A Deloitte Research Consumer Business Study

THE WORLD'S FACTORY: CHINA ENTERS THE 21ST CENTURY

Deloitte Research

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THE WORLD'S FACTORY: CHINA ENTERS THE 21ST CENTURY

Introduction

When China opened up to the world two decades ago, it was initially heralded for being a vast market of more than a billion consumers, attractive to the world's retailers and manufacturers. While China's domestic market is no doubt important and will remain so, China has become known largely as a prime location to make products to be sold the world over. China has become to the early 21st century what England was to the 19th. Moreover, China keeps getting better. In the early 1990s, China was seen as simply a low cost place to make basic, labor-intensive products. Today, China is competitive in many advanced technologies and is challenging the exporting prowess of many other emerging markets around the world, not to mention developed countries such as the U.S. and Japan. Consider the fact that China produces more than 50% of the world's cameras, 30% of the air conditioners and televisions, 25% of washing machines, and almost 20% of refrigerators – and the list goes on. Moreover, there are technically advanced manufacturing processes for which China is deemed superior to the United States.

With China's entry into the World Trade Organization (WTO) in 2001, the game only intensifies. The rest of the world has agreed to reduce protection of apparel and textile products, thereby increasing one of China's great advantages. So China is set to become an even more powerful force in global production. Moreover, China has agreed to open its market to a variety of goods and services. The result will be efficiency-enhancing competition for China's burgeoning private sector, accelerated privatization of the lumbering state sector, greater opportunities for global suppliers to reach Chinese consumers, and greater potential for Chinese companies to compete with those global giants.

All of this raises some interesting questions:

- Will China's industry continue to advance up the value chain, becoming a major player in the most sophisticated processes?
- Will the manufacturing sectors of other Asian nations become eviscerated by China's advance? How will those countries respond?
- Will protectionism rear its ugly head in the U.S. and Japan? What could this mean for China?
- Will China be forced to revalue its currency? If so, what effect will it have?
- Will China's banking mess derail its growth, or create new opportunities?
- Will the world's suppliers seek to diversify away from too much dependence on China? If so, where will they go? Who will benefit?
- Will Chinese companies follow the path taken by Japanese and Korean companies decades ago, increasingly exporting branded goods to the developed world?
- In five years, will all the hoopla have seemed like much ado about nothing?

This report considers these issues and offers our point of view on the direction of China. We offer the following conclusions:

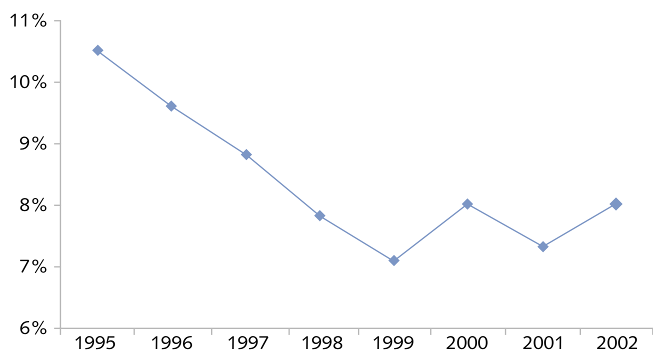
- China will continue to increase its share of the global export market, not just on the basis of low costs, but because it is becoming a world-class location in which to produce a wide range of goods.
- China will move up the value chain, with high technology products becoming an increasing share of its output and exports.
- Apparel will remain an important part of China's economy, and Chinese apparel exports will dramatically increase their market share in the years ahead.
- An increasing share of China's exports will come from Chinese companies rather than global giants. Some of these companies will emerge as global giants in their own right.
- Despite the rewards, China will present important risks. These include the likelihood of currency revaluation, the possibility of a banking crisis, the social unrest that could follow further privatization, and the risk that Western nations will impose new restrictions on Chinese exports. Therefore, some degree of sourcing diversification will be necessary on the part of global companies.
- Although beset by the China challenge, other emerging nations could actually benefit from the growing strength of China. They will provide global giants with sourcing diversification, and China will become an important export market for them.

First, the facts

First, however, let us consider China's recent export experience and the current situation.

In 2002, China's exports reached US$325 billion, a 22% increase over the previous year. This was up from US$92 billion in 1993, a staggering rate of growth. Exports provided a disproportionate share of China's strong economic growth throughout the 1990s. In 1996, exports accounted for 18% of GDP. Yet over the next six years, exports accounted for 31.5% of GDP growth, reaching 22.4% of GDP. In 2002, the Chinese economy grew 8.0%, making it one of the world's fastest.

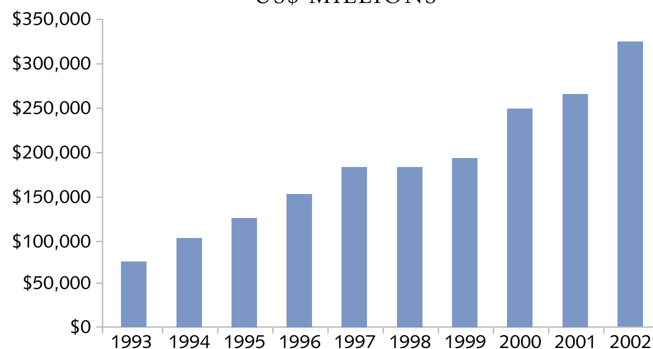
FIGURE 1. CHINA REAL GDP GROWTH
PERCENT CHANGE



SOURCE: IMF

China's emergence as an export powerhouse began in the 1980s when much of the apparel and toy manufacturing industries of neighboring Hong Kong moved to southern China to take advantage of low wages. In the 1990s, this process expanded to other merchandise categories as China's infrastructure and labor quality improved while wages remained relatively low. Overseas Chinese investors from Taiwan and Southeast Asia, as well as investors from Korea and Japan, rapidly shifted much of their manufacturing capacity to China.

FIGURE 2. CHINA MERCHANDISE EXPORTS
US$ MILLIONS



SOURCE: IMF

Much of the growth of exports from China has been due to reprocessing of components that are imported duty-free. In 2000, 55% of exports were processed. Moreover 41% of imports were destined for export processing. This demonstrates the degree to which China has become integrated into the global supply chain. Much of the processed export industry is the result of investments made by companies based in other Asian countries seeking lower cost assembly of final products. This is true of electronics companies from Korea, apparel companies from Hong Kong, and computer manufacturers from Taiwan. In the case of the latter, a vast amount of capacity was shifted during the 1990s from Taiwan to the mainland. This led to a huge increase in Chinese exports of computers and accessories, with 72% of those exports in 2000 accounted for by Taiwanese companies. Notably, China's exports of office and telecoms equipment jumped from $30 billion in 1999 to $52 billion in 2001. Thus electronics have displaced apparel as the fastest growing export category for China.

The result has been a dramatic shift in the flow of foreign direct investment (FDI) within Asia. In 1990, China received 18% of all Asian FDI while the countries of ASEAN (Association of Southeast Asian Nations) received 61%. By 1999, this had reversed with China receiving 61% and ASEAN receiving 17%. This reflected the rise of China's export manufacturing at the expense of Southeast Asian nations. Moreover, such investment in China is expected to accelerate further. For example, Japanese electronics manufacturer Toshiba, which already has one billion dollars invested in 37 factories in China, intends to invest another $2 billion in the next five years.

TABLE 1. RECENT INVESTMENTS IN CHINA BY FOREIGN CONSUMER PRODUCT SUPPLIERS

Investor	Latest Investment Announcement	Target/Proposed Investment	Total Investment in China	Facilities
Toshiba	May 2003	Toshiba will invest RMB 16 billion in China in the following five years	Toshiba owns 37 wholly-funded enterprises and joint ventures in China with investments around USD 1 billion	Toshiba's 400,000 square-meter industrial park in Hang Zhou, capital of East China's Zhejiang Province, not only acts as a production base but also a research and development and logistics center for the company. Toshiba will also build research and production facilities for products like refrigerators, washing machines, and air conditioners in the park
Amway	November 2002	It plans to build an additional 50 to 100 direct sales stores in China Plans to invest and expand capacity in China	It has built more than 80 direct sales outlets in China, at a cost of USD 18 million Amway has invested a total of USD 125 million in the manufacturing base, its largest outside the United States	It has a manufacturing base in Guangzhou, South China's Guangdong Province. Its also has its sole overseas research and development center at the Guangzhou base.
Goodyear Tire & Rubber Co.	March 2002	Expand its operations in China by expanding its existing tire plant in Dalian Plans to invest USD 120 million over a five year period starting from 2002	UA	Manufacturing plant in Dalian
Motorola	December 2002	It plans to purchase goods and services from Chinese suppliers worth another $10 billion and spend a further $1 billion in research and development in the country over the next five years Investment in China is expected to reach US$10 billion by 2006	It is one of the leading foreign investors in China and has invested around USD 3.4 billion and purchased USD 4 billion in goods and services from 17 local suppliers	Global production base and a global research and development center in Beijing
Philips	December 2002	Plans to make China one of its main centers for global product research and development	It has invested around USD 2.5 billion	The recent R&D enhancement is concentrated in Shanghai and Xian. The company has 17 joint ventures and about a dozen wholly owned subsidiaries
Nestle	December 2002	Plans to invest an additional RMB 30 million in the Dongguan City plant	So far, the total investment has exceeded RMB 350 million in this plant Total investments in manufacturing plants is around USD 807.22 million	It started with a plant in Dongguan City in South China's Guangdong Province. It has now established 21 plants in China
P&G	June 2001	Plans to invest more in China in the coming years	P&G has invested more than USD 300 million	It started with a joint venture in Guangzhou in 1988, subsequently setting up 11 joint ventures and wholly owned companies in cities like Beijing, Chengdu, and Tianjin
Unilever	November 2002	The new Unilever (China) Global Procurement Center is expected to export over USD 500 million of raw materials from China in the coming five years	It has invested around USD 1 billion	Unilever China is moving its three separate factories in Shanghai (two in Minhang district and one in Yangpu district) into one production facility in Minhang district. It has one other personal and home care product facility in Hefei city in eastern Anhui Province.

UA: Unavailable

TABLE 1. RECENT INVESTMENTS IN CHINA BY FOREIGN CONSUMER PRODUCT SUPPLIERS, CONT.

Investor	Latest Investment Announcement	Target/Proposed Investment	Total Investment in China	Facilities
Danone	January 2001	Danone Group has acquired a 50 percent stake in Shanghai Aquarius Drinking Water Co The transaction was valued at USD 21.7 million	Danone's has a controlling interest in Robust Corp., and a 51% stake in Robust's rival, Wahaha, and a minority stake in Shanghai Bright Dairy and Food Co.	UA
Coca Cola	October 2002	Plans to invest USD 150 million in China to set up 6 bottle filling plants in the coming 2 to 3 years	It has invested more than USD 1 billion	The Coca-Cola Co. has 28 bottling plants in China. Among the six upcoming bottle filling plants, two are expected to be set up in Changsha and Changchun
PepsiCo	May 2003	Plans to invest USD 30 million in building its largest noncarbonated drink base in Guangzhou Economic & Technological Development Zone	It has invested more than USD 800 million	The latest investment is in Guangzhou Economic & Technological Development Zone. Pepsi has 14 bottling facilities in China
Sara Lee Corp	February 2003	Plans to acquire a considerable part of state-owned Three Gun's shares, which produces knitted underwear	Currently, it has only product-focused cooperation with Three Gun	USD 36.5 million fabric production base in the Pudong District
Emerson Electric	December 2001	Plans to invest about USD 1 billion in China over the next few years Bought Avansys Power Co., a supplier of network power products to the telecom industry, from its parent, Huawei Technologies. The deal, valued at $750 million	It made its first investment there in 1978 It also has close links with the Haier Group	The company is to invest about USD 30 million to build a washing machine component plant in Qingdao in East China's Shandong Province. Copeland, Emerson's air conditioning compressor subsidiary, situated in Suzhou in East China's Jiangsu Province, will also be expanded
Mary Kay Inc	March 2001	Plans to invest USD 28 million in its Chinese operations to expand its business to 100 cities from the current 17 and make its factory and branch company in China its Asia-Pacific region production and sales centers	It entered the Chinese market in 1995 investing USD 20 million to establish its first overseas factory	It has a factory in the Hangzhou Economic and Technological Development Zone
Electrolux	January 2003	Plans to invest RMB 100 million It views China as a large home electric appliance market and an important production base of Electrolux	It entered the Chinese market in 1995	It has an electronic researching and development center in Shenzhen, working on products including washers, air conditioners, kitchen electric appliances, small home electric appliances, and whole cabinets
Fedders Corporation	March 2003	Announced a joint venture with Suning Appliance Group to manufacture split-type air conditioners in China	UA	It has manufacturing facilities in Ningbo, Shanghai, Quanzhou, Xian, Suzhou, and Nanjing
Whirlpool	July 2002	It paid USD 9 million to wholly acquire its former joint venture, Shanghai Whirlpool Narcissus Appliance Shareholding Co	It set up the USD 75 million joint venture in 1995 with an initial 55% stake and bought a further 25% from Shanghai Narcissus in 1997 for USD 12.25 million	It has manufacturing facilities in Shanghai. The company also makes microwave ovens in Guangdong province, mostly for export, and supplies compressors to air-conditioning makers
Heinz	August2002	It purchased Meiweiyuan Food Corporation, Meiweiyuan Food Factory, and Fanyu Jinmai Food Factory to expand its flavors and sauces businesses	It entered the Chinese market around 20 years ago, selling its baby food products	All the newly acquired factories are based in the Guangdong Province

UA: Unavailable

SOURCE: DELOITTE RESEARCH

An interesting example is that of companies based in Korea. They have invested huge sums in China in order to shift production to a lower cost environment. A recent survey of Korean manufacturers found that 44% have already shifted some production to either China or Southeast Asia. In the case of China, they are taking advantage of wages that are one sixth of those in Korea, in addition to gaining access to a fast growing market. For example, Samsung has invested $2.6 billion in manufacturing capacity in China. There, it employs 41,000 people in 26 plants.

A large part of the growth of Chinese exports has been driven by foreign-companies. According to the Bank of China, foreign owned companies account for 23% of China's industrial production, 48% of exports, and 80% of high-tech exports. Moreover, output and exports of foreign invested enterprises continue to grow rapidly while those of state-owned companies do not. For example, in 2001 exports by foreign-invested companies increased 11.6% while those of state companies declined 2.8%. From 1996 to 2000, exports of foreign-invested companies increased 94% while all other exports increased 45%.

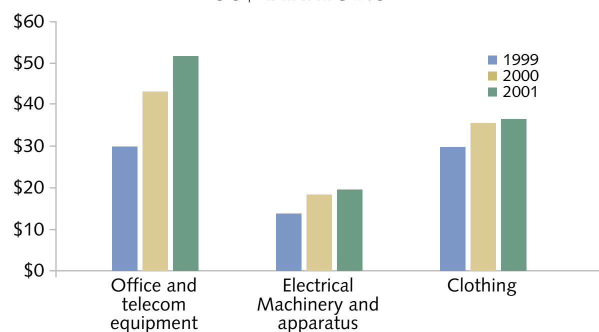
Advancing up the value chain

The merchandise mix of China's exports has shifted dramatically in recent years. For example, machinery and electrical appliances went from 2.8% of exports in 1986 to 23.7% in 1998. Consider these other examples taken from WTO data:

- China's share of the U.S. electronics market increased from 9.5% in 1992 to 21.8% in 1999. At the same time, Singapore's share dropped from 21.8% to 13.4%.
- China's output of personal computers went from 4% of world production in 1996 to 21% in 2000. The ASEAN share dropped from 17% to 6%.
- China's share of hard disk production went from 1% in 1996 to 6% in 2000, while ASEAN share fell from 83% to 77%.
- China's share of keyboard production increased from 18% in 1996 to 38% in 2000 while ASEAN share fell from 57% to 42%.

The bottom line is that China is moving up-market. In the process, the high tech manufacturing industries of neighboring countries are being quickly hollowed out. Why is China able to move up-market?

FIGURE 3. CHINA ACCELERATED GROWTH OF HIGH TECH VS. APPAREL EXPORTS
US$ BILLIONS



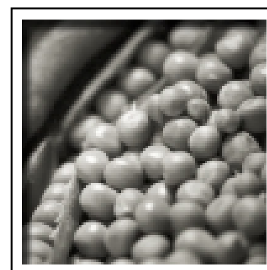
SOURCE: IMF

- Foreign technology companies are interested in investing in China, in part, to gain access to the vast and growing Chinese market.
- Local Chinese companies, attracting capital from overseas Chinese investors (especially from Taiwan), are becoming more skilled at producing high technology products.
- China's universities are producing large numbers of engineers (roughly 450,000 per year) who are relatively inexpensive to employ. However, questions have been raised about the skills and business acumen of this army of engineers.
- China has an excellent infrastructure for moving components and goods in and around the country.
- China is attracting investment by technology companies based in countries with more expensive manufacturing costs. A critical mass of talent and infrastructure is rapidly developing, thus contributing to a virtuous cycle of more investment and more output.

How will China's advance affect other Asian countries? The answer is that it depends on the level of development of the country in question. Relatively rich countries like Taiwan and Korea are becoming more like the U.S. and Japan with large service sectors. Employment in these countries will focus on business management, product development, and marketing as opposed to production. For these countries, China's move up the value chain does not yet represent a threat. Rather, it offers new opportunities.

As for poorer Asian countries such as the Philippines, Indonesia, Thailand, Vietnam, and India, they will face problems due to the attractiveness of China. It is important to note that not all production location decisions are made on the basis of low wages alone. Moreover, wages in Shanghai are, in some instances, higher than those found in Bangkok, Manila, and other cities of Southeast Asia. Instead, there are other factors that determine the location of production. China offers high levels of skill and efficiency, a relatively strong infrastructure, and a good political environment. It also offers a huge domestic market.

For the poorer countries, their saving grace will come from two things: first, a need for suppliers to diversify—especially with respect to low wage processes; second, a need for specialized tasks that these countries do well. In addition, these countries can benefit from exporting to China. China is becoming a huge importer, and its Asian neighbors stand to benefit. For example, in 2002 China imported vast quantities of food from Asian countries, US$185 million in fruits and vegetables from Thailand alone.



The role of the domestic market in China

Prior to China's recent entry into the WTO, foreign-invested manufacturers were required to produce at least 70% of their output for the export market. Manufacturers in China were permitted to import raw materials and supplies duty free if it was for re-export. Yet foreign manufacturers were basically discouraged from producing for the Chinese market. Thus, foreign retailers in China either had to purchase poor quality locally produced goods or import expensive foreign branded goods. Under the rules of the WTO, this will change. Foreign manufacturers will be able to produce for the Chinese market itself. They will be able to ship to foreign retailers operating in China.

This shift could have the effect of increasing imports of components into China and reducing China's trade surplus. Already the sizable drops in tariffs and nontariff barriers in the 1990s have led to a vast increase in imports of goods aimed at the domestic market or domestically oriented manufacturers. Moreover, foreign manufacturers will now have an even greater incentive to produce in China as it will offer greater access to the potentially lucrative domestic market.

With China's entry into the WTO, Chinese import tariffs will be reduced further in the coming years, thereby expanding the purchasing power of the domestic market. One notable example is the automotive market. From 1998 to 2004, the tariff on imported automobiles will have been reduced by 75%, thus making automobiles affordable to the small but growing middle class. This will not only enhance the real purchasing power of many Chinese, but it will dramatically alter their lifestyles as well. After all, possession of an automobile enables more flexible use of time, larger retail transactions, and more spending on leisure activities and goods.

The role of Chinese companies

Although China's export growth has been driven by foreign and foreign-invested companies, some domestic companies in China are beginning to emerge as serious competitors to global brands. Perhaps the best examples are Haier, manufacturer of white goods, and Legend, manufacturer of computers. These partially privatized companies began by developing the domestic market but are now starting to export in large quantities. Today, Haier has over 40% of the U.S. market for small refrigerators and even manufactures in the United States as well as other countries. For developed country retailers, these up and coming Chinese suppliers are starting to provide the basis for new, cheaper exclusive label merchandise.

In the future, this could become a much bigger issue as China's domestic market becomes liberalized. The key will be the future of the Chinese banking system. The reason is that heretofore Chinese companies have been able to survive for years while losing money because they can cover their losses by borrowing from state banks. Thus they had little incentive to be efficient or profitable. If and when the banking system becomes resolved, this avenue to survival will disappear, forcing Chinese companies to become profitable or die. Those that are already profitable are demonstrating the potential. With banking reform, many more will be forced to become efficient and, ultimately, world-class. The situation in China, therefore, is somewhat reminiscent of Japan in the 1950s or Korea in the 1970s. Those were the times when local companies started to become internationally competitive, producing cheap goods for export. This ultimately resulted in such global brand names as Toyota and Samsung.

In addition, with entry into the WTO, China will be required to remove many discriminatory rules that protect local producers from foreign competition. More competition will help many Chinese companies to emerge as strong, world-class players—especially if they gain access to global capital and credit markets. The latter will come about when foreign banks fully participate in the Chinese economy—something that is required under WTO rules.

Already, some Chinese companies are becoming global players. Consider Legend, China's largest maker of personal computers. Legend's sales in 2001 were US$3.5 billion, of which just $95 million was exported. That figure is expected to quadruple in the next four years. Legend has 26.5% of the Chinese PC market and faces increasing competition from the likes of Dell, Hewlett Packard, and others. Yet Legend is well positioned to be a global player in an increasingly commoditized market in which price is critical.

A bigger exporter is Haier, China's largest producer of consumer products with 2002 sales of US$8.6 billion. Of that, over 10% was generated outside China. Haier is best known as a branded producer of white goods and some electronics such as color televisions. Haier has 6% of the global market for refrigerators and 5.8% of the global market for washing machines. The company sells its products in 160 countries and has relationships with such retail giants as Wal-Mart, Home Depot, and Sears. Aside from selling Haier-branded products, the company also performs outsourced manufacturing. For example, Haier manufactures home freezers for Japanese producer Sanyo for sale in Japan under the Sanyo label. Due to its low prices and increasing brand awareness, Haier poses the same kind of challenge to Japanese and Korean producers as those producers did to U.S. suppliers a generation ago. Indeed, Haier already has a refrigeration factory in South Carolina in order to be closer to the ultimate U.S. consumer.

Another interesting example is that of Lianhua, China's largest domestic retailing company. Lianhua operates thousands of supermarkets, convenience stores, and hypermarkets in the Shanghai region. As such, it is a major purchaser of locally produced consumer goods. It has recently established a trading office in Europe in order to facilitate the export of foodstuffs and other consumer products from Lianhua to European retailers. Thus, Lianhua is exploiting its purchasing prowess to become a global distributor.

The future for Chinese companies looks bright for a number of reasons:

- First, Chinese companies already have a substantial and growing share of the lucrative Chinese market. Thus they are developing the critical mass necessary to compete in a global arena.
- Second, they are improving their technical prowess, increasingly participating in high tech markets such as personal computers and mobile phones. For example, Chinese companies now have 26% of the Chinese mobile phone market, the world's largest, with 60 million units sold last year.
- Third, Chinese companies are piggybacking on the technology developed by U.S. and Japanese companies. They spend a far lower share of revenue on research and thus have a cost advantage over the world's leaders.

On the other hand, Chinese companies have some disadvantages. First, they face increasing protectionist pressures in the U.S. and Europe. For example, the U.S. government is currently suing a group of Chinese television producers under anti-dumping statutes. Interestingly, Wal-Mart and Sears have filed briefs on behalf of the defendants. There is a strong possibility that duties of 84% will be imposed on Chinese television imports. Second, despite their low costs, Chinese companies are not yet known for the same quality as Western producers, often involving much higher defect rates. Third, the increasing output of China's electronics producers is contributing to global excess capacity, thereby putting downward pressure on prices and margins. Finally, Chinese companies are not investing sufficiently in research and thus cannot expect to reap the higher margins that accrue to innovators. They remain commodity producers.

The role of global retailers

One of the factors contributing to the rapid growth of Chinese consumer product exports has been the role of global retailers in directly sourcing in China. In fact, global retailers directly bought over $30 billion worth of merchandise in China in 2001. This figure will increase dramatically in the years to come.

- U.S. retail giant Wal-Mart bought $12 billion in China in 2002 and expects to purchase $15 billion this year and $25-$30 billion within five years. It has a global procurement center in the southern city of Shenzhen. Interestingly, in June 2003 Wal-Mart penned a deal with the government of Brazil to import $800 million worth of furniture, cosmetics, and other products from Brazil. This is indicative of Brazil's new competitiveness following devaluation, and its possible competition to China. Still, China will be the center of global sourcing for Wal-Mart.

- French retailer Carrefour bought $1.6 billion in China in 2002, a 27% increase over 2001, and plans to double that figure in a few years. Carrefour has moved its global purchasing center to China and has established purchasing offices in 11 Chinese cities. In addition, Carrefour continues to rapidly roll out stores in China.

- British retailer Tesco, which has a sourcing office in Hong Kong, is planning to open a sourcing center in Shenzhen in 2003, most likely in order to obtain preferential tax treatment for the products it imports from China through Hong Kong. In 2002 Tesco's Chinese purchases amounted to $500 million, a figure the company plans to treble in the next few years.

Many foreign retailers do not yet have strong sourcing in China. Moreover, many Chinese producers do not have the ability to pool resources in order to target foreign retailers. Using agents can be costly. The Chinese central government is, therefore, trying to change this by matching leading Chinese companies with foreign retailers. It is also promoting the use of global sourcing fairs in leading Chinese cities. For example, the recent Consumer Goods Procurement Fair in Shenzhen attracted 16 of the world's top 100 retailers in addition to many smaller foreign retailers. In addition, some Chinese companies are now opening representative offices in the U.S. in order to be closer to customers. Thus, there is huge potential for further growth of Chinese exports to the West.

TABLE 2. CHINA SOURCING BY WORLD'S LEADING RETAILERS

Retailer	Amount Sourced	Sourcing Methods	Future Plans
Wal-Mart	In 2002 , it bought USD 12 billion worth of Chinese products in direct and indirect ways, stocking their outlets worldwide	Usually Wal-Mart holds its Asia sourcing summits in Shenzhen, China. Due to this years travel restrictions it asked its suppliers, most of them from Asia, to fly to the Dallas showroom, exhibit their wares, and conduct the final rounds of negotiating and ordering for next year's spring season. This has brought down costs and reduced product turnaround times. It is considering relocating two of its four annual Asian sourcing summits to the U.S.	In the future the company is expected to substantially increase the volume of buying in China. The procurements in China is expected to reach USD 15 billion in 2003. It plans to expand the amount of procurement to USD 25-30 billion per year within five years
Carrefour	It sourced USD 1.6 billion worth of goods in 2002 from China, an increase of 27% from 2001	It has moved its global purchasing center to China from Southeast Asia and India. It has set up purchasing centers in 11 Chinese cities including Beijing, Shanghai, Wuhan, Guangzhou, Dalian, and Ningbo. It has granted decision-making power to its regional purchasing centers in Beijing, Shanghai, Guangzhou, and Wuhan; based on which, it has established a logistics system spreading all over China	Carrefour officials held that the huge potential was likely to make China's market a "pole" in the growth of the world's retail business. The sourcing amount could reach USD 2.6 billion in 2004
Home Depot	UA	Home Depot opened two sourcing offices in Shanghai and Shenzhen in November 2002. Home Depot imports from about 40 countries, with China being the largest. Imports include lighting fixtures, fans, flooring, bath accessories, faucets, hardware, and tools. Several of its proprietary brands, including Ryobi, Hampton Bay, and Glacier Bay, are made in China. Currently, about 7% of the products Home Depot sells are directly imported. Presently, these products are housed in seven huge import distribution centers in the U.S. Plans are already in place to build additional import distribution centers to accommodate the growth of direct imports.	The retailer intends to increase imports to about 10% of store sales
Tesco	It now purchases products worth around USD 500 million annually	In Shenzhen, Britain's Tesco Plc is also due to establish a procurement center the middle of this year	It intends to treble the amount procured from China within three to four years
Aeon	Its purchases from China jumped about 20 percent last year	It has a strategic alliance with Global Sources	It plans to set up a distribution and procurement base in Guangdong Province by 2004
Ito-Yokado	It purchases over 70 percent of clothing it sells from China	It has its procurement centers in Shanghai and Beijing	It intends to increase the amount procured from China
Daiei	It purchases about one-third of its goods from China	UA	UA
Target	Plans to set up its Asia-sourcing headquarters in Shenzhen soon	UA	UA
Fast Retailing	The company sources approximately 90% of its merchandise from Chinese suppliers	In 2000, Fast Retailing established a factory in Shanghai's Pudong New Area to produce low-priced clothing specifically for export to Japan.	Fast has instituted the 'Takumi Project' in China. The Takumi Project involves a team of experienced technical experts with skills in dyeing, weaving, knitting, sewing, and plant management who will train Chinese employees at Fast's production bases in China
Gap	The Gap sources approximately 14% of it merchandise from Hong Kong and China	It has a number of sourcing offices in China	It has finalized sourcing for its fall product, which is expected to hit Old Navy and the Gap divisions at the end of July and to hit Banana Republic stores by the end of August

UA: Unavailable

TABLE 2. CHINA SOURCING BY WORLD'S LEADING RETAILERS, CONT.

Retailer	Amount Sourced	Sourcing Methods	Future Plans
Metro	Along with Wal-Mart and Carrefour it is among the leading retailers to source goods from China	Its importing agent unit, Gemex Trading, has a strategic partnership with the Chinese business-to-business Internet portal Sparkice	While opening its store in Tianjin in April 2002, Metro announced that it will purchase more goods from Tianjin and other key cities in the country for its retail chain stores, not only in China but also around the world
Best Buy	UA	It has partnered with ST Xiamen Overseas Chinese Electronic Co Ltd to supply High-Definition television sets	UA
Sears	UA	It has a subsidiary Sears Buying Services Inc in Shanghai. Victory City lists Sears as one of its customers.	UA
Toys "R" Us	UA	It has partnered with Bandai Co to supply toys from its production site in China	UA
Auchan		It has purchasing offices in China	The retailer sees China purchasing efforts as a key strategy to drive growth
Kingfisher	It purchases construction materials, hardware and tools, electric appliances and general merchandise worth USD 1 billion from China	It has a strategic alliance with Global Sources	UA

UA: Unavailable

SOURCE: DOW JONES INTERACTIVE, ISI EMERGING MARKETS, I BANK REPORTS

The role of apparel in China's export economy

Despite China's growing prowess in producing advanced products, apparel and toy exports remain of paramount importance, especially given the potential impact of the Agreement on Textiles and Clothing (ATC), about which more will follow shortly. The history of China's apparel exporting industry is impressive. From 1980 to 1998, China's share of global apparel exports rose from 4% to 16.7%. Much of this increase in capacity came from the nearly complete movement of apparel factories from Hong Kong to China. In fact, from 1981 to 1999, apparel and textile employment in Hong Kong dropped from 382,000 to 75,000. Total manufacturing employment in Hong Kong dropped from 900,000 to less than 250,000. Yet by 2000, Hong Kong based companies employed five million workers in China. In 2000, Taiwanese firms employed three million mainland Chinese.

Interestingly, the largest growth of Chinese apparel exports has been exports to Japan rather than the U.S. This reflects a dramatic change in sourcing behavior on the part of Japanese retailers. It also reflects the fact that U.S. quotas have stymied further growth of Chinese imports. This could change in the near future.

As for Japanese retailers, they traditionally viewed apparel imports suspiciously, claiming that Japanese quality is superior and that Japanese consumers care little about price. Yet the success of price-oriented retailers in Japan convinced Japan's leading retailers to start sourcing in China. The result, according to the WTO, was that Japanese imports of Chinese apparel increased from US$10.5 billion in 1997 to US$14.8 billion in 2001. Similarly large increases also took place in other merchandise categories.

As for apparel reprocessing, China's growth of apparel exports has been so strong that China is now a net importer of textiles. These imports are necessary to provide the materials needed to produce the exported apparel. As apparel exports grow, textile imports will rise as well.

TABLE 3. CHINA: DETAILED EXPORT DATA BY COUNTRY AND CATEGORY $US MILLIONS

	1997	1998	1999	2000	2001
Office and telecom equipment					
U.S.	10,870	13,820	17,117	22,405	22,271
EU	5,902	7,359	8,705	11,889	14,933
Japan	3,630	3,570	4,260	6,418	8,117
Electrical machinery and apparatus					
U.S.	4,750	5,450	6,668	8,473	8,804
EU	2,872	3,473	4,396	5,985	6,182
Japan	2,410	2,470	3,038	4,152	4,198
Clothing					
U.S.	7,770	7,440	7,735	8,758	9,275
EU	6,715	6,846	7,459	8,095	8,427
Japan	10,490	9,550	11,431	14,713	14,760
Toys and Games					
U.S.	10,487	11,850	12,680	13,347	13,728
EU	3,877	3,915	3,289	5,405	5,626
Japan	1,652	1,487	1,576	1,819	1,949
Footwear					
U.S.	7,702	8,319	8,901	9,485	10,283
EU	1,573	1,542	1,141	1,796	1,733
Japan	1,774	1,419	1,717	1,937	2,017
Furniture					
U.S.	1,711	2,446	3,792	4,623	5,818
EU	502	638	657	1,157	1,196
Japan	605	532	713	1,077	1,321
Other Consumer Goods					
U.S.	29,770	33,550	38,538	42,289	45,770
EU	12,718	13,851	15,607	18,376	19,251
Japan	7,610	6,750	7,906	9,632	10,310

SOURCE: WTO

Agreement on Textiles and Clothing (ATC)

When the World Trade Organization (WTO) was created in the mid 1990s, it was decided that the regime of quotas imposed by developed nations on apparel and textile imports (known as the Multi-Fiber Arrangement, or MFA) should be abolished by 2005, thus ending one of the most distorting forms of trade protectionism. This decision was codified in the Agreement on Textiles and Clothing (ATC). When China joined the WTO in 2001, it was expected that the ATC would be particularly beneficial to China at the expense of other emerging nations. Given China's strength in apparel production and distribution, and given China's low wages and vast army of migrant workers, China was expected to not only offer lower wages than other countries but much lower unit costs as well due to strong productivity. If true, this would mean that, following the end of quotas, China's exports would explode. Due to concerns about this, the ATC included a set of safeguards under which developed countries could restrict Chinese apparel imports temporarily.

In those categories where quotas have already been dropped (for example brassieres and man-made fiber luggage), exports have skyrocketed. Thus, this portends a big increase in exports after 2005 in the absence of other protectionist measures or currency revaluation. Since January 2003, when some quotas were eliminated, some manufacturing plants in Mexico were shut down due to increased competition from China. Consider this: when quotas were lifted on man-made fiber luggage, the price for one unit dropped from $13.71 in 2001 to $5.23 in the first half of 2002. The volume of Chinese exports of this product rose 490% in the first eight months of 2002. Moreover, China's share of the U.S. market for this product rose from 13% to 62%. This provides some indication of the cost of protection and the potential impact of eliminating quotas. At the same time, man-made fiber luggage exports from other emerging markets dropped precipitously. For example, exports from Thailand dropped 49.3%, Philippine exports dropped 53.1%, and Mexican exports to the U.S. dropped 50%.

The ultimate impact of the ATC will depend, in part, on the degree to which the U.S. utilizes the various protectionist tools at its disposal (discussed later). It will also depend on whether China revalues its currency. Yet even in the absence of protection or revaluation, China's apparel exports are bound to grow. After all, cost is not the sole determinant of production, especially when it comes to more advanced manufacturing processes. Experts have offered various estimates of the potential impact, with all such estimates forecasting sizable growth. The most optimistic suggests that China's share of global apparel exports could reach 45% by the second half of this decade (the current figure is roughly 17%).

Not all increased apparel imports to the U.S. will come from China. Some will come from Latin America due to geographic proximity and the need for fast turnaround of high fashion goods. Also, Latin America offers especially low-cost production due to recent currency depreciation in Brazil and Argentina. Indeed, the Brazilian apparel industry is starting to attract the attention of Hong Kong traders.

For labor-intensive products other than apparel and textiles, growth will be more modest as there have been relatively few restrictions prior to WTO. This would apply to footwear and toys. More capital-intensive products have witnessed very strong export growth in the past few years, and this should continue due to the shift of production from middle-income countries.

Safeguards and Anti-Dumping Provisions

The terms of China's entry into the WTO provide the U.S. with safeguards in the event of a surge in imports that threatens U.S. jobs. Moreover, there is a low threshold for the U.S. to demonstrate "dumping" on the part of Chinese producers, thus enabling quick enactment of protection. So although the end of apparel import quotas opens an enormous door, that door could be closed quickly if the U.S. government chooses to act—especially if there are political costs to inaction. The good news is that the end of quotas in December 2004 takes place one month after the next U.S. Presidential election. This provides politicians with some breathing space.

Safeguards provision

Although WTO rules generally allow for temporary protection against surges in imports, the threshold for applying such rules is usually quite high. In the case of China, however, its agreement for accession to the WTO will enable the U.S. to impose restrictions on Chinese exports quite easily. While WTO rules normally require a country to demonstrate "injury" to its domestic industry, China's agreement requires the importing country to only demonstrate "disruption" to its domestic industry. This is more than just a semantic issue. Disruption takes place when "imports are increasing rapidly, either absolutely or relatively" in such a way as to merely "threaten" injury to the domestic industry. Moreover, the importing country may impose restrictions on China alone, even if imports are rising rapidly from other countries. Allowing such discrimination is unprecedented under WTO rules. Finally, the agreement leaves China little ability to retaliate. This entire provision remains in effect for 12 years after accession.

Why did China agree to such draconian terms? The answer is that, if it had not, it would not have obtained an agreement with the U.S. to enter the WTO. Such entry was of paramount importance, not only for stimulating growth but for reinforcing the political strength of reformers in the Chinese leadership.

Loopholes in the ATC

Under the terms of the Agreement on Textiles and Clothing (ATC), all quotas are eliminated by December 31, 2004. Yet the ATC allows countries to apply special safeguards until December 31, 2008. This safeguard would allow a country to limit the growth of textile and apparel imports from China to 7.5% per year. Again, the threshold for implementing this provision is very low. A surge in imports would be sufficient even if there is no discernable damage to domestic companies. In fact, restrictions could be imposed even if total imports are not rising, merely if Chinese imports are rapidly displacing imports from another country. Finally, China may not retaliate.

The general safeguards provision represents a greater threat to the development of freer trade than the ATC provision. This is because it stays in effect much longer, can be applied with no time limit, and involves fixed quotas while the ATC provides for restrictions on the growth of imports.

Anti-Dumping

Under the rules of the WTO, a country can impose anti-dumping duties on another country if it can demonstrate that imports are being sold below their normal value and that the imports are causing damage. The notion of normal value can be calculated in one of two ways. If the country is considered a market economy, then normal value is defined as the price at which the product is sold in the home country. If the country is considered a nonmarket economy, this method is not used as domestic prices are considered to be distorted. Instead, the normal value is determined either by examining the actual production costs, or by looking at prices in a third country.

In the case of China's entry into the WTO, the U.S. will be permitted to continue to define China as a nonmarket economy for 15 years—even though China's economy is far more market-oriented than many Western nations. Thus, in determining whether dumping is taking place, the U.S. will be allowed to examine the prices of products sold in third countries, including countries that have substantially higher labor costs than China. This will be the case even when the product price vastly exceeds production costs. In other words, it will be fairly easy for the U.S. to demonstrate that dumping has taken place. This will be especially true in the case of labor-intensive products such as apparel.

Thus, despite the end of quotas, the U.S. government will have broad discretion to protect the U.S. apparel industry from Chinese competition. Discretion will be so broad, in fact, that the outcome in any given case could be the result of the tug of war between the interests of unions representing apparel workers in the U.S. and U.S. apparel retailers.

How should apparel suppliers and retailers plan given this business environment? The answer is that it makes sense not to put all eggs in one basket. After all, the U.S. government will have unchecked power to act arbitrarily. Although China offers vast cost advantages, production and sourcing location decisions should be made on the basis of more than just cost.

Risks to doing business in China

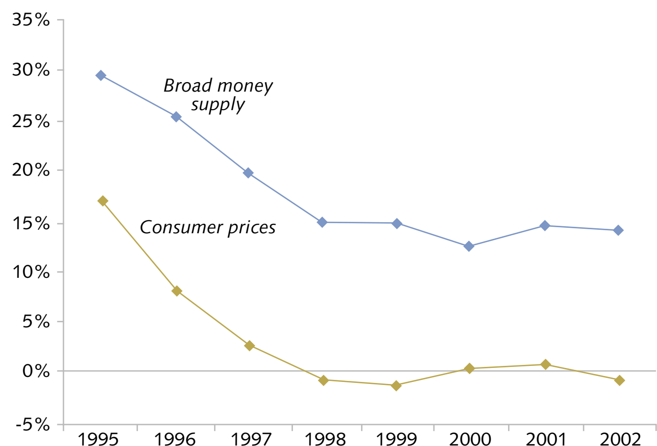
Let us consider some of the risks involved in doing business in China in the coming years:

The Economy

The Chinese economy is growing rapidly (7%-8% in 2003) and shows no sign of abating, even after the SARS scare. Yet growth carries risks. Moreover, there is a risk that the economy could slow down. If it does, the social and political impact could be troubling.

Let us consider the risks created by strong growth. The biggest risk is overheating, either through consumer price inflation or an asset price bubble. Yet despite China's rapid growth, there has been no inflation. Indeed, deflation has been a concern. How is deflation possible when the country is rapidly accumulating reserves? After all, in 2002 the broad money supply grew 17% while consumer prices actually fell 0.8%. The answer is that, with rapid economic growth, a fast growth in the money supply is not being fed into higher prices. Instead, it is either being absorbed by expanded economic activity or it is being fed into higher property prices.

FIGURE 4. CHINA CONSUMER PRICES VS. BROAD MONEY SUPPLY PERCENT CHANGE



SOURCE: IMF

In addition, there is so much excess manufacturing capacity that the demand for loans is low. Moreover, banks are simply holding back, afraid to lend to loss-making state-owned companies for fear of default, and afraid to lend to private borrowers for fear that it is not politically correct. The result is that there is an excess of deposits over loans in China's state banks. That means that there is a lot of money swimming around with nowhere to go. It may, in fact, be fueling speculation in property.

There are other reasons that inflation remains so low. These include rapidly rising productivity, declining import tariffs, and declining unit labor costs. The latter is due to rising unemployment as state-run enterprises dismiss excess workers. A combination of rising unemployment and rural-urban migration is keeping a lid on wages and thus on production costs.

Still, many observers expect inflation in China to pick up in the absence of a currency revaluation. In fact, positive inflation could remove some of the pressure for revaluation as it would effectively cause an inflation-adjusted appreciation in the currency. Interestingly, consumer prices, having fallen in 2002, finally began to rise in the first few months of 2003. Even if inflation does not emerge, the overheating property market represents a potential problem. If the property bubble bursts, there could be serious problems for banks and a negative wealth effect on economic activity. Therefore, the government faces a difficult balancing act between concern for growth and concern for asset market and price stability.

Note: there is a consensus among experts that China's economic growth figures are overstated by roughly 1% to 2% per year. Still, that leaves considerable growth. Yet two things are worth noting. First, experts believe that the overstating has actually increased in recent years as government bureaucrats have increasingly applied pressure on local officials to report strong results. Second, roughly 5% of Chinese GDP is increased inventories compared to about 0.5% in the U.S. This means that a good deal of China's GDP involves the production of useless, poor quality goods that no one wants to purchase. Thus, living standards are not as high as GDP figures would suggest.

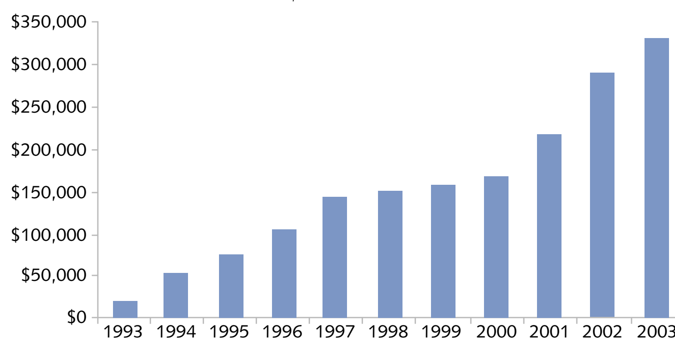
Currency issues

China's currency, the renminbi, is clearly undervalued. If it were permitted to float, it would most likely rise in value, thereby increasing China's export prices. The effect could be to reduce the growth of China's exports. On the other hand, it would dramatically increase the purchasing power of Chinese consumers, thereby stimulating growth of the domestic sector. Instead, China's government continues to hold the value of the currency fixed in relation to the U.S. dollar, and intervenes in the currency markets in order to maintain the fixed value. Let us consider some of the questions surrounding this issue.

First, why is there a general consensus that the renminbi is undervalued?

The answer is that China's foreign currency reserves are rising rapidly, from US$250 billion in early 2002 to over US$325 in mid 2003. This reflects excess demand for the Chinese currency. In a fixed exchange rate regime, the government is obligated to buy or sell the currency in order to prevent movements in the price. The excess demand is due to the fact that vast quantities of dollars are flowing into China. First, China has a trade surplus, which means that the private sector is accumulating foreign currency that it is selling to the government in exchange for renminbi. Second, China is attracting investment flows from overseas. This money, mostly dollars, must also be converted into renminbi for local use. Until now, foreign currency was of little use to Chinese as there were restrictions on investing that money outside the country. Now, the government is starting to allow such investment in order to reduce the excess demand for renminbi.

FIGURE 5. CHINA FOREIGN RESERVES
US$ MILLIONS



SOURCE: IMF

Why is China under pressure to revalue its currency?

There are several reasons:

- *Pressure from Japan.* China has a large and growing trade surplus, especially with Japan. Japanese officials have lobbied publicly for revaluation. They believe that revaluation would reduce the growth of Chinese exports to Japan, thus removing competition to Japanese workers. China accounts for 70% of Japan's apparel imports. More importantly, Japan is concerned that China is exporting deflation to Japan and that China's declining export prices are contributing to Japan's economic problems. This argument is actually quite specious, given that Japan's inflation is probably related to its own banking problems. Moreover, declining import prices contribute to improved purchasing power on the part of Japanese consumers. Still, it is the perception that matters and is driving Japanese pressure on China.

- *Pressure from Southeast Asia.* The countries of Southeast Asia want to become competitive again. Since 1997, Southeast Asian currencies have risen against the dollar while the renminbi has declined in real terms due to deflation. The result is that Chinese exports are becoming cheaper relative to exports from Southeast Asia. That fact, combined with China's increasing prowess in producing leading edge goods, means that Southeast Asia is losing global market share to China. Revaluation would improve Southeast Asia's competitive position.

- *Dollar woes.* Weakness of the U.S. dollar is creating pressure on China as well. Due to its large and unsustainable current account deficit (equal to 5% of GDP), the U.S. dollar must fall in order to boost exports and limit imports. Yet as the dollar declines against the euro and other currencies, the renminbi peg becomes more onerous to the rest of the world. The ability of a lower valued dollar to correct the U.S. current account deficit is being stymied by the renminbi peg. For example, although the dollar has fallen 27% against the euro over the past 18 months, it has fallen only 9% on a trade-weighted basis. As the dollar falls and the renminbi remains pegged, imports to the U.S. will simply shift from other countries to China. Indeed the renminbi peg is forcing the weight of U.S. adjustment onto Europe. The result is damage to European export growth and deflationary pressures in Europe. Chinese revaluation would take some of the pressure off Europe and would allow for a faster decline in the U.S. current account deficit.

- *Excess capacity.* China's vast increase in production capability has exacerbated the global problem of excess capacity which contributes to deflation and lower profit margins. Revaluation would help fix this problem.

- *WTO Entry.* Under the WTO agreement, import quotas on apparel in developed countries will be eliminated by 2005. This will create greater export opportunities for China, thus placing more pressure on the trade balance. Revaluation would offset some of the impact.

- *Domestic pressures.* Revaluation would mean cheaper oil and other commodities for Chinese companies and consumers. It would improve domestic consumer purchasing power and would help to create self-sustaining domestic growth. This is an important goal of China's reformers.

Why is China resisting revaluation?

- China is heavily reliant on exports as a prime source of growth. A higher currency will hurt export growth, especially for labor intensive industries. Interestingly, China's wages are not necessarily the lowest in Asia. A recent survey by the Japan Export Trade Organization (JETRO) found that the average monthly wage for a factory worker in Bangkok is US$163 while the average in Shanghai is US$207 (see chart). Revaluation would increase this difference. The gap may, of course, be the result of differing levels of productivity. Still, China's reputation as having the lowest wages is not necessarily deserved. Revaluation could, therefore, lead to the loss of many jobs. This at a time when privatization is causing millions of job losses.

- The Chinese government is afraid to hurt local industries that service domestic consumption needs. A higher valued currency would lead to increased imports of these items at the expense of local, state-run enterprises. These companies will already be hurt by the tariff reductions required by WTO entry.

- The government is concerned that revaluation would create further deflation. The result would be further damage to China's debtor state-run enterprises and greater difficulty in resolving the banking sector problems.
- Revaluation might require a proportionate change in the Hong Kong dollar. Otherwise it could be disruptive of Hong Kong's already fragile economy.

Why might China embrace revaluation?

- Revaluation would reduce the vast growth of the money supply that is being caused by China's accumulation of foreign currency reserves. Thus revaluation would reduce the potential for either inflation or an asset price bubble. The latter may already be under way in the property market.
- Revaluation would not be fully passed through in export prices as it would also reduce the price of imported capital and components. The latter account for about half the value of inputs used for exports. Moreover, this reduction in import prices would benefit industries focused on the domestic market. It would also enhance the purchasing power of Chinese consumers.
- Given the massive investment foreign companies have made in Chinese production and sourcing capacity, revaluation would not lead to a quick exit by these companies. For many, China's attraction is not just price but quality, speed, reliability, and access to the huge Chinese market.
- The effect of revaluation on exports would be offset by the impact of reduced trade barriers, especially the impending elimination of quotas on apparel and textiles.
- China already has a history of keeping its currency high. Consider what happened in late 1997. That was the time of the Asian economic crisis when the countries of Southeast Asia undertook substantial devaluations. There was considerable pressure from Chinese exporters for China to follow suit. Political leaders in ASEAN urged China not to devalue as that would damage the ability of ASEAN to recover. China resisted pleas to devalue and left its peg unchanged. This was an act of statesmanship which helped the global economy recover from a grave crisis. It also rendered China richer, with lower inflation, and did not really damage its export prowess. This history, if recalled, provides a lesson about the current situation.

TABLE 4. COST OF DOING BUSINESS FOR JAPANESE COMPANIES INVESTING IN ASIAN CITIES

Country	China	China	China	China	China	Taiwan	Thailand	Indonesia	Vietnam	India
City	Shanghai	Dalian	Shenyang	Chongqing	Shenzhen	Taipei	Bangkok	Jakarta	Ho Chi Minh City	New Delhi
Monthly wage for workers ($US)	153-261	64-151	117-193	104-161	103-339	749-1308	163	108	101-134	138
Monthly wage for mid-level managers ($US)	593-985	169-504	260-436	204-357	353-864	1729-2838	671	540	524-661	753
Monthly wage for mid-level engineers ($US)	312-661	106-328	131-239	135-259	140-482	1210-1631	296	205	188-458	320
Industrial estate rent (monthly per sq meter)	2.20	0.20	1.45-1.81	NA	2.72-7.85	4.26	4.60	3.80-4.10	0.08	NA
Electricity rate for business use (charge per kilowatt hour)	0.03-0.10	0.07	0.07	0.05	0.09-0.12	0.05	0.04	0.04	0.05-0.07	0.08
Cost of container transport to Los Angeles (40 foot container)	4,000	2,891	3,300	4,600	2,365	2,659	2,704	3,570	2,778	3,764

SOURCE: JAPAN EXTERNAL TRADE ORGANIZATION 2003

What might happen:

- The governor of the People's Bank of China has said that China might consider pegging the renminbi to a basket of currencies, rather than just the dollar. He also indicated amenability to gradual liberalization of the exchange regime. Repegging to a basket would be a backhanded way to gradually achieve revaluation, especially if the euro is properly weighted in a new peg. So the government appears not to have shut the door on changing the currency regime. Meanwhile pressure is intensifying, with Alan Greenspan recently joining the fray in calling for revaluation.
- If China lets the renminbi float and also drops capital controls, it is possible that the renminbi would depreciate. This would reflect Chinese savers taking money outside the country in order to avoid the risks of a faltering banking system. Too rapid a fall in the renminbi would be inflationary. If the central bank supported the renminbi, it would reduce its reserve holdings. This scenario, however, is unlikely at this time.

Impact of Revaluation:

The primary effect of a Chinese revaluation would be a slowdown in the growth of exports, in part due to a shifting of sourcing to other countries. Consider, for example, Brazil. There, vertically integrated apparel retailer Riachuelo used to import 30% of its merchandise, mostly from China. Following Brazil's currency devaluation last year, that is down to 3-5%. Now, a Hong Kong trading company has approached Riachuelo about selling Brazilian made apparel. Presumably they are not only attracted by the lower currency in Brazil but may want to hedge against a stronger currency in China. This scenario could be repeated thousands of times, not just in Brazil but in other low wage countries, especially in labor-intensive industries. Beneficiaries could include Central America and the Caribbean, Southeast Asia, India, and Eastern Europe.

Prediction

The case for revaluation is strong. Yet the short-term costs for China are real. Therefore, the most likely scenario is for an eventual revaluation, no doubt within the next two to four years but possibly much sooner. The government is undertaking actions to reduce the need for revaluation. These include allowing Chinese businesses to invest their dollars outside of China, and trying to create a bit of inflation through monetary policy in order to effect a real appreciation of the currency. Yet these will have only ephemeral effects. Ultimately, the government will change its currency policy. The problem is that, as currency speculators increase their expectation of revaluation, they will increase their purchases of Chinese assets. The result will be increased likelihood of revaluation as China's money supply growth accelerates.

Banking issues

Perhaps the greatest risk to the Chinese economy, and therefore to the business environment in which exporters operate, is the state of the financial system. For many years, state-owned banks have been lending money to loss-making state-owned companies. Rather than lend on the basis of creditworthiness, banks have done quite the opposite. That is, under political pressure, they have extended credit to the least creditworthy in order to keep them in business. It seems that the ultimate goal has been full employment. The raison d'être of many state-owned companies in China has been to suppress social unrest by keeping excess workers employed—even at the cost of losing vast sums of money.

Yet the real cost has been much greater. Truly creditworthy companies have been starved of credit, and most of the development of efficient business in China has been funded by foreign investors rather than domestic savers. Thus Chinese consumers, who save roughly 40% of their incomes, have been forced to park their money in state-run banks that offer a poor return. Those banks, having accumulated a huge portfolio of nonperforming loans, now represent a threat to the economic health of the nation. Moreover, the poor return on consumer saving is retarding consumer spending. If consumers were to obtain a better return on their saving, they might spend more of their income, a key to the government's goal of shifting growth from exports to the domestic economy.

The nonperforming loans (NPLs) of Chinese banks make up between 26% and 35% of total loan portfolios at China's four major state-owned banks. Nicholas Lardy of the Brookings Institution believes that bad debts could be as high as 75% of GDP. By comparison, in the U.S. in 1990, the S&L bad debts amounted to roughly 3% of GDP.

To deal with this problem, the Chinese government has established four asset management companies (AMCs) to take over the NPLs of China's four big banks and resolve them through sale or liquidation. This has taken place very gradually. Over 80% of the NPLs resolved by the AMCs have been converted to equity. This means that the AMCs own stakes in poorly performing state enterprises. Yet this does nothing to resolve the fundamental problem. The AMCs have been slow to sell these assets as the government has directed them to obtain a 30% recovery rate on loans—not a realistic number. Moreover, it is a daunting task just to resolve a handful of NPLs. Yet in one case, an AMC owns 200,000 NPLs. Valuing these is difficult due to poor financial information and inadequate human resources to do the job.

Worse still, the banks continue to create new NPLs due to government pressure to fund insolvent state enterprises and prevent social dislocation. On the other hand, the banks have been pressured to reduce their portfolio of NPLs. The result is that they have increased their liquidity and have become reluctant to lend money for creditworthy projects. This failure of banks to extend credit is stymieing the development of domestic business in China. It means that, even though the Central Bank is rapidly expanding the money supply, expansion is not being converted into inflationary pressures. To the extent that credit is extended, it is often based on politics or corruption, or both. Bribery greases the wheels of bank lending as does being the child of a high-level official. This means that credit is not being allocated in an efficient manner.

Under the terms of China's accession to the WTO, China must completely open its banking sector to foreign participation by December of 2006. By that date, foreign banks will be permitted to interact with Chinese consumers in local currency. That means they will be able to compete with state-owned banks for local deposits. Given that China has no deposit insurance, the presence of foreign banks could undermine confidence in state-owned banks if consumers believe that everyone else will move their money to the foreigners. The end result could be a run on government banks, leading to a financial crisis. Yet the Central Bank has adequate tools to offset the monetary impact. Worrisome, however, would be the effect on overall credit creation and economic growth.

On the positive side, foreign participation in banking will help make monetary policy more effective. Foreign owned banks will be more willing to create money by lending to private enterprises, and not on the basis of politics. Indeed, private Chinese companies are more likely to prosper with foreign investment in the banking sector. Until now, much of the foreign investment in China has been direct investment rather than portfolio investment. In order for Chinese companies to prosper, they will need access to foreign capital as domestic banks are not helpful. Hence, there could be a big shift in the type of foreign capital entering China. There could be a big increase in portfolio investment, something that would help the development of indigenous world-class companies. China's development, and especially its export growth, would thereby not be confined to the impact of foreign companies. That would be a good thing for China. Yet in order for this to happen, the banking crisis must be brought under control.

To resolve the banking crisis, the government must be willing to allow the AMCs to obtain a poor return on the sale of state-owned companies. Rapid privatization of these companies will be helpful. The problem is that there are many that can never be privatized and must be closed. The human and social cost of doing this could be enormous. That fact is the reason that reform is moving slowly.

Foreign investors have not yet been permitted to purchase NPLs. If they are eventually permitted, it will speed up the process of resolution. Yet the government has said that workers rather than creditors have first claim on state enterprises. Moreover, the bankruptcy laws of China are inadequate for protecting the interests of creditors. Therefore, the prospect for quick resolution is not great. For China's leaders, there are a range of poor choices: reform quickly and accept the enormous social cost; fail to reform and await a collapse of the system under its own weight; or close the economy to the outside world and protect the system from the vicissitudes of the global economy. The latter would lead to economic stagnation.

Prediction

The most likely scenario is for continued yet insufficient efforts at banking reform. The result will be some improvement in the situation but with a residual risk of a serious financial crisis. Such a crisis would not necessarily damage the ability of foreign companies to produce in China for export. Yet such a crisis could undermine the authority of reform minded leaders in China and ultimately damage the business environment for foreign companies.

Export incentives

One of the Chinese government's incentives for exports is a rebate on value-added tax (VAT) payments for exporters. This incentive was introduced in 1984 and expanded following the Asian economic crisis in 1998 as a way to offset the fact that China was not devaluing its currency at that time. There was a debate as to whether China should follow its Asian brethren in devaluing its currency. When officials concerned about inflation and China's prestige prevailed, it was decided that exporters needed some financial incentives in order to compete with lower-cost products from Southeast Asia. Thus, the VAT rebate program was deepened. By 2000, the rebates exceeded 70 billion renminbi (approximately US$8.4 billion), a fairly large expense for the Chinese government.

Today, there is renewed debate, this time as to whether to retain this expensive incentive, especially at a time when export growth is so strong that it is creating protectionist pressures abroad. Eliminating the incentive would surely improve government finances and would reduce the financial incentive to export. That could help to reduce the upward pressure on foreign reserves by reducing China's export growth. Yet for many exporters, the VAT rebate is roughly equal to their profit margin. This is especially true of domestic Chinese companies. Eliminating the rebate could be especially harmful to these companies that do not have the same financial flexibility as foreign producers.

Economic reforms and the consequences

China's integration into the global economy entails privatization of loss-making state-owned enterprises. The state sector is bleeding China. It is hogging scarce credit and domestically generated capital merely to cover its losses; it produces subpar products and services; and it contributes little to growth of output and productivity. Hence, the government has embarked on an ambitious program to reduce the size of the state sector through privatization.

Since 1998, 25 million Chinese workers have been made redundant due to privatization of state-owned enterprises. This vast number, plus vast rural-urban migration, has held down labor costs and enabled big increases in manufacturing capacity without substantial upward pressure on wages. With China's commitments under WTO, the pace of change will accelerate as domestic companies face increasing competition in a lower tariff world. This will mean more layoffs and a short-term surge in unemployment. If economic growth decelerates, this could create social problems. Already there are reports of rioting in many of China's smaller towns and rural areas where unemployed workers have few alternatives.

From 1997 to 2001, here is how employment has changed at various types of employers in China:

- State owned: from 110.4 million to 76.4 million
- Limited liability corporations: from 0.0 to 8.4 million
- Private enterprises: from 7.5 million to 15.3 million

TABLE 5. CHINA URBAN EMPLOYMENT (MILLIONS)

	1997	2001
State owned	110.4	76.4
Collectives	28.8	12.9
Cooperatives	0.0	1.5
Joint ownership	0.4	0.5
Limited liability corporations	0.0	8.4
Share holding corporations	4.7	4.8
Private enterprises	7.5	15.3
Foreign funded	5.8	6.8
Self employed	19.2	21.3
TOTAL	**207.8**	**239.4**

SOURCE: EIU

What it means for Western suppliers and retailers

Developed country retailers and suppliers have become accustomed to producing and sourcing products in China on a large scale. Moreover, with the WTO-mandated reduction in restrictions on trade, these companies can expect to source from China on an even greater scale. Changes in the trade regime will principally affect cost. Yet many other factors are now playing a role in the decision about sourcing and production location.

Sourcing decisions are often based on many factors in addition to cost: geopolitical stability, reliability, and quality of the transportation infrastructure; labor and environmental responsibility; political stability; production quality; and the ability to find local managerial skill. On all of these points, China is seen as relatively strong and improving. So costs matter but must be balanced with other considerations. All other things being equal, a shift in cost would make a difference in where sourcing takes place. Thus wages, exchange rates, and other cost factors do matter.

Diversity of sourcing is not necessarily important for global suppliers. Instead, many suppliers seek to create a more consolidated sourcing structure that can deliver on the various important factors. As such, many suppliers are shifting toward a smaller number of key countries that will vary depending on product, market demand, and the skill set necessary for quality production. For example, fashion apparel products often have a shorter lead time than basic apparel and might need to be produced closer to the end market. Basic apparel requires low cost.

As for China, given its size and growth, it offers retailers and suppliers just about everything they want, from low costs to high levels of skill. Therefore, the key issue with respect to China is the degree of risk. Retailers and suppliers must be prepared to deal with such eventualities as currency appreciation, a banking crisis, more Western protectionism, and social unrest that could emerge following renewed privatization. Moreover, they must be alert to the competitive challenge that Chinese companies may offer in the near future.

On the other hand, many potential opportunities could develop as a result of some of the risks: currency appreciation would make Chinese consumers richer and better able to purchase Western products; a banking crisis could ultimately lead to a more efficient financial system and more stable growth; faster privatization will help to suppress wages, thus rendering China a low-cost location for production; and the development of world-class Chinese companies will provide new low-cost sourcing opportunities for the world's leading retailers.

Conclusions

Lessons for retailers and suppliers:

- China is a great place to source consumer products, but there remain some risks. Therefore, be flexible and maintain some diversity of sourcing. This is relatively easy for producers of labor-intensive products such as t-shirts. It is not so easy when it comes to products that require more sophisticated manufacturing processes.
- Partnering with privatized domestic companies in China could be beneficial for many reasons. First, these companies offer extraordinary cost advantages. Second, better they be your friends than your competitors. Finally, they offer access and knowledge about the domestic Chinese market.
- Make sourcing decisions not just on the basis of cost. For many companies sourcing in China, cost is only one part of a much larger equation—and is not always lower than other emerging nations. Quality, reliability, speed of distribution, and sufficient infrastructure are some of the other factors determining sourcing location. Also political stability, social responsibility, and diversification for the sake of risk management are other factors.
- View Chinese sourcing as a tool for ultimately gaining access to Chinese consumers. Although exporting to China will become easier, there is no substitute for being close to the customer. Moreover, WTO rules will make it easier to distribute goods made in China to Chinese consumers.
- Chinese companies will emerge as serious exporters of consumer products. In some cases, this will mean serious competition for branded suppliers in the U.S., EU, and Japan. It will also mean exclusive label merchandising opportunities for retailers.

Risks:

- Revaluation of the Chinese currency—surely within two to four years and possibly much sooner
- End of VAT rebates for exporters
- U.S. imposition of protectionist measures following the end of quotas in 2005
- Failure of the Chinese transportation infrastructure to keep pace with demand
- A banking crisis in China that leads to social unrest
- Reversal of market orientation by Chinese authorities (low risk)
- Economic slowdown leading to problems with the vast army of excess workers

Predictions:

- Exports from China will rise rapidly, regardless of what else happens.
- China will ultimately let the renminbi rise.
- Europe will benefit from Chinese revaluation as pressure on the euro declines.
- China will reduce export incentives, if for no other reason than they are expensive.
- Some labor-intensive manufacturing processes will shift from China to other countries. Beneficiaries could include Vietnam, India, Philippines, Brazil, and even Russia.
- Higher value-added products will continue to be produced in China, even if costs rise.
- Mexico will be hurt by China's further global integration, as it already has unobstructed access to the U.S.

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ISBN 1-892384-67-5

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