

CHINA GROWS UP

*After 10 years in the
WTO, China's economy
is shifting gears.*

In partnership with:



THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会



A center of commerce:
A view of Shanghai
on the Yangtze River
at night.

WHEN YOU THINK about U.S. corporations' operations in China, chances are three words come to mind: low-cost labor. That's what has lured thousands of American companies into the country and enriched their gross margins. But now China's economy has arrived at an inflection point. Over the next decade, China's siren song will be these three words: enormous middle class.

"Anyone who's taken advantage of this cheap labor over the last several decades has done remarkably well. But as China develops, those opportunities recede. Rather than sourcing, China—with its emerging middle class—is becoming a place for selling products," says Christian Lundblad, an associate professor of finance at Kenan-Flagler Business School at the University of North Carolina at Chapel Hill.

In theory this transition will play out beautifully. China will add an estimated 1 billion people to the middle class over the next decade, nearly one-third

of the world's expected middle tier by 2020. With a huge new product market in China, U.S. firms can swiftly grow exports, correcting America's trade deficit in the process.

The risks? Inflationary pressures in China might push up costs in the short term. Increasing income disparity might cause instability. And the steady improvement in business conditions wrought by China's membership in the World Trade Organization (WTO) could slow, or possibly reverse.

After joining the WTO in 2001, China cranked open the trade gates by revising thou-

sands of laws and administrative processes, cutting import tariffs by nearly 40%, almost eliminating import licenses and quotas, relaxing ownership restrictions on foreign businesses, and allowing non-Chinese companies entry into previously off-limits sectors.

This cascade of market-opening moves—the latest in China's long-term effort to become part of the modern world economy—has generated eye-popping statistics. U.S. exports to China have grown 468%, to \$91.9 billion, since 2000. Trade has increased from less than 10% of China's GDP to 64% over the same period. Surges in Chinese demand account for roughly 50% of export growth of Hong Kong, Japan, and Taiwan.

"Foreign trade has grown rapidly, and foreign investment has poured into the country," says John Frisbie, president of the U.S.-China Business Council (USCBC). "The trend has created jobs, helped to raise incomes, and contributed to China's extraordinary growth."

Since 2000,
U.S. exports
to China have
grown

468%

SOURCE: BUREAU OF ECONOMIC ANALYSIS

LET'S SOLVE WATER.

LET'S PUSH IT UP 80-FLOOR BUILDINGS AND UP AND AWAY FROM 3,000-FOOT MINESHAFTS.

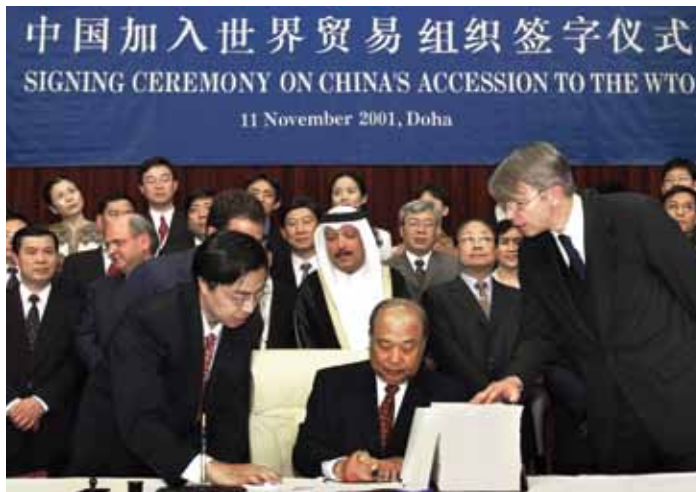
LET'S TURN UNLIVABLE LAND INTO ABUNDANT FARMLAND.

LET'S ANALYZE, PURIFY AND REUSE WASTEWATER.

LET'S CHANNEL THE ENERGY AND THINKING OF 12,000 DEDICATED PEOPLE. LET'S UNITE FOR A COMMON PURPOSE: INNOVATIVE SOLUTIONS TO GLOBAL WATER CHALLENGES.

From ITT comes Xylem.

Minister Shi Guangsheng signs China's WTO accession documents at a ceremony in Doha on Nov. 11, 2001.



China is now America's third-largest export market—**\$118 billion in 2010 when Hong Kong is included.**

SOURCE: BUREAU OF ECONOMIC ANALYSIS

The WTO's membership requirements lowered several key barriers for U.S. companies, including UPS. "The liberalization of express delivery services has been particularly important to the growth of UPS in China, as it allowed us to service our customers directly and provide greater efficiency and improved visibility for their supply chains," says Chris Grubb, vice president of marketing for UPS's Asia Pacific region. China also dropped its average tariff rate for medical devices and pharmaceuticals from 14% to about 6% in 2000. That move, along with removing its import quota for medical devices, encouraged UPS to increase its investment in health care logistics in China.

Since 2002, UPS has invested a hefty \$900 million in the country. Between 2008 and 2010 it opened hubs in Shanghai and Shenzhen, and a shared center in Hefei, Anhui Province. Today the carrier operates out of 45 locations, serving 330 cities, and employs some 6,000 workers.

Similarly, Xylem Inc. has positioned itself to reap the benefits of China's meteoric rise. The \$3.8 billion water business that was spun off of ITT Corp.

last month and renamed as a stand-alone company—is an old hand in China, where one-quarter of the total population lacks access to safe drinking water.

"China's five-year plan for infrastructure investments aims to provide China's population with improved access to clean water and superior wastewater treatment," says Bob Wolpert, head of Xylem's businesses in China and India, as well as president of the company's flow control business. "We've been doing business in China for more than 20 years, and we will continue to support these new-

est goals with our global water and wastewater transport and treatment business."

Xylem's history in China includes an award-winning effort it still operates called Watermark. Starting in 2009, Watermark and its charitable partners have designed and installed solar-powered safe water pumps, hand-washing stations and latrines for more than 8,000 students and teachers; taught a disaster risk-reduction course for an international NGO, and hosted a competition for Chinese students to find innovative solutions to water supply problems and pollution.

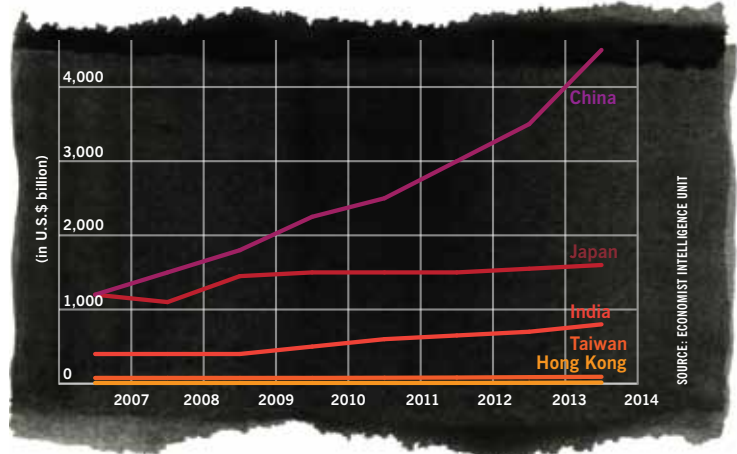
MATURING MARKET

During the last decade, relaxed trade regulations have paid off handsomely for most U.S. companies. Nearly 90% of USCBC members responding to a council survey in 2010 said that their China operations were profitable and that profit margins are the same or better than other ventures worldwide.

As China's economy matures, its emerging middle class is both a boon to U.S. corporations and a potential time

RINGING UP RETAIL SALES

China's retail sales growth has helped offset declines in other Asian markets.



AFP/GETTY IMAGES



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A bustling middle class shops on the world-famous Nanjing Road in Shanghai.

bomb. Chinese with disposable income are already ringing cash registers for U.S. consumer goods companies. Yum! Brands, based in Louisville, had more than 3,400 KFC and Pizza Hut restaurants in China in the first quarter of 2010. Starbucks has 700 outlets there and plans to open 80 shops per year going forward, making China the company's second-largest market.

One measure of the middle class's rapid growth: cellphone usage. China Telecom, which is a dominant carrier in China with broadband access to all 31 provinces and 70% of the country's Internet market, had some 28 million mobile subscribers in 2008. By August of this year, the figure had more than quadrupled, to 113.5 million.

The Chinese are hungry for America's big-ticket items too. GM, which held its first board of directors meeting in China this year, sold more light vehicles—16.6 million—in China last year than it did in the U.S. Back in 2000 it sold just over 1 million. That torrid pace will continue. J.D. Power and Associates predicts that in just seven more years, the Chinese market will reach 33 million vehicles. Needless to say, GM, Volvo, and

China's actual consumption will increase by more than six times by 2027 to as much as \$10 trillion annually.

SOURCE: BUREAU OF ECONOMIC ANALYSIS

other foreign and Chinese car companies are racing to build factories there.

Apart from autos, food, and beverages, the industries with the greatest growth prospects in China include retail, agricultural goods, processed foods, aviation, natural resources (particularly lumber, coal, wheat, and corn), entertainment, and tractors and trucks.

Alongside the growth in middle-class consumers is a significant rise in small and medium-size businesses. SMEs, as they are known (for Small to Medium Enterprises), contribute 60% of industrial output and 80% of jobs in China. Currently suffering from shortages of electricity, capital, and labor, as well as soaring costs, many of the

country's SMEs are facing the toughest conditions in years. The country's new national growth plan for SMEs calls for addressing these problems and other growth impediments by simplifying legal business structures, easing hiring rules and boosting development of targeted industries (including nanotechnology, biotechnology, defense, and pharmaceuticals) through incentives and other moves.

AliExpress, a new online wholesale marketplace launched by Alibaba.com, highlights the business-to-business opportunities in the SME market. Alibaba.com, which describes itself as the world's largest business e-commerce marketplace connecting buyers and suppliers, created AliExpress to enable consumers and businesses globally to buy products at wholesale prices. Through the integration of UPS technology and shipping services, AliExpress customers can manage their shipping and tracking processes on AliExpress's website.

GROWING PAINS

Amid the exciting prospects in China, however, new risks are growing. The country has been grappling with inflationary pressures. Loath to revisit the 20% inflation rate that prevailed during the late 1980s, China has put the brakes on monetary policy during the last year or so. But the current global economic slowdown, which has triggered a significant contraction in China's growth, calls for the opposite: stimulus policies.

Walking this fine line will be all the more challenging as millions of Chinese continue to migrate from rural to urban areas. "A global economic slowdown makes it more difficult for

86%
of U.S. subsidiaries in China are U.S. wholly owned or majority-owned.

SOURCE: BUREAU OF ECONOMIC ANALYSIS

the government to employ these interior workers who are moving to the coast," says UNC's Lundblad. Over the next 14 years, some 250 million Chinese will migrate, on top of the 200 million who've moved during the past 20 to 30 years. Income inequality, which has grown very rapidly, particularly from region to region, drives much of the movement and could be a threat to China's stability.

For companies already doing business in China, the chief concern is, as always, achieving equal footing in the country. The USCBC's members cited competition with state-owned enterprises, intellectual property rights enforcement, and licensing, business, and product approvals from regulatory authorities among their top 10 concerns, in last year's survey. The rise of protectionist voices in China

and the U.S., which could roll back recent market-opening measures if the voices become loud enough, concerns the USCBC's Frisbie.

"The terms of China's WTO entry agreement cannot be the end of the story," he says. "Services sector reforms and market openings, innovation and technology transfer policies that are based on global best practices for Chinese and foreign companies are all areas that will be crucial."

Clearly, doing business intelligently in China is getting more complicated as its economy matures. But the country's siren song is harder than ever to ignore. Who said growing up was easy? ●

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Riding the Middle-Class Boom

Whether you're a car maker or one-shop retailer hunting for opportunities in China, the first thing you're likely to do is make a phone call or send an e-mail to a prospective partner. That explains why revenue for China Telecom Americas, the first overseas subsidiary of China Telecom Corp., has been growing at an average breakneck speed of 40% per year for the past five years.

"Trade and investment flows between China and the U.S. have been growing quickly since China joined the WTO," says Donald Tan, president of CT Americas. "We have the dominant position in China, with 60% to 70%

of the broadband and trans-Pacific submarine cable system. So we're able to provide high quality and reasonable pricing for our products and services."

Admittedly, CT Americas and the other two international subsidiaries of China Telecom still contribute just a fraction of their parent company's \$33.4 billion in annual revenues. But as China's emerging middle class attracts heavy investment by companies such as Coke, GM, Procter & Gamble and other megabrands, CT Americas stands ready to provide essential connection and expertise. The company's customers in the Americas aren't standing still either.

"Sterigenics and Perficient, like many of our customers, continue to invest and expand in China, while Chinese companies, like Bank of China,

are increasing their investments in the Americas," says Tan. When you own an information highway like China Telecom's, the more traffic, the better.



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