China Integrated

The **China Integrated** Analysis
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China's Economy is Not Slowing for Businesses

How can we make the best out of the opportunity?

Dear Friends, Partners and Readers,

The Chinese New Year is about to begin. As described in our previous analysis we are confident that China is taking a turn for the best in addressing the fundamental issues and risks necessary to sustain its development.

A number of media have suggested that the current restructuring will be made at the cost of fast economic growth, but we are experiencing instead an acceleration of business results for international companies here in China. On the eve of Chinese New Year, we felt that it was timely to review the widely discussed growth and "slowdown" figures of China's economy in order to understand their meaning for our businesses.

While it is true that China's real GDP growth is not any more in the double digit range and that it is likely to decrease from 7.8% in 2014 to 7.2% in 2015, GDP growth, as a macro-economic measure, does not actually capture China's business potential for foreign enterprises.

Indeed, what matters to companies doing or intending to do business in China, is the amount of GDP the economy will be adding in the coming years in terms of Euros, US dollars or Swiss francs. To understand China's business potential better and how it is changing, one must first compare how much GDP the Chinese economy is projected to add in the future with the amount it has added in the past. To get a global picture, it is also useful to compare this absolute increase with the amount of GDP growth generated by other countries in home currency values.

As with every other country, China's real GDP is reported as the added growth in economic value in Chinese Yuan, minus local inflation. This growth rate makes complete sense, inasmuch as it captures the real economic progress (with inflation deducted) that the country is making with respect to its previous year's performance.
This said, because companies throughout the world account for their growth in their local currencies, without deducting inflation from their performance results, they measure a country's market potential in absolute volumes (millions or billions of USD) and not in growth percentage.

To illustrate this, take the case of Mongolia. With a 2013 real GDP growth rate of 12.5%, Mongolia is considered by the IMF to be "one of the fastest growing economies of the world". This growth, however, is based on a 2012 GDP of about USD 10 bil. Taking inflation (approx 10%) and currency devaluation (approx. 27%) into consideration, in 2013, Mongolia only added slightly more than one billion USD to its economy. In comparison, the USA, which only grew by 1.9% in the same year, has added approximately USD 500 bil to its GDP.

Ultimately, when managing a company, the absolute growth of a market is the useful figure to evaluate how much more business can be generated in the future.

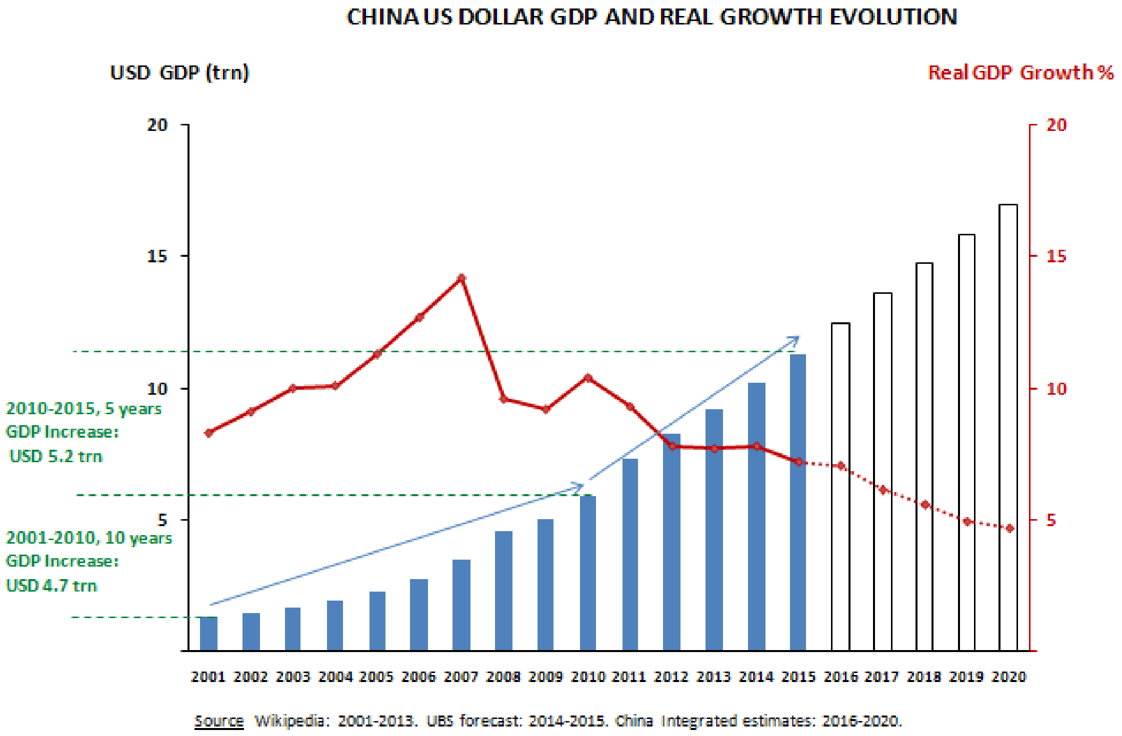
From this business point of view, it is striking to note that the Chinese market is actually **growing faster than it ever has.**

To illustrate this fact, the chart below, shows a clear acceleration of China's GDP growth in USD terms

Even though China is "only projected to grow by 7.2% in 2015, it will likely add more GDP in USD terms in 2015, than it did in each of the years of 2012, 2013, and 2014, which saw growth rates of 7.8%, 7.7 % and 7.8 % respectively. Indeed, should China sustain constant percentage growth rates, its GDP would increase exponentially.

As it stands, however, even with slowing percentage growth, China's GDP will carry on accelerating (though not exponentially). Ultimately, it is this continuous acceleration in absolute GDP growth that has an impact on businesses potential.

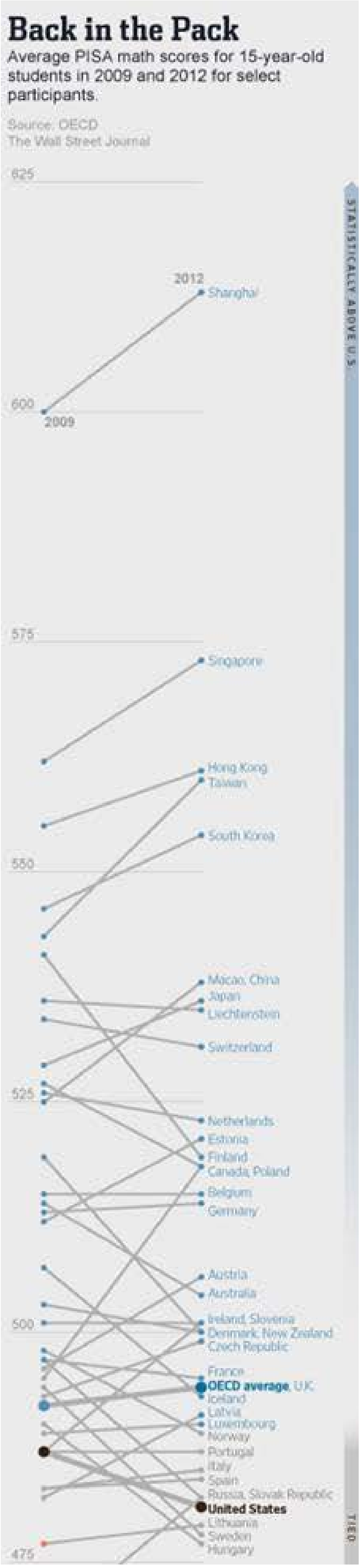
Most importantly, between 2011 and 2015, China has and is projected to add more than USD 5 trillion to its GDP, compared with USD 4.7 trillion in the whole decade of 2001 to 2010. In terms of business opportunities and in USD terms, this means that China is **growing on average twice as fast** today, than it did the previous decade.



When compared to other countries, China, which is adding approximately USD 1 trn more per year to its GDP, represents by far the greatest business growth opportunity in the world. In 2013 alone, the business opportunities offered by China were **twice as large** as the USA's, which is the second biggest growing market in absolute terms.

If we are to apply the same GDP calculations to other countries such as India, Brazil or Russia, it becomes clear that China's economy is the largest business opportunity in today's globalised world. Ultimately, the Chinese economy keeps accelerating in absolute GDP terms and this is what actually matters to businesses.

In light of the constant reminders of a Chinese economic slowdown conveyed by the media, we felt it was necessary to explain the situation in greater detail.



This business acceleration has been confirmed by the initial results of a survey that we will be co-releasing in a month or so: sales, profits, and worldwide share of sales for foreign companies in China grew faster in 2013 than in 2012 and are generally expected to grow even higher in 2014.

Now what are the implications for businesses and how can we benefit from these trends?

The first conclusion we can reach from this, is that international companies may not be ambitious enough in China. If accounted for in USD terms, business in China should have grown by 13.4% only to keep up with market growth, without gaining any market share. (This figure is obtained by taking 7.7% growth, plus 2.7% inflation, plus 3% currency appreciation). By comparison, business in the US would have had to grow by only 3.4%, or 1.9% growth plus 1.5% inflation to keep up with the USA's market growth.

For those measuring China's GDP in Euros or Swiss francs, there is a 2 to 3% difference that must be accounted for due to the appreciation of the Euro, which would bring the average market growth of China to 11%.

In 2014, the minimum rate of business growth necessary to keep up with China's growing market will stand at approximately 11.3% in USD. (Growth will still differ across industries and that is just a general average.) This figure takes into account, an expected inflation rate of 3.5% and a steady USD/Chinese Yuan exchange rate,

Another important point to keep in mind is that the expected growth will come more from the private than the state-owned sector.
Indeed the Chinese government will be providing incentives to the private sector, as a measure to increase domestic consumption and productivity (private enterprises are doing much better than the state sector in terms of return on investment)". (See our previous analysis)

While an increasingly privatized Chinese market with greater domestic consumption will be a welcome development for the world economy, it also means that competition in China will intensify. Local market players will therefore become more efficient and resourceful.

In fact, initial results from the survey mentioned earlier, already point to the fact that international companies in China perceive local players as their greatest competitors. (This is a marked shift from the past years where such companies reported international companies as posing the greatest competition.)

In other words, opportunities will increase considerably, but competition will be all the hotter!

Under these circumstances, managers have two paths to follow: **improve operational efficiency** (to deliver more with the same resources) and **move up the local value chain** (improve products and technologies to command better margins).

Harnessing the productive potential of technology will be a crucial step towards achieving these goals. Indeed, for companies to improve internal efficiency, it will be essential for them to implement greater automation (using more automated machinery to produce goods or using better software and IT systems to improve business processes).
Moreover, in this very competitive environment, improving or adjusting products and services to sell with higher margins will also require, more often than not, the use of technology

However, in the context of such a competitive Chinese environment being successful will also mean having the right mix of imported and **locally developed** products, equipment and IT.
Indeed, local capabilities are improving considerably and if the math score of Shanghai's 15 year old students is a pointer to the future (see chart on left with scores evolution), those capabilities will keep improving.

But, aren't product and operational quality the comparative advantage of international companies? To understand how to take advantage of the local situation, we will take the chance next to track the production costs evolution and review technology incentives for foreign companies. Meanwhile,

We wish all of you a flying Year of the Horse!
恭祝大家新年一马当先!

Your China Integrated Team

We hope that the above can be of support for your China strategy and plans. For more information about this topic, do not hesitate to contact n.musy@ch-ina.com.

China Integrated

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