Cracking China

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Despite the apparently giddy expansion of the Chinese economy, there is substantial room for growth

It is easy to allow the scale of things Chinese to overwhelm the senses. Yes, the Chinese economy continues to grow at around ten per cent annually. Yes, the balance of trade surplus rose 75 per cent in 2006, and is expected to hit US$200 billion (bn) when the 2007 figures are published. Yes, China's economy has been growing annually at over nine per cent for the past thirty years. But there are an awful lot of people in China, offering a cheap and reliable source of labour, as everyone is well aware. And three decades ago they were not producing very much of anything.

So possibly the most notable figure among China's economic indicators is GDP per capita. The government in Beijing has made great strides in bringing huge numbers out of poverty – perhaps as many as 300 million since 1978. Yet the GDP p.c. number for China is US$1,700. For the United Kingdom it is US$31,800. In other words, despite the apparently giddy expansion of the Chinese economy, there is substantial room for growth.

After the dramatic economic reforms inspired by Deng Xiaoping and subsequent retrenchment after the upheavals of 1989, the Chinese economy continues to undergo modernisation and change. Entry to the World Trade Organisation has brought further opening of domestic markets, although often in a more circumspect form than in other global marketplaces. Joint ventures are the preferred modus operandi for Beijing, and Western and UK companies in a number of sectors, notably finance, commodities and oil, technology and construction have moved to establish partnerships with Chinese counterparts eager to expand their commercial operations.

The flow of capital is two-way. China is awash with cash, and has not been slow to invest in oil, steel, mining and finance projects overseas. The sub-prime crisis that has enveloped and seized Western capital markets has so far barely rippled against Chinese economic shores. Indeed the China Investment Corporation, established in September and responsible for investing up to US$200 bn of foreign exchange reserves, has not been slow in discharging its duties. Before it came into formal existence it had snapped up ten per cent of US private equity giant Blackstone for US$3 bn, and last month injected US$5 bn into Wall Street scion Morgan Stanley. Fellow sovereign fund Citic pumped US$1 bn into troubled Bear Stearns, while the China Development Bank (CBD) invested US$1.5 bn in Barclays.

But Barclays itself has been looking east. In October it formed Commodities Strategic Alliance with CBD, focusing initially on areas of energy, metals and emissions. Barclays' global commodity capability, risk management and banking expertise played a crucial part in fixing the deal. Chairman and CEO of Barclays Asia Robert Morrice said, "Barclays has enjoyed a strong, long-standing relationship with CBD, and we are delighted with this further opportunity to work together. With CDB's strong market position in China and Barclays' extensive commodities capabilities, I have no doubt that this arrangement will provide substantial long-term benefits for both parties."

In late 2006, the China Banking Regulatory Commission issued a series of new rules to expand access to the rural market by domestic and international financial institutions in order to expedite the country's rural economic development.

Standard Chartered – for whom 2008 marks 150 years of uninterrupted presence in China – was one of the first banks to submit its application to set up as a local firm, a prerequisite to conducting business with Chinese individuals in local currency terms, and had over 35 branches or sub-branches and almost 4,000 staff in China by the end of 2007. As group chief executive Peter Sands commented to shareholders at the last agm, "In 2006, we more than doubled our income in China, tripled profit, expanded our network to 22 locations in 14 cities, and almost doubled staff numbers," he said.

"At the beginning of April 2007 we incorporated our business in China. Incorporation allows us for the first time to provide mortgages, credit cards and other local-currency services to Chinese individuals. Then we received licences to offer these services in five cities. This is a huge opportunity, and we're accelerating investment to expand our network," he added.

Standard Chartered's plan to boost growth in China is complemented by the fortunes of its Chinese partner, Bohai Bank, in which it owns a 19.9 per cent stake.

That partnership offered bright prospects given that the new lender had opened branches in around seven locations since beginning operations in late 2006, and held around US$1 bn (£518 million) in assets, Sands said on a visit to Beijing shortly after taking the helm at Standard Chartered. ▶

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◀ He revealed little about the bank's possible ambitions to buy into a second Chinese lender – the maximum allowed under Chinese rules – reiterating that he could not rule out a further acquisition on the mainland.

"We are very well positioned as we are with an organic business which is growing extremely strongly, with a strong successful partnership with Bohai Bank," he said.

HSBC, meanwhile, announced that it had begun rural bank operations in central China last month. While celebrating the opening a branch in Suizhou city in Hubei Province, Vincent Cheng, Chairman of HSBC subsidiary The Hong Kong and Shanghai Banking Corporation Ltd, said: "There is tremendous potential for economic development in the rural areas. HSBC's proven expertise in rural banking elsewhere will help us tap into a range of new opportunities for China's rural population of more than 600 million people in this fast-growing, but still largely under-developed market. HSBC has had a continuous presence for 142 years. China is a very important market to the bank."

By the end of 2007 HSBC had nearly 60 branches or sub-branches in mainland China.

One curiosity of China's economic outlook likely to be of interest to banks and pensions experts is the demographic of the country's population. The success of the one-child-per-family policy means that the over 60s account for 10 per cent of the population now, but that proportion will rise to 22 per cent by 2030 and 33 per cent by 2050 if current trends continue.

Allianz, the German insurer, says that old-age dependency ratios throughout Asia will worsen between now and 2050, with China among those countries most dramatically hit. The working population, Allianz says, will peak in 2010 and steadily decline thereafter. (Chinese economists paint a rosier picture, anticipating no labour supply problems for at least 20 years.)

The authorities in Beijing are at least aware of the potential problem, ushering in pensions reform that bears the hallmarks of the 'defined contribution' schemes now common in, for example, the UK. Pension assets under management are growing rapidly and the national social security fund – said to be eyeing stakes in US private equity firms – is likely to see its own assets increase within 20 years from the current US$27.5 bn to US$97 bn.

Powering China's growth has pushed the country to second in the world's ranks of oil consumers, behind only the USA. By 2010 China is expected to have 90 times more cars than in 1990. With vehicle numbers growing at 19 per cent a year, China could surpass the total number of cars in the USA by 2030. Another contributor to the sharp increase in vehicle sales is the very low price of fuel in China. Chinese fuel prices now rank among the lowest in the world for oil-importing countries, and are a third of retail prices in Europe and Japan, where steep taxes are imposed to discourage fuel use.

So where will the country's oil come from? China's ability to provide for its own needs is limited by the fact that its proven oil reserves are small in relation to its consumption. At current production rates they are likely to last for less than two decades. Though during the 1970s and 1980s China was a net oil exporter, it became a net oil importer in 1993 and is increasingly dependent on foreign oil. China currently imports 32 per cent of its oil, and is expected to double its need for imported oil between now and 2010. A report by the International Energy Agency predicts that by 2030, Chinese oil imports will equal current imports by the USA.

In November Beijing announced that it would prohibit foreigners from investing in small and mid-sized oil refineries under new guidelines limiting access for overseas firms seeking a foothold in the world's second-largest energy market.

The restrictions will also limit options for independent refineries in the coastal regions that had been hoping for alliances with foreign firms or domestic oil majors to improve their standing in the domestic market, which is dominated by a few state-run firms.

In new guidelines on foreign investment, jointly released by the National Development and Reform Commission (NDRC) and the Ministry of Commerce, foreign companies will not be allowed to invest in refineries with annual capacity of 160,000 barrels per day or less, which would include many independent refiners that have emerged in recent years.

Beijing said at the time of the announcement that the guidelines aimed to encourage foreign participation in exploration of oil, gas and coal-bed methane, tapping ▶

One way street: by 2010 China is expected to have 90 times more cars than in 1990

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◀ of oil and gas resources in low permeable reservoirs, and developing new technologies that can improve recovery rates for crude oil.

According to Zhao Zhiming, president of the China Petroleum & Petrochemical Equipment Industry Association, China's oil companies are expected to double imports of crude oil they produce overseas by 2010, as they increasingly invest in foreign oil assets.

"It's more cost-efficient to import oil produced by the companies' overseas assets than purchasing from the international market. And the overseas assets will provide long-term oil supply no matter how high international oil prices grow or how tight global supply is," Zhao said.

In 2005, China's oil companies imported about 50 million tonnes of crude oil from their overseas assets, including 35 million tonnes by China National Petroleum Corp (CNPC), 10 million tonnes by China National Offshore Oil Corp (CNOOC), and the rest mainly by Sinopec. The country imported a total of 127 million tonnes of crude in 2005.

China's expectation of growing future dependence on oil imports has brought it to acquire interests in exploration and production in places like Kazakhstan, Russia, Sudan, West Africa, Venezuela, Iran, Canada and Saudi Arabia. But despite its efforts to diversify its sources, China has become increasingly dependent on Middle East oil. Today, 58 per cent of China's oil imports come from the region. By 2015 that ratio will have reached 70 per cent. Though historically China has had no long-standing strategic interests in the Middle East, its relationship with the region from where most of its oil comes can only become increasingly important.

All this notwithstanding, UK oil firms have not been slow in also pursuing joint ventures in the region. Shell and CNOOC, China's third-largest oil company, operate what was at US$4.3 bn the largest petrochemicals joint venture in the country, until the announcement in December of a US$5 bn project by Kuwait Petroleum Corp and Sinopec. Shell and CNOOC share a 50:50 stake in the complex at Daya Bay, Guangdong.

BP has been active in China over 30 years, and has moved from licensing through onshore and offshore exploration to large scale equity investment and manufacturing. To date the company has invested US$3.4 bn in China, and is working in partnerships with Sinopec, PetroChina and CNOOC across oil, gas and chemicals. BP is also involved with 'Clean Energy Facing the Future' – a ten-year R&D initiative in partnership with the Chinese Academy of Sciences

Of course it would be fatuous to suggest that all is sweetness and light in commercial relations at opposing ends of the silk road. European (and US) manufacturers and producers commonly rail against 'cheap imports flooding' their markets. For example, the European steel makers association Eurofer is lobbying the European Commission to impose tariffs on soaring imports which they say are being dumped on the market at prices significantly below cost. And in the USA, the American Iron & Steel Institute made similar calls, claiming "the US steel industry can compete against other companies, but can't compete against other governments," suggesting that Beijing had subsidised its steel industry by, for example, removing the pensions burdens of many Chinese steel companies – a claim refuted by both Beijing and the industry itself.

It is also worth observing that such requests set the scene for a debate likely to divide European governments, as steel makers and companies reliant on imports fight out their respective corners. The extent to which some manufacturers are already dependent on imported Chinese steel makes the case a particularly delicate one for European trade commissioner Peter Mandelson. He recently confided in an internal document that a conciliatory approach to Beijing on trade was not yielding results and suggested that greater use should be made of trade defence instruments.

The commission will have to determine first whether dumped imports are injuring European steel producers, and then if countermeasures are in the EU's overall interests. Though the price of steel is relatively high, making it harder to argue that European steel makers are suffering, the commission will also have to consider whether a further surge of imports is likely to follow when construction for the Beijing Olympics is completed. This work is currently soaking up Chinese production, which could be redirected to Europe. A ruling is expected in 2008.

But as Mandleson told journalists accompanying him on a trip to China last year, "The only thing that frightens me more than China's economic growth, is that growth faltering." Xinhua, the state news agency, reported that "the primary task of China's 2008 fiscal policy is to prevent the economy from becoming overheated and to guard against a shift from structural price rises to evident inflation".

Inflationary fears, stemming from China's US$280 bn trade surplus, prompted the central bank to raise interest rates for the sixth time in a year in December. In November, inflation was running at 6.9 per cent – the highest for more than a decade. However, if forecasters are correct, lower exports, a smaller trade surplus and tighter money supply will effectively dampen any inflationary concerns.

While the planners in Beijing can do little to prevent the widely anticipated US and global slowdown, their own concerns centre more on balancing the heat of their economy, which in turn will continue to offer business opportunities to UK plc that will ameliorate the slowdown if and when it occurs. F