MANAGING THE DRAGON

Business in China – From the Ground Up

By Jack Perkowski   January 2, 2011

While in the States these past few weeks, I've been somewhat surprised by the number of questions I've received about China's economy. Before discussing the subject matter at hand, people want to know: "How's China doing? What's going on with its economy? Is inflation a big problem?" I wonder to myself, "Why all the questions?" It's as if everyone expects China's economy to collapse in 2011.

This sentiment is difficult for me to understand, because, except for the fourth quarter of 2008 and the first quarter of 2009 when China's GDP growth rate dipped below 7 percent, China's economy has been very robust, growing by 8.9 percent in 2009 and an estimated 10 percent in 2010.

The only conclusion that I can draw is that well publicized stories that focus on one aspect of the Chinese economy, such as high property prices or the recent accounts of rising inflation in the country, have tended to create a great deal of confusion as to the underlying health of the Chinese economy.

In this context, I regard making my 2011 predictions as an ideal opportunity to collect my thoughts and form my own opinions as to where China's economy is headed in 2011. Here goes!

Prediction #1: China's economy will grow at a sustainable 9 percent in 2011.

In response to the global economic crisis, China enacted a large fiscal stimulus program in November, 2008 and opened the lending spigots at the beginning of 2009. China's economy responded, with GDP growth increasing steadily from a low of 6.2 percent experienced in the 2009 first quarter to 10.7 percent in the fourth quarter of that year and 11.9 percent in the first quarter of 2010.

Since then, China has been taking measures to reduce China's double-digit growth rate in an effort to make the country's growth more sustainable. GDP growth declined from its blistering rate of 11.9 percent rate in the first three months of the year to 10.3 percent and 9.6 percent in the second and third quarters of 2010, respectively.

Most China watchers believe that China's GDP growth will slow in 2011 as China completes the withdrawal of stimulus measures and tightens credit to dampen inflation.

Liu Shijin, deputy director of the Development Research Center of the State Council, China, said China's exports and investments would be much better in 2011 than this year, but the growth rate of consumption would pull back slightly from this year's boom, making 9 percent growth "very likely."

A United Nations' report predicted that China's economy may grow 8.9 percent in 2011, and the World Bank in November said that China's economic growth may slow to 8.7 percent next year.

I will go with experts and predict that China's GDP will reach a level of 9 percent growth in 2011. Given the inherent productivity gains that are realized as China continues its conversion from an agrarian to an industrial economy, and the country benefits from past infrastructure spending, this rate should provide sustainable growth without undue inflation.

Prediction #2: Inflation will not be a problem in China and the Consumer Price Index ("CPI") will stay below 3.5 percent.

The headline CPI in China was 3.2 percent through the first 11 months of 2010. As we have discussed in previous posts, however, the CPI has been adversely affected by a jump in food prices, primarily fruits and vegetables, in October and November due to weather related shortages. As we have also noted, non-food inflation has been kept low by overcapacity in most industries and productivity improvements.

According to a report released by the World Bank in November, inflation may remain above the 3 percent target for some time as a result of higher food prices. However, it is unlikely to escalate as core inflation remains in check. The Chinese Academy of Social Sciences predicted inflation will remain moderate with the CPI rising 3.3 percent in 2011.

Andy Rothman, my good friend who is the China Macro Strategist for CLSA Asia-Pacific Markets, is in a similar camp. Andy believes that inflation will moderate as we move through 2011 and the weather-related food shortages work their way through the system.

For all of the above reasons, we do not believe that inflation will be the problem that many are predicting for China in 2011.

Prediction #3: The renminbi will remain pegged to a basket of currencies and will appreciate by 7 percent to 6.1 yuan to the dollar by the end of 2011.

On June 19, China de-pegged the renminbi from the U.S. dollar, pegging it instead to a basket of currencies. Since then, the renminbi has appreciated by 3.1 percent against the U.S. dollar, and the exchange rate now stands at 6.595 to 1.

Because China does not disclose the composition of the basket, setting the value of the yuan in this way provides its currency managers with a high degree of flexibility. As MTD has mentioned in previous posts, we believe that China balances the value of the yuan against both the dollar and the euro. The United States and the European Economic Community are China's two largest trading partners, and China has a vested interest in the prosperity of both. With one European country after another facing a debt crisis, it is in China's best interest to retain maximum flexibility to support the euro as it believes appropriate. For this reason, we believe that the peg to a basket of currencies will remain in place.

Most China watchers believe that China will allow the yuan to appreciate steadily against the dollar, and a 7 percent rate of annual appreciation is often cited as a rate that Beijing is comfortable with. The fact that the renminbi has appreciated by 3.1 percent against the dollar over the past six months seems to support this view. As a result, we believe that the renminbi will appreciate by 7 percent against the dollar in 2011. By the end of next year, the exchange rate of the yuan to the dollar should be in the neighborhood of 6.1 to 1.

Prediction #4: The Shanghai Composite Index will increase by 25 percent to 3500 by the end of 2011.

The Shanghai Stock Exchange Composite Index ("SSE") tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990 with a base value of 100.

The SSE reached its high of 6036 on October 17, 2007, and then declined precipitously to its low of 1720 on November 3, 2008 in the aftermath of the global economic crisis. After recovering to the 3500 level by mid 2009, the SSE has been flat to trending downward, closing at 2808 on December 31, 2010.

Since its high water mark in late 2007, the SSE has been plagued by concerns as to how China would be impacted by the global economic crisis, the effects of the fiscal and monetary policies which the country enacted, the property bubble and the credit tightening which followed, and the weak economic prospects for the United States and Europe, China's two largest trading partners.

If our first and second predictions are correct, and China enters a period of stable, sustainable, low inflationary growth in 2011, then Chinese stock prices should react favorably. Moreover, there are signs that the American economy will recover somewhat next year. The Bush tax cuts were extended before year-end, eliminating at least some uncertainty amongst decision makers, and the massive amounts of liquidity that the Federal Reserve has pumped into the system is bound to begin having an impact in the New Year. Mr. Liu's expectations of higher exports in 2011 suggests that Chinese policy makers believe that at least some of the developed markets will begin recovering. To the extent that they do, this will also be good for Chinese stocks.

With many of the uncertainties that have plagued the Chinese stock market now in the rear view mirror, we believe that the SSE will break free from the doldrums of the last few years and increase by 25 percent to 3500 in 2011.

Prediction #5: 2011 will be a banner year for cross-border mergers and acquisitions between China and the United States and China and Europe.

As noted in previous MTD posts, Chinese industrial companies are becoming more active acquirers of overseas companies. Chinese companies need and want the technology and market access provided by such acquisitions, and they have the access to the capital required to finance the transactions. While weaknesses in the U.S. and European economies have been a deterrent to date, economic recoveries in developed markets will embolden Chinese acquirers.

Look for a banner year for cross-border mergers and acquisitions in 2011, with Chinese companies taking big steps forward in their quests to become truly global companies. The transactions themselves, and the political ramifications they cause, will make 2011 a particularly interesting year.

2010 Predictions: How Did We Do?

Posted December 28, 2010

Well, it's that time again. As we approach the end of the first decade of the 21st century, and prepare for the beginning of the second, it's time to look back and see how we made out on our predictions for 2010.

On January 12, 2010, we made the following five predictions:

1. By the 2010 year-end, inflation will be the big economic story in China.

2. China will continue to peg the yuan to the dollar at 6.8 to 1 USD until it is confident that downward pressures on the dollar have eased.

3. Geely will acquire Volvo from Ford, and this acquisition will be a turning point for acquisitions of industrial
companies by Chinese enterprises.

4. The relationship between China and the United States will deteriorate in 2010.

5. China will begin to act unilaterally on global issues like Iran.

At the risk of being accused of grading our own paper, here is how we think we did.

Prediction 1: By the 2010 year-end, inflation will be the big economic story in China.

When we looked back, we had completely forgotten that we had made this prediction, but it proved to be dead on. By the end of the year, the news was all about rising inflation in China and what the increase in the Consumer Price Index might force China to do to slow its economy in 2011. Inflation was so topical that MTD addressed it in two posts in December: China's November Inflation and Inflation in China.

When we made the prediction, we believed that China's fast growth in 2010, combined with continued growth in India and other developing markets and a bottoming of the economies in the developed countries of the world, would put pressure on the prices of everything — especially energy, metals and food. We also noted that central bankers around the world, including those in China, had flooded the markets with money in response to the global financial crisis, and therefore concluded that the vast amount of liquidity sloshing around in the global economy would result in global inflation.

But, if you read the two December MTD posts on the subject of China's inflation, you know that that's not exactly what happened. While inflation has been on the rise recently in China, 75 percent of the price increases are due to jumps in food prices, particularly for fresh fruits and vegetables. Moreover, these increases have been due to weather, not an excess of demand caused by an overheated economy.

Meanwhile, a weaker than expected American economy, combined with general weakness in Europe, has kept global demand at lower than expected levels, and steady gains in productivity and overcapacity in most industries have kept non-food prices relatively in check in China.

Admittedly, we were right for the wrong reason, but nonetheless, we believe that we deserve the full 20 points for this highly accurate prediction.

Prediction #2: China will continue to peg the yuan to the dollar at 6.8 to 1 USD until it is confident that downward pressures on the dollar have eased.

In managing its currency, we said last January that China has to balance two issues. First, it must consider the impact of its currency policy on trade. Second, it must consider its impact on the $2 trillion or more of foreign currency reserves, much of it dollar-denominated, that it currently holds.

At the beginning of 2010, China's currency was pegged to the dollar, which had been in decline against the Euro, and the Obama Administration was projecting deficits of $1 trillion or more for "as far as the eye could see." As a result, we noted that "the yuan and the dollar are now linked together in a deathly spiral against the Euro and other major currencies of the world." At the time, one dollar could only purchase 0.70 Euro. If China's currency had been heavily weighted to the Euro during this period, the country's dollar-denominated assets would have been reduced by $150 billion for every $1 trillion of assets held.

By June of this year, however, the debt crisis in Europe had led to a flight to the dollar, which in turn caused an increase in the value of the dollar to the Euro. On June 7, the dollar had appreciated by almost 20 percent to the point where one dollar purchased 0.84 Euro.

It's no coincidence then that China chose on June 19 to de-peg the renminbi from the U.S. dollar in favor of a basket of currencies, providing support to the Euro in the process. With the increase in the value of the dollar, the Chinese authorities felt that they had room to divert some of their purchases to the other major currencies of the world.

Another spot-on prediction for which we will take 20 points.

Prediction #3: Geely will acquire Volvo from Ford, and this acquisition will be a turning point for acquisitions of industrial companies by Chinese enterprises.

Geely did indeed acquire Volvo from Ford, and there is no question that it was a watershed event that will pave the way for more acquisitions of industrial companies by Chinese buyers.

In our post on Why Bright Foods Likes GNC, MTD noted that the cross-border mergers and acquisition business was heating up. In addition to the potential $2.5 billion acquisition of GNC, the world's largest chain of specialty vitamin, mineral, herbal and sports nutritional supplements, by Bright Foods, announcements regarding Pacific Century's $450 million acquisition of Nexsteer from General Motors and Tianjin-based Xinmao Group's $1.4 billion bid for Dutch cable maker Draka were making the news.

As we noted at the time, "the appetite of Chinese companies for overseas acquisitions is quickly moving well beyond natural resources."

Chalk up another 20 points for this one.

Prediction #4: The relationship between China and the United States will deteriorate in 2010.

At the beginning of 2010, it seemed as though the relationship between the United States and China was quickly turning south. Bending to the will of the United Steelworkers Union, the first action taken by the new Obama Administration towards China in 2009 was to slap a tariff on imported Chinese tires. At the end of the year, the administration followed up with tariffs on steel pipe from China.

Protectionist trade measures, constant calls by the U.S. for China to allow the yuan to appreciate against the dollar, and China's concerns about the value of its holdings of U.S. assets, threatened to create considerable tensions between the two countries. With the Obama Administration facing near 10 percent unemployment in a mid-term election year, and a growing deficit and national debt, it seemed as though the Sino-U.S. relationship had nowhere to go but down.

Surprisingly, negative ads towards China on trade matters did not play as large a role in the mid-term elections as we would have thought, and the Fed's policy of quantitative easing to re-start the American economy seemed to blunt some of the U.S. criticism of China's currency policy. By the time of the G20 Summit in Seoul, the U.S. could no longer take the high ground on the currency issue, as one nation after another denounced the Fed's policy of printing money.

From the early talk about America's "partnership" with China at the start of the Obama Administration, the relationship deteriorated during 2010 to the point where the best that can be said is that the two countries simply have no relationship. There is little basis for the U.S. and China working together to solve the world's ills as originally thought.

Having said that, the relationship did not turn as frosty as we would have thought, and therefore, we can only take partial credit– and 15 points– for this prediction.

Prediction #5: China will begin to act unilaterally on global issues like Iran.

As MTD discussed in Copenhagen: A Failure in Leadership, the Obama Administration failed its first real test in Copenhagen on its ability to work effectively with China on important global issues. By not meaningfully engaging China in a discussion on climate change, and by acting unilaterally in Copenhagen, the United States gave China's leaders a first-hand view of what a dialogue and partnership with the Obama Administration means. Moreover, China had already made its own bilateral deals with Russia and North Korea by the end of 2009.

For all of the above reasons, we believed that China might begin taking the initiative on touchy issues like North Korea and Iran. In fact, China has remained silent on both. On the other hand, China is clearly exerting a leadership role in both Africa and Southeast Asia, as we have noted on our two posts on China's activities in Africa: China and Africa and China and Africa: Part II.

There is no question that the global financial crisis has accelerated China's rise in global influence, and that China is now exercising the muscle it has developed over the past 30 years of economic reform. Although China's rise in stature has not resulted in significant, visible help in resolving the thorny issues presented by North Korea and Iran, the country has been slowly, but surely, extending its reach around the world. We won't take any points for this final prediction, but we believe that we were pointing in the right direction when we made it.

A 75 percent grade is little more than a "Gentleman's C" at Yale, but then China is a particularly difficult course. We will gladly accept and begin preparing our predictions for what 2011 holds.

Happy New Year from all of us at Managing the Dragon!