



China's economy

– Where is it heading?



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Economic growth in China has slowed down and we have seen dramatic stock market losses and shifts in exchange rate policy. Since a large part of NCAB's manufacturing is in China, we are, in this edition, focusing our attention on what is happening with the Chinese economy.

We turned to Henrik Unell, currency strategist at the major Nordic bank, Nordea, in Stockholm, to help us shed some light on developments in China.

Last summer and the period around the New Year saw major stock market falls. What is actually happening in the Chinese economy, and what are the root causes?

"To start with, it is important to understand that there is a significant difference between the real and the financial economy. The real economy, which comprises the actual movement of goods, services, natural resources and labour, is only vaguely connected with what is happening in the stock market. Only a small proportion of China's population, maybe 10%, is affected by fluctuations in the stock market.

"When the Shanghai Stock Exchange rose around 130% between September 2014 and June 2015, that had nothing to do with how the real economy was performing. Ditto when the same stock market later rapidly fell 50%, the Chinese economy did not suffer any major damage from that event, things remained pretty much the same as prior to it.

"At the same time, we have quite clearly seen a knock on effect in the Western stock markets, both in the summer of 2015 and over the New Year period. The reason that there is such a clear risk of infection is due to the West beginning to harbour doubts about China's business model, and that's where the real economy comes in."

Figures show that economic growth has slowed in China. What are the implications of this?

"For a very long time, China was returning double-digit annual growth. It experienced a major downturn in the wake of the financial crisis in 2008, but by 2010 the growth rate was again exceeding the 10% mark. Since then, the official growth figure has dropped to 7%. However, the official statistics are being challenged, and all the major



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banks apply own models to estimate the actual Chinese growth. They look at other activity indicators, such as rail transport and electricity consumption, to gain an idea of the level of growth. Some scepticists estimate growth is as low as 3%, while others argue that it is 5-6%.

"The world could probably live with a situation where China moves to a 5% rate of change from a previously high GDP growth rate. But at the same time, there is concern that actual growth may be only be 1-2%. So what we are seeing, is the embryo so to speak, of a negative scenario that's taken shape due to China doing precisely what the West did, by borrowing money to speculate in the financial economy and real estate.

"If the fears of a 1-2% Chinese growth rate turn actually materialise, we would see an even bigger fall in the country's need for raw materials. That would lead to an implosion of the commodities market - which has been in decline for several years. It would have a devastating impact on many third world economies, and even hit the West hard, with falling stock markets. It would also add to the problems of the central banks in their efforts to get inflation going.

A downturn in growth and production in China would also lead to reduced demand for the machinery that the western world exports to Chinese industry."

What is behind the slowdown?

"We are witnessing [the beginnings of] a shift in China, from a purely export-oriented manufacturing economy to an economy that is increasingly driven by domestic consumption and the service sector. Nevertheless these changes will not make themselves felt overnight. The demographic trend, with the one-child policy starting to affect the age structure of China's population, is also a long-term change. However, as I see it, the direct explanation for what is happening now is the sudden standstill that has hit the massive construction boom of 2005-2011.



China real GDP growth. Economy is still struggling but has not dramatically deteriorated in the past few months. Source: Nordea Markets and Macrobond

"Another problem is that China has invested in a production apparatus that is being used less than expected. The manufacturing industry is suffering from excess capacity and many factories are un-

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profitable and returning lower profits. Through the banks, the state continued to subsidise the production apparatus, initially enabling the plants to survive, but now they are beginning to go bankrupt. It is a necessary process. You can't keep unprofitable factories going if you want to revitalise the economy. It's a painful fact, but a crucial one if China is to attain long-term sustainable growth."

How important is domestic demand and consumption in China's economy today?

"China is still an economy with low levels of private consumption compared to the West. The overall consumption is equivalent to 25% of GDP, which compares with 75% in the US and 50% in Sweden. The problem is that a prerequisite for increased consumption is that households need to have an optimistic view of the future. However, the Chinese tend to save more because the future seems very uncertain to them, this is also due to a weak safety net in the form of pensions for old age security. Now we are also seeing real wages at a stand still. They used to grow at a rate of 5% annually, adjusted for inflation and productivity, but now their real growth is down to around zero. That does not exactly help to boost confidence among households."

How significant is the weak price trend on the real estate market and what does the future have in store on this issue?

"Up to 2013, we saw a huge rise in the price of real estate in China. Since then, the market has experienced a downturn. The government allowed a market correction, which led to minus figures for a short



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time and now we are seeing modest annual growth figures in property prices. However if you look at disposable income in relation to the price situation, there is reason to ask how it is all going to work out.

“China’s financial exposure is largely in real estate, which can certainly be problematical in the future. Partly due to prices being at a level that makes it hard for buyers to afford a home, and partly due to fears of a property bubble, caused by dollar-funded real estate investments. Currently, the stronger dollar is making it difficult for borrowers to pay off their loans. They are having to rollover their debts and take new loans to pay the interest for their existing debts. Estimates say that these rollovers account for 30% of the loans on the capital market.

“This further complicates the shift to consumption-steered growth in China, since it is the private sector which has shouldered the real estate debts. China’s debt is reasonable in relation to GDP, but the total debt is high when you include the private real estate debt. This is where the presumed faulty allocation of monies can be found, where people in China, through property speculation, have allocated to incorrect risk premiums; in other words repeating exactly what earlier happened in the West.”

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HENRIK UNELL, CURRENCY STRATEGIST, NORDEA

What are your views on China’s currency policy?

“Given that the Chinese funded their loans in dollars and invested in the Yuan, on the assumption that it would rise against the dollar, the announcement of the devaluation in August 2015 came as a real shock. The Yuan had appreciated against the dollar since 2005. With the reverse now happening, people started getting really jittery. But this devaluation was necessary due to the strong performance of the US dollar from 2014 onwards. The Yuan was pegged to the dollar, and suddenly became unaffordable. China was already experiencing issues with high wages within the manufacturing industry and this led to a strengthening of the competitiveness of other countries in the region.

“The appreciation of the Yuan constituted a threat to China’s growth figures and the transformation of the economy. The Chinese authorities then announced they were leaving it to the market to determine the exchange rate. However, the Yuan lost 3 to 4% of its value in a matter of days, which led to the authorities changing their minds again. The problem is that China would need to cut interest rates further and get the economy going through increasing liquidity, but then they would risk an outflow of capital from the country and their foreign exchange reserves drying up.

“Another aspect is that the Chinese authorities’ intervention seemed badly thought out. It was an immature way of tackling a new problem. To some observers it seemed as if the state financial institutions did not know what was going on, which made the [capital] markets even more uncertain. The higher the perceived risk, the higher the cost of capital. Investors are loath to risk their money unless they perceive the infrastructure as reliable and efficient.

“Today, China has abandoned pegging its currency against the dollar and has since January this year balanced the convertible currency CNH against a trade-weighted basket of currencies in which the dollar is included, along with the currencies of its other major trading partners. The Yuan is not being allowed to lose too much of its value against the currency basket. The powers that be are hoping that the currency can be stabilized at a value where the country’s foreign reserves can be protected and its industry still retain its competitiveness. However, there are relatively heavy players in the world, including



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some hedge funds, who question the credibility of this approach.”

What might happen in the future?

“Despite the fact that China’s leaders have not actually expressed any intention of devaluing, there is much to suggest that the Yuan is too strong. China’s current account surplus is now more or less nonexistent. The major sticking point is whether China will loosen its grip to obtain a weaker currency and thereby achieve higher growth. What will happen then is that everyone else in Asia will devalue, which will lead to imports becoming even cheaper for the western nations and, in turn will make it harder to get inflation going.

“To hazard a guess, I’d say China will find itself having to continue on the devaluation trail. Judging from the signals we’re getting from China - such as its stock market movements, the panicky handling of the currency situation, the risky financial sector and weaker economic growth - the problems are more serious than they have been letting on. In any case, I think if you are in China you need to take that kind of risk scenario into account. One should focus on the issue and closely examine the risks, perform a stress test of your own business model. It is important not to be caught off guard if China actually devalues.

“This would mean that parties running manufacturing operations in China would, among other things, need to consider carefully who they do business with, because devaluation increases the risks of companies collapsing due to a lack of resilience or knowhow to survive in new economic reality with weaker growth. Today it is more important than ever to choose factories that are financially secure.”

What is driving the strong US dollar?

“Initially, it was driven by America’s expected rate hike cycle. The Americans have come further than Europe in their debt rehabilitation efforts following the financial crisis. The US were quicker in sorting out their bad loans. The US is perceived as healing in a way that the rest of the Western world has not managed, and this has raised expectations that the Federal Reserve will be the first to launch a rate hike cycle. The Fed also raised interest rates once, with the result being that all other currencies were depressed against the dollar, which has become the locomotive that pulls the entire world.”

Will the dollar continue to strengthen?

“I believe in a continued strong dollar, although I don’t think it will continue to strengthen further. The exchange rate might possibly price rise a bit more. My belief in a strong dollar is simply because I cannot see any other country picking up the tab in the ongoing currency war. No other currency would be able to handle the appreciation resulting from any fall in the dollar. The Yuan would have been the natural heir, but as we have already seen, it will not happen now. There is simply no alternative to a strong dollar.”



“Operating at less than full capacity is a disaster for PCB production since the chemical processes deteriorate if they are not used up quickly. We feel confident in our choice of plants because a relatively large proportion of their production goes to exports.” Anders Forsén, CFO NCAB Group.

“Having the right partners is more important than ever”

What then, are the implications of the economic situation in China, specifically with regard to PCBs? Anders Forsén, CFO at NCAB Group, says that the Chinese PCB factories will have to face a new reality.

“The past 10-15 years we have seen the factories operate under conditions of constant growth. Everyone’s focus has been on building new and better plants and investing in increased production capacity. Demand has really never been a limitation. During the downturn in 2009 that followed the financial crisis, the Chinese government stepped in and invested heavily in telecommunications infrastructure, but we can’t really see any signs of that happening this time,” says Anders Forsén.

“Operating at less than full capacity is a disaster for PCB production since the chemical processes deteriorate through lack of use”

ANDERS FORSÉN, CFO, NCAB GROUP

The management at the factories are finding themselves in an unfamiliar situation, suddenly having to run operations that are no longer growing at the same pace. The smaller plants that are lacking export outlets have been hit particularly hard. This is because of a stagnating domestic market, due to the absence of any major new government projects. With the factories running at reduced

capacity, quality suffers and they find themselves struggling to survive.

“Operating at less than full capacity is a disaster for PCB production since the chemical processes deteriorate if they are not used up quickly. China has often supported the unprofitable factories with state funding, but we think that this support will be cut back. This increases the risk of more bankruptcies,” Anders Forsén explains, and continues:

“Choosing such a plant constitutes a major risk of the customer being landed with an inferior product, which can increase costs considerably if it leads to the failure of the final product. We feel confident in our choice of plants because a relatively large proportion of their production goes to exports.”

LOCAL PRESENCE AN ADVANTAGE

It can be hard to obtain financial information about factories in China, not least because many of them are owned by private companies. This makes it difficult to assess the risks involved when hiring a specific factory. This is where having your own organisation on the ground in China is an advantage.

“NCAB has a very close relationship with its factories and the risk of having to face unexpected surprises is very small. We have



Anders Forsén, CFO, NCAB Group.

a large team in China who closely follow what happens at the factories. For example, we monitor the factories' production levels every month. We have our own personnel involved in quality control in the factories, so we can follow what is really happening and detect early warning signals if a factory is experiencing problems," says Anders Forsén.

The choice of the right factory has always been important, but with the risks involved now, it has become more critical than ever. A sustainable end product requires reliable partners.

DEVALUATION NOTHING NEGATIVE

"As regards a possible future, further devaluation of the Yuan isn't really a negative thing for NCAB, which has 95 % of its manufacturing located in China. Our factories buy much of their raw materials and production equipment on the world market and pay in dollars. Thus, a weaker Yuan does not impact on the final price of the boards," Anders Forsén continues.

"For NCAB's part, it is our business to minimise risks on all fronts. Much of the electronics industry is dollar-based. To ensure stability in the future and avoid currency risks, we set our prices in dollars and most of our funding is in dollars. For customers, this brings greater transparency, regardless of what direction exchange rates might be moving and we don't have to include a safety margin to cover any foreign exchange losses," says Anders Forsén.

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ANDERS FORSÉN, CFO, NCAB GROUP

Thus the main message as regards the way the economy is shaping up in China is that the situation does not in itself put those who buy PCB there at a disadvantage. Although the increasingly fierce competition brings new risks when it comes to choosing partners – a process that calls for a careful and well-informed approach.

TIPS IN THE LIGHT OF THE SITUATION IN CHINA

- In an increasingly competitive situation, it is usually the smaller factories and those who don't export any of their products who are likely to have serious difficulties to maintain full capacity. Production processes must be constantly running so as to avoid quality defects. The only parameter they will then be left to work with would be price - which in most cases leads to bankruptcy.
- Choosing a reliable and strong partner becomes even more important in unsteady market conditions.
- Even if the Yuan were devalued, much of the factories' purchases are in dollars. Moreover the cost, for example, of electricity, water and environmental charges will increase rapidly. Thus, devaluation may not impact to any great extent on the final price of PCBs.
- Those with a high volume of transactions in dollars, may also find it beneficial to arrange their funding in dollars.



Jerry Fu, Production Quality Engineer, NCAB Group China, is performing an audit. The choice of the right factory has always been important, but with the risks involved now, it has become more critical than ever.

Introducing our conscious component

In order to make the NCAB sustainability work more present and visible, the branding concept "Conscious Component" was developed during 2015. It incorporates the vital dimensions of ISO 26000, Environmental, Ethical and Social, which illustrates that we take full responsibility in everything we do.



Questions around the world: What impact have recent developments in China's economy had on your market?



USA

BARRY ZIELKE

General Manager, Central Region,
NCAB Group USA

"Historically, economic developments in China have turned out positive for the PCB market here in the USA. Competition from China changed the entire industry. The only local PCB manufacturers who managed to survive were the innovative producers. Many OEMs were able to cut their PCB costs, which has rendered them competitive in markets that would otherwise have been unviable for them."



SWEDEN

RIKARD WALLIN

Managing Director, NCAB Group Sweden

"China's economic development has been amazing for many years, and has affected all areas in the electronics production field. The somewhat weaker economic developments in the near future will affect us in so far as the NCAB Group, which is still performing strongly, will be even more attractive for Chinese factories. We are a safe bet to have as a partner, with local Chinese customers struggling for survival. Regarding the Swedish electronics industry as a whole, the impact has to date been minimal. As always, those who have good control of their supply chain will do best."



SWEDEN

MARTIN MAGNUSSON

VP Sales and Marketing, NCAB Group

"As the Chinese economy is currently rather unstable, we are working closely with our factories to help them shore up their finances. The fact that we possess the purchasing power needed to work with the best factories, enables us to secure quality, delivery performance and best total cost for our customers. As domestic demand falls, small PCB factories will find it hard to survive, but this will not affect our customers. The demand for PCBs will continue to grow in our markets and we look forward to another strong year."

Is this the end of China's dominance?

HANS STÄHL
CEO NCAB GROUP



With regard PCB manufacturing, the answer to the question in the heading is a definite NO! In this issue of our newsletter, you can read about the slowdown in China's growth. The fact is that this is not only a bad thing, even if it will have an effect on the global economy.

China still has a growth rate that is higher than anything that we see in Europe and the US. What is happening now is that all companies, including PCB factories, are undergoing an acid test where only the most adaptable will survive. The challenge for those of us who buy PCBs from China is obviously to make sure we choose plants that will survive, since PCB designs are long lived, some for up to ten years.

What is particularly important is to keep a close eye on factories that are having a difficult time financially; monitor them on a daily basis to ensure they do not resort to cost-saving shortcuts that directly affect quality. For example, this could mean reducing the amount of copper in the via holes, using pirated copies of the PCBs components, or reducing their level of competence through redundancies, more use of overtime and so on.

To manage this, it is vital your team monitors the situation on site at the factories. That's the only way you can have full insight on the plants' survival. If a factory, against all odds, were to fail, it is important you always have at least one alternative to switch to.



NCAB Group in Social Media

For a few months now, customers and other interested parties have been able to follow us on Twitter and

LinkedIn. We have also started a blog where we immerse ourselves in the versatile world of circuit boards! Follow us on:

» [Twitter](#) » [LinkedIn](#) » [Blog](#) » [YouTube](#)

Subjects we have covered earlier

Do read our earlier newsletters. You will find them all on our website, www.ncabgroup.com/newsroom/

» UL Approval

2015 12 09 | NEWSLETTER 4 2015

» Transition to outsource

2015 09 29 | NEWSLETTER 3 2015

» Purchasing PCBs

2015 06 01 | NEWSLETTER 2 2015

» Sustainable business

2014 12 22 | NEWSLETTER 4 2014

» High-tech PCBs

2014 10 07 | NEWSLETTER 3 2014

» Looking ahead with NCAB's Market Watch

2014 05 30 | NEWSLETTER 2 2014

Are we taking up the wrong subjects?

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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