A Transition Well Underway

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China’s first half macroeconomic data supports our view that the country is in the midst of a successful transition from a high-speed, heavy industry-based economy to a consumer and services-based economy, which, while decelerating, will remain the most important driver of global growth. We believe the challenges of continuing this transition will result in gradually slower growth rates and increased volatility, but the risks of a hard landing remain very low.

Winners and Losers in the Transition

To understand the trajectory of the Chinese economy, it is important to recognize that this economic transition is creating winners and losers. The services and consumption (tertiary) part of the economy, for example, remains robust and is now the largest part of the economy. This mitigates the weakness of the industrial (secondary) part of the economy, which is shrinking as a share of GDP.

2016 will almost certainly be the fifth consecutive year in which the tertiary part of China’s economy will be larger than the secondary part, and the tertiary part is driving an increasingly larger share of economic growth. In the first half of this year, final consumption contributed about 73% of China’s GDP growth, up from a roughly 60% share in the first half of last year, and a 42% share for the full year of 2006.

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**Figure 1. Contributions to China’s GDP Growth**

![Graph showing contributions to China’s GDP growth from 1995 to 1H16](chart)

Source: CEIC
A Healthy Chinese Consumer

The most important actor in this ongoing transition is the Chinese consumer, and we are keeping a careful watch over her health. In the first half of this year, her vital signs were excellent, but we are aware that as she matures, she is slowing down a bit.

China remains, in my view, the world’s best consumer story, with inflation-adjusted (real) retail sales rising 9.7% year-over-year (YoY) in 1H16, compared to a 1.6% pace in the U.S. in June. But that does reflect a modest deceleration, from 10.5% a year ago, because income growth, while still quite fast, is moderating.

Following a decade in which real income rose 130% (compared to 11% in the U.S.), real urban income rose 5.8% in 1H16, down from 6.7% a year ago.

How healthy is the Chinese consumer? New home sales—for which buyers must put down at least 20% cash in a market without subprime mortgages—rose about 29% YoY in 1H16 on a square meter basis, and sales volumes hit all-time highs in every month. Sales of SUVs rose 44% YoY during the first half, compared to 46% a year ago and 37% two years ago.

We can also examine the Chinese consumer from a global perspective. Last year, Chinese consumers accounted for almost one-quarter of all iPhone sales and about 40% of worldwide vehicle sales by GM and Volkswagen. Management consulting firm Bain & Company estimates that last year Chinese consumers accounted for about 30% of global luxury purchases, and outbound tourism expenditure from China rose 67% last year, according to the World Travel and Tourism Council.

Electricity consumption data illustrates the differing paths of the tertiary and secondary parts of China’s economy. Power consumption by the consumer and services sector jumped 9% during the first half, compared to an 8% growth rate a year ago. Residential electricity use rose by almost 8% during the first half of 2016, up from a 5% pace a year earlier. Power consumption by industrial and construction users, in contrast, increased by only 0.5% during 1H16, but that was a bit better than the 0.5% fall in consumption during 1H15.
Industry Weak, But Not Collapsing

Consistent with that small improvement in industrial power consumption growth, other data indicates that while China’s manufacturing sector is weak, it isn’t collapsing.

The growth rate of industrial value-added, for example, has stabilized, rising 6% YoY during 1H16 compared to 6.3% a year ago, although this is down from 8.8% two years ago. But a key problem is that industrial value-added is weak in China’s rustbelt, where it fell 1% YoY during June.

This slowing, but not collapsing, trend is also reflected in the average monthly income for migrant workers, the people who travel from the countryside to fill most of China’s industrial jobs. Average income rose 7% in June, compared to almost 10% during the same months in 2015 and 2014.

And while industrial employment is weak, the services and consumer sector has picked up the slack, accounting for all net new job creation since 2012.

The Transition to Private from State

Another important transition underway in China is toward an economy driven by privately owned, entrepreneurial firms, and away from an economy based on state-owned enterprises (SOEs).

Private firms now account for more than 80% of employment and all net new jobs, and, not surprisingly, these firms are far more profitable than SOEs. During the first five months of this year, privately owned larger industrial firms saw their profits rise 9.4% YoY, up from a 6.2% growth rate during that period in 2015. In contrast, profits at SOEs fell 7.3% YoY during the first five months of this year.

The Least Important Chinese Statistic

In my view, the data I’ve just discussed is far more important than China’s GDP growth rate. After all, how much weight do investors place on GDP growth rates in other countries? Since the media is obsessed with this, I will address it.

Yes, as the media reported, 1H16 GDP growth of “only” 6.7% was the slowest pace in seven years. But it was still growth of 6.7%! More importantly, as Figure 3 illustrates, the pace of growth has continued to decelerate very gradually, from 7% in the first half of last year and 7.4% in 1H14.
The base effect is also worth noting: the size of the incremental expansion of the Chinese economy in 1H16, when the growth rate was 6.7%, was roughly the same as the addition to the economy five years ago, when the GDP growth rate was 10.1% (in local currency terms, at constant 2010 prices). In other words, the opportunity for selling goods and services to Chinese at the slower growth rate this year was just as big as the opportunity five years ago, at the faster growth rate.

The Top Concern: Weak Private Investment

First half macro data suggests that the Chinese economy is stabilizing at a healthy pace, led once again by strong consumer spending and a hot (albeit somewhat cooler) housing market. My top concern is anemic investment spending by private firms: they are relatively profitable but are clearly not yet prepared to expand capacity or invest in more automation.

In 14 of the last 16 months, fixed asset investment by private firms—which account for about two-thirds of all fixed asset investment—rose more slowly than investment by SOEs. That trend, driven both by strong government spending on public infrastructure, which is channeled largely through SOEs, and by concerns about industrial overcapacity, reversed an earlier trend: prior to March 2015, investment by private firms rose faster than that of SOEs in 59 of the 60 previous months.

As the property market continues to cool and return to a more sustainable pace, a pickup in private sector capital expenditure will be important to preventing macro growth from decelerating too sharply. Overall, the Chinese economy is likely to continue on the same path as the last 10 years: gradually slower year-on-year growth with greater volatility, but there are no signs of a hard landing on the horizon.

Last year, China accounted for 35% of global economic growth, and if Brexit results in slower growth in the U.K. and anxiety in the developed West and in emerging Europe, the Chinese share of global growth could rise even higher. China—and the rest of the Asia region that Matthews Asia invests in, which (combined with China) accounted for about 60% of global growth last year—is likely to be considered a safe haven for investors, especially relative to European emerging markets.
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