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Decide with Confidence

China's Role in Shaping World Trade

Risk Insights

- China could become the largest economy in the world by the early 2020s.
- Chinese demand is reshaping international trade, and will play a vital role in determining which economies grow/stagnate in the 2010s.
- The trend has been for rising raw materials imports to satisfy China's domestic demand, but such demand can be volatile, reflecting abrupt policy changes and cycles/factors specific to the Chinese economy.
- The labour market in China has entered a period of structural change, with the risk of strikes as workers enjoy greater bargaining power with firms.
- Business intelligence on the Chinese economy and its global connections is essential for any company with an international presence.

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Knowledge of Chinese economic trends is crucial for companies

Recommendations

China's role as an engine of the global economy has become firmly established in recent decades. In the same way that companies with an international presence need to know how the US economy affects global economic developments, credit risks and inventory management, they need to be equally aware of trends in the Chinese economy and their impact on the world economy.

1. China is growing in importance as a market for foreign shippers: in Q1 2010 it imported goods worth USD341.8bn, not far off the USD427.6bn imported by the US in the same period. In this context, important insights can be derived from monitoring the role that Chinese demand plays in the world economy, and from assessing the resulting opportunities and risks.
2. In turn, analysis of the short- and long-term factors governing the Chinese economy itself provides intelligence on possible future trends.
3. Identifying the countries and sectors with upside exposure to China's economic growth, both to seize new market opportunities, and to manage credit risk when China's import demand slows or contracts, will be crucial for long-term corporate strategy and short-term credit risk management.
4. Monitoring Chinese economic developments should help to guide robust commercial decisions.
5. For shippers, we recommend a dynamic approach to setting terms for buyers, by monitoring whether buyers are benefiting from being part of an economy that is directly or indirectly exposed to Chinese demand. Country Risk Services' products such as monthly Country Riskline Reports can provide this information.

China could become the world's biggest economy in the 2020s

Background: What is Happening and Why?

China's economy grew to USD4.9trn in 2009 and will become the world's second-largest economy by 2011, ahead of Japan's. We expect the Chinese economy to grow by 7-9% over the next ten years, which would more than double its size. If the yuan or renminbi (people's dollar), as the currency is known, strengthens markedly against the US dollar over the next ten years, and the US economy stagnates, China could surpass the US to become the world's largest economy during the early 2020s.

Companies of all kinds can benefit from the effects of Chinese demand

How Can Companies Benefit from Chinese Economic Growth?

China's imports are much more weighted towards raw materials than the US economy, which mostly imports finished consumer goods. Accordingly, if your company is not a raw materials supplier, or a major supplier of components to Chinese factories from the tight-knit network of Japanese, Korean and Taiwanese firms serving China's electronics assembly industries, there may not be an obvious niche for your products in the Chinese market. However, if your company has expertise in selling goods and services overseas, including to countries that export to China and are having their economies stimulated by Chinese demand, then you could still benefit from growing Chinese demand.

The Diversification of Chinese Investment and Trade Links

In the early 2000s, China started to build up investment and trade links, often with countries that had poor relationships with the US, both because Chinese state-owned companies were too weak and inexpert to be competitive in more established markets, and for political reasons (China saw itself as an alternative to US 'hegemony'). However, China has since grown investment and trade links with many countries in all continents, including those that have long-standing relations with the US.

China has links with a wide range of countries

While Chinese companies' first forays abroad were to countries with high levels of political risk, the trend in the past few years has been for Chinese banks and companies to move into countries with more moderate country risk profiles. One of their criteria is a good infrastructure base; if such infrastructure does not exist, they may offer to build and finance it. Consequently, exports to China now play a key role in the economic growth prospects of a wide range of different countries. China's influence in this respect can be seen in the extent to which its demand has driven these countries' exports, and thus their recovery from the global crisis (see table of selected countries below; positive contributions are in bold).

Contributions to GDP Growth Made by Exports to China[1]

Country	Q3-08	Q4	Q1-09	Q2	Q3	Q4	Q1-10	Q2
Angola	21.9	-5.9	-18.2	-18.4	-8.6	9.0	19.0	19.7
Malaysia	3.2	-2.5	-3.2	-2.5	-0.6	8.7	11.6	11.2
Taiwan	1.2	-8.9	-11.4	-8.3	-4.5	7.2	12.5	11.0
Oman	15.6	12.0	-6.3	-10.2	-13.5	-11.8	8.0	9.7
Kazakhstan	2.8	-0.3	-1.4	-1.9	-1.7	1.3	6.0	4.9
South Korea	1.4	-2.1	-2.8	-2.3	-1.7	3.9	5.6	4.6
Philippines	-3.5	-7.4	-8.3	-7.2	-3.6	1.1	3.1	3.4
Thailand	1.4	-0.6	-2.6	-0.6	-0.1	2.4	4.8	3.3
Kuwait	4.6	1.4	-0.5	-0.4	-3.5	0.2	2.2	2.7
Chile	0.2	-0.4	-2.6	0.5	2.8	3.8	6.1	2.4
Australia	2.0	0.3	-0.3	0.2	0.0	1.4	2.3	2.0
Vietnam	3.0	0.2	-0.7	1.0	-0.6	2.1	1.7	1.9
Hong Kong	0.6	-1.5	-3.1	-1.9	-2.3	-0.6	2.1	1.6
New Zealand	0.3	0.3	0.2	0.5	0.7	0.5	1.4	1.4
South Africa	0.4	1.0	-0.6	-0.5	0.2	0.4	1.7	1.4
Venezuela	0.6	0.1	-1.6	-2.1	0.2	1.3	1.2	1.4

Note:1percentage point, US dollar terms.
Sources: General Administration of Customs; IMF, International Financial Statistics

Large Chinese companies have begun to evaluate political risk

Some Chinese buyers have also shown a tendency to retreat from political risk in more recent times (the fact that Sudan and Iran have been shifted to a second tier as sources of crude oil, in favour of Angola, is one example). That said, China has little evident concern about political risk in Venezuela, having just entered into a long-term supply agreement with Venezuela in return for USD20bn in investment. While China values political stability, Chinese companies have been shown to be more tolerant than most foreign investors to the risks of war or serious internal political instability, hence their involvement in countries such as Sudan, the Democratic Republic of Congo and Ethiopia. Chinese banks and corporations invest in or lend to authoritarian regimes and states with chronic insurgencies, but may not tolerate unusually high war risks.

Which Economies Benefit Most?

D&B has examined the countries that have so far benefited heavily from trade with China. In Q2 2010, the US, Japan, Korea, Taiwan and Germany were the big exporters of capital goods and components, while Australia, Brazil, Thailand and Saudi Arabia were the chief raw materials exporters, all being in the top ten in terms of market share. A similar set of countries, plus Angola and India, were in the top ten in terms of the year-on-year rise in their exports to China in Q2 2010.

China's Suppliers: Top 20 Countries, Q2 2010

Rank	Country	Exports to China (USDbn)
1	Japan	43.5
2	Korea	34.8
3	Taiwan	30.3
4	US	23.8
5	Germany	18.6
6	Australia	14.2
7	Malaysia	12.6
8	Brazil	10.3
9	Thailand	8.2
10	Saudi Arabia	8.0
11	Russia	7.2
12	Angola	6.7
13	India	6.1
14	Singapore	6.1
15	Indonesia	4.9
16	France	4.6
17	Chile	4.3
18	Iran	4.1
19	Philippines	4.1
20	Canada	3.9

Rank	Country	Rise in exports to China (USDbn)[1]
1	Japan	12.0
2	Korea	10.3
3	Taiwan	9.9
4	Malaysia	5.6
5	US	5.4
6	Germany	5.3
7	Australia	5.2
8	Angola	4.6
9	Saudi Arabia	4.2
10	India	3.4
11	Thailand	2.8
12	Brazil	2.2
13	Singapore	2.2
14	Indonesia	2.1
15	Kazakhstan	1.7
16	Switzerland	1.5
17	France	1.5
18	Philippines	1.4
19	Russia	1.3
20	Venezuela	1.2

Note: 1year-on-year rise.
Sources: General Administration of Customs; IMF, International Financial Statistics

Chinese growth could have disproportionate effects

Small economies with good infrastructure benefit most

However, when the actual impact of Chinese demand is examined from an economic growth perspective, a different set of countries emerges. This is significant, in that if Chinese economic growth proceeds at 7-9% per annum in the 2010s, these economies could grow disproportionately faster, with multiplier effects on their whole economies and many sectors. Ranked by the impact on GDP, small economies feature more heavily. Generally, they are countries with established connections to the world economy, and with moderate country risk, reflecting the fact that China has had to source investment goods, inputs and raw materials from existing sources in countries with already-developed infrastructure. In turn, the more open context for Chinese trade and investment reflects China's increasing prominence, its firms' deep pockets and the credit crisis and shock to Western economies since 2008.

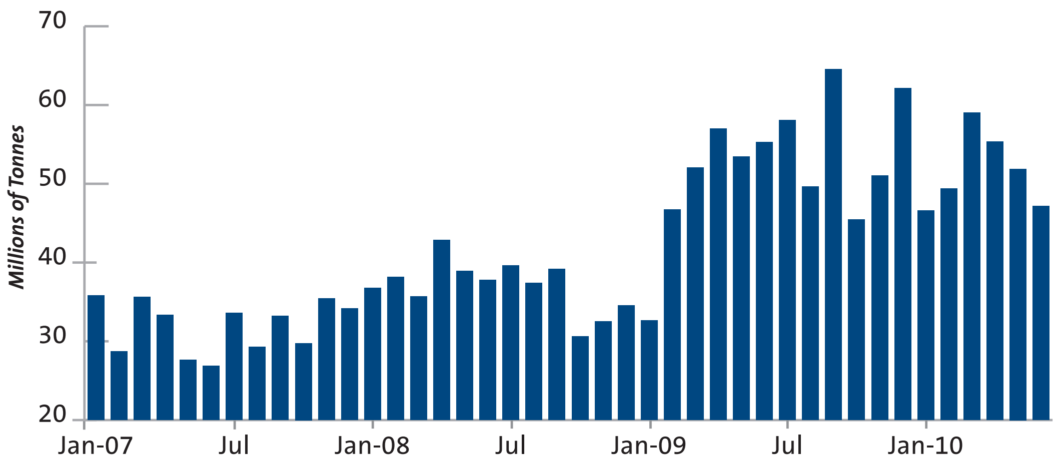
Is China a Dependable Source of Growth?

Chinese import demand is volatile and difficult to predict

China's GDP growth in the past 15 years has been more varied than official statistics might suggest. During the global economic financial crisis in late 2008 and into 2009, China's nominal manufacturing growth slumped to 2% year on year, its lowest level since the Asian financial crisis in 1998. China is a volatile emerging market, but it has become the 'swing' buyer for a range of raw materials and other imports, in effect determining their cost on world markets. Iron ore provides just one example of the volatility of China's import demand (see chart on page 5).

The most immediate risk stems from limited government access to borrowing

Chinese Iron Ore Imports: Higher, But More Volatile



Source: General Administration of Customs

China can act both as a stabiliser and a dampener for the world economy

Elsewhere, liquefied petroleum gas imports into China in 2010 have been falling year on year, now that more natural gas pipelines are reaching Chinese cities; by contrast, crude oil imports have risen rapidly in 2010 as new refinery capacity has come online, replacing fuel product imports.

The effect of Chinese demand can be counter-intuitive. For example, in 2008-09, as the world plummeted into recession, China's consumption of raw materials declined, but its imports did not fall as much, as private sector and official buyers built stockpiles to take advantage of lower prices. By contrast, in mid-2010, it seems that Chinese companies are electing to draw down stockpiles of some raw materials, despite the more stable growth prospects ahead, indicating that they expect prices to fall in the future, perhaps due to weak demand in the OECD economies in the US and Europe.

Chinese Government Policy as a Source of Demand Volatility

Long-term domestic development policy is changing significantly...

The Chinese government's policies provide another major source of demand volatility. Since April 2010, for example, central government policies to prevent a housing market bubble like that seen in the US prior to the sub-prime crisis have artificially depressed the housing market and, with it, the demand for steel and iron ore imports. As a result, Chinese iron ore imports will drop below 50m tonnes per month in the rest of 2010.

Meanwhile, big changes are under way in Chinese long-term domestic development policy. In general, the era of private-sector 'wildcat' investment in small-scale oil wells, steel foundries, coal mines, coal-fired power stations and cement factories is coming to an end (this lay behind the confiscation of private oil wells in recent years, and the closure of small coal mines due to tighter labour safety standards).

...in favour of boosting larger state-owned firms

Essentially, Chinese policymakers want to roll back chaotic and inefficient private sector investment by individuals, and boost large firms with the ability to conduct research and development, raise capital and attain giant economies of scale. Policy-makers want to create technologically-advanced 'national champions', with a state-owned 'Siemens' or 'Exxon-Mobil' as the goal. This is reflected in intellectual property laws announced in 2008, which require patents used in China to be owned by Chinese subsidiaries. While China's foreign direct investment (FDI) environment is still favourable and open, future decisions on standards and government procurement may well favour state-owned 'national champions.'

Outlook: What Will Happen Next?

The Outlook for the Chinese Currency

Because D&B was aware that the Chinese Ministry of Commerce was lobbying in the first half of 2010 against any revaluation of the currency (the yuan), we were able to predict that there would be no major realignment of the yuan against the US dollar. The change in the exchange rate regime since then has been mostly symbolic, and we expect the yuan to strengthen less than 3% against the US dollar by mid-2011. China does not want its exporters to face a painful adjustment as the world economy continues to move through a difficult patch: a stronger yuan would reduce exporters' competitiveness and/or profits, and the yuan had been fixed at CNY6.83:USD for two years until June 2010, when gathering pressure on China from the US and other G20 countries led China to 'refloat' the yuan. However, since then, it has barely moved against the US dollar.

Prospects for Exports to China Over the Next Ten Years

The list of countries supplying China will grow as its firms 'export infrastructure'...

China will continue to transform established patterns of international trade in the 2010s, thanks to its need for raw materials and input sources to feed domestic demand. Chinese companies are looking out on a five- to ten-year horizon at least, and have begun to help finance the necessary infrastructure in a long list of countries: across Africa, it includes Nigeria, Niger, and Guinea (in west Africa), Sudan, Ethiopia, Tanzania and Kenya (in eastern Africa), the Democratic Republic of Congo, and Republic of Congo (in central Africa) and (in southern Africa), Mozambique, Malawi, South Africa and Zambia. For its part, Angola alone is already a larger source of crude oil for China than Saudi Arabia.

...with Africa, Latin America and less-developed parts of Asia set to benefit further

While much has been made of the China-Africa connection, Latin American countries (Venezuela, Argentina, Bolivia, Brazil and Ecuador) are seeing Chinese credit facilities negotiated; in Asia, Sri Lanka and Myanmar should also benefit. Projects include refineries, airports, roads, mines, railways and dams. Chinese financing is not only for export infrastructure, but also for the domestic capacity to drive economic development, such as electricity generation. Chinese exports of infrastructure are not simply a means for China to import raw materials, but a profit-making endeavour in their own right.

Success will mean new patterns in international trade, but failure could bring another poor-country debt crisis

Much hangs in the balance. If projects go ahead but eventually fail, because of poor due diligence and unexpected changes in global demand, the stage could be set for another debt crisis in emerging markets, this time involving Chinese entities rather than Western bank or multinational creditors. If projects succeed and come to fruition, and China's demand is stable enough, the next five-to-ten years could see a transformation of world trade, whereby countries that only a few years ago had little prospect of developing the kind of infrastructure necessary for large-scale trade and investment could start to benefit directly from Chinese demand.

Key Issues in China in the Next Decade

Labour unrest reflects the increase in workers' bargaining power...

Rising wages should be the most noticeable change in the profile of China's domestic economy. Recent labour unrest reflects the fact that the balance of bargaining power in China is shifting to workers as surplus labour is absorbed by economic growth: labour unrest spread in the Pearl River Delta, Yangtze River Delta and across China in May-June 2010, disrupting high-profile operations such as those of Honda and Toyota. While the government has clearly been on the side of employers in the past 20 years (and the All-China Confederation of Trade Unions acts as a kind of 'industrial relations police'), local governments are today neutral in industrial disputes or tacitly support wage demands by mandating minimum wage rises above inflation.

...and could pose problems for some manufacturers and supplier structures

Over the short term, the scope for disruption to operations is such that most firms will accept demands for pay rises of 20-30% within days or weeks, after offering token resistance. Most can afford this, as labour costs are still a low proportion of costs. However, for Hong Kong-owned manufacturers in southern China, which often have thin profit margins, it could pose serious problems. And while labour unrest has affected various foreign manufacturers, including Japanese-, Taiwanese- and Hong Kong-managed operations, the consequences of different management styles and supply chain designs are coming to the fore; certain management styles are more likely to generate labour disputes, and certain supplier structures to be vulnerable. Thus, there is scope for further change in China's industrial structure and the pattern of foreign direct investment (FDI) as a result.

The labour market will stay tight in the 2010s because of demographic changes

The trigger for the increased bargaining power of labour in recent months is the result of accelerating growth of the inland provinces, which has reduced the pool of available labour in the coastal provinces. However, a second, underlying demographic turning point has arrived: China's working age population has been growing consistently, but UN forecasts indicate that it will start to stall in the 2010s, in part due to the One-Child Policy instituted in 1979. Accordingly, China's labour market should stay tight and wages will enter firms' calculations more keenly in the next few years.

China's imports and consumer goods market will both grow

However, wage increases will be affordable in many cases, given that productivity rises are likely. Therefore we do not think it likely that a wave of FDI will exit China for lower-wage economies such as Vietnam, Bangladesh or India. The benefits of companies clustering in geographic proximity to each other, and coastal China's excellent infrastructure are now as crucial as wages in many sectors. Rather than a collapse in China's FDI base, we see growth in China's imports as wages rise and its private consumption base develops. This will mean a larger finished consumer goods market.

Implications for D&B Customers

Patterns of growth will continue to change...

The patterns of growth we have come to expect during the past 10-15 years have changed and will change again. Some emerging markets will now grow more steadily and consistently than the OECD countries, but region/location will be less important in determining the pattern of growth; i.e. we expect individual countries' economic growth to depend much less on whether they are in Africa, Asia or Latin America, and more on whether they are linked into global supply chains serving Chinese import requirements, and whether they offer stable political risk prospects.

...and opportunities can be found in countries where Chinese demand is strong

For example, shippers and investors might be better advised to seek opportunities in Indonesia, India and Australia, where Chinese demand is likely to remain quite strong over the course of the 2010s, rather than in Mexico or Poland, which do not look set to be major suppliers to China. Of course, economies with greater exposure to China will suffer from demand volatility. Generally, customers should be aware of which economies have direct exposure to the Chinese economy, why this is, and how this subset of economies is likely to change.

Intelligence on China is a vital resource

Meanwhile, better business intelligence on the Chinese economy will remain essential for any company with an international presence. With most export growth in the past two years due to Chinese (and not US) demand, China is becoming a vital component of global economic growth patterns as well as being a dominant regional factor.

D&B Country Risk Services

At D&B Country Risk Services we have a team of economists dedicated to analysing the risks of doing business across the world (we currently cover 132 countries). We monitor each of these countries on a daily basis and produce both shorter analytical pieces (Country RiskLine Reports), at least one per country per month for most countries, as well as more detailed 50-page Country Reports. For further details please contact Country Risk Services on **+44 (0)1628 492595** or email **CountryRisk@dnb.com**.

Additional Resources

The information contained in this publication was correct at the time of going to press. For the most up-to-date information on any country covered here, refer to D&B's monthly *International Risk & Payment Review*. For comprehensive, in-depth coverage, refer to the relevant country's Full Country Report.