct investment in China reached US$53 billion in 2002, according to the World Bank, some 20% ahead of the flow in 1997. Elsewhere among the main southeast Asian economies, foreign direct investment flows of US$8 billion in 2002 were less than half the US$21 billion attracted in 1997.



While its growth performance has been outstanding for over 20 years, China's relative size meant that it was less important than the USA, Europe or even Japan as a national competitor. That is now changing.



It is within sight of becoming the world's largest economy. With that is coming added prestige in international forums and greater influence in global decision making. With critical mass, however, its economic progress is no longer seen as so unambiguously beneficial.

Within the region, China has become an economic hub. Its imports of semi-finished goods from within the region support regional development. Many companies are using China as a low cost assembly point.

However, in some quarters, China is being viewed as more of a threat than it used to be. Increasingly, its share of international trade is seen as coming at the expense of the trade performance of other nations.

Maintaining a currency tie to the US dollar is highlighting this anxiety. With the currency pegged at 8.27 yuan to the US dollar, Chinese exporters are gaining a competitive advantage as the dollar depreciates against the currencies of other countries.

There is an argument that China, like other major economies, should remove the peg and allow the yuan to find its own level. China's superior trading performance and burgeoning currency reserves would suggest that were the peg to be broken the yuan would appreciate. This would suit already hard-pressed Japanese exporters trying to overcome the effects of US dollar

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IMF Forecasts Signal Lower Returns

The forecasts of the International Monetary Fund (IMF) are a telling backdrop to company performance. Companies will be unable to outperform the business environment in which they find themselves.

The IMF publishes a twice-yearly review of the economic outlook with forecasts for individual countries and regions. The accompanying table shows GDP forecasts for selected countries published in the past week and the forecasts which were prepared for the same countries in the first quarter of 2003.

For the USA and Japan, the IMF is more optimistic albeit still expecting below potential growth.

For Europe, the forecasts have been scaled back yet again. While a recovery in growth is foreseen for 2004, this is based on little more than wishful thinking: there has been no change which would make that recovery more likely to occur than in the past when it had also been anticipated.

From an investor's viewpoint, three factors stand out:

IMF GDP Forecasts

% change from previous year		Latest		Previous	
	2002	2003	2004	2003	2004
USA	2.4	2.6	3.9	2.2	3.6
Europe	0.9	0.5	1.9	1.1	2.3
Japan	0.2	2.0	1.4	0.8	1.0
UK	1.9	1.7	2.4	2.0	2.5
Canada	3.3	1.9	3.0	2.8	3.2
Korea	6.3	2.5	4.7	5.0	5.3
Australia	3.6	3.0	3.5	3.0	3.7
Singapore	2.2	0.5	4.2	3.0	3.5
China	8.0	7.5	7.5	7.5	7.5
India	4.7	5.6	5.9	5.1	5.9

- The slowdown in global population growth means that the economic growth rates which had appeared normal in the last decade will generally not be achievable in the decade ahead. Europe is in a transition to a long-term lower growth environment where 2% pa might be a good outcome.
- Inflation remains in check. Price increases in the 2-3% range and often lower are the norm. With global excess capacity, there seems little to disturb this prospect. Perhaps only oil prices deliberately pushed higher by OPEC might change it.
- With nominal GDP growth of 4-5% a year in Europe, it is hard to envisage profit growth consistently higher. Occasional attacks on costs might boost short term profit growth temporarily but the macroeconomic environment sets the framework.

The limitation on profit growth imposed by this environment in turn constrains the returns which can be expected from equity investments exposed to these conditions.

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China To Be The Biggest

China's growth rate is strong enough to mean that it could be the world's largest economy in a little over ten years.

According to the International Monetary Fund, the USA is currently the world's largest national economy accounting for 21.1% of global GDP. The European Union countries combined are equivalent to 19.7% of global GDP but Germany, the largest of these, is only one-fifth the size of the USA. Japan, the third largest economy after China, measures 7.1% of GDP.

China's is the second largest national economy accounting for 12.7% of global GDP, about 60% of the size of the USA.

However, China's growth has consistently exceeded the performance of any of the advanced or major developing economies. The Chinese economy has averaged 8.7% annual GDP growth over the last thirty years compared with an average annual growth rate in the USA of 3.0% over the same period.

Maintaining such a relative growth outcome implies that in 11 years the size of the Chinese economy will have exceeded the size of the US economy to become the largest in the world.