



What's in store for the "Year of the Rooster"

February 2005

The lunar New Year celebration for the Year of the Rooster began on February 9th. It is believed that the Year of Rooster is one of "Good luck and Prosperity." We at SCI certainly hope so, since both Dr. Weckesser and Mr. Gu are "roosters."

All of us in business wish we could predict the future, but the fact is the best we can do is make informed guesses. We can certainly make some general predictions about China with a great deal of confidence but, as usual, the devil is in the detail. There is no question that growth will continue to be very strong. In 2004, GDP grew at the remarkable rate of 9.5%, the fastest in the last 8 years. 2005 growth is expected to be around 8%. Foreign direct investment (FDI) will likely continue its billion-dollar-a-week pace as more and more foreign companies set up manufacturing operations there. Moreover, because China has now made it much easier (and cheaper) for foreigners to set up trading, distribution and retail operations, we could even see an increase in FDI. (See our July 2004 Newsletter.) Wal-Mart, for example, says it plans to open as many as 15 new stores in China this year, and UPS says it plans to open facilities in 20 additional cities this year.

In this context of rapid growth, what about the issue of overheating and hard landing versus soft landing? This is tougher to predict. On one hand, the government has clearly cracked down on many projects. For example, despite the power shortage, Beijing suspended construction on some 26 new power plants valued at billions of dollars. They have also stopped other projects in steel, cement, and so on. (In 2004, China accounted for over 30% of global consumption of iron ore and cement.) Yet at the same time, Baosteel Group (the largest steel producer in China) announced a \$10 billion expansion to build a 10-million-ton-a-year plant in Guangdong province. Many observers seem fairly confident of a soft landing, while some, like the IMF, say not so fast – the government's administrative controls have not yet successfully moderated growth. But even the IMF says that, although a hard landing cannot yet be ruled out, "the consequences may be less dramatic than most commentators have argued." We think this is reasonable. We think the government is keenly aware of these problems and is likely to continue its moderating efforts such that an extreme "hard landing" is very unlikely. In addition, according to the AmCham China survey last year, some two thirds of US companies in China were confident of a soft landing.

Key problems that won't go away or find quick resolution are the banking system, yuan revaluation, and Intellectual property (IP) protection.

China has taken a number of steps to address its huge portfolio of non-performing loans, but new bad debt continues to mount. At the end of 2004, non-performing loans had reached a scary 13% of total bank assets. But it is a bit of a catch 22: because capital markets are underdeveloped, banks are the primary source of long-term funds. But the banks can't risk lending at the rate needed to sustain targeted growth. The banks have been able to remain solvent because of the high rate of savings in China and because the government can call on some of its huge Forex reserves to ameliorate the situation. But the real solution is complex, involving resolution of existing debt, improved risk management for new debt, reduced state influence, better transparency, and even foreign participation.

Yuan revaluation is going to happen sooner or later, probably at a modest rate at first that will not satisfy those who say the Yuan is 40% under-valued. Beijing has to weigh the effect of massive trade surpluses and US pressure against domestic financial and unemployment consequences. Conventional wisdom still has it that China is likely to start by widening the yuan trading band to around 5%, and adopting a multicurrency "basket". But predictions of this nature have been proffered for the last two years and we're



~ *US-Asia Business Solutions* ~

One Tower Bridge • 100 Front Street, Suite 1460 • W. Conshohocken, PA 19428 • Phone: 610-828-8060 • Fax: 610-828-8801

still not clear what will happen and when. Still, China is under increasing pressure from the G7 and is likely to initiate some kind of graduated response.

We need a separate newsletter on IP protection. Suffice it to say here that while China now has a solid legal IP infrastructure, enforcement continues to lag far behind. The courts are overwhelmed, and the judges are young and inexperienced. The Chinese government is sincere in its wish to curb IP piracy, but in some sectors this is extremely difficult to control. The problems with computer media are well-publicized, but many others are less well-known. There are a number of cases, for example, where Chinese nationals have registered company or product names with the trademark authorities, and then turned around and sued the real owners for infringement. One point must be made, however, and that is that many of the problems are the fault of the companies themselves. There are no guarantees in this matter, but we believe that if you are keenly aware of the risks and take appropriate steps, you can minimize your exposure in this area.

What is very interesting and portentous in our eyes is the growing middle class in China. Last year China's Academy of Social Sciences released a report that claimed some 19% of China's 1.3 billion people could now be considered "middle class" and that this number was going to jump to 40%, or 520 million people, by 2010. We think these numbers are a bit aggressive, but there is no question that a middle class is rapidly emerging in China. What this means is that tens and even hundreds of millions of people will have expanded buying power and will be demanding more and better products and services. This, in fact, is the engine of growth not only for the Chinese economy, but for the world economy. If, for example, just 10% of the Chinese population has the buying power of a middle class, we are talking about 130 million people – a larger population than most of countries of the world. In fact, the lower the percentage the better; that is, the more room this middle class has to grow, the more robust economic growth is likely to stretch longer into the future.

Happy Year of Rooster!

About SCI

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