

Business with China: Post-Olympics and Post-Election

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The second annual Business with China conference convened on Monday November 10, 2008. Attended by businesspeople, government leaders, scholars, and students from the Hogan Entrepreneurs programs at both Chaminade and Gonzaga Universities, the conference followed on the successful inaugural China Conference of 2007.

Ed Hogan opened the conference and put everyone in an entrepreneurial state of mind with a discussion of the metaphysics of entrepreneurialism, which is at the root of the creation of commerce. Driven by human ingenuity and the development of sharper and sharper tools, entrepreneurialism creates value that enriches human experience. Hogan expanded upon that theme with a reading of “Yes, Virginia, there is a Santa Claus”, drawing parallels to the entrepreneurial spirit and impact on the world. Even if you cannot see it, entrepreneurialism is nonetheless real, and the world is much better for it having existed:

Nobody sees Santa Claus, but that is no sign that there is no Santa Claus. The most real things in the world are those that neither children nor men can see. Did you ever see fairies dancing on the lawn? Of course not, but that's no proof that they are not there. Nobody can conceive or imagine all the wonders there are unseen and unseeable in the world.

CHINA A YEAR LATER

Ted Liu, director of the Hawaii Department of Business, Economic Development and Tourism, provided contextual information about developments in China over the past 12 months since the last Hogan China Conference. In many respects China assumed its place on the world stage in 2008, including hosting a very successful Olympics both in preparation and in securing the most medals of any country; executing the third launch of a manned spacecraft and first Chinese spacewalk; and tracking a US warship by Chinese submarine during RimPac exercises off Hawaii. Liu maintains that the news was not all positive for China, including the government's response to the May 12 earthquake, and tainted toys, pet food, and milk scandals. China continues in its search for raw materials in places including Darfur, Zimbabwe, and Iran, and the total effect on the global

financial crisis on China remains uncertain, except that China manufacturing for export has slowed considerably to an expected 8.5-9% growth rate.

Liu maintains that the significance of these events is to bring China to a possible turning point and rebalancing of the social compact between business, government, and the citizenry that has been in place since the 1970's, and may weaken the control that the government exercises. This rebalancing is driven by three forces: the urbanization of China and rising expectations of a growing middle class, now numbering 300 million; the exorcism of Chinese victimization as a nationalist theme that has existed since the Opium Wars, which removes a theme of shared national identity as one of the pillars of stability for the Chinese government; and the impact of the global economic crisis on Chinese exports and job creation which the government is trying to mitigate by increasing demand for domestic consumption in order to forestall social instabilities triggered by joblessness.

Liu maintains that these developments, and a weakening of the central government as a result, will create opportunities for "fast moving, nimble companies" and will increase pressures for increased regulation of industry. Social service organizations will expand, and social entrepreneurs, educators, and political organizations will have opportunities. An increase in internal consumption creates enhanced opportunities for entrepreneurs viewing China as a market, including for Hawaii products, which have strong brand equity in China and are seen as having a high degree of authenticity, quality, and naturalness, and which can command premium pricing, as well as demand for Hawaii as a high quality premium destination for tourism.

Dr. Chris McNally, a fellow at the East West Center, followed up on Liu's presentation by offering a view of China in the context of the global economic crisis, which he sees as influencing change in China as well as offering China potential benefits to continue to increase its clout on the world economic stage.

Like Liu, McNally also addressed the importance of the Olympics to China, although he drew the conclusion that the Olympics increased the internal legitimacy of the Communist Party. Most significantly, China's exposure during the Olympics increased global understanding of the modernity and potential of China, while also exposing the lack of civil and human rights in China and micromanagement of the games by the CCP.

McNally argues that Chinese capitalism differs from Anglo-American capitalism in several important regards, including a reliance on informal business networks, and the government's role in limiting the uses that capital accumulation can be put to. He regards the current Chinese economy as not yet making a full transition from the imperial political economy of the past, where the state allows a regulated small scale merchant capital but fundamentally controls how accumulated capital can be exercised. China remains to transition to a rule-based constitutional state, but that transformation will likely be forthcoming as China competes in a globalized economy with international competition for trade and investment, and to remain competitive will need to remove uncertainty for investors and businesses by adopting rule-based regulation and legal recourse.

The current scenario has been maintainable as long as the West benefited from low inflation and high corporate profits, and China benefited from capital accumulation. However, this will likely change in the face of the global economic crisis which is impacting Chinese exports and forcing, as Liu discussed, a shift toward stimulating Chinese domestic consumption with the realization that China cannot export its way out of this crisis. China, can, however, as the largest U.S. creditor, exercise substantial leverage in the redesign of whatever the global economic system becomes.

In some regards, the global economic system is moving towards China's system, rather than vice versa, with increased calls for more regulation and recent U.S. bailouts resulting in state ownership of financial institutions and other companies. In any case, McNally does not see severe civil unrest for China, relating that the CCP has been very nimble and reactive to pressures to change in the past, and is best characterized as a capable technocratic elite. The balance that the CCP is trying to strike is between opening up the system in areas of the law and media, but he acknowledges that the government does not want to give up complete control, as legal uncertainty actually creates the opportunity for government to exercise power against those who fall out of favor with the state, and supports the continuation of a CCP elite class.

THE ENTREPRENEUR'S EXPERIENCE

Manny Menendez, chairman and chief executive officer of MCM Group Holdings, Ltd., began his talk by arguing that observers need to be fair to China. While China is often criticized on the issue of transparency, the U.S. has its own problems with transparency, well-illustrated by scandals at Worldcom, Enron, Lehman Brothers and others. Menendez states, "No system on the planet is perfect," and we must accept that the U.S. is moving more towards Chinese policies than vice versa, including state involvement in both banking and insurance, something that we criticized China for over the past twenty years.

China is a study in contrasts: while the average Chinese income is equivalent to \$4,000/annum, over 200 million Chinese, 16% of the population, survive on less than one dollar a day. Menendez took exception to Liu's assessment of the Chinese response to the melamine outbreak, pointing out that 2/3 of the food in China is produced in factories with 10 employees or less, and that finding the source of the contamination was extremely difficult. Menendez maintains that it was a credit to the Chinese government that they were able to mobilize 450,000 inspectors into the field to find the source of the contamination so quickly. He states, "It is hard to take policy and bring it down to the local level" and that "what I've seen [in China] over the past 30 years is not good, it is not great, it is a miracle" given the scale of China. He points out that China has over 150 cities with populations of over 1 million, versus 9 in the U.S. and only 15 in Europe. "The scale is unbelievable." Housing, food, and public security are all market opportunities.

Menendez states that China is well aware of its problems, and that rather than go in with criticism, a “tip that will help [Western companies] moving forward in China is to go in with solutions and give ideas and examples.” He believes that China is following the same pattern as all industrializing countries have, but has transitioned and is addressing these challenges more quickly than the U.S. did. Menendez points out the China has set aside \$350 billion (which he agrees is not enough) to address environmental projects in the current five year development plan.

Menendez sees opportunity for entrepreneurs to do business with China, pointing out that while we have a \$233 billion trade imbalance, our #2 export to China is recyclables. “I think that we have to do better with our trade policy than shipping garbage to China.”

Responding to a question about the significance of *guanxi* to doing business in China, Menendez states that he believes that, like anywhere, relationships are important, and are helpful to getting accurate information and to move projects through the system, but that having *guanxi* alone was not sufficient to do business. He notes that contracts are becoming more common and important in China, not only to Westerners doing business there, but to the Chinese themselves. The Chinese “are now negotiating like New Yorkers” to protect their interests via contracts. Menendez offers other pieces of advice for doing business in China, including making sure to think through issues to address them in a way that no one loses face, and to describe situations in a harmonious way so that they can be resolved without direct confrontation. He also notes that gender may be less significant to doing business in China, and that he believes that the Chinese are pragmatic in evaluating the value that a person brings to the table rather than their gender.

Another significant opportunity that Menendez noted was the market for outside higher education. Of 350 million Chinese students, 10.1 million take the national exam, of which 5 million receive university placements. This leaves a potential market of 5 million prospective candidates for outside education. Currently 200,000 Chinese go outside of China to school, 85,000 to the U.S., with Australia and the U.K. being the number 2 and 3 education destinations. Menendez notes that there are 550,000 millionaires in China, and that the one child policy has resulted in the increased ability for Chinese parents to support investment in their child’s education.

Menendez gave a final tip to entrepreneurs, relating that Chinese farmers for the first time can now sell the lease rights to their land, which could lead to the growth of larger farms that could be mechanized.

Entrepreneur’s Panel: Jeff Au (PacifiCap Management); Dale Madden (Madden Corporation); Michael Terry (Belt Collins); Jun Zhou (PacifiCap Shanghai) [responses are abridged]

Q: Compare starting a company in Beijing versus New York

Madden: There has been a tremendous amount of change in the past 20 years. We are currently doing business with a lot of entrepreneurs in China, currently about 250 companies. On the small side, they employ between 500-1000 employees, to between 10,000-15,000 employees. Overall it's gotten much easier to do business in China

Au: It depends on the type of company, whether it's a true or paper entrepreneurialism. With the economic meltdown, paper entrepreneurialism may dry up, and true entrepreneurialism may become more important. These are mainstreet types of businesses [that produce a true product or service and rely on revenue rather than exit strategies.] Especially manufacturing in Southern China.

Zhou: the government still plays a very important role. You need to understand the application process. There may be 17 different seals and approvals that you need for a project. You need to do your homework.

Terry: Government policies and predictability has improved. [As a result] we only recently decided to set up a large office in Shenzhen. Who you have working for you is important. You will only be successful when you have the right managers and cultural knowledge to be effective.

Q: Is raising money harder now? Should I try to raise \$1 million or \$5-10 million for a venture in China?

Au: You may need less money for a start-up in China as the cost of labor is low, which is the #1 cost for start-ups. The scale that you would need to achieve for a return on \$10 million may be too large; you would need to return at least \$100 million.

Zhou: It's the same thing as in the U.S. for success. You need to have a strong value proposition, competitive advantages for the Chinese market, and a solid business plan. It is not so simple as success being assured because China is growing so rapidly.

Q: What will the impact of Obama be on China?

Zhou: Based on conversations I have had so far, [the Chinese] see the election as progress, but the #1 focus for the Chinese is trade, and Obama's talk of renegotiating NAFTA and taking jobs back to the U.S. is unsettling to the Chinese. Part of the slower [export] growth is rebalancing to encourage production for the domestic market.

Au: I may be more optimistic. I think that it is about pragmatism, and Obama had to say it to get elected; I don't think that he will resort to protectionism.

Madden: I think that they are encouraged by his pragmatism, and willingness to talk.

Q: how does being from Hawaii affect Chinese investment?

Au: Doing a deal in China, the value proposition is more important than where you are from. You need to be building businesses here that have a real value proposition; a product or service that the Chinese people are interested in.

Ted Liu: Up until this point, Hawaii was not good for quick turnaround real estate investments for the Chinese. But we will see the same pattern, that Chinese investment will follow Chinese travelers, the same as the Japanese investments followed Japanese travelers. Hawaii is also the ideal living laboratory for energy research, and has many competitive advantages. [this is an issue that the Chinese are interested in.] And there is a pent-up demand for education, especially in niche areas.

Q: How do you deal with the problem of reverse engineering and theft of intellectual property?

Terry: There are currently four companies in China masquerading as Belt Collins. [they adopt similar names or typefaces, as Belt Collins has a great brand association in China]. Five years ago, there was no entity to police this. Now the government is taking a stronger role to enforce copyrights. Also, [we've taken other steps] such as taking out full-page ads in the paper to say that "this project is not a Belt Collins project" and then the company will immediately take down their signage and stop claiming to be Belt Collins.

Au: You need to look at how you can protect the IP in addition to the legal protection. Can you build incentives into the agreement that make it more worthwhile to not steal the IP rather than steal it?

Madden: Partner selection is key. I can count the times that we have had IP issues on one hand. We have probably had more in the United States. We have 250 manufacturers working for us in China. Our staff and managers are constantly traveling. We don't use agents. We have had very few problems, and the key is the people that we have on the ground.

Menendez: You can combat theft through legal channels, partner selection and forming relationships. Many people who do business in China have no idea, other than a superficial idea, about who they are doing business with. And multisourcing is another way to protect IP, by producing different parts in different countries, which can even be done for software, too.

YOUTH MARKET

We heard from both Howard Snyder, producer of the film *My Beijing Birthday* that we watched over lunch, and Larry Powell, director, Mojo Ad, at the University of Missouri School of Journalism. Each described Chinese youth as an evolved consumer, personally untouched by the horror that their parents experienced during the Cultural Revolution.

Snyder's film captures his 1996 experience with a class of young Chinese children at the Cultural Palace learning *xiangsheng*, stand-up comedy that is a form of Chinese folk art, and follow-up with the same children – now teens and twenty-somethings, twelve years later in 2008. Many had experienced forced relocations as a result of rapid development in Beijing, and the contrast in the street scenes and backdrops between Beijing in 1996 and 2008 was striking. Snyder relates that anyone trying to capture the Chinese market must capture the hearts and minds of Chinese children, particularly as due to the one child policy, each child has six adults to dote and care for them.

ETHICS

Father Robert Spitzer, president of Gonzaga University, closed out the talks with an impassioned plea for the Western world to foster the development in China of a uniquely Chinese and culturally rooted system of business ethics. He believes that Chinese society is primed to develop the most ethical business culture in the world by its long history of ethical study and philosophy, but that Western institutions and particularly universities have the responsibility to share with the Chinese the Western experience of the history of the development of business ethics, likely rooted first in the formation of professional associations.

LESSONS

Many important themes recurred throughout the day-long conference. Over the past year, China has continued to emerge as a full partner onto the world stage, driven by events including the Olympics. The Chinese government continues to struggle to balance a level of economic freedom to encourage the innovation and entrepreneurialism that have been driving the economy, and preserving a system of tight social and political control. Pressures both internal and external seem to push for gradual relaxation of this control and a move to a rule-based constitutional state.

The global economic crisis both hurts the Chinese economy by slowing exports, but also, as the G20 meets and global economic systems are being remade, presents China with the opportunity to shape the emerging global system to its own interests. The slowdown in exports compels the government toward policies that encourage domestic consumption in order to create jobs that help to maintain stability, further accelerating the emergence of China as a consumer society, creating new opportunities for entrepreneurs.

Companies that can offer a real value proposition to Chinese markets in the areas of social entrepreneurialism, advertising and consumer rating organizations, education, infrastructure development, and which offer products and services that appeal to the increasingly individualistic YAYA's have the best chances of success. On the other hand, American companies that target this market compete with increasingly mature Chinese companies and businesspeople. One observer at the conference succinctly stated that ten years ago in China it is was much harder to get a business deal, but if you did do

a deal you were guaranteed to make money. Now, it's much easier to do a deal, but much harder to make money.

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