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China Report: *Studies in Operations and Strategy*

CHINA AND THE NEW RULES FOR GLOBAL BUSINESS

China and the New Rules for Global Business

Opportunity or Threat? Global Firms Must Learn to Leverage China

That China holds the potential for incomparable benefits for multinational corporations has long been an accepted piece of conventional wisdom. With a population exceeding one billion and an immense supply of low-wage workers, China is coveted both as a consumer market and a superb location to manufacture and source products.

But is the conventional wisdom correct? Is China really a place that major corporations the world over need to be in the decades to come? Consultants at the Boston Consulting Group and faculty members at Wharton say that China is indeed pivotal for companies that wish to capture global advantage and may turn out to be even more critical than companies have yet to realize. China's importance is becoming more apparent with each passing year, as MNCs operating there continue to pull back the curtain on a vast and growing country, learning from successes and mistakes alike. It is essential, the Wharton and BCG experts say, that corporations view China as a core component of their overarching approach to globalization and not simply as a low-cost country for sourcing, as important as that is in its own right.

Despite its allure, China never has been, and has not yet become, an easy place in which to operate. China's business and legal environments can be maddeningly unpredictable, its political system still oppressive and inconsistent, its vast interior nearly impervious to the easy establishment of distribution channels required to bring products to market, and its managerial ranks razor thin despite its staggering population. The so-called China Opportunity can only be exploited to the fullest if companies identify and overcome some difficult challenges inherent in setting up shop in the world's fastest-growing economy, say professors at Wharton and BCG consultants.

"China is a must-play place for any global company," according to David Michael, a BCG vice president based in Beijing. He explains that this doesn't mean the company must be producing or selling in China, but it probably needs to be doing at least one of these. "It also means that inevitably you will be competing with Chinese companies, or with others who are leveraging China better than you are," Michael adds. "If you don't have a China strategy, you're missing the biggest single business opportunity today." says George Stalk, senior vice president in BCG's Toronto office, with extensive experience in international strategy.

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> —David Michael, vice president, BCG

Marshall W. Meyer, a Wharton management professor whose research interests include China, puts it this way: "There has always been promise in China, but the promise hasn't always been realized. What's new today is the appearance that China has somehow transformed what was a very poor society into a modern industrial giant. People say, 'What am I going to lose if I don't participate in that?'"

A recently published BCG report, *Capturing Global Advantage,* states that China is "emerging as the industrial power base of the future." For the United States and Europe, China already represents a large and fast-growing source of industrial products. For example, imports from China represent nearly 20% of all imports from low-cost countries into the United States and Germany, and these imports are growing 15% to 20% annually, according to the report.

As a repository of potential customers for everything from soft drinks to shampoo to personal computers, China is huge. It is the world's largest market for refrigerators and mobile telephones, third largest for electronics, fourth largest for chemicals and fifth largest for automobiles, according to Michael. Many of these industries were small just a few years ago but have quickly mushroomed. Moreover, China's economy is growing at a much faster pace than global gross domestic product. "If you are a global player in those industries, you have to figure out how to play here or come up with some global model that works without having to play here," says Michael.

It is well known that China offers tremendous advantages in labor costs. A Chinese factory worker earns less than $1 an hour, compared with $15 to $30 an hour in the United States or Europe. What is perhaps less well known is that cheap labor in China is unlikely to disappear any time soon. In an article they wrote in the March 7 edition of *The Washington Post,* Stalk and Dave Young, a senior vice president in BCG's Boston office and a specialist in international industrial strategies, pointed out that China still has 800 million people living in rural areas, nearly three times the entire population of the United States. "The migration of China's rural labor force to manufacturing jobs will mitigate any steep rise in low-skilled wages in this decade," they write.

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But China offers multinationals more than labor-related savings. According to BCG, China and other low-cost countries such as India and Mexico provide lower capital-investment costs, larger economies of scale, and government incentives aimed at attracting foreign investment.

"Because of China's low labor costs, MNCs that manufacture goods that are being made, or can be made, in China must consider how much of that manufacturing should be done in China or how much of the input of their products should be sourced in China," Michael notes. "Basically, any company that's big enough will face one or both of those dimensions when it considers the role of China in its planning."

Along with these advantages, China also is becoming, albeit slowly, a more corporate-friendly place in which to conduct business. And companies around the world are using whatever advantages they can muster to get an edge on competitors.

"It is getting easier to do business in China," says Eric W. Orts, professor of legal studies and management at Wharton. "Taiwanese businesses have an advantage culturally. Japan has geographic advantages. U.S. companies have the advantages of significant flexibility in basic organizational freedoms. European companies are perhaps at the greatest disadvantage because of inflexible regulatory structures, especially regarding labor."

Orts also says that the Chinese government, now into a third post-Mao generation, seems committed to a continued fostering of the Chinese-style of capitalism that was launched some 20 years ago under the leadership of Deng Xiaoping. The rule of law, he says, is also gaining institutional ground.

BCG's Michael agrees that gaining entry to China is less difficult for MNCs than it once was, even if the Communist Party leadership has not yet swung the door completely open to Western-style capitalism. For one thing, China's admittance to the World Trade Organization has required officials to lift trade barriers and grease the skids for foreign companies to participate in the China boom. In addition, provincial and municipal governments in China are vying for the attention of foreign investors, in much the same way that local government officials in America offer incentives to woo industries across state lines.

In many industries, foreign firms were previously forced into unattractive joint ventures with government enterprises or bureaus in China, according to Michael. Inevitably, the capabilities and motivations of the partners were quite incompatible. Today, however, things are becoming more flexible. In many sectors, firms can establish wholly-owned enterprises without local partners, or select from among much more business-minded local counterparts. Opportunities in sectors deemed nationally important, such as airlines, telecommunications, or electric utilities, remain rather limited. Nonetheless, MNCs simply must begin to factor China into their strategic thinking even if they have not yet entered that market. Says Michael: "Any big player in an industry that is affected by China either has to be here or has to have a China plan — not necessarily a big China plan but they have to understand how China fits into their overall thinking."

Comparisons with Japan

Because he spent about six years in Japan during the 1980s and continues to work there frequently, Stalk, the BCG senior vice president, has a unique perspective on China's economy and business climate — a perspective that underscores just how critical it is for global companies to grasp the enormity of the changes occurring in China.

Stalk says China's emergence in recent years as a manufacturing powerhouse — what he calls its "industrial boost phase" — is reminiscent of Japan's industrial ascendancy in the 1970s, but with at least two important differences. First, China's growth is occurring at a much faster clip than Japan's. Second, major multinationals may find that, in years to come, they will face stronger competition from Chinese companies than they did from Japanese firms, even during the era when the seeming invincibility of Japan Inc. sent shudders through boardrooms worldwide.

Not only has the growth of China's industrial might accelerated much faster than did Japan's, China's growth "is coming off a much larger base," Stalk explains. "China is both an important domestic market and a source of competition [for MNCs globally]. China is also unlike Japan in that succeeding within China is just as important [for MNCs] as being able to compete with companies coming out of China, be they Chinese companies or multinational competitors. The price to pay for not being in China is allowing your competitors to set up significant bases of operations from which they could attack Western markets. This was also true of Japan, but the numbers [of potential competitors] in China are huge. Competitors are emerging in China that will be threats to Western companies in their own markets."

Stalk says that he, like other consumers, remains stunned by how China, seemingly overnight, became a manufacturer of so many products that people use every day, even high-tech PCs. "It's interesting how fast it turned around in China. Many Gateway and Dell products such as flat-screen televisions are produced in China. I don't think consumers understand that."

The challenges that arise in doing business in China can appear overwhelming at times, but they can — and must — be dealt with. The experts at BCG and Wharton identified some key problem areas and offered ideas on how to handle them:

Finding the Right Partners

"One of the major issues is just knowing whom to partner with in China," says Hal Sirkin, senior vice president in BCG's Chicago office and head of the firm's global operations practice. "Companies have to ask, 'What do we actually want to accomplish in China? Is our goal to source materials, components or finished products? Are we producing for Chinese consumption or U.S. and European consumption? How must we change the product so that it is better suited for manufacturing in China?'"

A company may find it necessary, for instance, to forego robotics and adopt old-style processes in which people, not machines, insert bolts into holes and fasten screws. "It's difficult for companies to come to grips with that," Sirkin notes. "They say, 'Let's put in a plan with expensive, highly automated equipment,' forgetting that the main reason they're going to China in the first place is for the low-cost labor." Adds Michael: "Indeed, part of the savings comes from foregone investment in capital equipment as well as labor savings."

Start Slow and Stay calm

Companies inevitably make mistakes, and mistakes can be compounded when doing business in a developing nation 8,000 or 10,000 miles away from corporate headquarters. "We tell our clients to start slow and build," according to Sirkin. "You have to understand how to communicate with people, figure out what's possible and what's not, and then start to ramp up. There's a tendency to get excited."

Managing the Relationship Between HQ and the China Operation

The CEO and other senior executives at the multinational's headquarters must take steps to ensure that the firm's China operations are viewed as essential to the corporate enterprise. By the same token, the managers of the China office must do all they can to achieve that goal, which is especially difficult at large companies with multiple product lines.

> "You've got to know the risks. Go slow. You wouldn't necessarily take your best technology and put it in China."
>
> —Hal Sirkin, senior vice president, BCG

By definition, of course, multinationals operate in many countries around the world and establishing the best possible relationships between country managers and home offices is far from a new issue. But Michael argues China is a special case because it is such a large market and is very complicated in that China operations often involve manufacturing, sourcing and selling the product.

"Companies struggle with that," he says. "If you're going to succeed in China, you may need to do things like sign complicated joint ventures. One thing this means is that you may need more senior people, with real credibility, on your side at headquarters to oversee activities in China. Having headquarters working on your behalf also means they may be able to get a greater level of attention from the government and potentially make bigger plays than someone at a more junior level in China. Also, things change in China so quickly. Unless [senior] management is keeping on top of what's happening, frequently you can get a disconnect between the reality on the ground and what headquarters thinks is happening in China."

Looking for a Few Good Managers

While China's labor force is immense, the pool of experienced managers is shallow. "One real big challenge (in doing business in China) is human resources," says Michael. "It's easy to get laborers but it's very hard to find middle and senior managers. It's hard to develop and retain those people as well. The biggest challenge that multinationals face is scaling up their organizations with a group of strong, capable, local managers."

Not many days after Michael made that comment, *The New York Times* reported in a front-page story that some companies are finding that going to low-cost countries is not always the best move to make precisely because of workforce shortcomings. The article focused on India, not China, but the message could be applied to many low-cost countries. The story described how the India-born co-founder of a Massachusetts technology company had contracted software programming work to India for the past three years, but decided to bring the work back to the United States because Indian programmers did not have sufficient "depth of knowledge" to handle the assignment.

Michael notes that some corporations have gone to great lengths to address the manager-shortage issue by building strong brand names in China's recruiting market and forging strong relationships with universities. Astute MNCs also offer training and career development to Chinese managers and do all they can to make them feel part of a global company.

Risks Associated with Intellectual Property

The potential for intellectual theft in China is not limited to pirated CDs and DVDs. If they do not handle things right, multinationals may find that they are at risk of giving away the store when it comes to equipment or manufacturing processes. Experienced MNCs in China go to great lengths to protect their intellectual capital. "Though the environment is far from perfect, many MNCs have found effective ways to protect their intellectual property," says Michael. "It requires continued, aggressive, locally-focused efforts. But it can be done to a sufficient degree that it is still worthwhile to be present in China. Indeed, you need to be here to protect yourself."

"If I'm going to teach a Chinese partner how to do something, are they going to become my competitor?" Sirkin asks. "You've got to know the risks. It comes back to what I said earlier: 'Go slow.' You wouldn't necessarily take your best technology and put it in China. Don't take away things critical to a factory somewhere else." If intellectual theft issues arise, an MNC may be left holding the bag. Sirkin points out that China's judicial system, while improving, remains "a difficult environment."

Relationships Matter

Echoing Sirkin's point, Wharton's Meyer says that China's legal system is unlike that of the West because personal relationships can often trump contractual obligations.

"The Western conception of law is unusual in China," Meyer explains. "We in the West have a conception of the law as something apart from persons. In China, respect is owed to people — your mother, father, boss, husband — and not to abstract principles. You write a contract and three weeks later they say, 'the contract's over.' There are famous cases where this has occurred." In addition, Meyer says, "Language is ambiguous. Everything is nuanced. Everything is in the context of a relationship. There is an endemic difficulty eliciting cooperation from people who don't know one another."

Doing the Right Thing

Wharton's Orts stresses that finding "savvy and trustworthy local partners" in China can help MNCs stay on the right side of the ethical divide. "Bribery and collusive relationships are said to be common in China, and companies need to remind themselves of their own ethical standards," he says. "Human rights is another very large challenge. If companies are doing business in China, then they have an ethical obligation to consider how they are helping the country to make progress on various dimensions of direct concern to the company, labor and human-rights practices included."

Marketing is Mostly Local

Meyer, who has made numerous trips to China since the 1990s, says companies must think of China not as a single market but as many markets — on the provincial and sub-provincial levels — and as markets that are often closed to foreign firms.

He notes that the local nature of the way the Chinese think about marketing is reflected in the fact that the names of most Chinese companies begin with the place in which they are based: Shanghai Pharmaceutical, for example, or Guangdong Honda. Fewer firms use the national moniker "China" than do companies in Europe and the United States (British Airways, U.S. Steel, Deutsche Bank).

"There's extreme localism in marketing; there aren't a lot of national brands in China," according to Meyer. "The brands that have better recognition are the foreign brands," which, he is quick to point out, is an advantage for multinationals.

Logistics Can Be a Nightmare

China's size and primitive infrastructure make it difficult to distribute products. What is more, companies face the possibility of piracy when shipping goods. "Shipping can be inefficient and your distributors can be in the piracy and counterfeiting business," Meyer says. "The guy who distributes your products by day may at night distribute counterfeit stuff" in bottles that have legitimate brand-name labels on them.

Michael agrees that distribution channels are not well established in China. "There are no plug-and-play solutions for a whole range of distribution problems to get your products to market. You don't have a simple set of national distributors and transportation entities. Every city requires a different solution."

Meyer says there is a silver lining to this problem: International delivery companies may find superb opportunities in attempting to bring order to the logistics chaos that can be found in China.

In the years to come, how will people be able to identify the MNCs that have emerged as the big winners in China? "The multinationals that will still be there will be the ones who will build Chinese businesses as opposed to just doing Chinese procurement," according to Sirkin. "Not only will they ship products [around the world] from China, they will sell products in China. China will be part of their overall manufacturing system and they will have a customer base in China. They will not just use China as a low-cost procurement or manufacturing location. They will build a local brand and a local reputation."

Sourcing: How China Compares With the Rest of the World

George Feldenkreis, chairman and CEO of Perry Ellis, an international apparel company, was born in Havana, Cuba, to Polish immigrants. But neither his natural affinity for Latin America nor his Eastern European heritage seem to influence where his company chooses to source a good deal of its products. In a keynote address at this year's Wharton China Business Forum, Feldenkreis sang the praises of the country where, according to media reports, a full 23% of his firm's purchases were made last year: China. Sourcing in Latin America, he noted, had been problematic due to shipping delays, and as a result, his company was increasingly turning to Asian countries like China instead.

> "Companies look to source from low-cost countries for three reasons: direct cost savings, talent and access to the domestic market."
>
> —Jim Hemerling, senior vice president, BCG

From machine tools to computer parts to home furnishings, companies in the U.S. and Western Europe see China as the producer of choice for components or finished goods. Traditionally, the U.S. has tended to source products from its neighbors to the south, while Western European countries have turned to their Central and Eastern European counterparts. But a large, productive labor pool, low wage rates, and efficient shipping capabilities have put China on everyone's map.

Among low-cost countries, China's industrial output is the largest — and it's also growing the fastest. What makes China so attractive, and how should companies choose the right sourcing locations for different parts of their value chain? Experts from Wharton and The Boston Consulting Group offer some advice for corporate decision makers.

The Case for China

The globalization of sourcing, and the move from high-cost countries to low-cost countries, is the new reality, says Jim Hemerling, a senior vice president in BCG's Shanghai office. "There is a large amount of manufacturing still occurring in high-cost countries that will migrate to lower-cost countries. By dint of its size and growth rate, China will attract a disproportionate share of the migration."

Low-cost countries, he notes, can be split into two types. "Proximate countries are those where the wage rate is three to five times that of China, but the distance to the target country is smaller. For products with complex logistics or less labor content, they are still advantageous. The other type of low-cost country tends to be farther away, but offers much lower costs to be competitive. These countries include China and India, and to some extent, Brazil."

Companies look to source from low-cost countries for three reasons, notes Hemerling: "A big part of it is labor — they are looking for direct cost savings. But it's also about talent, and about having access to the domestic market of the country they source from." For many firms, China's population of 1.3 billion represents a consumer base that's hard to pass up.

When it comes to sourcing products with high labor content, China's very low wage rate is a clear advantage. But technical skills aren't lacking, either, says Hemerling. "China also graduates a lot of engineers and has many domestic- and overseas-trained PhDs. So companies are finding skilled people for higher-level jobs." He cites companies like General Electric and Siemens Medical Systems, as well as mobile phone companies, that have tapped into this large talent base.

Because the Chinese economy is so large, the country also leads or nearly leads the world in consumption of a large number of products, like televisions, refrigerators, some packaged and industrial goods, steel, cement, and specialty chemicals. "Manufacturers want to be there so that their operations can serve as a base to gain access to those domestic consumers," says Hemerling.

China's favorable industrial policies are another factor: "The government is very responsive, the tax structure is straightforward, and there is tax relief for exported products," says Hemerling. "More than 500 special economic zones have been [established] where the infrastructure enables quick set-up of businesses. Interest rates are low, as household savings rates are high and loans are subsidized."

Beyond the low wage rate, the characteristics of the actual Chinese labor force are also appealing: "Firms can draw on a highly mobile, very productive and largely nonunionized labor force with a strong, disciplined work ethic," Hemerling says.

Indeed, there is a good deal of incentive for people in rural China to seek out manufacturing jobs, says Marshall W. Meyer, professor of management and sociology at Wharton. "The rural household income is very low — about $100 a year, even though China's GDP per capita is now around $1,000. The rural population has not seen an increase in real income since 1996, so as farm prices rise and income erodes, those people go off to cities to work in manufacturing and support their extended family for a few years. With such a large labor pool, costs remain constant."

The discipline of the Chinese labor force, says Meyer, also has to do with the fact that the workers often have very few rights: "A factory CEO may also be party secretary, but many of those are nominal titles," which means that protection of the workers is minimal.

East to West

For certain companies, geography matters a great deal — the less physical mileage between factory and market, the faster products can make it into consumers' hands. "If you have a product with short lead times whose demand fluctuates greatly, proximity is a clear advantage," says Kevin Waddell, vice president in BCG's Warsaw office. "Getting things from countries like Poland into other areas of Europe takes less than a week, and that time is ever-declining." Naturally, there also are fewer time zone differences and fewer cultural differences to deal with when sourcing there.

What gives these countries a disadvantage, of course, is labor cost. "The labor cost in China is $1 or $2 an hour, and the supply is vast," says Waddell. "But a lot of people think China is a homogeneous country, a place where they can simply drop their plant, when in fact there are many regional differences. It's harder for them to see Central Europe as one region because it is made up of so many countries."

Companies also sometimes fail to consider other factors, says Waddell. "There are inventory savings to look at, training costs, and the process by which products move from source location to end market." Much of the investment in Central and Eastern Europe centers on highly skilled tasks that cannot be given to just any factory worker. "We see a lot of precision machine parts, vehicle parts, and electronic equipment made here, especially things that require craft or a learning curve," says Waddell.

Like China, countries in Central and Eastern Europe are offering investment incentives for bringing in business, but most of the activity is on a country-specific basis. "There is not much in the way of industrial policy on a region-wide level — in other words, countries are competing with one another and with China for the business instead of asking, as a group, 'How do we compete?' They're not stepping back and taking a larger view."

South of the Border

Many of the issues facing European firms also exist for U.S. companies. Jesus de Juan, vice president at the BCG office in Monterey, Mexico, explains why that country has been appealing to American outfits: "The Mexican economy has undergone tremendous transformation in the last decade. Since 1994 the economy has been relatively stable, and this is the fifth year with single-digit inflation. The labor rate is one-ninth that of the U.S., so it is very competitive. It takes just two to six days for something from here to reach any mainland U.S. location by truck."

In addition, its free trade agreement with the U.S. and Canada has done much to disentangle customs formalities. Exports make up 25 percent of the Mexican economy, of which around 80 percent are to the U.S. The country has transitioned from being a supplier of basic commodities like oil to being a source for electronics, auto components, and cars, says de Juan.

While lower-cost countries have labor advantages and require less capital investment due to the use of more simple machines, the disadvantages can be numerous, he notes. "Duties levied and managerial costs can be significant, for instance. Our time zones and seasons are symmetrical with those in the U.S., while there is many hours' difference with China — and that can make things difficult to coordinate or communicate. So Mexico may not be more advantageous for a company, but it can be the least disadvantageous."

In the final analysis, the right sourcing solution for a company is increasingly likely to be a mix of various parts of the world.

Cities like Monterey, with a modern infrastructure and frequent transportation options to the U.S., make it easier for Americans to manage the production process, says de Juan. "There are schools there like American schools, and about 15 daily flights into the U.S. — it's easier to move your operation here, and there are managers with MBAs from top American schools."

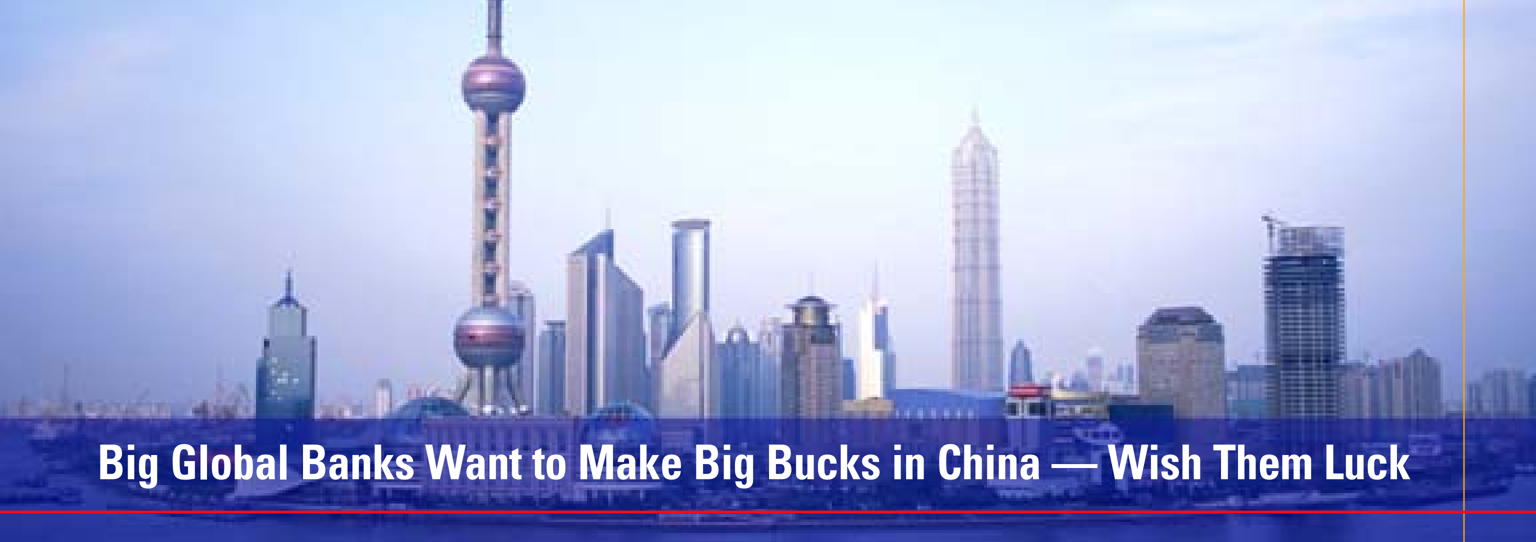
What's more, says de Juan, a company's secret sauce will generally remain secret in Mexico. "There's no risk of losing intellectual property in Mexico, as there can be in some lower-cost countries. Other than in certain sectors such as energy and telecommunications, there are very few limitations to foreign ownership here, so you can buy out a firm and become a 100 percent owner. Repatriation of profits is also simple."

In contrast to Mexico, countries in Central America and parts of South America are not as advantageous, de Juan explains. "During the last 20 years, many Central American countries have been under dictatorships for much of the time. They also have problems with harbors and road infrastructure, so driving trailers can be a nightmare. Some of the same issues exist in South America — political instability in Venezuela, drugs in Colombia, a collapse in Argentina." Chile, while stable and growing, has an economy largely comprised of services and natural resources, and, says de Juan, it's too far to be of much use unless a company is shipping goods to the Pacific.

The rush to China, says de Juan, is partly a fad. "Clearly the labor is cheap, and the sheer size of the Chinese domestic market is compelling. But despite the competition, Mexico is gaining market share in sourcing. Companies like Maytag, Whirlpool, and Electrolux are investing in Mexico. For bulky goods, proximity is very important. And auto component companies like coming here because the short distance makes just-in-time inventory management easier."

BCG senior vice presidents George Stalk and Dave Young agree with de Juan that in some cases it makes sense to source production to nearby locations. In an article titled, "The Hidden Costs of Globalization," they say, "Not all products should be outsourced to distant locations. Products that might do better to stay home, or close to home, include certain highly complex products, products with a variety of designs and options and products likely to be in high demand one day and languish on the shelf the next. Similarly, services that require significant customization and highly responsive providers may or may not do as well abroad as at home. In taking such products and services to low-cost countries, a company could lose overall advantage in an effort to gain a narrow unit production cost advantage."

So, where should a company be sourcing? In the final analysis, notes Hemerling, the right solution for a company may be — and is increasingly likely to be — a mix of various parts of the world. "Firms have to look at their entire supply chain. Perhaps research and development should be in one area, production of components in another, assembly in still another place. It's not just something to be dealt with by a procurement person — this has to be the CEO's agenda. The global dynamic has — and will continue to have — significant organizational implications."



Big Global Banks Want to Make Big Bucks in China — Wish Them Luck

When it comes to China, the American International Group won't take no for an answer. The New York-based insurance giant has been kicked out of the country twice — once by the Japanese, once by the communists. But when China started to reopen its potentially massive market to foreign financial companies, it was one of the first to take steps to enter. AIG chairman Hank Greenberg paid a formal visit shortly after former President Richard Nixon's famous diplomatic journey to the country.

AIG's stick-to-it-iveness has paid off. In 1992, it became the first foreign company to win an insurance license in China. Unlike other insurers, its license isn't jointly owned with a Chinese partner; AIG owns it outright.

Insurers, banks and brokerages that want to follow AIG to China need that same sort of patience and persistence, says Giles Brennand, a Hong Kong-based vice president with the Boston Consulting Group. "Because AIG was committed and started early, it negotiated a very favorable deal," he says. "It's the leading foreign insurance company here."

China, of course, is opening up to the West. It entered the World Trade Organization in 2001, agreeing, among other things, to begin liberalizing its rules for foreign financial companies. By 2006, it will have to give them full access.

The country offers both great promise and great perils for financial firms. With 1.3 billion people and growth estimated at about 10% a year, it has the potential to become the largest economy in the world. But for that to happen, China will have to build the sort of financial infrastructure that westerners take for granted. And at this stage, its financial sector is a seedling, lacking such basics as independently audited financial statements and the corporate transparency that comes with them.

Banking on the Big Four

To be sure, China has plenty of banks and insurers. But many of them are state-sponsored relics of its communist past. Its four biggest banks, for example, are hobbled by loans that aren't being repaid and may never be. Their staffs lack such basic knowledge as how to assess the creditworthiness of borrowers and how to price loans based on their risk of default. What's more, the banking sector has been artificially propped up by the absence of robust capital markets; without the option of investing in stocks and bonds, Chinese savers have little choice but to leave their money in banks.

The country offers both great promise and great perils for financial firms.

Rolling out financial products and services and assisting China's banks and insurers with their transition to a competitive economy represents a glittering new market for foreign companies. Many Chinese consumers, for example, don't yet have access to such basic financial services as credit cards. Analysts estimate that fewer than one in 20 Chinese has a credit card, compared with four out of five Americans. And the rush to provide financial products and services has begun, with announcements of new Chinese ventures by large western financial companies coming weekly.

In March, for example, New York-based American Express said that it would begin offering credit cards in China. Balances on the cards, which will be issued in partnership with the Industrial and Commercial Bank of China, can be paid in either U.S. dollars or Chinese yuan. Like AIG's foray into China, American Express' was preceded by years of business-style politicking. In 1986, the company opened its first representative office — the business equivalent of a diplomatic mission — in Beijing and, in 1992, it opened a second one in Shanghai.

Also in March, Citibank, an arm of New York-based Citigroup, said that it would offer a Visa credit card that could be settled in either dollars or yuan. Long before launching its card, Citigroup took a step that Richard Herring, a professor of finance and international banking at the Wharton School, would recommend for any company that's looking seriously at expanding into China. It bought a minority stake in a local bank — the Shanghai Pudong Development Bank, which is also its partner in the credit-card venture.

> "You have to view the investment as part of a broader strategy. It's like paying tuition to learn about the market."
> —Richard Herring, finance professor, Wharton

"Citigroup never wants to be a minority shareholder, and China's one of the worst places in the world for that," Herring says. The country lacks many basic legal protections for minority shareholders' rights. "But you have to view the investment as part of a broader strategy. It's like paying tuition to learn about the market." As an investor, Citigroup is privy to information about Shanghai Pudong and its customers that would otherwise have been off limits. That kind of access is especially critical in a market where reliable financial reports are scarce.

When it announced its new credit card, Citigroup did something that BCG's Brennand sees as critical to any company's success there. It sent its chief executive, Charles Prince, to China. "If you're serious about China, your CEO needs to be prepared to visit three or four times a year," Brennand says. "If he isn't prepared to do that, then the Chinese won't take you seriously. It doesn't matter how big a check you write."

Besides being an essential courtesy, such visits signal a company-wide commitment that's required if a firm is going to succeed in China. "You will need a large number of people from your head office to come to China," Brennand adds. "You'll also need to be willing to take Chinese nationals into your head office for one to two years to give them experience. That can be as many as 100 people — it's a massive commitment to supervising and coaching. You'll need to tailor your IT, marketing and risk-management systems to China. You can only do all that with the support of the CEO."

Consider AIG. Besides frequently visiting China, its CEO, Greenberg, routinely stresses how important the country is to his company's future. In an October conversation with stock analysts, for example, he highlighted a new venture between AIG and China's state-owned People's Insurance Co., calling it "a huge home run." Through the deal, People's Insurance will be marketing AIG's accident, illness and cancer policies. The arrangement gives AIG access to People's approximately 500 branch offices and 100,000 agents.

That's just the sort of innovative distribution plan that western companies need in China, Brennand said. Another example is New York Life Insurance Co.'s joint venture with Haier Group, a Chinese electrical appliance distributor. The joint venture's agents will sell New York Life's policies out of Haier's stores. "Haier is pretty well the only organization that has retail outlets throughout China," he points out. Lately, business people have been dazzled, even transfixed, by the opportunities in China. But risks and problems remain, especially in the financial sector.

Non-performing Loans

Perhaps the biggest problem is the huge number of nonperforming loans (NPL) carried on the balance sheets of China's four biggest banks. These banks, all state-owned, are the bedrock of China's banking system; they control 60% of the country's deposits and 65% of the loans, says Rodney Ward, chairman of UBS Asia, the Asian arm of the Swiss bank. They're not only a barometer of the health of China's financial sector, but in some ways, determine it. Consumers' faith in the burgeoning banking system will be shaped by their dealings with the Big Four, and many foreign financial companies will be forced by Chinese rules to do joint ventures with them. At the macro level, the nonperforming loans — and the bad lending practices that caused them — could drag down China's economy.

"These banks are going to have to be recapitalized," said Wharton's Herring. "But the deeper challenge is that the state banks have been used to support state-owned enterprises." That is, they've been forced by the government to make loans to SOEs, even when the SOEs lacked the financial health and discipline to justify that. "China has to fix the underlying business problem — the government's tendency to use the banks to prop up inefficient SOEs. It's a tough political problem. They're very worried about the unemployment consequences of closing the SOEs. But unless you restructure that, the NPL problem won't go away long term."

Franklin Allen, a Wharton finance professor, counts himself among the scholars who believe Chinese policymakers will be able to solve the Big Four's problems. The Chinese government has enormous foreign reserves and has begun to use those funds to recapitalize the banks, he pointed out. Granted, policymakers still have to grapple with the political problem, but Allen believes they will.

Allen recently wrote a paper in which he argued that, in China, a set of informal norms based on relationships and reputations has sprung up to take the place of the West's more formal rules and that these informal norms have propelled the economy's fast growth. "There exist very effective, nonstandard financing channels and corporate-governance mechanisms to support the growth of the informal sector," he writes. Combine those with the desire of Chinese policymakers to reform the banks, and the financial sector should continue to thrive.

Further, Chinese policymakers have shown that they can restructure a bank. Witness the Bank of China Hong Kong, said UBS's Ward. "The Bank of China Hong Kong was based in Hong Kong but operated like a Chinese bank. The success of its restructuring has given a model for restructuring the Big Four." UBS assisted with the restructuring.

"You couldn't believe how uncommercial the operation was," Ward said. "It operated through 13 entities that barely spoke to each other. We worked with a number of people to create a simpler structure to bring these disparate entities into one holding company. There's a new board, which includes some independent directors."

The new governance structure enabled the bank to weather a scandal last year in which its chief executive was accused of making an improper loan. And the bank's performance has surged. Its profit has more than doubled. Its nonperforming loan ratio has been reduced to 5.8% from 18.5%. And its return on equity has nearly doubled, reaching 13.5%.

"There exist very effective, non-standard financing channels and corporate-governance mechanisms to support the growth of the informal sector."

—Franklin Allen, finance professor, Wharton

Like Allen, Ward sees the recent reforms as reason for optimism about the future of Chinese banking and finance. "The dangers of stagnation are widely recognized by the authorities, and they're determined to put matters right," he noted. "They've made great strides in curing and restructuring some of their SOEs. And the big state banks have been the beneficiaries of the largesse of authorities — their deposit margins have been restricted, while the lending margins have been opened up. This means they're encouraging the banks to distinguish between good clients and bad ones and to price risk." That is, they're encouraging them to act like banks.

Watch Out: Will China's Rising Upstarts Upstage Global Multinationals?

In 1987, when Motorola arrived in China with pagers and cell phones for trendsetting city-dwellers, the U.S.-based company became a dominant player in the Middle Kingdom's handset market. Not long afterward, Finland's Nokia came in and grabbed second place, followed by other European companies. But these first movers were soon losing sleep over the fact that they had begun to lose market share to Chinese upstarts like Ningbo Bird, which are hardly known outside Asia. The rise of Ningbo Bird jolted its foreign rivals and grabbed their attention, as did its recent partnership with Siemens in which the two companies will collaborate to make and market mobile phones for the Chinese and international markets. China's TCL Communications ignited similar anxiety among global multinationals when it last month acquired a 55% stake in a joint venture with the mobile phone business of France-based Alcatel.

> It is important to distinguish between two issues: the ability of Chinese companies to gain market share domestically, and their chances of succeeding globally.

Are such fears justified? As Chinese companies such as Ningbo Bird and TCL in the telecom industry join better-known firms such as Legend (computers) and Haier (white goods) to challenge international firms, should executives in multinationals fear for their market share and profits? Experts at The Boston Consulting Group and Wharton explain that while Chinese companies are fast learning how to compete against multinationals in the domestic market, these upstarts will find it challenging to emerge as global players. Over time, however, they could become as well-known as other Asian giants such as Samsung or LG.

David Michael, a BCG vice president based in Beijing, believes it is important to distinguish between two issues: the ability of Chinese companies to gain market share domestically, and their chances of succeeding globally. On the first question, "Chinese companies have fought back to gain market share domestically in high-tech markets such as PCs, mobile handsets and telecom equipment," he says. In addition, as one might expect, Chinese companies have tended to dominate domestic markets in consumer electronics and white goods, and Western multinationals have found it tough to compete against them.

"Going global is more difficult, but Chinese firms are making headway," Michael says. He believes real differences exist between the Korean, Japanese and Chinese companies in this regard. "Korean firms such as Samsung and LG are intensely technology-oriented, and they first strategically developed technology advantages in areas such as display, handset design and DRAM manufacturing," he says. "Then they began to build global brands around these technologies. They were quite open to Western technology suppliers in building their abilities, but ultimately, with their armies of Korean PhDs, they have built their own strengths." Japanese firms have built similar advantages, but without much Western assistance, Michael explains. He notes that Japanese firms are "much more vertically integrated, and they do much more in-house."

The Third Way

Chinese companies are pursuing a different, third path. "They are very open to technology assistance from Western suppliers, but they have yet to develop the strong technology-based competitive strategies that the Korean firms have adopted," Michael notes. "Chinese companies have not had to globalize as quickly as Korean firms since the large domestic Chinese market provides ample opportunity for growth." As a result, although the emerging Chinese companies are big and well-established, they still have norms, cultures and capabilities based on the domestic rather than the global market. "The relevant domestic capabilities have a lot to do with domestic distribution, keeping costs and prices low, using muscle and boldness to 'claim the territory' in the domestic market land grab," Michael says. That, however, is a very different ball game than "adapting to the global environment, where the market demands are very different," he adds.

Wharton management professor Marshall W. Meyer believes Chinese companies today are where Korean companies were in the past. "Just look at LG and Samsung," he says, noting that once these companies were hardly on the world's radar screen but they are now well-known players. "Their learning curve was around 30 years, so it can take a similar amount of time for Chinese companies to achieve the same," Meyer adds.

Hal Sirkin, senior vice president at BCG, also likens the evolution of Chinese firms to the emergence of Japanese companies over the past several decades. "In the early 1960s and 1970s, Japan mainly made cheap transistors. And Toyota's first cars in the U.S. were a disaster. Now? Japanese products command premium prices."

The challenges, however, remain substantial. "With LG and Samsung, of course, it helps that (South) Korea is a smaller country and that the government structure is different. While the (South) Korean government lets certain family-based chaebols proliferate and dominate the landscape in an industry, the Chinese government has been reluctant to do so." What's more, in China, says Meyer, companies are not used to the idea of a Western-style decentralized firm with tight accountability. "Since they're accustomed to a highly centralized organization, it will take a few years before a company can truly go global and say, 'OK, country manager, go do it.'"

Haier, a Chinese appliance company, is a case in point. "Haier has intense support systems in China, so that when a person comes in to install an appliance in a house, he will also look around and try to sell you the next appliance," says Meyer. "But the company was so focused that it hasn't emphasized internationalization as much." With about 30% market share in China, the company has catered to its local markets to such an extent that its products are sometimes extremely need-specific. "The market in China is very diverse, so Haier ends up making some strange products – like the combination washing machine/potato washer," says Meyer.

Still, Haier is in Europe and the Middle East, and even has a strong presence in wine coolers and mini-fridges in the U.S. However, the firm has encountered all kinds of issues in the process. "It has to learn how to manage a U.S. labor force, and to deal with the vicissitudes of international shipping rates," Meyer says. "It has to manage its product mix between exports and locally manufactured appliances."

Growth through Acquisition

One way that some Chinese companies are entering international markets is by buying up other outfits, Meyer notes. "China doesn't yet have a large trucking industry, but China International Marine Container (CIMC), a shipping container and semi-trailer company, is already selling in the U.S. HPA Monon, an Indiana company, was bought by Vanguard National Trailer Group, a subsidiary of CIMC. Hundreds of U.S. jobs were created, so the state of Indiana provides subsidies. The company uses a U.S. name, so many people don't even realize it's Chinese."

These pathways that allow companies to evolve are important, says Sirkin. "Chinese manufacturing production quality and capability are growing rapidly. So many firms will get cash, create joint ventures, become suppliers so it gets them into the marketplace, and later purchase the company they are supplying to." While most won't become huge multinationals, they will still be real businesses with global positions, he says.

"Not all the seeds will bloom, of course," adds Sirkin. "But a lot of them will work through the structural issues. There are very good entrepreneurs in China, and enough of them will figure out how to solve these problems. Government is one of those barriers that will disappear faster than people think. Even the disparity between urban and rural areas in China will be worked out, through imports, better farming land, and better food traded for lower-cost manufactured goods. It's part of the natural cycle of an economy developing."

Players to Watch

In the high-tech sector, Huawei, TCL, and ZTE are companies to watch, says Michael. "Huawei and ZTE make telecom equipment, and they are already selling their products to telecom operators, particularly in emerging markets and to a lesser extent in Western markets. Several of these players are starting to make hundreds of millions of dollars in sales in overseas markets, and they are doing deals and partnerships abroad. Huawei has a $100 million joint venture with Siemens in telecom, and also a joint venture with 3Com in networking equipment."

> "It's not just about Chinese companies — the broader picture is of nontraditional companies…and how they are taking advantage of China in constructive ways."
> —David Michael, vice president, BCG

"TCL focuses on televisions and mobile phone handsets, and it has started to globalize," adds Michael. "On a private-label basis, it makes many of the Magnavox televisions in the U.S. for Phillips Electronics." In addition, TCL recently formed a global joint venture with Thomson to make TVs and another one with Alcatel to produce mobile handsets. These are examples, he says, of competitors that are already making inroads. "They may not yet be at the level of Samsung — there are yet many growth challenges — but they're not standing still."

Another key area to look at, Michael notes, is the proliferation of external companies that are leveraging China effectively. "It's not just about Chinese companies — the broader picture is of nontraditional companies (Asian MNCs in Hong Kong, for instance) — and how they are taking advantage of China in constructive ways." Many of these firms, he says, are growing internationally based on highly competitive manufacturing bases that they have established in China, or by capturing a lot of the domestic demand in China to gain scale. "It's this category of company that will be competing on the global scene more quickly than Chinese companies," he notes.

An example is UTStarcom, a telecommunications equipment company founded by several former Chinese executives at Lucent Technologies, that has taken older networking technology and developed it into a service fitting a certain market need in China. "Some 90% of sales and 100% of the company's production is in China, and the operating headquarters is in Beijing. But it's incorporated in the U.S., and its original capital came from Softbank in Japan. It's run by overseas Chinese," says Michael. "The company is adept at dealing with Western companies, and is fully capable of playing the game abroad."

Johnson Electric, a Hong Kong-based MNC, manufactures most of its products — small motors for fax machines and car air conditioners — in China. "Built over 20 years, it has made global acquisitions and is highly profitable," says Michael. "It dominates its category globally." Similarly, Techtronic, a power tool maker that competes with Black & Decker, started out as a contract manufacturer with factories in China. "It was co-founded by a German and a Hong Kong Chinese person a few decades ago; now it has branched out and is acquiring older appliance and power tool brands," says Michael. "It also makes private label tools for Home Depot. It has 11% market share and is gaining on Black & Decker's share every day."

While pessimists might note that there is still no Samsung in China, every economy is a little bit different, says Michael. "You will have a lot of hybrid companies coming out, as well as traditional Chinese firms. Plus, keep in mind that many of these companies will be more effective in competing in other emerging markets than they will be in the U.S. or Europe. After all, that's where the growth is supposed to be in the future. TCL already has a plant in Vietnam, it will be going into Pakistan, and it is pushing its product in India. So if Western firms think the market in these emerging countries will still be around when they get to it, they're mistaken."

Will Low-Cost Countries Live Up to Their Name?

Some business analysts contend that countries like China, India, and Mexico, where costs are low at present in relation to the U.S. and Europe, will ultimately lose that advantage. As the following excerpt from a Boston Consulting Group study titled, Capturing Global Advantage: How Leading Industrial Companies Are Transforming Their Industries by Sourcing and Selling in China, India, and Other Low-Cost Countries, *shows, however, that that is unlikely to happen:*

Many observers have suggested that the low-cost country (LCC) cost advantage will evaporate in the foreseeable future (variously defined as the next five, 10, or 20 years). They argue that while LCC factor costs are currently low, they will increase much faster than costs in developed countries, thereby narrowing the cost gap. BCG maintains, in contrast, that the cost gap not only is unlikely to close within the next 20 years but in some cases may actually increase, for several reasons.

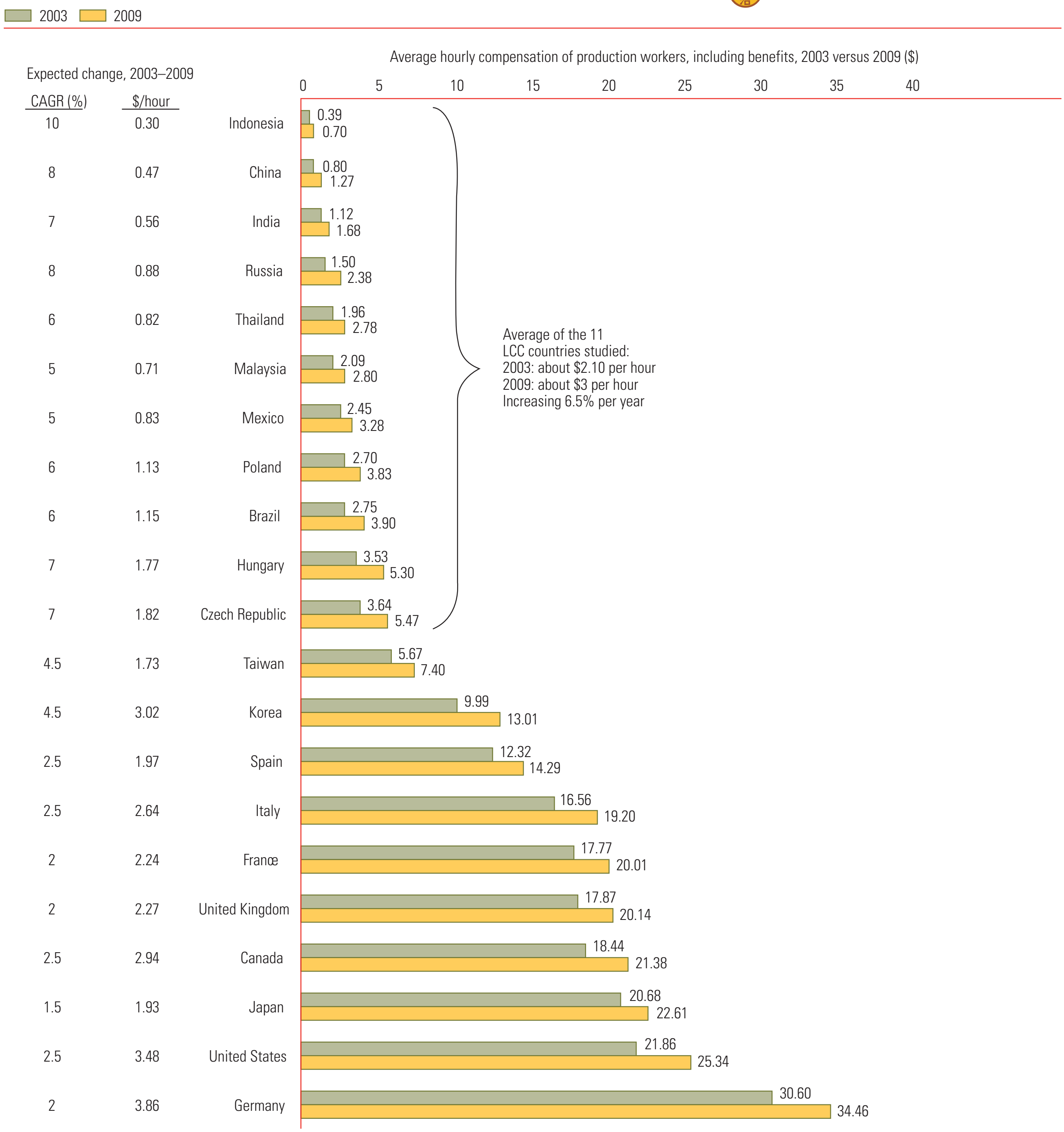
First, and perhaps most important, leading companies operating in some LCC markets have consistently been able to lower their purchase costs over time, achieving annual cost reductions that significantly exceed what can normally be achieved in the West. For instance, 10% improvements in cost per year are not uncommon for products newly relocated to China. Notably, this annual performance improvement comes on top of the initial 20% to 40% savings that companies typically achieve by moving operations to China. The subsequent annual improvements stem from expanded scale, deepening relationships with suppliers, and a very competitive environment. Obviously, such continuous improvements in cost positions constitute a growing advantage for companies that make the move early.

Second, the growth of wages in China and India will be limited because of the enormous reservoir of underemployed people in these countries. China still has more than 800 million people — some 12% of the world's population — living in the countryside. They are expected to exert very strong downward pressure on wages for low-skilled positions over the next few decades. Although there will be more pressure on higher-skilled positions, the supply of candidates for such positions is also very large. For example, several million engineers graduate from Chinese universities each year. On the other hand, China currently has a severe shortage of experienced managers, which is driving salaries up and creating a war for talent — especially for managers with at least ten years of experience. This is an important challenge that companies must actively address. India, for its part, has a pool of 25 million educated, English-speaking workers, expanding by a million every year. So the rapid growth of IT and BPO services has had a negligible impact on wage rates. Moreover, India is one of the few countries in which the working-age population is projected to grow for the next 40 years or so, keeping wages low.

Third, the current differential in labor rates is so big that the gap between them will remain substantial for the foreseeable future, even if there are double-digit differences in the rates at which they grow. (See the chart.) In fact, the gap in real wages will actually increase in absolute value, at least for the next several years, because the bases are so widely different.

Typically, a U.S. or Western European factory worker costs an employer $15 to $30 per hour. A Chinese factory worker earns less than $1 per hour — a gap of $14 to $29. If wages in China increase at an annual rate of 8%, while in the United States and Germany they increase at annual rates of 2.5% and 2%, respectively, in 2009 the average hourly wages will be approximately $1.30 in China, $25.30 in the United States, and $34.50 in Germany. So, despite the disparity in growth rates, the gap will have expanded by $2 to $3 (assuming that there is no significant change in the relative values of the countries' currencies). Government-mandated labor costs, such as workers' compensation, will further widen this gap.

In contrast, labor costs in the smaller Eastern European countries and Mexico might come under greater pressure. These countries will remain competitive vis-à-vis the United States and Western Europe, but they will likely slip further behind China and India because they start from a relatively high cost base and generally experience substantial annual increases.



Expected change, 2003–2009

CAGR (%)	$/hour	Country	2003	2009
10	0.30	Indonesia	0.39	0.70
8	0.47	China	0.80	1.27
7	0.56	India	1.12	1.68
8	0.88	Russia	1.50	2.38
6	0.82	Thailand	1.96	2.78
5	0.71	Malaysia	2.09	2.80
5	0.83	Mexico	2.45	3.28
6	1.13	Poland	2.70	3.83
6	1.15	Brazil	2.75	3.90
7	1.77	Hungary	3.53	5.30
7	1.82	Czech Republic	3.64	5.47
4.5	1.73	Taiwan	5.67	7.40
4.5	3.02	Korea	9.99	13.01
2.5	1.97	Spain	12.32	14.29
2.5	2.64	Italy	16.56	19.20
2	2.24	France	17.77	20.01
2	2.27	United Kingdom	17.87	20.14
2.5	2.94	Canada	18.44	21.38
1.5	1.93	Japan	20.68	22.61
2.5	3.48	United States	21.86	25.34
2	3.86	Germany	30.60	34.46

Source: *The Economist Intelligence Unit; Euromonitor; S&P DRI; U.S. Department of Labor; BCG analysis*

Additional Reading

More business insights on China from Boston Consulting Group and Knowledge@Wharton are available at the following Web links:

Boston Consulting Group

- *Capturing Global Advantage,* BCG Report, April 2004
- *Building Professionalism: The Next Step for Life Insurance in China,* BCG Report, March 2004
- *What Is Globalization Doing to Your Business?,* BCG Opportunity for Action, February 2004
- *Made in China: Why Industrial Goods Are Going Next,* BCG Opportunity for Action, November 2003
- *Aim High, Act Fast: The China Sourcing Imperative*, BCG Opportunity for Action, February 2003

For these and other BCG publications, please visit
http://www.bcg.com/publications/publications_splash.jsp

Knowledge@Wharton:
(Free, registration is required)

- "China: Will Asia's 800-Pound Giant Crush Its Neighbors?"
  http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&id=908
- "Does China Pose an Economic Threat to the United States?"
  http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&id=895
- "With Key Reforms, China's Capital Markets Will Be Ready for Take-off"
  http://knowledge.wharton.upenn.edu/articles.cfm?catid=9&articleid=803
- "A Contrarian's View of What's Behind Foreign Direct Investment in China"
  http://knowledge.wharton.upenn.edu/articles.cfm?catid=9&articleid=806
- "Intellectual Property Concerns Aren't Keeping Firms Out of China"
  http://knowledge.wharton.upenn.edu/articles.cfm?catid=9&articleid=804

China Report: Studies in Operations and Strategy

China and the New Rules for Global Business

For further information or inquiries, please contact:

The Boston Consulting Group

Chris Mark
china.ops@bcg.com
212.446.2800

Knowledge@Wharton

Jamie Hammond
hammondj@wharton.upenn.edu
215.898.2388