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Building A China Presence- Some Lessons for Australian Organisations

By Mike Canny

Introduction

This paper is based on a presentation to the Australia-China Business Council-Melbourne 31 May 2000.

It is designed to assist organizations in assessing their strategies for establishing and operating in the China market. It draws from the experience of Australian and international companies over the past ten years and provides a broad overview of the range of issues that need to be addressed. The discussion of is supported by case studies of two organizations the writer was responsible for during their first five years.

Whilst the paper's focus is on organizations seeking to establish themselves on the Chinese mainland to supply China's domestic markets, many of the principles are equally applicable to trading companies and businesses aimed at export markets.

Background

Since the opening up of China in the late 1970's foreign investment has gone through several phases. The initial foreign invested enterprises (FIE's) were trading enterprises or representative offices designed to access Chinas growing demand for imported equipment and commodities.

The 1980's saw FIE's shift their focus to investment in manufacturing facilities to take advantage of China's low labour costs and primarily producing goods for export. By the early 1990's the trickle had turned into a flood as companies throughout the world had begun to recognize China's potential and scrambled to establish a beachhead.

Manufacturing entities were joined by JV's in the service and resource sectors. The early wave of investment, driven often by short term opportunism, begun to be replaced by a more measured approach as international organizations recognized the need to have a presence in China as part of their global strategy.

With China's admission to the World Trade Organisation in 2001, and the associated market liberalizations, the focus has well and truly shifted to Chinas domestic markets. Whilst foreign investors setting up in the mid 90's certainly had an eye to the domestic markets, it was mostly export businesses that yielded profits. Today profits from China's vast domestic markets and rising consumer spending are a reality.

The Chinese operating environment has also changed greatly over this period. Access to hard and soft technology, finance and “modern management methods” is no longer a barrier to domestic Chinese companies. Although the effects have been distributed very unequally, sustained high levels of growth and foreign investment and improved transport infrastructure have enabled some very significant productivity improvements. The past couple of years has seen the emergence of local companies that leverage world class technology with the best of Chinese traits. Some of these companies are now starting to aggressively build local brands and win back share lost to the major global players.

China Risk Factors

Chinas sheer size, strong economic growth and growing demand for western products and services makes it an attractive market. Whilst the rewards have always been there, the risks of operating a business in China have reduced significantly over the past 10 years. The influence of the party is waning, the legal and financial systems and other institutions have moved into a more mature phase and the currency risk is low.

Despite this progress some major risks remain.

- **SOE reforms:** China’s opening up and gradual march to a market economy with socialist characteristics if putting millions of people out of work. The has been painful for China’s thousands of State owned enterprises, many of which, having survived the 90’s by selling off assets and borrowing from the banks, are now bankrupt. Despite this, they continue to trade, earning income to support their workers and their families who depend on the work unit for food, housing, medical and education.

- **Chinas debt:** Liquidity remains a problem with many Chinese enterprises asset rich but cash poor. Growth does not solve all problems. For long time China watchers the current boom looks all too familiar, there were growth cycles in 1987/88 and 1992/93. Each eneded in massive over-investment in production capacity, resulting in years of excess stock and bad loans. In many sectors it is not uncommon for receivables to average 90-120 days. The banking system continues to be burdened by an estimated 25% non-performing loans waiting to be written off. At the root of such excesses is an iron triangle of companies, banks and local government officials who work together to push production and investment to excessive levels.

- **Lack of transparency:** Chinas ascension into the WTO has opened access to new sectors of the economy and brought with it a commitment to strengthen the rule of law, however China is and will remain an uneven playing field. It will take many years for these initiatives to flow down to provincial, municipal and township governments. Despite these institutional structures, individuals within and outside the government continue to exert influence behind the scenes.

- **Uneven growth:** Although a country of 1.3 billion people 75% of China foreign investment has taken place in the coastal provinces, an economy of 300 million people. Here wages have risen by almost 1000% and demand for western goods and services is high. Some regions, most notably the Pearl River delta, are even starting to experience labour shortages. At the same time labour costs, and hence purchasing power, in Chinas mostly rural inland provinces remain amongst the lowest in Asia.

The Government has deliberately pursued a trickle down policy aimed at concentrating the benefits of the growth along the coast.

Impact of cultural factors

The need to take into account cultural factors in entering into a new market is critical. Nowhere is it more critical than in China where the country's 5000 years of history, the impact of communist party rule and China's recent history of isolation has contrived to establish a very complex set of cultural and social norms. At its most basic level this translates to the foreign and Chinese managers looking at the same picture and hearing the same words but seeing and understanding something quite different

Yes, China has seen a massive influx of foreign players and foreign brands, but it must be remembered that almost 80% of this investment has been by Hong Kong, Taiwanse and overseas Chinese corporations, organizations with strong cultural links.European companies with their experience across diverse cultures and respect for history seem to stumble less often, for Australian companies though, the challenge is huge.

Strategies and tactics that work for Australian markets, customers and employees do not translate to China. International companies wanting to be successful in China must strive to build a mix of the best of Chinese and western cultures and must be able to see the world through Chinese eyes.

How can you make the right decision with less than 50% of the information? How can you lead without understanding what motivates your people? If you, or your China Manager, does not have the capacity to see your Chinese business through Chinese eyes, then make sure you get someone who can.

This does not mean appointing as your China manager a recently hired overseas Chinese, someone you would never put in charge of your Australian business in a fit, or sending the volunteer manager who always wanted to "explore new cultures." China is a very demanding business environment, you must send your best people.

Leading and managing in China is different. However, successfully adjusting to Chinese culture does not mean lowering your standards. The values and operating standards that have made your organization what it is, -attention to detail, equipment maintenance, quality assurance, or performance management systems and personal integrity, the things that attracted your partner or your customers to deal with you in the first place remain important. As a foreign organization you are expected to be different in the areas that count. Failure to maintain these standards sends a dangerous message to your people and can ultimately lead to a loss of respect from your JV partner and your customers

Another common mistake foreigners make is to see China as one market. Regional differences are significant. Chinas size, geographical barriers and, until recently, poor internal transport links, have resulted in a nation that is, in many ways more like Europe. Regional differences are reflected not only in language, but in the extent to which markets embrace new products and services. Savvy, outward looking Shanghai has always been the first to adapt to international trends and embrace new fashions. Whilst the clever Cantonese and their brothers and sisters returning from Hong Kong and overseas have made the Pearl River Delta almost an extension of Hong Kong.

Competitors

Firms entering the China market can expect to face competition from the following organizations:

- **Foreign invested enterprises**: A factor often overlooked by Australian companies, China's markets have attracted the attention of the major players throughout the world many of whom are already practiced at building a presence in a new markets and in new cultures. These are the big boys, with deep pockets, they may be relatively unknown in Australia but they certainly should not be underestimated.

- **Overseas Chinese companies:** Whilst these organisations can be quite large, they are often organized and behave like family companies. They have strong service traditions, emphasise commercial acumen but may outwardly appear un-sophisticated. They are often widely diversified across different businesses and few have the benefit of strong brands or proprietary technology. Despite their baggage, they have the dual advantages of understanding the local culture, and having relationships with the people that matter. Unlike their western competitors, even the largest companies have an ability to move quickly.

- **Mainland Chinese companies:** There are some very large and sophisticated local players emerging. This group ranges from companies emerging out of the major national SOES with listings on foreign stock exchanges, to the new breed of largely privately owned companies. Whether public or private these companies still have close relationships with national, provincial and municipal governments. They benefit form direct and indirect support ranging from access to bank financing, approvals and exclusive licences. Flexible and adaptive, they are quick to seize market opportunities or to use technology to catch-up and even leapfrog global competitors. On the negative side they still suffer from highly personalized management styles and lack the structures and skills to build large national businesses.

- **SOEs:** The remnants of China's centrally planned economy and originally established as production or distribution units controlling assets on behalf of national, provincial and municipal and township governments. These organisations were required not only to fulfill the government's production plans but also to meet social objectives, providing employment, housing, education and medical facilities and pensions to workers and their families –the so called "iron rice bowl". Since 1993 China has been in the process of restructuring its SOEs, separating the enterprises from government and making them profit responsible. In practice many SOEs still operate as loss makers, suffering from inefficiency and overstaffing, and limited understanding of how markets operate. Government financial support means that often they do not behave as profit motivated entities and they may invest in excess capacity, or price their products below cost as they seek to achieve other objectives. Don't assume the motivation of their leaders in deciding to trade with you or form a joint venture is in improving their business, It may be more to do with improving their own lifestyle or traveling abroad.

The Data where is it?

One of the most immediate challenges facing any potential new entrant into China is the difficulty in obtaining accurate market data. There are two factors at work here.

Firstly China's size and the problem of finding your way around the bureaucracy makes it difficult. Demand for market data, as opposed to production statistics, is only a relatively recent phenomena. Other than the government, there are few sources of information. In many cases the data just does not exist. Where government data does exist, it is frequently unreliable. Indeed this can be understood by the fact that, until recently, senior leaders spent much time setting targets and exhorting their people to work hard and devote all their energies to achieving these outcomes. Often linking success to national pride –"face". Government officials and party cadres were rewarded, or punished, for exceeding or missing these figures, leading to a culture of reporting the good news and covering over the bad.

The situation is getting better as the central government moves to collect more data itself and cracks down on offending bureaucracies but over-reporting of economic and production data persists. It is most common at township and municipal level and for less sensitive data, but even some provincial GDP growth figures continue to be inflated. An industry of private researchers is developing but it will take time and the chances are you will need to do most of this work your self.

Secondly, and perhaps more critically, the Chinese deal differently with facts. Faced with a lack of information in the past, managers formed their own views, they also developed a very cynical view of the official figures. In my experience it is not uncommon for members attending a meeting of a company board to arrive with their own set of numbers, their own opinions as to what is really going on. The "correct" figures inevitably belong to the most senior person present. The idea that it is possible to peal away the layers to reveal the one single universally held truth has not yet fully taken hold. In this context it is not surprising then that, when you ask an official for data on the size of markets and growth rates regardless of the information they have available they will often give you detailed numbers rather than admit to a lack of knowledge and risk loss of face.

The Role of the Party

The party has come a long way since Deng Xiaoping called for the introduction of a market economy in 1992. Discussion of China's socio- economic environment often highlights the Chinese political system and national or provincial leaders and their positions within the party. What is frequently overlooked is role of the party in the day-to day running of SOEs. Whilst the number of public and privately owned entities is increasing, if your strategy involves establishing a joint venture with a Chinese organization, it is most likely to be a SOE. Many of your key people will come from and continue to belong to the SOE work unit.

Until 1993 the role of the party in managing and guiding the affairs of SOEs was enshrined in legislation, which provided that the local organization of the party was responsible for supervising the implementation of the party's "guiding principles". Although diluted, the party's influence continues. For JV enterprises the influence of the party is most visible in the HR area and through the appointment of a party secretary for the JV.

This official will expect to be consulted in all major people matters including decisions on new appointments, promotions and salary increases. In the more conservative regions industries, it is not uncommon to see the JV's formal system of performance management to be shadowed by the party's procedures under which the performance of the JV personnel on the Chinese side are closely examined by the part secretary.

Joint Venture Partners

Early foreign investments in China were inevitably either Equity or Contractual Joint Ventures as this was a requirement under Chinese law. As the rules were relaxed JVs continued to be popular as a means of reducing risks and learning more quickly, the foreign investor assuming management control and using their JV partner's relationships to access markets, obtain permits and approvals and shore up government support. The Chinese JV partner often contributed the land. Given China's complex and sometimes chaotic system of land tenure, the foreign party was happy to see the Chinese partner attend to the problem of dealing with the bureaucracy without distracting the JV.

Joint Venture partners are no longer a necessary evil. Studies show that, whilst JV businesses have generally been able to achieve more, early, this has often come at the expense of the business' long term development and locked in in-efficiencies and poor practices. JV partners inevitably bring baggage, the most common being a lack of cash. Whilst this is itself not fatal, the partners' needs must be compatible, the local partner must be prepared to support expenditure on advertising and brand building, staff training or to water down their equity if they are unable to contribute their share of the JV's cash needs.

In short, both partners must have a common "vision" for the JV and the local JV partner must be able to add value throughout the life of the JV, otherwise go it alone.

Common Strategy mistakes

The most common mistakes made by companies in their China strategies, in no particular order, come under the following headings:

- **Lack of strategy**

Enticed by the glitter of China's large rapidly growing market and its apparent lack of sophistication and encouraged by local joint venture partners eager for new technology and modern management methods, many China entrants have found themselves on the ground owning capital and people without a clear strategy. History has proven that this lack of strategy, sometimes excused an "opportunistic strategy", has rarely succeeded.

- **Attempting to transplant Australian business models**

Only marginally more successful than companies without a strategy are those who's strategy is to rely on the business model that works at home. Many of the Australian and western models, - the truisms that we have grown up with in business, simply don't work in China. For example, labour is very cheap, business models based on saving time and people are unattractive to customers for whom labour costs are cheap and who cannot lay-off staff. Business models that rely on JIT and slick national distribution have foundered in the face of three, sometimes four, layers of state owned distribution monopolies and poor transport infrastructure. Time and time again foreign players have overshot the mark by offering the products they make back home, products of a higher quality than customers demand or are willing to pay for. Your China strategy must recognise the uniqueness of Chinese markets, culture, social and physical infrastructure.

- **Underestimating time and resources**

Having done their homework and developed a business model capable of succeeding in China new entrants often underestimate the time, cost and resources it takes to fully implement their strategy. Expatriate costs can be as much as 100 the cost of local managers and can send a JV to the bottom before it is able to build a market presence. Building factories and penetrating markets in a foreign environment inevitably takes longer than expected. There are few people who speak English, even fewer with skills and experience in areas such as management, marketing, and operating to global quality standards. Many of these businesses would have been profitable in the long term had they been able to weather the storm. The tendency of CEOs to counterbalance their board's nervousness, and the higher risks of doing business in China by over-promising has often compounded the problem.

- **Underestimating the strength of competition**

Chinas markets are amongst the most dynamic and competitive in the world. Aside from the presence of the leading global players and the emergence of major local companies, there are two other factors that set Chinese markets apart. The Chinese are deal-makers and they learn very quickly. The Chinese are very quick to adapt and close the gap on their competitors, outstanding negotiators, ruthlessly exploiting weaknesses and leveraging any potential source of competitive advantage. Stories abound of foreign partners contributing leading edge technology to their Chinese joint venture only to find that the technology has been copied in their JV partners much larger and better-located factory.

- **Lack of market understanding**

Much of the early foreign investment in China was concentrated on building and operating factories or securing access to resources or licenses. As these investors turned their attention to domestic markets, the most obvious opportunity was to use the new technology to obtain step changes in productivity and product quality. The pathway to squeezing out the poorly managed low technology local players seemed obvious. However, many of the products produced were not wanted by the local market, manufacturers overshot the market in terms of quality and markets turned out to be much smaller than anticipated. In short, this focus on operational efficiencies had distracted from the more difficult and important task of understanding customers and market dynamics. Other companies took a different and often more successful route, entering into local manufacturing only after many years of selling into China markets through representative offices and trading companies. The situation is changing, quality expectations are rising and some quite wealthy consumer markets are emerging. Nevertheless the winners will continue to be those companies that have taken the time and effort to build an understanding of the market.

In summary, despite the apparent attractions of the world’s largest population and fastest growing economy organizations entering the China market must get the strategy basics right.

- They must be clear on what they are good at
- These competencies must be aligned with the strategy that they choose
- Strategies involving cost leadership involve more than just investing in equipment, they require a long term commitment to building a competitive advantage through market presence, people and economies of scale.
- Very simple strategies based on technology advantage are unlikely to be sustainable in the medium, long term

Lastly, in recognition of China’s very different operating environment, they must set out to learn faster than their competitors.

Case studies

We now have over 12 years of history of Australian companies operating in China, indeed there are now some companies that have in China for over 30 years.. There is a lot we can learn form these organizations. There have been some major successes and some costly failures.

In many cases the mistakes made were not so much the result of a lack of strategic thinking or poor strategies but, the result of an inadequate understanding the Chinese operating environment. In other cases the business’ failure was ultimately a result of difficulties in executing strategies. In understanding what went wrong it’s the detail, the texture that is important.

To assist this understanding I will take the reader through two case studies involving Australian joint ventures in the building materials industry.

Case Study 1: CSR Tianjin Readymix

Background

- Feb 1994 Joint Venture agreement signed and US$50M Readymix investment committed.
- JV with SOE subsidiary of Building Materials Bureau (30%).
- JV to build 4 premix plants and acquire bankrupt quarry (incl 550 people).
- Tianjin high growth market, foreign invested enterprises and high rise buildings demanding higher quality standards.

Strategy

- Utilise superior technology and high quality product to win market from local producers.
- Grow the use of premix by demonstrating its advantages vs site mix.
- Utilise the quarry to provide high quality raw materials and generate long term returns.

Results

- April 1995 plants commissioned, 500 people trained.
- 1996 sales exceed 450,000m3 (approx size of CSR Melbourne business) - 30% of market.
- 1997 small profit, further plant built in Tanggu.
- Quarry: in excess of 1000 competitors, prices less than 50% of feasibility study.
- 2002 quarry sold back to original owners, proceeds used to buy out JV partner.
- 2004 market entry into Qingdao.
- Currently earning in excess of cost of capital after $20million write down.

Positives

- First mover advantage gave strong sales growth, no other global players in Tianjin market.
- Established strong relationships with Tianjin Government.
- Brand well known throughout North China.
- Business model (strategy) refined and now used as a model for entry into other markets.

Negatives

- Ownership of land and key assets (Quarry) by Joint Venture partner disputed-leading to operational difficulties and partner’s equity overvalued.
- Time, cost (incl. high levels of working capital) and management resources to establish business much greater than anticipated.
- Growth of premix slower than expected, strong resistance from local construction industry.
- JV partner’s lack of cash impacted growth of JV.

- High charges form JV partner controlled entities - rail, transport depots, diluted earnings.

Neutral

- People development much slower than expected, limiting expansion to other markets.
- CSR culture not yet in place.

Case Study 2: Beijing Plasterboard

Background

- Daxing (Big Happiness) factory 45km SW of Beijing.
- J V (CSR 55%) with SOE, Beijing Light Building Materials (BLBM).
- Parent organisation similar size to CSR (70 JV's).
- BLBM to contribute one of two Plasterboard factories.
- Plasterboard on-allocation, strong growth forecast as high rise buildings take-off .

Strategy

- Expand small low tech factory to supply northern China.
- Develop strong brand and national distribution network to support major factory expansion
- Improve pricing by offering superior product
- Build on JV partners parent's established relationships, networks.

Results

- 1994 CSR first global player into China, strong brand position
- 1996 factory expansion unable to achieve design capacity
- High quality product unable to achieve significant price premium over local product
- Major global players (Lafarge, Thai Gypsum, Boral) enter market

- 1997, 280 Million m^2 plasterboard capacity in China market of 80 Million m^2
- Prices and sales volumes decline, inventories grow and debtors increase to over 100 days
- 1998 Joint Venture near insolvency, partner continues to operate own factory
- Partner agrees to purchase CSR 55% equity for cash
- Chinese Government legislates minimum prices
- Provincial governments approve 4 new factories

Negatives

- Wrong partner, wrong plant
- Inadequate market intelligence
- Conflicting Joint Venture objectives
- CSR Core competencies in marketing /product development not easily transferable

Positives

- Successful early exit, things can and do get worse.
- CSR reputation and key relationships preserved
- Clear objectives and HO support enabled management to “play hardball” and negotiate a better outcome than typically the case
- Learnings that can be applied elsewhere

Background Papers

Chinas banking system

As China moves to rationalise its creaky banking system, it also needs to create more robust capital markets. Bank reform is progressing well but capital-market reform is barely getting off the ground.

Bank lending growth will be far slower over the next three years than it was during the past three. This is partly because the past three years saw an unhealthy credit binge to which Beijing has rightly put a stop. More important, however, are new capital-adequacy rules which will force mainland banks to focus on shoring up their capital, rather than increasing their loansThis means corporations will have to find other sources of funds. The two main sources are the stock market, which is in poor shape, and the bond market, which is virtually non-existent.

The stock market is burdened by two problems. First, two-thirds of the shares of listed companies are non-tradable shares owned by various state entities. The government has yet to find a way to release these shares into the market without making stock prices plummet. The other problem is that most of the 130 or so brokerages that conduct market trades are either insolvent, hopelessly corrupt, or both.

After years of inaction and hundreds of exposes in the mainland financial press, the China Securities Regulatory Commission (CSRC) finally appears ready to clean up the brokerage industry. Starting with China Southern Securities in January, the commission has orchestrated the takeover of at least eight major brokerage firms. Several have been placed in the hands of the asset management companies set up in 1999 to work out the mountain of non-performing loans accumulated by the state banks. In addition, the CSRC has created a "blacklist" of 63 high-risk brokerages - nearly half the total - which are likely to be closed or reorganised in the next 18 months.

Exactly what commission and asset management companies will do with the brokerages they have taken over is unclear. Most likely, there will be an elaborate, behind-closed-doors shuffle of assets and liabilities which results in the closure of the worst brokerages, partial payoffs to the firms' shareholders, and the squirreling away of the brokerages' bad debts in the management companies, where they can be kept off the government's books for several years.

Once the brokerage sector is cleaned up - a process which is unlikely to be complete before the end of next year - the government may be ready to tackle the state share problem. But not before then.

Developing a corporate bond market is trickier and may take longer. The first major issuers of bonds will be the state-owned banks, which are likely to issue tens of billions of yuan in debt over the next two years as they try to shore up their capital bases. Real bond issues by real corporates will be slower in coming, in part because rules have not yet been established to enable major institutional investors such as insurance companies and pension funds to invest heavily in such bonds. Another reason is that China does not yet have a really effective credit-rating industry, essential if bonds are to be properly priced.

A final problem is that development of a bond market directly conflicts with the development of the stock market. Who would be the most likely firms to issue bonds? The top 50 or so state-owned corporations, with strong market positions and steady cash flows.

Unfortunately, it is precisely these same 50 companies that are being asked to step up and rescue the stock market. With cheap funds easily available from the stock market, what corporation in its right mind would issue bonds that add to its debt load and interest costs? Most likely the end of the decade will arrive before China has a bond market worthy of the name.

The Party's influence waning

Recent reforms at two of the mainland's big four state-owned commercial banks may be eroding the long-entrenched role of Communist Party committees at Chinese financial institutions.

Historically wielding huge influence over day-to-day operations and lending practices, the representation of party committees on boards and their power to appoint key managers have been reduced during recent reorganisations at the Bank of China (BOC) and China Construction Bank (CCB).

Suggestions have also been floated to merge the investigation and disciplinary functions of the party committees into the internal audit systems being strengthened at both banks, according to Xie Ping, general manager of Central Huijin Investment, the company set up last year to manage state equity stakes in the banks.

"During the experiments with corporate governance reforms at state-owned banks, the role of the party committee is the most challenging and debatable issue," he said. "The topic is being explored."

So too is the issue of party-related expenses.

"We are also calculating party-related activities' contribution to the banks' operating expenses," Mr Xie said.

Beijing chose BOC and CCB last year to pilot a far-reaching reform programme to transform the big four - including the Industrial & Commercial Bank of China and Agricultural Bank of China - into competitive modern corporations.

Party committee members now occupy only four of the 13 board seats at each bank, while non-executive directors now have taken up the majority of board seats.

Addressing concerns by independent directors that their voices may be silenced by party decisions, Mr Xie said that "the relationship between the party committee and the board of directors is clear" and that the party would not interfere with commercial operations.

"The board of directors is set up under the company law," he added. "The Communist Party documents say clearly that the party's activities must abide by the country's law."

While Communist Party committees may still retain the authority to appoint branch chiefs and departmental heads, CCB and BOC have replaced life-long civil servant positions with business-defined managerial roles subject to standard employment contracts.

The two banks have hired headhunters to recruit chief risk officers and chief credit officers internationally. Such high-level executives would have been appointed by the party's organisation department under the old system.

Mr Xie also called for the published and actual take-home pay of senior managers and board directors to be unified and determined by market forces, to reduce the incentive for graft. "A dollar value must be put on duty-related consumption. Subsidies in the forms of housing and use of cars should be monetised," he added.

The disparity was at the heart of the downfall of former BOC vice-chairman Liu Jinbao who faces charges of graft, bribery and embezzlement involving more than 41 million yuan during his tenure as chief executive of BOC Hong Kong (Holdings).

China and Globalisation

In the 1980s, Japanese firms made headlines worldwide by acquiring trophies such as Columbia Pictures, the Rockefeller Centre and Pebble Beach golf course. This global expansion generated envy and resentment, but over-expansion and a decade-long recession at home brought a mass retreat in the 1990s.

Now China is the new rising sun in the east, acquiring oilfields, mines and global brands such as IBM Corp, Thomson Investments Group, MG Rover Group and Ssangyong Motors. In 2003, China spent nearly US$3 billion buying foreign firms and the figure this year could reach as high as US$14 billion.

Amid the euphoria over these high-profile purchases, there is concern that Chinese companies will meet the same fate as their Japanese counterparts.

"Chinese firms have such a long way to go," said Wang Zhongming, director of the research centre of the State Assets Supervision and Administration Commission. "Only a handful of Chinese companies operate globally and they are only in the initial stage."

The odds are against China, given the fact that firms such as Lenovo Group and TCL International Holdings are young and inexperienced in the global market. They know more about price wars and building capacity in a domestic market that has been partially protected than operating in different countries and cultures.

State monopolies such as PetroChina, CNOOC and China Minmetals Corp are even less tested in the real business world. They have an unimpressive record of corporate governance and risk management. As the scandal at China Aviation Oil (Singapore) Corp shows, government bureaucrats are ill-equipped to run high-risk operations in the real business world.

The most obvious problem is that firms are paying too much. Many believe Lenovo overpaid for its US$1.75 billion purchase of IBM's personal computer division.

BOE Technology Group of Beijing is another example. In November 2002, it spent US$380 million to buy a South Korean manufacturer of liquid-crystal displays (LCD).

On January 7, BOE shares on the Shenzhen exchange hit a new low of 5.61 yuan - a quarter of its record high of 24.08 yuan four years earlier - as investors feared it had spent too much on acquisitions, running up a debt it would not be able to service when LCD prices fall.

Then there are other problems common with cross-border mergers and acquisitions - clashes of corporate culture and working practices and finding and keeping capable managers.

In the background is a bigger problem - a political backlash against China in a world already wary of its rising economic and military power. During its ascension, Japan survived constant criticism of its economic policies from the United States and Europe because it was a close ally of Washington, which needed a strong anti-communist friend in East Asia.

But China is rising in a post-cold war world and belongs to no global alliance. Its two biggest neighbours, Japan and Russia, regard its economic success with ambivalence, welcoming the chance to export and invest but uneasy where the success will lead.

This is why Chinese companies have failed to buy Russian companies Slavneft Oil and the largest production unit of Yukos Oil, while Moscow preferred a pipeline to its Pacific Coast to supply Japan over one to the Chinese city of Daqing.

China does not have the political clout to back its overseas expansion, like the US or colonialist Britain or France. Britain's commercial power at the end of the 19th century depended on the world's most powerful navy, the world's dependence on the London capital market and the technological prowess of its companies, a role which the US has largely taken over. China has none of these attributes.

For example, in the case of a conflict in the Middle East, which accounts for more than half of its oil imports, Beijing has no military presence and can rely only on quiet diplomacy.

China also cannot develop global companies as Japan and South Korea did by virtually closing their markets to foreign goods and investment to enable their own companies to accumulate profits at home to fund an aggressive export strategy and substantial research and development (R&D) spending.

The two nations were able to do this as allies of the US, which tolerated their protectionism and high trade surpluses as the price it had to pay to keep them in the anti-communist camp during the cold war.

Despite these concerns, Chinese companies believe they have no choice but to go overseas. Acquiring oilfields, mines, steel plants, forests and other overseas resources is essential to support continued growth at home. By 2020, China will be self-sufficient in only six of the 45 most important minerals and will run out of domestic copper reserves in 10 years.

For manufacturing firms, using capital to acquire a global presence is essential for long-term survival.

They see a domestic market saturated in most products, with low-profit margins, and to which the foreigners enjoy increasingly better access under the World Trade Organisation terms. The foreign firms are better managed and financed, and have decades of global experience and key technologies.

Multinationals have built giant plants on the mainland to exploit the same cheap land and labour as local firms, leaving them to take on their foreign rivals abroad as well as at home. Foreign firms now dominate the Chinese market in mobile phones, digital cameras, copiers and lifts. The share of Chinese brands in the local handset market fell from 50 per cent early last year to less than 40 per cent in June.

"Before WTO, we could rely on the domestic market alone," said Li Dongsheng, chairman of TCL, one of the few Chinese firms that can call itself global. "But, once the domestic market was completely open to foreign companies, our option to rely on this single market was closed."

Driving Chinese firms abroad is the search for what they need to become global companies - international brands, key technologies, a strong R&D capability, presence in different markets, access to global capital and the qualified personnel able to operate such companies.

While China was the world's third-biggest trading nation last year, more than half of its exports were produced by foreign-invested companies. China overtook the US as Japan's largest trading partner last year - but many of these Japanese exports became televisions, shoes, cameras and other products that were exported to the US. In other words, Toshiba Corp and Sony Corp simply moved the factories for their American customers from Japan to China.

As a result, China has almost no global brands, and many of its companies produce for someone else. It has become a platform for multinationals who have turned China into a global centre, where they enjoy the lowest production costs and challenge domestic firms at home as well as abroad.

"To say China is the workshop of the world means something different to what it was in Britain, the US and Japan," said Mr Wang. "These countries not only had leadership in their industrial sectors but were also breeding grounds for new technologies.

"China is actually a global manufacturing plant - and the workshop is not in China but in Silicon Valley and the science parks of Europe and the United States."

He said that the majority of Chinese firms were at the primary stage of internationalisation, making OEM (original equipment manufacturer) goods with limited profit margin. In the second stage were a handful, such as TCL and Huawei Technologies, with overseas production and sales networks. "The third stage means global operations, with investment companies and R&D centres worldwide. This is far in the future for Chinese firms." This is the new Long March on which Chinese companies have embarked, whatever the price they have to pay.

Increasing Worker Activism

The recent surge in industrial unrest in China is due in part to a growing awareness of workers' rights in the country, observers say. The internet, in tandem with a surprisingly activist press, is giving Chinese workers unprecedented access to information about wages, benefits and work rules.

The presence of multinational corporations is also helping to raise expectations. "Labour unrest has been around in China for some time, but the frequency has been increasing in the past three years, particularly this year," said Liu Kaiming, executive director of the Institute of Contemporary Observation, a non-government organisation focused on migrant workers.

The central government, too, appears keen to ensure its urban working class political base gets its fair share of the country's newfound prosperity - and equally eager to prevent labour tensions from manifesting themselves as general social unrest.

Workers who lead protests and strikes still do so at great risk of prosecution. But Beijing now publicly acknowledges that millions of Chinese workers are underpaid, overworked or otherwise exploited.

National television network CCTV began broadcasting regular programmes on labour laws and fair labour practices a few months ago. Some newspapers have also reported on poor working conditions and labour disputes at mainland factories.

"The workers are smarter than before. They know their rights," said Wandy Lau Suk-kwan, assistant general manager at a factory of the TAL Group in Dongguan.

Last month, the Ministry of Work and Social Security announced a five-point doctrine for improving employment conditions for migrant workers in urban areas.

First, the government will eliminate restrictions on companies employing migrant workers. Second, public job agencies will be opened to migrant workers. Third, labour in the countryside will be included in government training programmes. Fourth, the government and private sector will jointly provide job information for migrant workers. Fifth, job training centres will be set up in poorer regions.

Multinationals are also playing a role in spreading awareness of workers' rights in China. Some now conducted courses in work safety and labour laws in the factories of their suppliers, said Stephen Frost, a research fellow at the City University of Hong Kong.

Over-investment

Let us take care of one non-issue straight away: China now is not like Southeast Asia just before the financial crisis. The Southeast Asian countries, notably Thailand, did not have enough domestic savings to finance their high investment rates. So they brought in a lot of short-term foreign capital, via loans and equity sales. This was cheap for them, because their exchange rates were overvalued. But when returns on investment began to look shaky, foreign capital fled, and currencies and banking systems collapsed.

China has an almost exactly reverse situation. Its high investment rates are covered by even higher domestic savings rates; foreign capital comes in mainly in the form of direct investment, which is inherently long-term; and its currency is, if anything, undervalued not overvalued. So an Asian-crisis style collapse is not plausible.

Much more plausible is a Japan-style slowdown. Excessive investment in low-return projects leads to ever-increasing non-performing loans in the state banks. So much capital is tied up in low- or zero-return projects that it cannot be redirected to high-return projects. As a result, growth slows dramatically, and for a long time. This scenario is the single biggest medium-term threat to the Chinese economy, and officials are well aware of this. In November, National Development and Reform Commission chairman Ma Kai , head of Beijing's planning bureaucracy, said excessive investment was "a chronic illness of the Chinese economy".

But China has a good chance of escaping the long-run slowdown forecast by some pessimists. The reason is that it is making serious progress towards making capital allocation more efficient.

As we noted last week, China may be wasteful now, but it is far less wasteful than it was a decade ago, when its state-owned factories churned out goods nobody wanted. Now China's factories, private and state-owned, churn out goods and keep lowering their prices until they find buyers. This is not nirvana, but it is progress.

Of course, the only reason manufacturers can lower prices without limit is because their cost of money is effectively zero. In short, China now employs its capital assets more efficiently than it once did, but it does not price them efficiently. Looking ahead, China can maintain efficiency gains only by forcing the price of capital to rise.

This is precisely the aim of the central effort of current government economic policy - financial sector reform. Conventional wisdom says the banks are in horrendous shape and the task is appallingly hard. So what? Exactly the same was said of state-enterprise reform a decade ago. It is ludicrous to assert that a government that could throw 20 million to 40 million industrial workers out on the street has neither the wit nor the guts to shake up the financial system.

The political problem we foresee is not, as generally discussed, some sort of popular uprising against Communist Party rule. Rather, it is a backlash against the foreigners who control ever-greater swathes of the Chinese economy. Foreign firms control a large (55 per cent) and ever-rising share of China's exports, and are even more dominant in hi-tech fields. Foreign companies are likely to be major buyers in the manufacturing-industry consolidations that will occur over the next decade as the cost of capital rises.

Opening Up China to the Multinationals

Letting foreigners into the domestic market has always been controversial in a country with a history of unequal treaties and foreign concessions. From the merits of setting up special economic zones in the 1980s to joining the World Trade Organisation (WTO) in 2001, there have always been critics shouting about a sell-out to foreigners.

Now, as China moves close to fully opening its market in 2007, as required by the WTO, the Ministry of Commerce has published a report that has focused domestic attention on this sensitive subject. The ensuing debate will shape policies on tax and other privileges enjoyed by foreign investors.

The report by a ministry think-tank concluded that, although the flood of investment since 1980 had improved China's technological prowess, it had not brought about all that the country had hoped for.

"The increase of investment by multinational companies [MNC] has not brought to China the benefits it should have and not entirely fulfilled the original promise of `exchanging market for technology'," said a summary of the report on the ministry's website.

"The negative impact on the technical progress of domestic firms is becoming evident, with MNCs using their superior market position to create monopolies and limiting competition in some sectors."

While foreign investment was a major driver of gross national product growth, this was not matched by a commensurate growth in national income, the report said, noting about US$12 billion in profits from foreign ventures left China each year between 1993 and 2003.

The report was published at the end of last month, just one month after the third anniversary of China's entry into the WTO and the date on which the government further opened the markets, especially in sales and distribution.

Domestic retailers are alarmed by the expansion plans of Wal-Mart Stores, Carrefour, Metro and other foreign giants.

Chinese firms across the board are calling for an elimination of the tax privileges accorded to foreign-invested companies, saying they are outdated and unfair to them now that the domestic market is open.

More positive than negative, the report does not indicate any major change in policy and Chinese leaders continue to stress inward investment is vital to maintaining a high level of growth and keeping unemployment at a tolerable level. Rather than eliminating the privileges, Beijing is more likely to fine-tune them to attract investment that brings more benefits. Pressure is rising on Beijing to equalise business taxes paid by domestic and foreign firms, which enjoy a substantially lower rate.

For their part, MNCs are deepening their involvement in China, diversifying from simple manufacturing into replicating their foreign supply networks, as well as research and development, marketing, distribution and after-sales. By the end of last year, foreign coompanies had set up more than 750 research and development centres in the mainland.

Since the late 1970s, China has attracted more than US$550 billion in foreign investment, which accounts for 10 per cent of its fixed-asset investment, more than half of its trade and 20 per cent of taxes. It has also brought 22 million jobs.

Wang Zhile, director of an MNC research centre and the report's main author, said the flood of foreign investment had been very beneficial to China overall and the country must continue to work hard to attract it.

Chinese companies must accept much of the blame for their lack of technological progress, Mr Wang said.

"Chinese firms do not want to spend on R&D. They buy equipment and technology and make a product and then buy another one. We should not criticise the foreigners for this. This is our problem."

Chinese firms should learn from Japanese counterparts that invest in technology and absorb it to create their own.

"You can buy technology but you cannot buy the ability to create. Some people in China do not understand this," Mr Wang said.

He said that China must keep incentives for foreign investment but use them more selectively to attract funds into chosen industries and geographical areas.

Competition for foreign investment was global and China's neighbours were especially eager for it, Mr Wang pointed out.

Xu Xiaotian, secretary-general of the China Semiconductor Industry Association, said the massive injection of foreign investment had greatly accelerated the development of the chip industry in China.

The industry had moved beyond mere assembly and had begun to develop its own intellectual property, he said.

"How you use this foreign investment is a measure of the success of exchanging market for technology," Mr Xu said.

Other economists were not so sanguine about MNCs.

MNCs only used China as a base for making low-cost products and jealously guarded their key technologies, they said.