Letter from CH-ina #2
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# China is Rebounding -
## China's economy is the first to bottom out of the global crisis. It is on a fast track to become the world second largest economy - ahead of Japan.

After a sharp slow down at the end of last year, China's economic engine has picked up significantly in the first quarter of 2009. At the same time, production prices have gone down to early 2007 level. The state's infrastructure investments are providing access to the country's low cost interior and spurring innovation, while rural consumption incentives moves growth inland. Deflating prices puts pressure on costs and make the local market ever more competitive.

However, lower production costs and higher availability of skilled labor make China ever more attractive as a production base, particularly for quality products. But most interesting in today's depressed economic times, the needs for world class technology to complete huge infrastructure projects provide rare market opportunities to international companies.

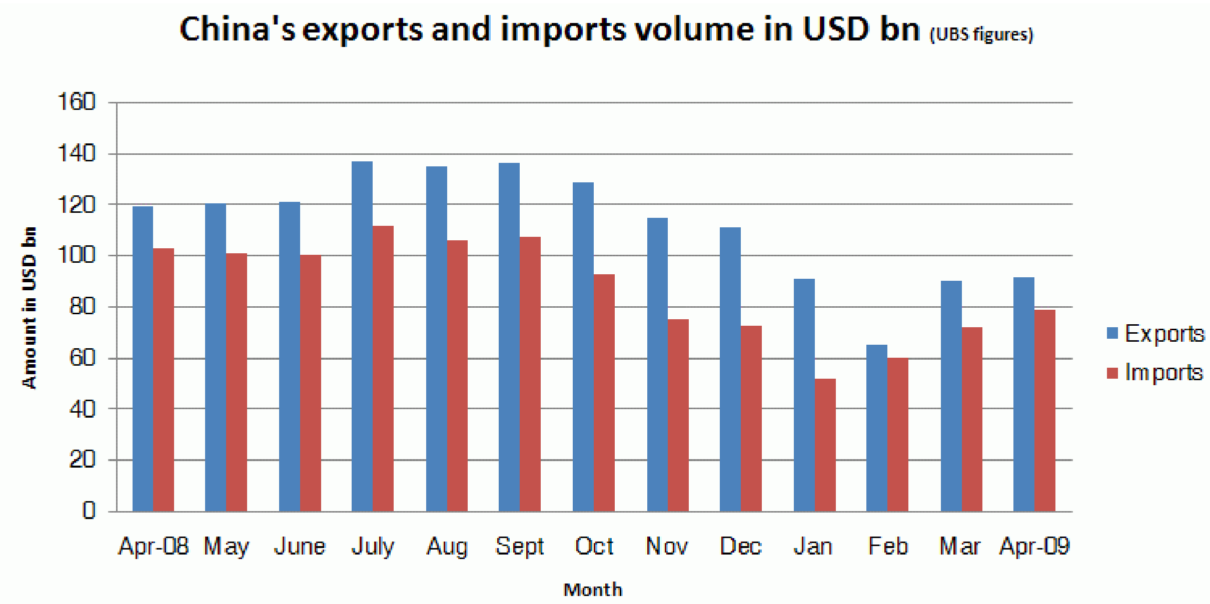
China's growth got as low as 2.6% in the last quarter of 2008 in annualized terms. The rebound for the first 3 months of 2009 is considerable: 6.1%. What's more, expectations for the next quarter are at 14%, so that economists generally expect 7 to 8% overall growth this year[i].

What is it, then, that makes China the only top world economy that grows, and astonishingly fast, while the rest of the world experiences its worst performance in 50 years?

First of all, retails sales have continued to increase strongly despite the missing consumption of 23 Mio migrants workers who lost their jobs in coastal export industries. To keep retail growing, the government has offered China's 800 Mio farmers VAT exemptions on big ticket electrical appliances. The result is an ingenious replacement of exports through inland domestic consumption without a loss for the state: VAT is anyway refunded on exported goods. As a result, retails sales went up almost 15% this April when compared to a year ago, a pace unchanged from the beginning of the year.

Besides, China announced its stimulus investment program last October and took extraordinary measures to make it happen. About two months later, just before year end, 93 projects for an investment of USD 58 Bio were approved within 3 days! Also, the Chinese banking system did not suffer from the credit crisis. Chinese save most in the world and in so doing they allowed the largest bank in the world (in deposit terms) to become Chinese: The Industry and Commerce Bank of China (ICBC) just passed its American and Japanese rivals JPMorgan and Mitsubishi-UFJ. In market capitalization, China is now home to the top 3 banks, reflecting the confidence of investors in Chinese banks. And they have been lending: new loans in the first quarter of 2009 accounted for more than all new loans in 2008!

Finally exports are picking up too. From a monthly all time high of USD 136 Bio in September 2008, exports fell every month to a low of USD 65 Bio in February (25% less the 2008 figure). But, in April they rebounded to 91 Bio.




| | April 2008 | May | June | July | Aug | Sept | Oct | Nov | Dec | Jan 2009 | Feb | Mar | Apr |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Exports** | 118.8 | 120.6 | 121.2 | 136.6 | 134.9 | 136.3 | 128.2 | 114.9 | 111.1 | 90.4 | 64.9 | 90.3 | 91.1 |
| **Imports** | 102.4 | 100.8 | 100.4 | 111.4 | 105.9 | 106.9 | 92.9 | 74.8 | 72.2 | 51.4 | 60.1 | 71.7 | 78.8 |

## Rare Market Opportunities

Imports have also started to recover since the beginning of the year. Even equipment goods companies have started seeing an increase in enquiries from China. Participants to the China International Machine Tools fair in the second week of April were surprised that the attendance was, well, as high as usual (about 200’000 visitors!)

While developed economies are at best stagnating, China’s size and growth make it a rare opportunity in 2009. The country is certainly a growing consumer market: China counts 825’000 Euro millionaires, on average younger than 40. But the USD 600 Bio stimulus investments to be spent over the next 2 years generate urgent needs.

Among others, high speed trains (350 Km/h), metros, power plants, telecommunication systems, hospitals and water treatment plants will be built in second and third tier cities, while business processes outsourcing (BPO), and high-technologies have been singled out for fast investments on the coast. Local R&D and innovation is also strongly encouraged, generating needs for imports of instruments and hi-tech components for the new products to be made in China.

As an example, the Chinese cabinet announced heavy incentives for the purchase of electric public vehicles (buses and taxis) in 13 cities. Up to USD 80’000.- will be subsidized for every electrical bus purchased. In the next three years, production is expected to jump to an annual 500’000 electric vehicles[ii]. In so doing, the government not only reduces its environmental costs, but also prepares to boost exports in new technologies. Instead of becoming a major exporter of traditional cars as Japan and Korea did, China’s leadership intends to leapfrog competitors and become a top exporter of electrical cars.

To support employment creating higher value than low-cost manufacturing, the systematic export of labor intensive services is also given an enormous push. Companies (local or foreign) setting-up BPO operations are offered a mix of tax incentives, free office space over five years and outright cash: USD 1'500 per hired employee.

## Falling Production Costs

In addition to stimulating the economy, these investments have the advantage to bring along an accelerating efficiency. Citizens benefit with opportunity for a healthier life, enterprises for a more efficient production environment.

Mass investments in transportation reduce logistics costs and provide access to lower-cost inland manufacturing bases, while locally developed technologies provide more adapted and cheaper production solutions.

Besides, the lack of international demand pushes down labor costs. Migrant workers who found jobs back on the coast after the Chinese New Year have been reported to take 30% to 50% reductions in salaries or benefits usually provided free (meals and dormitories, for example).

Estimates of Hong-Kong based manufacturers in China indicate that business activity is stabilizing 20-30% lower than before the crisis. Forced to reduce prices in an over-supplied environment, Chinese producers have no other choice but to become most competitive, also against other Asian producers.

Unavoidably, production costs have been falling: the producer price index went down 4.5% year on year, to its November 2007 level. The trend accelerated in April with a 6.6% drop. Consumer prices followed suit, resulting in an actual deflation of -1.6 % starting in February and confirmed by the -1.5% just reported for April.

## The World's Second Largest Economy Emerges

China's high-speed reaction to the crisis is enabling it to be the first to bounce back. This speed will not only result in China taking the second position of the world economies, but will push it further up the value chain. In order for it to sustain the growth it needs for its own stability, China has no choice but to climb the hi-tech value chain, invest and increase its overall cost competitiveness, making it ever more attractive both as a market and a production base.

As long as China's key trading partners are able to stabilize their markets and avoid another major fall in economic activity, China's rebound will bring essential market opportunities for a sustained world recovery.



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[i] quarter on quarter annualized GDP growth
[ii] South China Morning Post, 11 April 2009