

SPECIAL REPORT

**CHINA:
THE RISE OF “THE MIDDLE KINGDOM”**

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Everyone is asking about China. Will the economy hold up? What is the nature of its long-term plan? Can China sustain the manufacturing base it has won and build a sustainable industrial economy?

It is hard to dispute that China is a major player now and more so in the long run, able to affect every other part of the world. While the United States and most Western economies are only now tentatively emerging from the chaos of the global financial crisis, the Chinese economy seems to have barely skipped a beat. Premier Wen Jiabao assured business leaders recently that the economy would hit its 8% growth target for this year.

This objective is virtually assured given the \$600 billion government stimulus program and a massive lending campaign by China's largely state-owned banks. Unlike the United States, where the deployment of federal stimulus funds has taken many months to have any kind of impact, in China the spending has been immediate and has effectively countered the drop in foreign demand for Chinese manufactured goods.

That said, it should be noted that these government measures are stop-gap in nature and cannot be sustained too long. Despite all the positive indicators of continued prosperity, China is, in fact, at a crossroads.

The global financial crisis has dramatically illustrated the vulnerability of its economy, which remains far too dependent on foreign consumers to fuel growth—particularly those in the U.S.

At the same time, a troublesome issue that continues to cast a shadow over U.S.-China relations is the unanswerable question of whether China will go on financing our huge national debt, currently at the rate of around \$300 billion annually, or almost a billion dollars a day. China has been, by far, the world's largest purchaser of all U.S. debt—more than two trillion—enabling the U.S., in turn, to be China's No. 1 export market. Will this critical symbiotic relationship endure? No one can say with any certainty. It is surely an advantage the Chinese enjoy.

Meanwhile, there is great opportunity in China. There is also great risk.

EXPORT-DRIVEN ECONOMY

Over the last two decades, the Chinese economy has been driven by export-led industries and huge government expenditures on infrastructure. The model has been an indisputable success, with China posting sustained growth rates unprecedented in modern history. However, with over-leveraged U.S. consumers still tightening their purse-strings, China must take the next step in its evolution as a viable market economy—the development of a strong domestic market.

For years, American politicians and trade representatives have exhorted the Chinese to open up markets, foster more consumer demand domestically and, in the process, reduce the U.S.' growing trade deficits—\$268 billion in 2008—with China.

The Chinese leadership has heard the refrain and, for the last several years, has at least been saying that the Chinese economy required a greater balance between foreign and domestic demand. The global recession, however, may have finally convinced those leaders that the country must now move more aggressively in that direction. “We should focus on restructuring the economy, and make greater effort to enhance the role of domestic demand, especially final consumption in spurring growth,” said Premier Jiabao of the government’s stimulus program.

This year, China is expected to pass Japan as the world’s second largest economy—several years ahead of predictions. In part, that speaks to the economic malaise that has beset Japan in the last decade. But much more so, it signals the emergence of China as an economic superpower. This is increasingly important to the overall health of the global economy, and vital to efforts aimed at tackling global issues such as climate change and free trade. If the country is successful in unlocking the consumer buying power of its 1.3 billion people, it will set the stage for a sustained recovery in the global economy.

THE CHINESE CONSUMER: NOT QUITE READY FOR PRIMETIME

China has become the world's workshop over the past two decades, with thousands of domestic and foreign companies investing in low-cost manufacturing facilities to serve global markets. In the process, the Chinese economy has become closely integrated with developed economies around the world—most notably, the United States, which purchases nearly \$4.50 worth of goods and services from China for every \$1 worth of goods it sells there. The recent tariff that the Obama administration, under pressure from the United Steelworkers Union, decided to slap on tires manufactured in China over the next three years, will hurt several U.S. companies with operations in China as much as anyone else.

China, having recently passed Germany as the biggest exporter in the world, will remain a powerhouse in international trade for many years to come. But if the country is going to continue growing at the heady pace of recent years, domestic demand will have to fuel much more of the growth. The Chinese consumer currently accounts for only 36% of the country's GDP—barely half the level in the United States and well below the 50%-60% range of typical European countries. In fact, China has one of the lowest consumption to GDP ratios of any major economy.

A NATION OF PARADOXES—PLENTY OF CHALLENGES

Economically speaking, China continues to be a nation awash in paradoxes and contradictions. Although the adoption of an authoritarian style of capitalism has very substantially raised the standard of living of at least 300 million or more Chinese, the majority of its huge 1.3 billion population remains basically impoverished.

The typical Chinese consumer saves approximately 25% of his or her income—about six times as much as the average American. A big reason for this prodigious penny-pinching is the lack of a significant social safety net. China now has only the most rudimentary health insurance, pension programs and public retirement systems. If one gets sick or loses one's job in China, there is little public support to rely on. That being the case, the Chinese are saving more in order to protect themselves.

Experts say that excess saving is very much an outgrowth of necessity rather than part of its culture. And it's up to the Chinese authorities to really deliver on a safety net; to persuade families so that the savings motive can change.

What's more, Chinese consumers only account for about 56% of national income—a significantly smaller share than their counterparts in Europe and the United States. Smaller incomes mean less consumer buying power.

Beyond addressing health and retirement issues that motivate consumers to hoard cash, the country has to make more and better products and services available to consumers. That means giving both domestic and foreign producers better access to the markets and reducing the involvement of the authoritarian Communist Party in the economy. In no industry is this more necessary than in financial services. China's centralized financial system has functioned spectacularly well for large, usually state-owned enterprises targeting foreign export markets and for government infrastructure projects that continue to fuel economic growth. However, the system has not encouraged the development of more innovative smaller and mid-sized businesses.

CONSUMER LENDING LAGS

Consumer lending, for example, has not kept pace with the overall economy. Consumer debt in China amounts to just 3% of GDP—far lower than other developing economies such as Russia and Brazil. The privatization of China's housing stock has unleashed huge demand for mortgages—which represent about 90% of consumer debt, but there is limited access to credit cards or personal loans. That industry is growing very rapidly, albeit from a currently small base. If consumer lending in China were to reach the levels experienced in Taiwan over the next five years, it should result in up to \$1.5 trillion in new consumer expenditures.

To get there, the Chinese economy will need the help of foreigners. New, more relaxed regulations passed by Chinese banking regulators earlier this year provide more opportunity. But, sub-prime lenders need not apply. The Chinese government can, and will, enforce responsible lending and borrowing standards far more vigilantly than in the United States.

Adhering to the Chinese model, foreign investments in financial services and other consumer-oriented businesses will likely take the form of joint ventures with established, often state-owned enterprises. A consortium led by U.S. private equity firm Kohlberg Kravis Roberts, that includes the Singapore sovereign wealth fund and a Chinese investment bank, recently invested \$160 million for a 30% stake in International Far Eastern Leasing Corp. The company lends to education companies, hospitals and infrastructure projects as well as other consumer-oriented businesses. State-owned conglomerate Sinochem is the majority owner. The deal marks the third investment by KKR in China since it opened an office there in 2005.

The development of the Chinese consumer is the only sustainable way for the country to continue growing at anywhere near the pace set over the past decade. While Chinese leadership has proven it can tackle difficult problems, this structural transformation of the economy will likely present new and serious challenges to the centralized Communist leadership.

SHANGHAI “MICKEY”

As recently reported, “The Magic Kingdom” is setting up another shop in “The Middle Kingdom.” After a 20-year-long courtship, Walt Disney Company received approval from the Chinese government to build a \$3.5 billion Disney theme park in Shanghai. The company has been operating a Hong Kong Disneyland for the past four years. Hotels, shopping facilities and other infrastructure will also be built on a 1,000-acre site in the city’s Pudong District. Approximately 300 million people live within two hours of the proposed site. If Disney can increase the interest of the Chinese population in its already popular entertainment assets, the cornucopia of consumer products it sells, such as DVDs, video games and toys, could be a major source of growth.

Disney, like every other company in the world, sees the vast opportunity that a population of 1.3 billion people just beginning to develop consumer tastes represents. Although foreign direct investment around the globe has plummeted since the economic crisis began, according to the United Nations Conference on Trade and Development, China remains the most attractive destination for foreign investors, followed by India, the United States, Russia and Brazil. The sometimes arbitrary authoritarian government, the pervasive corruption, rising organized criminal activity and the limited legal and business regulatory system present major risks for would-be corporate investors. But the greater risk may be not venturing into the largest, potentially most lucrative, market on the planet.

While the rest of the world is busy drafting strategies to get into the Chinese market, China and its largest companies are also on the hunt for foreign assets. With foreign exchange reserves of more than \$2 trillion, China is loaded. And, in a post-financial crisis world, there are scores of bargains to be had across a wide range of industries and assets. China is expected to greatly step-up its foreign direct investments over the next decade. To date, the large state-owned enterprises have been interested predominantly in natural resource companies to help fuel the country's growing manufacturing base. Witness the enormous investments (approximately \$120 billion) that state-owned enterprises like China National Petroleum Corp. have made to secure development rights for Iran's huge oil and gas reserves. It's noteworthy that China does not support tougher economic sanctions against Iran.

Chinese companies have, in fact, also been investing heavily in resource development in the former Soviet republics, Africa and Brazil. With the decline in global asset prices, however, analysts expect the country will increasingly look towards acquiring assets further up the value chain—including Western companies with strong brands in industries such as financial services, manufacturing and technology. Just as Japan's spending spree in the U.S. did during the 1980's, that is sure to stoke Western fears about foreign ownership—particularly by state-owned enterprises.

China's foreign investments last year totaled \$50 billion—still, less than a sixth of that spent by the United States (\$318 billion), the world's largest exporter of capital in 2008. Given the Chinese government's stated intentions to develop its own consumer market and its desire to expand beyond the manufacturing partnerships it has with the world's multinational corporations, expect China's foreign investing to rise substantially in the years ahead.

CLIMATE CHANGE: A PLATFORM FOR G2 COOPERATION

The unofficial G2 (the United States and China) may not yet be driving the entire world economic agenda. But it's close.

On the issue of climate change, the positions of the two countries are key to any international efforts to reduce greenhouse gas emissions. When President Obama visits China this month, climate change is expected to be a major item on his discussion agenda with President Hu Jintao. As the two largest emitters of greenhouse gases on the planet, the U.S. and China each account for about 20% of the world's total emissions. If they don't come to some meeting of the minds on the issue, the international climate change talks slated to begin in Copenhagen this December will be a failure.

Until now, the intense economic competition between the U.S. and China has given both countries an excuse for not engaging on the climate change issue. Chinese leaders believe the United States hopes to hobble the emergence of China as an economic power, while opponents of the climate change bills in the U.S. House and Senate argue that China will not honor emission reduction commitments. They argued further that the U.S. business community will be saddled with another layer of costs that their Chinese competitors won't have.

By most estimates, China recently surpassed the United States as the largest emitter of greenhouse gases on the planet, and its emissions continue to grow far more rapidly than other major economies. According to projections by the U.S. Energy Information Administration, if current trends continue, China's emissions will grow by more than 50% over the next two decades to roughly 12 billion tons of carbon dioxide annually.

Both China and the United States face daunting challenges to reduce their carbon footprints. While approximately 50% of electricity generated in the U.S. is produced by burning coal, the figure is closer to 70% in China. Both countries have ample and relatively inexpensive supplies of this greenhouse gas-heavy source of energy. A new coal-fired power plant was, at least until recently, being brought online in China every week. The replacement of coal as the energy source of choice in China will be an expensive proposition, and the Chinese will expect developed countries to foot much of the bill.

CHINA ALREADY PROFITING

China already is receiving substantial money through the Kyoto Protocol's Clean Development Mechanism. The program allows businesses in China and elsewhere in the developing world to sell credits for emission-reducing projects to businesses in developed countries that are subject to emission targets. As climate change is a global issue, emission reductions in the developing world—often cheaper to accomplish than in developed economies—can be used by advanced nations against emission targets.

China may not commit to emission reductions since it has seen the Western world emit its way to prosperity for the last century. But Chinese leaders also see clean energy development as a key growth industry for the future. In typically direct fashion, they have launched major initiatives in the sector, building one of the largest wind and solar power industries in the world over the past several years. The U.S. company, First Solar, is now in the process of building the biggest solar power installation in the world in Inner Mongolia. Also, Applied Materials, this nation's leading solar equipment producer, will shortly open the world's largest privately funded solar research facility in Xian, China.

Are the Chinese "going green?" Only time will tell.

Meanwhile, if the international community is going to effectively respond to global warming, the United States will have to partner with the Chinese on new technologies that will reduce emissions. That will include potential carbon capture and sequestration/storage technologies for large stationary emission sources. And it will include collaborating on electric car technologies that can provide a cleaner path forward for China's rapidly growing vehicle market. While China's dubious record on intellectual property rights will complicate the issue of technology transfer, cooperation is the only viable solution.

In sum, whatever one believes about China going forward, this reality is indisputable: It is a colossus that will only continue to grow in power, influence and wealth. Some economists have even been predicting that it will overtake the U.S. as the world's

largest economy no later than 2025. That is certainly something to think hard about.

SUMMARY

China has enormous potential. Much of it has been developed, but much more is still to come. At the same time the country faces serious economic, environmental, political and social challenges. It will be a test of leadership not only for Beijing, but also Washington and other Western capitals, to manage the long-term success of this nation and its relationship to a world that it may dominate for the next several generations.