January 13, 2010, a young Chinese woman lays flowers on the logo of Google in front of the headquarters of Google China in Beijing. Photo courtesy of ImagineChina. ©2010 ImagineChina.

Direct Foreign Investment in China
SURE BET OR FOLLY?

By Stewart E. Sutin with Mary Caroline Milan

Between 1995 and 2003, I was the Senior Vice President of Mellon Financial Corporation responsible for international banking operations. The bank's chief executive officer was intrigued by the prospect of establishing an operating presence in China and asked me to undertake a feasibility study. Since Mellon had very large and competitive asset management, custodial, and shareholder services businesses, there were sound reasons to evaluate growth and income generation potential for these operations in China. The task of developing a market entry strategy was daunting, given China's complexity and my lack of prior business experience there. The bank CEO and I agreed upon a methodical approach to evaluate strategic objectives and business risks in a balanced way. Previously, I created a course for the Katz Graduate School of Business Administration at the University of Pittsburgh entitled "Managing Risk for a Global Enterprise," and employed a similar evidence-based approach to evaluating business opportunities and risks for Mellon in China.

This article shares a practitioner's perspective of the variables, analytical constructs, and criteria for decision-making that guided our assessment of business opportunities and risks associated with Direct Foreign Investment (DFI) in the China market. It is not a review of business, political, or socio-economic literature. Current facts about China are included as a way of underscoring how many trends evident in 2002 remain intact in 2010. Some of the observations that follow are basic to any foreign investment, while China-specific information is identified. Attention focuses upon DFI in local operating companies rather than short-term investments in common stock or bonds. An assessment is included about areas of concern to foreign investors.

Why invest in China or in any foreign market? Financial Performance as a Motivator

Global commercial and capital market connectivity offers a foundation upon which corporations develop business strategies, a subset of which may involve DFI. Inclinations to invest in foreign markets vary by country of destination and the product and services mix of an enterprise. Shareholder interest in sustainable growth of revenues and income prompts executives to consider opportunities in attractive markets. Trend line improvements in Earnings per Share (ESP) and Price/Earnings (PE) ratios, as well as investor expectation of future performance, effect stock price and, in many instances, executive compensation. So publicly traded corporations that have headquarters in relatively mature low-to moderate-economic-growth economies are motivated to find ways to improve shareholder value through overseas expansion. A publicly traded company based in the US or Europe is virtually compelled to explore opportunities to do business in the fast growing China economy. Companies considering investing in new markets must evaluate a wide range of factors prior to making final decisions about where and how to invest, and with what degree of resource commitment. Corporate leadership must make prudent decisions that support sustainable growth of revenues and income.

A publicly traded company based in the US or Europe is virtually compelled to explore opportunities to do business in the fast growing China economy.

January 21, 2010. During a press conference in Beijing, Ma Jiantang, Director of the National Bureau of Statistics, holds up a graph that shows China's V-shaped 2009 recovery and GDP expansion of 8.7 percent. Photo courtesy of ImagineChina. ©2010 ImagineChina.

Official figures cite nine percent economic growth in China during 2009, a remarkable performance in view of the prevailing global economy.

A Strategic Approach to Foreign Investment

Some considerations for investing in foreign markets may include: the size of an existing market for one's products and services, projected economic growth, the outlook for political stability, potential rate of return for capital on a risk adjusted basis, resources required for a successful undertaking, the quantity and quality of labor supply, local transportation, energy and telecommunication infrastructure, quality of health care and education, and perceived risks associated with each investment opportunity. In an ideal world, DFI in any country is preceded by the formulation of a global business strategy that prioritizes certain regions, countries, and product sales and/or procurement opportunities. This process calls upon the expertise that their executives have acquired from doing business in the nation under consideration. A country-specific case study may evaluate sustainable competitive advantages and product or service differentiation in order to achieve an in-house appraisal of perceived market opportunities, trends, and competition.

Studies of investment opportunity in foreign markets often contain quantitative and qualitative evaluations of such variables as socio-political trends, the state of the economy, demographic and infrastructural realities, and nuances of the legal system. Studies should include both current and anticipated market competition and projected growth of local market demand for the products and services offered by that company. An implementation plan would then address critical resources required, such as capital and staff, barriers or limitations upon market entry, laws, and practices directly affecting foreign investment, profit repatriation, and market practices and norms of behavior that may support or restrain income-generating opportunities. These and other variables within the study should then be translated into a multi-year financial model in which risk/reward, cost/benefit, and return-on-investment analyses are undertaken. Although some companies may respond to unplanned or unpredicted opportunities, a more thoughtful approach to DFI is likely to result in superior and sustainable success over time.

Strategic Considerations of Investment in China

The magnitude and growth of the Chinese economy during the past thirty years has been impressive. It should be no surprise that so many foreign companies want to enter a market characterized by an average annual growth of fifteen percent for about twenty years prior to the recent global recession. Official figures cite nine percent economic growth in China during 2009, a remarkable performance in view of the prevailing global economy. China became the top market in the world for sales of autos in 2009, with 13.6 million units sold.[1] Sales opportunities within China will expand as a growing percentage of its vast population becomes economically enfranchised. In addition, China is still a low-cost producer of a wide range of manufactured goods (sustainable for years in view of the large percentage of the population living at bare subsistence levels), sustains a foreign exchange regime pegged to the US dollar, and manages both fiscal and monetary policy responsibly. Inflation has been kept in check, and the government exercises care in its spending practices. Competition from more sophisticated local business operations and from new foreign entrants to the Chinese market is likely to intensify. Market awareness, brand, and product adaptation to meet local buyer behaviors, and the value of product/service differentiation, is an imperative.

Manufacturing companies have additional options to evaluate. First, a company must decide upon the importance of ownership, management, and control. Second, they must ask themselves if the objective is to compete directly for sales within China, or to use China as a base for low cost manufacturing of a product intended for export. Ownership control and management offer advantages, but places more capital at risk and mandates more careful attention to financial and legal matters because of potential ownership liability. Certain companies, especially retailers, have the sole objective of sourcing low cost products for their global sales and entering into procurement contracts with locally owned manufacturers.

Service companies in such fields as finance, law, accounting, and consulting primarily focus upon indigenous sales opportunities.

In their industries, capital required to support market entry, while important, is secondary to concerns about staff deployment, percentage of legal ownership and control permitted, repatriation of profits, liability, operating and reputation risk.

In summation, industry- and company-specific considerations vary. There is no substitute for clear thinking about corporate objectives and for developing a plan most likely to serve one's self interest. China should not be so inviting to a potential investor that hype overrides coherent planning. Is China a complex and occasionally vexing country in which to do business? Absolutely! Will business executives who work in China learn from their experiences? Absolutely! As Mark Twain reportedly once said, "The person who grabs the bull's tail will learn 40 to 50 times more than the person who stands around and watches." Many foreign executives I met in China described local business practices as "the wild West." Nevertheless, the Chinese government welcomes foreign investment, and it is likely to do so for the foreseeable future. It is not uncommon for foreign companies to view China as an environment that meets their long-term global strategic business objectives and accepts growth pains as a cost of doing business. Notwithstanding a largely positive historical posture toward foreign investors, recent events surrounding Google and the trial of Rio Tinto executives in China are a basis for concern as to whether China 's fundamental position toward DFI is undergoing modification. Time and evidence will be revealing.

China's Investment Attractiveness in Context

Outlook for Political Stability and Treatment of Foreign Investors: Corporate investors focus more attention on the outlook for political stability and governmental disposition toward foreign investment than they do on questions of ideology or forms of governance. Private sector leadership generally values predictable political behavior and the likelihood of receiving fair treatment from government leadership. Although investors are well advised to develop keen and objective political antennae and to cultivate diverse and insightful sources of information, witness pre-Castro Cuba and Iran under the shah, today's China is largely viewed positively by the foreign business community precisely because it is politically stable and its leadership is committed to an increasingly capitalistic economy. Local and foreign private sector investment is deemed essential to sustain aggressive economic growth targets. This process has evolved over more than thirty years and has withstood stress from forces within China and from outside China. China has been resilient and its leadership—albeit anti-democratic—has been thoughtful and responsive in seeking to wean the country from the proliferation of effectively bankrupt state owned corporations.

Government leaders appear committed to a formula of political stability integrated with largely sound economic planning. They are pragmatic rather than ideologues and understand the importance of private enterprise in general and direct foreign investment in particular. Economic growth offers a vehicle to facilitate improvement of the dire socio-economic conditions of the nation's impoverished majority. Capitalist practices and foreign investment are proactively encouraged by Chinese political leadership as a means to achieve domestic socio-economic priorities. Put another way, it would be catastrophic for China to have to deal with the political consequences of rampant unemployment should state run enterprises and public sector banks become insolvent in an environment where more than half the population is economically disenfranchised.

Capitalist practices and foreign investment are proactively encouraged by Chinese political leadership as a means to achieve domestic socio-economic priorities.

December 2, 2009. Chinese migrant workers take a rest in front of a billboard advertisement for the Ford Focus in Fuzhou, China. Photo courtesy of ImagineChina. ©2010 ImagineChina.

As of 2007, China had the largest population in the world with an estimated 1.33 billion residents, the world's fourth largest economy (after the US, EU, and Japan) . . .

Shoppers queue up to enter a Louis Vuitton (LV) boutique in Hong Kong, China. Photo courtesy of ImagineChina. ©2010 ImagineChina.

To understand China's political climate, foreign investors are well advised to be mindful of the broader context in which socio-political and economic decisions are made in China. The Communist Party, with an estimated 57,000,000 members chosen through a highly complicated system, selects and oversees leadership at all levels of government.[2] Dissent from within is not readily transparent to outside observers. Foreign investors may never fully understand the intricacies of China's political processes, but they should pay close attention to policy decisions and governmental practices that directly influence their business operations and be vigilant in assessing the sustainability of their evolutionary model.

Management of the Economy: China is a highly regulated and controlled economy, notwithstanding occasional superficial efforts to appear otherwise. Their model is largely one of *controlled reform*. There are many parameters by which to evaluate an economy, including whether the management of fiscal, monetary, and foreign exchange policies is sound. Recent concerns over potential inflation and a real estate asset bubble led China's policymakers to increase reserve requirements of banks, thereby making money less available to borrowers. The Chinese government is reluctant to rely upon deficit spending and carefully safeguards their foreign exchange reserves. Inflation is kept in check.

International pressure notwithstanding, China continues to peg its currency to the dollar. In view of its foreign exchange reserves and balance of trade surpluses, China has the option to revalue its currency against the dollar and still retain a globally competitive export position for its products, but the decision maker's disposition is to resist external pressures to manipulate currency, fiscal, or monetary policy in ways that serve short-term economic objectives. Foreign investors seem content with this predictable behavior, and those who export products from local manufacturing facilities are the beneficiaries. A certain harmony exists between Chinas' long-term socio-economic objectives and their day-to-day management of fiscal and monetary policy.

As observed previously, China's government has been weaning the economy from domination by inefficient, money-losing, state-owned enterprises, and it is beginning to recapitalize state-owned banks. The three largest state-owned banks in China are also the three largest banks in the world in terms of market capitalization. Given the lack of transparency, it is not known whether these banks would be truly solvent in accounting terms if loan loss reserves were established to account for non-performing loans to state owned companies. Brookings Institution economist Nicholas Lardy asserted in 1998 that, "China's four major banks as a group have negative net worth and thus are insolvent."[3] While the solvency of these banks has likely improved over the years, the lack of transparency makes it nearly impossible to determine their true financial condition. Ironically, the same can now be said about several large commercial investment banks and securities firms in the United States circa 2007–08. The banking system in China, still dominated by public institutions, has been gradually opening to foreign banks and asset management companies—albeit with joint ventures rather than wholly-owned subsidiaries subsidiaries. These kinds of ventures usually afford local (China based) branches of foreign banks preferential treatment.. Foreign business interests appear to respect this reasoned and judicious approach toward managing the nation's economy.

Dimensioning China: A significant body of data supports the case for investment in China. As of 2007, China had the largest population in the world with an estimated 1.33 billion residents, the world's fourth largest economy (after the US, EU, and Japan), with a 2009 estimated GDP of $4.6 trillion, and the largest annual economic growth, by far, of any major economy, estimated at 15.1 percent per annum between 1997 and 2007. China also accounted for 10.4 percent of the worlds exports, had the largest balance of payments surplus in the world (estimated at $371.8 billion), and the worlds' largest financial reserves (estimated to be $2.3 trillion). As of 2010 (depending upon the calculation method employed), China had either the world's second or third largest GDP.

The precise size of China's foreign exchange reserves are not publically reported, nor is the information as to how they are invested—but these numbers are probably reasonable estimates. Industrial output was second only to the United States, at $1.555 trillion, and agricultural output of $357 billion ranked first in the world. China ranked sixth in the world in DFI at $83.5 billion. China hosts the world's third largest stock market in terms of total market capitalization. Between 2003 and 2008, China's average annual inflation equaled 3.6 percent, which is remarkable for such a fast growth economy. Interestingly, China's service sector now accounts for an estimated 41.8 percent of GDP, thereby reflecting an increasingly diversified economy.[4]

In many ways, the US and Chinese economies are joined at the hip—a source of both comfort *and* discomfort to each country's head of state.

The economically symbiotic relationship that exists between the United States and China is perhaps as significant as the raw data. China is the second largest trading partner of the United States, with two-way trade estimated at $354 billion in 2007.[5] China is the largest investor in US treasury securities, estimated at $800 billion in 2008.[6] In addition, China is a major source of manufactured products to multinational companies—regardless of whether the supplier is an indigenous company, joint venture, or wholly owned subsidiary of a US corporation. Walmart's imports from China alone constituted fifteen percent of all US imports from China in recent years.[7] In many ways, the US and Chinese economies are joined at the hip—a source of both comfort *and* discomfort to each country's head of state. Nevertheless, from the standpoint of foreign investors, awareness of this reality is helpful as they detect evidence of China 's disposition to play in the capitalistic sandbox.

Areas of Concern

Opportunities for foreign investors may appear bountiful in China, but so too are the risks associated with such investments. Concerns include the prospect of long-term political instability, the occasional signs of anti-foreign sentiment, the soundness of the local banking system, the quality of the legal, energy, education, health care, and transportation infrastructure, foreign exchange controls that may impede ability to convert local currency to major international currencies to remit profits, responsiveness of government officials to private sector and foreign investor needs, tariffs on imported and exported goods, and the inflation outlook. Lack of transparency, coupled with curbs on local media coverage and hostile reactions to comments deemed critical of the current political regime, raise questions about accuracy of socio-economic data from government sources. Recent news about efforts, allegedly by Chinese officials, to hack into the operating system of Google in China to identify local dissidents, serves as a reminder of the risk to local residents about sharing their candid views about local conditions. This complicates the task of evaluating the prospect for long-term political stability and continued vibrant economic growth.

The presence of certain positive political and economic indicators does not suggest that China lacks serious socio-economic challenges, some of which may eventually portend political consequences. Structural problems persist. Despite visible signs of economic growth and vitality, largely in major affluent eastern and coastal urban centers, per capita annual income remains relatively low, largely due to poverty in rural areas where the majority of the population still lives.

Years of sustained economic growth will be needed in order to recapitalize state owned banks and privatize or close thousands of state-owned enterprises. The need for transportation, school, energy, and health care infrastructure persists. Some skeptics contend that economic growth rates are overstated and unemployment rates are understated. There are signs of open discontent, especially in the impoverished cities in the west, evidenced by protests against inept or corrupt local political leadership. Reports of the rise of organized crime in China are worrisome. A December 28, 2009, article in *Forbes* magazine titled "Ponzi in Peking" warns readers about the purported growth of a real estate bubble in China and its potential adverse consequences.[8]

Can China sustain political stability and continue economic progress that leads to improved living conditions for the hundreds of millions of Chinese who have yet to benefit from this generation's economic miracle? Vast direct foreign investment into China suggests that few are willing to allow lingering long-term considerations to keep them from making consequential investments in China, yet the long-term sustainability of China's economic and political model is difficult to forecast with a high degree of assurance. The optimistic scenario is that China succeeds with the growth-driven evolution of an expanding

The Wal-Mart Supercenter in Fuzhou, China. There are over 135 Wal-Mart Supercenters in China.
Photo courtesy of ImagineChina. ©2010 ImagineChina.

CHINA'S ECONOMIC GROWTH
A Brief Overview

China's return as an economic power for the first time since it was one of the world's richest economies for much of the imperial period is a major international development. The scope of China's rapid growth in the last few decades is staggering. Economic reformer Deng Xiaoping came to power in 1978. By 1980, provincial governments were initiating economic liberalization policies such as low tax rates and minimal regulation to encourage local industry growth. By 2006, China's economy was ten times larger than when Deng assumed power. As of 2009, China's economy had been growing at an average annual rate of ten percent for the thirty years since the beginning of reforms.

China's economic growth, despite being negatively affected by the 2009 world economic downturn, still managed over nine percent expansion last year: the largest for any major nation. Although this was the world's fastest expansion, much of the growth resulted from a large government stimulus and record lending because of low interest rates. Twice in February 2010, Chinese government policy makers ordered banks to raise discount rates in an effort to stop early signs of inflation. Inflation rates quickly rose from slightly over one-half percent in November 2009 to almost two percent by the end of the year. These seemingly modest recent problems notwithstanding, China is an economic force with which to be reckoned.

Economist Nicholas Lardy, from the Peterson Institute for International Economics, provides context for China's economic rise by contrasting GDP growth for the economy of Latin America as a whole in the years 1980–2005. The *cumulative*, not annual, growth rate for Latin America during that quarter of a century was ten percent. Although India has also benefited from economic liberalization, as of 2006, China's GDP was three times the GDP of India, and the gap between China and India appears to be growing.

More importantly, in human terms, China has succeeded in helping over 250 million people to escape abject poverty since the beginning of the reforms. Despite widening gaps between rich and poor, and urban and rural residents, as well the existence of serious environmental problems, it is important to realize that most people are materially better off in China than before the reforms began. China was one of the world's poorer countries before the economic reforms. Today, despite coexistence of fabulous wealth and abject poverty, average Chinese are "lower middle class" by world standards with the average family having about the same purchasing power as that of a Ukraine family.

How did China do it? According to Lardy, three of the major factors include creation of a competitive market economy, openness to foreign investment, and high savings rates.

Teachers and students who are interested in accessible prose explanations of China's economic rise and challenges should read Nicholas Lardy's article available at the Web site of the Foreign Policy Research Institute's Wachman Center for International Education, Nicholas R. Lardy, *China's Economy: Problems And Prospects*, Febuary 2007, 12 (4) at http://www.fpri.org/footnotes/124.200702.lardy.chinaseconomy.html, and three short China-related chapters in Zhiqun Zhu, "Understanding East Asia's Economic Miracles," *Key Issues in Asian Studies* (Association for Asian Studies, 2009).

EDITOR'S NOTE: In addition to Lardy and Zhu, the following sources were utilized in compiling this insert: "China GDP Growth Rate," *Trading Economies* at http://www.fpri.org/footnotes/124.200702.lardy. chinaseconomy.html, and *CIA World Fact Book 2009, China* at https://www.cia.gov/library/publications/the-world-factbook/ geos/ch.html.

Investors are urged to set realistic expectations, limit capital outlay, devote the time required to learn the market, and develop local relationships slowly before building for scale.

middle class, closes down bankrupt state-run enterprises while not increasing unemployment, and gradually eases political and economic controls. Still, there are other challenges that concern foreign investors when they consider investing in China.

Legal and Business Practices: Corruption is an area that is subject to increasing scrutiny and action by the Chinese government. Questionable business practices and an evolving (some contend dysfunctional) legal system suggest that a foreign investor is well advised to proceed with caution. Numerous constitutions have been approved during the past thirty years as the government seeks to align its law with socio-economic and political objectives. Notwithstanding certain improvements, concerns remain about protection of intellectual property and the ability to obtain and enforce judgments from the judiciary. Chinese political leadership is aware of these concerns, and continues efforts aimed at judicial reform. Safeguards for intellectual property rights and the outlook for repatriation of income generated from DFI in China remain areas of concern.

Local business behaviors have long been a source of unease. These behaviors sometimes take the form of corrupt or unethical practices; at other times, the manifestations are more subtle. The author is reminded of a business trip to China that included a stopover meeting in Europe with the president of a prominent asset management company. The president described, with considerable pride, the due diligence process that preceded their investment in a Chinese asset management company, and the exceptional care devoted to the legal structure of their joint venture partnership. Once in Shanghai, the Chinese chief executive officer of that same local joint venture company invited me to lunch. Not knowing of my relationship with their European partner, he acknowledged their newly formed joint venture. Without pause, he then inquired as to whether Mellon might consider an investment in their company in the event that their barely consummated joint venture proved unsuccessful. These sequential discussions accentuate the importance of recognizing how differences of behavior, culture, and expectations will have to be overcome for joint ventures in China to be successful.

Flawed Implementation Plan: Executives experienced with doing business in China have seen many well designed market entry strategies fail for lack of sufficient attention to sound tactics. Investors are urged to set realistic expectations, limit capital outlay, devote the time required to learn the market, and develop local relationships slowly before building for scale. Those who invest in joint ventures are advised to select local partners with care and to define their role in management. The need to design and implement sound operating controls may help mitigate such business risks as the potential for theft of intellectual property, capital, and physical property. Consider reputation and liability risk when choosing partners and local staff. Some foreign businesses have elected to work through partners in Hong Kong in an effort to mitigate some of these risks and concerns. If local laws in certain sectors of the economy restrict ownership to a minority or non-controlling ownership in a Chinese company, then one should consider whether strategic and financial objectives are realizable and realistic, and whether the probability for favorable outcomes exceeds the business risks inherent in the undertaking.

Concluding Observations

The growth of the Chinese economy, prospects for continued political stability, and the government's generally favorable posture toward foreign investors has inspired confidence and motivated businesses to invest billions of dollars in local operations. A mid-game test for the government and foreign investors alike will occur when consequential socio-economic stress emerges. Notwithstanding China's extraordinary record for impressive economic growth within an evolving and controlled political environment, unpredictable events or trauma have ways of occurring. The ability of government leaders and business interests to respond thoughtfully and effectively to such challenges will be indicative of the sustainability of their socio-economic and political model. Not many years ago, Japan similarly inspired confidence among foreign investors only to become mired in negative to low growth during the past ten years.

If the stimulus program implemented by China in response to the global economic recession of 2008–09 is at all indicative, private sector business interests have cause for optimism. In late 2009, the *Wall Street Journal* cited a report from China's National Bureau of Statistics indicating that the countries' real 2008 economic growth had been upwardly revised to 9.6 percent.[9] This encouraging economic data notwithstanding, I still recommended that Mellon pursue a careful, non-capital-intensive approach to investment and that caution be exercised in selecting a local partner. ■

NOTES

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