

China's Auto Industry: Can It Sustain Its Rapid Pace Of Growth?

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Introduction

Last time I spoke to DCBA, the topic was the importance of granting Permanent Normal Trade Relations to China

Today I appear less than a week after the US and the EU announced they are seeking WTO consultations with China regarding its allegedly discriminatory treatment of auto parts imports

Is this the first skirmish in an eventual trade war?

- Slower economic growth
- Slowing China's auto industry growth

Or, is it a sign of maturity in the relationship?

- Negotiations among equal partners
- Continuing strong economic and auto industry growth

GM IN CHINA

In 2005, GM became the largest seller of vehicles in China

GM's success can be attributed to:

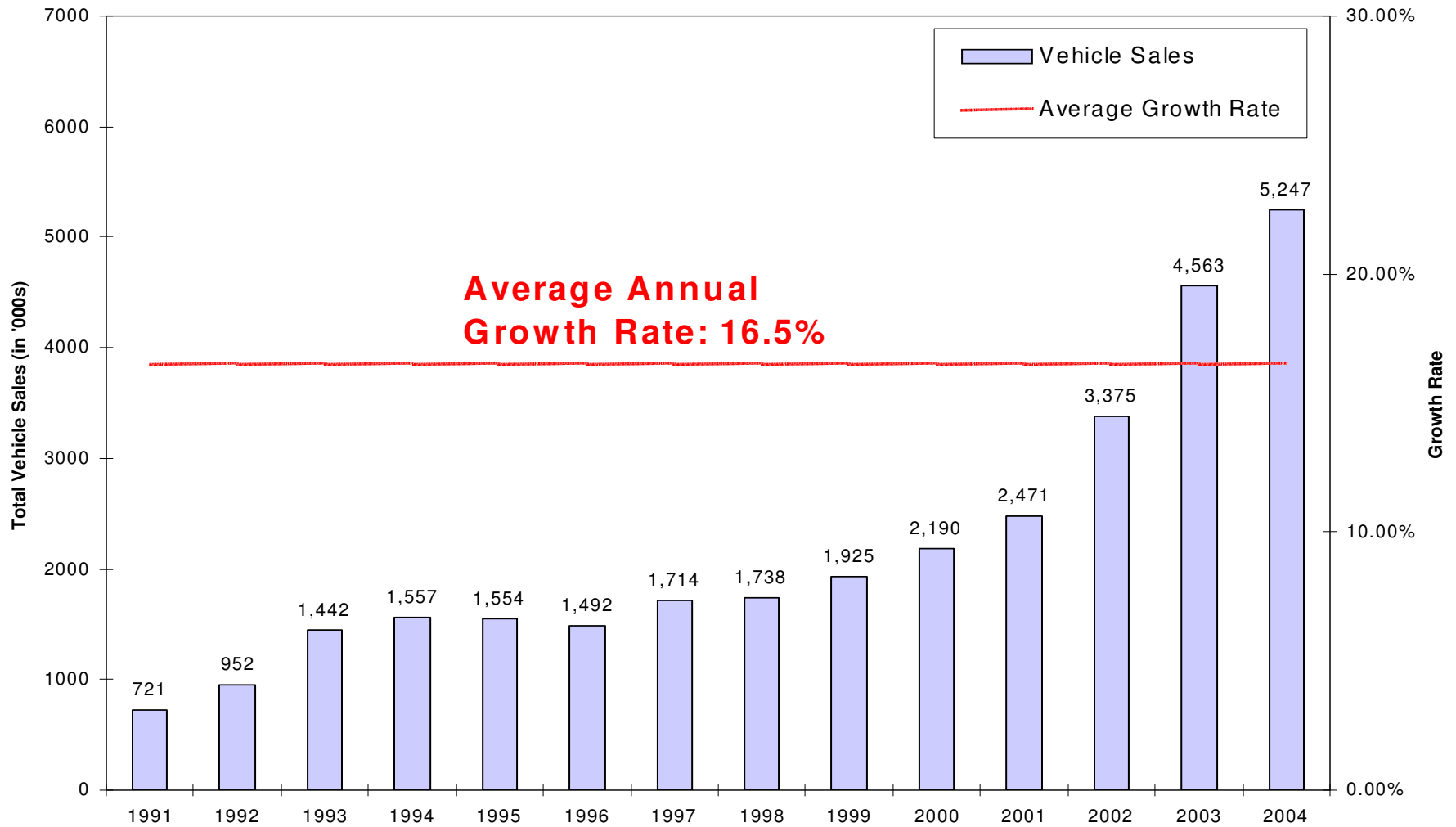
- Vision and sound Strategy
- Strong partner (SAIC)
- Willingness to take risks
- Ability to respond quickly to changing economic conditions

Will need more of each to continue growing

But, will also need good economic relations between the U.S. and China

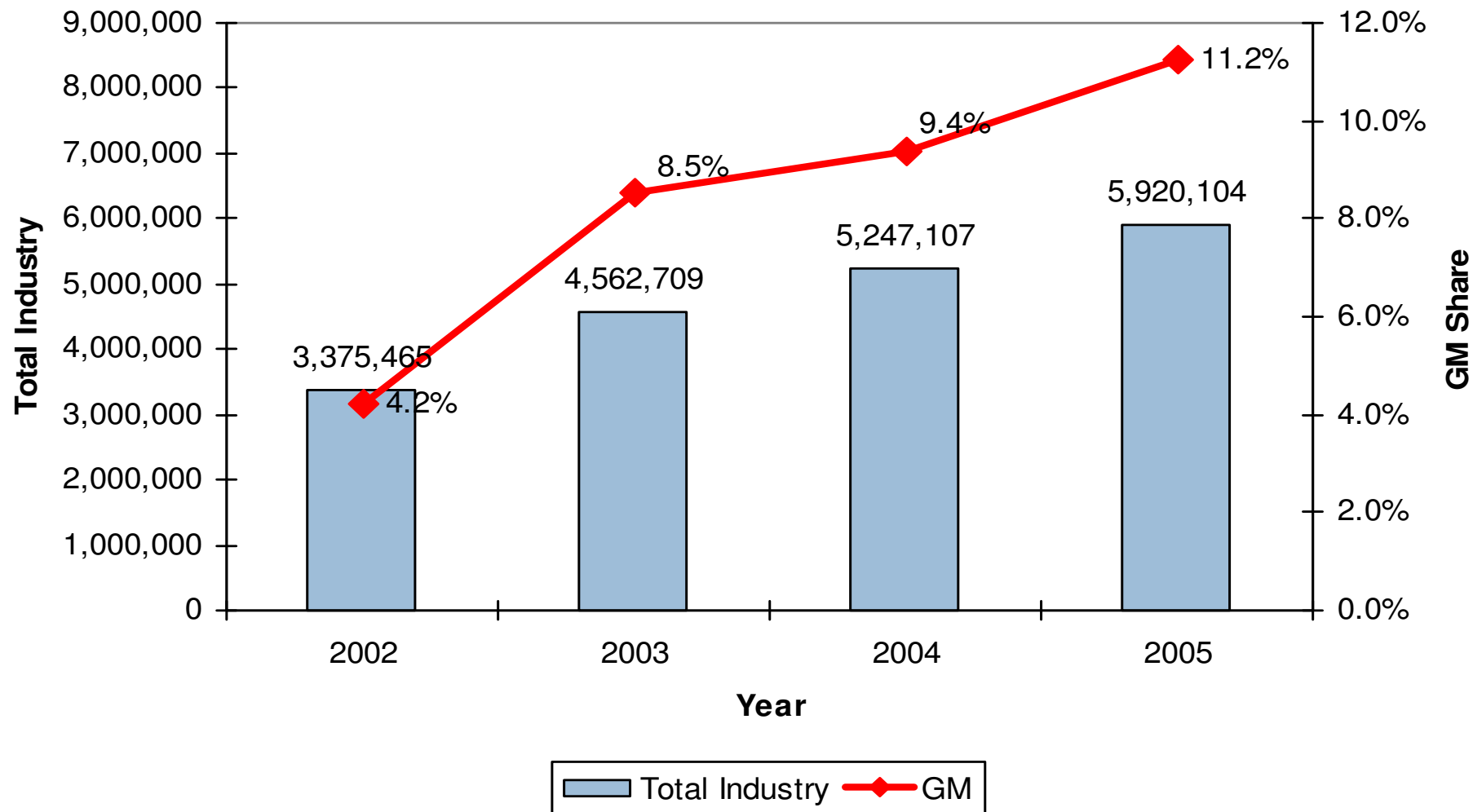
And, continuation of Chinese government policies promoting auto industry growth

Rapidly Growing Vehicle Market



Industry sales took off following China's accession to the WTO in 2001.

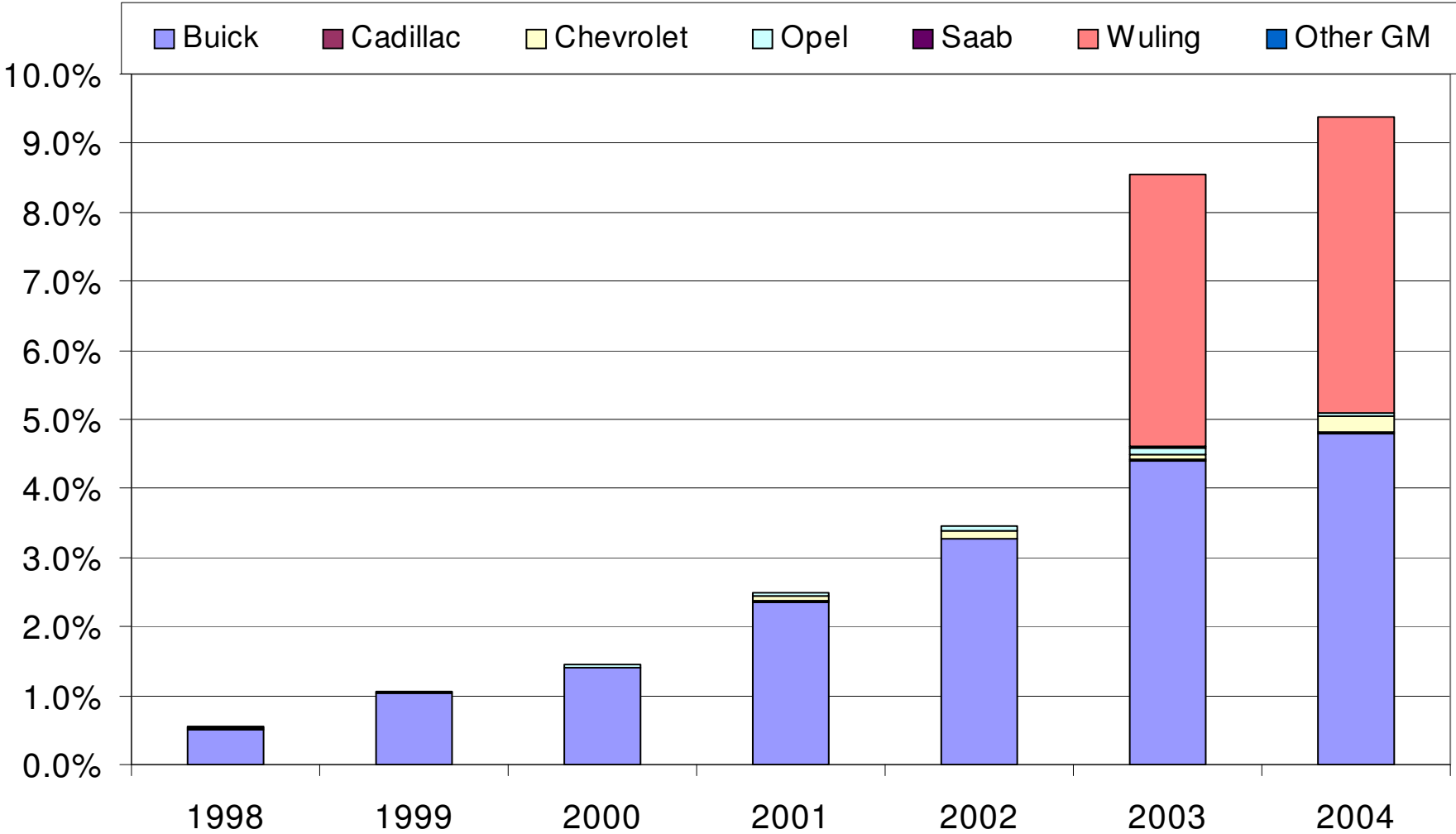
China: Total Industry & GM Share, 2002-2005



Demonstrates GM can compete with any company on a level playing field

China: GM Market Share* Growth In China

China: GM Market Share Growth



GM Total	9,485	20,364	31,907	61,615	131,646	389,818	492,011
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Products based on low-cost GMDAT and Wuling architectures were key contributors to GM's sales success

Can China Maintain Its Rapid Pace of Growth?

The Fundamentals Are In Place To Sustain Growth

A hard-working and disciplined labor force

The integration of China's vast rural labor pool into industry

Political stability and growth-oriented government policies

Low labor costs and extraordinary gains in productivity

Increasing foreign investment and trade

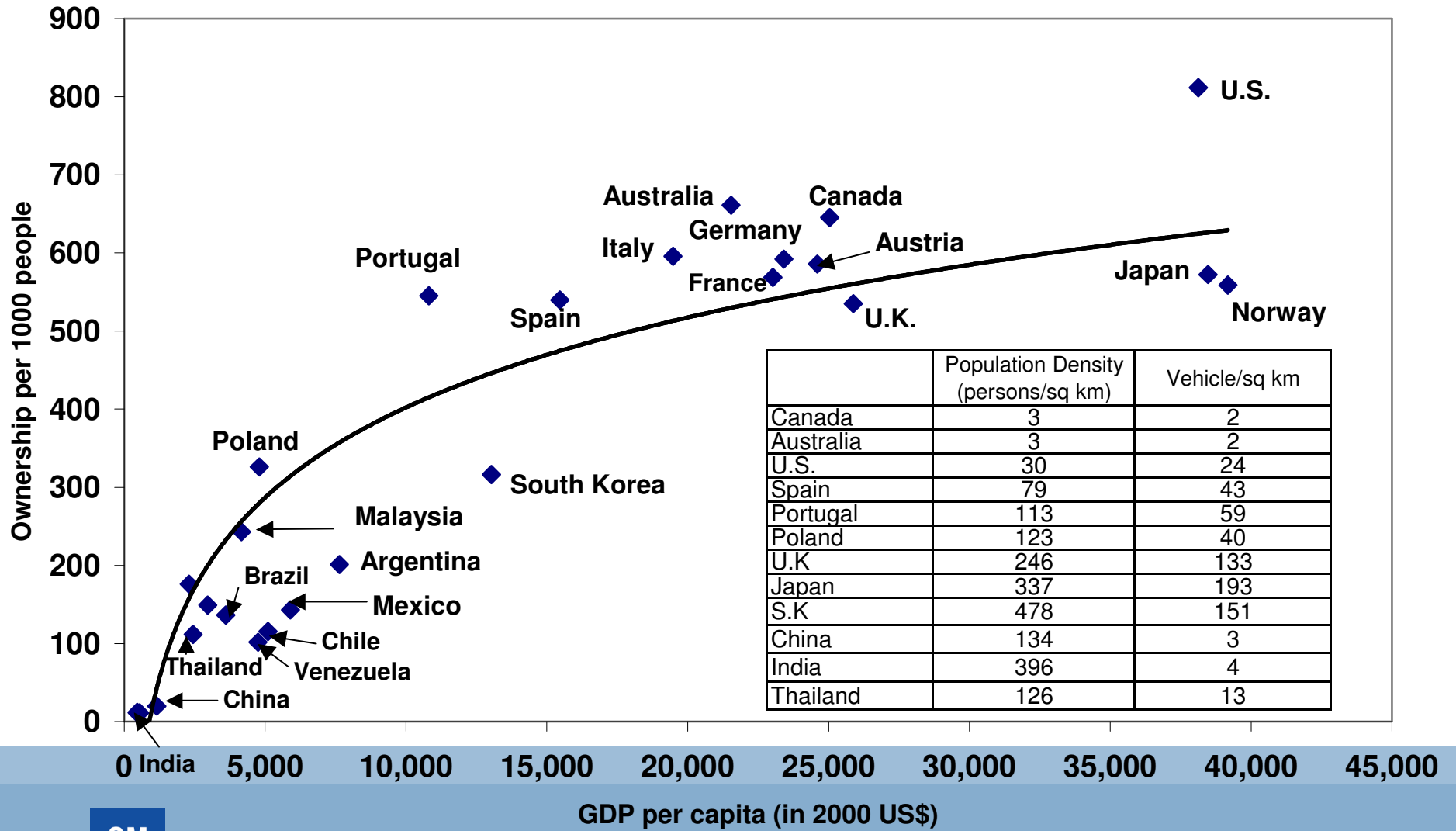
High saving rate supporting massive spending on infrastructure and capital investment

An accommodating external environment

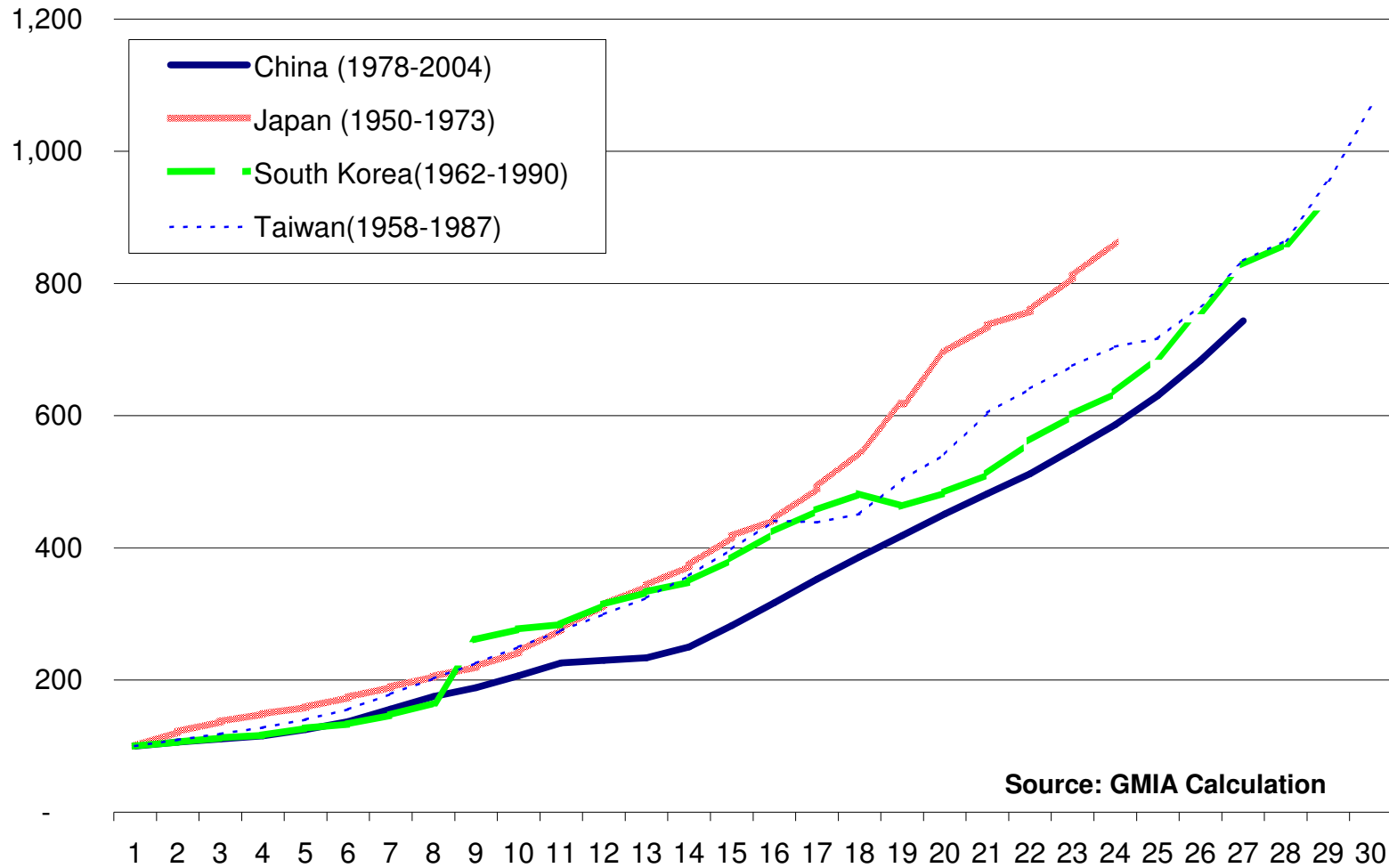


Global Comparison : 2004

GDP per capita (in 2000 US\$) vs. Ownership per 1000

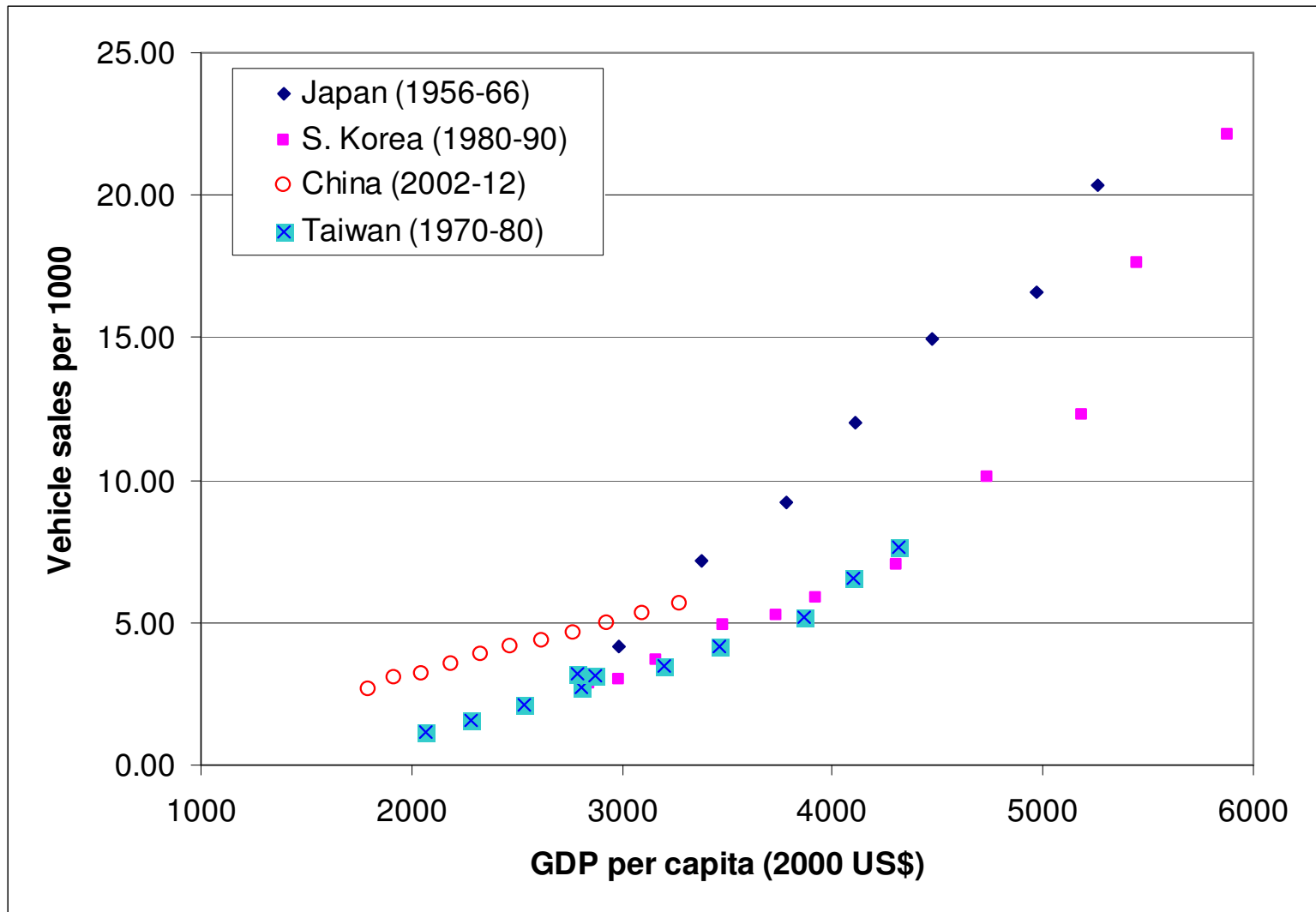


East Asian Growth spurts (GDP/Capita, Base Year = 100)



China's growth of GDP is not exceptional by the standard of other east Asian countries.

China: Following the path of Japan and Other Asian Nations



Source: GMIA 2003 Global Environmental Scan

Risks To Growth Are Political Not Economic

Pace of economic reform

- Financial system reforms are key
- Reallocation of resources from SOEs to private sector
- Shift to market-based exchange rate
- International diversification of investments

Trade Conflict

- With the U.S. and the EU
- Growing tensions with Japan

Focus on trade friction with the U.S.



Frictions in U.S.-China Economic Relations

U.S. trade with China has been in deficit for some time

- In 2005, U.S. trade deficit with China exceeded \$200 billion, the largest with any country ever

Increasingly, U.S. businesses and politicians argue that China is not playing fairly

- China's pegged exchange rate has been the focus of attention
- China has been threatened with legislation that would impose punitive tariffs if the RMB is not allowed to appreciate

Amazingly, though, there have been surprisingly few trade actions directed at China

But, that could change quickly if U.S. economic growth slows

Sources of Friction

1.The impact on commodity prices of China's rapidly increasing imports

2.China's high savings rate and the resulting capital surplus

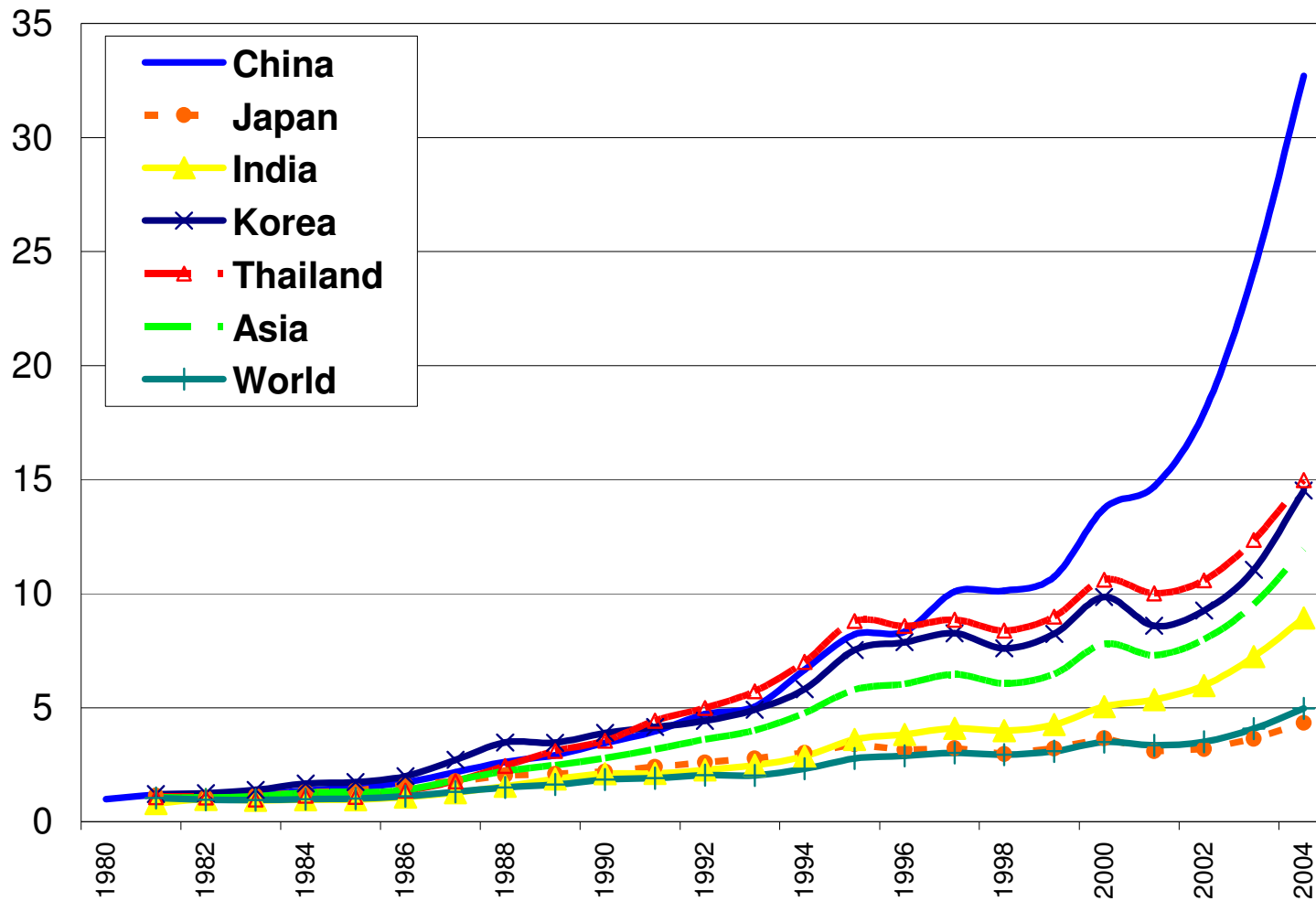
- Undervalued currency
- Capital to acquire sensitive assets abroad

3.Rapid increase in imports from China

One can debate the merits of each, but there is no question that each is readily subject to political manipulation

China: The Export Power – “Factory of the World”

Growth in Exports (Index, 1980 = 1)

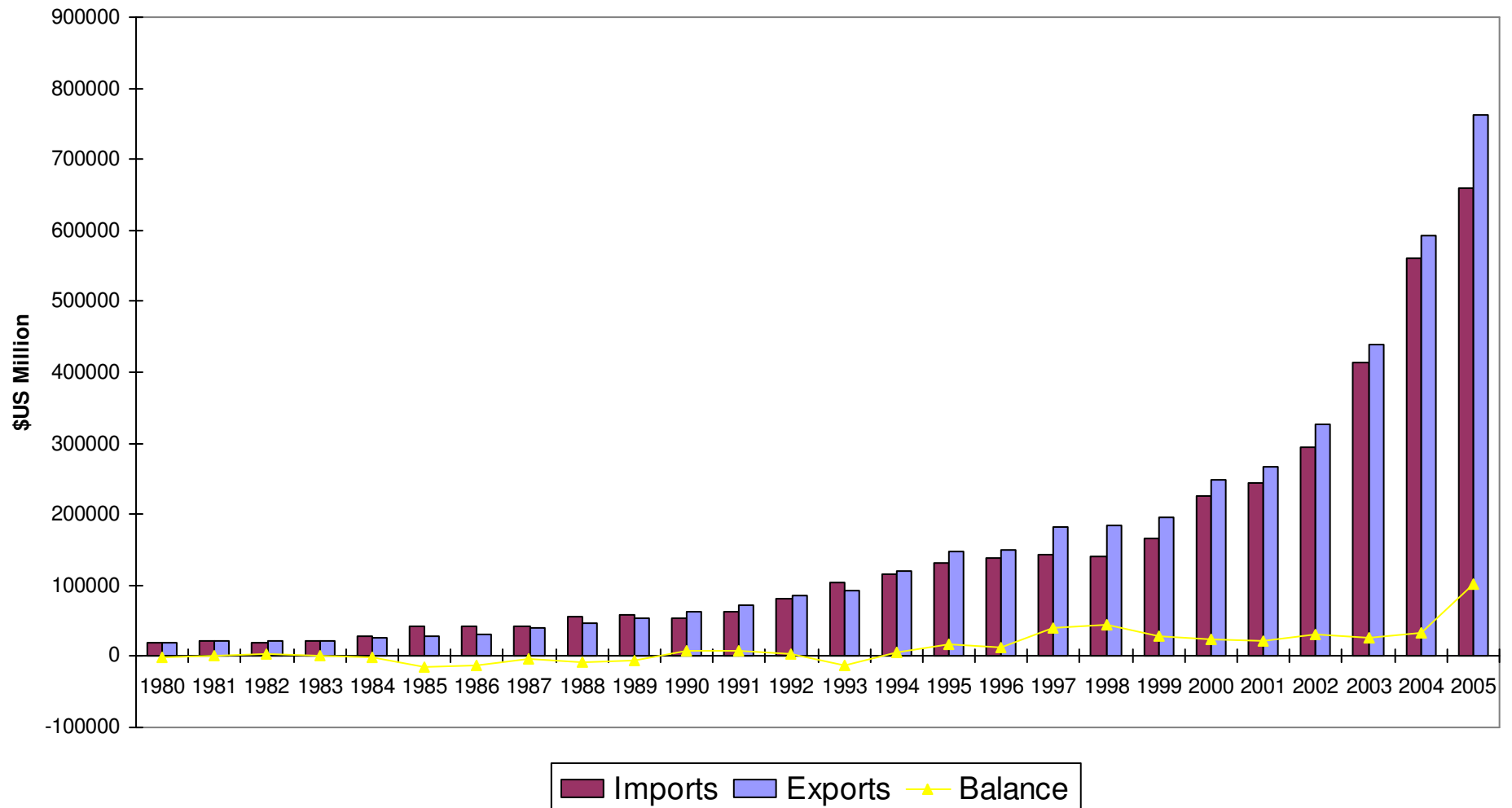


Source: IMP, Direction of Trade Statistics



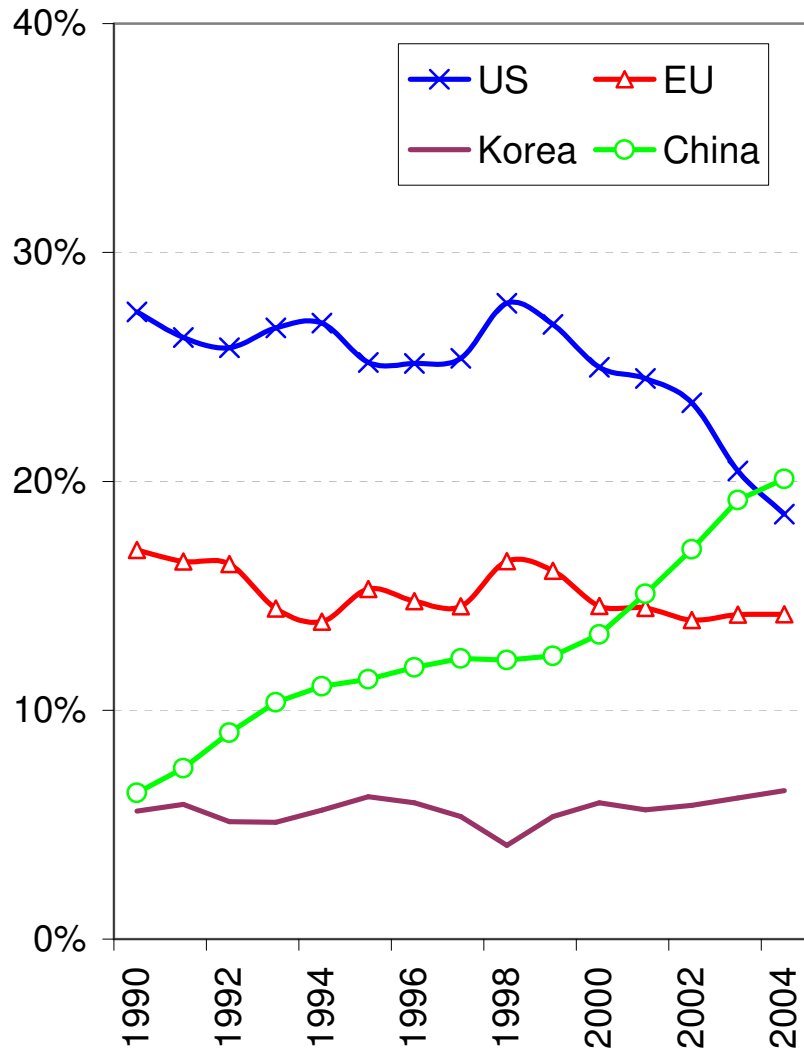
China has shown explosive growth in exports since 1997 while Japanese exports have essentially just kept pace with the rest of the world

China: Merchandise Trade



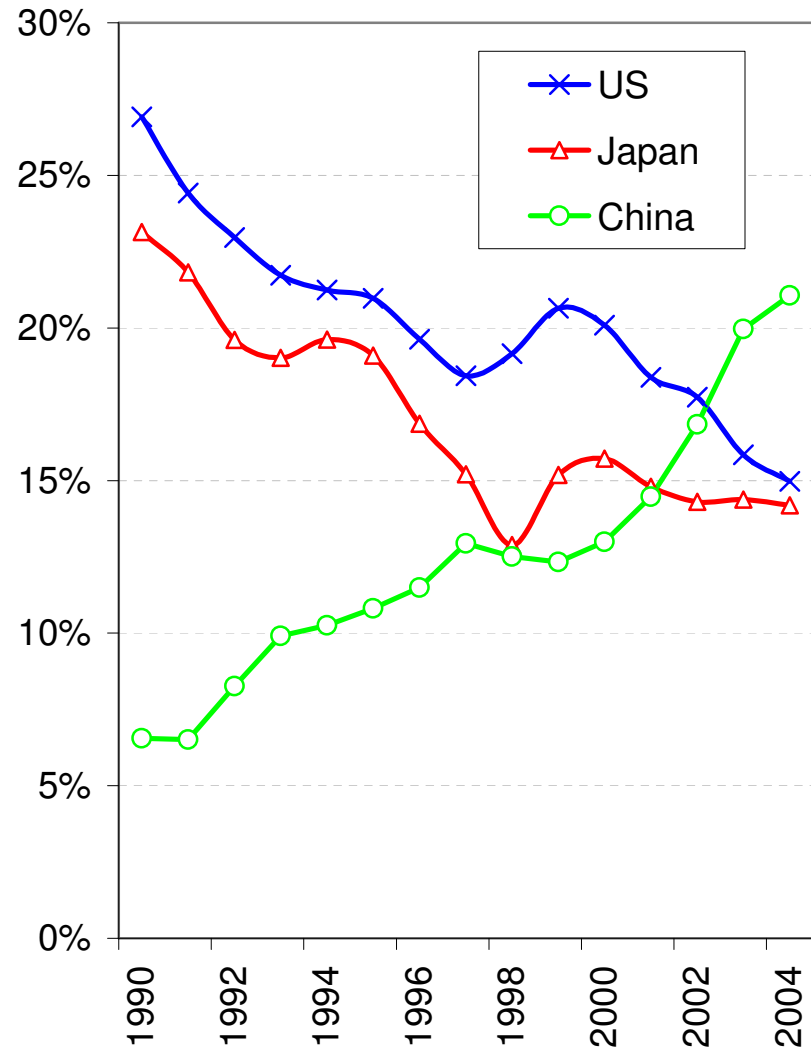
Until last year, China's trade balance with the world had shown only a small Surplus.

Share of Japan's Bilateral Trade



Source: Ministry of Finance/Japan Tariff Association

Share of Korea's Bilateral Trade

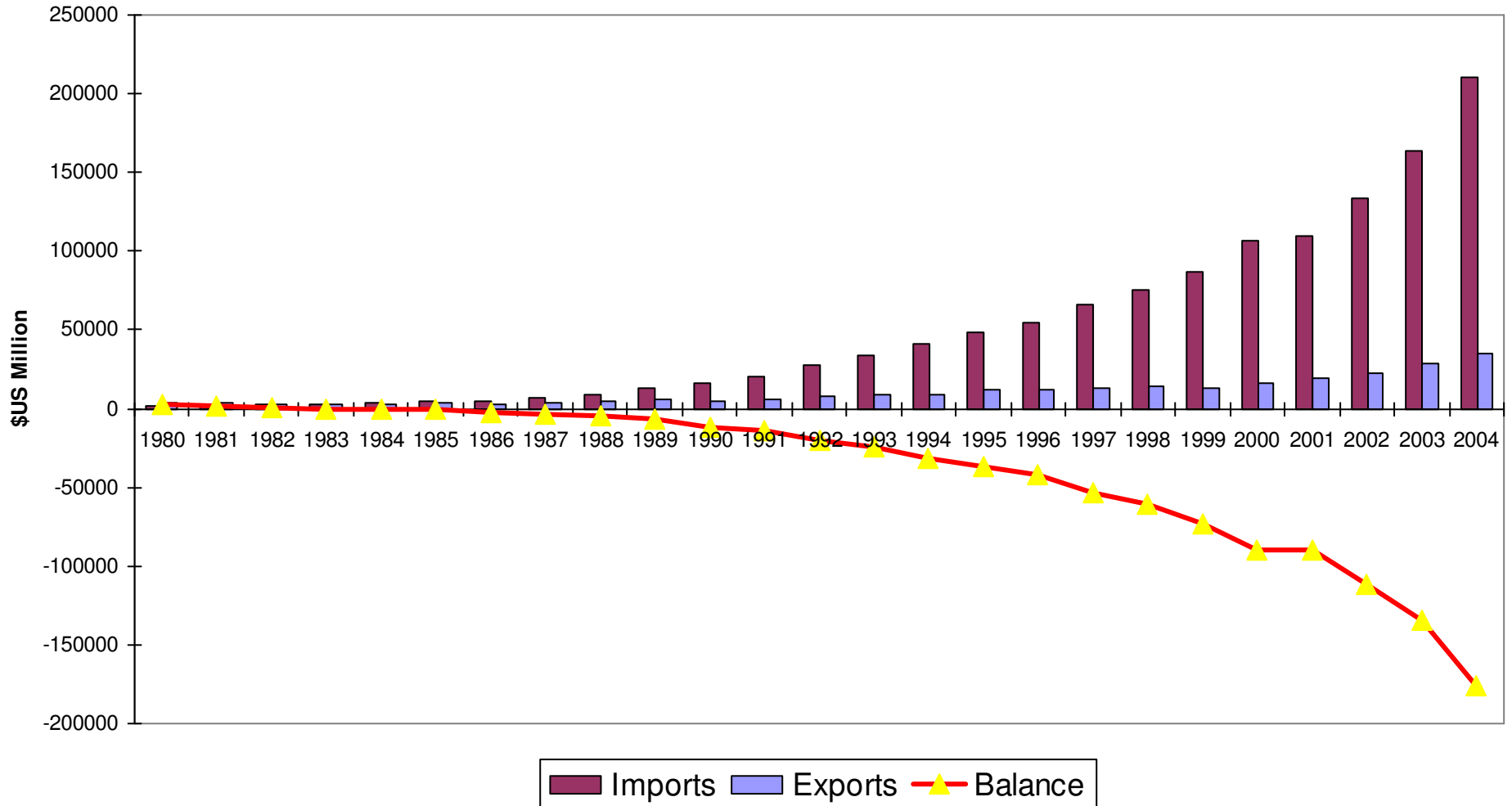


Source: S.K. Bureau of Statistics



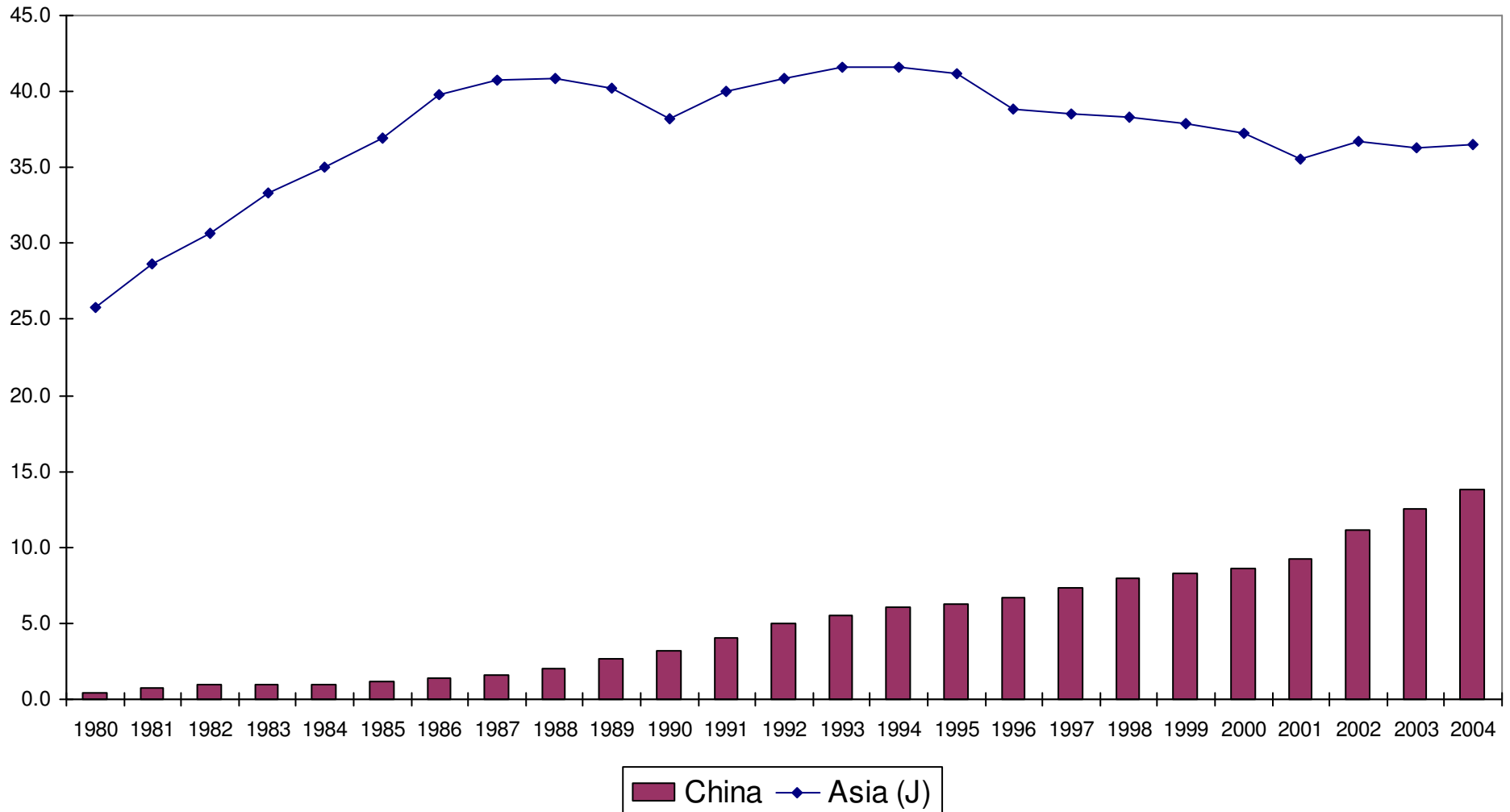
AP trade continues to become more China-centric

U.S.-China Trade



Trade with U.S. is a completely different story. China has run larger and larger

Share Of U.S. Imports



Asia's share of U.S. imports has declined, even though China's share has increased, which is indicative of China's emergence as the hub of U.S.-Asia trade

Efficient Division of Labor in Asia

China is increasingly the final assembly center

Other Asian countries export components to China for final assembly

The final product may be stamped “Made in China”

- But, significant value added originates elsewhere

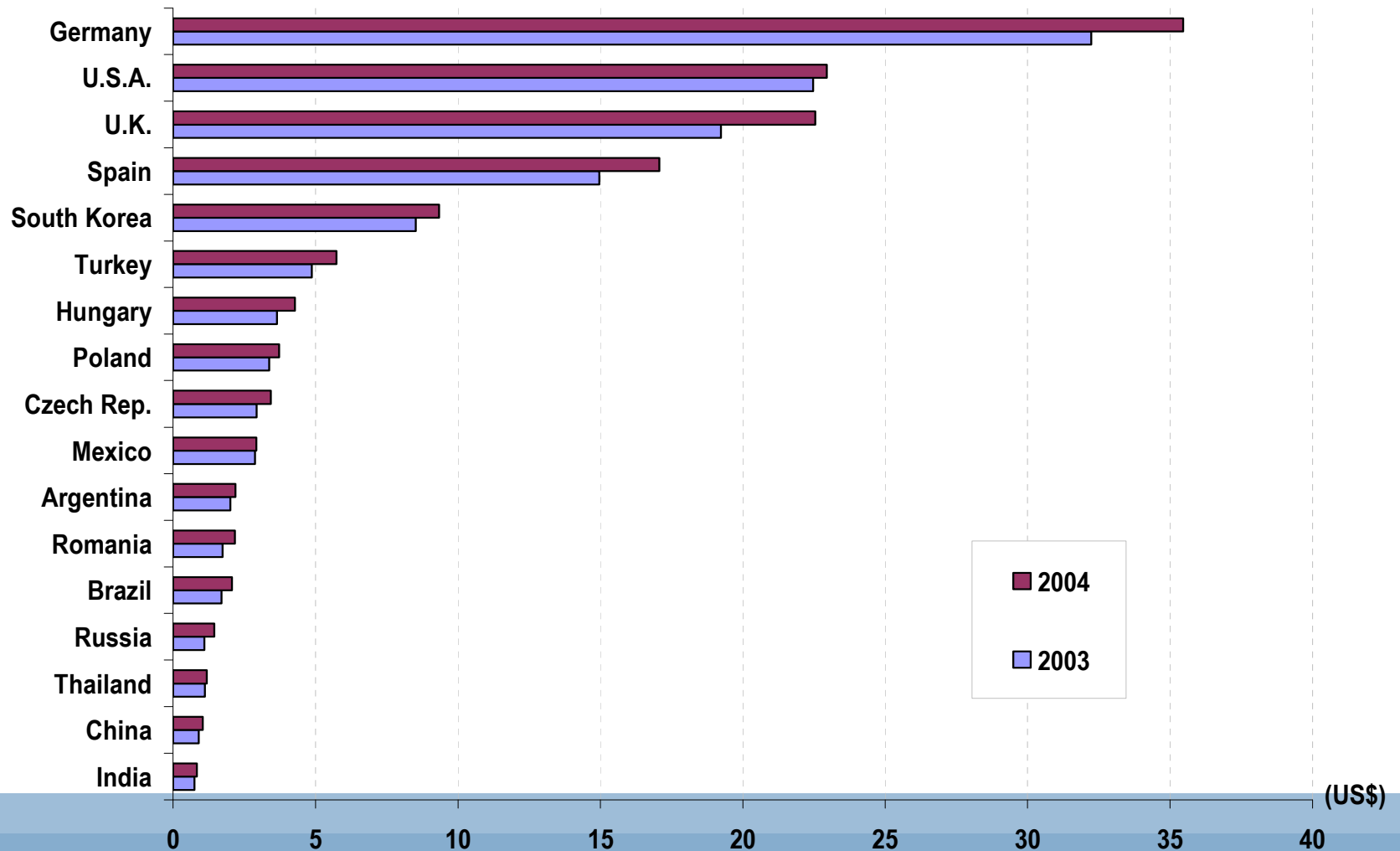
In short, China is increasingly replacing imports from other Asian countries into the U.S. – hence the lack of industry-specific trade friction

Of course, there are exceptions such as apparel and furniture

How long will that continue?

Labor-intensive manufacturing in emerging markets has a significant low-cost competitive advantage

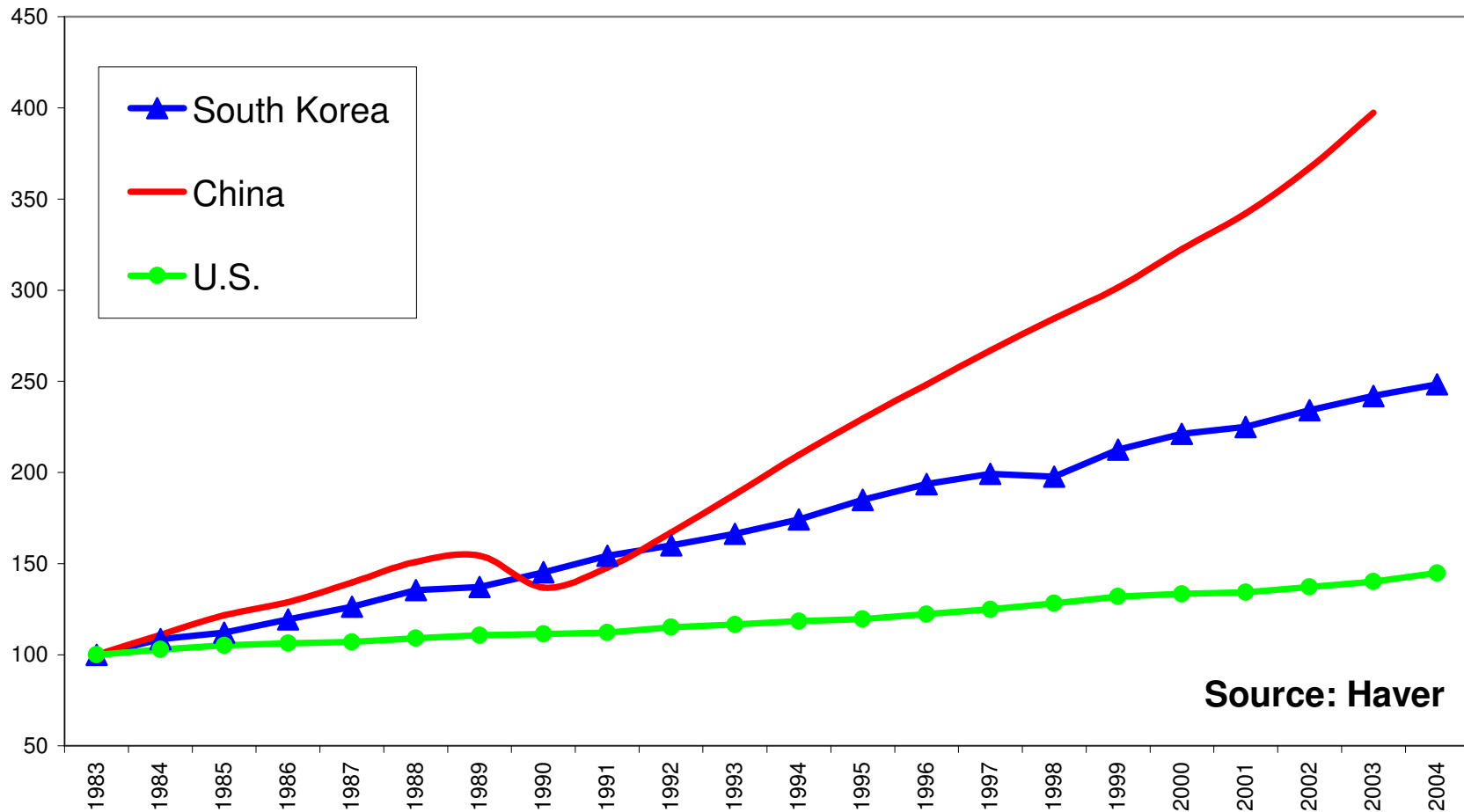
Manufacturing Labor Costs per Hour (US\$)



Source: ILO, UNIDO, US Dep't of Labor / EIU

Productivity Gains

Output Per Employed Person (1983=100)



China's impressive productivity gain comes from technologies and resource re-allocation from lower to higher value activities.

Trade Conflicts Will Increase

As China's exports move up the value chain and begin to displace U.S. production

Already a concern in the steel industry

Are auto parts next?

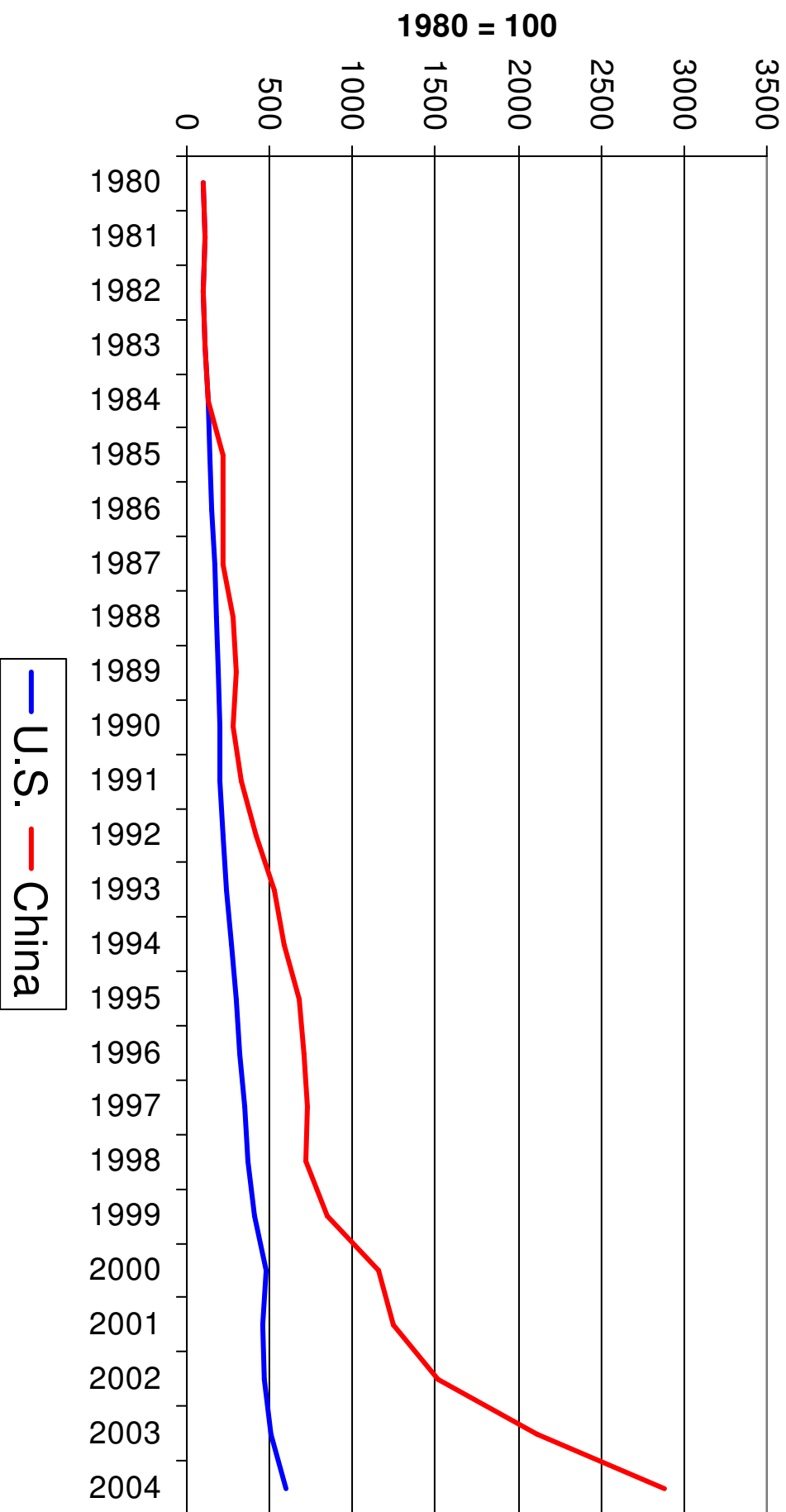
More likely if China is believed to be impeding U.S. exports and/or subsidizing its own exports

Resolution of EU/US WTO complaint could avoid some future conflicts

China: The Importer



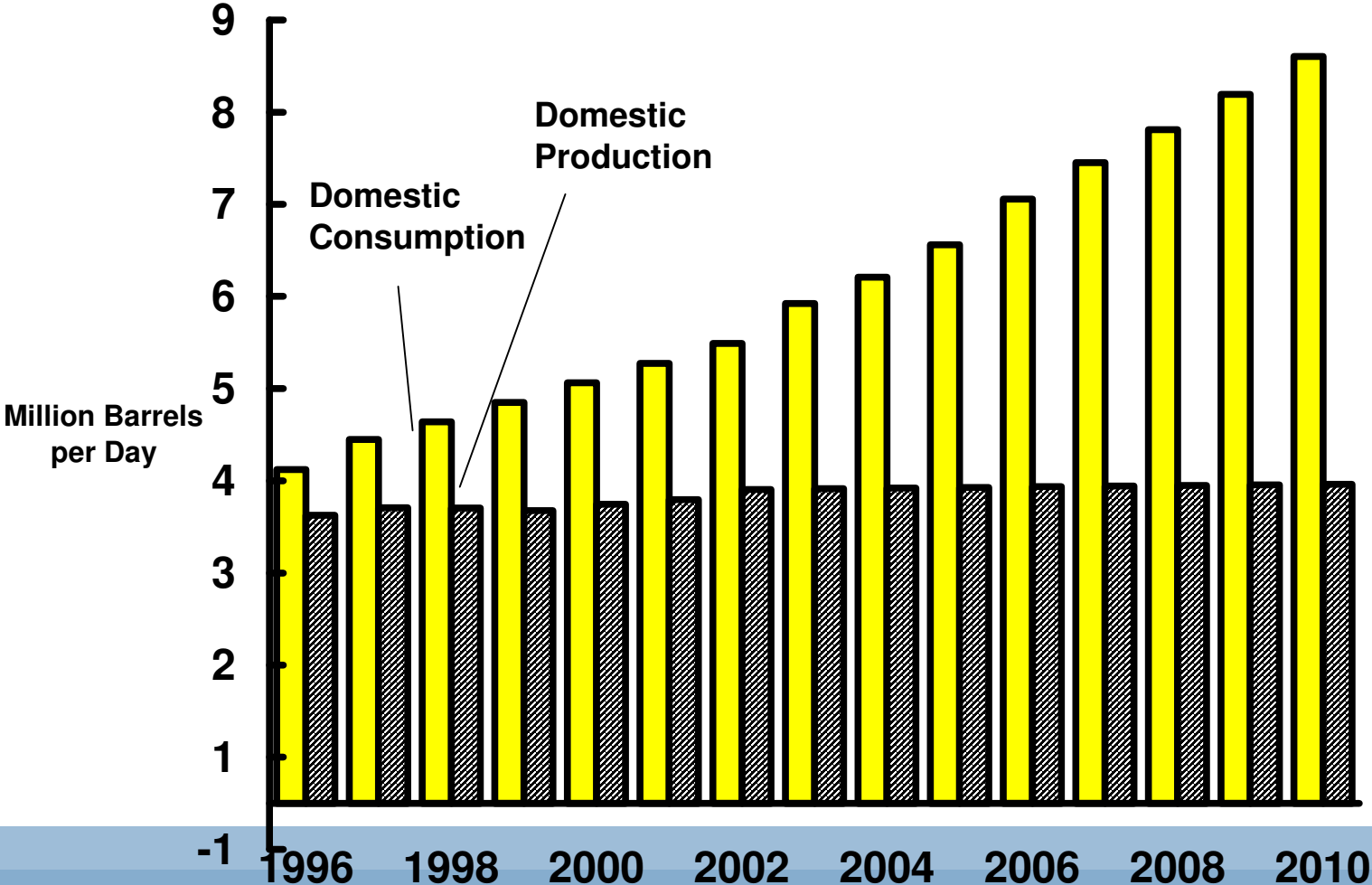
Import Growth



China's imports have also grown dramatically

China's Oil Supply-Demand Balance

CERA Forecast to 2010



Source: Cambridge Energy Research Associates.

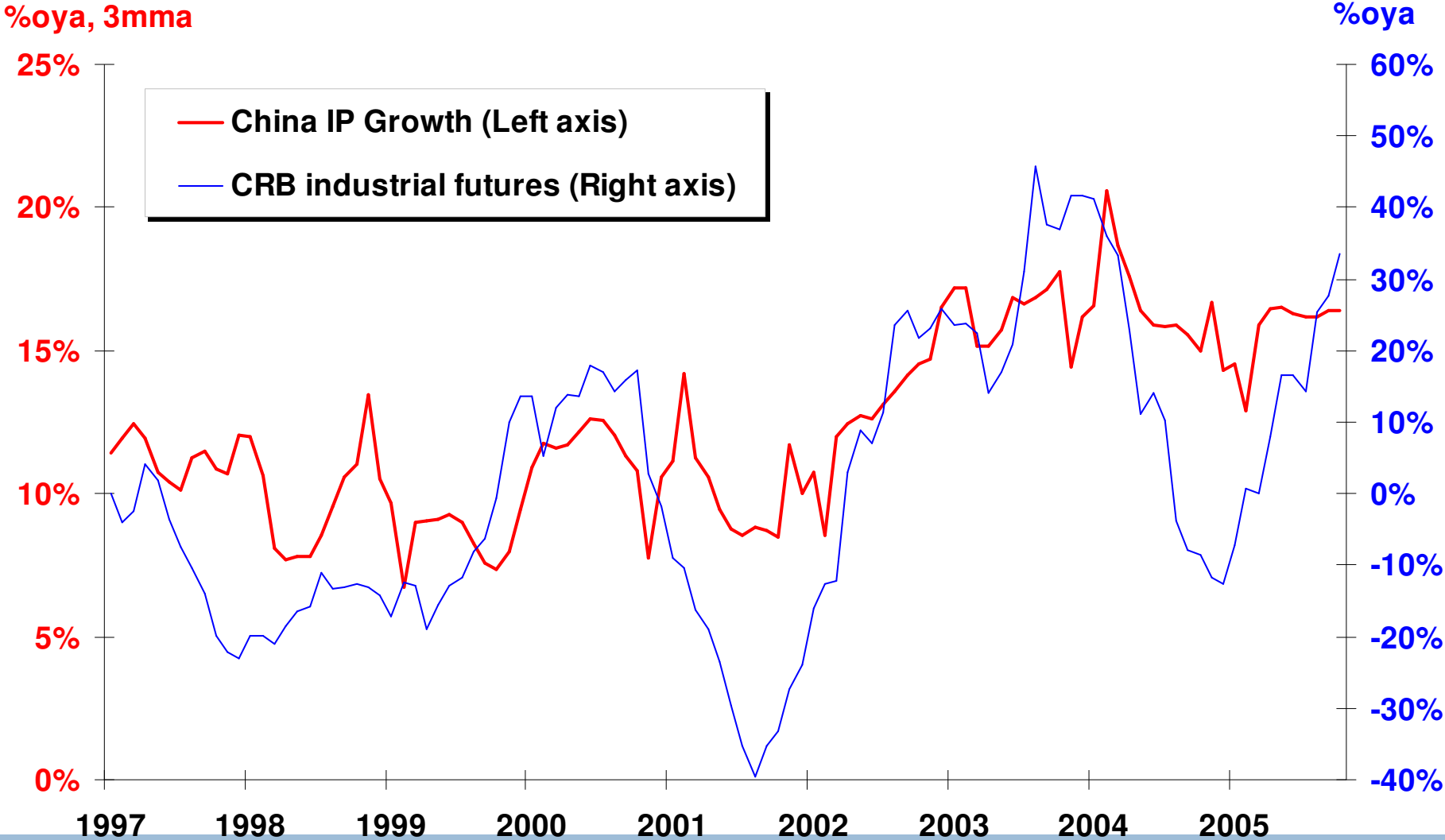
China and Global Commodities

	2002	2003	2004	2005
Steel				
% share of global demand	22.5	26.4	28	31.4
% share of global growth	76.4	78.9	41.6	81.7
Iron ore				
% share of global demand	31.2	33.8	38.3	45
% share of global growth	67.1	60.7	75.4	107.1
Aluminum				
% share of global demand	16.6	18.7	19.8	21.3
% share of global growth	-	44.7	32.7	57.3
Primary nickel				
% share of global demand	8.3	10.8	11.3	12.2
% share of global growth	-	47.9	33.7	34
Copper				
% share of global demand	17	19.8	21.1	22.7
% share of global growth	-	116.6	40.4	61.8

Source: JP Morgan



China IP growth and CRB industrial futures



Source: China National Bureau of Statistics, U.S. Commodity Research Bureau / Haver Analytics



China's Growing Demand For Raw Materials

Result in higher prices for industrial raw materials

- Impact will be felt worldwide
- Other users will face cost pressures
- Commodity producers will prosper

Result in conflicts with the US and other developed countries over resource ownership and development

Its not a zero sum game

- All will benefit if China expands supply

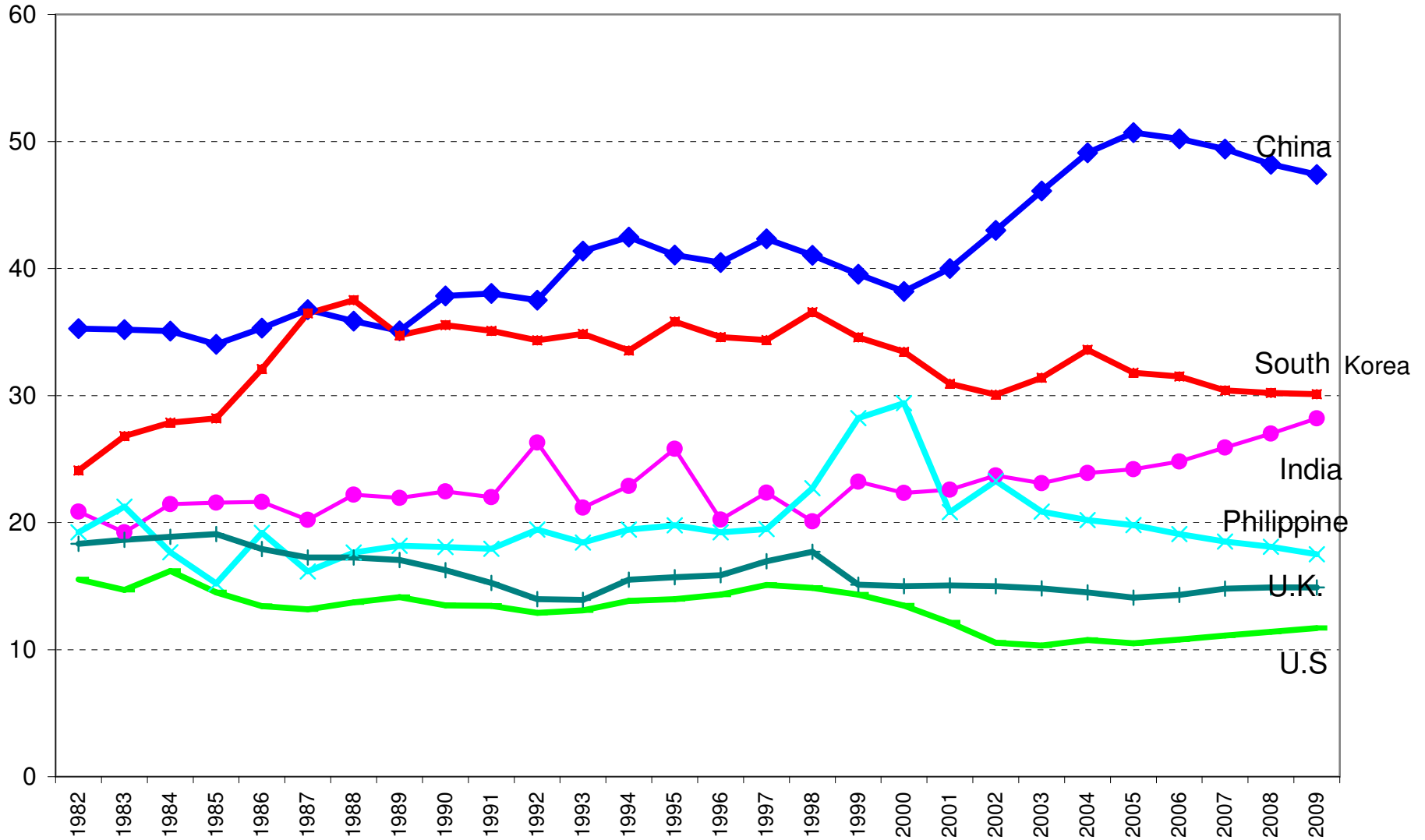
But, easily be manipulated for political gains

- Make economic sanctions less effective

China: The Financier

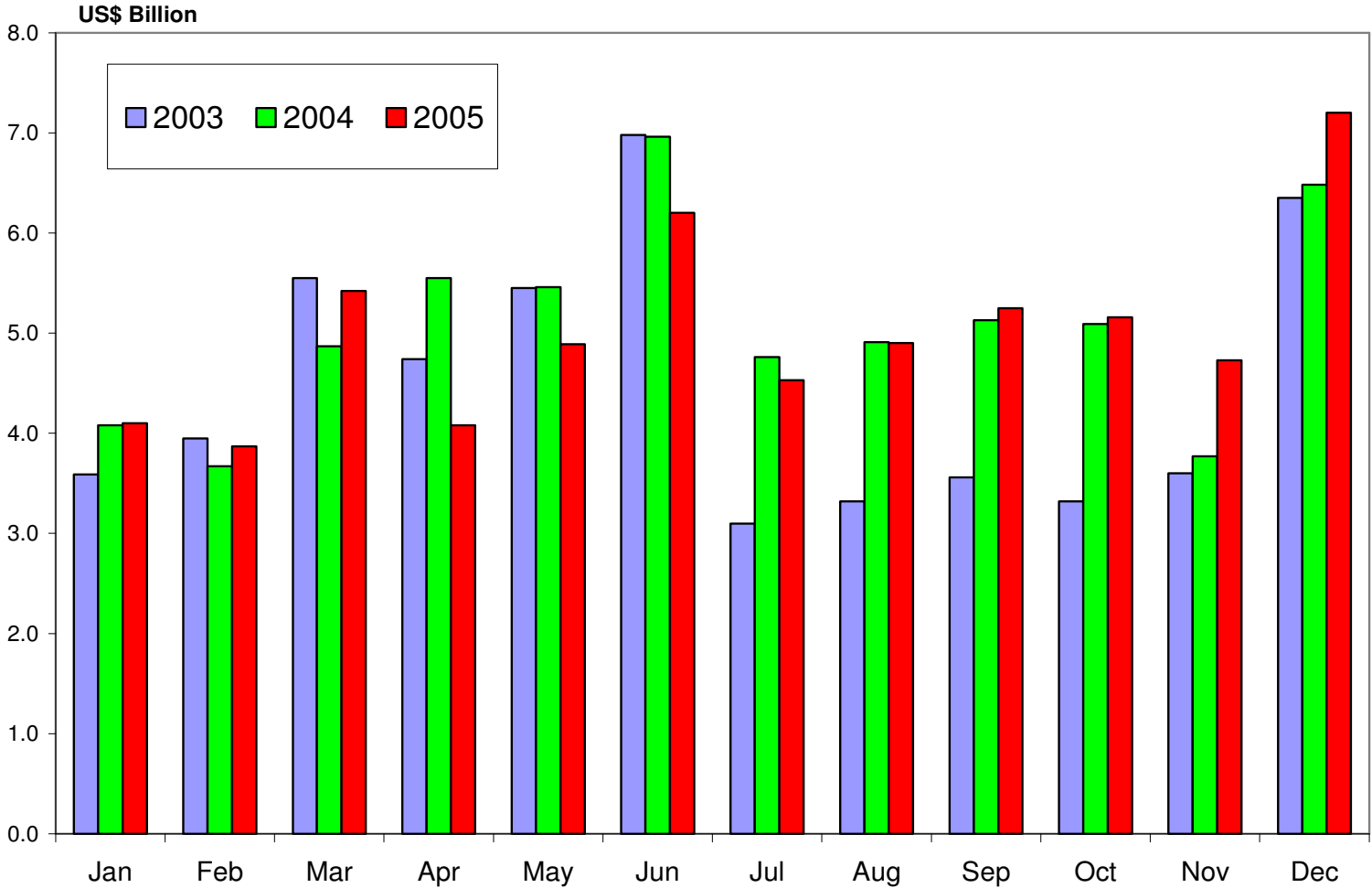


Gross National Saving Rate (%)



High Saving Rate Enabled the Economy to Grow on Investment.

China Utilized Foreign Direct Investment

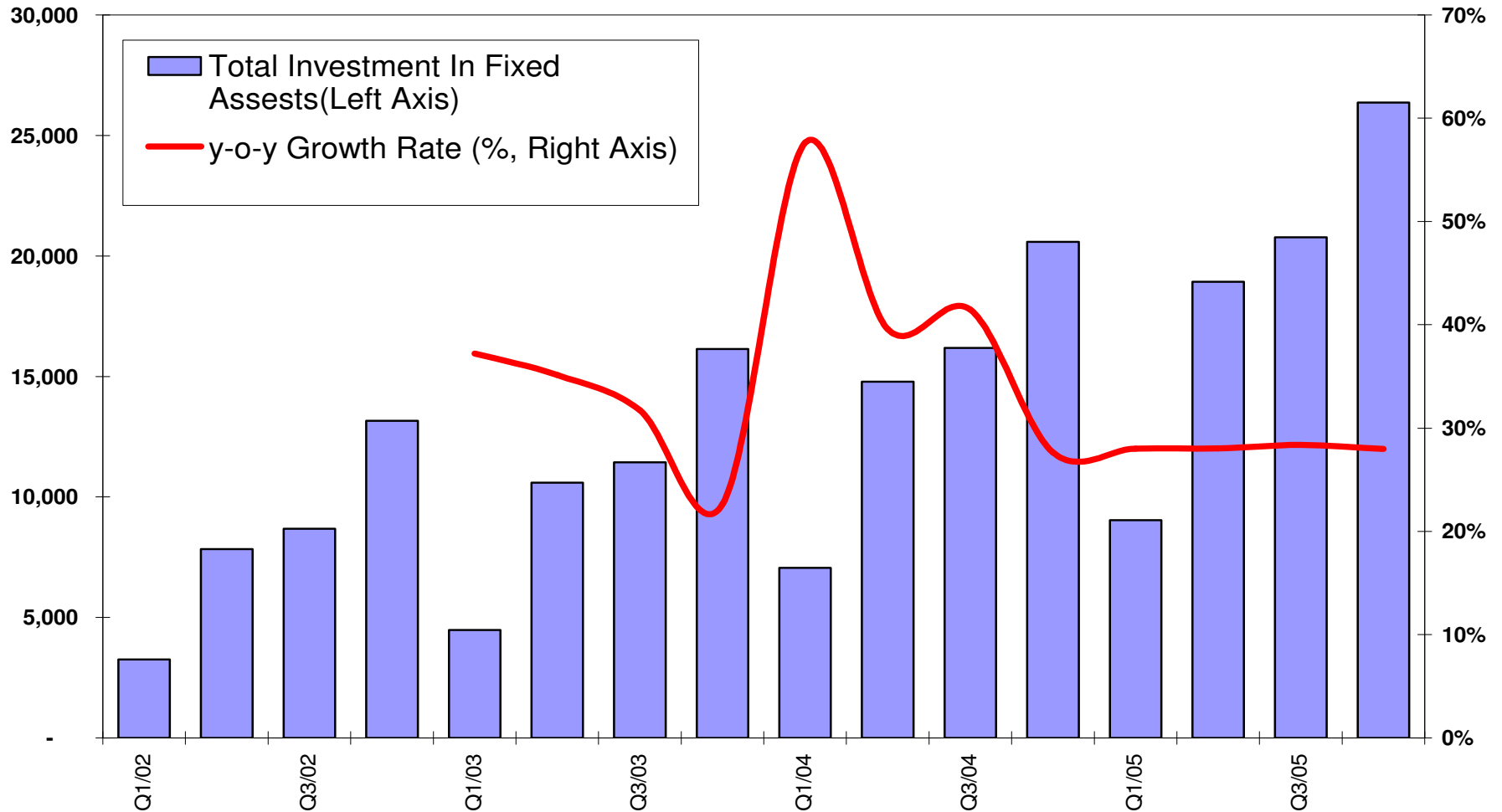


Source: China National Bureau of Statistics



In addition to its own savings, China is attracting substantial amounts of FDI

China: Quarterly Fixed Asset Investment (100 Mil. Yuan)

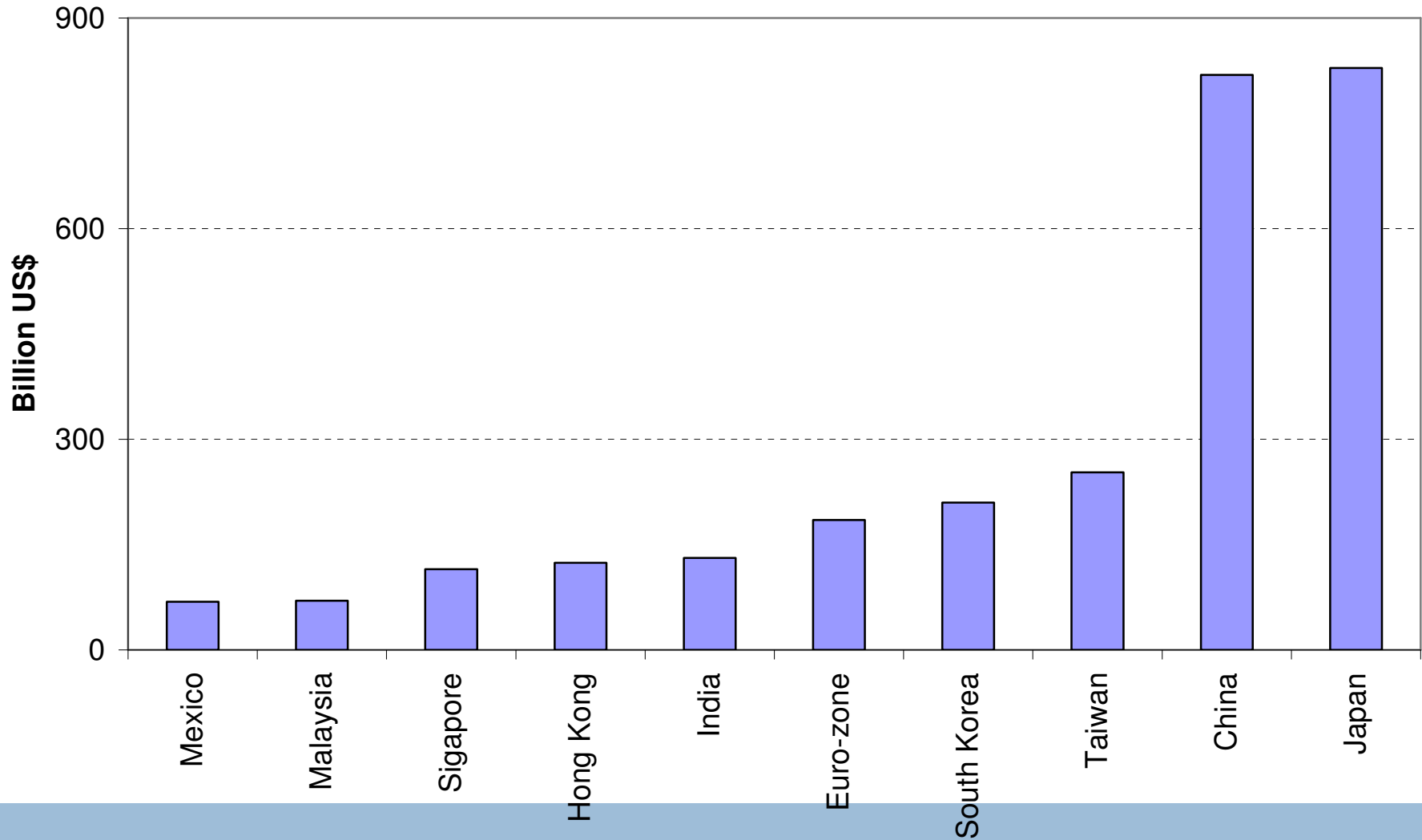


Source: China National Bureau of Statistics



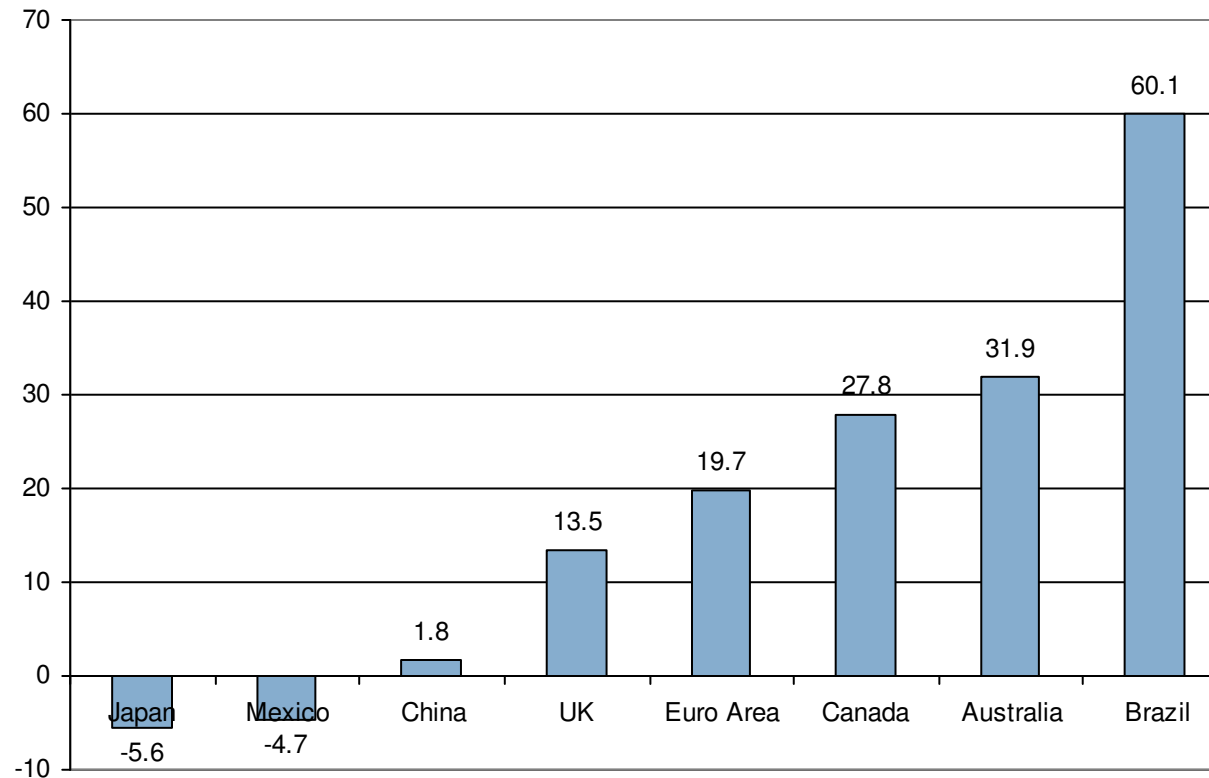
Domestic savings and large FDI inflows supporting high level of investment

Foreign Exchange Reserves December 2005



The sum of domestic savings and FDI exceeds domestic investment, resulting in rapid accumulation of FX reserves

Real Change Against the U.S. Dollar Feb 2002 – November 2005

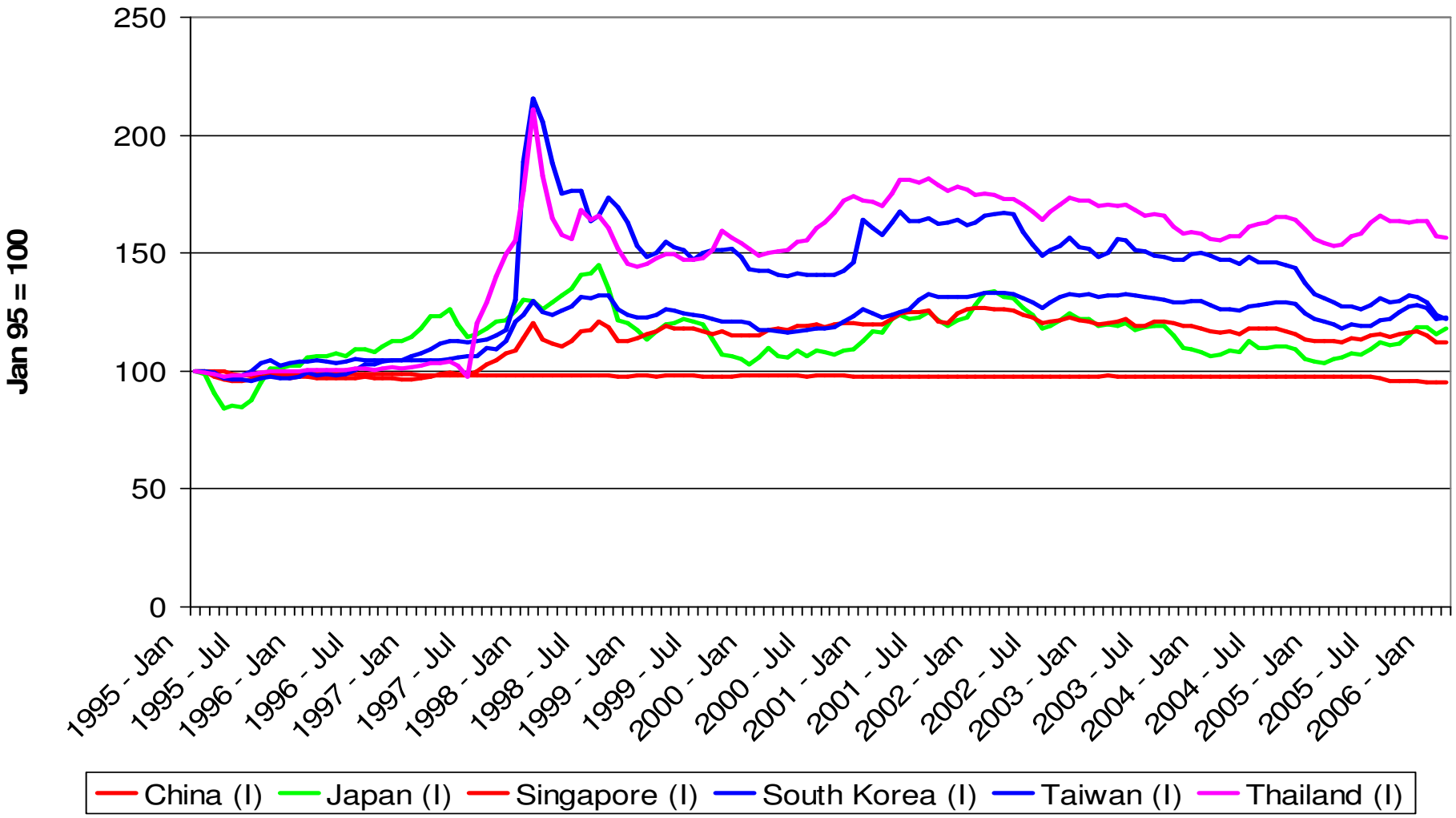


Source: William Cline, IIE



FX reserve accumulation keeps the RMB from appreciating

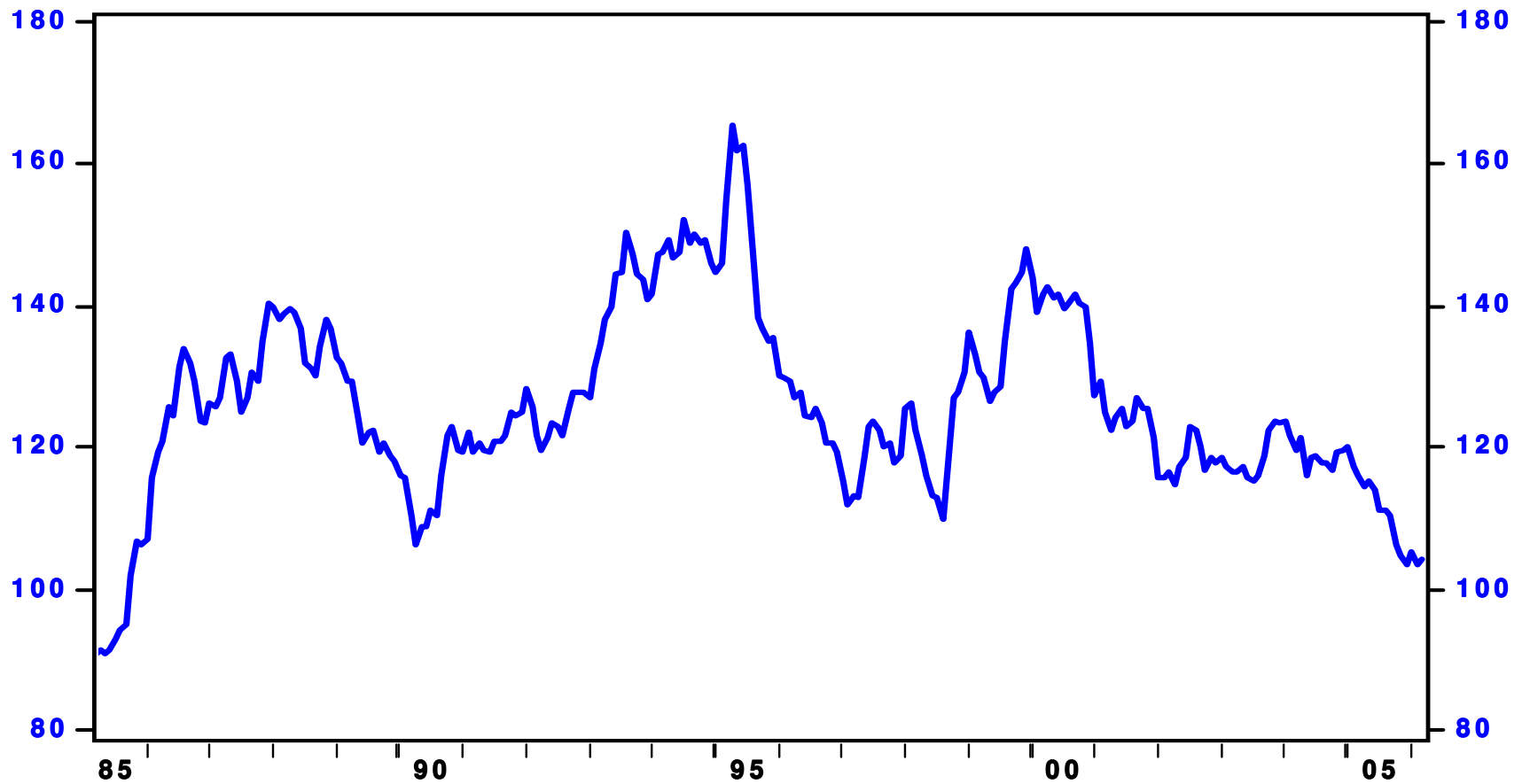
Asian Currencies



RMB has been the strongest currency in Asia since the 1997 financial crisis

Japan: Real Effective Foreign Exchange Rates

Mar 1973=100



Source: Bank of Japan /Haver Analytics

GM

This is especially true as compared to Japan

China will remain major capital exporter

Currency reserves indicative of capital misallocation

China's savings will be invested in higher yielding assets over time

- Global equities
- Purchases of foreign companies
- Acquisition of natural resources production

U.S. will complain about currency implication, but enjoy resulting lower cost of capital

- China enabling “guns and butter” policy

But, issue is easily politically manipulated

Implications for Auto Industry Growth

China's auto Industry is poised for continued rapid growth

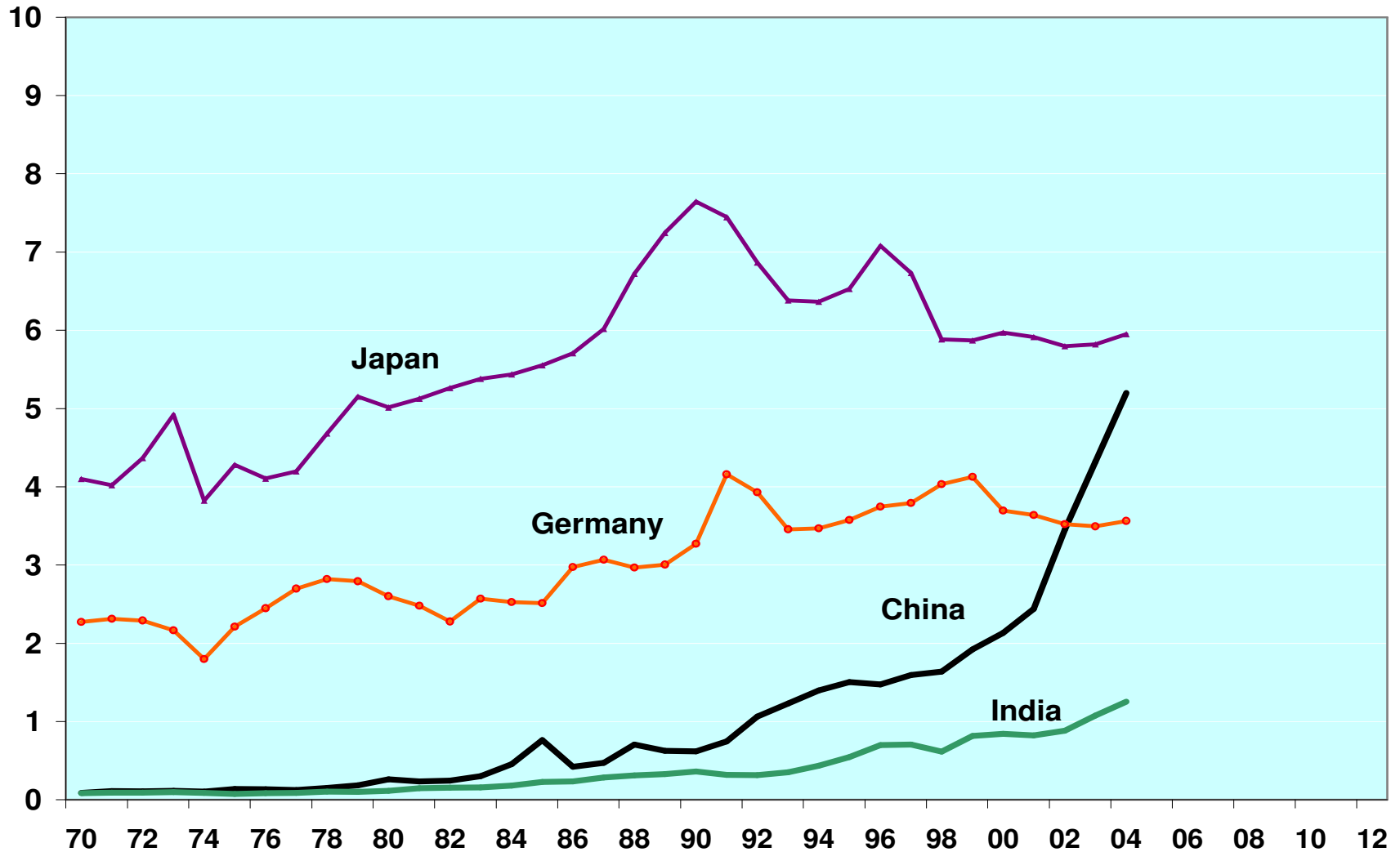
- Incomes are rising
- Affordability is improving
- Product choice is greater than ever
- Government policy remains supportive

China remains attractive for foreign OEMs

Chinese-owned companies will play a significant role in future growth

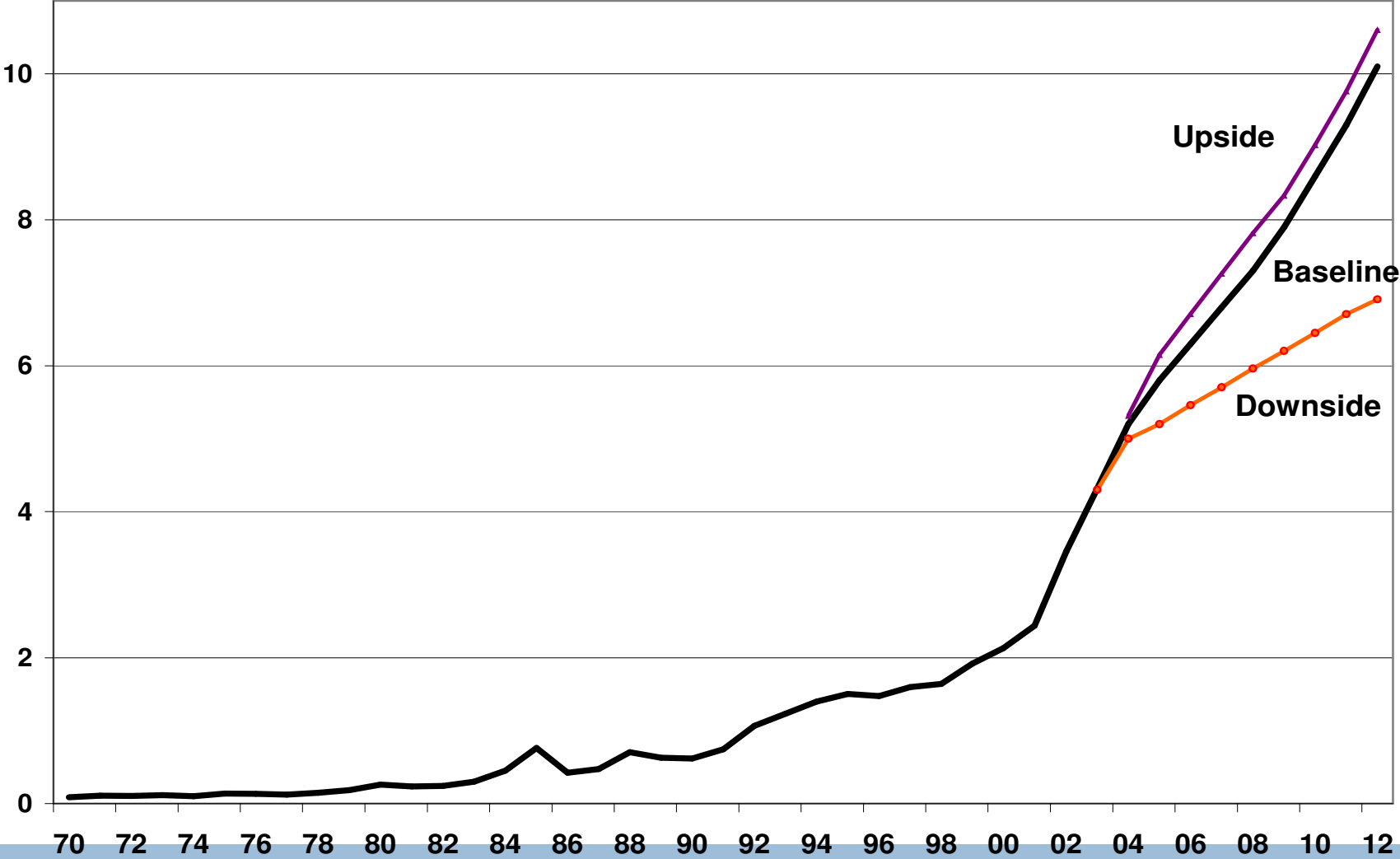
Total Vehicle Sales: 1970 - 2004

Millions



China vehicle sales projections

Millions



Summary

Auto sales in China have grown explosively since WTO accession

The fundamentals for future growth are well established

Industry demand will grow fast enough to attract

- Investment by foreign multinationals
- Chinese-owned firms seeking to profit from rapid industry growth

The risks are primarily political

- Pace of domestic reforms, especially in the financial sector
- Access to foreign markets

The government of China has proven adept at managing these risks

- No reason to believe that will change

