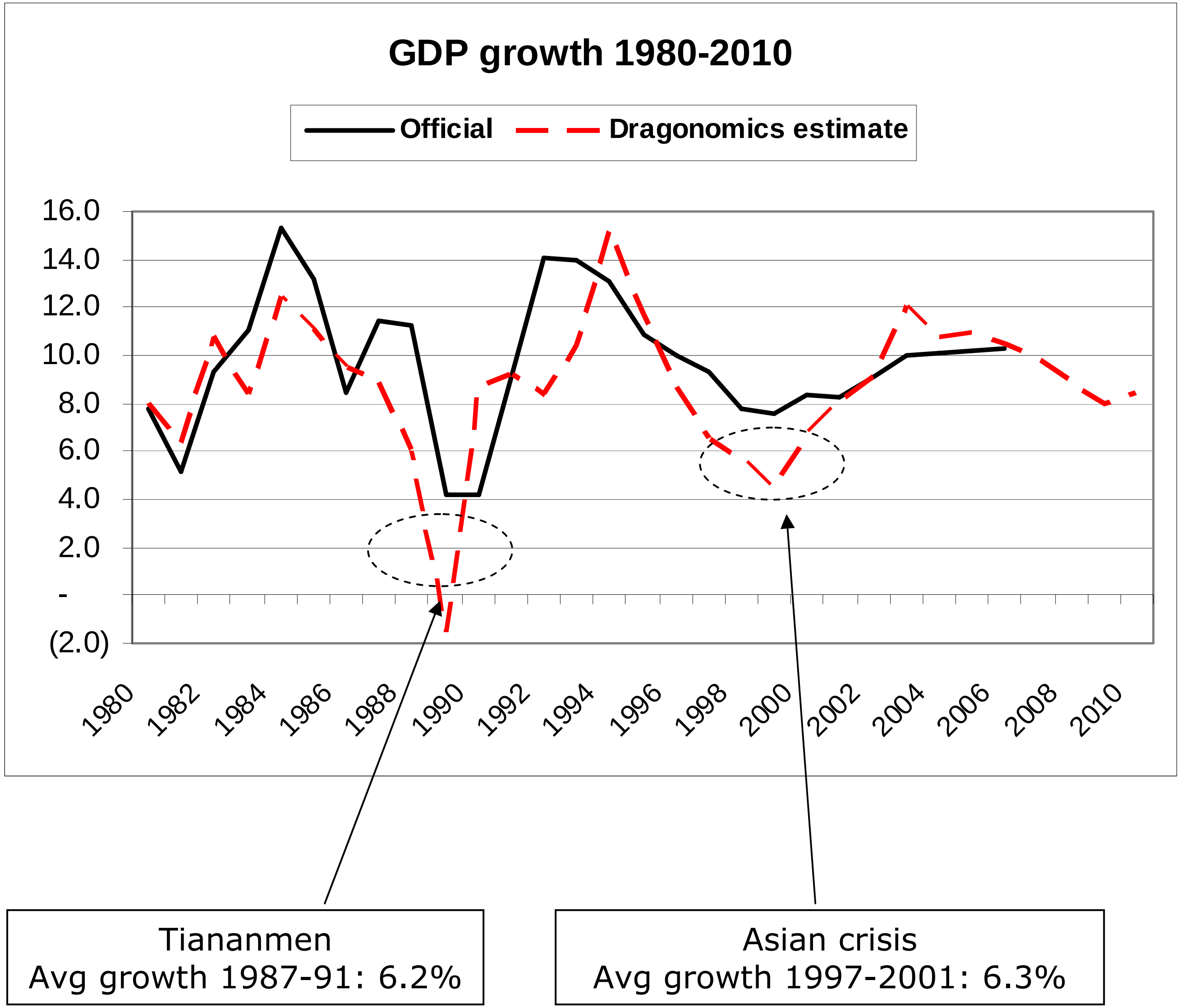
Dragonomics
Research & Advisory

China’s competitiveness: sources, constraints, lessons

Arthur Kroeber
Director, Dragonomics Research

China growth: long-term view

Dragonomics Research & Advisory



Structural growth: very strong and increasingly stable

- When everything goes wrong at once (1989, 1998), China can slow to 6½% growth on a five-year average basis.
- Today the structure of domestic demand is much healthier, so the next cyclical trough (2008-2010) will be shallower than the last two.

Avg growth 1980-2005	
Official	9.8%
Dragonomics	8.7%
Avg growth 2001-06	
Official	9.7%
Dragonomics	10.3%
Avg growth 2007-2010	
Dragonomics	8.8%

China's global impact

Dragonomics
Research & Advisory

- China is returning to its natural state

China share of world:

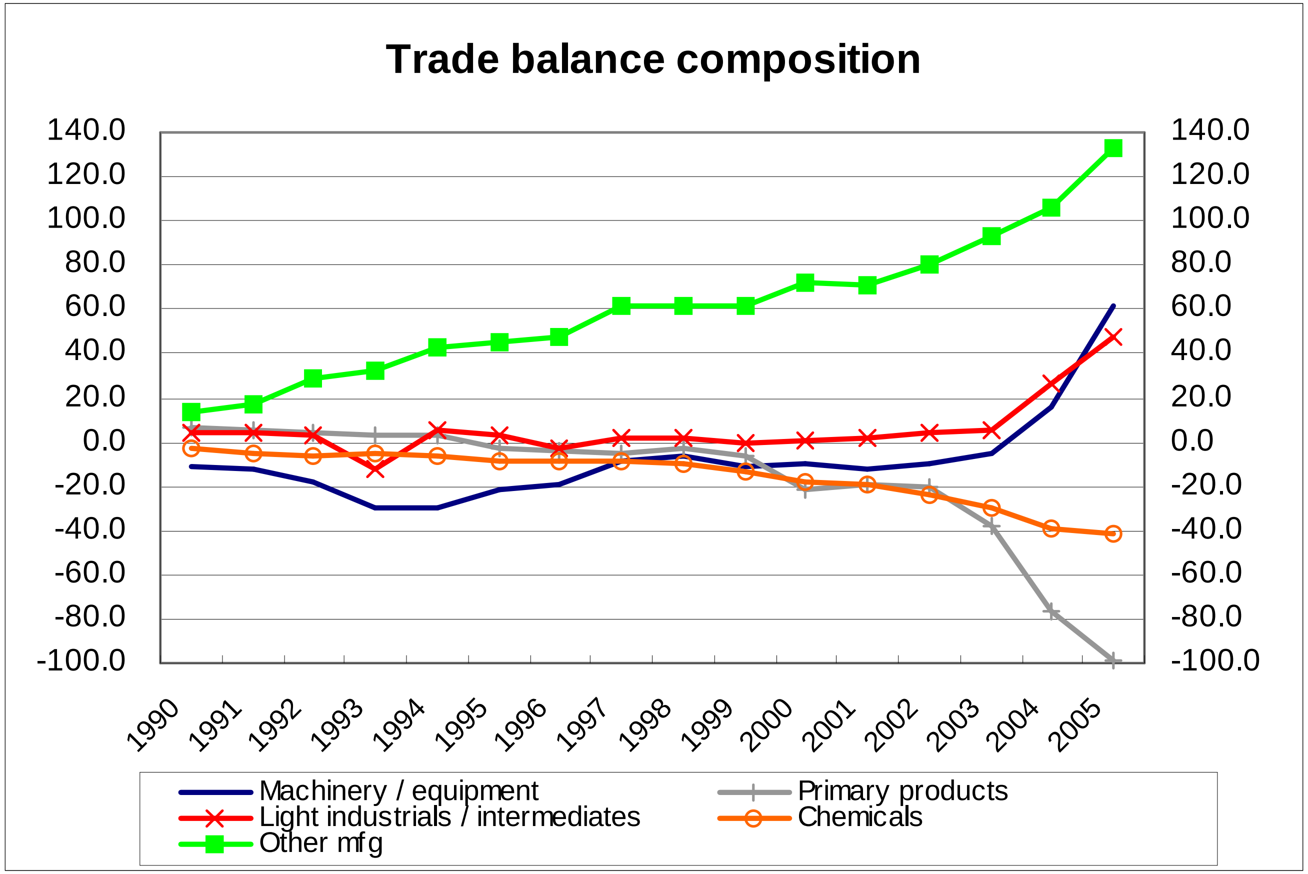
	Population	Manufacturing value
1800	33%	33%
1950	25%	<1%
2005	22%	7%
2040	20%	20%

- Why: third-world labor cost plus first world infrastructure

- What it means
  - Big market for raw material suppliers
  - Super-efficient export platform for global manufacturers
  - Secular shift in commodity / manufactured goods / service terms of trade

Trade balance composition

Dragonomics
Research & Advisory



Import substitution increases; exports move up the value chain

- The rapid broadening of China's export mix means export growth is sustainable at a high level.
- Virtually all of the surplus comes from processing which is not vulnerable to a slowdown in global demand.
- Import substitution in basic materials and capital goods is well underway. Next up: downstream chemicals.

China's competitive edge

Dragonomics
Research & Advisory

- Third-world labor cost plus:
  - First-world infrastructure
  - Low capital cost
  - Strong state capacity well applied
  - Pragmatic policies building on East Asian developmental state experience
  - Acceptance of competition even in 'natural monopoly' industries
    - Legacy of decentralization
  - Subsidies, lax regulation, cheap capital

- Most advantages equally available to foreign firms (though this may be changing)

Unfair competition?

Dragonomics
Research & Advisory

- Low capital cost stems from:
  - Government policy favoring industry over financial sector
  - Economies of scale in construction
  - Cascade effect from cheap labor
- Low regulatory cost:
  - Results more from decentralization than from deliberate central policy
  - Is an advantage at home but a handicap abroad

Role of the state

Dragonomics Research & Advisory

- State has always played a large role
  - China invented fiat currency ca 3rd century BC, 2000 years before the West
  - Major activities state monopolies, but 'the state' has always been regionally fragmented
  - Long history of entrepreneurship but no corporations until 20th century
- The state today
  - Enables hard and soft infrastructure
  - Prevents private resource monopolies and their malign social/political effects
  - Constrains financial sector to promote broad-based industrialization

Chinese companies

- Big state enterprises:
  - Cash-rich and on the acquisition trail
  - Weak on innovation
  - Slow to close deals

- Entrepreneurial companies:
  - Dynamic and efficient
  - Capital constrained and little market power

- Conclusion: China is <u>not</u> the second coming of Japan

Private firms: constraints

Dragonomics Research & Advisory

- Lack of market protection and guaranteed profits
- Local protectionism and reliance on political patronage discourage consolidation and encourage random diversification
- Lack of management expertise
- <u>Few of these constraints apply to big SOEs</u>

Risks on the home front

Dragonomics Research & Advisory

- Entrepreneurial companies' home position is insecure; vulnerable to takeover by better capitalized foreign rivals
- Labor-cost and distribution-channel advantages are
  - Non-transportable abroad
  - Replicable by foreign companies at home
- Rising incomes improve brand pricing power: advantage MNCs

Who is going abroad

- Beijing policy: 30-50 SOE MNCs
  - Oligopoly positions -> cash rich
  - Buying resources, IPR and market entry
  - Examples: CNPC, CNOOC, Minmetals, Yanzhou Coal, Baosteel, SAIC

- Entrepreneurial companies
  - Competitive markets -> cash poor
  - Buying brands, distribution, escape from excess competition at home
  - Examples: TCL, Haier, Lenovo
  - Japanese-style firms with brand and technology are rare: Huawei the main one

Chinese firms: not innovating

Dragonomics
Research & Advisory

- Firm investment in R&D <1% of sales
- R&D spend / value-added = 1%, 1/7 OECD average
- Technology imports:
  - 80% hardware
  - 20% licensing, consulting and services
- ‘Indigenization’ <10% of tech spend
  - In Japan / Korea in 1970s and 1980s the figure was 60-75%

China grows: winners & losers

Dragonomics
Research & Advisory

Winners:

What does this tell us about Chinese profitability?

- Consumers — Lower prices
- Commodity producers — Higher prices
- Service providers — Lower input costs
- MNCs — Efficient production platform
- Anyone who can use technology or management skills to mobilize Chinese human resources more effectively than Chinese corporations

Losers:

- Old-line manufacturers (unless they go to China!) — China will go from 7% to 20% of world manufacturing
- Intellectual property owners – if not careful — IP degrades much faster
- Over-regulated economies

Dragonomics
Research & Advisory

Dragonomics is an independent research and advisory firm specializing in China's economy and its influence on Asia and the world.

For more information:

www.dragonomics.net

arthur.kroeber@dragonomics.net