Will the Chinese consumer save the World?

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Authors:

Mahamoud Islam
+852.3665.8989
mahamoud.islam@eulerhermes.com

Ludovic Subran
+33.1.84.11.53.99
ludovic.subran@eulerhermes.com

Executive Summary

- The US represents the largest final consumer market with nearly 30% of global household consumption. As it contemplates more protectionist policies, the world may have to find itself a substitute. China is a strong candidate thanks to its economic size (USD11tn+) and growth track record (6 %+). Chinese aggregate final consumption went from representing 1/10 of the US in 2005 to 1/3 in 2016. Extrapolating this trend and assuming a gradual opening of the Chinese market for consumer goods, China's private consumption could match the US in 2040.

- Three Cs to make China the #1 Consumer: Consumerization and income growth from smart industrialization, successful currency internationalization, and strategic cooperation and influence building.

- The main winners from the rise of the Chinese consumer are: (i) producers in the US, Western Europe and industrial Asia (Singapore, Japan) of consumer goods for China's middle class; (ii) commodity exporters in Russia, Central and East Asia, and Oceania as One Belt One Road reduces transaction costs; and (iii) competitive suppliers in ASEAN and South Asian countries fit for China's *Manufacturing 2025*.

- There are three risks to this projection: (i) a disorderly credit crisis in China; (ii) a negative demand shock from the US; and (iii) regional political escalation.

1. The rise of the Chinese consumer

The global economy did start the year on a strong note as global trade accelerated, driven by strong import growth from China and the US. Yet, more protectionist measures from the US could harm this outlook. Imports from the US account for 13.5% of global imports of goods and services. More importantly, the US is the largest final consumer market with nearly 30% of global household's consumption.

As China accelerated its internationalization (2010-2015), its economic size (USD11tn+), recent growth trajectory (6%+ per annum in real terms over 2017-18), and ambition to uphold free trade, make it a strong candidate to offset a potential retreat from the US as the number 1 consumer market.

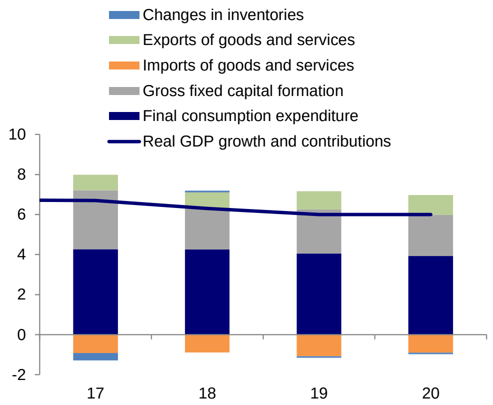
Strong consumption growth and greater openness could push China to become the single largest consumer market – one day. In 2016, China's consumer market accounted for 10% of the total aggregate household consumption and the US consumer market still is 2.9 times larger than China's. However, China now represents 1/3 of the US consumer market (a rise from being 1/10 in 2005) and now accounts for 25% of the total consumption growth, when it was only 9% in 2005. In the meantime, the US went from accounting for 30% in 2005 to 25% in 2016.

Figure 1: USD denominated global trade, China and US imports growth (3 months moving average y/y, %)

Sources: IHS, Euler Hermes

Our central scenario for China is that growth will rise by +6.7% in 2017 to slow gradually to +6.0% by 2020 reflecting a progressive tightening of monetary policy and continued cutting of overcapacity. Proactive fiscal policies with public deficit above 3% GDP will support domestic demand. Post 2020, economic growth is set to stabilize around a slower but healthier pace of +5.5% underpinned by solid growth in domestic private demand. Less leverage and less overcapacity would allow a positive and sustainable rise in investment which may create a positive feedback loop, fostering wages and employment and thus consumption. Net trade performance would decrease gradually reflecting stronger growth in imports.

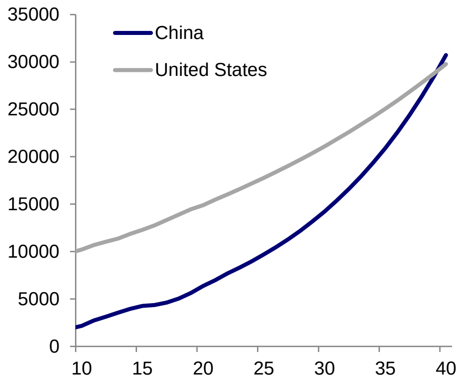
Figure 2: Real GDP growth forecasts and contributions in China



Source: Euler Hermes forecasts

Assuming a gradual opening from the Mainland to foreign goods[1], a broadly stable trade compact with the US[2], and that the Chinese private consumption in USD terms grows at a pace of +8% p.a. in the longer term (compared to a pace of +16.5% p.a. in 2005-15) and that the US one reties with long-term trend (+4.0% p.a.), China aggregate household consumption could match the US in 2040.

Figure 3: Private consumption (USD bn)



Source: Euler Hermes forecasts

[1] President Xi's recent political call for a more open economy echoes a gradual opening of the Chinese market for investors and exporters alike, which is confirmed by the reduction by a third YTD of the number of protectionist measures. Note that consumer goods are often spared while harmful trade restrictions often focus on industrial goods (chemicals, metals), according to Global Trade Alert.

[2] The last 10-point bilateral trade agreement points to that direction: China agreed to open its market for specific US corporates (beef and LNG exporters, credit card providers and rating agencies); and the US made concessions on poultry imports from China, and promised fair treatment of Chinese banks in the US. While this secondary (the bulk of China-US trade is concentrated in Electronic and Electrical), it sends positive signals to investors and corporates worried by a trade war between the two nations.

2. Consumerization, Currency, and Co-operation will drive Chinese consumer takeover

There are three driving forces behind the rise of the Chinese consumer.

Driver #1: Consumerization and income growth

In the short term, there is room for firm growth in private consumption: +7.1% in real terms in 2017. Households' balance sheets are robust as household's debt is relatively low at about 45% GDP and household's savings accounts for 36% of their disposable income. In the wake of the 13mn additional urban jobs created in 2016, we expect an increase of +12mn in 2017. Last, wages are set to increase as: corporates profits are improving (industrial profit up +22.7 YTD y/y in Jan-May; +8.5% in 2016 after -2.3% in 2015); there is a continued rise in minimum wages (albeit at a slower pace); and population is aging and the supply of high skilled workers is tight.

In the longer term, *Manufacturing 2025* will be pivotal to ensure sustainable growth of private consumption. It consists of a comprehensive upgrade of China's manufacturing sector to higher tech and higher value added activities. Key measures include: (i) supportive policies (fiscal incentives, public investment, e.g.) for the development of 10 key sectors (see Figure 4); and (ii) major changes in the business environment to promote innovation (with strengthened Intellectual Property Rights protection, e.g.). Going forward, the change in the Chinese growth model should be reflected in employment and wages structure: white collars, high-skilled, and jobs with higher pays should increase. This will in turn increase the overall purchasing power of the Chinese consumer for foreign goods and services.

Figure 4: Manufacturing 2025 key sectors

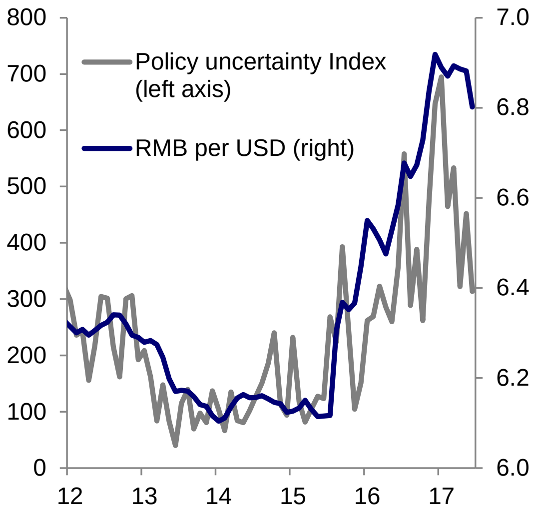
China Manufacturing 2025 - top priority sectors
Next generation information technology
High-end numerical control (automation) and robotics
Aerospace
Ocean engineering and high-tech shipping
Advanced rapid transit (metro, light rail)
Energy-efficient and new energy vehicles
Electrical power equipment
Agricultural equipment
New materials
Biotechnology and high-tech medical devices

Sources: State council, IHS, Euler Hermes

Driver #2: Currency internationalization

On top of higher revenues, the Chinese consumer will need to have a fully convertible and strong currency, buy and borrow from abroad with reduced risk of transaction. In 2016, RMB weaknesses mechanically translated into subdued wealth effect in USD terms: China's USD denominated GDP growth slowed to +1.3% in 2017 (from +5.5% in 2015), slower than US nominal economic growth (+3% in 2016). Total capital outflows were substantial at USD640bn in 2016 (647bn in 2015). Figure 5 shows that higher policy uncertainty explains most currency movements.

Figure 5: China's policy uncertainty index and RMB per USD



Sources: IHS, Economic Policy Uncertainty, Euler Hermes

Going forward, capital account liberalization and a successful internationalization of the renminbi (RMB) are sine qua none conditions for the Chinese consumer to matter. A stronger RMB would improve China's purchasing power, decrease imports costs and support a rise in domestic consumption; the Chinese private sector could rely more on external financing and stimulate the economy further. Further financial openness, sound policies to lure investors (reduce overcapacity and debt concerns), and enhanced currency management are needed. There are all on the to-do list.

Driver #3: Cooperation and strategic influence

China's decisive move to speed up its influence agenda will help put the Chinese consumer at the center stage. A couple of examples of the Chinese block approach: First, the Regional Comprehensive Economic Partnership could be a game changer. The group, which involves China, Japan, South Korea, India, Australia, New Zealand and ASEAN members represents 25% of global households' consumption, 27% of global imports of goods and services, and 45% of global savings – an impressive amount to finance home-grown investments. Secondly, One Belt One Road (OBOR), which could also initiate a positive feedback loop from investment and trade to consumption. The strategy aims at boost connectivity and cooperation across countries in Asia, Europe, Middle East and Africa through infrastructure investment.

These two initiatives come on top of a myriad of bilateral agreements that China has been sealing with countries from Iran to the US to Panama and Angola, across sectors. As a result, the Chinese consumer's tastes have changed, in sync with China's selective opening to the rest of the world. Going forward, we believe that economic diplomacy will continue to boost the share of global consumption coming from China.

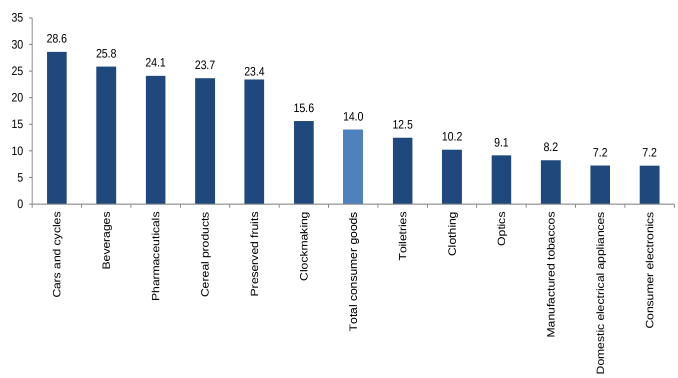
3. Who stands to gain?

If China were to become the largest final consumer, the winners will be threefold.

First, high-quality goods producers. China's demand for consumer goods has increased rapidly between 2005 and 2015, at an average growth rate of +14% per annum led by a rise in demand for cars, pharmaceuticals and food products, in line with the rise of the middle class. Countries that are investing heavily in innovation and that are well positioned in selling consumer goods to China have better chance to catch the eye of the Chinese consumer: Western European countries such as Germany, Switzerland and France, and Asian markets like Japan and Singapore. South Korea, Taiwan, and the US are also very competitive but politics could cloud the outlook.

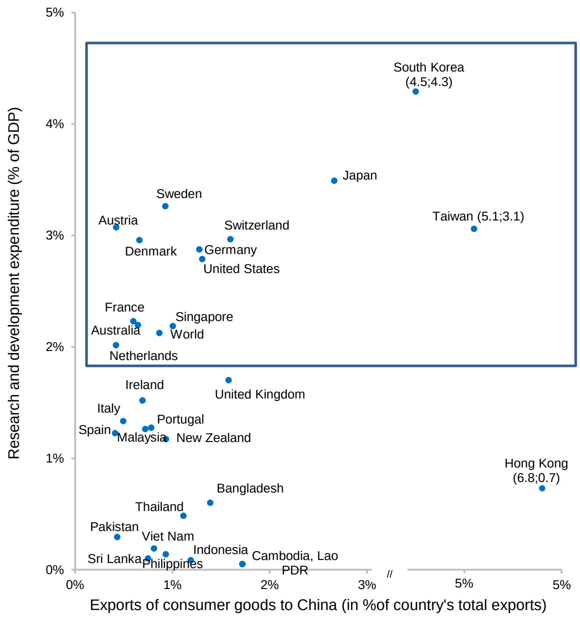
Second, cheap and nearby commodity producers. Industrial needs for commodities may be less important as the country moves to a more service-based and quality-driven economy. So the winners will be on the most cost-competitive suppliers. Large regional producers such as Indonesia-Malaysia (Mining, Energy), Russia (Energy) and Australia (Mining) will remain close partners due to strong economies of scale and strong positioning. However, we expect newcomers like Mongolia, Myanmar, and Turkmenistan to grab market share gradually as improved infrastructure eases transaction costs. Robust opportunities in agriculture will continue to rely on ASEAN and Australia-New Zealand production.

Figure 6: China's imports of consumer goods (2005-2015 growth average, %)



Sources: Chelem, Euler Hermes

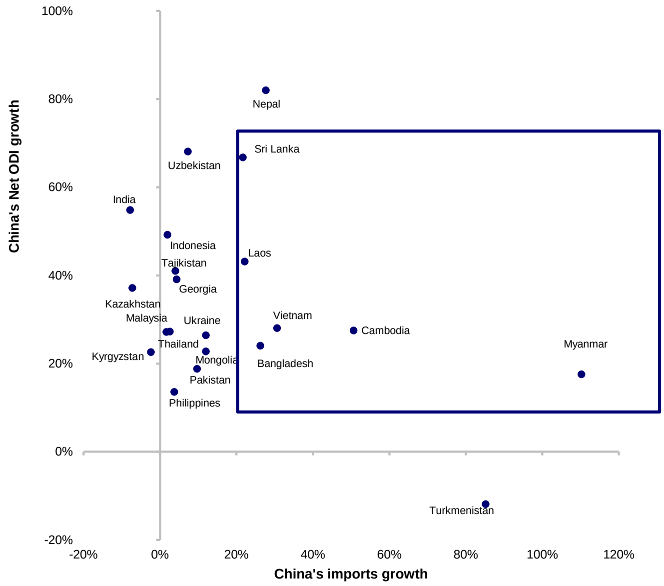
Figure 7: Country's exports of consumer goods to China and expenditures on Research and Development (% GDP)



Sources: Chelem, World Bank, Euler Hermes

Third, strategic and cheap manufacturing suppliers. With rising labor costs in the Mainland, China's companies are set to outsource part of their manufacturing production (low tech, labor intensive) to lower-cost countries. South Asian markets (Pakistan, Bangladesh, Sri Lanka) and ASEAN CMLV (Cambodia, Myanmar, Laos and Vietnam) would be the main winners. Figure 8 provides evidence of growing integration between China and the CMLV with rising investment from China to these markets and imports from these markets to China. Competitive labor costs, large and young workforce, geographical proximity to China and goof connectivity improvement determine the main winners.

Figure 8: China's outward direct investment* and import growth average (2010-2015)



*Accumulated net outward direct investment
Sources: ITC, WIND, Euler Hermes

4. Mind the risks: China, US and politics

Going forward, we see three risks that could hinder this projection. They are at a low likelihood for now but will require close monitoring.

First, a disorderly adjustment in China. Credit risk is elevated with corporate debt at 166% of GDP, and the return of shadow banking activities (27% of aggregate credit lending flows in Jan-April 2017) fuel persisting overcapacity (in basic material, e.g.). China has started to adopt targeted macro-prudential rules to address such risk but should China undergo a credit crisis, the consumer will have to tighten its belt and therefore contribute less to global consumption growth.

Secondly, a negative demand shock from the US. The US account for 18% of China's merchandise exports that is to say 3.4% of GDP. As such, a sharp decrease in demand from the US could have a significant impact on export revenues, industrial production, and thus job creation and consumption growth. Disappointing policies and clear signaling of protectionism – China represented 44% of the US trade balance deficit for goods in Q1 2017 – could jeopardize consumer awakening.

Last, geopolitical tensions in Asia. Renewed risk of war in the Korean peninsula is the most immediate concern. Regional tensions have escalated recently with North Korea stepping up its military efforts. In the long run, China will also have to face rising discontent from legacy frenemies nations such as India as OBOR includes a China-Pakistan Economic Corridor on disputed territory.

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