China Integrated

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China’s Goals & Key Challenges –

and the opportunities they generate!

Since Deng Xiaoping launched his reforms, China has given itself the goal to be, once again, a world power. Due to the expanding space that China is taking, economically and on the geo-political scene, the developed world is challenged and often views China’s rise as an aggressive development. Yet for the Chinese people, this is no more than regaining a position that China held not so long ago – its rightful position.

During his second mandate, President Xi Jinping, firmly in power, is making a bid to reassert China’s position in its traditional Asian sphere of influence. In doing so, it is giving itself a number of goals and challenges which will collide with US policy under its new course.

China’s goals and US policy will no doubt set the agenda of the world’s economic opportunities for the years to come and create chances and risks, all at the same time.

Yet, while US policy seems to have become less predictable than China’s intended path, much information is available on the USA’s development. China’s goals and challenges, however, are much less analyzed. Understanding them will allow business leaders to better steer their own path in a changing world.

China and USA: the twin engines of international economic opportunities

In 1820, China accounted for **one third** of World GDP.

In 2017, the People’s Republic was responsible for roughly 15% of total GDP while sustaining about 18.5% of the world population. At the same time the USA generated 25% of the world’s GDP while being home to 4.3% of the world

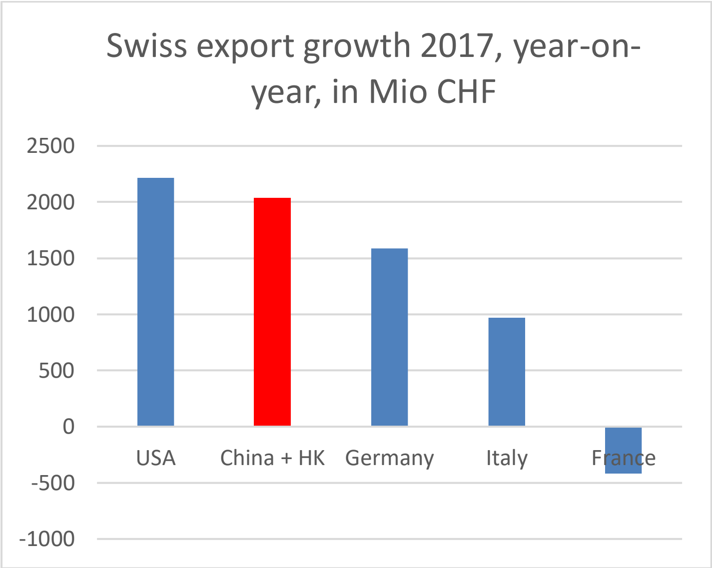
population, only.
(Russia, by contrast, hosts 1.9% of global population and generates 1.8% of total GDP.)

In 2017, compared to 2016, China bought goods from Switzerland for an additional amount of CHF 2 billion. It was the second biggest absolute increase in Swiss exports and amounted to almost as much as the additional CHF 2.2 billion in purchases made by the USA last year.

This example tells the recent story of the world's international businesses development.

From 2008 to 2017, Swiss exports to the world increased by a mere 6.8% (from CHF 202 to 220 billion), while at the same time goods sold to China increased by 66% and those to the USA by 73%.

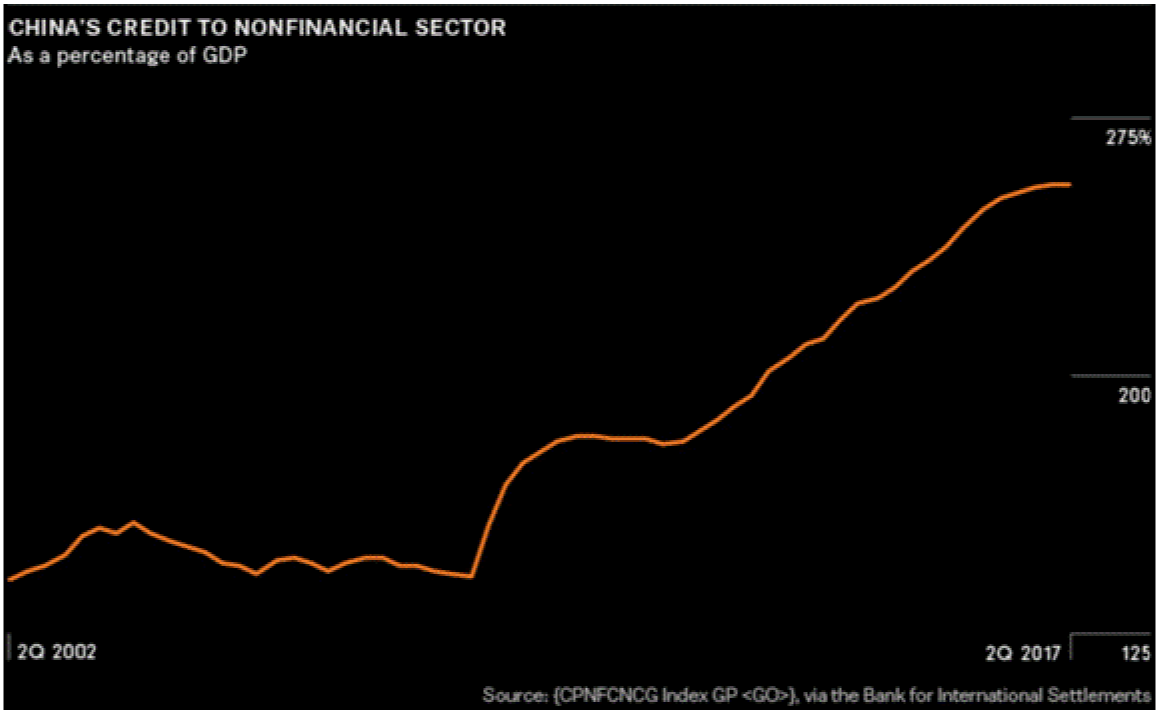
During the same 10 years, India's total import of Swiss products went down from CHF 2.3 to 1.6 billion, a negative growth of 26%. In 2017, India with a population count similar to China's, accounted for just one tenth of Swiss exports to China.



However, while the recent corporate tax reduction will certainly boost investments in the US and therefore continue to generate valuable opportunities for international businesses, the IMF is warning that China's financial system is at risk[1].

China's regularly announced and never happening financial crisis

There is no doubt that China's increase in debt is alarming by the speed at which it is happening. Besides, it is a new phenomenon. It happened during the last 10 years only. Before 2008, China's impressive double digit growth was generated while keeping debt stable with respect to GDP.



Surely, no leader can feel comfortable with such a curve. Why, then, did this happen?

This unprecedented acceleration in debt levels is the answer that China's leadership could give to the new international economic situation following the 2008 world crisis. With the drop in export markets, growth could only be maintained through an extraordinary increase in domestic projects spending.

Indeed, increasing China's population living standards, until they reach levels comparable to those of the Western world, is one overarching goal of the Communist Party. This commitment to provide a better life to the Chinese, along with the restoration of China's national pride, are the key terms of the unwritten contract that the government has passed with its population. This "Compact with China" affords the leadership its most critical legitimacy and ensures social stability.

In Deng Xiaoping's words: "**development is the irrefutable argument**".

This is not new, or news. However, understanding the critical importance of growth for China means that, unless a financial crisis or a geo-political confrontation arises, growth will continue to happen. China will continue to generate upwards of 10 million urban jobs a year[2], even though this will certainly also translate into lower growth rates (in percentage), year by year.

The Compact with China is also the very reason why a financial crisis is very unlikely to happen. While the Chinese are able to sustain enormous hardship inflicted by outside circumstances, an economic crisis due to a failure of financial or other internal systems would create the very situation in which the government will lose its mandate.

That does not mean that China is immune to economic reality, but that ensures that the government pays considerable attention to the risks it is taking and makes sure to control them, before they materialize.
As a matter of fact, the likelihood of a financial crisis is quite low, first because all the new debt that is generated is essentially financed from the Chinese population's savings, but also because most of it is absorbed by state owned companies that are under government control and will not be allowed to fail. In other words, the government controls both ends of the debt: the lenders' savings in government owned banks and the recipients of the loans, which are state-owned companies for 67% of the debt.

Still the challenges faced by the leadership are also encouraging it to increase the financial system's professionalism and efficiency. As a result key limitations on foreign ownership of financial institutions in China are widely expected to be lifted, following the official announcement of November last year[3]. This will no doubt offer many additional opportunities to the international financial business community.

In addition, a comprehensive set of measures have been taken last year to control debt risks effectively[4].

Nevertheless, bolstering the financial system cannot compensate upgrading the real economy for long.

China's growth model of is changing – will the Middle Kingdom eventually become a tech innovator?

In the mid to long term, growth will need to happen through productivity improvement. That is making and selling more value-adding products and services. Additionally, Chinese people need to invest directly, so that money continues to flow into the economy, yet without being borrowed from the population's savings and, as a result, without increasing debt.

The answer to this challenge is smart and simple: turn the Chinese economy into an innovation economy and to do so, let hundreds of thousands of entrepreneurs create new innovative enterprises.

Yet, while Chinese have entrepreneurship almost coded into their DNA (a Chinese abroad is more than often a business owner), China has not lead in technical innovation since its opening up. Indeed, there are so many businesses to be built and so much money to be made by adapting existing innovation made abroad that, today, “Innovated in China” entails mostly “business model” innovation.

Wechat is a good example. It is the third largest social media platform worldwide. And, when using it, one can only agree that by combining the functions of Facebook, Whatsapp and PayPal (and adding some more) Wechat is a fantastic solution. Still, it relies on technology and ideas that were initially developed abroad. The same is true of Alibaba, Xiaomi (smartphones) or Huawei, Cisco’s competitor. (Despite the fact that Huawei is among the top 3 companies, worldwide, filing the largest number of international patents and could well become a true technology innovator in the future.)

As a result, China’s technology sector, from cars to machinery and robots is dominated by foreign players who have come to and invested in China.

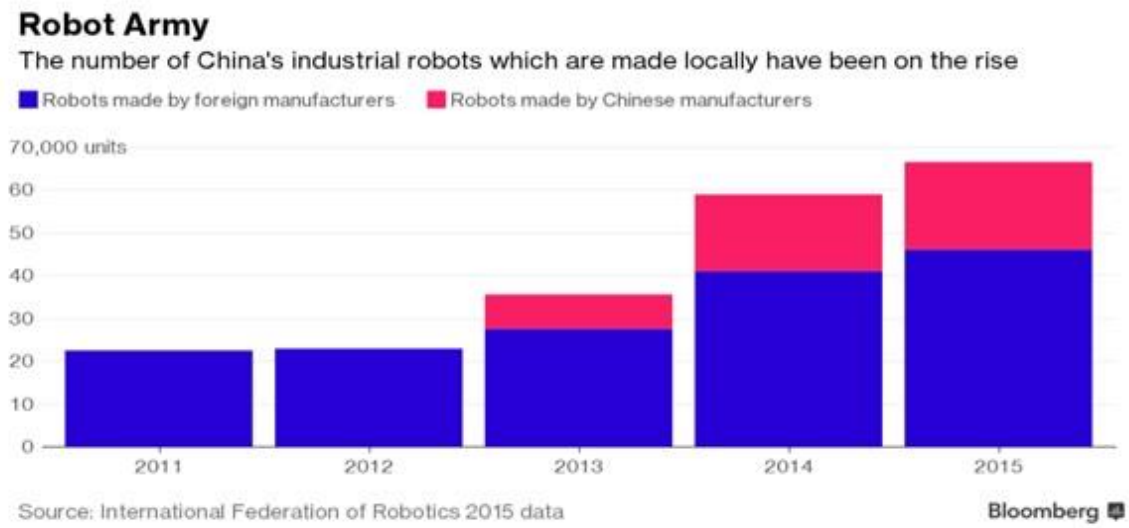
If China hi-speed rail technology is fully dominated by the one and only Chinese railway company (the state-owned CRRC), this has been achieved by requiring that foreign companies offering railway technology make joint-ventures with Chinese counterparts or transfer their technology to Chinese companies.
(This has also been required from foreign auto-makers. However, international car producers are in charge of the design of the finished vehicles, which are fast and constantly evolving. Train engineering development is a much slower process.)

To fill in the gap and jump start domestic technological innovation, the State Council has launched in 2013 the “Made in China 2025” plan. It essentially aims at upgrading China’s industrial sector and supporting technology made in China (by Chinese companies) in key sectors. (Such as electric cars, advanced machinery, industry 4.0, IT and integrated circuits, biopharma and advanced medical products.)

In taking up the challenge to upgrade its indigenous technology production, China is launching a frontal challenge to international businesses operating in the country.

Still, if the plan is going to succeed, foreign technology will remain critically needed.

Robotics is a good illustration of this situation. Since 2015, China is the biggest industrial robot market in the world. Yet, even though local robot makers are fast taking market share from the likes of ABB and Kuka, those very robots made by local companies rely totally on imports for critical components (controllers, decelerators and servo-motors) [5].



And should official confirmation be needed, the plan calls for 70% of technology products to be "Made in China" by 2025. This indicates that the more high-tech elements will still be imported. In fact, it is reasonable to assume that demand for such components will actually increase due to the additional needs generated by the government push for technology. All in all, the plan will definitely create considerable opportunities up the technology value chain, which is where international technology niche champions are particularly strong and stand to benefit.

For sure selling technology products in China is not without risks. Yet, there are ways to mitigate these risks and we will come back with more and specific experience on the subject in a follow-up analysis.

But now, will China become a true technology innovator, in the sense that we understand it?
Well, the examples above illustrate our opinion: most probably not in the short and the mid-term.

In fairness, it is difficult enough to catch up with fast developing technology. It is even more difficult in an era of technological acceleration such as the one we are about to witness, with the onset of the fourth industrial revolution. In this respect developed economies keep an enormously advantageous position.

Besides, it is not China's ambition to catch up in the coming years: the 13th Five Year plan calls for China to become a "world powerhouse in scientific and technological innovation" by 2050, more than 30 years from now[6].

To be strong in the mean time, China's leadership believes it needs to grow its international influence. And to assert its international position, it intends to use its economical prowess and its already home grown technology.

This is the rationale underpinning the One Belt one Road (OBOR) initiative, yet a new goal that China's leadership has given itself!

The New Silk Road – China is going abroad, selling and shopping!

With the slowing down of growth, China's infrastructure industry has grown oversized. Capacity reduction is underway (the famous "supply side reform"), however another way to solve the problem is to bring China's vast experience in infrastructure building abroad and help reduce overcapacity by generating more business at home. The state-owned companies are eagerly proposing infrastructure development in Asia, conveniently financed through loans fueled by China's large foreign exchange reserves.

In so doing, financing neighbors infrastructure is naturally a chance to establish closer relations and improve the Middle Kingdom's position in the region. And by the way, it allows China to establish its own multilateral institutions, such as the Asian Infrastructure Investment Bank in Beijing (AIIB), which most of the developed world joined in funding, except the USA. As a result, the World Bank and the Asian Development Bank (essentially financed by developed nations) will have less of a monopoly in Asia.

To unroll this New Silk Road throughout Asia, Chinese enterprises are strongly encouraged to go abroad, to realize infrastructure projects but also to buy businesses and increase China's global presence.

Ports and container terminals are being built and purchased (the Piraeus in Greece is an emblematic example), hi-speed railways are being planned and funded in South East Asia, highways and dams are constructed.

On the investment side, Syngenta's purchase (by ChemChina, a state-owned enterprise) for over USD 40 billion is the most visible example of this drive. And while such investments aim to strengthen China's overall ability to do business worldwide, they are also a mean to build up China's own technology.

Here again, China's ambitious goal of becoming a regional leader is creating large size opportunities. Those who partner up with Chinese companies building infrastructure abroad move in a China-size sales channel. And those who can utilize Chinese funds looking for a bridgehead abroad may have a fast track to develop their company in addition to gaining market access in China. Again, this is not without risks. (We will take the chance to detail the precautions to be taken in the follow-up to this analysis.)

The one Belt one Road initiative still has maybe its most attractive road to riches to unveil. In early November 2018 President Xi will open in person the first China International Import Exposition (CIIE) in Shanghai. It will become China's regular import fair, the counterpart to Guangzhou's export fair. To strengthen its image and become a more attractive international business player, China wants to balance its trade and import a lot more than it does now. This signals the opening of vast opportunities in sales of imported food, apparel, designer and luxury items or individual services, to cite but a few.

The first CIIE is meant to be China's most important international event of 2018. To drive the message home, Shanghai has built for the occasion the largest building in the world (2 million square meters). But can we still be surprised …?

The new Chinese Year of the Dog opens up with a background of new developments, new challenges and new opportunities. But once again, the valuable prospects far outweigh the risks, provided one does not ignore them!

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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Engineering your Success

[1] China's financial system harbours large risks, says IMF (7 Dec 2017, BBC)
[2] More than 13 million jobs were created in 2015, 2016 and 2017, each.
[3] China makes historic move to open market for financial firms (Bloomberg, 10 Nov 2017)

[4] This is well explained in the following article: http://nationalinterest.org/blog/the-buzz/scary-statistic-chinas-debt-gdp-ratio-reached-257-percent-22824

[5] http://thediplomat.com/2017/05/who-will-satisfy-chinas-thirst-for-industrial-robots/

[6] China Science and Technology Powers Ahead (China Daily, 17 Nov 2017)