ASIA PERSPECTIVE

China Economic Update Report

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This Issue

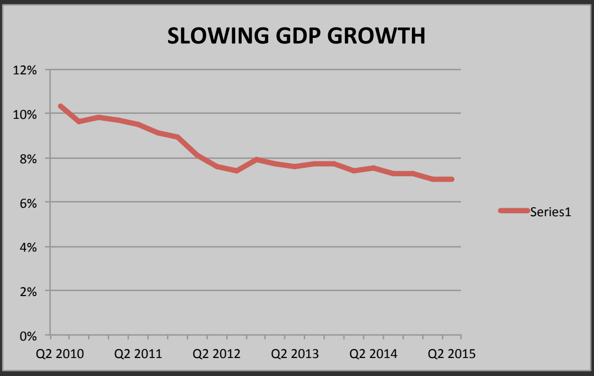
Continued deceleration of the Chinese economy

China's GDP growth slowed to a 7% year-on-year rate during both the first and second quarters of 2015, reaching a six year low. Despite growing concerns about the economy a government aim set at 7% was achieved. Officially reported numbers are however distrusted and independent observers estimate the real GDP growth to be well below the 7% target. A Bloomberg survey among 11 leading economists set he median estimate at 6.3%. Even if the official numbers were really obtained that would be a considerable slowdown compared to the 7.4% growth during 2014.

Amongst fears for slowing growth and stock market decline in China the growth estimates for the coming years are lowered. Moodys lowered their estimate for Chinese growth 2016 from 6.5% to 6.3%. A new reality of a more slowly growing China is being established. Even though the growth rate is decreasing it is important to remember that the economy is growing more in total value each year than it did during the highest growth rates 10 years ago.

Industrial overcapacities and a struggling real estate sector are putting pressure on the Chinese economy. This is counteracted by a soaring services sector and large influx of new firms that promises brighter days to come. During the first three months of 2015 there was an impressive increase of 38.4% in the number of new firm registrations compared to the previous year.

Free trade zones and structural reforms are already being implemented to stimulate the economy but authorities must resist the temptation to artificially sustain short term growth in the industrial sector and instead encourage the gradual transition into a service based economy if growth is to be sustained in the long term.



Large increase of FDI in Services

FDI in China increased by 8% year on year during the first two quarters of 2015 compared to an increase of just 2.2% in 2014. Total FDI during the first half of the year reached $68.4 billion.

Vice commerce Minister Wang Shouwen attributed growing investments to reforms in free trade areas, a relaxation of government regulation and the opening up of certain industries and inland areas. Liberalized regulation in the financial sector was arguably one of the most important factors.

The majority of all FDIs in China were in the service sector accounting for 66% of the total number of FDIs in January after an impressive 45.1% year on year increase of investments in that sector.

The Dragon is leaving the factory

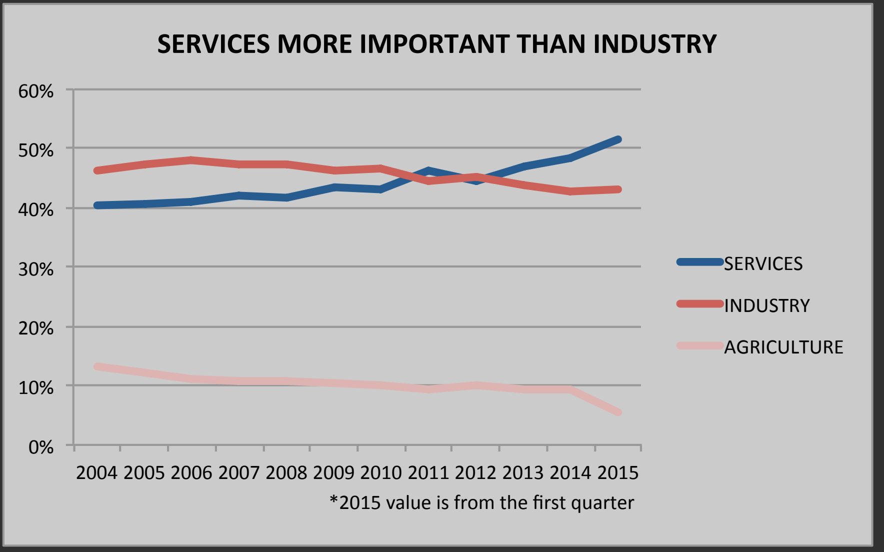
Chinas economy is moving away from relying heavily on the manufacturing industry and focusing more on services. The growth in the service sector is accelerating, from 7.9% in the first quarter of 2015 to 8.4% during the second quarter. The industrial sector decelerated from 6.4% to 6.1% during the same time. By the end of the second quarter services were accounting for 51.6% of the country's total GDP.

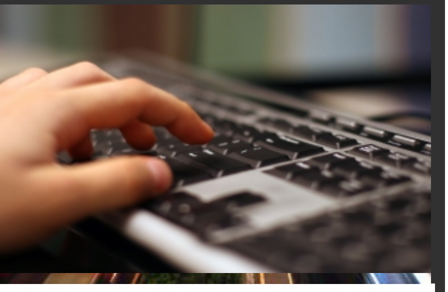
This illustrates how services are becoming an ever more crucial part of the Chinese economy. A lot of the increased growth in services is however attributed to financial services that were spurred by an equity bubble on the Shanghai stock exchange. This has given rise to some concerns regarding the sustainability of that growth. The recent market turmoil is in fact expected to devour 0.2-0.3% of the overall GDP growth during the third quarter due to a decline in financial services. The growth in the service sector will nevertheless by far surpass that of the industrial sector. Another indicator of changing times is that the majority of all newly registered firms during the first six months of the year were in the service sector.

With overcapacities in the manufacturing industry, that was once the engine of not only economic growth but also of employment and urbanization, the government is now putting its faith in services. The service sector is expected to generate no less than 10 million new urban jobs during 2015.

The described trend gives reason to reevaluate the common perception of China as the factory of the world. In the near future we might instead be talking about China as the global service provider. Investors and procurement officers alike might need to take a closer look at Chinese service providers in order to find those higher levels of growth that Chinese manufacturing was once famed for.

The service sector does however still face some serious problems in the form of excessive government regulation. Domestic and foreign ventures alike are competing on unequal terms with government enterprises. Monopolies and oligopolies are not unusual. In order for the sector to keep a high growth rate this regulation needs to be liberalized.





Start ups are spearheading a change in intellectual property laws

China has seen a tremendous growth of start-ups during the recent years and tech companies have been leading the surge. The government is changing its approach towards this kind of ventures and is now increasing its efforts to to support them. As of now authorities are offering everything from sabbaticals at universities to financial support to Chinese and foreign nationals alike that are founding technology companies in China.

Thousands of small ventures are Now developing their own products instead of copying foreign technology at large scale in the way that the country has become famed of doing. As this development continues the government will need to rethink its intellectual property laws in order to protect domestically developed technology. The Chinese start up frenzy might thus be spearheading a complete revaluation of Chinese intellectual property laws and eventually put an end to the country slack approach toward piracy.

Real Estate in China: a long fall from the top

The decline in the Chinese Real Estate sector that started in September 2014 continued throughout the first quarter of 2015 but reversed during the second. The highest decline in housing prices ever, since authorities started compiling data in 2011, was noted in February as average prices fell by 5.7% that month alone. During the preceding month prices fell by 5.1%. This sharp decline hit almost the entire country with housing prices declining in 66 of 70 Chinese cities in February.

As prices fall people grow more reluctant to invest in property fearing further loss of value. The amount of housing floor sold declined by 16.3% during the first two months of 2015 compared to 2014. In turn, lower demand pushes prices even further and thus accelerates the decline in a bad circle.

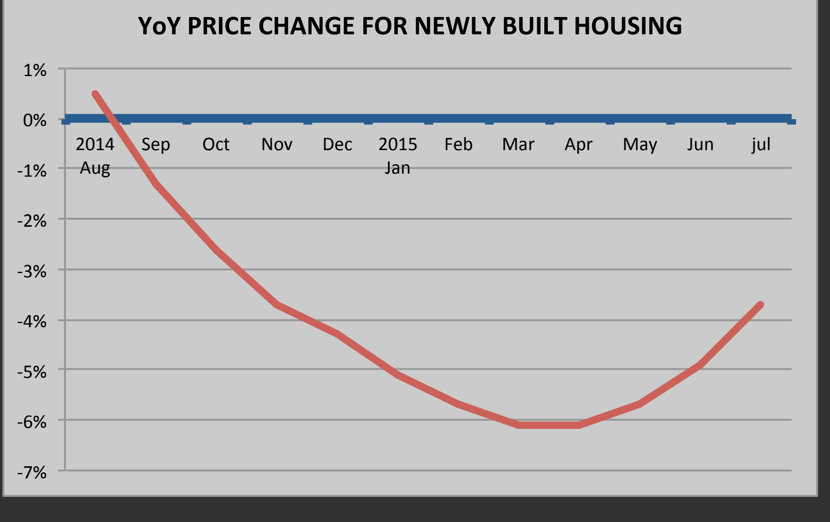
With prices falling, demand waning and new properties remaining vacant its no surprise that property developers hesitate in getting involved in new investments.

Construction has slowed and was down by 17.7% during January and February compared to the previous year.

The Government has however taken measures to stop the decline in property value. These measures involve lower interest rates and relaxed reserve requirements for banks in order to spur lending and thus property investments.

A credit totaling $16 billion was also given to the country's largest property developer in order to avoid bankruptcy. This measure has given rise to a large surge in Equity valuation of property developers as markets now believe that authorities will keep the troubled sector under its wings with favorable treatment and additional bailouts.

The effects of the supporting measures on housing prices were noted in May when prices started to rise again for the first time since august 2014. June and July brought additional improvements and prices are slowly returning back to the values of the 2014.



Sharing is Caring

The general slow down of the Chinese economy and property market decline has given rise to a new trend; shared offices. The latest year saw the founding of no less than 3200 such companies across China.

The idea is that landlords are providing an all inclusive office environment with shared common areas and conference rooms. The concept is well suited for small companies and entrepreneurs that lack the economic muscles to keep an entire office of their own and that might benefit of the social setting with other similar enterprises.

For landlords this is a way of avoiding vacancies; attracting customers that would not normally be able to rent. As of now the vacancy rate of office space is still rather low in China, reaching just 5% in cities such as Beijing, but it is expected to increase to levels around 20% in a couple of years. This will push property owners into rethinking and shared offices might be a way to lure the growing number of start ups in China.

ASIA PERSPECTIVE

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With a highly collaborative team of problem solvers and a passion for excellence we will add value to your business. We work closely with our clients to create and deliver insight, advantage and real impact.

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