Report on China Study by the Japan Economic Research Center

Growth of Middle Class Leads to a "Global Market" Narrowing of the Gap a Priority Further Reform Will Give Depth to the Market

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Recent foreign direct investment in China is based on a keen awareness of the local market open to the world. Some observers, however, question whether China will be able to sustain in the medium to long term, growth comparable to the 9.5 percent achieved last year. A contraction of the Chinese market will have grave consequences on the economies of Japan and the world. From this perspective, the China Study Group of the Japan Economic Research Center has prepared a report on "The Chinese Market in 2010 and 2015."

More than 300 Million Mobile Phone Subscribers

In 2003, imports to China amounted to 413.1 billion dollars, accounting for 5.3 percent of total world imports. For the first time ever, its ratio to total world imports exceeded that of Japan, which stood at 4.9 percent. Imports to China increased by 36 percent year on year to reach 561.3 billion dollars in 2004. In terms of the amount of trade, which is a sum of the amounts of imports and exports, China now ranks third in the world. The number of mobile phone subscribers exceeded 300 million in July 2004, which was almost twice as large as that in the United States (170 million). Last year, automobile sales reached 5.07 million vehicles, approaching Japan's figure of 5.85 million vehicles.

The expansion of the Chinese market can be attributed to the growth of the middle class and deregulation. China Youth Daily reports that the middle-income class, people with assets of 150,000-300,000 yuan (approximately 2 million-4 million yen), is estimated to have accounted for 19 percent of the population in 2003. The ratio is increasing by one percentage point each year. The easing of restrictions on foreign entries accompanying China's accession to the World Trade Organization has resulted in the opening of Wal-Mart, Carrefour and other foreign supermarkets, and convenience stores such as Lawson, in rapid succession, which has stimulated consumer demand.

For the sustained expansion of the Chinese market, however, various problems need to be solved. In China, private consumption accounted for only 43 percent of gross domestic product in 2003, a figure much lower than the approximately 60 percent seen in Japan and other advanced, industrialized nations. This is because the income of farmers, who account for 60 percent of the population, has been increasing much more slowly than that of urban dwellers. Therefore, it is essential to raise the income of farmers in order to bring vigor to consumption.

Chinese enterprises depend on foreign companies for core technologies and basic components. Unless China achieves independence in terms of technology, it will not outgrow its role as a "subcontractor of the world", nor will it be able to create new markets.

The ratio of nonperforming loans of the four major state-owned commercial banks was still high at 15.6 percent at the end of 2004, putting a squeeze on the extension of credit to private enterprises and the rest of the private sector. The stock market has been stagnant for a long time due to the following two facts: 1) "non-distribution" shares of state-owned enterprises have yet to be released, and 2) securities companies have been beset with unruly management. As a result, the means of fund raising are limited even for enterprises with high growth potential.

Imports to China May Grow to 14 percent of World Imports

Taking these factors into consideration, economists and experts in various industries have forecast the Chinese market in 2010 and 2015 in three scenarios: "standard," "optimistic" and "pessimistic." What follows are forecasts for factors such as the extent of internationalization, political and social conditions, and the financial system, all of which will affect the market, and for the electronics and electric machinery industry.

Concerning the extent of internationalization, the share of China in total world imports is forecast based on the assumption that imports to countries other than China will grow at the same rate as the real economic growth rates of these countries between 1999 and 2003.

In the standard scenario, the assumptions are that China will maintain annual economic growth of eight percent and carry out market liberalization in keeping with its promise to the World Trade Organization, and that it will develop an appropriate legal framework with relative ease. In this scenario, both imports and direct foreign investment will increase, resulting in an expansion of local sales. Subsequently, the share of China in world imports will rise to 7.2 percent by 2010 and 8.9 percent by 2015.

In the optimistic scenario, a cooling of overheated investment will raise the annual rate of growth to 12 percent, and Chinese enterprises will invest surplus funds on hand resulting from improved profits on research and development, which, in turn, will improve technology and expand the market further. The share of China in world imports will reach 9.2 percent by 2010 and 13.6 percent by 2015, which will be more than double the figure for Japan.

In the pessimistic scenario, the government will not be able to cool overheated investment, and excess capacity will cause the bubble to burst. The growth rate will decline to 4 percent, resulting in contraction of consumption. As the recession will have prolonged effects, China's share in world imports will remain at 5.5 percent in 2010 and 5.6 percent in 2015, never rising significantly.

With respect to political and societal changes, as the communist party is cautious about political reform, the standard scenario envisions that the present political system will be maintained through 2010 or thereabout. Between 2010 and 2015, there will be experiments with elections in rural areas and some small cities. Growth of the middle class will steadily increase consumption, but transparency of the market will be achieved slowly because some protectionism will remain in provincial areas.

However, since Chairman Hu Jintao and other leaders are sensitive to popular sentiments, democracy may be introduced step by step. In the optimistic scenario, direct elections may be introduced by 2010 to choose the heads and assembly members of provinces and cities in the coastal region, and in national politics between 2015 and 2020. The market will become increasingly transparent and grow in depth, as consumers' values diversify.

At present, however, when it comes to the granting of official permission or approval, there is no end to corruption, and to protest this, there have been a series of demonstrations against local governments. It is possible that the government will be forced to suppress such protest movements with force. In this pessimistic scenario, consumption will shrink and some foreign companies may well pull out of China.

In the financial system, as a solution to stock market problems is expected to take time, the standard scenario foresees that firms will continue to depend primarily on bank loans for funds. The stock market will gradually restore its functions between 2010 and 2015, slowly expanding the scope of financing methods for private enterprises.

Since the Chinese government is promoting capital participation in the country's financial institutions by foreign companies, management techniques and ethics of Chinese banks and securities companies may improve thanks to foreign participation. In the optimistic scenario, the financial conditions of banks and stock market functions will improve by 2010, expanding financing methods for private enterprises. By contrast, the pessimistic scenario foresees that disclosures one after another of scandals perpetrated by Chinese financial institutions will discourage foreign capital participation and securities companies will collapse one after another due to the failure of rehabilitation efforts. In this scenario, no visible progress will be made in improving the financial conditions of banks or in instilling soundness into the stock market. Even promising private enterprises will not be able to meet their needs for funds.

In all three areas of internationalization, political and social change, and financial system, the probability of each of the scenarios coming true is as follows: 70 percent for the standard scenario; 20 percent for the optimistic scenario; and 10 percent for the pessimistic scenario.

Replacement Demand for TV Sets Put at 200 Million Units

In the standard scenario for the electronics and electric machinery industry, the government's industrial development policy will get off the ground, and Chinese enterprises will be able to expand their businesses to other countries and develop their own technologies to some extent. By 2010, Chinese companies will catch up with their overseas counterparts in terms of technology. By the same year, digital broadcasting will start in earnest. By 2015, fourth-generation devices will replace earlier mobile phones, and the market will have expanded thanks to the development of numerous new products through, for example, the fusion of personal computers and communications technology.

In the optimistic scenario, by 2010 Chinese enterprises will get serious about investing money and human resources in research and development and establish a system for supplying domestically made materials and devices to the nation's industries. By 2015, there will emerge a de facto global standard of Chinese origin for technology in certain fields. Digital broadcasting will start in earnest by 2010 and a total shift to digital broadcasting will be completed by 2015. Replacement demand for TV sets will amount to a cumulative total of 200-250 million units for the 10 years from 2005 to 2015.

On the other hand, if resistance from those with vested interest hampers market liberalization, technology could stagnate due to price competition among Chinese enterprises. In this pessimistic scenario, China will not be able to outgrow its place as the factory of the world. Foreign direct investment will also stagnate and some companies may pull their research and development centers out of China.

In the case of electronics and electric machinery, the probability of the standard scenario coming true is approximately 50 percent. The probability of the optimistic scenario is rather high at 30 percent, but there is a 20-percent chance of the pessimist scenario coming true.

It is important for Japanese enterprises to take advantage of their own strength in industries and sectors that are growing in China. Such industries include housing and automobiles. In the former, a broad range of demand, including interior finishing and other related sectors, is expected to emerge, while in the latter, Japan enjoys a very high level of technology. In the area of after-sale services, Japanese companies, which have advanced know-how on each and every aspect thereof, will enjoy an advantage. At the same time, since demand is increasing rapidly for physical distribution, there is ample room for Japanese companies to succeed thanks to their rich knowledge and experience. Japanese enterprises will also be able to cooperate using their technology and equipment in solving China's pollution problems, which are growing in severity.

There is some cause for concern, however. For example, there are moves to boycott Japanese products in some parts of China, due to Japan's bid for a permanent seat in the United Nations Security Council and because of the dispute over the handling of history in some textbooks recently approved in Japan. It is essential for Japanese enterprises to focus on improving their corporate images in the communities where they operate and actively make a contribution to society.

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