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#2012

INFOCUS:



China reforms

– Changes in the Chinese economy

China's rapid growth during the past decade and the NCAB Group's desire to manufacture high-quality and increasingly more technically demanding PCB's at competitive prices have been instrumental in the NCAB Group's continued success within its markets. Since China's economy has a major impact on us all today, we are devoting this "In Focus" issue to examining the current economic situation in China and looking at possible developments in the future.

We asked Annika Lindblad, analyst specializing on China at the major Nordic bank Nordea in Helsinki, to guide us through a number of issues.

A much discussed question, not least regarding US-China relations, has been China's monetary policy. Where is China on that point today and what impact will its actions have in the future?

"China's currency is regulated, with the CNY (Chinese Yuan) allowed to float within a band of 1.0% against the dollar, and at an exchange rate determined by the Chinese central bank on a daily basis. Furthermore, the central bank is known to actively participate in the currency markets, selling and buying currency and thus steering the exchange rate.

There is nothing strange or divergent about China, as an emerging market, choosing to regulate the rate of exchange, as it facilitates stability. What is interesting now is the process China has initiated to ease the regulations. In April, the band at which the CNY was allowed to fluctuate widened from 0.5 to 1.0 percent, which constitutes a further move towards a freely floating currency. The driving force behind this process, which may take up to five or ten years to fully implement, is China's ambition to make the CNY a major global trading currency. A freely floating CNY would be particularly favourable for foreign and domestic companies and investors. On the other hand, I don't think that currency deregulation would have any significant effect on China's competitiveness and strength as a manufacturing nation.

Another sign of an impending deregulation is the test China has carried out with a new artificial floating currency CNH (offshore CNY settled in Hong Kong), which trades in Hong Kong. It is convertible

"They are apparently satisfied with an 8% growth rate in exchange for a balanced economy."

Annika Lindblad, Analyst, Nordea Helsinki

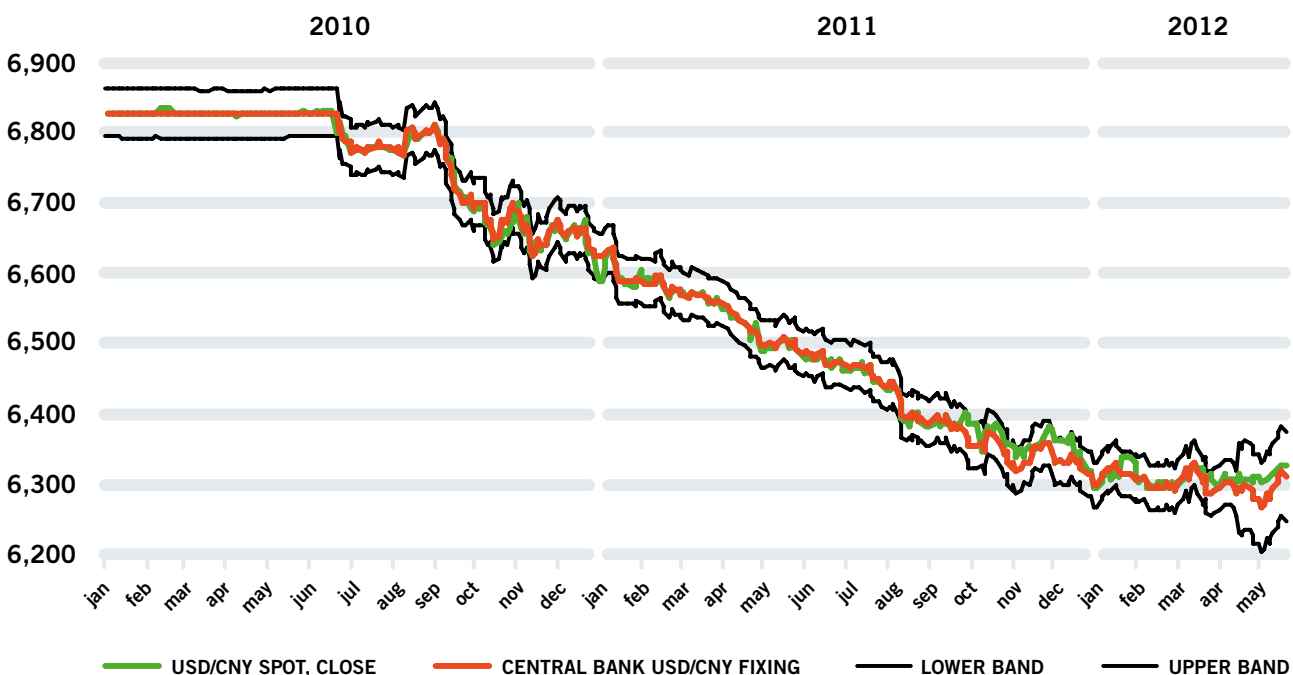


against the CNY and can, for example, be used as a means of protecting the currency. The two currencies have mostly remained on a par with each other, but it would be hard to forecast what might happen in a crisis situation. One could say the CNH is a way of testing a floating Chinese currency."

Income levels have risen sharply in China in recent years. What is this due to and what consequences will it have?

Incomes are still rising strongly. Last year, workers who have migrated from rural China to the cities received average income rises of 21 per cent. This is linked to the strong economic growth and improved standards of living and is normal for high growth economies such as China. Furthermore, there has been a slowdown in the number of rural migrant workers, which also impacts income levels.

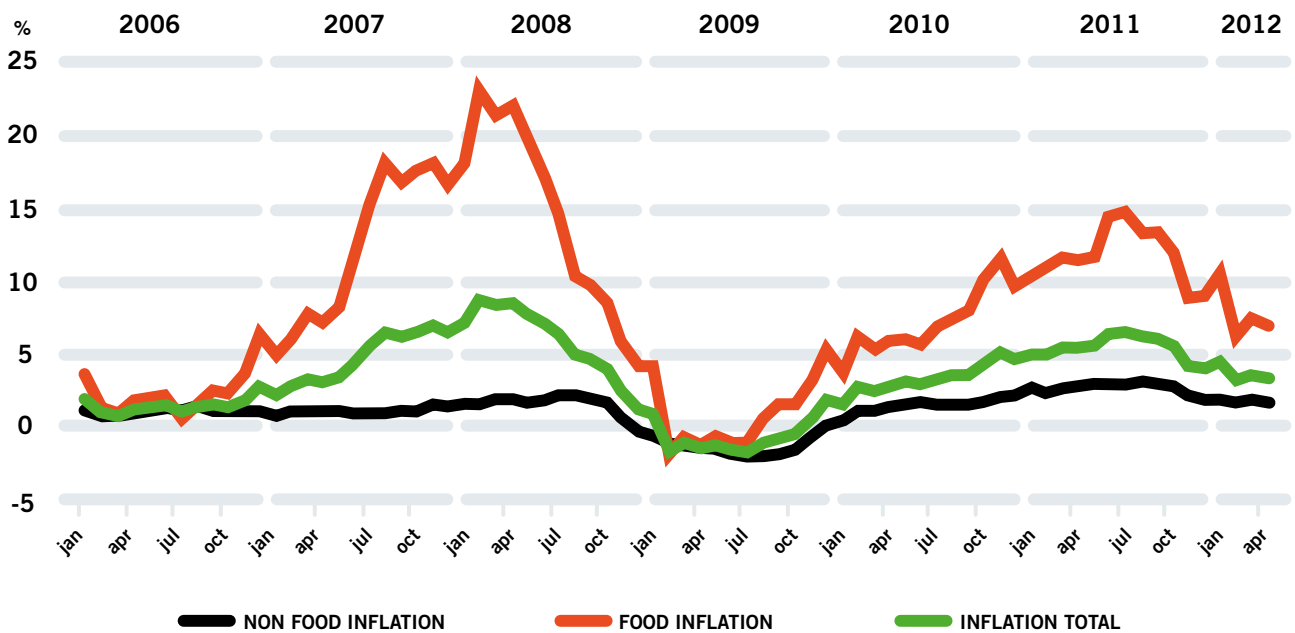
THE VALUE OF THE CHINESE CURRENCY AGAINST THE US DOLLAR



After having appreciated some 30% against the dollar during the two previous years, China's currency, the CNY, has remained stable compared to the dollar.



INFLATION IN CHINA



Source: Nordea Markets & Reuters Ecowin

After peaking last year, inflation has fallen to a relatively low level, very much thanks to a fall in food prices.

One development we may see, with China in some instances, no longer being the cheapest manufacturing country, is manufacturers moving their bases from China to such countries as Vietnam and Thailand. This applies mainly to the production of basic staple goods and indicates that China should focus on more sophisticated production and on developing its service sector. One of the challenges the Chinese economy faces is to train its workforce to manage the transition to a level of manufacturing with higher quality demands.

We are also seeing tendencies for the manufacturing industry to move from the east coast to the less affluent inland provinces, in order to cut their costs. After all, China is and will always be a huge country, with a massive labour force. This process is still in its infancy, but it could also serve as a way of bridging the enormous imbalances within China. I don't actually have any reliable statistics to refer to, but to the extent that it is happening, it is probably mainly within the basic staple industries sector.



The Communist Party has been hoping to see a growth in domestic consumption, but growth has been slow due partly to increased housing prices.

There has also been much talk about the threat of inflation in China. How would you describe the situation with regard to growth and inflation respectively? And what effect is the crisis in Europe having on China?

“Economic growth has slowed down, but we’ve seen it stabilize at around 8 to 8.5 percent. Inflation has fallen significantly and is now under 4%, very much due to the lower cost of foodstuffs. China’s exports to Europe account for a fifth of its total exports, so the European crisis is, of course having a negative effect. If the crisis is restricted to Europe, it shouldn’t however, have any major impact on China.

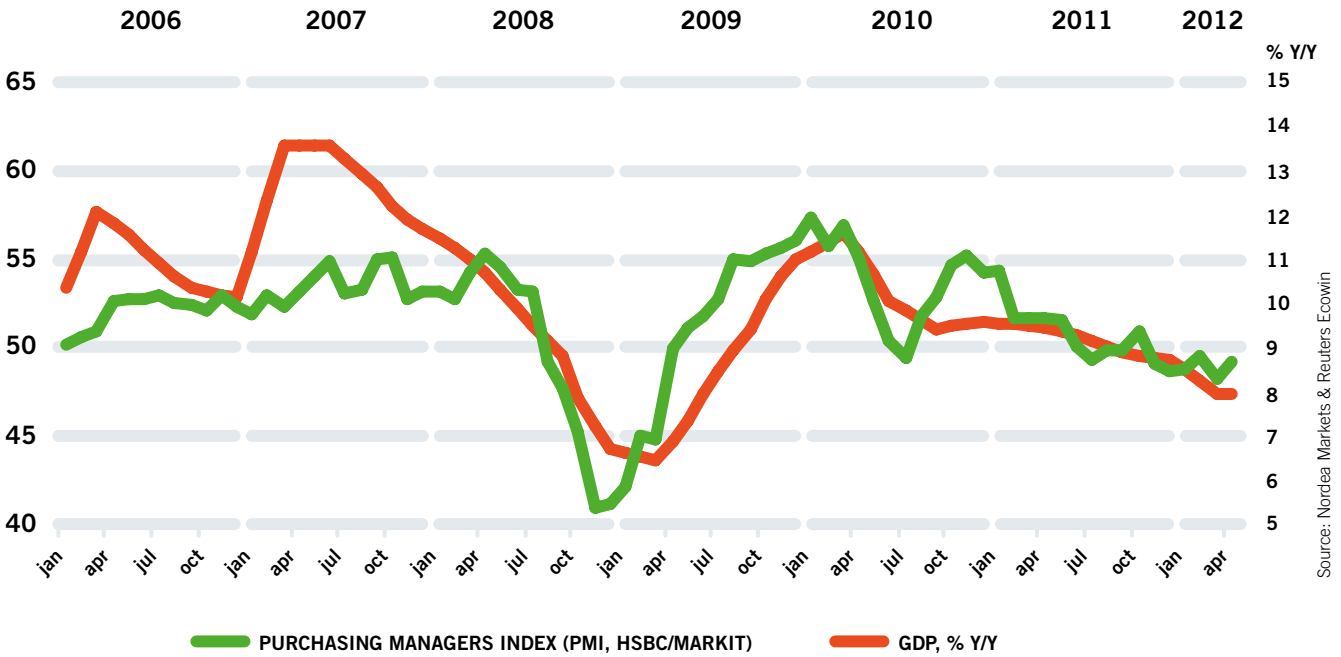
The lower growth level we are seeing in China is due not only to global problems, but also to a slowdown in government investments as well as efforts to stabilize the rise in housing costs. In the current situation, the authorities are adopting another approach than that applied during the 2008–09 finance crisis. China’s economy did better than that of most other nations, due mainly to government support in the form of new investment projects and an easing of monetary policy, e.g. lower interest rates and capital reserve requirements. The largest and most important banks are owned by the state and provided loans to investors, particularly to state-owned companies.

In the last six months, however, the state hasn’t reacted in the same way. Instead it has applied a somewhat different strategy, concentrating on attaining balanced growth in GDP without investment and inflation bubbles. It appears that they are satisfied with a growth rate of 8% in exchange for a balanced economy.”

How important is domestic demand for China’s economy today?

“When exports have slowed down, we have to date seen public investments kicking in as an auxiliary engine for the economy. If we compare the situation prior to the 2008 finance crisis, exports, measured as a percentage of GDP, had fallen by approximately 10% to 25-30%. Furthermore, since China’s public finances are in a far better condition than those of the United States and European countries, the state doesn’t need to save. Government savings in many other countries are otherwise significantly hampering growth.

CHINA'S ECONOMIC GROWTH



Growth in the Chinese economy has slowed during the past year, but stabilised at 8.0 – 8.5%

But as I say, China has to date opted to avoid an expansive approach this year.

In its latest five-year plan, adopted in 2011, the Communist Party expressed the hope that private domestic consumption would play a more important role, but this hasn't happened yet despite the rise in incomes. Development is relatively slow. This is partly linked to higher housing prices, but above all, to a total lack of a social safety net, with people having to save money to cover basic needs such as medical care, pensions etc, which they do, despite the very low rates for savings."

What then are China's plans for the future?

"They are looking very much at opening up and reforming the capital markets. As I mentioned earlier, I believe China will allow the currency to float freely, free up the credit markets, reduce state influence in the bank sector and more. They also want to find new growth strategies that take into account a population that will start to diminish, with China probably having to meet growing competition from cheaper manufacturing countries. Supporting private consumption will constitute yet another major challenge for the economy. Major reforms are going to be needed in China in the years to come, something the new generation of leaders due to be appointed this autumn are expected to address.

In the longer term, there is a 30-year plan that the World Bank and China have drawn up. Among other things, it looks at the role of the state and private sector and emphasizes the need of a shift more towards the private sector and of supporting innovation, research and development, green investments as a growth option, promoting equality and social security, shoring up government finances long term, as well as China's integration with the international markets."

What is happening on the political front? Will China become a democracy?

"The process leading up to the changes in the Communist Party and state leadership, scheduled for the autumn, is proceeding relatively

smoothly. The major figures in the new generation of leaders are said to have themselves been involved in planning the latest five-year plan and developments will probably continue in accordance with that plan. One difference here, is that the new leadership cadre appears to be better educated and more internationally oriented than earlier generations. This should contribute to speeding up the internationalization of the markets in China.

On the question of a possible Democratization process, it is hard to say what will happen with any certainty. But the most likely scenario is a very slow move from today's combination of a centrally controlled Communist state and market economy towards greater democracy. Democracy usually becomes an issue for people when the standard of living rises, but developments rarely happen fast and China is a vast country, which makes it difficult for people to stage any organized and effective protests.

The fact that the State is now trying to do something about spiralling housing prices can be seen as a result of growing demands from the population. If incomes rise too slowly, more and more people will call for changes, which could then lead to a more democratic society."

What about the rule of law as applied in China? How much of a problem is corruption?

"Here we should make the distinction between those living within Chinese society and foreign companies and investors. Foreign companies are indeed affected by corruption and a flawed judicial system, but these are problems that exist in all emerging markets. Relatively speaking, China is a welcoming country for foreign companies. The World Bank's Business Index, which ranks 183 countries according to these issues, places China 91st in the rankings, which compares favourably against Russia listed at 120th, Brazil 126th and India in 132nd place."

Source: Norddea Markets & Reuters Ecwin

Information gives you the power to change

HANS STÄHL
CEO NCAB GROUP



The world today is undergoing rapid change and it seems that the waves marking cyclical fluctuations are becoming shorter and sharper. 2009 was, for example, a crisis year, during which production fell by about 20%, before bouncing back with a 30% rise just 1 year later. Today Europe is in the midst of a new crisis. When we look back at what was the norm 20 years ago, economic crisis in those days lasted two years and occurred again every 10 years or so.

Economic cycles seem to have definitely become more transient. Those of us working within the manufacturing industry will need to respond more smartly to those rapid fluctuations and plan our production capacity carefully and appropriately. We have to fully grasp these cycles and be more proactive.

Our business concept has enabled us to effectively handle market shifts over time. Through our factories, we have significant production capacity at our disposal which can be scaled up instantaneously. If we were to use, for example just 30% of our main factory's capacity today, that adds up to an annual production of €250 million. As much as 95% of all the PCBs that NCAB produce today are

manufactured in China, an economy that is growing extremely rapidly. We are seeing today both the beginnings of a move by some manufacturing plants away from the core manufacturing region of south east China and the way the financial structure is rapidly changing with regard to income, taxation and other aspects. It is extremely important that we understand these changes in order to be able to make the strong business decisions, for example, our sourcing strategy for new factories.

NCAB is also taking all necessary measures to ensure it is up-to-date with changing taxation and environmental laws as well as other legislation, - essential if we are to continue offering our customers the best possible, long-term solutions and terms. A number of partners and businesses support us with information. One of those sources is, of course, our bank. We are happy to have an opportunity to share some of this information with you and hope that you will find our interview with Nordea Bank's China specialist, Annika Lindblad, interesting and informative.



Would you like to know more about economic developments in China?

- » [Nordea's continual China analyses](#)
- » [The IMF's reports and prognoses on China](#)
- » [The Economist's reports about China](#)
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We are always looking for interesting subjects that we could take a more in depth look at. If there is something you would like to learn more about, or perhaps you would like to comment on anything we have written, do get in touch with us and tell us more.

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