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The business of doing business with China:
An ambassador reflects

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Both nuanced and overtly aggressive, dogmatic yet flexible, and wise but having much to learn especially about corporate governance, China's leaders and its business operating environment represent a supreme challenge for the Canadian manager. In many ways, China is a new market unlike any other, though, as the Canadian ambassador explains in this article, the differences can be overcome and success stories can be written.

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One of the defining features of the early 21st century is the emergence of the People's Republic of China as an economic power. Among observers and interested parties, the suddenness of China's rise and its role in global affairs generates optimism and excitement about seemingly unlimited opportunities. Yet China's emergence also generates uncertainty and questions about the broad implications of its rise.

China could perhaps be viewed as a conventional state that has stepped boldly to the forefront by continuous and rapid economic development, replicating in many ways the experience of Japan, Korea and Taiwan. But this tells only part of the story. In fact, most people believe that China's sudden emergence is defined by exceptional characteristics and dynamics which make this story uniquely important. This view also suggests that the challenges posed by China's growth must also be unique. In these and other respects, I think that most people are right.

The facts are clear: China now accounts for 4.5 percent of world GDP in dollar terms and 13 percent of world GDP in PPP terms. The British Treasury projects that this share will increase to about 19 percent by 2015. The World Bank believes that, because of China's rise, developed countries' relative share of global output will decrease, even as the absolute volume and value of that output increases. In global macro-economic terms, we will all, potentially, gain. I don't think that this is an optimistic projection. I think that it is a realistic one, because I believe that China's growth will be sustainable. The question is: For how long? This question and others that pre-occupy business executives are discussed in this article.

Three facts must be taken in to account when determining if China's growth is sustainable:

Trade and investment, both domestic and foreign, have driven much of China's recent growth.

Continuing reform of the domestic economy is the key to sustained, long-term growth.

Maintaining China's growth is in the interests of us all.

Trade and investment is China's primary engine.

Investment alone has accounted for more than 35 percent of GDP growth during the past 25 years. Since 2001, exports have increased by 225 percent. Straight-line projections alone indicate that if China's exports continue to rise by 35 percent, they would be worth US.$12 trillion in ten years, roughly the value of the current US. GDP China imported more that 1million barrels of oil per day in 2004, a total of 122 million tons, up 34.8 percent year on year. If China's petroleum imports continue to rise at this pace, in just a decade 20mm barrels will be imported each day, one quarter of

curren t total global production. Noone believes that this increase will occur so soon. More likely, the downward

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will work inexorably to slow things down.

will work their way into the real economy. These deflationary forces may be countered by continued groVJth, though dependence on conswner spending as the driver of the Chinese economy will still remain low: Until a relatively secure social security system is in place, savings rates will remain high, putting a damper on conswnption.

Perhaps most importantly, China's own infrastructure investment, rapid as it is, is having trouble matching the pace of economiC growth, especially in energy. During the latest phase of its boom, China has had nwnerous blackouts and brownouts.

Export-lead groVJth causes the rapid displacement of non-Chinese goods. This risks creating a political backlash, one which China will have to address. For example, US. imports of Chinese goods increased from $125 billion in 2002, to $152 billion in 2003 and $197 billion last year. In the first two months of 2005, China ranked behind only Canada as a source of US. imports. Some textile imports have already increased dramatically in the first few months of this year, impacting seriously on Canada, the U.S. and EU, and even more so on developing countries. Both the U.S. Congress and the EU are already showing signs of impatience. Proposals for WTO-inconsistent tariff increases and pressure to increase the value of the renminbi will only continue.

With respect to the environmental impact of growth, real costs may be about 2 percent of GDP, according to green accounting. The Chinese government appears to be increasingly committed to achieving clean development goals. This will eventually raise manufacturing costs and make marginal projects unviable.

At some point, the deflationary effect of the overproduction of capital and consumer goods, the [mancial impact of a low or negative return on investment, and unpaid loans to the banking sector,

Even if the rates of GDP and trade growth are not sustainable in the long run, overall positive growth will continue nevertheless, because the underlying fundamentals of Chinese growth are very strong indeed. These include WTO-mandated open export and import markets; emerging FTA's with Southeast Asia, Australia and New Zealand; sustained foreign and domestic private investment in manufacturing, and low - albeit rising -- labour costs. The government's support of trade and investment remains flexible and forward looking. The irrepressible entrepreneurial spirit of the Chinese people, while not quantifiable, is also a very significant driver of groVJth.

The bottom line is that China will meet the challenge of sustainable groVJth, but only while it pays the price for increasing energy efficiency, protecting tl1e environment and expanding social benefits to the labour force. A hard landing and even a crash can't be excluded. The performance of the banking sector remains problematic, as do factors such as the overdependence on [illegible] construction for urban economic groVJth.

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I don't believe that planning for a crash is necessarily the best approach to China, given its track record over the last 15 years. The fact of the matter is that we all have a stake in China's success. According to *The Economist,* Pacific Asia has accounted for about 45 percent of global GDP growth since the mid-nineties. China alone has accounted for 25 percent of this growth, surpassing the contribution of the U.S. at 20 percent and the EU, at 14 percent.

The challenge sustaining stability

U7ending yadao ichie, "stability above everything," IS one of Deng Xiaoping's principal legacies. This one, like all inheritances, especially the philosophical or political kind, can be read in many ways. And like all political slogans, its meaning needs to be adapted to changing circumstances. Since 1989, when Deng emphasized stability, China's population has increased by 180 million and its per capita income has grown from 1634 rmb to 9073 rmb. The middle class now numbers 125 million people. Private automobile ownership has risen from almost nothing to over 10 million cars today. Not much stability here, if by stability one means stasis, lack of change.

Information is more broadly accessible today than at any time in Chinese history. Two decades ago, there were 382 newspapers in China, everyone of them published by the state and the Party. Today, there are over 2,000, the vast majority competing for readers in a very dynamic market. Ten years ago, there were 10 million TV sets in China, while today there are 350 million, reaching virtually the entire population. Ten years ago, 4.5 million Chinese travelled abroad. Last year, almost 29 million did so. Not much stability here either.

These changes occurred in less than one generation. If anything, the pace of these kinds of changes is increasing.

Nothing changes people more than education through the availability of information and the prospects of a continuing rise in disposable income. This is happening in China today, despite the ongoing and too-frequently successful efforts of the government and the Party to suppress news they doesn't like. Nevertheless, access to large amounts of information is a new reality in China and this is changing the country profoundly. So, there is no stability here either.

There are less desirable indications 0f change. Growth has brough t drama tic inequalities. Urban to rural income disparity measures three to one on a national basis. Even in the major cities, there exists a large class of urban poor - certainly in the tens of millions - whose income has not risen in tandem with that of the urban population. The frustrations that boil over from imbalances are obvious to anyone who follows the news in China and to the Chinese people themselves. The Gini coefficient is now .45, and getting worse. It is much higher than India's, for example. (The "Gini coefficient" is an international index of income equality that ranges from 0-1.0. A rating of 0 represents perfect equality; as the rating approaches 1 the income gap is considered to be growing).

However, one thing that has not changed is the right of the Communist Party of China to exercise absolute power over Chinese society. This is stability of a sort, but many people, within China and without, wonder if it is the kind of stability that will vouchsafe the continuing rise of China not only as an economic power, but also as a society and a people, and its willingness and ability to address the serious challenges of inequality.

It is not the job of Canadian diplomats to tell the Chinese government or people what kind of institutions they need to enable them to adapt to China's changing society and economy, and to ensure that change brings the greatest good to the greatest number of people. China has always had, and its governments have frequently valued, public and private intellectuals and thinkers whose role in life is to ponder the state of the nation and provide advice on its future directions. You meet these people today and every day, in every walk of life, both within and outside the Communist Party. Nobody argues in favour of instability. However, there is wide recognition that, in modem societies, stability comes from the capacity of institutions to deal effectively with conflict and to manage change. Authoritarianism and coercion have proven to be much less effective.

There are ongoing debates on change and stability in China. Some deal with issues of national governance and others with issues that affect the individual. At the 'level of national governance, stability is linked to representative institutions and accountability, rule of law and good governance. On the ground, at the level of individuals, this means rights and individual freedoms, equity, justice and probity, the free flow of information and the end of endemic corruption. It also means freedom from undue influence by those in power.

The Communist Party asserts that it can deliver good government without universal representation, as well as social stability and continuing economic growth. It also states that it alone represents the wishes of the Chinese people, through the workings of limited forms of intra-party debate and decision making. It also believes, to cite President Hu Jintao, that copying Western forms of democracy is "a blind alley for China."

As a matter of recent historical experience, no country has achieved high levels of development and modernization without some forms of broad representation, accountable institutions, and the meaningful rule of law. China's objective is to have a per capita income of $5,000 well before midcentury. However, if it is to achieve this goal, and respect the aspirations of the poorest members of its society, it must have a system that puts its national and local rulers to an occasional test of accountability and public support.

Among the top 20 developed countries in the world, no country has achieved and sustained its standards of living without respect for individual rights, rule of lav.r, and representative institutions. This is just an empirical fact, not a political or value judgement. There is no example of a modern, functioning market economy that is not governed by an effective framework of rights and the reliability of an independent judiciary, putting into effect the utilitarian value of the rule of law. It's just that simple.

It is up to the Chinese, of course, to work this out for themselves. To those who argue that this is not the business of people outside China, I counter that real stability is in everyone's interest, within China as much as outside the country. All sorts of decisions are made and will be made on the basis of widelyheld views on its long-term stability. In my view, it is in the interests of China's continuing social, economic and political progress, and its continued integration into the global commons, that a means of progressing from Leninist centralism to representative institutions be found and deployed. How and when it will do this is up to China to decide, but such decisions will be made under the full glare of international attention and assessment. That, too, contributes to stability.

China is having an impact not only on the world's economic arrangements but its political situation as well. Its rise changes the relative shares of power and influence and affects the various balances of power. There is also a demonstrable change in the size and distribution of military power. This year's stated military budget is equivalent to Cdn$ 37 billion, twice the amount of five years ago. It is believed to represent as little as one-third of actual defence. expenditures.

Military power is not the only form of Chinese influence in the globalized world: So too are economic policy and diplomacy, examples of which include free trade agreements with countries on its southern flank - ASEAN, Australia, New Zealand; an economic agenda in the Shanghai Cooperation Organization, which includes Russia and the Central Asian states, and investments in oil-producing countries in Africa, the Middle East and Latin America. This economic expansion is the unavoidable corollary of the involvement of a large, ambitious economy in a global market.

China's broad ambitions - in economic, political and security matters - should contribute to making the world feel more, not less, secure. That, of course, is what we all want. China asserts that it wants this too, referring on occasion to its peaceful intentions. Time will tell if the equilibrium of interests in favour of such a strategy will prevail.

In addition to bringing their goods, services and even military might to the global environment, countries also bring their respective concepts of good governance. We cannot expect China to be any less forthright in expressing its views on values and an approach to governance than we are.

Canada's foreign policy is based on the promotion of our values, especially the respect for human rights and the rule of law. We believe in the sovereign rights of states, but are ready to subsume tllose rights in the growing, complex web of international and plurila teral agreements and in terna tional law. Our promotion of the right to protect civilian populations against serious human rights abuses includes the notions that sovereign states do not have the right to abuse their own people and that international intervention is justified if it can bring massive abuses ·to 'a stop.

In contrast, China's foreign policy is based on the sovereign rights of the state. Generally speaking, China is uncomfortable with the trans-border reach of institutions such as the International Criminal Court, which it has not joined. Its emphasis, in its own society, is on collective rights, not those of the individual. Its approach to law is top down and based on a 2,500 year old Legalist tradition that uses law as a tool of control. In China, it's rule by law, raciler th~n rule of law, and the Communist Party is not subject to the full force of the law.

The differences between Canada and China, the ED and China, and the US. and China, on these issues can usually be managed, though sometimes only by an agreement to disagree. As Canadians, however, we don't leave it at that: We have an active, persistent and funded campaign to promote human rights, good governance and the rule of law in China. Canadians, and the Chinese struggling in the background for human rights and democracy, expect no less.

Two-way trade between Canada and China last year was about US.$25 billion. TIus is a fraction of the more than the US. $1.7 trillion in the two countries' total global trade in goods, both imports and exports. Thus, Canadian trade dependence on China and Chinese trade dependence on Canada is not a significant issue. In fact, tlle numbers suggest that for Canada, China represents a commercial opportunity rather than a threat.

and games, clothing, footwear and furniture, represented over 20 percent of our imports from China; products such as computer and peripheral equipment, audio, video, electrical machinery and telecoms equipment accounted for another third. Chinese market penetration is also solid in such product areas as barbecues, bicycles, plastics and furniture.

Canadian companies manufacturing such products in Canada today have reason to be concerned about their future. According to some estimates, labour costs in China averaged about eighty cents per hour in 2003. In Canada, they averaged $18.44. If labour input -- as opposed to design, continuous innovation, new product development, marketing or intellectual property -- is the basis of Canadian firms' competitiveness, these same firms are seriously vulnerable to being crushed. As Bob Keyes of the Canadian Chamber of Commerce recently (and bluntly) put it, Canadian fums must "Adapt or perish."

But most Canadian firms are not in the manufacturing industries above, at least not now. Canadian production of toys, audio, video, t/ c/ f represents only 6.5 percent of total Canadian production in 2003. So at the macro level, China's threat is limited ..

China's market penetration of the u.s. market in these light industries has been significant. But these products only account for 7.5 percent of Canada's exports to the United States. Canada's main exports to the U.S. are resources and resource-based manufactured products, automobiles and parts, food stuffs, oil and gas, and hopefully, once again and in the not too distant future, beef. There are few Chinese suppliers of these products.

While Canada's share of U.S. imports has been steady at 18-20 percent, China's share rose from 3 percent to 12 percent in 2003. Japan and East Asian countries have taken the brunt of China's growth. In one de.cade, their share of u.s. imports has declined from 34 percent to 21 percent. However, we can expect to see increased 'competition in the U.S. from Chinese motor vehicle parts - something that is already happening - and in machinery. Chinese competition in services is also on the horizon, ",;'th architecture and engineering representing the leading edge.

The competltIve threat is there, but it is not generalized. David Ricardo's doctrine of comparative advantage remains firmly in place. China is not changing the basic rules of market economics. Canadian business has consistently demonstrated a capacity to adapt to the forces of the global market. We are not any less able to do so today than were those who adjusted their businesses to conform to the GATT and WTO trade negotiations, the creation of the FTA and NAFTA, not to speak of exchange rate volatility. Adapting to change and challenge is frequently as tough as it is enervating, but Canadian business has always come out on top. A much bigger concern is the danger of a progressive structural mismatch between the Canadian and Chinese economies arising from insufficient cross-investment. This is both a shortterm problem and a more profound, long-term issue.

More than half of China's imports and half of its exports are generated by foreign enterprises established in China. They import resources, machinery, technology and management skill, and export the products that they manufacture. According to a major study by the Economist Intelligence Unit, factors such as the rise of middleclass consumer demand and a business-to-business market, the development of brand recognition, significant improvements in the transportation infrastructure, and progress in standardizing the legal and regulatory systems, are all contributing to a growing "localization" of foreign-invested enterprises.

With some important exceptions, only a relatively small number of Canadian companies are part of these mega-trends, largely because Canadian investment in China is not large. According to the best available figures, total Canadian FDI stock in China is less than $750 million dollars, much less than one percent of total FDI stock now in the PRe.

I'm not entirely sure why Canadian firms don't invest more aggressively in China, especially when the U.S., UK, Japan, South Korea, Taiwan, France, Germany, Italy and other mature economies have done so to the tune of more than $600 billion in the last decade and a half. We are, after all, a major force for investment in the world and a net outward investor at that.

The reasons may be related to the fact that ours is both a resource-based *and* post-modern economy, heavy on resource extraction and processing on the one hand, and on services such as real estate, banking, insurance and engineering on the other. China has not yet welcomed foreign investment in mining, although it does attract companies engaged in the exploration and processing of metals and minerals, as well as in oil and gas. On the other hand, its services sector is both heavily regulated and immature. Consumer goods manufacturing is not significant in Canada and we have few global brands. Given the structure of China's competitive edge, this state of affairs may be more of a blessing than a curse.

Our challenge isn't getting into consumer markets in China. Rather it is becoming part of the vast global supply chains that now dominate the manufacturing sector. Business-to-business is also very much what we are good at, but not enough Canadian companies have yet found it in their interest to make manufacturing in China part of their strategies. The decision to do so or not do so is for individual businesses to make. All I can hope is that every Canadian business is conducting its ongoing strategic planning exercises with China very much in mind. All companies must be aware that their Canadian and foreign competitors are doing so and that the Chinese competitors are not far behind.

The other side of this coin is Chinese investment in Canada. China's total overseas FDI is estimated at about $37 billion, less than half a percent of global stock, but it is growing rapidly, in tandem with the 'go abroad' directives from the state council. Canada's current share is about one quarter of a billion dollars, less than 0.1% of the total.

The China Academy of International Trade and Economic Cooperation has produced a very detailed and current report on Chinese FDI. It states that, aside from Hong Kong, Macao and various Caribbean tax and accounting havens, the top FDI destinations are, in order, the U.S., Australia, South Korea, Singapore and Thailand. These are followed by energy suppliers in Africa and Latin American. Canada is not even in the top 20 destination countries.

Chinese FDI is primarily in the ICT sector, in distribution, oil, gas and mining, and also in some manufacturing and services. Half of FDI comes from the large state-owned companies. The principal reasons motivating Chinese FDI include market expansion behind the borders, where protectionism is a threat; strategic long-term corporate development; access to technology and management skills; and access to resources, the latter being large scale and heavily reported in the media. In the past, Chinese FDI in Canada has focussed on light manufacturing, transportation services, trading and retail. No'Jl, as we see, it is moving into resources. Some Canadians are ambivalent about these developments, partly, I think, because China's rise is part of the shock of the new - remember the concerns over Japanese investment - and partly because of their views on Chinese governance.

Although China's corporate mix includes large private companies, it also features significant mixedownership systems as well as very large state-owned enterprises under the general authority of the State Assets Supervisory and Administration Commission, which in turn is under the State Council. The Communist Party of China is formally involved in the nomination of some top executives. Some people question how these various roles, behind the borders in China, would affect investments operating behind the borders in Canada.

An unscientific sampling of major Chinese SOE FDI in other countries suggests that, in broad terms, Chinese companies are seeking to model their behaviour and performance on standards that are not glaringly different than those adopted by western firms. China's SOEs are being urged, by the Communist Party and the government, to adopt private-enterprise models of governance, with strong, bottom-line objectives. China wants to wean companies off of public financing; it wants them to develop world class S&T (S&T), products and management skills, as well as global brands in global markets. They are to become accepted members of the international community, as one face among others of China's presence in the 21st century, globalized world.

I am confident that the Foreign Investment Review Act, with its emphasis on "net benefit to Canada" criteria, will allow us to assess whether large individual investment applications should be allowed to proceed. There is a limited but not insignificant track record of Chinese firms - public and private investing in Canada. To date, none has proven to pose particular problems.

With respect to competing with China, I remain confident that we will adapt to the commercial and economic challenges it poses ? if we develop our global and corporate strategies, and if we bring to the task the skills we have shown in competing with firms from the U.S., Japan, the ED and developing countries. We will compete successfully because we have no choice, only the imperative that we must do so.

All strategies for a successful relationship with China must embrace the following three principles.

Leadership. China strategies require the clear and explicit commitment of leaders, CEOs and presidents and boards of directors. In my view, money and staff time are largely fungible in any organization; a leader's time is not. The buck stops at the desk of a very small number of people and they have only 24 hours in their day: Leaders must define their organization's priorities, and act and be seen to act on them. This means that a China strategy must include the leader's vision, and her or his direct involvement. It means being informed systematically. It means taking the time to travel to China to make direct judgements. This is expensive and time consuming, but considerably less so than the consequences of failing to meet the China challenge head on.

2. A joint effort is essential. This arises with the designation of any issue as a priOl"ity -the necessity of the key parts of a business or an organization to come on board. In Ottawa these days we speak of a "wholeof-government' approach" with regard to the Canadian government's China Strategy. This simply means that relations with the PRC are not only the responsibility of the Foreign Affairs Department, but also involve International Trade Canada, CIDA, Industry Canada, Agriculture Canada, Natural Resources Canada, and others. It should include provincial views and interests as well. All of these governments and departments must have their individual China strategies, but they must work also together. That is what we are attempting to do. In addition to those in the executive suite, staff in corporate planning, finance, manufacturing and marketing have to be convinced of the China Strategy's relevance to them, and their role in its implementation.

the operative principle is NAA: Never Assume Anything. Never assume anything either -with respect to seemingly objective facts or very subjective human behaviour. Mixing -with the Canadian business milieu does not prepare you for doing business in China. Our built-in expectations about return-on-investment, reliability of contracts, rule of law, mutual trust, formal and informal rules of business conduct often have little relevance in China. You have to prepare yourself for a totally different operating environment.

The corollary of this principle is that all and every piece of information is incomplete. China is so big and it is undergoing a profound transformation. Moreover, its regions are varied, national and local policy objectives can be different, and sources of information can have their own self-interest foremost in mind. This is why you can, and will, regularly obtain perfectly plausible, though completely contradictory, facts and impressions wherever you decide to look. It is the reality of today's China that no single source of information will give you a complete picture. So there is a huge premium on obtaining as much and as varied information as possible on which to base your judgements.

The same caveat applies to people. Never assume anything about human behaviour. There is no alternative to getting to know your counterparts, and getting to know them well. And usually, the more sources the better. I've seen too many projects fail because the Canadian company relied excessively on one, usually self-styled, superbly well-connected player.

Fortunately, -with regard to facts on the ground, there are more sources of information today to assist you in your due diligence on China. We have an embassy in Beijing and consulates in Hong Kong, Shanghai, Guangzhou and Chongqing. You should base your understanding of the China challenge to your company on the views of as many of these sources as possible. In modem business, there is no such thing as too much information.

In my view, the challenges come down to two simple observations.

First, China is unavoidable. We mu~t **and should deal with it and the opportunities its growth represents.**

Secondly, if we get our strategies right, its rise will be manageable and of great and sustaining benefit.

We have been there before and we will be there again. []