China :: Integrated

The **China Integrated** Analysis
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Will 2019 be the Year when Foreign & Swiss Businesses do better than their Chinese Competitors?

China grew 6.6% in 2018, a less than impressive figure when reading press headlines reporting the slowest growth in 28 years. Yet China added USD 850 Bio to its GDP. In fact, it is no small feat since this increase is more than the total 2018 GDP of Switzerland ($709 Bio).
And Switzerland is one of the world top 20 economies.

No wonder then, when recasting China's economic performance in comparison of other countries GDP, that the Swiss Business in China Survey (which we co-conducted in December 2018) shows very good results for Swiss (and international) companies in 2018.

Still bad economic news abound and the future looks less than rosy when analyzing them.
For example, China's car sale dropped by 19% in December 2018 compared to the same month of 2017, recording its 6th consecutive month on month fall and bringing annual car sales 2.8% lower than in 2017. This is the first yearly automotive decrease since 1990 after the Tiananmen crack down. For those who have experienced the Chinese environment in the last decades, negative growth in any sector is just unheard of.

More bad news come from the Shanghai stock market. It just ended the Chinese Year with its worst loss since 2008 (-18.2%). And the official Purchasing Manager Index indicates that China's manufacturing has been contracting for the last 2 months, at least.

The surprise, therefore, is that international companies surveyed are inordinately optimistic for 2019: overall they predict that this year will be better for their business than the last. But what is even more extraordinary is that they make such forecast while local Chinese companies see it the other way round!

Increasing sales for Swiss (& US, EU) businesses – but opposite trend for Chinese firms

Year after year, in the past 4 years, more and more international companies have forecasted growing sales. (See the chart below. Swiss in red, EU in blue and US in green.)
Looking at Swiss businesses, 76% expect growth in 2019, up from only 59% in 2016. It is a remarkable evolution, which is mirrored by EU (79% up from 61%) and US (74% up from 59%) firms responding to the survey.

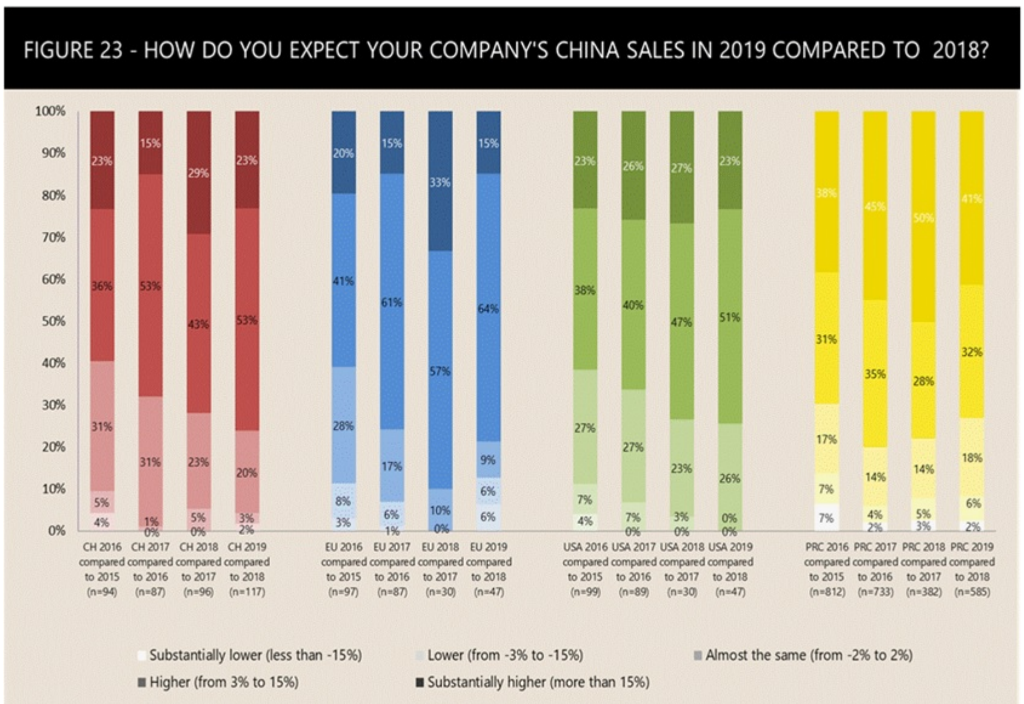


FIGURE 23 - HOW DO YOU EXPECT YOUR COMPANY'S CHINA SALES IN 2019 COMPARED TO 2018?

Extraordinarily, from 2017 onwards, less and less Chinese companies have announced improving sales forecast. So much so that in 2019, 73% of them only expect growth, less than the respondents representing all the other countries.

In a country that is known to promote and protect its own businesses, one would expect domestic Chinese companies to show a trend better than foreign ones, or at least a similar trend. Why could that be so?

Conventional wisdom is usually wrong in China matters

As pointed out in our previous analyses, what meets the eye in China rarely provides satisfactory explanations. As a result, misunderstandings on what happens in China are more often the rule than the exception.
In this case, we believe that China's overall need for product quality and manufacturing efficiency provides good reasons for this situation.

Indeed, China has embarked in a drive to improve the quality of its products. As mentioned by Vice-Premier Liu He in Davos a year ago, China needs to stop producing more but produce better instead. And product quality is undoubtedly, still today, a competitive advantage of international companies operating in China. Examples abound: Swiss sell more and more of their watches in China (11% more in 2018, see details here), while the Americans and European continue to sell high quality cars and airplanes, among others.

There is however another important element, in our opinion, that we believe is a key factor to understand this trend. It is the relentless need for productivity that businesses must fulfill in China since a few years. It is no secret that salaries in China go up every year by amounts unheard of in the rest of the world. 6% to 15% increases are common depending on the industries and different locations. What is not so well understood is that these wages hikes do not stem from scarce labor and market forces. The key reason is actually the minimum wages increase ordered by the government all over the country. At the same time, competition is so intense that prices are not going up. In manufacturing, actually, factories still have to lower prices yearly under heavy customer pressure. As a consequence, margins are squeezed every year ever more tightly. The inescapable result is that China operations face the relatively new, but ruthless imperative to make more products with less resources, every single year.

In the past decades, the western business world has faced a mirror situation which required very much the same measures. Prices in our home markets came under pressure from low-cost, Chinese-made products. China was named the Great Deflator and businesses have been forced to lower the unit costs of their products to stay competitive.
Japanese manufacturers invented lean and industrial robotics, European followed and developed better and better production techniques and equipment. The Swiss additionally had to find ways to compensate the appreciation of their currency to remain competitive worldwide.

Today, in an almost ironic reversal of fortunes, the relentless chase for efficiency that western companies had to pursue for the last 3 decades has put them a step ahead of their Chinese competitors. Western companies active in China can reasonably easily increase their productivity by copy-pasting the efficiencies they have developed in their home countries. On the other hand it is at the moment much harder for domestic firms: they have to change their mindset from just making more to become efficient in everything they do. They have to learn from scratch how to raise their productivity, often by a brutal amount every year.

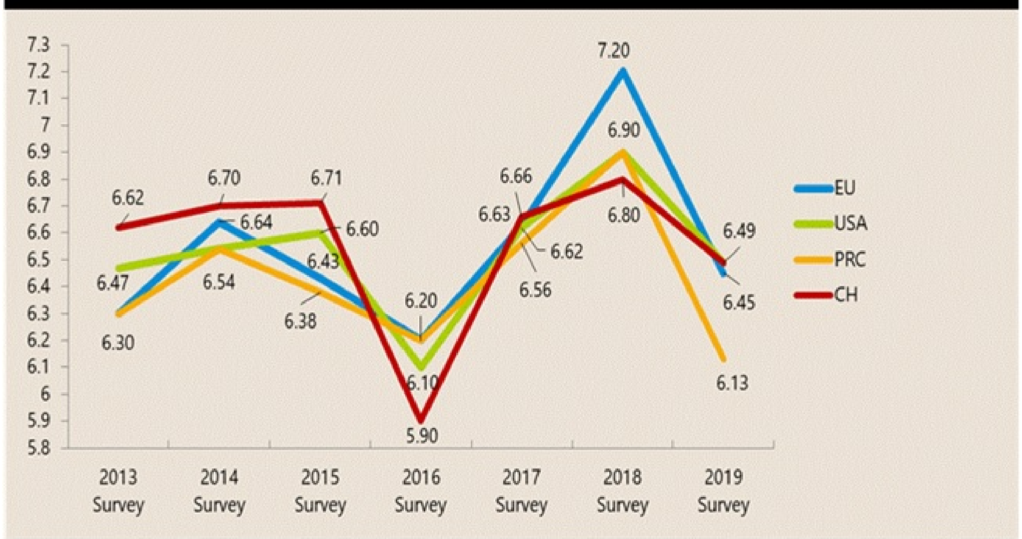
No reason for hubris though – confidence is going down

The productivity know-how and quality competitive advantages of international companies are welcome good news but still no reason for complacency. Indeed and despite the positive forecast of international companies, the bad economic news is real and it is reflected in the lower confidence levels that all economic actors express for 2019.

On a scale of 0 to 10 (with 7 labeled as “confident” and 10 as “extremely confident”) Swiss, EU and US companies report a confidence of around 6.5 on average, clearly lower than what they expressed a year before.

The Chinese businesses announce the biggest drop in confidence among all companies, in consistence with their relatively lackluster sales expectations and confirming the pessimistic growth views of Chinese businesses, if need be.

FIGURE 28 - HOW CONFIDENT ARE YOU THAT YOUR OPERATIONS IN CHINA WILL BE SUCCESSFUL IN THE NEXT YEAR?



All in all, the new Chinese year opens up on a background of economic uncertainties. We will all be watching the international developments, hoping for a degree of sanity in international relations leading to a resolution of the Sino-American conflict or a long term armistice, at least.

Business in China has never been easy. Clearly, if it get further complicated by a worsening trade war, we have to be ready for more difficulties. Yet, the aspirations of the Chinese consumers will remain and China’s large needs for quality growth will still need to be fulfilled.

And then, if we make full use or our natural competitive advantages, we should be able to make the Year of the Golden Pig another prosperous year, hopefully yielding fat profits!

Your China Integrated Team

We hope that the above can be of support for your China strategy and plans. For more information about this topic, do not hesitate to contact n.musy@ch-ina.com.

China Integrated

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