Innovation and wage growth fuel long-term change in China

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Signature Global Advisors was recently in Beijing to meet senior government officials, leading business people from both Chinese private and state-owned companies as well as foreign multinationals, and prominent analysts and other astute China observers to hear their views and outlook for the country. The timing was opportune, given concerns about slowing growth and pending leadership changes in the government.

Can China continue to grow?

Never has a country grown so fast. Forty years ago, it was inconceivable to think of China as an economic superpower; now it is taken for granted.

However, concerns over Chinese growth have arisen in recent months. One businessman mentioned that the trend of 60 quarters of double-digit retail sales growth at his outlets had broken down recently.

Private Chinese corporations have already experienced a slowdown and profitability has been under severe pressure for 18 months. Global quantitative easing had the unintended consequence of wage and rental inflation. Higher borrowing rates and a rising currency added to the problems. Manufacturers suffered, as they were unable to pass on costs. Europe, which accounts for 22% of exports, is clearly slowing. It is no wonder that the Shanghai equity market is at its lowest point since the Lehman Brothers bankruptcy.

Government policy actions have not helped. In 2009, the government was criticized for providing too much stimulus. This led to excessive borrowing and poorly directed spending that left a legacy of non-performing loans and underutilized infrastructure. The government then cut back on stimulus in an attempt to cool down the property market and tighten lending. This, in turn, caused the recent slowdown. By June, conditions had deteriorated more than expected, forcing the government to adjust interest rates and restart property market incentives.

We worry that the practice of state-owned banks lending to state-owned enterprises is not the makings of a modern economy. Financial reform and improved access to capital for private markets would be better policy actions. But real financial reform is challenging, as markets lack depth and capital controls distort decision making. The tried-and-true playbook of resuscitating the economy with infrastructure spending seems more comfortable, albeit fraught with problems.

These issues will face the new Chinese leadership as it assumes power in 2013. While pundits are encouraged by potential candidates for the next Standing Committee, the timing of this transition adds to short-term uncertainty as economic activity slows.

Moving past an export-based economy

Though policy is slow to change, China has been actively moving itself away from an export-led economy. Low-end manufacturing has already moved to cheaper climates now that rising wages have made China less competitive. The focus now is how to leverage rising wages to create a consumption-led economy, moving from a “Made in China” model to a “Made For China” model.

Smart and innovative multinationals have recognized this and are acting accordingly. To be truly effective, they will have to think differently. They must fully integrate their China operations into other global operations such as R&D, design and innovation. To win in China, you must fully embrace it; locals will outmanoeuvre you otherwise.

China is fortunate as it has the talent base to make this shift. One executive summed it up by saying, “The quality and quantity of top graduates here is truly astonishing.” China is becoming a leading global innovation centre, as new patent filings will attest.

This is the positive side to the obvious negative of wage inflation – namely, that if China can move up the innovation curve, wage growth will create the next leg of growth as Chinese professionals approach Western-style wages. Pundits are already betting that based on this dynamic, China will become the largest retail market in the world, surpassing the U.S. We shall see.

Energy and commodity independence still a challenge

China needs raw material inputs to fuel its growth and is scouring the globe to secure more resource assets to underpin its economic future – especially resource-rich Canada, as seen in the recent CNOOC-Nexen bid.

We believe that China is far from being independent in its resource needs. The economy is growing too fast and is too reliant on many commodities. Metallurgical coal deposits have been found but high-quality deposits are scarce. China has an abundance of rare earths, but the population is tired of the pollution these mining operations cause. There are large shale gas deposits, but the geology remains difficult and the infrastructure to exploit them is lacking.

Agriculture is also a challenge as the country shifts to higher-protein diets that require massive increases in agricultural inputs. So it is no wonder that 70% of global soybean exports are going to China and that China is taking all the pork that farm states such as Iowa can produce. Food safety remains an issue as food scandals such as tainted milk persist. Research shows that Chinese consumers spend twice as much time as North Americans reading food labels.

Still constructive on China

Even with the headlines about slower growth, investment challenges and future political change, we remain constructive on Chinese progress. Every year, China seems to confound its skeptics by doing the impossible – managing growth on an unprecedented scale.

The policy tools appear to be blunt but they are effective. And while change may be slow, it is pointed in the right direction. This does not go unnoticed. The Chinese we met may have criticisms but they are still confident that the new government, once in place, can restimulate the economy. This confidence in government leadership cannot be found in most countries right now.

China stands in sharp contrast to certain emerging market peers, where slowing growth has exposed far worse cracks. With its long-term growth potential intact thanks to its growing middle class and leadership in global innovation, China still appears to be a solid BRIC. ❖

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