

## China's Five Surprises

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Booz & Company

01/16/2006

# China's Five Surprises

In the world's fastest-growing economy, the last 10 years are not the best guide to the next 10 years.

by Edward Tse

**T**he test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function," F. Scott Fitzgerald once wrote. He might as well have been describing the future of China. There are at least two prevailing views about this country's emerging global identity. Believers assert that by 2030, if not sooner, China will be the world's largest economy. It is already the fastest growing, averaging a 9 percent GDP increase annually over the past 20 years. Skeptics respond that its growth is bound to falter, soon, amid the environmental, social, and political problems brought on by rapid expansion.

These two perspectives are persuasive and compelling — but simplistic. Like Japan in the 1980s, China has become difficult for outsiders to see clearly in the 2000s. In part, that's because China is not a static business environment. It is rapidly transforming from a planned economy to a market economy. Capable and competitive Chinese companies are emerging, the

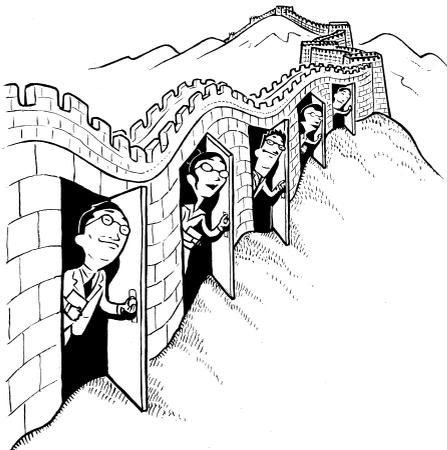
consumer marketplace is growing, sales and distribution channels are being developed, and the regulatory context is changing, all at accelerating rates. Thus, the lessons of the last 10 years will not necessarily be relevant for the next 10 years. As foreign companies attempt to do business in China, their success depends on their ability to get inside the minds of their Chinese competitors (or partners).

There are at least five "surprises" in China's future: facets of life and global business, stemming from the cultural, economic, and political evolution of this unique country, that will turn out differently from the way most outsiders suspect. These surprises are:

**1. "Why not me?"** The intensity of Chinese entrepreneurialism is propelling many companies, even now, beyond a role as producers of low-cost commodities.

**2. Fearless experimenters:** China's emphasis on rapid-fire research and development makes it a seedbed for original products and services in the future.

**3. China's "brain gain":** The ability to attract and retain executives from around the world has



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The author wishes to thank Grace Leung and Weld Royal for their help with this article.

provided a higher level of competence for China's enterprises.

**4. Out from *Guanxi*:** Outsiders still view China as a largely patronage-based economy, in which connections and ethnic background determine success, but increasingly (at least in some sectors), high-quality management and transparent governance structures count more.

**5. China's overseas ambition:** The country is taking on a role as a catalyst of sustained economic growth in the emerging markets of the developing world.

### "Why Not Me?"

Many foreign investors base their business plans on the assumption that their Chinese counterparts are simply low-cost competitors. They will be surprised by the ability of some of these companies to compete on product and service differentiation as well.

The most critical factor for Chinese competitiveness is the historical source of the present-day Chinese mind-set. Beginning in the mid-1800s (the latter part of the Qing dynasty), there was a period of relative technological and economic stagnation in China, capped after 1949 by more than 40 years of economic standstill under Communism. Only in 1992, when Deng Xiaoping made his now-famous "southern visit" to the city of Shenzhen, was the current wave of economic momentum unleashed.

By now, the momentum has grown so strong, it feels as if holes have been punched into a steam pipe that was building up pressure for a long time. After growing up on a steady diet of two ideas — "Life is good under Communism" and "Acceptable behavior is determined by the authority of the par-

ent, boss, and leader as outlined by Confucius" — Chinese businesspeople are now calling into question the effectiveness of those values.

One question is in the mind of every fledgling entrepreneur in the high-tech startups of Beijing's Zhongguancun neighborhood, the fabrication hubs of Wenzhou, the industrial region of Dalian, and dozens of other Chinese business centers: "Why not me?" Success is all around them. The recent Nasdaq IPO of Baidu, a Chinese search engine company led by young entrepreneurs, generated front-page acclaim in the Chinese press. Young Chinese businesspeople are driven by materialistic desires, eager to "catch up" with the rest of the world, and almost giddy with a sense of multiplying opportunity. They have read Internet chronicles of the triumphs of Yahoo, Silicon Graphics, and Google. They see themselves as the creators of the world's future Intels, Apples, and Microsofts, and some of them probably will be.

Because they are in such a hurry to make a place for themselves, and because it is still early in the life cycle of their ambition, Chinese entrepreneurs tend to give the impression that they don't care much about quality. However, that is not universally true. Many of them recognize the trade-offs among cost, quality, and time that exist for any startup, and they have explicitly chosen designs and processes that sacrifice quality for the sake of speed and cost savings.

But this doesn't mean that China will always be a nation of commodity enterprises; indeed, many Chinese businesspeople know the price of a Motorola phone in Chicago or a pair of Nike sneakers

in Manhattan. They ask themselves, “If I can make these things, why can’t I sell them for higher prices?” Some of them are already laying the groundwork for the evolution of their industries from low-cost producers of shoes, handsets, and components to branded enterprises.

Within China, some industries are already developing a maturity that their Western counterparts took decades to reach. In auto-

profitable, even as annual sales volumes increase by 10 percent or more per year. Similar consolidation is taking place in appliances, electronics, and textiles. These are the hallmarks of a maturing set of enterprises.

And many Chinese business leaders are eager for that maturation. Yes, they want to get rich quickly, but they don’t want an anarchic, free-for-all atmosphere;

tunes could rise dramatically in the future if they hitch their wagon to the right entrepreneurial star. The anarchic “hungry spirit” of Chinese culture currently provides a supportive intellectual climate for invention, not constrained by the conventional wisdom of existing technological or market paradigms. And the needs of Chinese consumers are often latent and quickly evolving, which makes them open to purchasing the experimental and low-cost products that local innovators produce.

Financial support for research and development is also burgeoning. Cities such as Shanghai, Beijing, and Shenzhen are regular stops on Asian pilgrimages made by foreign venture capitalists. Chinese local governments have built business incubators offering cheap rents and technical infrastructure to small and medium-sized enterprises in Zhongguancun, Shanghai’s Zhangjiang High-Tech Park, and similar locations. The national Ministry of Education has promised to quadruple the number of technical universities to which it gives financial support in hopes of raising them to world-class status. And it has introduced incentives to encourage universities, professors, and returning students to commercialize their research. With all this public and private money in play, China recently became the nation with the world’s third-largest R&D investment, after Japan and the U.S. And there are many indications that this money is spent more frugally (and thus more productively) in China than it would be in the U.S. or Europe. (See “Money Isn’t Everything,” by Barry Jaruzelski, Kevin Dehoff, and Rakesh Bordia, *s+b*, Winter 2005, for more on the cost-effectiveness of R&D spending.)

Hence, a surprise is coming for

## Chinese business leaders want to get rich quickly, but not in an anarchic, free-for-all atmosphere.

mobiles, for example, full-service retailers have emerged (formerly, they were state-owned enterprises or joint ventures between the government and foreign manufacturers like Volkswagen). Chinese vehicle manufacturers are establishing global vehicle brands, such as First Auto Works, the world’s foremost producers of mid-sized heavy-duty trucks. The Wanxiang Group (a privately held manufacturer of auto parts from Hangzhou) is acquiring ownership stakes in American, European, and Japanese companies to build a global supply chain and develop a global brand. Chinese component suppliers are consolidating; some are establishing themselves globally. Most significantly, according to a Booz Allen Hamilton analysis of cost figures, price competition in China (along with price competition from India) has put enough pressure on margins that vehicle manufacturers will probably need to reduce costs by 8 percent per year within the country to stay

they want sustained, stable growth. Of course, they won’t reach full stability very soon; too many entrepreneurs are trying too many new things. But the best Chinese companies will develop sophisticated supply chains, brands, research labs, and financial infrastructure more quickly than most observers suspect. Even if only a small percentage of the mass of Chinese entrepreneurs cross this threshold, it will have a striking impact on the global business community.

### Fearless Experimenters

Not every Chinese company is good at technological innovation. But those that are can take advantage of several factors unique to China right now. Chinese universities are churning out engineers. Between 1996 and 2001, the country practically doubled the number of engineering and science Ph.D.s it graduated. Many of these individuals are willing to start their careers at relatively low wages, conscious that their for-

those who regard Chinese companies primarily as imitators, prone to borrowing ideas from other businesses or infringing on patents. These habits infuriate Western companies, but many Chinese are less concerned because they view it as a step in their enterprise development.

The most salient quality of the new Chinese innovators is not their imitateness, but their willingness to take chances and learn from failure, especially compared to their more risk-averse Western counterparts. They require a relatively low burden of proof when deciding to invest in a new product or technology. “Let’s try it,” they say. Then, if they see it doesn’t work, they abandon it immediately and try something else. Speed characterizes every action. They also learn from one another; word travels quickly about practices and results. The ability to

seem to come out of nowhere, not aimed at American or European markets at all. Those surprises, like the Chinese inventions of paper and gunpowder, could have transformative effects everywhere.

#### China’s “Brain Gain”

A glance at the upper management ranks of China’s leading home-grown businesses yields a startling view: not much gray hair. Youthful leadership is the norm because China stopped all formal education from the late 1960s through most of the 1970s (the years of the Cultural Revolution) and thus lost a generation of highly educated managers. To make up for this gap, in a time when managers are needed more than ever before, Chinese enterprises feel an explicit need to recruit and develop responsible business expertise in a hurry.

“[Those R&D centers] are giving us an exposure to the quality of [Indian and Chinese] students — most of whom, historically, would have come to the United States. But more are either not coming at all, or coming here and then going back.”

This represents the acceleration of a 30-year trend. Today’s economic success in China owes a great deal to its diaspora — to the Chinese who live abroad. Even when the economy looked permanently stalled, overseas Chinese sent money home. They were also realists; they saw China as a source of cheap labor, and of relatives, however distant, whom they could trust to handle logistics and money. As opportunities expanded in China, these expatriates began to return in person. Entrepreneurs from Hong Kong, Taiwan, and Macau opened factories back home; students who had won positions in American or European firms returned to China to start their own companies, bringing with them technological and management knowledge, as well as Rolodexes full of contacts — including contacts with one another. In one study of immigrant professionals in Silicon Valley, AnnaLee Saxenian, dean of the School of Information Management and Systems at the University of California, Berkeley, found that 73 percent of Chinese immigrant professionals said they would consider establishing businesses back in their homeland — and a large number had already done so.

Edward Tian is a notable example of the influential role that some globally experienced Chinese executives play, even in government-supported enterprises. After earning a Ph.D. in ecology at Texas Tech University, Mr. Tian started a high-

## Knowing the nephew of a Communist Party leader still opens doors, but the trend is toward transparency and merit.

replicate successes and rapidly move up the learning curve has already given Chinese companies an advantage against today’s Western entrants in China.

Many Chinese entrepreneurs seek to create the kind of technological “killer apps” that can establish them as global competitors. Sooner or later, incremental innovation — and the sheer number and speed of their unfettered experiments — will lead to breakthroughs that appear far more original than anything emerging from China today. Some technological developments will

Often, that expertise is imported. Lured by economic reforms, by the excitement of building a nation, and by the central government’s incentives, foreign-trained and expatriate managers are bringing credibility, leadership, and financial and marketing skills to the executive suites of Chinese companies. Microsoft Chairman Bill Gates, during a panel discussion at the Microsoft Research Tech Fair held on April 27, 2005, in Washington, D.C., talked about this phenomenon in the context of his own company’s new research centers in India and China.

tech venture in Texas. The Chinese national government then recruited him to be the CEO of China Netcom, originally a small startup telecommunications firm based in Beijing. In 2002, China Netcom merged with a major part of the incumbent China Telecom, the then-state-owned primary national telephone utility, to form a new, giant-scale China Netcom, with Mr. Tian as the president. Another example is Fu Chengyu, the president of China National Offshore Oil Corporation (CNOOC), who led that company's 2005 bid to acquire Unocal. Mr. Fu holds a master's degree in petroleum engineering from the University of Southern California. Early in his career at CNOOC, he led the joint management committee, which oversaw joint ventures between CNOOC and global leaders such as BP (then BP Amoco) and Shell.

For its part, the Chinese government realizes that, to turn startups or state-owned enterprises into world beaters, it needs to build strong management capabilities. Executives of state-owned enterprises regularly attend management and leadership training sessions, held either in China or at top academic institutions overseas. They are thus exposed to cutting-edge Western management philosophy and techniques. Meanwhile, the government's "go out" policy encourages corporate executives to acquire foreign assets — not to exploit, but to learn from. The oil industry, in particular, will continue to be on a global watch for companies that will help China build up its strategic reserves in management as well as in oil. China, in short, is no longer an isolated place, and its bridge to the outside world is this growing cadre

of people who are comfortable in both places.

### **Out from *Guanxi***

China's business environment is far more diverse than it seems at first glance. Japanese, Korean, European, Australian, and American multinationals compete against overseas Chinese and local Chinese state-owned and privately owned players. The mix of strategies and tactics has created the world's biggest management laboratory.

However, the most successful participants are not always the Chinese. There are two types of Chinese industries. Wherever the government has a policy of restricted commercial ownership — in industries such as energy, telecommunications, financial services, and banking — the ethnic Chinese still have a home field advantage. For example, although there is a timeline for relaxing restrictions on it, foreign ownership of telecommunications companies is still limited.

In the second category of industries, including consumer products, personal computers, handsets, and pharmaceuticals, there is a much more level playing field. These industries are open to competition from companies all over the world, including Western multinationals, Asian multinationals, overseas Chinese, and local Chinese enterprises. They compete on products, brands, sales and distribution channels, and services, and they often need to bring their best capabilities to China to win. In these open industries, the winners are sometimes the foreign multinationals and sometimes locals. The key to success is effective management and corporate governance practices that can succeed in the marketplace

rather than through government favoritism.

Recognizing this, many Chinese companies deliberately use their acquisitions to gain management expertise and good governance structures from abroad. When Lenovo, China's largest computer hardware maker, bought IBM's \$1.25 billion personal computer division, one goal was openly acknowledged: gaining IBM's skills, structures, and experience with marketing, research, and probity. The new company has headquarters in New York, research centers under way in North Carolina and Beijing, and a former IBM executive, Steve Ward, as its CEO. Some state-owned enterprises are privatizing specifically for the sake of performance improvement. Private owners can bypass the costly shackles that keep enterprises from making money, which include guaranteed employment rules, guaranteed housing, and limited compensation for high-performing individuals. The new managers are also better equipped to make reforms in corporate governance, and to address some of the toughest issues that state-owned enterprises face: human capital, measurement and rewards, and social responsibility.

Together, government liberalization (in some industry sectors) and global integration have changed the rules of the game. Conventional wisdom makes much of the mystique of *guanxi* — a word that strictly translates as "connections," but usually implies that success is based on relationships, favoritism, and patronage. But in the relatively unfettered sectors today, while knowing the nephew of a Communist Party leader can still open some doors, the trends are toward trans-

parency and merit. What you know is already more important than who you know, and will be more so in the future.

### **China's Overseas Ambition**

The CNOOC bid for Unocal focused attention (and resentment) on China's drive for American acquisitions. But the more significant trend is China's increasing investment in other countries, particularly in the developing world: Asia, the Middle East, Latin America, and Africa.

Three obvious objectives underlie Chinese overseas investment: to secure the supply of resources such as oil and raw materials; to enter new markets (often by acquiring local brands and distribution networks); and to gain new skills and technological competence. But the country's overseas investment initiatives also have a surprising impact: China plays a key role, deliberate or not, in accelerating the growth and industrialization of the developing world. This is happening not through grand, World Bank-style investments, but rather through private investments conducted with the same fast pace, experimentation, and pragmatism that have become so common within China. Some of this investment represents a "soft power" of the new China. But much of it is simply the natural consequence of unfettered entrepreneurialism. Instead of mercantile competition with Europe and America, Chinese capitalists are seeking a far bigger prize: Becoming the provider of choice for the newly comfortable people of Africa, Asia, and Latin America. Like Henry Ford with his \$5-per-day wage, they are gambling that raising the living standard of people in the developing

world will pay off enormously.

In Africa, for example, China's economic, commercial, and political relationships with Zimbabwe, Angola, Sudan, South Africa, and Nigeria have grown rapidly in the last few years. The country now imports about a quarter of its oil from Sudan, Nigeria, and Angola. State-owned and privately owned Chinese enterprises have invested in a variety of African businesses in textiles, telecommunications, hotels and tourism, and construction and engineering.

### **Renaissance Nation**

Of course, all five of these trends will be surprises only because they are often unseen. The forces creating them are so strong and irresistible that the outcomes are hardly in doubt. Still, they will probably be the undoing of many businesspeople from outside China who come expecting an isolated, inward-looking country.

The smartest business executives who come to China from different corners of the world have responded with their own willingness to embrace the same qualities that lead to success in China: intense entrepreneurialism, unfettered experimentation, rapid-fire ambition, openness to outside leadership and alliances, and attention to emerging markets. In this way, these outsiders have also helped to create the new Chinese business culture. In the end, rather than either dominance or weakness, China is facing something altogether different: its first chance of a real renaissance in more than 100 years. +

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is published by Booz & Company Inc.  
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or call 1-877-829-9108.

Originally published as “China’s Five Surprises” by  
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