

China Business Summit 2004**Beijing, China****Balancing opportunity and risk in China**

China has averaged 9% annual GDP growth for 25 years now, astounding economists and strategists, some of whom see the country as an emerging economic superpower. The country's performance and demographic profile also raise serious questions as to its global and regional ambitions and how it will exercise its newfound power. Rising levels of trade and economic integration with its Asian neighbours point to an eventual challenge to the United States as Asia's main growth driver. Some 500 business and political leaders met in Beijing at the Forum's China Business Summit to chart the impact of these key issues. Debate also focused on China's financial and banking systems, its growing energy demands, the need for infrastructure improvements and greater intellectual property protection, and the social upheaval created by China's rapid transformation into a major industrial economy. A variety of insights emerged from the two-day event. These include:



"We will speed economic reform on restructuring and the adoption of market-based systems."

*Zeng Peiyuan,
Vice-Premier of the People's
Republic of China, addresses
the World Economic Forum's
China Business Summit 2004.*

Business and economics

- Despite impressive growth, China's economy will face its most critical test to date over the near to medium term, especially as it exposes key industries to competition. Some analysts also worry about the easy availability of credit and a potential speculative bubble in the urban Chinese property market.
- The banking industry and financial system must be put on more solid footing, with the introduction of sound commercial practices at state banks. The provisions for bad loans and improvements in the regulatory regime already undertaken represent key steps in addressing the high level of non-performing loans (NPLs).
- New bankruptcy and antitrust laws and the preparation of certain state firms for merger and acquisition should speed the restructuring of state-owned enterprises. In China's fast-changing environment, companies must embrace a corporate governance culture to free themselves of state influence and diminish the negative effects of any future crisis.
- China will exercise the right to create or adopt standards, although to some extent market forces will determine the outcome. Businesses should deepen their understanding of policy-makers' concerns and position themselves proactively.

Geopolitics and security

- China is assuming a greater leadership role in world affairs, and has been invited to attend the G-8 talks. Beijing has also assumed greater diplomatic status by leading talks involving the US and Russia as well as Japan and the two Koreas regarding Pyongyang's nuclear capabilities.
- As China's share of world trade continues to grow, protectionist sentiment is certain to rise in both Europe and the US, especially if growth stalls and more jobs are lost. Some in the West will come to view China as an economic threat.
- Energy security is increasingly tied to geopolitics. Given China's need for foreign oil, Washington and Beijing might diverge over Middle East policy.

Culture, values and leadership

- Physical presence is critical in China's relationship-based market. People working locally are necessary to develop a real network. Senior executives may prefer Hong Kong for tax reasons or lifestyle but risk losing out on the personal connections that enable success.

- A fusion of Western entrepreneurialism and traditional Chinese values sometimes works best. Leadership can be cross-cultural if it is passionate, original and based on mutual respect.

- When making investment decisions, businesses should look beyond local income levels and market size and also factor in regional and industry-specific issues such as transport costs, industrial fragmentation, and local regulation and enforcement.

"For the companies that have blindly invested in overheated sectors, we need to use market competition and legal means to restrict them... But regarding local government interference, we have to use administrative measures to stop them."

Ma Kai, Chairman, National Development and Reform Commission, People's Republic of China



Yoriko Kawaguchi, then Minister of Foreign Affairs of Japan; current Special Adviser to the Prime Minister of Japan

China Business Summit 2004

Beijing, China

Adapting to geopolitical changes

Big picture

- Despite periods of past friction, Sino-US relations are less problematic today than at any point over the past ten years. Still, contentious issues remain, including the value of China's currency, its commitment to the war in Iraq and a poor Chinese record of protecting intellectual property. For their part, Chinese authorities complain about onerous US visa requirements.
- China has assumed greater diplomatic status by leading talks involving the US and Russia as well as Japan and the two Koreas regarding Pyongyang's nuclear capabilities. Trade is growing between China, Japan and the Republic of Korea, but ongoing political tensions could still adversely affect trade relations.
- Relations between China and India – once bitter regional rivals – have also improved and bilateral trade has risen tenfold over the past decade to a projected US\$ 10 billion in 2004. The two countries may eventually join forces in a future pan-Asian trading bloc although cultural and historic differences would likely prevent any formal alliance.



"The day will come when China emerges as the world's second growth engine, after the US."

Jeffrey Garten, Dean,
Yale School of Management,
USA

Context

Sino-American ties are currently seen by Washington as America's "most dynamic strategic relationship". The Bush administration has embarked on a policy of "leveraged engagement" involving senior dialogue virtually every month. There is plenty to talk about, and some US officials worry that China is seeking to become a global military power. The Chinese government claims to spend US\$ 20 billion a year on its military, while sceptics in Washington believe the real number is twice that.

The US trade deficit with China is another point of friction, having risen to US\$ 68 billion during the first half of 2004 and predicted in 2004 to double that of 2003. China's trade surplus with the US is now twice the size of Japan's and has become a source of political tension during an election year with American voters worried about jobs and the economy.

Strategic insights

- Chinese demand for raw materials may encourage Beijing to take a more active security role in South-East Asia and the southern hemisphere.
- As China's share of world trade continues to grow, protectionist sentiment is certain to rise in both Europe and the US, especially if growth stalls and more jobs are lost. Some in the West will come to view China as an economic threat.
- A huge and growing trade deficit will encourage US officials to pressure China to adopt more free market policies and alter its exchange rate regime.
- The Taiwan issue has reached an impasse and businesses should adjust accordingly.

Understanding the economy's new growth engines

Big picture

- China's ambitious vision of quadrupling GDP to US\$ 4 trillion by 2020 will require accelerating economic reform as well as developing science and technology to spur innovation.
- China's development may be enhanced by a new focus on emerging technologies, high-growth industries and entrepreneurial companies.
- Growth in consumer markets is currently constrained by inadequate infrastructure, fragmented domestic markets, high logistics and transport costs, and unequal distribution of income.



Naoyuki Akikusa,
Chairman and
Representative Director,
Fujitsu, Japan

Context

China has a strong foundation for innovation with its huge pool of science and engineering graduates. Some 2.5 million students graduate from its universities each year, with 60% in technical fields. This compares with India's 1 million graduates (50% technical) and the US's 2 million (25% technical). Creating an innovation-based economy, however, will require better intellectual property protection, a dynamic venture capital industry and a culture that both tolerates failure and rewards success.

While China's abundant low-cost labour has driven success in light manufacturing, the domestic creation and adoption of technology are needed to grow world-class companies. Innovative Chinese companies already exist such as telecommunications vendor Huawei – a competitor of Alcatel, Nortel and Siemens – and DSL equipment provider UTStarcom. Most Chinese firms, however, remain weak in areas such as marketing, supply chain management and knowledge management.

Automobile, retail, tourism, financial and basic resources industries enjoy significant opportunities due to the rising incomes of Chinese consumers, though the risk of overcapacity remains for certain industries. Because of its fast-growing domestic market, China's decisions on technologies and standards will increasingly shape the global corporate leadership agenda.

"The China factor in world affairs is now fully recognized, like an elephant running at 100 miles per hour."

Victor L.L. Chu,
Chairman and Chief Executive
Officer,
First Eastern Investment
Group, Hong Kong
SAR

China Business Summit 2004

Beijing, China

China remains at the crossroads in developing strong IP and legal systems. After developing a raft of laws and institutions, it must now shift to the task of enforcement. The coming decade will generate further friction – internally, because of conflicts over autonomy and revenues and externally, because of increasing pressure from foreign businesses and governments. In the meantime, it will be crucial to adjust business and investment strategy by segregating operations to minimize IP exposure and through the selection of appropriate joint venture partners.

China's emergence as a critical link in the global supply chain remains constrained by underdeveloped infrastructure, a lack of logistics professionals, insufficient rail development and overlapping local, provincial and national licensing requirements. Logistics costs represent 18-20% of GDP in China vs 9-11% in the US and Europe, due to multiple intermediaries and high inventory levels.

Strategic insights

- In order to move beyond low-cost manufacturing, Chinese companies will need to build distinctive strengths such as specialized manufacturing abilities, brand management and supply chain management.
- When making investment decisions, businesses should look beyond local income levels and market size and also factor in regional and industry-specific issues such as transport costs, industrial fragmentation, and local regulation and enforcement.
- China will exercise the right to create or adopt standards, although to some extent market forces will determine the outcome. Businesses should deepen their understanding of policy-makers' concerns and position themselves proactively.



"The rampant growth of investment indicates that enterprises are behaving irrationally ... Corporate decisions should be based on rational assessments of market supply and demand, risk and return..."

*Qin Xiao, Chairman,
China Merchants Holdings,
Hong Kong SAR*

"The most important thing is to further push market-oriented reforms of interest rates, with the ultimate goal of making interest rates, the exchange rate and the price of capital truly reflect market supply and demand."

**Li Ruogu, Deputy Governor
of the People's Bank
of China**

Confronting the challenges to sustainable growth

Big picture

- In recent months, the Chinese government worked to cool an overheated economy, using administrative controls to moderate growth in sectors such as real estate and infrastructure development.
- The government has also employed traditional monetary measures such as raising bank reserve requirements to slow high credit growth due to low short-term interest rates and indiscriminate lending practices. A sharp rise in fixed-asset investment has raised fears of speculative bubbles, particularly in the property market.
- Chinese authorities have used traditional planned-economy tools such as administrative controls and moral suasion. The introduction of a wider range of market-based mechanisms could be facilitated by the adoption of a flexible exchange rate regime. While the leadership appears committed to do so, full currency convertibility is unlikely in the short term.
- China's complex reform programme includes the restructuring of state-owned enterprises (SOEs), the overhaul of the banking system, tighter corporate governance and the protection of property rights. But these goals must be finely balanced, with each impacting on the others. Thus, the overall reform process can appear chaotic and bumpy.
- The transition of China from a command to market economy will necessarily continue to be gradual. Increasingly, however, China will have difficulty sustaining its customary high growth as it faces a range of major challenges at home and in the global economy.



*Cheng Siwei,
Vice-Chairman,
Standing Committee,
National People's
Congress, People's
Republic of China*

Context

Over the past 25 years, China's real GDP has expanded at an average of 9% a year. Growth in foreign trade has averaged 15% a year since 1978. Current projections indicate that China's GDP could be second only to the US's by 2016 and may exceed it around 2040.

But a host of challenges are likely to prevent straight-line growth. As China becomes more market oriented and integrated into the global economy, tensions between command and free enterprise forces will lead to volatility and greater risk.

The current period of overheating is an example. The mix of macroeconomic measures and administrative controls used to slow rampant fixed-asset investment and credit growth has achieved limited success. While economists have noted China's preference for macro controls, the government stresses that it uses what market-based mechanisms it has at its disposal to tackle such problems as the excess liquidity in the banking system which contributes to excessive lending.

China Business Summit 2004

Beijing, China

As the China growth story moves forward, the state-dominated banking industry and the shrinking SOE sector provide obvious potential crisis points. The “big four” banks account for 60% of total banking assets and up to 80% of new loans. Non-performing loans (NPLs) now total about 26% of all lending – the real figure may well be higher. The state banks have no incentive to assess risk properly because they know the government will bail them out. Such a system cannot be sustained.



“China must address key challenges such as an underdeveloped financial system.”

William G. Parrett,
Global Chief Executive
Officer, Deloitte Touche
Tohmatsu, USA

SOEs, meanwhile, are being primed to go global, but the restructuring needed to turn them into viable companies has been uneven across sectors. Many state firms remain unprepared to venture abroad or face new foreign competitors at home, and are reluctant to adopt corporate governance standards or to enhance accountability, transparency and management skills.

Strategic insights

- More market-based economic control mechanisms could help the government better manage and fine-tune the economy, particularly during periods of financial stress.
- The banking industry and financial system must be put on more solid footing, with the introduction of sound commercial practices at state banks. The provisions for bad loans and government bailouts already undertaken represent key steps in addressing the NPL problem.
- New bankruptcy and antitrust laws and the preparation of certain state firms for merger and acquisition should reinvigorate the SOE restructuring process. In China’s fast-changing environment, companies must embrace a corporate governance culture to free themselves of state influence and diminish the negative effects of any future crisis.
- The Chinese economy faces structural challenges including the absence of social safety nets such as a robust pension system and adequate unemployment compensation. The state will be hard pressed to afford healthcare for an ageing population, the inevitable recapitalization of technically insolvent state banks, the restructuring of SOEs and the costs of unchecked environmental degradation.
- China’s tricky two-track transformation – from planned economy to market system, from agrarian society to an industrialized one – will entail major dislocations, even as the government aims to continue the high growth needed to maintain social stability. Complicating this situation is the growing disparity of wealth: urban income is 2.4 times the countryside’s, up from 1.8 times in 1995.
- If growth slows sharply or unemployment spirals out of control, the economy could experience one or more serious corrections, possibly increasing pressure for reforms to address governance and efficiency issues such as corruption and the need for more accountability. A financial crisis would test social harmony and cohesion.

Dealing with a new global heavyweight

Big picture

- As its economic power grows, China is exerting greater influence in the world. China's unprecedented growth will increasingly require it to balance the internal and external impacts of its policy choices.
- China's expansion is creating greater scepticism in developed countries towards free trade and globalization.
- Suppliers and consumers around the world must adjust to the consequences of China's growing need for energy and natural resources.

"China needs to achieve 7% growth over the next 10 years. I see no scenario in which that happens where China does not become a major software centre. ... And you can't have a very strong software industry without a strong IPR system..."

Joseph P. Schoendorf,
Partner, Accel Partners, USA

Context

In the last 20 years, China's income per capita tripled to US\$ 1,000 and is projected to triple again by 2020. Chinese economic emergence may trigger a backlash against free trade and globalization in developed countries, particularly those that fail to implement the restructuring needed to remain competitive.

China contributes only 4% of global GDP yet accounts for 13% of energy consumption. In addition to aggressively diversifying sources of energy, China requires pricing mechanisms that reflect the economic cost of power, thus inducing more efficient use of energy. Regional diplomatic shifts, the integrity of supply lines and environmental issues will determine China's energy security.



Zhou Yucheng, Chairman of the Board of Directors, China Worldbest Group, People's Republic of China, and Li Rongrong, Chairman, State-owned Assets Supervision and Administration Commission, People's Republic of China

China Business Summit 2004

Beijing, China

As global companies become more reliant on China for sales or production, the country will also emerge as a major source of foreign investment. The descriptions of China as “the world’s factory” and India as “the world’s outsourcer” are fast becoming obsolete.

Strategic insights

- China’s economy may be due for a major correction as the positive global environment that has nurtured its growth in recent years may well worsen. Challenges include mounting unemployment, the lack of social safety nets, the growing pressures associated with an ageing population and increasing healthcare needs, and a shaky financial sector.
- Increased domestic demand may not generate the 15 million jobs that China needs to create every year to maintain growth and reform. Nevertheless, domestic demand will continue to grow as urbanized populations accumulate wealth and spending power, and businesses can benefit if they adapt products and messages to meet and guide the needs of the market.
- Developed countries must prepare for the rapid integration of China and India into the global economy, through enhanced education, retraining and innovation. A political backlash could emerge in countries slow to adjust. Resulting protectionism would impede China’s growth and potentially damage the world economy.
- China may flex its market muscles to gain strategic advantage through economic diplomacy within its spheres of interest. Free trade agreements with ASEAN, Japan and the Republic of Korea will help businesses to leverage the comparative strengths of economies throughout the region.
- Successful international businesses will regard China not just as an opportunity to transfer best practices, but as a source of Chinese best practices that may be employed effectively in global markets.



*Miao Gengshu, President,
China Minmetals Corporation,
People’s Republic of China*

*“You should show
them you really care,
then they will follow you.”*

Zong Qinghou, successful
Chinese entrepreneur

Understanding China's leadership and entrepreneurship

Big picture

- China's transition to a market economy has been accompanied by a shift in business culture, increased recognition of entrepreneurship and the emergence of new styles of leadership.
- Wholly-owned subsidiaries are growing in favour as an alternative to joint ventures as companies recognize the importance of local knowledge.
- SOEs face difficulties transitioning to a market economy given their culture, a past reliance on soft loans, short senior management tenures, and increased exposure to domestic and multinational competition.
- China's enterprises need talented senior management to transform them into global players.

Context

Foreign firms entering China have used any number of approaches including joint ventures, establishing local offices and financing local entrepreneurs. Different cultural values, business and leadership styles, and perceptions about intellectual property present challenges for foreign companies, private Chinese entrepreneurs and Chinese SOEs now being forced to manage the transition to a market economy.



Grant Aldonas,
US Undersecretary of
Commerce for International
Trade

Many multinational companies increasingly favour wholly-owned subsidiaries to JVs following years of limited partner choice (typically SOEs) and partners that later became direct competitors, sometimes even taking intellectual property which then "leaked" into the market.

Foreign companies recognize the need to align both values and interests when selecting a partner. Understanding of cultural differences is improving as more companies establish a physical presence in China and employ Chinese employees educated overseas as bridge builders. Many returning Chinese students and business people are forgoing the structure and hierarchy of foreign multinationals and

SOEs to launch their own businesses. They are creating a distinct business culture which is neither Western nor traditionally Chinese, across a variety of sectors.

China Business Summit 2004

Beijing, China



World business leaders at the closing plenary session

Strategic insights

- Legal frameworks, lack of convertibility and access to capital will remain significant challenges facing entrepreneurs in China. The fledging venture capital industry will require feasible exit mechanisms to function effectively. Chinese entrepreneurs should consider foreign listings as a possible strategy.
- To manage growth in recognition of diverging business cultures, authorities will need to instill a sense of risk and imagination in SOEs even as they temper unbridled enthusiasm in private companies.
- Physical presence is critical in China's relationship-based market. People working locally are necessary to develop a real network. Senior executives may prefer Hong Kong for tax reasons or lifestyle but risk losing out on the personal connections that enable success.
- A fusion of Western entrepreneurialism and traditional Chinese values sometimes works best. Leadership can be cross-cultural if it is passionate, original and based on mutual respect.

"Ownership reform is critical... if I don't have the authority to designate a vice-president, or make decisions on investment, then my company is doomed if I want to compete globally."

Liu Xiaoguang, President and Chief Executive Officer, Beijing Capital Group, People's Republic of China

China Business Summit 2004

Beijing, China

Centre for Strategic Insight

The World Economic Forum's Centre for Strategic Insight (CSI) supports members by identifying and analysing the global, regional and industry tasks that matter most. With strategic insights gained through the Forum's position at the hub of many global communities and interest groups, CSI's approaches include exploratory work, strategic mapping and scenario projects. Our mission is to proactively create relevant strategic insight through a range of activities. Particular emphasis is given to identifying emerging risks and developments that will shape the new agendas of business and government.

For further information on the Centre for Strategic Insight, please contact: insight@weforum.org

Asia Programme

For over 25 years, the World Economic Forum's Asia Programme has convened global leaders from all walks of life to focus on the issues shaping the region's future. Regional Summits in China and India along with Asia Roundtables allow participants to engage in frank dialogue about common challenges with key stakeholders. The Asia Programme aims to support businesses in Asia in managing the uncertainties and identifying the opportunities that arise in a complex global economy.

For further information on our Asia Programme, please contact: asia@weforum.org

The China Business Summit is held in cooperation with the China Enterprise Confederation and with the support of the World Economic Forum's partner, the National Development and Reform Commission of the People's Republic of China.

The World Economic Forum wishes to recognize the support of the following companies as Partners of the China Business Summit 2004:

Strategic Partners

ABB
Accel Partners
A.T. Kearney
Audi
Bain & Company
Bombardier
Deloitte Touche Tohmatsu
Fluor Corporation
IBM Corporation
KPMG
McKinsey & Company
Microsoft Corporation
Volkswagen
Zurich Financial Services

Summit Partner

Ogilvy Public Relations Worldwide

Service Provider

I.T. UNITED

Richard Evans
Editorial Director
World Economic Forum
91-93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Telephone +41 (0)22 869 1212
Fax +41 (0)22 786 2744
publications@weforum.org
www.weforum.org

The World Economic Forum is the foremost global community of business, political, intellectual and other leaders of society committed to improving the state of the world.