China: From Manufacturing to Buying

For the better part of 20 years, China has been the world's factory, and its low labor costs have helped tamp down inflation in developed nations by allowing them to import cheap, Chinese-made goods. The torrent of foreign direct investment (FDI) that flowed into mainland China—some $900 billion since 1990, according to United Nations data—helped finance factories along the southeastern coast that slaked the global thirst for inexpensive goods. It also underpinned phenomenal economic growth. The country's GDP grew from $357 billion in 1990 to $9.3 trillion last year, a nearly thirty-fold increase in a single generation. But that growth also spurred deep social changes. Millions migrated from inland, rural provinces to coastal cities in search of manufacturing jobs, and some 300 million Chinese vaulted into the middle class. The net result: China's days as the world's low-cost factory are numbered. They're going to be buyers now.

That shift has picked up pace in the last five years, says Robert Prior-Wandesforde, Credit Suisse's Head of Macroeconomic Research for Southeast Asia and India, who recently published a report entitled, "Asia: FDI Truths, Myths and Prospects." The latest catalyst, of course, was the global financial crisis, the ensuing economic slowdown that sapped demand for China's industrial output, and the immediate response from the country's leaders—a huge dose of Keynesian stimulus.

To a large extent, the strategy worked. Beijing was able to maintain domestic demand and strong economic growth during the worst of the global slowdown, while building infrastructure that in some cases has leapfrogged that of the West. China's high-speed rail system, for example, may still be relatively small for such a large place, but it far outstrips what the United States has been able to build in the last 50 years. The country's middle class remains vibrant, and a growing sense of national pride underpins an increasingly muscular foreign policy. But there are limits to what Keynesian spending can do, and there is an emerging consensus in China that the response to the financial crisis was excessive. The country's new leaders, headed by President Xi Jinping, seem to have concluded that they can no longer rely on government spending, which has caused local government debt to soar, to underpin domestic demand.

Nor can China rely on the rest of the world to buy its goods with the same voracious appetite, despite the fact that developed economies are healing. That's in part because China is becoming a more expensive place to make things. The same success that created a middle class roughly the size of America's total population is also fueling increasing calls from working Chinese for change—from higher wages to policies that would improve access to healthcare and protect the environment. Higher wages mean more expensive goods. And retrofitting factories to meet stricter air and water pollution regulations isn't going to be free, either.

China also wants its own consumers to buy a greater share of the goods that previously went to buyers in Europe and the United States. Xi and his team made that clear during the Chinese Communist Party's Third Plenum in November 2013, where they released a list of changes including pledges to bring the economy to "a new stage of development." Judging from increases to the minimum wage announced so far this year in cities such as Shenzen (13 percent) and Yangzhou (15.6 percent), which would in theory stimulate domestic demand, the country's leaders appear to be following through.

When you sum it all up, China is on the way to becoming a self-sustaining economy, says Prior-Wandesforde. At the same time, he cautions that it will take years to effect the changes that will convince the Chinese to sharply reduce their notoriously high savings rate, such as providing a more comprehensive social safety net. Nonetheless, there is certainly a demonstrable and growing demand for consumer goods from a significant portion of the population. Out of nowhere, China has become one of the world's fastest growing markets for wine—imports jumped from around $50 million in 2004 to more than $350 million in 2009, according to Chinese customs data. They're buying big-ticket items, too: According to the International Road Federation, the number of vehicles per 1,000 people in China jumped from 48 to 57 in 2010 alone. And there is plenty of room for the domestic economy to grow. Per capita income in China was just $6,091 in 2012, compared to $51,479 in the United States the same year, according to the World Bank.

That potential has not escaped the attention of foreign investors, who believe China's domestic economy will provide significant profits down the road. Although net FDI in mainland China dropped to 4 percent of domestic GDP in 2012, the lowest level since 1990, that's more due to the fact that China's outward investment has been rising since the mid-2000s than any serious drop-off in foreign investor interest. Indeed, inward FDI of $121 billion in 2012 hit a record high of 3.7 percent of the global total. While Prior-Wandesforde cautions that it is difficult to confirm where those funds are going, he thinks we're likely seeing the dawn of a second wave of foreign investment in China—this time, focusing on Chinese consumers.

Not only that, a growing portion of the export-driven torrent of FDI that used to flow into China is moving elsewhere as well, to now-lower-cost Asian countries such as Laos, Bangladesh, Sri Lanka and Vietnam. China will likely hang onto higher value-added manufacturing—think auto parts or precision machinery—but in the future, your jeans are unlikely to be made in Guangdong.