

# MeesPierson Reads

## Eastern Promise

### Frank Moon looks at the effects of the economic awakening of China

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China’s economy has been growing at 9-10% a year and seems set to continue to do so for the foreseeable future. The country has cheap labour and minimal environmental controls. The economic awakening of China has had extraordinary effects on the world economy and in particular on demand for hard commodities and oil. The prices of virtually every metal or energy related commodity are trading at, or near, 20 year highs. Current GDP per capita is around \$1,000 per annum against US \$35,000 for the US. China’s newly voracious consumers are also seeking luxury goods with a vengeance.

Now most leading Western banks have agreed that they must be in China, seemingly irrespective of the price, because of this rapid growth. They cannot resist the lure of potentially 1.3 billion savers and borrowers. There is now hardly a major foreign bank that is not considering a foray into Chinese banks and assets, in one form or another. It is a global herd on the move. All of these foreign banks can only buy minority stakes, not control, as Chinese law bars this. All of these institutions claim to be playing the long game and that their expertise will help sharpen up the domestic banks. However, when every major bank has the same brilliant idea at the same time, it is time for other investors to be very nervous.

The last occasion that this happened was between 1993 and 1996. Banks had loaned huge amounts to just four countries, Korea, Thailand, Indonesia and Malaysia. They had no natural business in these nations but wanted to take advantage of superior growth and higher interest rates. The collapse of the banking systems in these countries in July 1997 caused a domino effect into Russia and Latin America and a global banking crisis was only narrowly averted.

In 1998, the Chinese Guangdong International Trust and Investment Corporation (GITIC) collapsed. It was a specialist investment company owned by the regional government of Guangdong province. The total debt was approximately \$4.5 billion. The collapse was caused by poor investment decisions and very bad management. These lenders had also become exuberant at China’s explosive economic growth following Deng Xiao Ping’s “liberal” reforms. They had naively and wrongly assumed that CITIC, as an enterprise owned by the regional government



and controlled by the Central Bank of China, was government guaranteed and therefore represented a sovereign and low risk. The Chinese government belatedly arranged a bail-out. At present the Chinese banking system is bloated with excessive bad and doubtful debts (up to US \$750 billion on some estimates). Hopeless state owned enterprises have been propped up by cheap credit. The whole financial system cries out for reform and occasionally weak attempts are made. However, more common are state funded bail-outs. The authorities gave US \$45 billion in 2003 to prop up the Bank of China and the China Construction Bank. This does little to discourage widespread corruption and incompetence.

Investors should remember when wearing their rose-tinted spectacles that a banking crisis in China is a near certainty.

Interestingly rapid economic growth in Asia does highlight another risk and opportunity – that a prolonged period of cheap food may be history.

China has 1.35 billion people and 320 million acres of farmland. The US has 294 million people and 430 million acres of farmland. When people have more money to spend they add more variety and more expensive high-end foods to their diets. Today China is the world’s largest consumer of both meat and grain. It also used up twice as much fertiliser as the US in 2004. Like hard commodities, soft commodities have spent much of the last 20 years in a nasty bear market but this is now changing. No one is suggesting starvation as technology usually provides. But it does suggest rising soft commodity prices and tremendous opportunities for food producers and businesses that feed into food production. This looks to be the surest bet.