China :: Integrated

China's 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 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 opportunities 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.

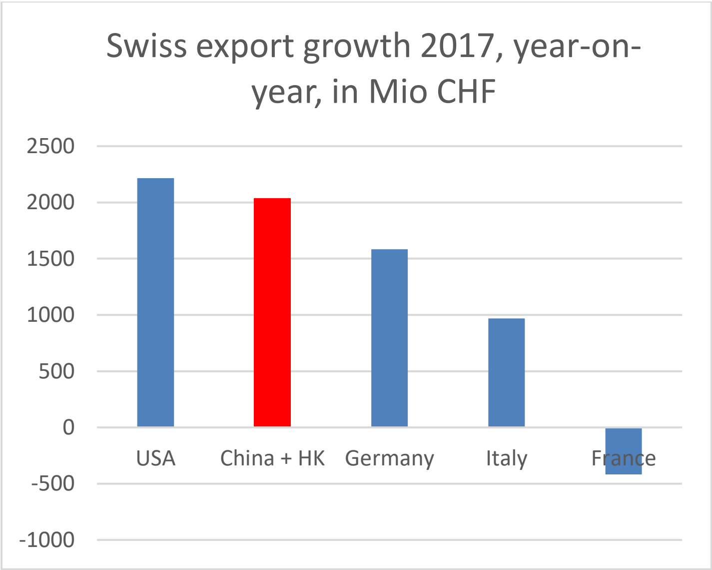
In 2017, the People's Republic was responsible for roughly 15% of total GDP while sustaining about 18.5% of the world population. At the same time the USA generated 25% of the world's GDP while being home to 4.3% of the world population, only.
(Russia, by contrast, hosts 1.9% of global population and 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.



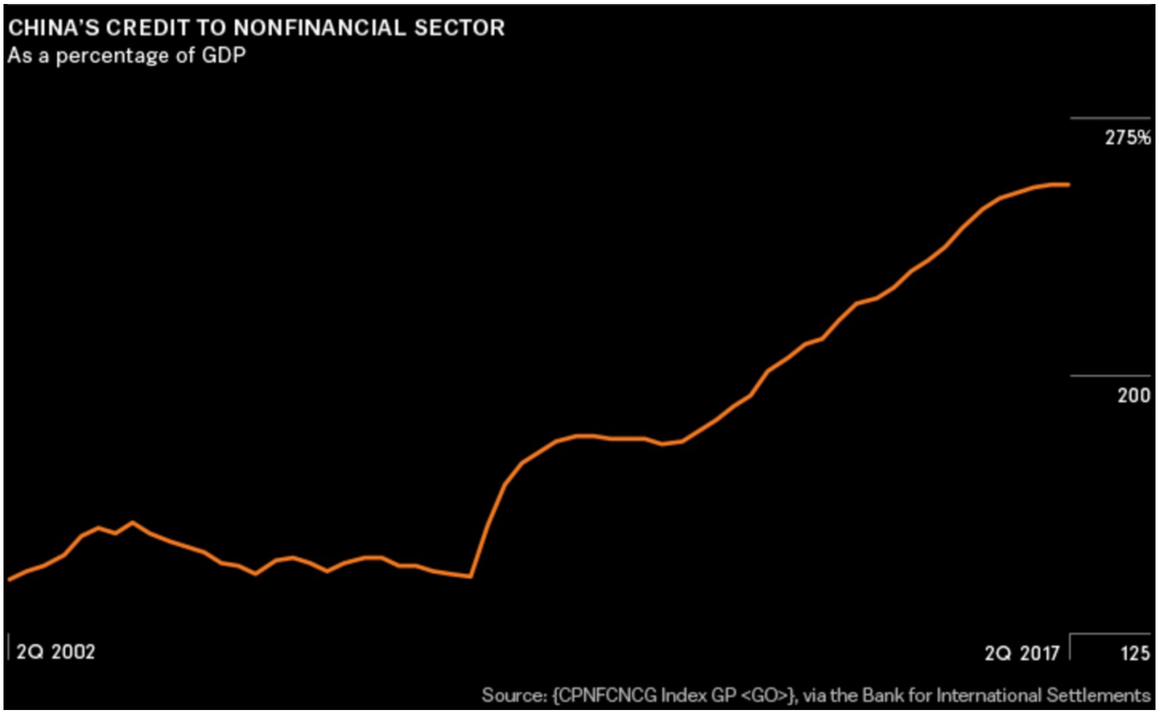
However, while the recent corporate tax reduction will certainly boost investments in the US and therefore continue to generate valuable opportunities for international businesses, the IMF is warning that China's financial system is at risk[1].

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 phenomenon new to the last 10 years. Before 2008, China's

[1] China's financial system harbours large risks, says IMF (7 Dec 2017, BBC)

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 of domestic projects.

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.
However, understanding the critical importance of growth for China means that, failing a financial crisis or a geo-political confrontation, 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 an 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 then, before they materialize.

In financial terms, the likelihood of a financial crisis is quite low, first because all the debt that is created 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.

Still the challenges faced by the government are also encouraging it to increase the financial system's professionalism and efficiency. As a result key restrictions on foreign ownership of financial institutions in China are widely expected to be lifted, following the official announcement to this effect[3]. This will certainly provide additional opportunities to the international financial business community.

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

The growth model of China is changing – will it become a tech innovator?

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

In the mid to long term, growth will need to happen through productivity improvement therefore 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 therefore without increasing debt.

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

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[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

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 innovation made abroad that, today, “Innovated in China” entails mostly business model innovation.

Wechat is the third largest social media platform worldwide. And using it one can only agree that by combining the functions of Facebook, Whatsapp and PayPal (and adding some more) Wechat is a great 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.)

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

If China hi-speed rail technology is fully dominated by the only Chinese railway company (state-owned CRRC), it has been achieved by requiring that foreign companies offering railway technology make joint-ventures with Chinese counterparts.
(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.)

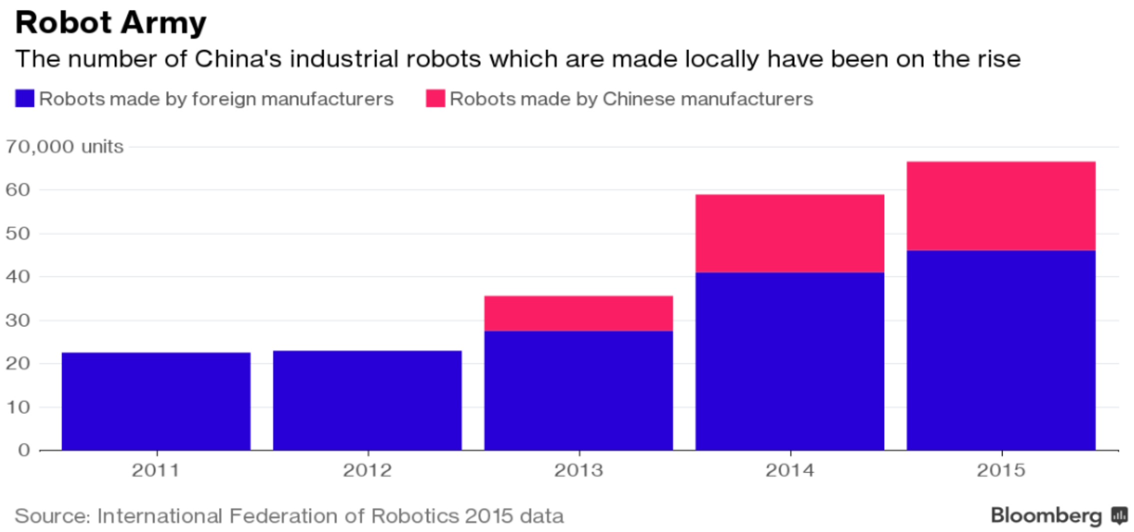
To fill in the gap and jump start technological innovation, in 2013 the government has launched the “Made in China 2025” plan, which essentially aims at upgrading China’s industrial sector and to support technology made in China by Chinese companies in key sectors. (Such as electric cars, advanced machinery, 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 is the plan is going to succeed, foreign technology will remain critically needed, if robotics is an example.

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 controllers, decelerators, servo-motors and other critical components[5].

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



And if official confirmation is needed, the plan calls for 70% of technology products to be "Made in China" by 2025. This indicates that demand for the more high-tech elements will remain and actually increase with the additional needs generated by the government stimulus. All in all, the plan will definitely create additional opportunities up the technology value chain; which is where international niche players are particularly strong.

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 information and specific experience on the subject with a follow-up analysis.

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

It is difficult enough to catch up technology developments. 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.

And it is not China's ambition either: 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 get there and be strong, China's leadership believes it needs to grow its international influence. And to do so, it intends to use its economical prowess and home grown technology to assert its international position.

This is the rationale underpinning for the One Belt one Road (OBOR) initiative, a new goal that China's current government has given itself.

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

The New Silk Road – China is going abroad

With the slowing down of growth, China's heavy and infrastructure industry is oversized. Capacity reduction is underway (also called "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 the same time, it is naturally a chance to establish closer relations within the region and improve China's position in the region. As well, it allows China to establish its own multilateral institutions, such as the Asian Infrastructure Investment Bank in Beijing, which most of the developed world joined in funding, except the USA.

To realize these aims Chinese enterprises are encouraged to go abroad to realize projects and to invest.

Ports and container terminals are being built or purchased (the Pyraeus in Greece), hi-speed railways are being planned and funded in South East Asia, 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 have the aim to strengthen China's overall ability to export its technologies, they are also a mean to build up China's technology.

Here again, China's goal of becoming a regional leader is creating opportunities for all those who can partner up with Chinese companies to sell their technologies through the OBOR initiative, and for those who can utilize Chinese funds to develop their company and market access in China. But yet again, this is not without risks, which we will detail in the follow-up to this analysis.

The New Silk Road has one more component that will be unveiled in early November 2018 in Shanghai, at the China International Import Exposition (CIIE), which President Xi will open in person.

To be a more attractive business partner and a fair international business player, China aims at balancing its trade by importing a lot more than it does now.

The first CIIE is meant to be China's most important international event. For the occasion Shanghai has built the largest building in the world. But can we still be surprised?

The Year of the Dog opens up with a set of new developments, challenges and opportunities. But once again, businesses have that many more chances to deal with!

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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