

**Australian Industry Group
Annual National Forum 2005: 'Rethinking Business'
Session Five: 'Rethinking World Industry'
China
Richard Martin
Managing Director, IMA Asia
15th August 2005, Canberra, Australia**

KERRY O'BRIEN: Our first speaker this afternoon, Richard Martin, is managing director of a company called International Market Assessment Asia, IMA, which advises managers of Asian operations based in Australia. He has more than 20 years experience in analysis, research, publishing and consulting in the Asia-Pacific. Richard publishes regular briefs on the economic and business environments throughout the region and he is becoming a regular at this conference too. His brief today -- China. Please welcome Richard Martin.

RICHARD MARTIN: Thank you very much, Kerry, and thank you very much to everyone at AIG for getting me back here. I might say that I am a director of businesses in both India and China. I am a founding director of the IMA India business run by my good friend Ada Chain (sp) and we've been working over there since 1990. We have a subsidiary operating in China out of Beijing, which has been up there for about 10 years as well.

As I look at the two markets, probably the thing that has struck me most in the last six or eight months was some work we were doing with Mercer, the actuarial human resources adviser, where they were doing a survey of some 3,000 or 4,000 MNC operations in Asia about six or seven months ago. They asked those 3,000 or 4,000MNC operations in Asia what their

forecasts were for head count growth across Asia in the next 12 months, which took them through to a few months down the road. For most of Asia the average was somewhere around 5 per cent to 7 per cent. There were a couple slightly stronger. Hong Kong had a fairly fast head count increase.

The two countries that really stood out in terms of projected head count increase in this 12-month period that started around June last year were India and China where MNCs were forecasting they were going to increase their head count by 30 per cent in that 12-month period. It is one of the very few charts you will see where the two countries lie side by side, because so much of the economic data shows them at quite different ends of the spectrum. But it certainly says that they are two markets which are getting an enormous amount of attention now.

I have a little cartoon on my office wall, which we were using four or five years ago, and the cartoon shows a mother giving a missing person's report to a policeman. She's got a couple of little children clinging to her skirt and the policeman is saying, "Tell me, when did you last see your husband?" The answer is, "When they added India to his territory." I am afraid for some of you in the room that's probably what the reality is, because you already have the demands of doing business in China which are substantial. And for some of you in the last two or three years India has come onto the radar screen in a big way as well. The span of management control that is required to cover these two markets is big and growing and how you cope with that is a very big issue.

The title I was given was rethinking China and I have taken the liberty of

putting " - manufacturing" on the end of it. Rather than just looking at rethinking China from an Australian perspective, what I thought would be interesting is to do what you have been doing for Australia, to rethink what are the issues about manufacturing in China or for any type of company that's working in China and not merely to stick so much about the Australian perspective on what's going on.

To keep this presentation short and to allow our Indian colleagues to get their information out, I have kept it down to about 10 slides. I want to deal with three issues: is there a need to rethink manufacturing in China? You could come up with 10 but these are five issues that have really struck me in the last couple of years working with clients in China about what's going on there. And then who's going to do best in the China market?

Do we need to rethink manufacturing in China? If you look at the macro numbers, you'd say no. This is doing phenomenally well. The lines we have on the chart, the red line is obviously exports from China to the rest of the world, getting through that \$600 billion level. In the last 24 years they have gone from less than 1 per cent of global exports up to 6.5 per cent of global exports. Now extrapolate that forward, if you look at the steepness of the curve, how long do you think it's going to take them to get to 10 per cent or 15 per cent of world exports? We have benchmarked them there against some of the strongest exporters in the world -- Japan and some of the newly industrialised economies such as Korea, Taiwan who are not shabby exporters in their own right.

When you look at the steepness of the curve, you have to say they're going

to hit 10 per cent some time in the next two or three years. They're going to hit 15 per cent somewhere around 2014 to 2015, and they will be up at 20 per cent by the time you get through to 2020. So the message you take away from this is: if you think what we have seen in the last few years is something, just recognise we are only about a third of the way through the process and it's going to keep running.

A couple of things that are exceptional about what's happened with manufactured exports out of China: this year was a really slow year for manufactured exports world wide, and in East Asia we saw export growth rates fall by two-thirds. People who racked up 30 per cent last year were lucky to get to 10 per cent this year, with one exception -- China. China's export growth rate for the first half of this year is just a few percentage points down from what it racked up last year. When you look right across the spectrum of goods coming out of China they were getting 30, 40 or 50 or 60 per cent growth rate in category after category. It's not just one area that's doing it; it's not just textiles, nor is it electronics. In electronics they did very well, whereas the other big electronics countries in Asia fell over in the first half of this year. They are doing very well in steel. They were a big importer of steel last year; this year, they are exporting \$4 billion or \$5 billion worth of steel a month out of China. In white goods they are doing very well. Do they need to rethink export manufacturing? Probably not on that measure.

We are also seeing something unique happen in China which has not happened before in an emerging market, which is they are working across the manufacturing spectrum. This is a forecast from AUTOFACTS, a division of PricewaterhouseCoopers which is looking at growth in

production at the world auto market through to 2012. This is for light vehicle production -- autos and pick-up trucks and things of that sort. They are going to go from around 59 million units world wide up to 69 million units by 2012. A third of the increased capacity in auto manufacturing through to 2012 is going to come in one country, it's going to come in China. You talk to the auto industry guys and they say that extra 3 million units are all going to be consumed in China. And we expect stable production, the guys in North America will hold onto their market share and the guys in Europe will hold onto their market share. That's a wonderful hope. Where it goes wrong is if we get demand dropping in China, because they will start pushing their product out and we will have to deal with rationalisation very quickly in the auto sector.

The span goes from the auto sector all the way back to low-cost low wage manufacturing. You will see in a few more slides why this goes on. This is China's share in 2000 of the global textile market where they had around 22 per cent -- it's the red bar at the bottom. You take the tariff protection off on textiles, which we did on 1 January, and the forecasts are that China would very rapidly jump to 50 per cent. This is a study from McKinsey, the WTO. The UN has done various other estimates and they actually put it slightly higher that China's share of the global textile and clothing industry would get up towards 65 or 70 per cent.

If you slam on the brake, which is by the way what we have just done in the European Union and in the United States -- I don't know if they are still selling textile companies here -- you may know that six weeks ago they agreed emergency quota protection in the US and Europe for this year on

textiles and clothing. And two weeks ago they pulled that quota for 2005, so they will not import into the European Union and into North America from now until the end of the year cotton jeans or cotton trousers, knit tops and all of that. You are talking about a phenomenal whiplash in global growth going on here. But the point here is the span of manufacturing. These guys are holding on to the cheapest end of the manufacturing scale and going for the top end.

If you listened to the radio this morning you would have heard that Airbus is talking about putting production in China. Where you fill up from that six per cent of global exports towards the 20 per cent of global exports by 2020 is you just start filling up the manufacturing spectrum with more product out of China. That's what happens if you delay it. If you delay it, we will get a little boost in South-East Asia. India will get a boost out of that.

A third aspect in considering whether China needs to rethink manufacturing is that manufacturing is critical to social goals in China. The red bar is the average wage in manufacturing, and measured in US dollars since 1996 the average wage in manufacturing has gone up 12 per cent a year in US dollars. It's also dragged the entire national average up and it's dragged up the wage rates in the rural areas. The wage rates in rural areas have gone up at about eight per cent per annum. So manufacturing is creating wealth in China. It's creating the income distribution and any time anyone talks to you about an Asian miracle, their numbers relied almost wholly on this lifting of the work force pay rates that goes on in China that's going across hundreds of millions of people.

There is a second aspect that you need to keep your eye on. The population growth rate in China has dropped down towards about 0.7 per cent. But that's not what you want to look at. What you want to look at is the urbanisation rate, how fast is the urban population growing. The natural growth rate in the urban area in China -- there are about 450 million people in urban China -- is generally very low. It's around 2 million people per annum. But each year they're moving about 18 million to 20 million people out of the rural areas and into the urban areas and they need work for them. Now there's a tremendous shuffle going on here because they are moving employees out of the state-owned enterprises, which are manufacturers, but at the same time they have to be able to keep manufacturing growing fast enough to absorb this new labour. That, by the way, is how they hold on to all ends of the manufacturing spectrum. Because in Taiwan, Korea and Japan when they did their 40-year burst of growth and they left textiles and footwear behind and went into motorcycles and then went into cars, they did it because they ran out of people. China is not going to run out of people to keep bringing in at the bottom end. It can keep bringing 20 million new people in at the bottom end of its manufacturing work force every year from now through to 2020 because it still has a lot of people out there in the rural area to do that.

What's wrong with the whole manufacturing goose that laid the golden egg? Two things are wrong. It's destroying capital. The big four state banks in China, non-performing loans if you averaged them across the market today they would be about 16 per cent; in other words they are insolvent. If you took the entire banking system, you're probably talking about 25 to 30 per cent in non-performing loans. All of us know what these arguments are.

They have been covered for 10 years. The government knows it can't keep running it the way it's working at the moment.

The second thing that is wrong from a manufacturer's perspective is now after four or five years of profitability we are drifting back into an area where we're starting to destroy profits. I mentioned already that you're facing a salary bill that's going up at 12 per cent per annum in China. The top line on that second chart is the producer price index measuring the cost of your inputs if you're buying in intermediate goods into your factory, and it's going up at eight per cent. The bottom lines which are beneath the zero horizontal axis are just a grab bag of various items I picked off the retail price index in China. The bottom line, the red one, is measuring white goods. So if you are selling white goods in China even though your price is falling at five per cent per annum -- so five per cent per annum your price is going down -- your materials cost is going up at eight per cent, your wages cost is going up at 12 per cent, your margin is just collapsing like this. This is going on today in China.

Of course, you're seeing the reverberation of that out here in the Western markets as the products come out. How long will that process go on is a very, very good question. The answer is probably another four or five years because what would make it stop? It will stop when the state-owned enterprises have a cost of capital, and that's not going to happen fast. It will stop when there is no more cheap supply of labour, but unfortunately the cheap supply of labour goes on and on. So this is a big problem if you're manufacturing in China right now, and of course it's becoming a bit of a global problem as well. That's what's wrong.

Here are five things to think about on manufacturing in China: your first response to this sort of environment is you have to get your price down. This is what people who have been successful in China have been working on for the last 10 years, and about five years ago a lot of them started to drive into profitability because it worked. They are all the basic steps that I think you would do in your business domestically and certainly you would do them in a cross-border business. It required a little bit of building your supplier base in China and all of that sort of thing. It required rethinking how you run the business and rethinking the sort of products you have.

The second thing you can do, although I know people complain about technology protection in China, is bringing in some of the latest technology and product designs is actually a way you win in this market. We have recently seen a big example of a turn around in a very important market segment here -- mobile phone handsets. This is the world's biggest market for mobile phone handsets. That chart is through to June just a couple of months ago. There are 280 million subscribers now. They grew handset sales by 68 million last year and all of that.

From 1999 to 2004 you would have said the dominant characteristic in the competitive environment was the rise of local suppliers, people like Ningbo Bird and TLC Communications who grew from four per cent of the market up to 40 per cent of the market by having ultra-low costs driving hand set prices down to points people never thought they would see them again. But now we have a surprise. What's been happening since 2004 and the first part of 2005 is that these two firms Ningbo Bird and TLC are losing market share

and their profits are taking a hammering. One of them actually made a \$50 million loss in the first quarter of this year and has been caught with a lot of inventory on its hands.

What's going on in the market here? By the time you have 380 million people signed up, you've got a lot of your people who are into their second or third handset. If you've got your salary going up at 12 per cent per annum in US dollar terms, you are becoming wealthy very quickly. The US\$15 handset you had as your first phone doesn't interest you any more by the time you're onto your third phone, you want the camerability, the music playing and all of that. Now Ningbo Bird and TLC don't have it. But the people who do have it are Nokia, Samsung and all of that. So their sales are booming and their profits are booming. Motorola's phones selling for US\$1,000 is one of the top sellers now, at least in the main urban cities. So consider bringing in your latest technology.

Also consider bringing in your oldest technology and let me show you how this works. This was some work we were doing with a client last year. They supply to a number of leading Western consumer goods makers in China. The Western consumer goods makers in China started back in the mid-80s going into the big coastal cities. The unit price for sales in the tier 1 cities when they were doing that was about 9.51. In the tail end of the 1990s they started going into the tier 2 cities, about 100 of them around China, they dropped their unit price down to 6.1 and now they are pushing out into tier 3 cities where they have to get their unit price down to 2.50. It's a price point that we've never seen before. In fact, the only other country where we see this price point is in India where we seriously doubt whether some of our

FMCG clients are ever going to make money at it, but they believe they are.

Our client, however, is a supplier of industrial goods to them and he faces constant demands about "you have to cut your price to us". They were first supplying a product at about 30 yen through to the western manufacturer. Then they cut it to 20 yen and then when they were told to cut it to 5 yen they had to go back and say, "Look, we can do that but we're going to have to give you a product that is 20 years old. We haven't made it for 10 years anywhere in the world." Then you have to build a marketing system where you can explain to your salesmen that in your portfolio is your latest technology and stuff that we don't even make anywhere else in the world and get them to work on the market that way. The market requires that of you.

A balance sheet strategy is required for this environment. What do you do when sales price falls beneath production costs, because that's the territory we are going into. Western firms generally say, "We are committed, we are going to ride it out," or they want to do some rationalisation à la Foster's with the brewery selling it off and all of that – or they restructure their business. They say, "Maybe we want to be in China but we don't want to be a manufacturer in China," or they leave China. Overseas Chinese, particularly the Taiwanese who are very, very large players there leave if they don't make money. So the issue of staying around and weathering it out isn't really on their agenda. They just hone their margins, redeploy part of the value chain out or they will leave China.

But your problem is these guys down the bottom -- the state-owned

enterprises. They increase production because their target is market share. They have no cost of capital. They don't need a return on capital and, as I said, that is the game plan that they are all facing for the next four or five years in China. It's going to be a bumpy and somewhat brutal ride.

A fifth and final point on these five points that seem to be coming up again and again when we talk with clients: the linkages to the global market are important because if you are talking about rethinking manufacturing here in Australia or rethinking Australia, what's happening default is the country boundaries in your strategy are fading. The real issues are your ability to build value chains that go across boundaries, wherever they are. The boundaries don't matter that much.

So Western MNCs as they look at China -- you have great technology, you have great product name, you can leverage values you have got in those by getting low cost product out of China. You do have a couple of problems you have to worry about. There is the infamous China blowback, which is say that western NMC firm, the FMCG firm I talked about a few moments ago is selling its product to 2.51 in Guangdong province and it's got product in the rest of the world priced at about US\$2. It doesn't want that product out of Guangdong drifting out through Hong Kong and into the Singapore and Malaysian markets. Also it doesn't want its competitor to drift their product out. Avoid overdependence on China -- this might be the Wal Mart issue. You suddenly find that you are getting 80 to 90 per cent of your product out of China; you may have a bit of an issue if there's a trade war.

Chinese enterprises have their own problems. They dominate that

component of the value chain that's to do with manufacturing and they can get to the low point there. Their problem is that there is not a great deal of profit being on that point, particularly in the next few years, so they have to increase their span of the value chain. They can move upstream by buying into raw material supplies; they can move downstream by buying Western brands, Western companies to try and increase their span of the value chain.

So who's going to do best in this market? The equity market analysts in Hong Kong are saying that no manufacturer is going to do that well up there. The people who would do well supply to the manufacturers. You sell them the real estate; you sell them the logistics; you sell them the advertising; and you consult to them -- but the manufacturing itself doesn't do particularly well.

Another way of looking at it is to say, "Okay, global cost of production, global technology, global linkages, who does well?" You can see where the Chinese firms are trapped and the hole they are trying to get out of -- it's a very tough position they are in. You can see that the Western firms are actually better positioned if they can deal with the cost problem. If they can't deal with the cost problem, they might want to outsource it.

Just a final point here: the Taiwanese are worth a mention. They are the biggest foreign direct investor in China. They dominate in Guangdong province, the hub of manufacturing in China, to the point that neither the government in Taipei nor Beijing is comfortable with acknowledging their role. The 100 biggest exporters out of China are all electronic firms, 55 per cent of whom are foreign owned and the majority of those are Taiwanese

firms. They have the best production cost management ever. The labour they hire is some of the best labour you can get and they pay local prices for it in China. They also have the ability to work cross-border manufacturing value chains in a way that no Chinese enterprise can do it to get its costs down. They have excellent technology. I guess the Taiwanese are the second biggest nationality in Silicon Valley in terms of venture capital-- that is, after the Americans. They have fine global linkages often though not with the brands but their global linkages are pretty good. And their global brands are sort of moderate.

So go back to that issue of Lenovo, China's biggest computer maker, who six months ago bought the personal computer division of IBM worldwide. IBM sold it because it realised-- its computers were being produced in China and it just couldn't get the production costs down as far as the Chinese owned producer. So it sold it to Lenovo because Lenovo theoretically could get the production cost lower. What did Lenovo do? Lenovo turned around and subcontracted its PC production in China to the Taiwanese firm Qanta, the biggest notebook maker in the world, because these guys control the margin completely and dominate in this way. Sometimes when I hear the debate from America with China about the trade surplus that China holds with America, I say, "yes, yes, the trade surplus is the trade surplus that the Taiwanese manufacturing niche operating in China holds with the Americans," but that's a politically difficult issue for everyone to have a go at. So there we are, a quick run across China.

Thank you very much.