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The Rise Of China - 25 Years of Globalization

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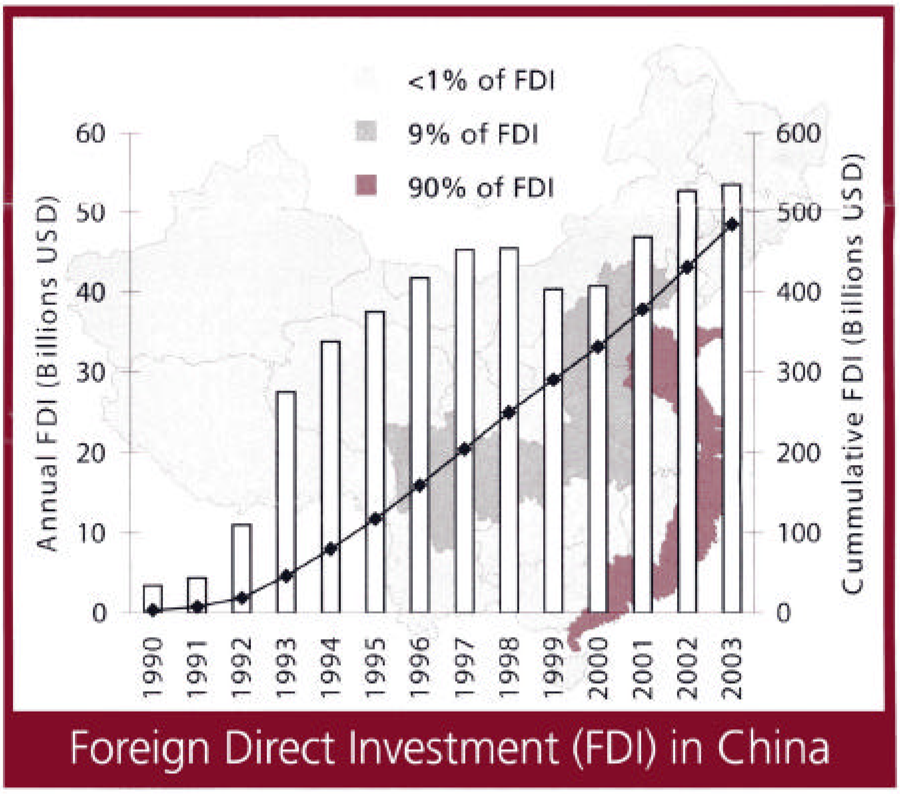
When Deng Xiaoping initiated economic reform policies in 1979 China was a relatively closed society After gaining control in 1949, the communist government had limited trading partners. Historically China moves from open trade - the Silk Road - to discouraging trade - portions of the Ming and Qing dynasties. Is China poised to become the powerful global presence its size would ordain?

The first economic reforms focused primarily on agriculture, but China began to open cautiously to the world. The government established five Special Economic Zones-three in Guangdong Province - in 1980. Other economic zones followed as the reforms expanded. The slow transition from centrally planned economy continued. In 1992, the economic reform program moved into the "socialist market economy" period. The move to open trade culminated in China's admission to the World Trade Organization (WTO) - after much negotiation - in December 2001.

The coastal region - where most of the population lives - has attracted most of the foreign investment. China's "Western Development Strategy" began in 2000 to attract development in the inland regions. Realized values of foreign direct investment (FDI) into China reached USD 500 billion by the end of 2003. FDI totaled less than USD 19 billion during the 1980s.



Foreign investment is enabling China to become a leading producer of many goods. However, increased consumption of basic commodities is a consequence of manufacturing growth. Construction to provide infrastructure supporting the growth consumes increasing amounts of cement and steel.

Since reform began, the economy has enjoyed a historically unprecedented growth rate - an average annual growth rate of about 9 percent for 25 years. China's share of world Gross Domestic Product (GDP) is now 10 percent. GDP per capita rose to USD 1,087 in 2003 - a five-fold increase since reform began. Accompanying is a rise in spending for consumer goods - televisions, refrigerators, washing machines and mobile phones.

Even automobile sales are rising. With the explosion of cars, there is mayhem on the already crowded roads of the major urban areas from the lack of rules. The Chinese now have the expression "che piq" (car temper) in their vocabulary to describe road rage.

Sheer volume of consumption does not tell the potential. After all, this is the world's most populous country - 1.3 billion. (China and India have over one-third of the world's population.) A look at the underlying per capita values explains the real interest. Compared with other developed countries, the appetite for consumption can only grow.

Investors are seeking markets and lower production costs.

China in World Economy

Rank	Producer	Consumer
1	steel, cement, coal, mobile phone, digital cameras, color televisions, DVD players, pharmeceutical ingredients	steel, cement, copper, tin, platinum, zinc, coal, 'fine' chemicals, mobile phones
2	electricity	oil, aluminum, lead, electricity
3	semiconductor chips	nickel

The Push-Pull of China

Barry Piper, Director of Atkins Faithful & Gould in China, discussed the Push-Pull of China at the recent China Investment Forum.

The significant pull factor for many is that China is an inexpensive place for business. Low cost and abundant labor and low start-up and operating costs attract labor-intensive industries. China offers investment incentives - import/export, tax and land - and the state provides large subsidies for infrastructure improvements.

China's entry into the WTO only increases attractiveness for offshore procurement and manufacturing. Total import and export volume increased from USD 509.7 billion in 2001 to USD 851.2 billion in 2003. Exports are only slightly higher than imports.

The push factors are many. China is transforming - still a work in progress - so there are higher risks. Rule of law is still an issue as the "sanctity of contracts" and protection of intellectual property rights remains a concern for investors. Internal protectionism remains high.

Despite extremely high growth rates, there are serious concerns about the economy. State owned enterprise (SOE) reform is slow. Productivity increases compared with non-state enterprises are small. Their economic performance is lackluster. Authorities are phasing out uncompetitive companies - large consumers of energy and environmentally unfriendly companies are prime targets.

The financial system has troubles intertwined with the SOEs. Loans to the non-profitable SOEs create an accumulation of bad loans. China has transferred funds to banks for several years. Estimates of non-performing loans vary widely - between RMB 2,000 billion and RMB 4,000 billion for the four large state-owned banks. Banks are selling their non-performing to state-owned asset management companies in preparation for public offerings of bank shares to investors.

On the positive side, the savings rate of the Chinese is among the highest in the world.

While it may be difficult to conceive in a rapidly expanding economy, unemployment-estimated at about 20 percent - is growing. Privatization and downsizing of SOEs are primary reasons. There are signs of unrest as the transformation from centrally planned to market oriented economy is painful.

Investors must always consider quality. Quality of labor remains an issue, as does procurement quality control. It is inexpensive to do business in China, but quality can add to the cost. Investigate and understand typical quality of service and product. Consider local standards for Health, Safety and Environment (HSE) procedures. Without implementing "Western" standards for HSE, investors can expect higher rates of accidents and loss of life. Higher standards produce higher costs.

Corruption problems are well known. Improved transparency is the government's goal, but investigations still find corruption at all levels of the government. The death penalty is a possible punishment for officials found guilty of corruption.

George Kluempke of Braun Intertec, an infrastructure engineering company in Minneapolis, Minnesota, cautioned the group to remember that the "Chinese people are ethical, but the Chinese system applies ethics differently." Professional standards and policies are different. It is important to understand this.

Piper noted that local contractors realize that the project completion date is critical. They might delay completion to have the contract renegotiated. It is part of the Chinese culture - negotiations are final. The contract is only the basis for further negotiations. Project budgets need to have reserves for the renegotiations.

Culture Clash

China is different from anywhere else in the world. Perhaps cultural aspects present the greatest challenges. "The Chinese have all the time in the world," said Piper. "They use attrition - wait you out - to get what they want." Your Chinese counterpart has some basic understanding of your cultural leanings just as you of the Chinese.

Piper presented viewpoints from a publication of the Fujian Foreign Investment Bureau illustrating how the Chinese perceive other nationalities:

- Japanese - "polite and modest ... very astute and patient ... they often put things off so they can find your real intention"
- Americans - "quick ... we should not take too long"
- British - "careful and very hard to get close to"
- Germans - "pay attention to the contract ... require every detail to be negotiated ... afterwards everything has to be followed strictly by the contract"
- Australians - "have the power to make decisions ... expect the same with us ... very efficient ... do not like to set price high at the start and then reduce by haggling"

Kluempke said they would have liked "a better understanding of culture and business practice" before investing in China.

Expectations

Investors should realize that the Chinese have expectations of the foreign investor. China's opening-up policy was and remains about the desire to acquire needed foreign equipment and technology. The government expects their WTO agreement to act as a political lever to help accomplish the necessary internal reforms.

The expectations of the foreign investor and a Chinese joint venture partner are likely to be very different. Kluempke told the group that it is important to "make sure the expectations are aligned." Their joint venture partner's goals were very different. Braun Intertec viewed the joint venture as a long-term investment, but sought a return on the investment. Local public entity partners were not focused on returning profit to investors. They wanted to improve the standard of living for themselves and the company employees.

Piper quoted the Chinese saying "Sleeping in the same bed, but having different dreams," to illustrate the potential problems with joint ventures.

Investors need to do their homework. Presenters left several keys to being successful in China:

- Understand and embrace the Chinese and their culture.
- Build relationships with the Chinese.
- Show commitment to China.
- Realize that institutions are evolving. Changes will continue.
- Hold your Chinese partner accountable.

"It is simple," said Piper about the approach to working in China, "starting right equals finishing right."

China Comparisons

	China	India	U.S.A.	U.K.	Germany	Japan
Rank						
Population	1	2	3	22	15	10
Area	4	7	3	78	62	61
Corruption Perception	66 (tie)	83 (tie)	18 (tie)	11 (tie)	16	21 (tie)
Per Capita						
GDP (USD)	1,086	2,900	37,800	27,700	27,600	28,000
Electricity (kWh)	1,010.1	466.8	12,292.4	5,742.4	6,148.6	7,573.8
Oil Consumption (bbl/day/1,000)	3.5	2.0	67.1	28.4	34.1	41.5
Mobile Phones (per 1,000)	159.1	20.6	480.4	824.2	728.5	637.1
Finished Steel (kg)	163.1	28.1	369.2	213.3	407.1	562.4
Machine Tools (USD)	5.09	0.26	13.90	12.02	52.52	32.36