RIDING THE DRAGON'S TAIL

How can Westerners tap into China's burgeoning growth?

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Since 1978, Chinese reform has transformed not only the Middle Kingdom but our global economic balances as well. Pushing down prices of what it produces, pushing up prices of what it consumes, and beginning to play a major role in global capital flows, China is an economic force that should be carefully understood and integrated into the plans of both manufacturers and investors.

With average growth rates close to 10%, China is now the second-largest economy in purchasing power parity, and ranks among both the largest exporters and importers. Unlike certain other Asian economies, however, China is not primarily export-driven; furthermore, there are a number of dimensions to the Chinese economy that surprise many. Less than 50% of the economy is now under state control, the number of state-owned enterprises has fallen more than 100,000, and there are now more than 2.5 million private firms driving the bulk of domestic economic growth and providing the majority of increased governmental revenues and employment growth.

The Chinese economy is not without its stresses and strains: budgetary deficits have been the norm for years, especially since the Asian financial crisis of 1997, although the current deficit is well below the magical 3% acceptability level. Recent growth in consumption and retail sales has more than offset a decline in government spending and the squeeze on credit applied by the state to reduce overheating. Income disparities between the urban east and the rural west—and between state employees and participants in the private economy—are of concern to the current government, which has made increasing agricultural incomes its highest priority. The banking system remains burdened by non-performing loans, although these are being reduced through improved credit discipline, transfer to asset management companies, and injections of state funds. Furthermore, the banking sector is unlikely to become the Achilles heel of the economy because of the huge deposit bases the banks draw on, the high national savings rate, and the lack of alternative places for the average Chinese to put their money.

China is increasingly a consumer society, with average urban households holding both discretionary spending power and assets against which they can leverage credit. Housing, which was given an enormous stimulus through former Premier Zhu Rongji's reforms, has emerged as a major driver of economic activity and is likely to remain so for decades to come. The automotive sector is also emerging as an important sector and is being fuelled both by growing demand and by the infusion of credit. Other consumption sectors, from electronics to food to leisure and travel, are also important and relatively new drivers.

Another major underlying force driving demand growth is urbanization, which will see an additional 200 million people move from the land to the cities over the coming decade, driving infrastructure development, construction and general consumption associated with urban economic activity.

Although the Chinese economic miracle is truly world-tilting, taking advantage of Chinese growth is not easy: direct retail investments on the Chinese stock markets are not yet possible, although the recently introduced Qualified Foreign Institutional Investor program will permit greater access. Even so, the markets of Shanghai and Shenzhen are highly unreflective of the Chinese economy, being limited primarily to state-owned listings. Investors can take advantage of a number of China-focused funds, or a number of specialty instruments such as exchange-linked notes. Major private equity houses are increasingly active in China and offer opportunities, as do direct investments in certain commodities and companies whose futures are closely linked to Chinese growth. ■