Insatiable Dragon

What the Future Holds for China

by James Kynge, China Editor, Financial Times

It's been an unusually wet summer in Beijing.

But while the capital has been drenched, the countryside all around has remained desiccated by drought. How has this happened? Have the clouds been obeying some secret Communist party directive to hold their rain until directly above the capital?

Of course not. In fact, the rain has been caused by an immense cloud-seeding programme: more than 30 modified aircraft, 6,900 anti-aircraft guns and 3,800 rocket launchers have done battle with the heavens to squeeze more moisture out of the sky. But why seed the clouds directly above Beijing and not in the surrounding countryside? The answer, apparently, is that the prime object of this rainfall has not been to ease a shortage of water but to alleviate a dearth of electricity. The more it rains, the cooler it is – and the less people use their air conditioners.

I tell this story not because, being British, I am obsessed with rain, nor do I seek to make a point about China's environmental challenges. Rather it is because in economics, as in meteorology, China is often not quite what it seems, and rarely what the national bureau of statistics would have us believe.

All Wet – and Yet Overheated?

I am not one of those that believes that China is badly overheated and heading for a crash. I think there will be a soft landing this year, with GDP growth coming in at somewhat above 8.5%, compared to an official 9.7% in the first half and 9.1% last year. The slowdown now under way will become more pronounced next year, but it is likely that even at the end of 2005 growth will still be around 8%.

So in what sense is China not badly overheated? Official figures show that fixed asset investment contributed 47% of GDP last year and has been growing so far this year at over 30%. These admittedly are scary figures – way above the long-term trend line for China and above any sustained experience in other countries like Japan and Korea. But the Chinese official figures give slightly the wrong impression. First, and unusually, they include land sales. Second, they include not only investment in property by developers, but also retail purchases of property. These figures are inflated by a big one-off shift: about five or six years ago, the houses and apartments of people in China were not really traded commodities. But reform of the housing market – which in my opinion was the single biggest source of wealth creation in China in the last decade – has meant that homes are now freely traded, the mortgage sector has taken off and property prices have risen sharply.

So this should bring some solace to those concerned about China's fixed-asset investment figures, because these purchases are an expression of demand, not supply. The other point here is that as house prices rose from an anomalously low base five years ago, the asset appreciation also shows up in the fixed asset investment statistics, thereby inflating those figures further.

My third point about fixed-asset investment is more contentious and more personal. As somebody who travels in China every month and has reported from every province, the economy does not look terribly overheated or overbuilt.

The March of Consumerism

My theory about why the figures seem out of sync with observable fact is that consumer spending – especially on services – is quite a bit higher than the official statistics show, which makes it look as if the contribution to GDP from investment is higher than it really is.

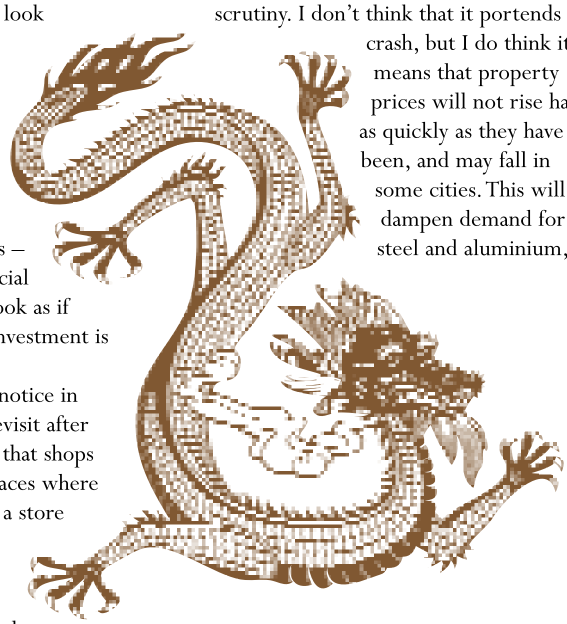
The biggest difference that I notice in small towns and villages that I revisit after an absence of five or six years is that shops have sprouted everywhere. In places where the only shop five years ago was a store selling peanuts and nails, there are now typically a motorbike sales outlet, a restaurant, a hardware store selling agricultural pumps, a garbage collection point, a place selling building materials and, without fail, a place offering foot massages. Well, I suppose there are 2.6 billion tired feet out there.

This boom in services is very striking, but it does not show up in official figures. The stats bureau says that services still contribute only about one third of GDP. While the tax bureau complains bitterly about service sector companies dodging taxes, statistics bureau officials deny the possibility that the same service companies may be under-reporting to them too. "We have complete confidence in the accuracy of our figures," the head of the stats bureau said recently.

The truth, I think, is that the service sector forms the bulwark of a large and established underground economy that remains beneath the radars of the tax and stats bureaux.

I have spent some time on the issue of investment because I regard it as crucial to understanding that China is not badly overheated. But it is equally important to realise that it is a bit overheated.

The steel, aluminium, cars, cement and property markets have grown considerably faster than their historical trends and against what has been observed as sustainable elsewhere. The average price of a dwelling in 35 Chinese cities is now 10 times the average urban wage – a statistic that does bear scrutiny. I don't think that it portends a crash, but I do think it means that property prices will not rise half as quickly as they have been, and may fall in some cities. This will dampen demand for steel and aluminium,



undermine the wealth effect being felt by homeowners, restrain speculation in the housing market and curb consumption. As this happens, much of the investment that was predicated on investment demand – for example, the expansion of steel, aluminium and cement factories – will be mothballed and a mildly vicious circle will emerge in these sectors.

I suggest that such a scenario will come to pass naturally. However, if it doesn't, government action will probably precipitate it. Officials in Beijing have been telling me recently that the property market is now regarded as the source of China's over-investment troubles. Beijing's aim is to reduce house-price appreciation to around one or two percent a year from an average of 10% in 35 cities recently. They will use the various weapons in their armoury to bring this about.

The outlook for property forms the foundation of my prediction that a GDP slowdown is in prospect. In addition, other areas are showing signs of growth fatigue – car prices are falling and sales growth has slowed dramatically from last year. Corporate earnings are starting to moderate. Inventories are climbing.

A Look inside the Dragon

This makes it both more interesting and more challenging to predict the future. First, a disclaimer: I am not an expert on precious metals. I will confine myself to looking at some of the big trends that are shaping China's future. I want to focus on demand, to study the anatomy of the dragon's appetite, to take a look inside the belly of the beast.

China's appetite has become the theme of this year – and with good reason. From being a significant but not spectacular buyer of base metals, China in 2003 transformed itself into the overwhelming factor in global markets. It accounted for 100% of the growth in world copper demand, 99% of the growth in nickel demand, 95% of the growth in steel demand, etc. The drama of China's arrival in global markets was matched only by its speed.

And what happened to the base metals market may be about to be repeated in many other areas. Take tourism, for example. China's outbound tourists numbered 20m last year, are growing at around 20% a year, and are now more numerous than Japan's. There are expected to be 100m outbound Chinese tourists by 2020, and that in my view is an exceedingly conservative estimate. When they arrive at their destination, they are not afraid to open their wallets; in Hong Kong, mainland tourists spend an average of US$772 a night, about $100 more than an average American. So where has this sudden projection of Chinese buying power come from? And more importantly, where will it go from here?

The first element in the anatomy of appetite is population, which has three main aspects: first its size, estimated at 1.4bn but almost certainly greater, second its growth rate, about 14m a year and third – by far the most important – its mobility. In the old days 25 years ago, Chinese were basically tied to the places that they lived. Now there are by official reckoning about 120m workers that have migrated from villages to urban areas. Some are temporary; many will become permanent urban dwellers. By 2020 there will be an urban population of 900m people in China – up from 484m urban dwellers in 2003.

This migration, the greatest by far in human history, is both a consequence and a catalyst of the other big driver of Chinese demand: an industrial revolution unfolding at warp speed. It took centuries for China to attain its status as the world's economic superpower in the mid-1700s, when it produced about one third of the world's GDP. But in the eyes of some, it will only be 30 to 40 years from now before it regains that position. China's emergence, spurred on by the globalisation of trade, technology and capital, is evolving at a far greater pace than the similar transformations that took place in Japan, Korea and the other Asian tigers. The other point about China's emergence is that its appetite will be more enduring than anything we have yet seen. When, and if, China overtakes the US as the world's largest economy, its people on a per capita basis will only be one sixth as wealthy as Americans. They will still be hungry, still cost competitive.

It is the scale and speed of China's transformation that make it unique. Many people had heard the predictions of what would happen when the world's biggest market took off, but it was last year that the world really began to feel it in earnest. When you travel inside China and witness what is happening, it is breathtaking.

The Rise and Rise of a Services Economy

These factors – the movement of people and the industrial revolution – together form part of the dragon's yearning to be fed. Other drivers are more subtle, but no less important. Among these, the emergence of the middle class is key. My forecast is that the middle class will grow more quickly than GDP each year – which is another way of saying that the gulf between rich and poor will widen each year.

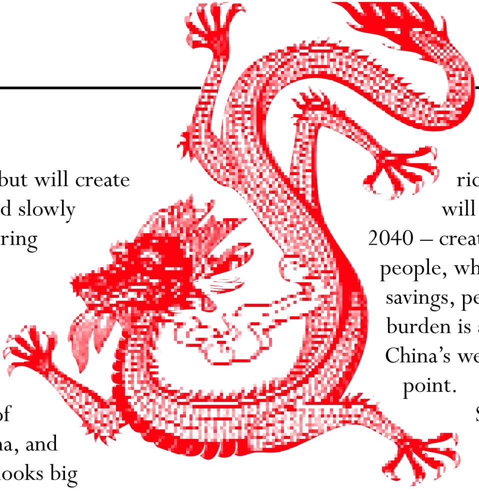
First, let's define who qualifies as middle class. I would set the bar quite low because, according to the rules of purchasing power parity, a little cash goes a surprisingly long way in China (unless you are staying in a hotel in Pudong). In 2002, there were 28m people who earned more than RMB 4,500 a month, or in US dollar terms, more than $6,500 a year. This category I call wealthy. Another 168m people earned between RMB 2,776 and 4,500 a month. This category I call well off. Together they make up a middle class, which in 2002 totalled 196m people.
By 2010 there may be 560m people belonging to the middle class, and 154m of them will be in my wealthy category. You may quibble with my categorisation, but I believe the trend is clear. The reason that I think the middle class will grow more quickly than GDP is that China is now capitalist, and in capitalist societies, the rate at which capital appreciates outstrips the rate at which wages rise. That was Karl Marx's bugbear.

But it won't only be the capitalist class that gets richer. Life is about to get considerably better for Chinese workers too. The ascent of factories along the east coast up the technology ladder has meant better wages for workers in the medium- to high-tech segment. Workers' pay in the Pearl River delta around Guangdong is about double what it is in Anhui, an inland province about eight hours drive west of Shanghai. That has two big implications: first, that low-tech factories are being forced to move inland. Second, that factories along the coast must move up the value chain and pay more to their workers. This is a good thing for China. It will increase the contribution of consumer spending to GDP, helping to rebalance the current investment-dependent model of development. At the same time, it is almost beyond doubt that independent or semi-independent trade unions will spring up in the years to come, creating greater wage bargaining powers and therefore higher wages.

This trend will coincide with another basic re-alignment – that from a manufacturing-led to a service-led economy. At the moment, the shape of the Chinese economy is highly anomalous. It is a continental country with a pretty much maritime economy. Total trade amounts to about 60% of GDP, compared to about 30% for big continental economies such as the US. At the same time, services in China contribute only one third of GDP, compared to over 60% for most western economies. But China, as it matures, will start to resemble its type. Trade will amount to a much smaller portion of GDP and services will start to drive the economy.

A services economy is, by its nature, a knowledge economy. And a knowledge economy is brand conscious, fashion conscious, argumentative and high tech, at least in parts. When this services economy starts to take hold – and let's be clear that it is already growing fast – the nature of China's appetite will start to change. Maybe people will become even keener on adorning themselves with precious metals.

There is another reason why I think a services economy will emerge: the current model of development is unsustainable. In my view the problems on the horizon are not of the type that will cause China to collapse, as



some have predicted, but will create volatility in growth and slowly sap China's manufacturing energy. The two main problems are environment and demographics.

Environment first. About one fifth of humanity lives in China, and although the country looks big on the map, only half of it is habitable. So these people live on and around 7 % of the cultivatable land. There is already intense competition in land use; the local governments generally want to use it for factories while the central government, worried about China's ability to feed itself, wants to ensure that enough is left over for crops.

Chronic water shortages in the north of the country add another very physical limit to industrial development and to China's appetite.

Air pollution is so bad, and getting worse, that the health care bill incurred through factory emissions will one day start to exceed the value created from new factories. In addition, China already has too much stuff; more than 90 % of manufactured products are in oversupply and the thin or negative margins gained from selling them are a prime cause of the mountains of debt in the banking system.

The last inhibitor of development and appetite is demographic. China may grow old before it grows rich. The part of the population over 60 will rise from a current 11 % to 28 % by 2040 – creating an elderly segment of about 400m people, which will place a huge burden on savings, pensions and the capital markets. The burden is all the more stark because few of China's welfare liabilities are funded at this point.

So in summary the type of China that I see emerging 10 years from now is one in which manufacturing is still king, but services are creating more depth and balance to the economy. Its appetite for base metals, food and probably also luxury items will strain the world's ability to produce them. But its people, tired of the pollution and the daily ferment, will be travelling abroad, buying property abroad and educating their children abroad in numbers that will shock the world. The government in Beijing will at times resent this dependence on the outside world, but they will have no option but to accept it. The dragon's hunger will make it tame. ■

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