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Update on China: Opportunities and Challenges Facing the World's Greatest Growth Story

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August 2011

This paper was originally presented by Ms. Pomerantz at William Blair's Global Investing Summit in Chicago on July 12, 2011.

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The following overview is intended as a framework through which to interpret the news flow on China.

Introduction

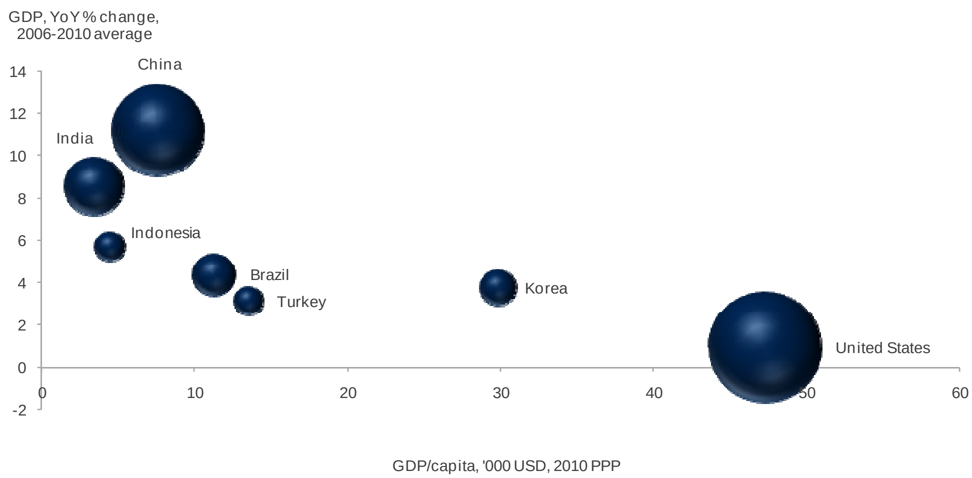
Over the last decade, China's economy has evolved into the engine of global growth: today, China's economic well-being is the major determinant of global growth. Following three decades of 10% annual GDP increases, China offers ample growth opportunities to virtually every company. Recently, several economic indicators have pointed toward a slowdown in activity. Given China's eminence in global growth, any evidence of a slowdown generates considerable anxiety in the markets. Ongoing market commentary on "hard landing" focuses on whether China's economic miracle is coming to an end and growth is about to slow sharply.

One way to approach a discussion on China's imminent slowdown is to start with the realization that China has paid an exorbitant price for its performance to date: environmental degradation; heavy reliance on natural resources, which it must procure from abroad; and increasingly skewed income distribution. Put differently – China cannot afford to continue growing at the current pace without changing the composition of its growth. China's leadership has long recognized these challenges, and has been proactive in addressing them. Specifically, government policies are aimed at enabling and enforcing more efficient use of resources; encouraging strong income growth across all income brackets, in both rural and urban cohorts; and actively building a social safety net with initiatives in health insurance and universal education. The transformation toward a more sustainable growth path is gradual: it will take years. The fact that China is proactive about it bodes well for its continued success in the economic arena.

China as the Driver of Global Growth

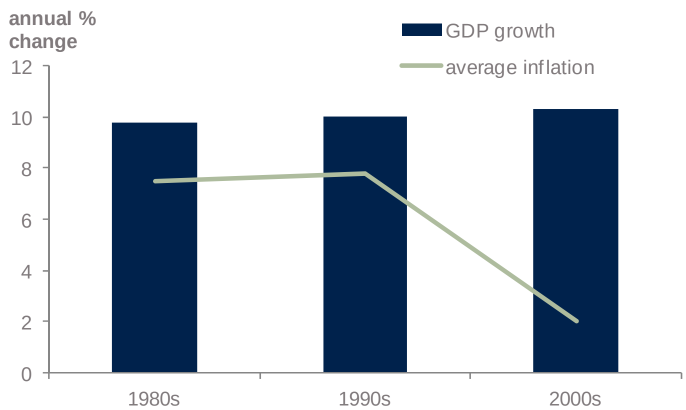
Following three decades of double-digit growth, China has become the engine of global growth. Chart 1 depicts GDP growth, economic size and relative wealth for some of the better known emerging markets and several developed economies, such as Korea and the United States. China is not only the fastest growing, but also nearly as large – in terms of market size – as the US. This combination of size and growth is the reason for excitement about China.

Chart 1
Relative Opportunity Set Within Emerging and Developed Markets



Source: IMF World Economic Outlook database, April 2011; author's calculations

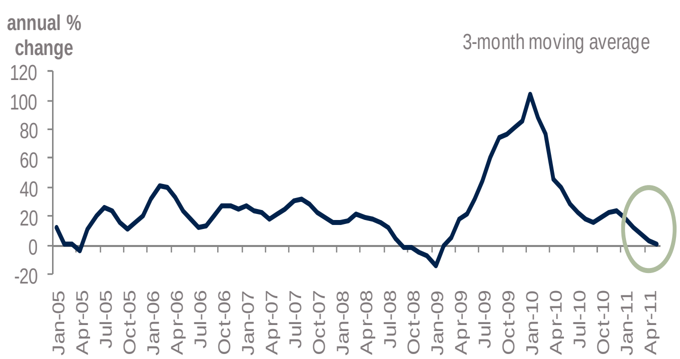
Chart 2
Real GDP Growth and Inflation Performance in China



Source: CEIC; IMF, World Economic Outlook database, April 2011

Chart 2 highlights China's average growth rates over the past three decades with corresponding inflation performance. Growth averaged near the 10% mark, and was coupled with relatively low inflation, particularly in the last decade. Such economic performance – real growth consistently outpacing inflation over an extended period of time – is unprecedented among the emerging market economies in the post-World War II period.

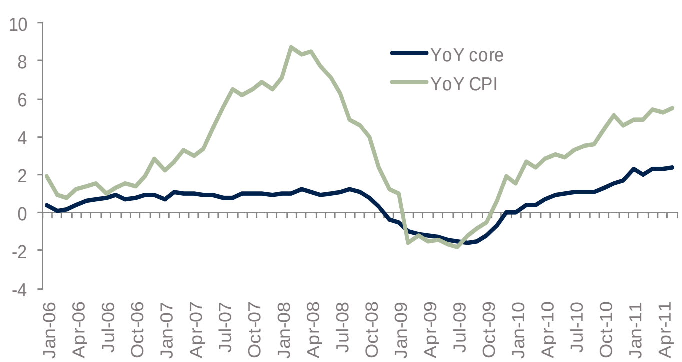
Chart 3
Car Sales in China: Annual Growth



Source: CEIC

More recently, high-frequency indicators are suggesting a deceleration in economic activity. Since the beginning of this year, car sales growth has decelerated to zero, as shown in Chart 3. Although car sales grew by nearly 100% in 2010, many market commentators are alarmed by the current ongoing deceleration in growth from last year's peak.

Chart 4
Annual Inflation Rate in China

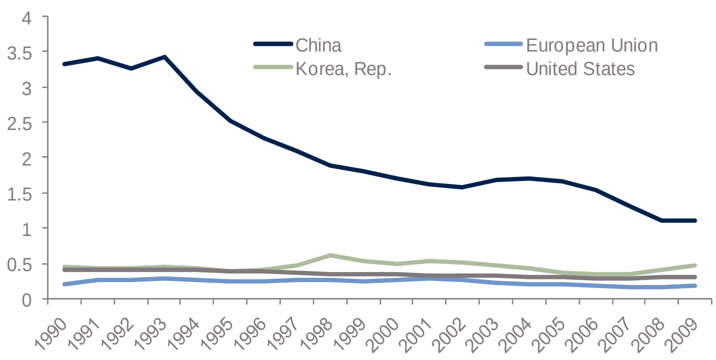


Source: CEIC, author's calculations

At the same time, consumer price inflation – as measured by core and overall CPI – is rising rapidly, as shown in Chart 4. In China, as in emerging markets broadly, inflation is driven by food prices, as these represent a major component of the CPI basket. The rapid rise of inflation is also generating cautious commentary on China.

Structural Impediments to Growth

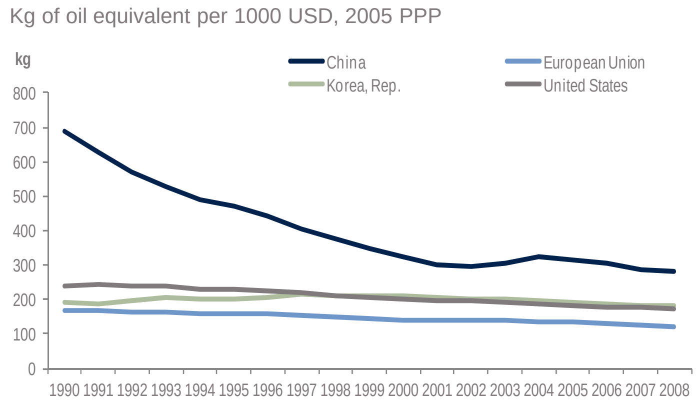
Chart 5
Carbon Dioxide Damage as a Share of Gross National Income



Source: CEIC, author's calculations

Rapid growth, summarized in the previous section, came at an unsustainably high price. In particular, environmental damage to China as a result of its rapid and sustained industrialization has been immense. Chart 5 illustrates the World Bank's measure of the damage from carbon dioxide emissions as a percent of gross national income (GNI) across several countries. Environmental degradation, as approximated by the cost of carbon dioxide emissions, is twice as high in China as compared to the more developed economies.

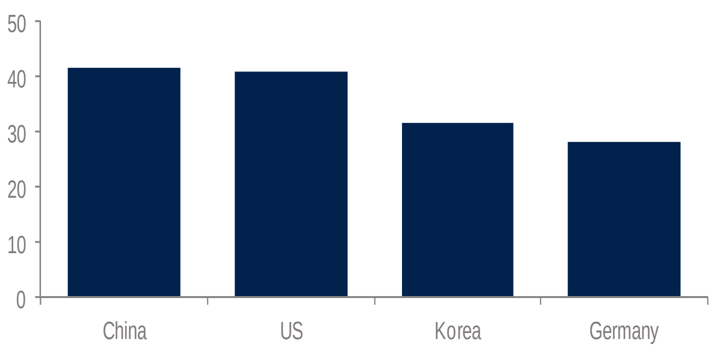
Chart 6
Energy Use in GDP



Source: World Bank, World Development Indicators (WDI) database, 2011

China's growth is also expensive in terms of its use of natural resources. Chart 6 highlights the fact that it takes China nearly twice the amount of energy to produce the same amount of GDP as compared to its industrialized peers. What is more, China was gaining efficiency in the use of its resources in the 1990s, but has since plateaued at a still high level relative to the developed economies. This suggests that China still has room to improve in its use of resources. It cannot continue to grow at a 10% clip without changing something about the mix of its GDP composition because its economy is large enough that its rapid growth results in resource constraints and skyrocketing commodity prices.

Chart 7
GINI Coefficient of Wealth Distribution



Source: World Bank, World Development Indicators (WDI) database, 2011

Finally, China's growth from the perspective of income inequality warrants a review. China has surpassed the U.S. in terms of income inequality, as illustrated in Chart 7, which shows GINI coefficients of income inequality as calculated by the World Bank. Perhaps more importantly, income inequality rose extremely rapidly in China: the country's income was distributed relatively evenly in the early 1980s. Such rapid and visible rise of inequality is alarming to the extent that it could feed social discontent. There is broad understanding in China that some groups will accumulate wealth ahead of other groups, as part of industrial transformation. At the same time, three decades of inequitable returns can leave increasingly large portions of society feeling cheated out of the promise of prosperity associated with growth.

Ongoing Transformation

The government has long recognized the aforementioned challenges to growth and has moved to address them. There are several ongoing initiatives that promote a more efficient use of resources. China is in the midst of building what will be probably the world's most sophisticated electric power grid. Geographic concentration of energy consumption in the East and South versus energy production in the West and North means that distances between energy producing centers and consumers are large. Transporting coal via railway or road – as has been the case until recently – is expensive, inefficient, and contributes to pollution. To connect power producers directly to consumers, China is building ultra-high voltage transmission lines across the country and plugging in all the existing cities and towns into this grid. This is a multi-year project, which is scheduled to be finished by the end of this decade.

Although coal will remain the dominant source of electricity in China for years to come, the country is moving aggressively to adopt the cleanest available coal technology and scale. Sixty percent of the newly constructed coal-burning facilities use technology that did not exist in China five years ago. Adoption of the latest, cleanest technology possible is moving quickly along with mandates that IPPs use it.

In addition to ensuring efficient electricity supply, Chinese government is proactively moving to close down obsolete capacity in such industries as steel, cement, and aluminum production. These are all heavy energy users and polluters in industrialized areas. Closing down some of these inefficient plants and regulating capacity will contribute to improving the resource allocation. As importantly, China is aggressively building out its rail network, not just passenger high-speed rail, which has received a lot of press attention lately, but also freight rail. Moving cargo via rail is far more efficient and less costly than via trucks.

In a gradual but comprehensive way, the government is building a social safety net to further promote consumption growth. China's consumption story is already one of the best in the world, as expressed by retail sales growth. In order to elevate and sustain higher consumption growth, China is investing in a national healthcare system, universal education, and programs that are commonplace in the OECD countries. Chart 8 shows that government expenditure on medicine and healthcare facilities has grown faster than overall expenditure in each of the last five years. Chart 9 highlights that the share of healthcare expenditure in government budget increased from a low of 2.5 % up to about 5% over the same time period. Given that China's fiscal expenditure is rising all the time, this actually translates into significant additional financial resources. The government is serious about building a national healthcare system by 2020. As part of this effort, China unveiled a rural healthcare plan in 2009 which included an increase in the number of clinics and access to local hospitals. By all accounts, the roll-out is progressing well. The aim of the healthcare spend is on prevention, and linking costs to improving people's access to basic healthcare including child healthcare.

Chart 8
Growth of Healthcare Spending

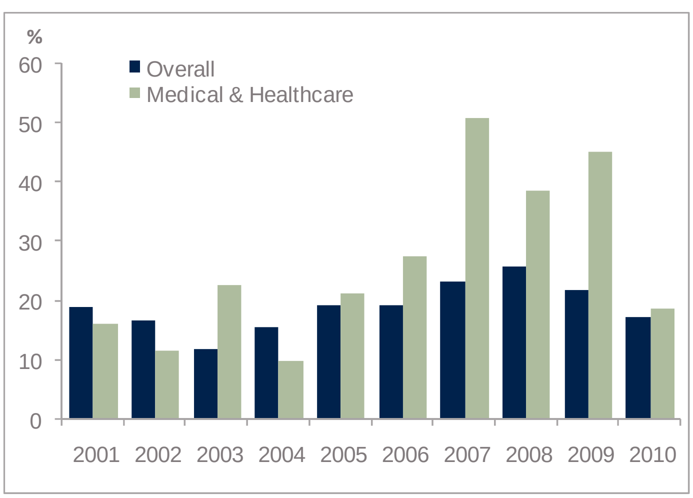


Chart 9
Healthcare Spending in China
% of overall government spending

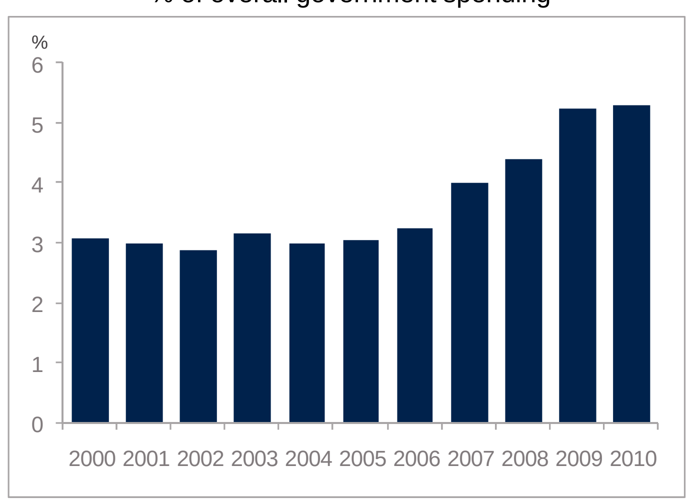
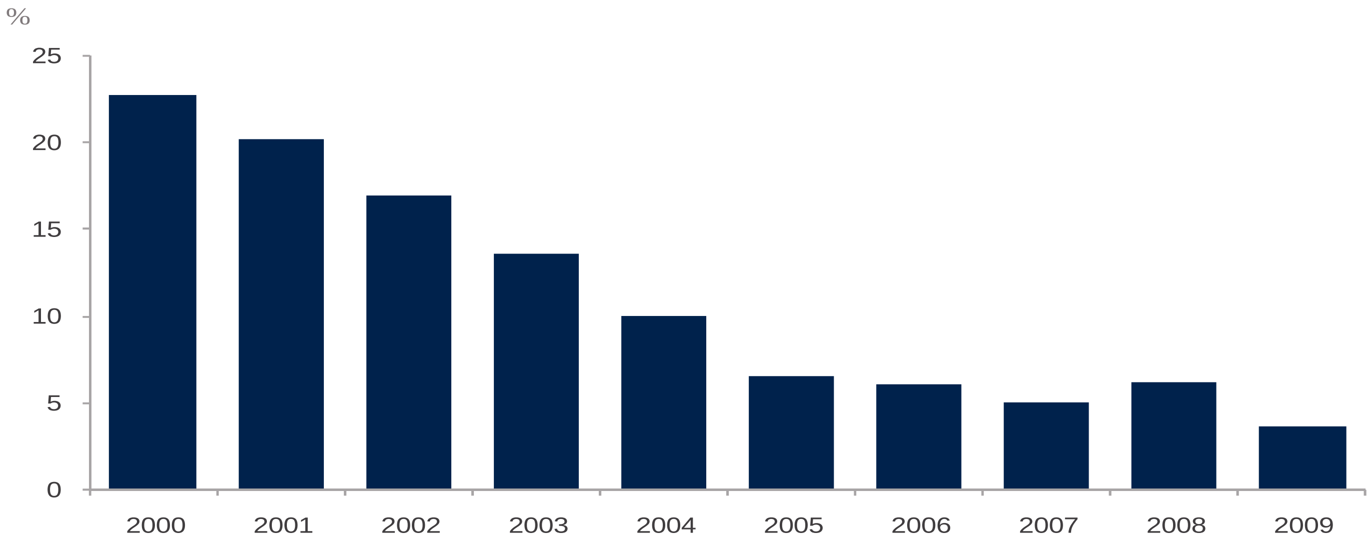


Chart 8 and Chart 9 - Source: CEIC, author's calculations

It appears that social housing may get off the ground this time. The idea of social housing is not new in China. When government privatized real estate housing stock in the late 1990s, it promised to allocate a significant portion of the residential real estate market for building social housing. That promise was not delivered, as can be seen from Chart 10, which shows that the proportion of social housing has declined consistently throughout 2000s. Current government targets are quite ambitious, but the specific figures may be less relevant. Instead, government targets on social housing serve as indicators that the government plans to build whatever is necessary to house about 15% to 20% of the urban population in social housing. In other words, it aims to provide people that cannot buy real estate in the open market with a decent place to live and alleviate the need to save for home purchase.

Chart 10
Economic Housing as a Share of Commercial Housing Sold

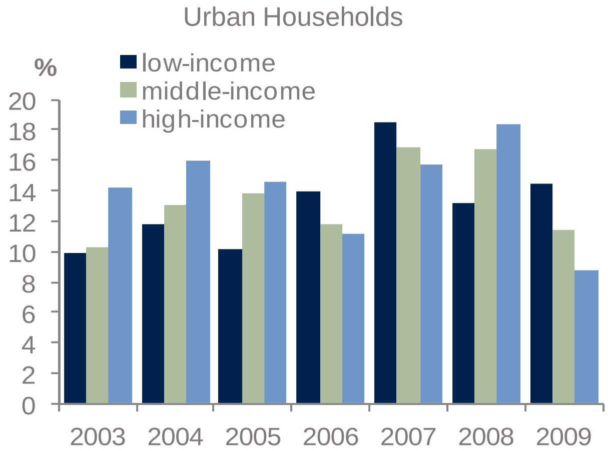


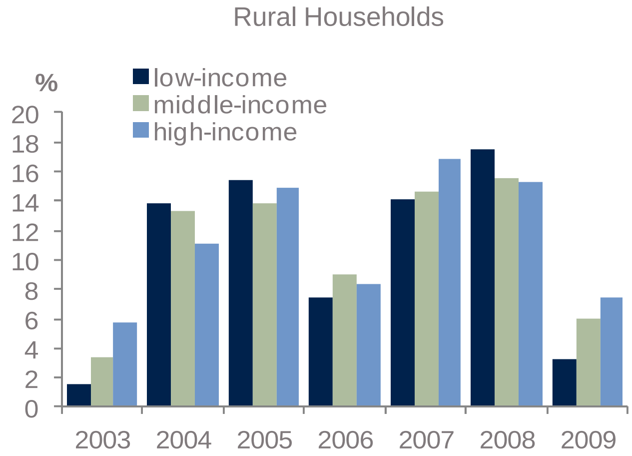
Source: CEIC

As further evidence of China's commitment to social housing, the government assembled a cross-functional team from the Ministry of Finance and the Ministry of Housing to inspect social housing development progress across 28 cities. Social housing is not only about ensuring social cohesion; it is a vehicle to boost private consumption growth. Surveys suggest that once people in China purchase or rent a new home, they increase their consumption, which is logical. People move into a new home, they tend to purchase white goods and other items to make the new house a home. Furthermore, the need for precautionary savings declines somewhat, resulting in freedom to spend more on what is usually referred to as "disposable goods."

As importantly, wages in China have been growing by 15% on average for all income groups. High income growth has been consistent for a number of years, as shown on Chart 11. Although rural households are experiencing slower income growth – resulting in the growing disparity between rural and urban cohorts – they are still experiencing real income growth. Adjusted for inflation, incomes are growing by about 7% to 8% per year. To the extent that this can been sustained, it bodes well for continued consumption growth.

Chart 11
Income Growth in China

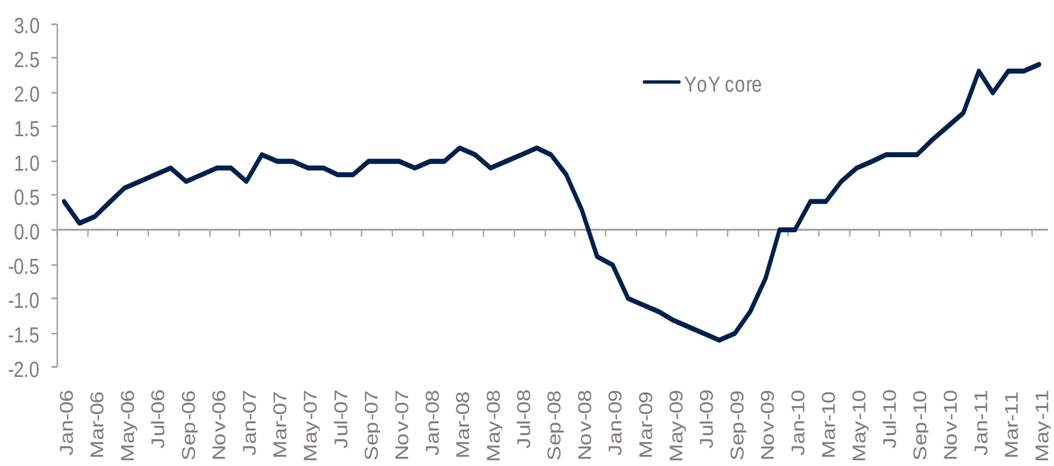




Source: CEIC, author's calculations

The ongoing fundamental changes in the structure of China's economic growth manifest themselves in inflation. Inflation has been remarkably low in China, typically averaging around 3% during the last decade. As part of the rebalancing away from investment and export-led growth towards services and consumption, China needs to have a sustainably higher rate of inflation. The reason for higher inflation has to do with productivity growth differential between manufacturing and services sectors. Services sector productivity tends to increase less rapidly as compared to manufacturing: a haircut cannot be automated in the same way that a plant can be mechanized. Given productivity growth differentials, sustained wage growth across the economy results in sustainably higher rate of non-food inflation, which is exactly what is seen in China today, as shown on Chart 12. The challenge that the government is currently facing is re-anchoring expectations from the 2-4% range closer to the 5-6% range without losing control and without people losing faith in the process. Chart 12 shows that China is on the upper trajectory of this and inflation has not stabilized at a higher rate yet. Changes in the underlying structure of China's growth will manifest themselves through changes in inflation drivers.

Chart 12
Core Inflation in China: Too High?



Source: CEIC

Conclusion

The talked about transformation of China's economy toward a more balanced growth model based as much on services and consumption as on investment and exports is actually ongoing. Incomes are increasing rapidly, social housing build-out is finally underway and the expansion of heavy industry is being curtailed – all, while improving efficiency of resource utilization. This transformation is gradual and its results are not yet reflected in hard data. To the extent that inflation dynamics may provide a glimpse into fundamental changes in China's economy, early signs are encouraging. Looking ahead, China's evolution into a high-income society is by no means assured, but focused and proactive government policies bode well for China's continued rapid growth.

Olga Pomerantz joined William Blair & Company in 2009. She is responsible for economic research across all regions and sectors. Previously, Ms. Pomerantz was a senior economist at the National Institute of Economic and Social Research in London, where she was responsible for macroeconomic forecasting and thematic research projects for international organizations and government bodies. Education: B.A., University of Chicago; M.S.c in economics, London School of Economics and Political Science.