Consumers are driving China's economic growth – and foreign investors have noticed

But foreign companies face new political risks when pursuing Chinese consumers

Where does the US café chain Starbucks have the largest of its 28,200 company-owned and licensed outlets that are found in 76 countries? In Shanghai, China.

On December 6 last year, as a long line of Chinese waited to be let in, Starbucks opened a 2,800-square-metre roastery in the coastal city's retail hub that people describe as about half a football field in area. Opening the outlet proved a bonanza because the Shanghai Roastery became Starbucks's biggest revenue earner on day one. "We shattered every sales record in the history of the company," said Starbucks chairman Howard Schultz.[1] Such a result explains the Starbucks ambition to nearly double the number of outlets in China from 3,200 now to 6,000 by 2022, which would entail opening more than a store a day.

The Starbucks plans for China mimic the strategy of countless other multinationals since China modernised its economy from the late 1970s – namely, to seek a slice of the 1.4 billion strong consumer market that is growing in wealth every year. The World Economic Forum this year forecast Chinese consumption to grow 6% p.a. from 2016 to 2027, to nearly double in size to US$8.2 trillion over that time.[2] (For perspective, US consumption is about US$20.0 trillion.)[3]

China's consumer market is expanding for two reasons. The first is that China's economy is poised to grow at a 6% to 7% pace in coming years and be, after India, the world's fastest-growing major economy.[4] The other reason is that Beijing is trying to change China's economic model to one driven more by consumption. The results point to a surge in consumer spending power in coming years.

But China's emergence as the world's number two economy carries political implications that complicate the Chinese ambitions of foreign companies, especially consumer ones. The first is that China's increased economic might is making the country more assertive in global politics. Another is that other countries are fighting back against the loss of their global influence (in what is a zero-sum situation), especially against China's 'unfair' trading practices. Foreign businesses in China risk being stigmatised, if not targeted, amid such disputes. Foreign companies seeking to profit from China's growing consumption must recognise that political events might harm their investments – as Japanese and Korean companies as well as companies from other countries have discovered in recent years.

To be sure, political considerations have long governed foreign investment in China. Chinese consumers value global, and especially US, brands, which gives these goods some protection from Beijing-inspired actions. Perhaps China and other countries including the US will resolve their differences, which some days looks likelier than others. But heightened nationalism among Chinese, Beijing's growing confidence in international affairs and a backlash against China's emergence as a world power, especially in the US, are global political shifts that are likely to endure. Foreign investors must allow for political risks such that at times it might not matter too much that Chinese consumers are playing a bigger role in propelling China's economy.

Helping households

In 2007, China's then prime minister Wen Jiabao said the country's export- and investment-led economic model was causing "unsteady, unbalanced, uncoordinated and unsustainable" development.[5] Beijing's response to the model's fraying was to shift to a prototype driven more by personal consumption. But shifting to a more consumption-driven model came with challenges because it entailed boosting labour costs while correcting the underpricing of the other two key ingredients of economic growth – namely, land and capital.

This underpricing of land and money (in the form of the exchange rate and interest rates) and cheap labour favoured investment over consumption such that China was spending about 50% of its GDP on new capital stock.[6] At the same time, personal consumption only stood at about 35% of GDP compared with anywhere from 50% to

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[1] CNBC. 'Eight weeks in, Starbucks Shanghai Roastery is raking in insane sales.' 25 January 2018. cnbc.com/2018/01/25/eight-weeks-in-starbucks-shanghai-roastery-is-raking-in-insane-sales.html. See also: Puget Sound Business Journal. 'Shanghai Roastery opened as the world's 'highest-grossing Starbucks,' CEO says. 27 January 2018. bizjournals.com/seattle/news/2018/01/26/highest-grossing-starbucks-store-shanghai-roastery.html

[2] World Economic Forum. 'Future of consumption in fast-growth consumer markets: China.' 26 January 2018. bain.com/publications/articles/future-of-consumption-in-fast-growth-consumer-markets-wef.aspx

[3] Annualised figure from US GDP report for the first quarter of 2018. Bureau of Economic Analysis. US Department of Commerce. National data. Table 1.15. Gross domestic product. Billions of US dollars. Seasonally adjusted in annual rates. 27 April 2018. bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=3&isuri=1&1921=survey&1903=5

[4] Based on IMF forecasts. World Economic Outlook Database. April 2018 edition. China's economy is forecast to expand at 6.1% p.a. from 2018 to 2023 while India's is forecast to grow 7.9%. imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx.

[5] Ministry of Foreign Affairs of the People's Republic of China. Transcript of China's Prime Minister Wen Jiabao responding to question of China News Service during media conference at the end of the Fifth Session of the Tenth National People's Congress in Beijing on 17 March 2007. fmprc.gov.cn/eng/zxxx/t304313.htm

[6] IMF. Op cit.

about 66% of output for most advanced economies.[7] The means by which this happened was that a cheap yuan made imports expensive for consumers while it helped exporters. Low interest rates cheated household savers of income while governments and enterprises enjoyed subsidised loans. Land grabbed for factories left peasant farmers impoverished while supressing production costs. Low wages gave people less money to spend while they reduced manufacturing costs.

Untangling the underpricing of land and money while boosting wages was a risky step for Beijing because it heightened the risk of an economic slump. Policymakers, mathematically, needed to set GDP growth at a slower pace than consumption growth to enable consumer spending to become a bigger part of output.

By allowing the yuan to move closer to its market value (in 2010, for instance, a two-year peg was ditched, while in 2012 a trading band was widened), liberalising many interest rates, boosting wages and compensating farmers for lost land and livelihood, Beijing has met this challenge. Household spending has become a bigger driver of the economy while growth has been maintained at about 7% p.a., even if policymakers relied on an increase in debt the equivalent of China's GDP to achieve this feat.[8]

The World Bank readings of China's economy show household consumption has risen to 39% of GDP in 2016 from a record low of 35.8% in 2007.[9] Perhaps a better way to highlight consumption's growing importance is that since the start of 2016, household spending, on average, has propelled 65% of China's growth each quarter.[10]

Hostage Treasuries

Beijing's export-led industrialisation strategy relied on other interventionalist policies, apart from cheap labour and the underpricing of land and money. Import tariffs and quotas, local-content requirements, decisions based on 'national security' and the forced transfer of technology have helped drive China's endless current-account surpluses, the widest measure of a country's trade in goods, services and money. Even now, China's mercantilist trade practices are rife enough for the US government to accuse China of following policies "in conflict" with its membership, since 2001, of the World Trade Organisation.

A key election promise of US President Donald Trump was to reduce the US trade deficit with China, which reached US$375.2 billion in 2017.[11] In March, the White House duly targeted China with at least US$50 billion worth of tariffs. Beijing countered with threats and Washington made some more warnings before the two countries started trade talks in May.

China entered the trade talks with many ways to fight back against the US in the case of any lasting trade disputes (or in retaliation for sanctions on Chinese companies tied to other reasons), though three options stand out. The biggest weapon that Beijing holds against the US is that it has amassed the world's biggest hoard of US Treasuries. China could boost US interest rates by selling some of its US$1.2 trillion of US government bonds. But do that and Beijing would harm the US and other key Chinese export markets. Another drawback is that any rise in US interest rates would reduce the value of the remaining Treasuries Beijing still held, which, along with any selling, reduces future threats. The biggest worry, though, might be how Washington would retaliate if China's bond selling so destabilised the US economy it was judged an act close to war.

A less-inflammatory-but-still-aggressive option for Beijing would be to impose tariffs on US imports. In April, China toyed with this route by announcing 128 US items that could face tariffs. Even more pointed politically, China listed many agricultural products that are produced in rural areas that voted for Trump in 2016. But Chinese tariffs on US goods would add to costs for Chinese consumers, businesses and governments and could stir inflation in China, already at 3% for the 12 months to February. Another problem with this option is that China's trade surplus with the US places China in a weaker position to hurt the US in a tariff tit-for-tat. On 2017 numbers, Beijing has only US$130.4 billion worth of US imports to hamper, whereas Washington has US$505.6 billion worth of Chinese imports to target.[12]

Shunned goods

Last year, South Korea installed a US missile-defence system to protect itself against North Korea and that introduces a third option if Beijing wanted to pressure the US. This option is to stoke boycotts against US products largely by weaponising consumer spending, though Chinese businesses and governments would shun US goods too. Boycotts are a frequent Chinese response to international tensions and one that predates the Communist takeover in 1949.[13]

Boycotts are effective in China because once a country's products are stigmatised, enduring damage is usually done to sales. Last year's boycott of Hyundai and Kia cars, the blocked streaming of Korean TV shows and K-pop music videos, a near-halt to Chinese tourists to South Korea, and the forced closure of more than 80 Lotte stores in China because the South Korean company had handed over

[7] IMF. Regional Economic Outlook. "Asia and Pacific. Managing spillovers and advancing economic rebalancing." Chapter 4. "Is China rebalancing? Implications for Asia". Page 47. April 2012. imf.org/external/pubs/ft/reo/2012/APD/eng/areo0412.pdf

[8] China's economic growth averaged 7.1% p.a. in the five years to 2017 compared with an average 9.8% p.a. in the 15 years to 2012. IMF. World Economic Outlook Database. April 2018 edition. imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx. China's total debt to the non-financial sector has risen from 131% of GDP in 2007 to 234% of output in 2016. IMF Working Paper. WP/18/2. 'Credit booms – is China different?' Sally Chen and Joong Shik Kang. January 2014. Table 4. PDF. Credit Booms—Is China Different? WP/18/2, January 2018 - IMF

[9] The World Bank. 'Household final consumption expenditure, etc (% of GDP)'. For all countries. data.worldbank.org/indicator/NE.CON.PETC.ZS?locations=CN. The comparable figures for Australia and the US in 2016 are 58% and 69% respectively.

[10] National Statistical Bureau of China. 'Final consumption contribution to share of growth of GDP, current quarter (5)' For March quarter. data.stats.gov.cn/english/easyquery.htm?cn=B01

[11] US Census Bureau. 'Trade in goods with China'. census.gov/foreign-trade/balance/c5700.html

[12] US Census Bureau. Op cit.

[13] In 1915, for instance, Japanese exports to the US dropped 40% after Chinese consumers boycotted Japanese goods after Japan's government sent '21 demands' to China's government that would have extended Japanese control over the economy and country. See, Wikipedia. Twenty-one demands.' en.wikipedia.org/wiki/Twenty-One_Demands

land for the missile shield, are estimated to have shaved 0.4 percentage points off South Korea's economic growth in 2017.[14]

The boycott on South Korean goods last year was reminiscent of Beijing's dispute in 2012 with Japan over contested islands in the East China Sea under Tokyo's control. Japanese brands such as Suntory and Sony were shunned, Japanese-owned Fast Retailing and 7-Eleven stores were closed and companies such as Canon and Toyota suspended production in China due to protests.[15] Other strikes against Japanese interests in China occurred in 2005 and 2003. In 2012, the same year Beijing was clashing with Japan, China boycotted bananas from the Philippines over contested waters around the Scarborough Shoal about 120 kilometres off the Philippines. French retailer Carrefour encountered protests in 2008 after pro-Tibet activists disrupted the Olympic torch relay in Paris before the 2008 Summer Olympic Games in Beijing. Australia is yet to suffer a boycott but it has received threats of one. In December last year, *The Australian* reported that Beijing warned Canberra that its proposed espionage and foreign interference laws and its criticism of Chinese influence in Asia-Pacific could trigger boycotts.[16]

For China, boycotts hold advantages over the other options. They are easy to orchestrate via social media while Beijing can hide its meddling. Boycotts appeal to the growing nationalism among Chinese that Beijing is stoking. Victim companies can only respond by applying political pressure at home to resolve whatever issue is angering China.

But boycotts carry risks for Beijing too. The first is that other countries retaliate like they would with tariffs. Another is that foreign companies might freeze expansion plans and shut off a source of innovation for China. Hundreds of thousands of Chinese are estimated to work for the companies of any one foreign country and they might resent any loss of income. Far more numerous (and so a bigger political concern) are Chinese consumers who respect foreign brands. US products are especially valued because of their quality and there is little poisonous history between the US and China, unlike, say, with relations between China and Japan, which invaded China in 1937 and fought over Manchuria in 1931 to name but two hostilities. Chinese shoppers might resent being told to avoid foreign brands and could ignore government sanctions against Nike runners and Apple iPhones.

Starbucks, which first entered China in 1999, has faced official threats before in China only to thrive thanks to the popularity of its lattes and cafés. In 2007, nationalists who opposed any foreign presence in Beijing's Forbidden City, the home of China's emperors for five centuries until 1911, forced Starbucks to close its outlet in the zone – an outlet that, at 19 square metres, was less than one hundredth the size of Shanghai Roastery the company opened a decade later.[17] But that was a less-assertive China and Beijing has more foreign investment to hold hostage now.

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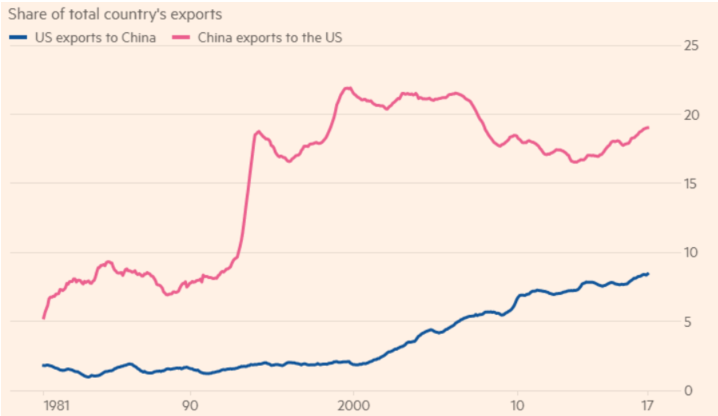
China-US goods trade relationship since 1981



Source: Thomson Reuters Datastream/Financial Times

[14] Reuters. 'Trade tensions stoke worries of anti-US backlash in China.' 4 April 2018. reuters.com/article/us-usa-trade-china-backlash/trade-tensions-stoke-worries-of-anti-u-s-backlash-in-china-idUSKCN1HB1XJ
[15] Financial Times. 'Anti-Japan protest spread across China.' 18 September 2012. ft.com/content/85f4f7a2-0138-11e2-99d3-00144feabdc0
[16] The Australian. 'Chinese warnings of consumer-led boycott over worsening relations.' 22 December 2017. theaustralian.com.au/national-affairs/foreign-affairs/chinese-warnings-of-consumerled-boycott-over-worsening-relations/news-story/00558abc6d9011bc8f4ef7e2ed63d70f
[17] The New York Times. 'Starbucks closes coffeehouse in Beijing's Forbidden City. 15 July 2007. nytimes.com/2007/07/15/world/americas/15iht-starbucks.4.6664994.html. Foreign Policy. 'China's ridiculous war on Starbucks lattes.' 21 October 2013. foreignpolicy.com/2013/10/21/chinas-ridiculous-war-on-starbucks-lattes/