



The China Factor: Mystery, Myth or Magic? CTMA Roundtable

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Founded in 1983 and based in Grand Rapids, Michigan, IRN has gained national prominence as one of the premier consulting firms providing the automotive community with marketing and strategic planning assistance. IRN's reputation has evolved after years of working closely with OEMs and component suppliers around the world. Specific areas of expertise include strategic planning, global market and product analysis, vehicle forecasting, technology management, and merger and acquisition facilitation. IRN's mission is to provide automotive intelligence to help improve the decision-making capabilities of its clients.

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- Machine Tools and Manufacturing
- Manufactured Housing and Recreational Vehicles
- Appliance

AGENDA



PURPOSE:

To explore the risks and opportunities presented by the China market.

CONTENTS:

- China basics
- Assessing the risks, with a focus on the Chinese banking system
- Assessing the opportunities
- Strategic options

Summing It Up



- **China is a real threat and very few companies are immune to it**
- **There is a real risk of a “bust” in China in the next 5-10 years; it will create many victims**
- **All manufacturing firms, large or small, operate in international markets**
- **International competition on high value-added manufacturing is here to stay; the North American and European “locks” on this niche are gone**
- **You can’t afford to wait around for someone else to solve the problem; start doing something now**

Background



•In the fall of 2002, The Right Place, Inc., West Michigan's regional economic development organization, and its Manufacturers Council commissioned IRN, Inc. to develop a background paper on the future of the manufacturing economy.



•The position paper, A Growth and Innovation Agenda for Manufacturing, was released in December of 2002. The paper has received wide circulation and became a primary source of information for many CEOs and associations interested in developing a more coherent national manufacturing policy and strategy.

•The Council's position paper dedicated only two out of its more than 100 pages to "the China Challenge."

•Because the issues surrounding our trade with China have taken on such a high profile in the policy debate, the Council commissioned IRN, Inc. to develop a supplemental position paper focused exclusively on issues related to China as a manufacturing competitor. This report is expected to be released by the Council in March of 2004. It will include some case studies of West Michigan firms and their experiences with the China market.

•The views expressed in this presentation are those of IRN, Inc. and not The Right Place or its Manufacturers Council.

Quotes on the “Chinese Miracle”



“The country has developed a powerful combination – a disciplined, low-cost labor force; a large cadre of technical personnel; tax and other incentives to attract investment; and infrastructure sufficient to support efficient manufacturing operations and exports.

Long-term trends in China, moreover, promise continued growth. The country has vastly improved its elite educational institutions and is quickly expanding its pool of technical talent. China graduated a million technicians and engineers in 2001 and will to still higher in 2004.” (HBR, 11.03)

“In the course of two decades, China’s large enterprises advanced their business capabilities, undertaking evolutionary institutional change in key aspects of their business organization. China’s large, state-owned enterprises have grown rapidly in terms of value of sales. A group of them has floated on international stock markets. They have absorbed a great deal of modern technology. They have learned how to compete in the marketplace. They have substantially upgraded the technical level of their employees. They have learned wide-ranging managerial skills and gained substantial understanding of international financial markets. They have become sought-after partners for multi-national companies. China’s large state-owned enterprises avoided the industrial collapse of the the former USSR. China has become the fastest growing part of the global industrial economy.” (Peter Nolan)

Quotes on the Risks



“The potential persists for major social and political unrest. Political frictions at the top, for instance, could prevent the government from taking effective measures to deal with some escalating financial crisis that could ultimately produce runs on the banks, riots, and a cascading breakdown of authority and order. Should that occur, few firms will escape without serious losses.” (HBR, 10.03)

“Despite many appearances to the contrary, China’s political economy is at a critical and fragile stage in its evolution from the planned economy. Its own leaders have warned of the dangers of system collapse. This is not an idle warning to justify continued one-party rule. It reflects a realistic evaluation of the magnitude of the development challenge that confronts the new leadership. Collapse of the former USSR was a disaster for the Soviet people, and was harmful to global prosperity and stability, no least through the effect on terrorism. Financial instability across wide swathes of Latin America, East and Southeast Asia, has also harmed the prospects for global economic progress and stability. The consequences of the disintegration of China’s political economy would dwarf these. This outcome would be disastrous, not just for China, but for the USA also.”
(Peter Nolan)

Quotes on the Risks



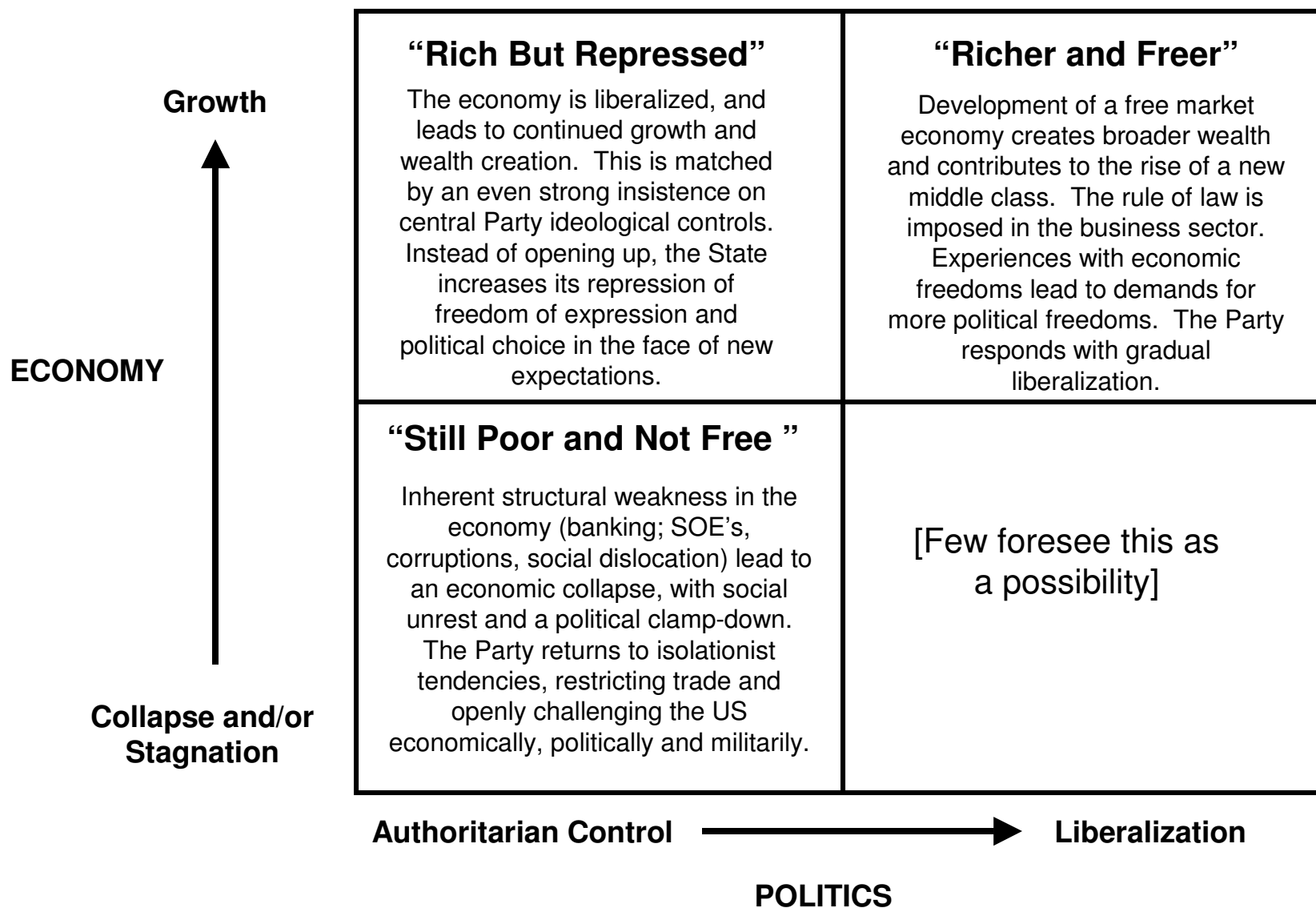
“The Chinese economy will continue to grow, but the growth will be slower than in the recent past. You should not discount the possibility of significant problems arising in the Chinese economy from unforeseen political or economic disruptions. The problems in the state sector – especially the banking system – could rapidly become critical if they are not properly managed. Unemployment could cause social unrest. WTO will actually increase the economic volatility of China, as adjustments are made to meet requirements.” (U.S. Commercial Service, American Embassy, Beijing)

Strengths and Weaknesses of the “Chinese Miracle”



STRENGTHS AND OPPORTUNITIES	WEAKNESSES AND RISKS
<p>“China’s economic success has been astounding – the word is an understatement.” (Harvard Business Review, 10.03)</p>	<p>“Despite many appearances to the contrary, China’s political economy is at a critical and fragile stage in its evolution from the planned economy.” (Peter Nolan)</p>
<ul style="list-style-type: none"> •Ideological shifts to support private market development •Improvements in regulatory transparency •Growth of a quality technical labor force •Beginning reforms of the State-Owned Enterprises •Opening of markets to foreign firms •Rapid growth in GDP •Rapid growth in Foreign Direct Investment (FDI) •Improvements in personal income in many regions of the country 	<ul style="list-style-type: none"> •Continued domination of the private sector by politics •Widespread poverty, unemployment and rural migration •A growing inequity in incomes between rural and urban residents •Political repression and lack of human rights •No rule of law •Industrial policy, government subsidies and unfair trading practices •Lack of a globally competitive domestic business base •An insolvent banking system •Massive un-funded public liabilities

Future China Scenarios





Background on China

Basic Demographic and Economic Data



China is:

- **Large**
- **Mostly rural**
- **In the “middle of the pack” in terms of the size of the economy**
- **Rapidly growing**

Population:

- Estimated at 1.3 billion in 2002.
- 70% of the population (800 million) lives in the countryside.
- 50% of employment is agricultural (vs. 3% in the US).

Geography:

- 3.7 million square miles.
- Third largest country in the world, behind Russia and Canada.

Basic Demographic and Economic Data



Gross Domestic Product:

- Estimated at \$1.23 trillion in 2002, approximately 12% of the size of the US economy (US GDP of \$10.4 trillion in 2002).
- China ranks in the “middle” of the 13 economies that constitute 80% of the global GDP.
- With 3.7% of global GDP, China is the 6th largest economy in the world, behind the US (32.5%), Japan (13.6%), Germany (6%), UK (4.5%), and France (4.2%).

Growth Rates:

- According to official statistics, in the last decade, China has had the fastest growing economy in the world.
- Economy has been reported to be growing at annual rates of between 9-11%.

Cautions on Chinese Economic Statistics



“Unless China has embarked upon an unprecedented economic trajectory that combines high speed growth with rising unemployment, sluggish demand, massive excess capacity, glutted commodity markets, mild deflation and low expectations, we cannot avoid concluding that something is seriously amiss with Beijing’s growth claims for the past four years.” (Thomas Rawski, University of Pittsburgh, 2002, quoted in Chang, 2002)

“The data that show China as the fastest growing economy in the world are not worth the paper they are written on.” (Credit Lyonnais, January, 2002)

“The Bureau, by releasing the full year 2001 GDP number before the end of that year, continued its ridiculous tradition of issuing figures prematurely. In developed countries it takes months to produce a final statistic measuring the output of an entire economy, but in China officials can arrive at a number before the year is over. Beijing’s statisticians are able to not only measure the past, but also foresee the future.” (Gordon Chang, 2002, Appendix 1: Reliability of GDP Statistics)

Income and Employment Data



China is characterized by:

- **Extreme poverty for most citizens**
- **High levels of unemployment**
- **Geographically-concentrated wealth (in coastal cities)**
- **Wealth concentrated in a small segment of the population**
- **Large differences of opportunities between rural and urban areas**

Income and Employment Data



- **Average per capital rural income is estimated at \$290, or 80 cents a day. Average per capital income of the estimated 480 million urban residents was \$830 in 2001.**
- **There are estimated to be anywhere from 80 to 150 million rural residents who work in urban areas without residence qualifications. Their average pay is equivalent to \$1-\$2 per day.**
- **“Official” unemployment is a little over 3%. Most objective analysts believe the real figure is closer to 10% to 15%. As many as 48 million people are unemployed as a result of reform of State-Owned Enterprises (SOE’s).**



Income and Employment Data

- **Wealth is highly concentrated – it is estimated that 0.16% of the population (20 million) control 65% of the country’s liquid assets.**
- **Wealth is geographically concentrated in the coastal regions of Guangdong, Shanghai, and Beijing. With 1.25% of the population, these regions are estimated to account for 30% of the country’s GDP and over 70% of FDI.**
- **The size of the “upper income” market in China is very limited. HBR estimates that less than 2 million Chinese have incomes above \$20,000.**

Trade Data (1)

China has dramatically increased its global trade over the last decade.

- From 1991 to 2001, the total value of China's trade (exports and imports) grew from \$100 billion to nearly \$510 billion. (USCC – Chapter 2)

China's net trade surpluses (including trade with all foreign countries) are modest; China has trade deficits with many countries.

- In 2002, the government reported a net trade surplus of only \$30 billion.
- China has significant trade deficits with many countries, including Taiwan, \$20.4 billion; South Korea, \$11.9 billion; Russia, \$3.2 billion; and Malaysia \$2.9 billion. (Lenz)

The US trade deficit with China has ballooned in the last decade.

- China is our fourth largest trading partner, behind Canada, Mexico, and Japan.
- The US trade deficit with China is the largest of any trading partner, at \$103 billion in 2002.
- In 2000, imports from China amounted to 10.2% of all manufacturing imports. (21% of manufacturing imports were from Japan.)

Trade Data (2)

Virtually all of China's trade surpluses are in manufactured goods.

- In 2000, manufacturing accounted for 88% of Chinese exports (compared, for instance, to 94% in Japan, and 80% in the US). (Lenz)
- China's agricultural trade alternates between modest surpluses and modest deficits; the services sector typically runs a modest deficit.
- China is a net energy importer, with a \$20 billion energy trade deficit in 2000. (Lenz)

Much of China's manufacturing trade surplus comes from low-technology, labor-intensive sectors.

- \$50 billion of the total Chinese trade surplus comes from a combination of clothing, footwear, toys, furniture and other low-technology items.
- China's projected market penetration of total midwest manufacturing, where the concentration is on higher value added components, is estimated at only 2.3%.
- Imports from molds for the plastics sector, for instance, were less than 1% of the US total mold market in 2002.

Trade Data (3)

Chinese trade in high technology sectors is increasing rapidly.

- Exports of advanced technology products to the U.S. have increased from basically zero in 1990 to over \$13 billion in 2001. (USCC)

China has surpassed the US in terms of Foreign Direct Investment.

- China attracted \$53.2 billion in FDI in 2002, (an increase of 12.5% over 2001. This compared to \$52.7 billion for the US in 2002. (HBR, 10.03, Lieberthal)

While the US is a major investor in China, it is a small percent of the total.

- In 2002, US FDI was less than 10% of the total FDI in China. Over 60% came from Asia, with the bulk of that coming from Hong Kong (32%), Japan (7.8%), Taiwan (6.9%) and South Korea (5%).

A relatively small percent of total US manufacturing FDI goes to China.

- According to the New York Times, less than 5% of total US manufacturing FDI was invested in China. The majority went to the EU.

Chinese Imports Are Replacing Imports From Other Countries



- In many instances, the increase in imports from China reflects more of a shift of production from other low wage areas to China, than new competitive threats to existing American manufacturing.
- This impact has been dramatic in some locations, for instance in Mexico's *maquiladora* region, where 500 of 3,700 operations have been closed (13.5% of the total), at a cost of 218,000 jobs. (NYT, 9.3.03)
- In this context, China is more of an immediate threat to low wage regions that are already importing to the U.S., than to exiting higher value-added firms here at home.



Most Imports Come From Foreign Operations In China, not from Domestic Chinese Companies

- A high percentage of exports from China have come from multi-nationals that have invested in China, rather than Chinese domestic companies – foreign-invested enterprises produce about 45% of China’s exports.**
- The bulk of these investments are Asian.**
- Goods exported from China to the U.S. have a relatively low domestic (Chinese) level of value added – averaging 20% to 30%.**

China Auto Sector



Growth, Growth and More Growth:

- Over a third of the growth in global vehicle sales from 2003 to 2008 is expected to come from China.
- If current trends continue, China will be the third largest vehicle market in the world, behind the U.S. and Japan, by 2006.
- Passenger car sales in 2002 (1.1 million units) represented a 56% growth over 2001 levels; sales are up 82% for the first half of 2003.

Very Concentrated Growth:

- 50% of sales are concentrated in three coastal urban centers – Shanghai, Beijing and Guangdong.
- 80% of sales are in the overall coastal region.

China Auto Sector



An Investment Binge:

- In 2002 and 2003 YTD, new vehicle assembly capacity investment in China exceeded that in the U.S.
- Over \$12 billion has been invested since 1994.
- Half of this investment (\$6.3 billion) was committed in the 18 months from 2002 through June of 2003.
- There is some concern that the market is developing overcapacity

Emerging Overcapacity?

“Consulting firm KPMG predicts that China will have the capacity to build 2.3 million more cars in 2005 than projected sales in that year of about 2.5 million. Although the overhang will narrow the rest of the decade, KPMG says, it still will total 1.4 million units in 2010.

That much overcapacity will spread price wars, confined today largely to the subcompact segment in which local companies compete, to all segments, decimating profits.”
(AN, 7.20.03)

Two Very Different Points of View

“China’s overall economic target is 7 percent growth over the intermediate term. Outside of some major external disturbances, I see that as achievable. If that happens, the auto industry can continue to grow 10 to 15 percent a year. I disagree with the people who say that companies involved in the auto industry here are going to be facing some severe downturns. I don’t see that happening.”

(Phil Murtaugh, President, GM China, quoted in Automotive News, 10.20.03)

“I don’t know who it is in the Chinese economy they think is going to buy more and more cars, but if some of my thoughts about the personal income statistics turn out to be on target, the combination of very rapid ramping up of production capacity and possible softness in income growth could create some unpleasant surprises...I suspect someone in GM is projecting a rather robust path for the Chinese economy. If that projection turns out to be optimistic, someone is going to get hurt.”

(Thomas Rawski, professor of economics, University of Pittsburgh, quoted in Fortune, 11.14.03)



Assessing The Risks

Trade Barriers Abound



- High import tariffs
- Import licensing
- Testing and standards
- Local content requirements
- Quarantine procedures
- Sanitary measures
- Discriminatory administration of value added taxes
- Quantitative quotas
- Export licenses
- Discriminatory anti-dumping procedures
- Unpublished laws and regulations
- State licensed trading rights
- Required use of local agents to distribute imported goods
- Import substitution measures
- State certifications
- Import quality licenses
- Import commodity safety licenses
- Labeling requirements
- Hidden export subsidies
- Weak enforcement of intellectual property laws
- Distribution restricted to Chinese-owned firms
- Highly regulated transport and logistics
- Unofficial local content requirements

China and the WTO



Major commitments include:

- **Reducing average tariff levels on goods from 24% to 7%**
- **Phasing out all tariffs on Information Technology Products by 2005**
- **Opening up services sectors, such as insurance, banking, securities, telecommunications, legal, accounting and computer services**
- **Permitting U.S. companies to operate wholesale, retail and franchised distribution networks**

There are major barriers to China effectively implementing its WTO agreements, including lack of a functioning legal system; provincial protectionism; failure to enforce intellectual property laws; resistance of SOEs to reform; and overall lack of transparency for enforcement.

Sector-Specific Requirements:

- **Aerospace.** Reduce average tariffs on civil aircraft products from 10.5% to 7.2%.
- **Automotive.** Lower tariffs on imported autos from current levels of 80-100% to 25% by July, 2006, and eliminate quotas by 2005. Auto parts tariffs will be reduced from an average of 23.4% to 10%.
- **Financial Services.** Banks will be allowed to offer full financial services beginning in 2006.

“WTO implementation will be a tremendous challenge to China. Localism and provincialism heavily influence the Chinese economy and decision-making processes, and the willingness of provincial and municipal governments to comply with WTO commitments is uncertain.”
(USSC, Ch. 3)

Intellectual Property Theft Issues



- China's own Development and Research Center estimates that counterfeiting is a \$16 billion industry in China
- The International Intellectual Property Alliance estimates that the piracy rate for business software, entertainment software and music is 90%, and cost U.S. firms \$1.5 billion in 2001
- China is at the top of the US Customs list of Intellectual Property Rights seizures, accounting for 49% of all seizures in FY 2002 (US customs Service) China, Taiwan and Hong Kong account for 80% total
- While China's laws have been amended to comply with the requirements of the WTO membership, enforcement is non-existent, making the laws essentially useless.
- Many foreign businesses have found that the source of their intellectual property violations are their own business partners.
- Intellectual property piracy is a favored domain of organized crime, who figure the risk/reward ratio is high because penalties for getting caught are typically low, or can be mitigated by the ubiquitous custom of bribery.

Lack of a Competitive Business Base



Despite the outside appearance of prosperity, China has yet to develop a base of domestic companies that can compete with other multi-nationals on a global basis without propping up from the government.

“At the start of the 21st century, not one of China’s leading enterprises had become a globally competitive giant corporation, with a global market, global brand, and a global procurement system...The brutal reality is that after two decade of reform, China’s large firms mostly are still far from being able to compete with the global giants. ” (Nolan, P. 12)

Lack of a Competitive Business Base



Barriers to Chinese Firms Becoming Globally Competitive:

- Lack of a high value-added consumer base
- Lack of management talent and leadership
- Insufficient expertise with sales, distribution, advertising and service networks
- Regional fragmentation of markets and local protectionism
- Bureaucratic corruption
- Unwillingness to reduce employment levels
- Overwhelming dominance of global markets by well established consolidators

Lack of a Competitive Business Base

- The 11 Chinese companies on the *Fortune 500* are predominantly state-owned firms, deeply protected from international competition.
- China has only one company in the world's top 600 companies ranked by R&D expenditures; China has no companies on *Business Week's* list of the world's top 100 brands.
- 80% of China's consumption of semi-conductors is imported; of the top 30 suppliers of micro-chips to China, none are indigenous Chinese firms.
- China's largest private sector company only had \$1 billion in sales in 2002.

There are, however, many Chinese firms that are emerging as potential “global brand” players, including the Haier Group (\$8.6 billion -- home appliances); the Legend Group (\$2.6 billion -- computers) and the Wanxiang Group (\$1.4 billion -- auto components). Many of these firms are “hybrids” that combine state ownership with private investment.

Environmental Degradation

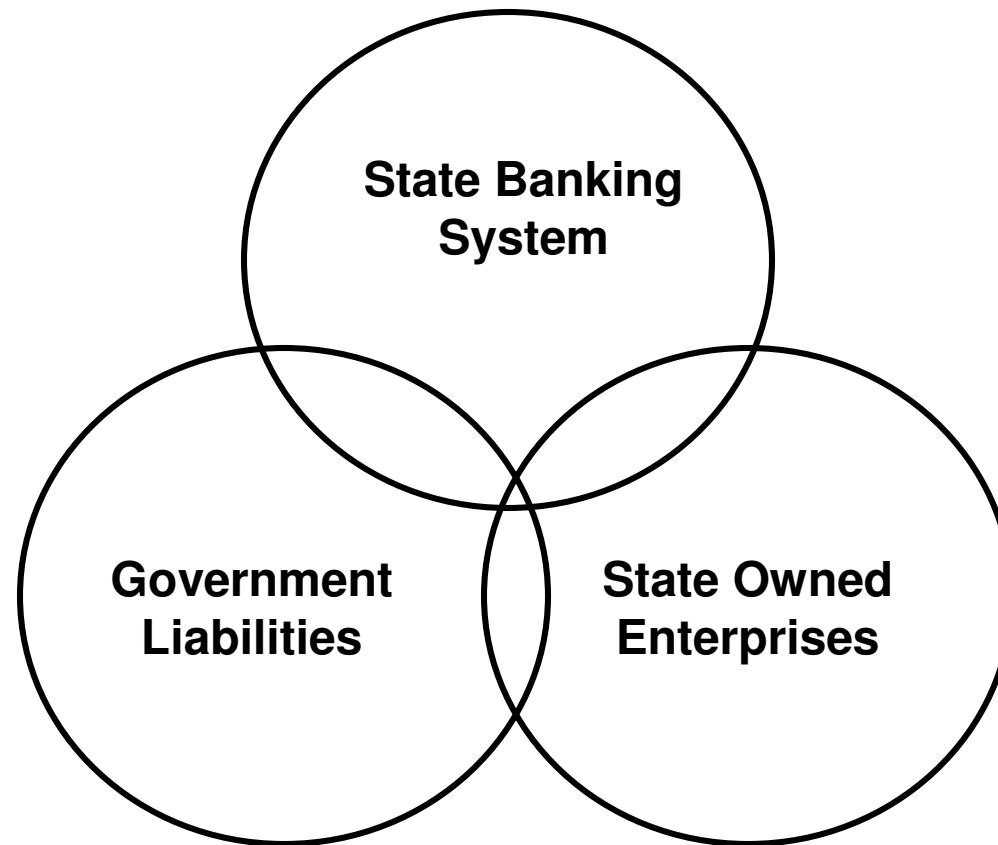


- 38 percent of the country is affected by serious soil erosion
- Half of China's forests have been destroyed in the last 40 years
- Half the population lacks access to clean water; 90% of urban water bodies are severely polluted.
- Seven of the world's ten most polluted cities are in China.
- Respiratory and heart disease related to pollution are the leading cause of death
- China is now the second largest producer of greenhouse gases after the US.
- Pollution costs China about 7-10% of GDP annually

“If it follows the free market approach to industrialization, allowing, for example, complete dominance to the automobile, then the prospects for the world are terrifying. If China’s 1.4 billion people were to sustain their current growth path and at some point catch up with today’s USA level of per capita income, and were to use similar technologies, China’s use of commercial energy and emission of carbon dioxide would be one-fifth greater than the entire world today – a terrifying prospect.”

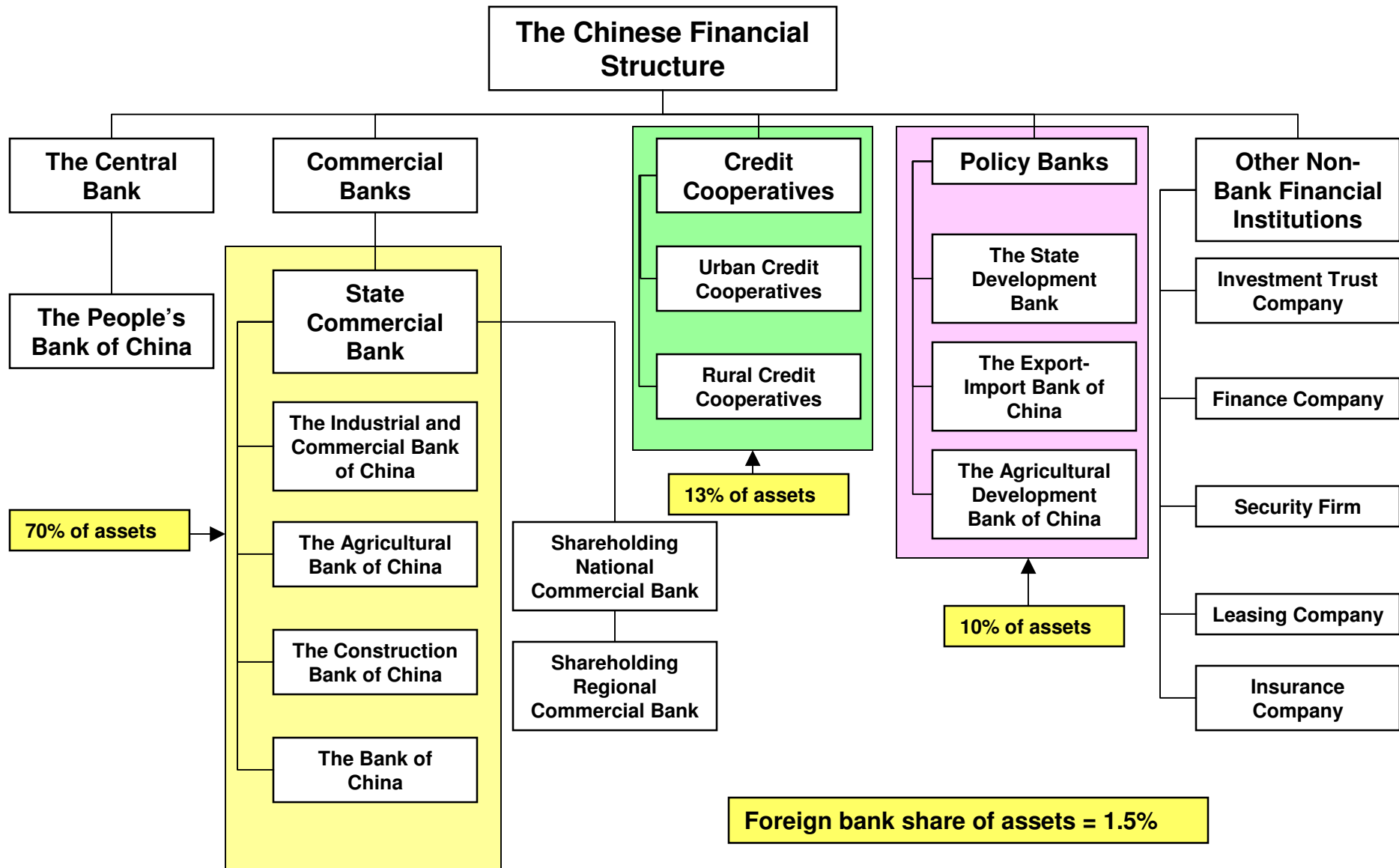
(Nolan, P. 4)

The Financial Challenges



Three Deeply Inter-Related Issues

The Chinese Banking Sector



(Adapted From: "The Structure and Development of China's Financial Markets", Chen Baizhu and Feng Yi, in The Dragon Millennium, 2000)

Problems in the Banking Sector



• **Insolvency.** Non-performing loans are estimated 40% to 50% of total loans. It is estimated it would cost over \$500 billion to “clean up” the problem. This equals 40% of the annual GDP. (For perspective, local and national governments only raise about 11% of GDP annually in revenues.)

• **Inefficiency.** Banks are “massively overstaffed” – assets per employee are one-fifth of U.S. banks.

• **Political Influence.** Large amounts of lending are still directed through political connections. Regional party leaders “direct” loans to their pet projects.

• **Corruption.** Financial fraud was estimated at \$12 billion a year in 2000. A recent scandal at the Bank of China involved the looting of \$480 million.

Provincial political players depend on bank loans to stimulate economic development and job creation. The loose and uncontrolled credit policies of the bank have been a major contributor to the construction and real estate boom that has occurred in China’s coastal provinces. Many of the development zones and high technology parks that have impressed North American business visitors have been funded by these loans, most of which have low chances of repayment.

Quotes on the Banking Issue



“The non-performing loans that several of China’s four largest banks ultimately will have to write off almost certainly exceed the combined value of their reserves and their own capital. On a realistic accounting, these banks’ capital adequacy is negative and they are insolvent.” (Nicholas Lardy, China’s Unfinished Economic Revolution, 1998)

“The state-run banks are notoriously corrupt and inefficient, issuing huge loans to well-connected people and businesses that do not repay them. The banks do not receive timely payments now on nearly half their loans.” (NYT, 9.21.03)

“Due to the number and intensity of the challenges that China faces, there is a high possibility that at some point a ‘fire’ will break out. It cannot be predicted where, when, or how. It is highly likely that it will be connected with the financial system...China faces a massive challenge in the financial sector.” (Peter Nolan)

The Banks and State Owned Enterprises



- State Owned Enterprises (SOEs) historically got their financing in the form of grants from the central treasury. Their losses were paid for out of tax revenues.
- **With the move toward privatization and market-based reforms, grants to SOEs were replaced with loans from the State Commercial Banks.** This difficulty was that SOE managers continued to treat the loans as if they were grants, and did not manage their enterprises with the expectation of repaying them.
- **In 2000, SOEs accounted for over half of all the bad debt held by the central banks.** Because they are only about 60% as efficient as foreign-funded operations, they are estimated to be unable to generate cash flow to pay interest on at least 30% of their total debt.

The Banks and State Owned Enterprises



- **The so-called “loans” to SOEs therefore constituted a massive subsidy to the state-controlled manufacturing sector.** This infusion of new capital provided a significant boost to the Chinese economy.
- **The problem was that it has been financed, not by taxes, but by depositors.** The government in effect shifted the risk from its own treasury to private citizens.
- **The state cannot hold the SOEs accountable for financial discipline until it relieves them of their social obligations,** including unemployment insurance, old-age pensions, health care, housing and schooling. (In the mid-1990’s, hospital built and run by SOEs accounted for one-third of all hospital beds in the country.)

It's Not Sustainable



- Despite some attempts at reform, the **pace of uncontrolled lending shows no signs of abating**. New loans made in the first seven months of 2003 (\$228 billion) exceeded the loans made in all of 2002 (\$224 billion).
- Because such a high proportion of the loans are non-performing, the **banking system is being propped up by deposits** from savers who have no other options for placing their money. (The Chinese have one of the highest savings rates in the world, estimated at 40%.)
- There are strong capital controls in place – primarily to **keep depositors from pulling their savings out and causing a collapse of the system**.

It's Not Sustainable



The Growth Formula is Just Not Sustainable:

“China’s underlying formula for growth has depended on a closed domestic financial system. It worked by channeling individual savings (roughly 40% of GDP) into state-owned banks, which in turn have funneled most of these funds into state-owned enterprises. They have used the money to expand capacity, despite an oversupply in many markets. This has been done to avoid the social shock of shutting down the major state-run companies, a move deemed politically too painful, considering that many smaller ones have already been shut down or privatized and tens of millions of workers laid off. The predictable results are a combination of rapid GDP growth, rising output, declining retail prices and high levels of loan defaults. Because the major state-owned enterprises need not show a profit to survive in a soft loan environment, price competition in the domestic market has reached ruinous levels for many goods.

That growth formula will have to change.”

(HBR, Oct, 2003)

Attempts At Financial Reform



- In 1998, the government issues \$32 billion in bonds to re-capitalize the banking sector.
- In 1999, four asset management companies were created, one linked to each of the state commercial banks. They took over \$170 billion in bad loans.
- Tougher lending criteria and higher loan reserve requirements have been imposed.
- In January of 2004, the government engineered a complex \$45 billion transfer from foreign exchange reserves to the Bank of China and the China Construction Bank. Also in January of 2004, the Ministry of Finance wrote off its \$41 billion stake in both of the same banks.
- Both moves are preparation for 2007 when foreign banks begin to compete more fully in China.

The Two Significant Risks



- An economic slowdown coming as a result of less liberal credit flowing to unsustainable projects and enterprises (lending reform)
- An economic slowdown coming from a crisis in central bank finances

“China still has some advantages that, at least in the short term, may forestall a plunge in investment. One is the banking sector willingness to lend heavily to even the most indebted companies, providing that they have political connections. But in postponing the final reckoning in the current business cycle, China may be making an eventual bust even worse...

If the economy slows sharply, political instability could follow. That would be a serious problem, and not just for China, but also for the rest of the world.”

New York Times, 1.19.04, “Is China the Next Bubble?”

Important Questions for Auto Suppliers



- How much of the automotive buying boom can be attributed to wealth generated by these state subsidies?
- What would the automotive market look like in the absence of these subsidies?
- What will happen to consumer demand when the inevitable “correction” occurs?
- What are the odds of a “crisis” in the Chinese financial system?
- What happens to consumer demand if there is a financial “crisis”?



Opportunities and Strategic Choices

The Opportunities



- **Access to a potentially very large market**
- **Significant cost advantages (but be careful – they are often not as large as they appear) – cost advantages are typically in the 20% to 40% range**
- **Experience in international sales and sourcing**
- **Ability to provide options to your customers**

Strategies At Three Levels



Strategies for dealing with offshore competition need to occur at three different levels:

- **Your individual company**
- **Collaborations between companies (e.g. the U.S. Tooling Coalition as an example)**
- **Public policy**

So What Do I Do About China?



- **DON'T PANIC!**
- **DON'T IGNORE IT!**
- **Every manufacturing company needs an INTERNATIONAL sourcing and sales strategy, not just a “China Strategy”**
- **Remember that if China crashes, India is waiting in the wings...**
- **Your strategy should be based on your desired market positioning and your core competencies; strategy is still the best defense**
- **Don't be naïve about your comparative advantage in a global economy; be ruthlessly objective; know where you are vulnerable**
- **Get there before your customers do; be one step ahead of them**
- **Be willing to call your customer's bluff on “global pricing” if it is irrational**



The “Global Pricing” Ploy

- **Customers ask for quotes in standard formats**
- **Prices are broken down into different categories (direct and indirect labor; overhead; material; internal processing; outside processing; packaging; shipping; profit; etc.)**
- **Customer takes the lowest figure from each category and combines it for the “global price”**
- **This process creates a completely distorted view of the actual price, because it ignores strategic tradeoffs between categories made by different suppliers**

Building Global Alliances

Many tooling firms have responded to off-shore competition by joining it rather than fighting it. They have developed their own foreign alliance and/or subsidiaries, which they have used both to take advantage of cheaper sourcing, and also to sell their own capacity into these new markets.

This strategy allows tooling firms to bid on a package of tools at a “blended” price – some using low cost off-shore prices and some at domestic prices. Typically the larger and more complex tools are built domestically and the smaller tools are sourced off-shore.

“Many larger tool shops look on Asia more as an opportunity than a threat. They are either opening shops overseas or redoubling efforts to keep business in North America.”

(Plastic News, April 2, 2001)

“The ability of those shops to work globally and offer services will be their saving grace.”

(Don Madison, President Marland Mold, Inc. quoted in [Plastic News](#), 4.2.01)

Advantages of Global Alliances



- It allows tooling companies to be more competitive on price.
- It creates a broader “global” sourcing capacity for the company.
- It retains control of key customer relationships.
- It allows the tooling company to control the design process.
- It potentially opens up new markets for selling into.

Pros and Cons of Offshore Sourcing



- **Communications**
- **Lead times**
- **Inferior products**
- **More difficult service and try-out**
- **Losing control of intellectual capital**

If You Do Decide to Do Business In China



Be Clear About Your Strategic Intent

- Avoid the “gold rush” syndrome.
- Be clear about whether you are there for exporting or for selling to the local market.
- Be explicit about the relationship between your China operation and the organization as a whole.
- Establish realistic timeframes on return on investment.
- Be prepared to invest significant amounts of leadership time in making the venture work.

Pick Your Partners Carefully

- Work with trusted intermediaries (they are essential); Know your partners from many different angles.
- Be careful about joint ventures.

Stay Legal

- Never pay bribes, even if it is the “custom”; Maintain WTO compliance.

If You Do Decide to Do Business In China



Understand the Risks

- Maintain a clear exit strategy; be willing to pull the plug if the facts tell you to.
- Take steps to manage the inherent risks (lack of a legal system; corruption; potential social collapse and disruption; etc.)
- Get payments in advance.
- Don't rely on promises of subsidies.

Respect Regional Differences

- Have different strategies for the national and regional levels.
- Understand how your markets vary region by region.

Understand the Culture

- Take time to build relationships
- Restrain your “western” instincts (aggressiveness; confrontation)
- Be prepared for long, tough and contorted negotiations

Common Characteristics of Winners



- **Control of the “intellectual high ground.”** Suppliers dominate the intellectual property related to their market segment – they are the source of industry expertise, whether it is product, process or technology related.
- **Clear differentiation from competitors.** Leading suppliers focus their organizations in niches where there are few competitors, and seek to do different things from their competition – they change the rules of competition.
- **In-depth customer knowledge.** They have deep knowledge of their customers, and have relationships at multiple levels of the value chain, and within their primary customer companies.
- **Operational excellence.** They are rabidly focused on lean practices, and understand the strategic flexibility that a lean organization gives them.
- **Leveraging the supply base.** They are strategic about how they manage their supply base and they look for long-term partnering opportunities where their supply base can contribute to their niche leadership.
- **Superb financial management.** Leading suppliers treat finance as a strategic function, not an accounting function. They drive for deep understanding of their cost structure, and use pricing as a strategic tool.

*Source: Winning In An Age of Change – The New Rules of Engagement in Automotive Supply, Kim Korth, Jim Gillette and Melissa Anderson of IRN, Automotive World Publications, 2001.

Summing It Up



- **China is a real threat and very few companies are immune to it**
- **There is a real risk of a “bust” in China in the next 5-10 years; it will create many victims**
- **International competition on high value-added manufacturing is here to stay; the North American and European “locks” on this niche are gone**
- **All manufacturing firms, large or small, operate in international markets**
- **You can’t afford to wait around for someone else to solve the problem; start doing something now**

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