

Is China a bubble that's about to burst?

Investment
insights

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Key points

- Concerns that China is a bubble that's about to burst are unjustified.
- While further monetary tightening is likely in China, we don't anticipate a bust any time soon and continue to expect Chinese GDP growth of around 10% this year.
- This is positive for the commodity price outlook.

China worries

Making the right call on China is now critically important in terms of the investment outlook. However, while there is always a lot of scepticism regarding China, it seems that the 'China is a bubble about to burst' camp has grown in number, or at least become more vocal. The principle arguments are that China has overinvested, its export potential is exhausted, its assets are in a bubble, bank lending has been excessive and, as stimulus is removed in response to inflation, its growth will collapse. While such a scenario cannot be ruled out, it is unlikely. This article looks at why a collapse in China any time soon is doubtful.

Has China overinvested?

Investment in China is now 40-50% of GDP, which is well above comparisons to other countries and there is no doubt it won't continue at this pace. Yes, there are pockets of excess. However, there is nothing to suggest that China has overinvested on a national basis.

- China is still a poor country, with per capita GDP of just over \$US3,000, compared to \$US46,000 in the US and \$US40,000 in Japan. It still has a lot of catching up to do and it needs investment to do so.
- The recent surge in investment in China has not been in factories, but rather in infrastructure. It still has a fraction of the railway length the US had a similar stage in its development 100 years ago. It also suffers from significant transport bottlenecks. This has all sorts of implications, such as forcing it to become a coal importer, despite having significant coal reserves of its own.
- The surge in investment in recent years has not been in the coastal provinces, but rather in inland provinces where the shortage of productive capital, including transport infrastructure, is most intense.

- The stock of productive capital per person is about 5-10% of what it is in the US and other advanced countries, so there is a long way to go before it can be claimed that China is overinvested.
- Despite claims to the contrary, there is little evidence investment in China is seeing a lower return in terms of GDP growth than has been the case in the past.

What about China's reliance on exports?

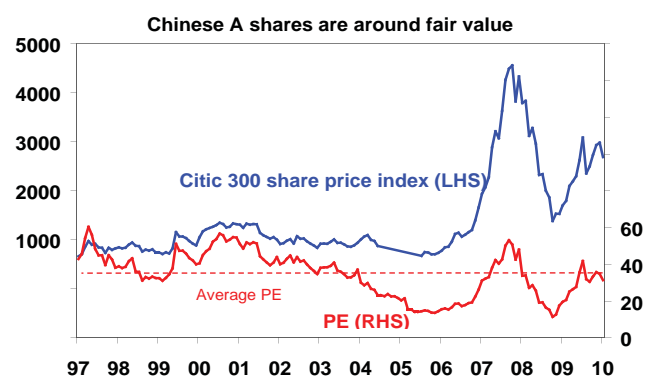
A common concern is that, with China's wages on the rise and consumer demand in the US, Europe and Japan likely to be subdued, China's export boom is over. However, we think this concern is overblown for several reasons.

- The importance of exports has been exaggerated. Thanks to strong import growth, net exports only accounted for 1.2 percentage points of China's average 11% GDP growth rate over 2000 to 2007 (that's just 10%).
- China has diversified its export destinations – 10 years ago 49% of China's exports went to North America, Europe and Japan, now only 38% do.
- China is doing a lot to encourage consumer spending, including boosting social welfare to reduce precautionary saving. China currently has just about the world's fastest rate of growth in consumer spending.
- Chinese wages are still very low, particularly in the largely untapped central and western provinces.

Are China's assets in a bubble?

Emerging countries are often prone to bubbles, given their strong growth potential, more volatile economic cycle and, at times, easier monetary policies. This is made worse in China with interest rates being maintained at an artificially low level and the exchange rate is undervalued (which creates problems with hot money capital inflows). However, right now, it is hard to see a broad based bubble in China.

Firstly, while the Chinese A sharemarket is up strongly from its 2008 lows, since August last year it has been range bound and is still down 50% from its all time 2007 high.

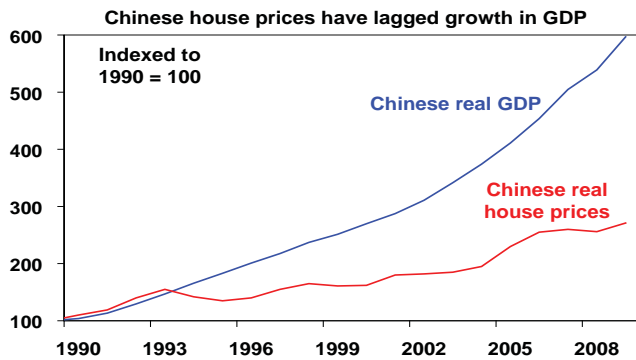


Source: Thomson Financial, AMP Capital Investors

Similarly, while Chinese shares are trading at a price to historic earnings multiple of 31 times, this is actually below its average over the last decade or so. Since earnings are expected to rise by 30% over the year ahead and 20% in 2011, the forward earnings ratio is 18 times. So, it's hard to argue there is a bubble in the sharemarket.

There has been concern about a bubble in residential property. This is a valid concern in some cities – for example, house prices in Shanghai rose 40% last year. However, China is a big place and it is dangerous to draw conclusions based on the situation in just a few cities. Several points suggest there is no housing bubble overall.

Although China's average 70 city house price index rose 9.5% over the year to January, this is not that strong given nominal GDP has risen by around 13%. It's been a similar story over longer periods, with average house prices not keeping up with growth in GDP (see the next chart). For example, over the last decade China's real GDP growth averaged 9% pa, but real house prices only rose 5.3% pa. By contrast, in New Zealand, over the last decade real GDP growth averaged 2.7% pa, but real house prices rose an average 7.6% pa. Who has the bubble here?



Source: Bloomberg, AMP Capital Investors

Household financial indicators that might point to a housing bubble are not present: average deposits are around 30% of values, around 20% of buyers pay in cash and household debt to disposable household income is low (at 35%, versus 130% in the US and 155% in New Zealand).

So, while there may be issues in some cities, nationwide there is no housing property bubble in China at present.

Will the bank-lending boom be followed by a bust?

Total bank lending rose by more than 30% last year and many fret that this will lead to a massive rise in bad debts. However, several points are worth noting.

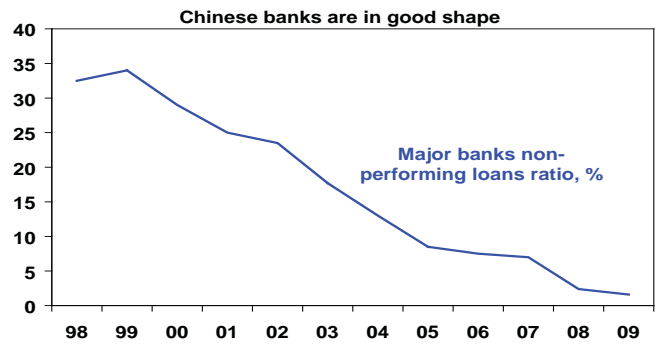
Firstly, it followed several years where outstanding credit grew less than GDP. While private sector credit is now 130% of GDP, this is low compared to 173% in the US and 153% in New Zealand.

Secondly, there is a significant buffer between asset markets and the banking system – mortgage lending has been very conservative with loan to valuation ratios of around 70%, corporate gearing is low and bank exposure to shares is low.

Thirdly, the non-performing loan ratio of major banks is very low at just 1.6% compared to 30% a decade ago. A reasonable estimate is that this could rise to 7% as some of last year's lending turns sour, but that would still be low.

Finally, since much of the recent surge in bank lending was to fund infrastructure spending, it is arguably a form of government stimulus. So if infrastructure projects run into difficulty, the

likelihood is the debt will end up back in the government sector. Public debt in China is just 20% of GDP compared to an OECD average of 90%.



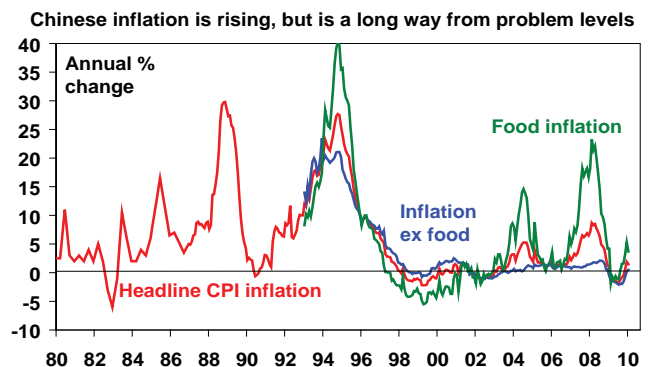
Source: AMP Capital Investors

How big a problem is inflation?

With Chinese inflation running at an annualised 4% over the last six months, it is almost inevitable that the year end rate - currently 1.5% - will rise in the months ahead, possibly up to 5%. As a result, and with the economy recovering, Chinese authorities have started to unwind the stimulus put in place to combat the global financial crisis.

However, it would be wrong to say China has a major inflation problem. Much of the increase is due to food, with non-food inflation near zero and likely to remain low given spare capacity in some industries. The current situation is radically different to the 25-30% inflation rates of the late 1980s and mid 1990s, when China suffered from a shortage of productive capacity.

In short, inflation will rise further, but, a draconian monetary tightening won't be justified and, given the political imperative to keep growth strong, will not occur.



Source: Thomson Financial, AMP Capital Investors

Concluding comments

In a fast growing country like China, there will always be pockets of excess and bouts of overheating. But, right now, there is no evidence of generalised overinvestment, China's reliance on exports is overstated and likely to diminish with consumption taking a greater role, it is very hard to argue there is an asset bubble and China's banks are in reasonable shape. While inflation is on the rise, it looks to be manageable without having to crunch the economy. This all suggests that a collapse in China is not imminent and that it will remain a strong contributor to global growth and hence the demand for commodities.

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