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strategy x economics

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The Lucky 8

Eight opportunities for Australian businesses in the new Chinese economy

Notes from AlphaBeta's recent research trip

Preparing for the New China: 8 opportunities for Australian businesses

Notes from AlphaBeta's recent research trip

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The ball's in our court

We went to China last week to research the question many of our clients are asking right now: *How will the changes in China's economy affect Australia?* But in the course of meeting dozens of business leaders and government officials, it became clear we were asking the wrong question. The more important question for Australia is: *How can we adapt to ensure we continue to profit as China's economy changes?*

We've been negative on the Chinese economy for a long time. While most Australians were drinking the commodities super-cycle Kool-Aid, we were forecasting serious challenges ahead for our largest trading partner. We warned at the height of the boom in 2011 that China's growth was unsustainable; we forecast growth to fall to between 5.0 - 7.5% and pointed out the diabolical consequences for Australian commodity prices. These were unpopular views at the time, but they have since become a painful reality.

We continue to believe that China's economy will slow further. But, for Australian businesses, more important than *how fast* China grows, is the question of *where* it grows? China's economy isn't just slowing, it's changing lanes. To make the most of new circumstances, Australia will have to change as well.

Our trip to China reaffirmed two conviction views:

- **There are big headwinds ahead.** Make no bones about it, based on our current pattern of trade, China's rebalancing presents a 5-10 year headwind for Australian growth. Even if the Chinese government manages a smooth transition, the planned investment slowdown represents around a 1% drag on Australian GDP growth for the next decade.

- **Australia can change too.** We can overcome the investment drag by repositioning to take advantage of new opportunities as China changes. We identified 8 growth opportunities for Australian business and investors that will open up as China's economy transitions.

This won't be easy. For the last ten years, we rode the China minerals wave by luck. We had bountiful supplies of what China crucially needed (i.e., minerals). The next China growth phase won't be so straightforward for Australia to take advantage of, and will require much more active positioning to ensure we can benefit from China's growth. To catch the next wave we need to work harder to reposition our economy to complement the China of the future, not the past.

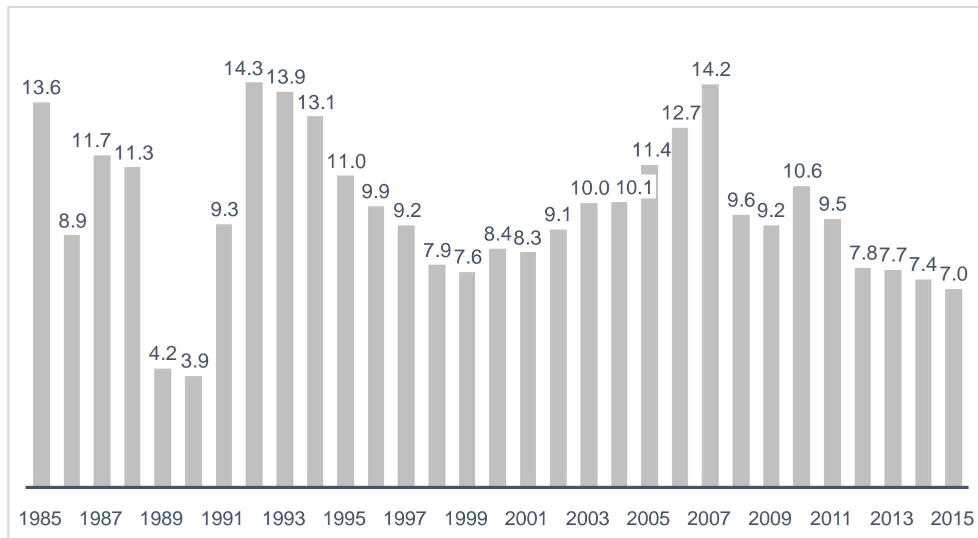
China's economy is slowing

Even Chinese government officials acknowledge that growth is slowing. The 'party line' we heard over and over from officials in China is that growth will be "slower but safer". One official pointed out that while China's slowdown is receiving a lot of attention this year, the economy has actually been slowing for at least five years – evidence, in his view, that the economy was in the middle of a "gradual and orderly" transition from a "high-growth" economy to a "medium-high-growth" economy. That might be true, but China's economy is now growing its slowest annual rate in 25 years, and there are now signs that we've reached the bottom.

EXHIBIT 1

China now growing at the slowest pace in 25 years

China GDP growth
Percentage of total in survey, %



SOURCE: World Bank

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And growth might be even weaker than official statistics suggest. The 7% growth rate reported by the Chinese statistical agency this quarter was spot on Beijing's official target, evoking suspicions from many within China who doubt the reliability of official statistics. Fuelling the skepticism, the official numbers appear at odds with a range of other verifiable indicators. For example, the recently released trade data showed exports down 5.5% and imports down 13%. One businessperson we spoke to asked: 'How can China be meetings its growth target when it's more than 10% behind its trade target?"

China's trading partners are questioning Chinese numbers, with Rintaro Tamaki, the Secretary General of the OECD, said last week that last month's slowdown in Japan's exports to China was "drastic" and questioned how this was consistent with the steady pace of GDP in official statistics.

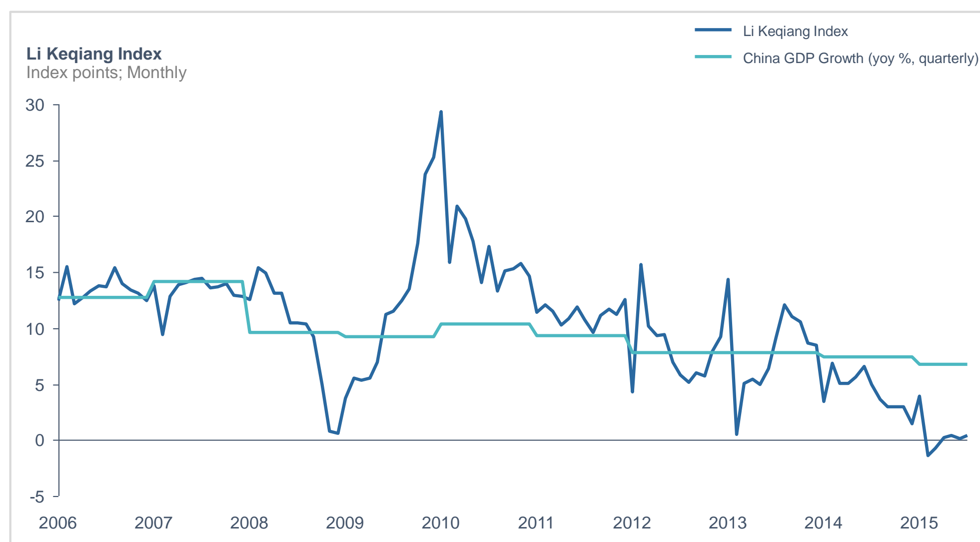
So what is the actual growth rate in China? Different methods have been proposed to measure China's growth. According to a State Department memo (released by WikiLeaks), Li Keqiang (then the Party Committee Secretary of Liaoning, and current Chinese Premier) told a US ambassador in 2007 that the GDP figures were unreliable and that he himself used three other indicators: the railway cargo volume, electricity consumption and loans disbursed by banks. We combined Li's three indicators into a single index with equal weighting and compared it with official GDP numbers (See Exhibit 2).The index has fallen dramatically over the last several years, suggesting that current Chinese growth maybe falling much faster than official statistics suggest.

EXHIBIT 2

Real indicators show China's growth slowing faster than official statistics

Li Keqiang Index vs. GDP growth

Index is average of annual change in electricity consumption, rail freight and money supply; %



SOURCE: IMF, National Bureau of Statistics of China, AlphaBeta

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We pressed a number of Chinese officials on these numbers and they were adamant they simply represented the shift from an industrial and export-oriented economy to a services and domestic-oriented economy. That may be true, but the pace of change is worrying.

Chinese economists pointed us to metrics that try to capture growth in the service sector economy (such as cinema box office receipts and 4G usage). These provide slightly more optimistic estimates, but still generally lower than the 7 percent official growth rate.

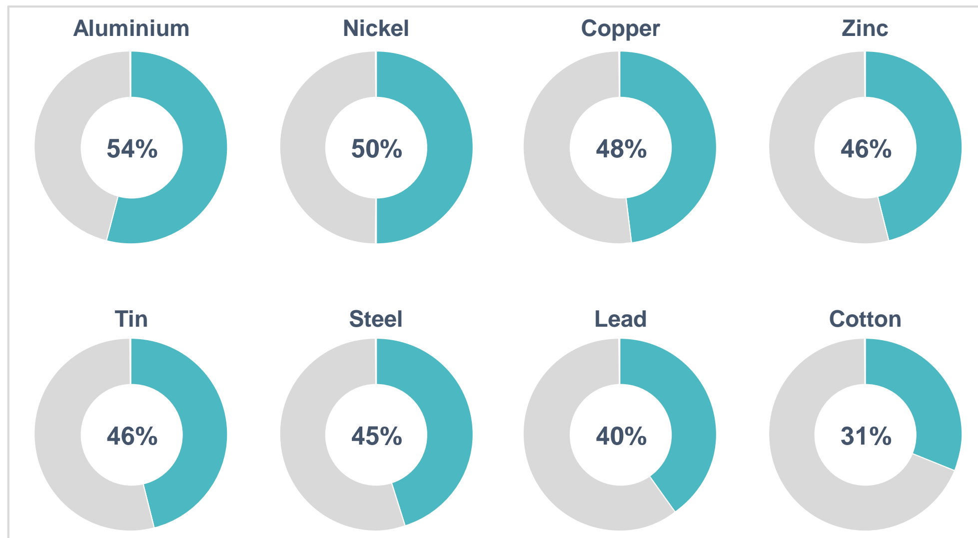
The resources super-cycle is over

Our conversations last week reaffirmed that the resources super-cycle is over and not coming back anytime soon.

Over the last two decades, China tried to grow rapidly by boosting manufacturing, heavy industry and infrastructure. In the process it began to consume staggering quantities of raw materials. China uses as much coal as the rest of the world combined, and consumes almost half the world's steel. In the last three years alone, China poured more concrete than the United States did in the entire 20th century.

EXHIBIT 3

China consumes a huge share of global commodities



SOURCE: World Economic Forum

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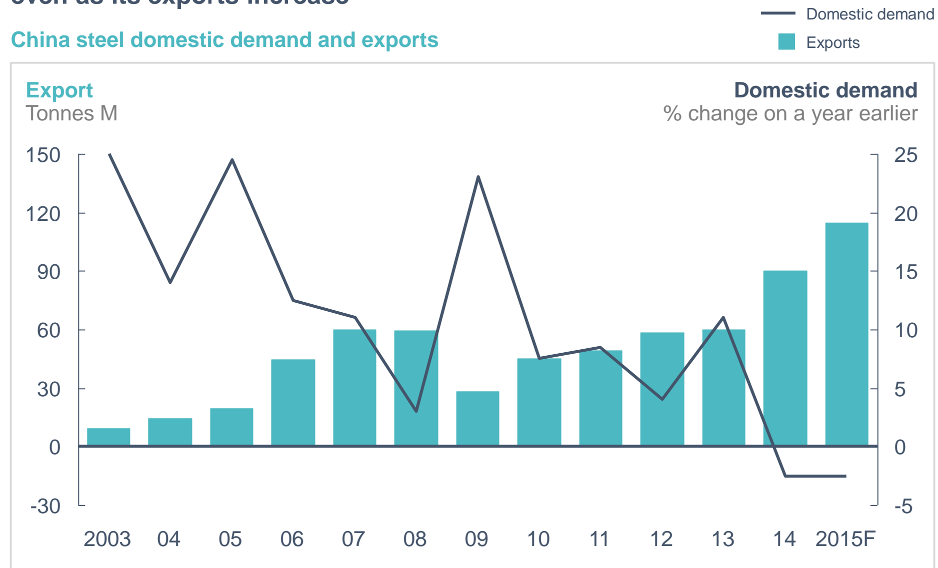
Investment will slow. But the Chinese are now pivoting. The old model of relying on investment — building apartments, factories, highways and bridges — and growing at double digit each year seems to be hitting diminishing returns. Everyone we spoke to accepted that the investment binge that has been powering Chinese growth has to stop. There is too much excess industrial capacity, too much poor quality infrastructure spending, and both residential and commercial construction got out of control.

China's future will be less resource-intensive than its past. As investment slows, China's vast appetite for raw materials is now tapering off. Given it is such a large part of global demand, this

will have huge impacts on global commodity markets. Already, the price of oil has fallen by more than half over the past 12 months, while other commodities like iron ore, aluminum and copper have seen significant drops.

EXHIBIT 4



SOURCE: Moody's Investor Service; Thomson Reuters

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Last week, Justin Lin, a former Chief Economist of the World Bank, said the new drivers of economic growth will be less-resource intensive sectors, especially services. We heard a similar message from the top at the World Economic Forum meeting in Dalian where Premier Li Keqiang said China would abandon its "over-reliance on investment." In particular, the slowdown in domestic steel consumption has been coming for a while (see exhibit). Chinese iron ore import volumes ground to a halt in the most recent data, and were down nearly 40% in value terms on the back of falling prices. Chinese officials explained that this wasn't a temporary slowdown, it was part of a 'new normal'.

Where will China's future growth come from?

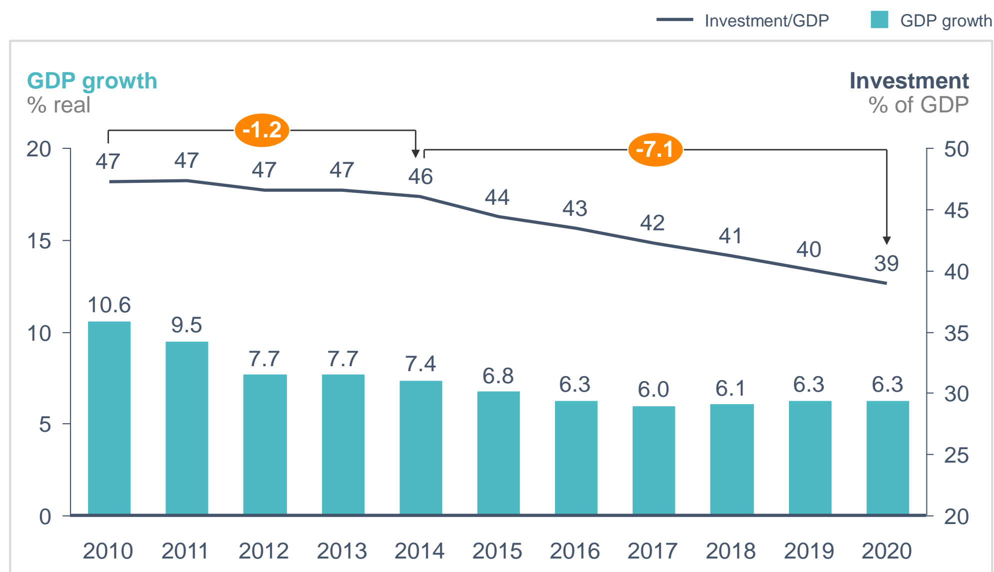
The growth model behind the double digit growth rates of the past decade is over. Chinese officials all accept that China needs a new source of growth.

To unlock new sources of growth, China will need to reform its economy. Just as China delivered growth by liberalising its product markets from the grip of government in the 1990s, a new wave of growth will power its economy forward. Key production factors including capital, labour, land and energy, remain highly regulated. The government has announced plans to liberalise the financial system, deregulate the exchange rate, reform the sclerotic state owned enterprises and allow people to move and work more freely around the country.

With these reforms, the IMF is optimistic that China can maintain growth in the range of 6.0-6.5% for the rest of the decade (see chart below). This forecast implies investment will fall rapidly from 46% of GDP in 2014 to 39% in 2020, with the gap being filled by strong growth in consumption.

EXHIBIT 5

China's outlook: IMF smooth transition scenario



SOURCE: IMF, AlphaBeta

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Pessimists doubt China's capacity for further reform: There are many doubters. A senior US state department official told us "Their rhetoric is about reform, but their actions are the opposite. Every time the economy gets into trouble, the big hand of government intervenes. As the economy slows, we see the reform window closing, not opening."

Many believe a serious crash is possible: One businessperson with experience in the construction sector told us he expected a very bumpy rise ahead. In a highly leveraged environment, "a growth slowdown can spiral on itself … investors financed their projects expecting 10 per cent growth". If those projects can't meet their financing costs, the result isn't a smooth transition to lower investment returns. The result is credit default.

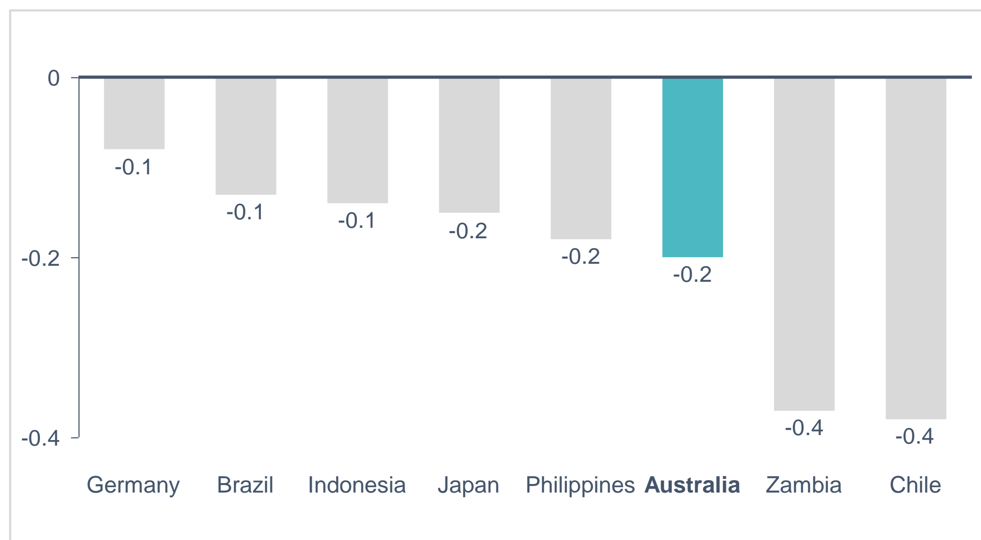
The best summary of China's current growth challenge was provided by a senior Chinese economic official, who told us confidentially, "the number doesn't matter. 7%, 6%, 5% … China can pump money into the economy to deliver any number it wants. What matters is the quality of growth. Is it sustainable?"

China's transition is a headwind for Australia

Whether China crashes or crashes through, one thing is clear: the commodity boom is over for the near term. Canada, Chile, Zambia, Kazakhstan and just about every other commodity exporter are already reeling from the impact of China's transition. The message from the ground is that the transition has only just begun and will be a drag on the growth of commodity exporters for 5 – 10 years.

The implications for Australia were underlined to us by the IMF Deputy Managing Director, Min Zhu. In an "on the record" briefing, Min Zhu presented unpublished IMF estimates of the impact of China's transition away from investment on a range of trading partners. For every 1 percentage point reduction in Chinese investment, the IMF is estimating that Australia's growth rate will fall by -0.2 percentage points.

EXHIBIT 6



SOURCE: IMF unpublished analysis

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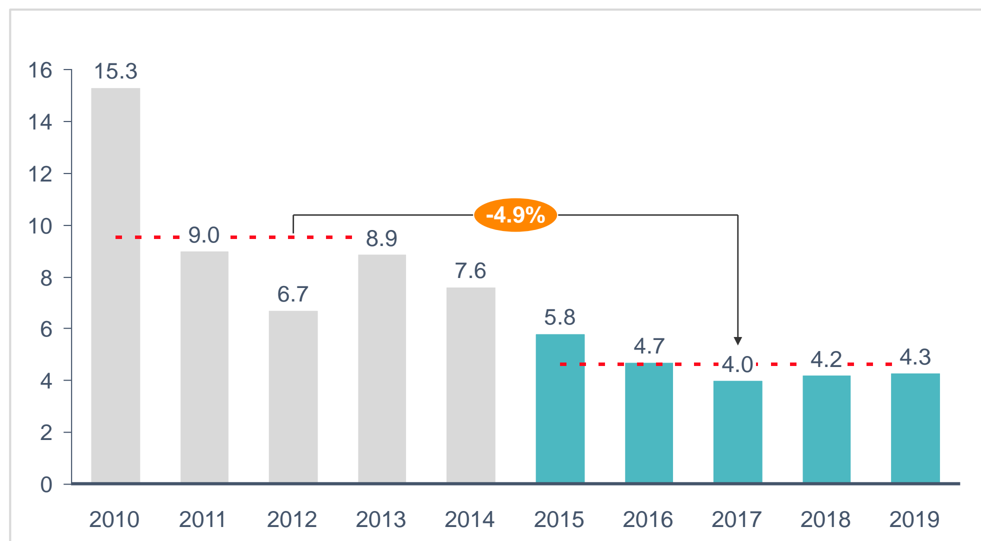
Putting that together with the IMF's own forecast for Chinese investment, that implies is a massive drag on Australian growth (of around 1 percentage point per annum) as Chinese investment slows by around 4.9% from an average of 9.5% over the last five years to an average of 4.6% over the next five years.

EXHIBIT 7



SOURCE: IMF, AlphaBeta

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And this drag will not be brief. China's own plans are for investment to fall steadily for ten years from 46% of GDP today to around 35% by 2025.

The Lucky 8: Opportunities for Australia in China's future

The decline in Australia's economic relationship with China is not inevitable. Australia has many comparative advantages beyond mining that could be complementary with China's future growth. We should have been reorienting our economy towards the new sources of growth over the last five years, rather than assuming the resources prices would defy gravity indefinitely. Fortunately, it is not too late. And China is committed to opening up Australian trade and investment, as evidenced by the recent free trade agreement.

Where are the opportunities for Australia in China's future? Well, fortunately, China has given us a strong hint as to where the future growth drivers will be. Two announcements are worth paying close attention to, but have largely gone unnoticed outside China. First, in November 2013, China held the Third Plenum of the 18th Central Committee of the Communist Party of China. At the meeting, China's leadership outlined some priority areas of future growth, including railroads, healthcare, finance, petrochemicals, online retail, agriculture and environmental services. Second, in May 2015, China's State Council unveiled a national plan recently, dubbed "Made in China 2025". It is the first 10-year action plan designed to transform China from a manufacturing giant into a world manufacturing power. The target sectors include information technology, numerical control tools and robotics, aerospace equipment, ocean engineering equipment and high-tech ships, railway equipment, energy saving and new energy vehicles, power equipment, new materials, biological medicine and medical devices, and agricultural machinery.

Given Australia's current areas of strength and latent potential, we have identified 8 opportunities for business and investors outside mining. The word for "eight" is auspicious in Chinese culture as in Mandarin it sounds similar to the word which means "prosper" or "wealth" – hopefully these eight sectors will lead to prosperity for Australia too. Capturing all of these opportunities will require a much more proactive approach by Australian businesses and governments:

1. **Retail.** There are currently just over 200 million households in China that are part of the "consuming class" (i.e., the level of income where households can afford discretionary purchases). That is forecast to rise by over 300 million by 2030. Working age people continue to benefit as they shift from jobs in farming to better- paid non- agricultural work. And the government's social policies are extending social safety nets including pensions for rural elderly people, education and health care. Social transfers have increased by an estimated five percentage points of household disposable income. This could represent a significant opportunity for Australian retailers. For example, Australia has achieved international recognition for its beauty and grooming industry and some 200 Australian companies currently export their products overseas. These include Jurlique, The Natural Source, The Ward Group, Cat Media, Laderma, Lifeforce Pty Ltd, Becca, Bloom, Napoleon Perdis and Aesop. Capturing the opportunity though will require deep understanding of China's consumer markets (for example, the strongest growth is in the tier 2 and 3 cities in China, not the capital cities), dealing with fragmented distribution channels, and forming partnerships with local firms, many of which are family-owned businesses.

2. **Agriculture.** China's rising consuming class will also fuel food demand. For example, by 2030, per capita meat consumption in China could increase by 40 percent to 75 kilograms a year—which would still be less than per capita meat consumption in the United States today. At the same time, urbanization globally could lead to the loss of an estimated two million hectares per year, with about three-quarters of that being agricultural land. Given China is forecast to have an additional 265 million people move to cities by 2030, this will put further pressure on local agricultural supply. Chinese officials are highly conscious that they need diverse sources of food imports to maintain food security. Australia is ideally well placed to benefit given our large availability of arable land, geographical proximity, extensive free trade agreements and counter-seasonal production for the northern hemisphere. But Australia is losing global market share in agriculture. As noted by McKinsey & Company's report on the Australian economy ("Compete to prosper"), it is critical that Australian agricultural firms reap potential scale benefits. Governments should encourage (or at least not impede) the professionalization and scaling-up of farming enterprises. The tendency to nurture small-scale farming should be weighed against the opportunity cost of not having larger, more capitalised and more efficient farms in their place. There are some lessons here for Australia from across the Tasman. New Zealand became the world's leading exporter of milk and added $7.5 billion annual export growth. Their success was underpinned by a whole of system approach where New Zealand farms got bigger, processing scale and efficiency increased, and investment in branding and technology was scaled up. Today, the average New Zealand dairy farm is 80% larger than a Victorian one, and processing plant utilisation is 15% higher. Fonterra, the New Zealand milk products monopoly, spends proportionately 40% more on R&D and 300% more on marketing than our equivalent Murray Goulburn Co-operative

3. **Tourism.** Travel is one of the top aspirations for China's new consuming class, especially as the current generation reaches retirement. China's travel mania is being fuelled by many factors including more annual leave for workers, visa relaxation by the government, worsening mainland pollution, and an increasingly overloaded domestic tourism infrastructure. By 2020, outbound Chinese tourist numbers will reach 200 million, double the 100 million who left China in 2014. Moreover, spending abroad by Chinese tourists will triple. Tourism is critical to Australia's broader economic development, particularly in regional areas; every dollar spent on tourism generates an additional 91 cents in other parts of the economy, and 46 cents of every tourist dollar are spent in regional Australia. Australia is ranked 7th by the World Economic Forum for Tourism competitiveness, but it is not price competitive, where the ranking plunges to 138th. Ongoing efforts will be needed to ensure the supply of labour and the investment in tourism infrastructure keeps pace in a hotly contested global market.

4. **Financial services.** Liberalisation of capital markets is at the top of China's reform agenda. Chinese officials recognise that their economy of the future will require more sophisticated and flexible financing support. The government has promised to allow greater foreign competition into the financial services sector. Australia is well positioned in many areas of financial services, such as wealth management, fraud prevention, credit risk assessment, and funds management, but getting scale in China will require a patient and long-term focus, as well as keeping on top of the fast pace of financial reforms.

5. **Clean energy and environmental services.** As China has progressed along an economic reform path, its environment has suffered degradation from rapid urbanisation and industrial development. Pollution and resources misuse have resulted in environmental damage in both the rural and urban setting. It is estimated that environmental damage costs up to 9% of China's gross domestic product (GDP) each year. In reaction to this, China is experiencing the fastest growth in demand for environmental products and services in the world. It is estimated that total output of the environmental protection and energy conservation industry will account for over 7% of GDP. There are many areas of opportunities for Australian firms, including soil and water remediation, waste water treatment, and green-building energy efficiency solutions. Navigating the routes to market in China in this area is critical – for example, there is generally no centralized source for environmental protection projects and product procurements, instead firms need to scour individual websites of central and local environmental government authorities and industrial associations.

6. **Healthcare.** As of 2014, the aged population (over 60 years old) of China exceeded 200 million, accounting for almost 15% of the total population. The demand for healthcare in China will grow rapidly due to China's ageing population and government moves to set up a social safety net. In September 2013, the Chinese State Council announced that it would speed up aged care industry development. Its plan outlines that China needs to reach a target of 35 to 40 aged care beds per thousand elderly (approximately 7 to 8 million beds) and a working force of 10 million (currently approximately one million) by 2020. The plan encourages private aged care service providers to take on the role of developing a strong aged care industry. There are significant opportunities for Australian firms across the healthcare space, ranging from home care services through to healthcare products. Australia is well positioned in many of these areas. For example, Australia has around 400 biotechnology companies. Of these, 49 per cent are involved in therapeutics and 13 per cent in diagnostics. The regulatory landscape is changing rapidly in China and Australian firms will need to closely monitor this to capture opportunities.

7. **Advanced manufacturing.** China's 2025 manufacturing strategy identifies a number of sectors in which Australian firms could benefit. For example, in railroads, Australia has several niche areas of expertise, including heavy haul, rail safety, training and signalling. In aerospace, Australia has strong capabilities in system and software design, engineering, component design, manufacturing and servicing, air systems integration, airport equipment and services, air traffic management and aircrew training for both civil and defence applications. However, with a few notable exceptions (such as Cochlear), most of Australia's leading firms in advanced manufacturing have struggled to get significant penetration in overseas markets. Lessons from abroad suggest a few areas will be crucial to address. The first is having a clear plan for growth. For example, the United States has developed a roadmap for the development of the advanced manufacturing sector. It will also to be crucial to foster high performing clusters through active government support. Australia has taken some steps in the right direction with CSIRO's Global Precincts strategy, but Australia still ranks 43rd on state of cluster development according to the World Economic Forum. Third, there is an opportunity for Australia to shape local demand growth through public purchasing or regulation. For example, the US is exploring making more strategic use of the General Services Administration and the Department of Defence to expand their use of early procurement in order to accelerate innovation in advanced manufacturing. Finally, there is the

opportunity to build market intelligence to support the growth of Australian manufacturers abroad. International Enterprise (IE) Singapore is a good example here.

8. **Education.** Australia has over 90,000 Chinese students currently studying in our country (almost 40% of our total foreign students). Education is Australia's largest service export, and could be worth another $13 Billion by 2020 just by maintaining global market share. However global competition is increasing and Australia has recently underperformed competitors in capturing the education export market. Underlying this is a high cost structure—studying in Australia is 8 percent more expensive than the US and 60 percent more than Singapore. Government action will be critical, including ensuring a supportive student visa policy and providing incentives for Australian universities to target foreign students.

Change brings opportunity

For three decades Australia and China have come together in a teleological confluence of history and geography, in which China's vast demand for raw materials was perfectly complemented by Australia's extraordinary natural endowment. Rivers of iron-rich red dirt have flown inexorably north across the ocean from Australia's desolate landscapes to China's teeming new coastal megalopolises. Australia's resources have helped China industrialize, raising cities from the ground, lifting tens of millions of people out of poverty and allowing the government to build a whole new system of ports, highways, airports, railroads, bridges, buildings and tunnels. As the world's largest exporter of both iron ore and coal, Australia supplies part of China's life force, the juice in the machine.

The impact on Australia has been massive. Over the last 20 years, the country's economic growth has been no less than one-third faster than the United States, twice as fast as Europe and three times faster than Japan. The growth rate – the most reliable barometer of our progress towards a better, or at least richer, future – is faster than any other comparable economy and the longest period of a sustained prosperity by any developed country ever in the modern era.

China's transition from an investment-led economy to one that is based on services is underway. The change will mean falling prices for Australia's exports, rising prices for imports and more competition for global capital. As these changes flow through to Australia, they will profoundly change the nation's economy.

But change brings opportunity. Australia has great strengths beyond its resources, including a well-educated workforce, world-leading institutions, a multicultural community and an open economy. Whereas the country has spent the last 20 years supplying raw materials to build the skyscrapers of Shanghai and many other cities, now it must begin to supply products and services to the businesses and workers who occupy those skyscrapers.

Dr Andrew Charlton, Director, AlphaBeta

Andrew is based in Sydney. He has senior experience in business, government and international institutions, including as senior economic advisor to the Prime Minister of Australia, working with the OECD and United Nations, and authoring a book on trade issues with Nobel laureate Joe Stiglitz.

Andrew has conducted extensive academic research covering international economics, trade and development which has been published in leading international journals including the American Economic Review, World Trade Review and World Economy.

He recently co-authored a report on understanding how Australia could develop an effective industrial policy - *Rethinking Industrial Policy: Seven rules for pro-competitive, pro-globalisation industry policy*, AlphaBeta, June 2015.

Prior to AlphaBeta, Andrew served in senior corporate and strategy roles at Wesfarmers and as senior economic advisor to the Prime Minister of Australia and Australia's senior government official to the G20 economic summits.

He holds a PhD and MA in economics from Oxford University and is a Rhodes Scholar.

Dr Fraser Thompson, Director, AlphaBeta

Fraser is a Singapore-based Director of AlphaBeta. Fraser has led economic development projects for over a decade in Europe, the Middle East and Asia.

Fraser has led widely acclaimed research pieces on the region and on topics related to sector productivity and growth:

- Rethinking Industrial Policy: Seven rules for pro-competitive, pro-globalisation industry policy, AlphaBeta, June 2015.
- Beyond the boom: Australia's productivity imperative, McKinsey Global Institute, August 2012.
- Resource revolution: Meeting the world's energy, materials, food, and water needs, McKinsey Global Institute, November 2011.
- Compete to prosper: Improving Australia's global competitiveness, McKinsey & Company, July 2014.

Prior to AlphaBeta, Fraser was a consultant at McKinsey for 9 years, including leading McKinsey Global Institute (the economic research arm of McKinsey) in Asia-Pacific. Before McKinsey, Fraser was a consultant at the World Bank, a lecturer in development economics at Oxford University and a consultant at BCG (Australia). He holds a PhD and MA in economics from Oxford University and is a Rhodes Scholar.