China's Economic Slowdown, Transition from Investment, Export Growth to Consumption Growth Create Global Implications

Structural economic reform is underway in China, the world's second largest economy, as it deals with the excesses of the past cycle such as elevated property and raw material prices, excess investment and credit creation, and the drying up of surplus labor. The weaker than expected data set of economic metrics year-to-date in China has led to downgrades of growth projections and speculation regarding the potential for future pro-growth stimulus measures from Beijing to raise domestic demand in a transition from investment and towards consumption.

Export growth has been slowing due to the European debt crisis and the modest U.S. recovery. Late last month, China's National Development and Reform Commission, its economic planning agency, announced it has accelerated approval of investment projects, but concerns about increasing inflation will likely keep such stimulus measures at moderate levels, and more consumer driven, such as the recently announced subsidies attempted to boost sales of energy-saving household appliances such as refrigerators and washing machines.

China's overall growth rate has moderated for five straight quarters and its manufacturing sector is near recessionary levels. As GDP growth rates decline from the 8% - 9% levels of the past to the consensus range of 5% - 7%, and as China's slowdown spreads from its manufacturing to the services sector, implications include the potential for inflationary consequences in both labor and currency markets, as well as deflationary consequences in the basic materials sector and for savings rates.

High levels of investment in years past led to increases in prices and wages. According to the IMF, China's tier 1 cities are now more expensive than many developed market cities, and many Chinese companies are relocating part of their supply chain to other, lower-cost Asian countries such as Vietnam. While China boosted export growth in the past with an artificially weak currency, the Yuan has already increased 7% against the dollar over the last two years. Moreover, the political commitment to higher levels of consumption, and pressure from the U.S., will likely lead to additional currency appreciation.

With the expected deceleration in investment for such things as ports, highways, dams and high-rise office towers, demand for raw materials such as cement and steel may be closer to peaking than previously expected. As the marginal buyer for many basic materials (e.g. China accounts for approximately half of the world's cement consumption), this deceleration will likely generate continued negative headwinds for commodity prices and the materials sector.

Household consumption currently only accounts for around a third of the economy due to China's remarkably high savings rate at 51% of GDP. Given robust income growth, and as the population in China modernizes, industrializes and ages, savings rates could start falling. Moreover, any national policy measures that boost health care, pensions, housing and poverty could help open the purse strings for rainy-day funds.

China's consumption as a percentage of GDP trails most Asian growth countries, which average 50% - 55% of GDP, and the U.S. at 70%. According the Michael Pettis, finance professor at the Guanghua School of Management at Peking University, China should aim to get to 50% consumption as of percent of GDP in the next 10 years, which would require household consumption to outpace GDP growth by 4% each year. While consumption failed to grow as fast as incomes over the past decade, as China's GDP growth slows over the next decade, consumption as a percent of GDP will undoubtedly rise, providing continued growth opportunities for global consumer, healthcare and technology companies, among others. Please contact Godsey & Gibb for more specific information on strategies and companies benefitting from China's ongoing economic transition.

Consumption as a Percent of China's GDP

Year	Consumption
2000	46%
2005	40%
2010	34%

Source: Michael Pettis, professor of finance at the Guanghua School of Management at Peking University.

RICHMOND, VA
6806 Paragon Place, Suite 230
Richmond, Virginia 23230
(804) 285-7333

VIRGINIA BEACH, VA
4445 Corporation Lane, Suite 206
Virginia Beach, Virginia 23462
(757) 213-6862

GREENVILLE, SC
40 West Broad Street, Suite 350
Greenville, South Carolina 29601
(864) 312-5130

COLUMBIA, SC
1310 Lady Street, 9th Floor
Columbia, South Carolina 29201
(803) 254-9241