

2014 Swiss Business in China

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The research team

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Exclusively involved in China trade, investment, strategy and project management, he has been residing in the Shanghai area since 1988. He co-founded the first Swiss industrial SME in China, Suzhou 2-ply Co. Ltd (www.2-ply.com) and is the co-owner of LX Precision (www.LXprecision.com).

Founding Partner of China Integrated (Shanghai) Co. Ltd. (www.ch-ina.com), He has successfully supported a number of multinationals and over 300 mid-sized companies on market entry, operations management and restructuring in the past 20 years.

China Integrated is a solution provider dedicated to support international companies to successfully establish and develop their business in China, whether their needs are market entry, growth or acquisition. Building on its **20 years of experience** and its internationally trained Chinese professionals in business research, Chinese law, recruitment, tax & finance, IT & ERP and PR, **China Integrated provides the expertise needed to ensure the long-term, superior success** of foreign businesses in China.

China Integrated has successfully served about 300 International firms, large and small, with innovative solutions and cost-effective best practices developed through its decades of experience in Shanghai, Beijing, Hong Kong and Mongolia.

Based on its research and experience, China Integrated regularly publishes books and analyses, to facilitate the decision making of managers at international companies dealing with China. In 2007, China Integrated conducted the first business survey of Swiss companies in China, "Behind the China Kaleidoscope", highlighting success factors of local Swiss companies and offering a comprehensive roadmap for those planning to do business and operate in China. This was followed in 2009 by an analysis of human resources practices, the "China HR Paradox", identified as the key challenge and success factor in the 2007 research. Then, in collaboration with CEIBS, "2010 Doing Business in China: A Survey of European Companies" was published, integrating both analysis and contributions from experts. The success of this publication led to yearly surveys and this 2014 Business in China Survey, which analyzes the business landscape for foreign companies in China.

You can find more information on www.ch-ina.com.

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Founded in 2000, Swiss Center Shanghai (SCS) is a non-profit organization supporting Swiss companies in business set-up, expansion and operations in China. SCS not only offers instant workshop, showroom, warehouse, and office space, but also supports its members with government relations and a comprehensive network of experts. Together with its service partners, SCS has served more than 250 companies in China – SMEs and large enterprises alike. SCS is by far the largest cluster of Swiss companies in Asia, with 30 Swiss companies in one industrial park (SHXIP) accounting for over 50'000 sqm of industrial space.

Since 2014 Swiss Center has operated the Machinery, Trading and Business Center in the China (Shanghai) Pilot Free Trade Zone where 4000 sqm is dedicated to Swiss Businesses.

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Aline Ballaman is the Operation Manager of the Swiss Center Shanghai. Aline holds a Bachelor's degree in Business and Administration from La Chaux-de-Fonds. After 8-years management experience in the tourism and watch industries in Switzerland, she came to China in 2011 and enrolled in a 1-year Chinese language at Suzhou University before joining the Swiss Center Shanghai in 2012 as Operation Manager. For the past two years, she has been responsible for the Shanghai Office in advising and supporting Swiss businesses entering the Chinese market. In early 2014, she successfully managed a new 4000 sqm facilities project dedicated to Swiss businesses complete with a showroom, offices, and a warehouse in the China (Shanghai) Pilot Free Trade Zone.

PREFACE & KEY TAKEAWAY

In cooperation with the China Europe International Business School (CEIBS) (www.ceibs.edu), the Swiss Center Shanghai (www.swisscenters.org), swissnex China (www.swissnexchina.org), SwissCham (www.cn.swisscham.org) and China Integrated are pleased to bring you the findings of Swiss respondents who participated in the **CEIBS Business in China Survey 2014**, to analyze them and draw conclusions that we hope will be useful for Swiss companies and their activities in China.

This latest CEIBS survey is of particular interest not only for its findings but also because:

- With over 1'000 responses it gathers **the largest amount of respondents** in one such yearly survey. (by comparison, 557 companies participated in the 2014 EU chamber survey and 365 in the 2014 American Chamber in Shanghai survey).
- It is the only survey that collects responses from **Chinese** as well as **foreign companies** in China.
- It allows **comparisons among firms of different national origins**, based on a sufficient number of replies for each origin.

This is also the **first time that a business survey has been able to analyze a sizeable sub-sample of foreign SMEs in China**. Though barely 50 Swiss and EU companies employing 300 employees or less globally (classified as SMEs) answered the survey, this sample shows among others **that SMEs are generally more successful in China than larger firms** and the probable reasons for this success.

For the Swiss business community, it is for the second time possible to understand **how similar Swiss, European and American companies perceive their China environment**.

As a result, some findings on European and American companies can also be used to estimate and confirm Swiss companies' trends. Globally speaking, Swiss, European, and American companies in China are doing well. **On average they doubled their average profit growth expectations from 2012 to 2014**.

The confidence level of Swiss companies for 2014 continues its upward trend since 2012, though going up only slightly compared to 2013. **Swiss companies are also markedly more positive** than their EU, US and Chinese counterparts. Interestingly, the latter (non-Swiss) are all announcing very similar levels of confidence.

And while non-Swiss respondents have only very little more confidence in the future (in 5 years) than in 2014, **Swiss companies keep seeing much brighter prospects for the long term** than other respondents.

And, in a change from last year's survey, Chinese companies, too, are more confident in the success of their business in 2014.

All but the EU companies are planning to invest more on average than the previous year, **with the Swiss increasing most**, certainly reflecting their generally higher levels of confidence. Bad economic conditions in the EU, no doubt, are the reason for the absence in EU investment growth.

All foreign companies are, however, united in expecting better sales and better profits on average in 2014 when compared to 2013. Profitability increase expectations are considerably higher for foreign firms than for the Chinese ones.

Challenges are growing as well. **Increasing competition from Chinese companies** is again the most important management challenge. However, **it is the first time that competition from private Chinese companies is perceived to be more important than from other foreign ones**, regardless of their nationality.

Thus, managers who are facing the market in China see different challenges than managers in the headquarters. Like last year, **lack of understanding and support from the head office** is the **second most important management challenge**. This illustrates the constant perception gap between head offices and their subsidiaries operating in China.

In addition to the common misperception reported in the media about Swiss and foreign companies' lack of success in China, we find a **general overestimation** of the importance that **corruption and IP infringements has on companies in China**.

This year again, **a much larger proportion of Swiss SMEs is answering the survey** when compared to the EU and US respondents (in proportion Swiss SMEs respondents are almost twice as many when compared to EU SMEs), lending credence to the fact that **a larger proportion of Swiss smaller companies are successfully penetrating the Chinese market** when compared to other international companies

In addition to an analysis of key answers from Swiss companies in China, you will find some **additional analyses** that we believe are of much interest. In particular, a review of China's growth that explains why in business terms, **China's GDP growth is actually accelerating** and not slowing down. You will also find a review of the reasons why China has no other choice but to reform and **provide a more level playing field to the private sector**.

The first part of this report emphasizes Swiss companies, while the overall results of the **CEIBS survey and analysis of foreign and Chinese companies** are presented in the second part of the report.

Hopefully, this survey will dispel misperceptions and **highlight the actual situation that Swiss and international businesses face in China**. Additionally, we hope that these facts and analyses as well as the benchmarks they provide will help Swiss companies to **become even more successful** in the coming years.

We also want to express our **sincere gratitude to all the respondents**: thanks to them, a representative and objective point of view on Swiss-China business is available to all. At the same time, we take the chance to **encourage everyone to participate in the 2015 survey**, to expand the knowledge pool available to do successful business in China.

EU & SWISS SMES: MORE SUCCESSFUL IN CHINA THAN LARGER FIRMS!

About 31% of Swiss respondents can be classified as Small and Medium Enterprises (**SMEs**) defined as companies with **less than 300 employees globally**; and close to 31% are large companies with over 10'000 employees worldwide.

By comparison, other western SMEs are much less represented with only 18% of European and 2% of American companies having less than 300 employees.

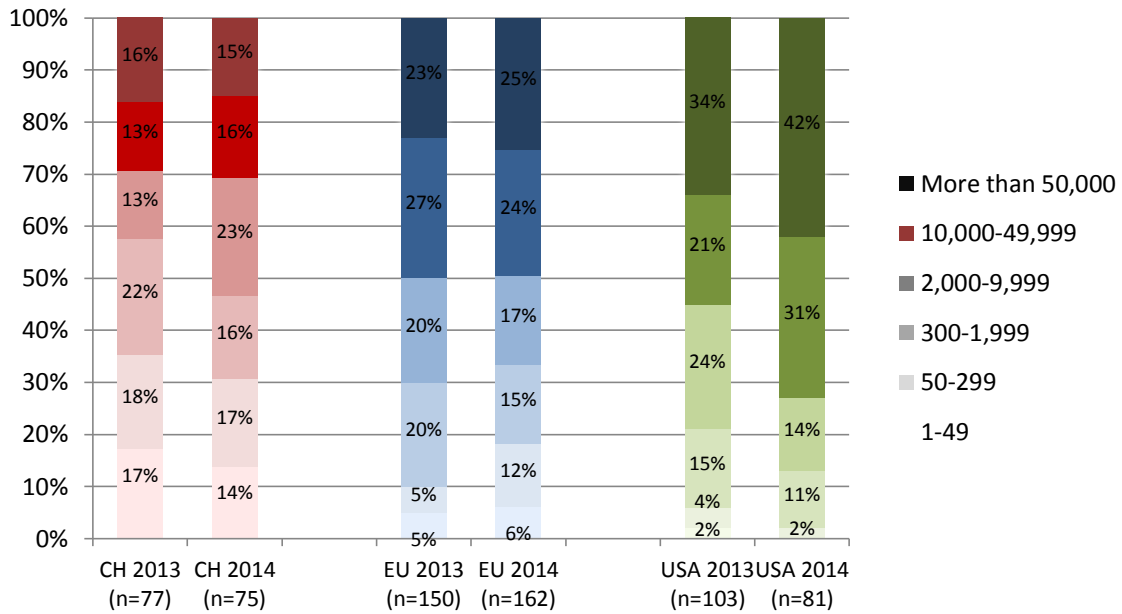
We cannot determine for sure that the firms who responded to the survey are representative in terms of size of the total Swiss, European and American population.

Still, this difference which was uncovered in 2013 persists in 2014 and creates grounds on which to believe that Swiss SMES have been comparatively faster at establishing themselves in China than their counterparts from Europe and America.

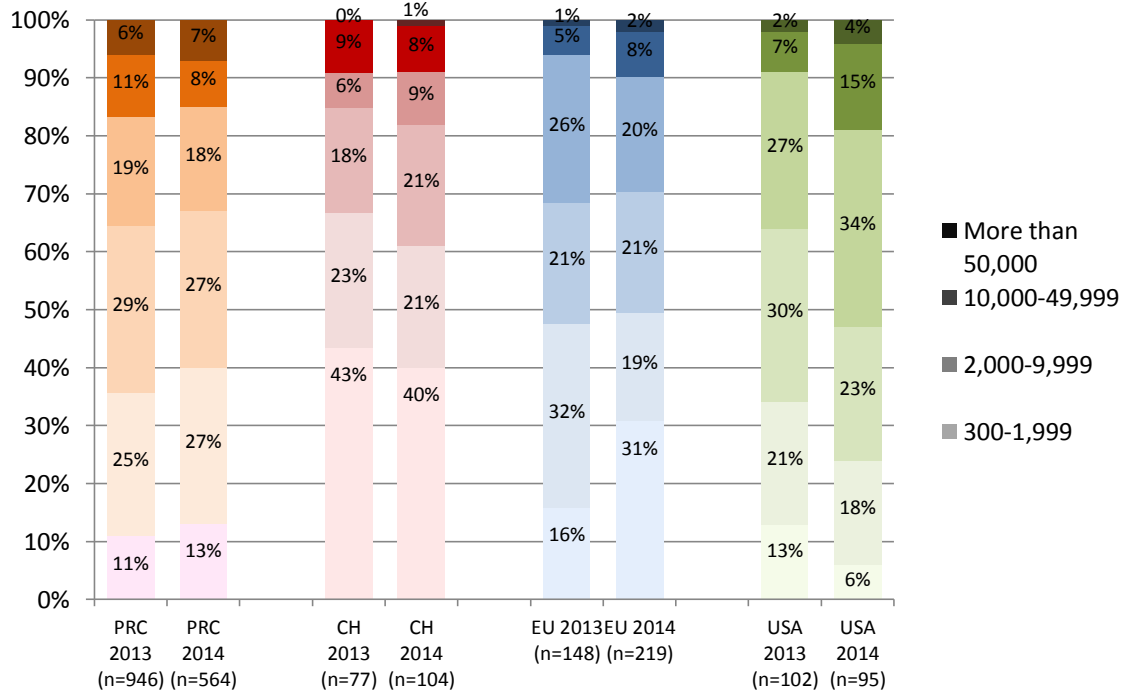
These results are also consistent with the fact that Swiss SMEs, due to the small size of their domestic market, are more adapted and geared towards internationalization than their counterparts.

The 2014 respondent companies' size is generally consistent between 2013 and 2014, at least for the EU and Swiss respondents, allowing us to compare the evolution between the two years with some confidence.

HOW MANY EMPLOYEES GLOBALLY?

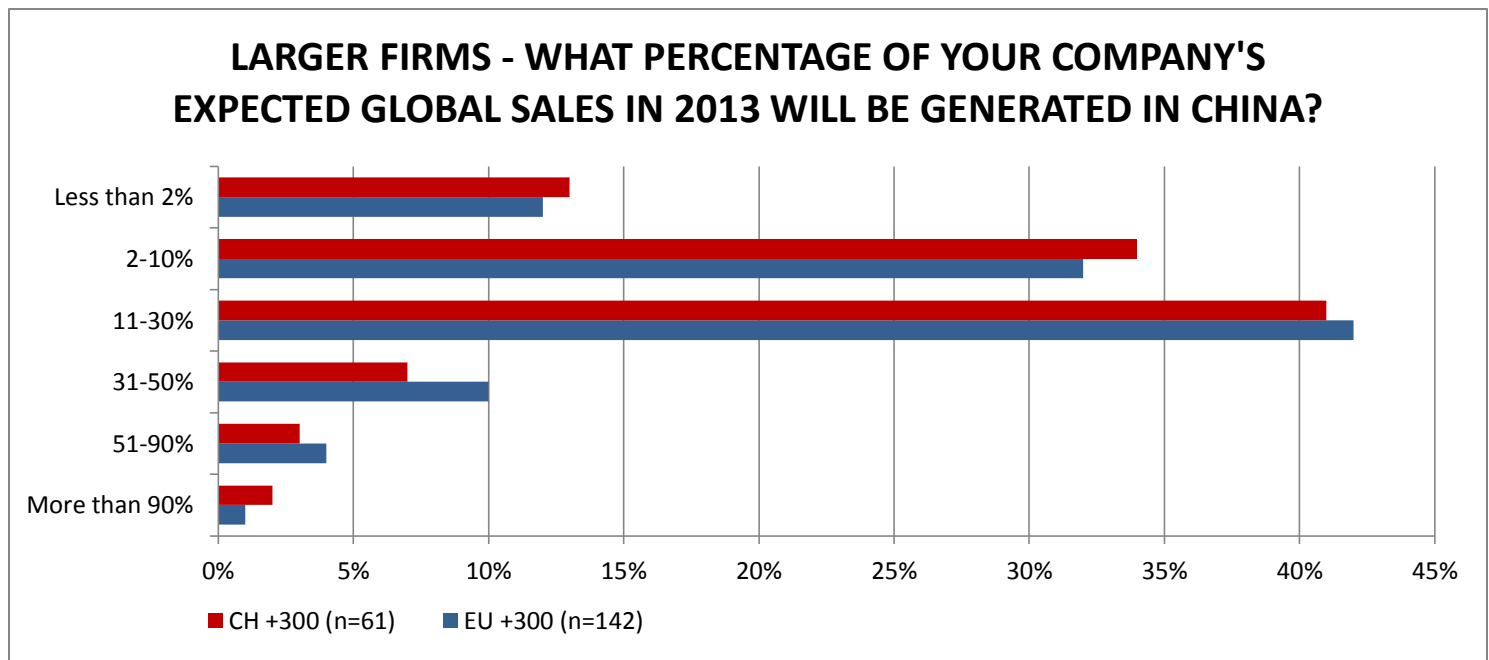
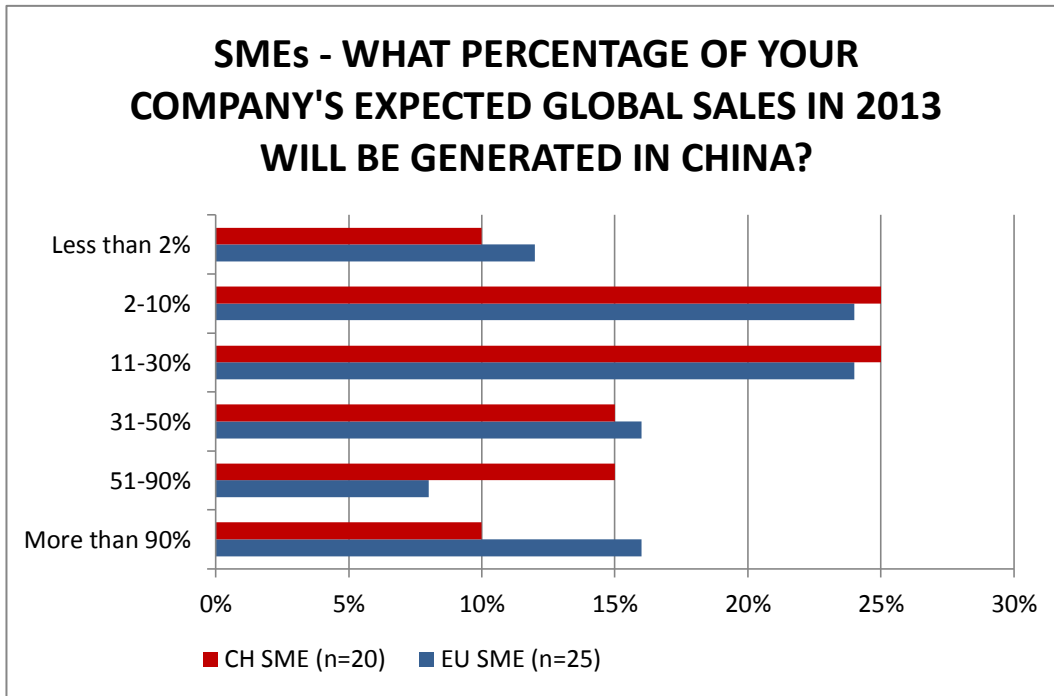


HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE IN CHINA?



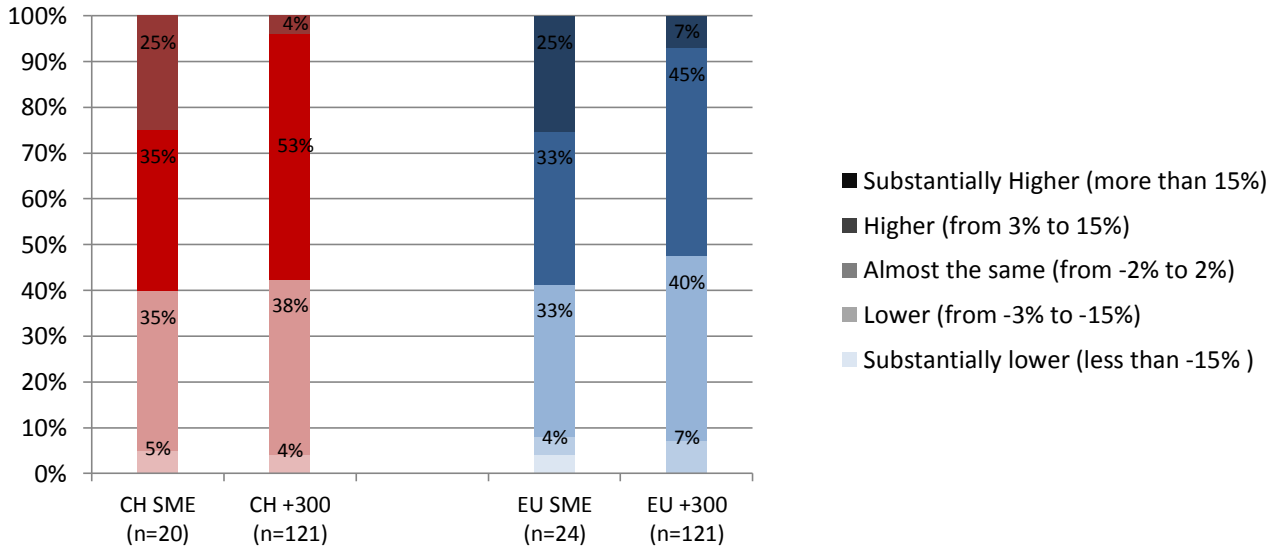
China, contrary to its portrayal in the media, is becoming a venue for SME success

Swiss and European SMEs in China are now more than ever seeing higher percentages of global sales being generated in China.



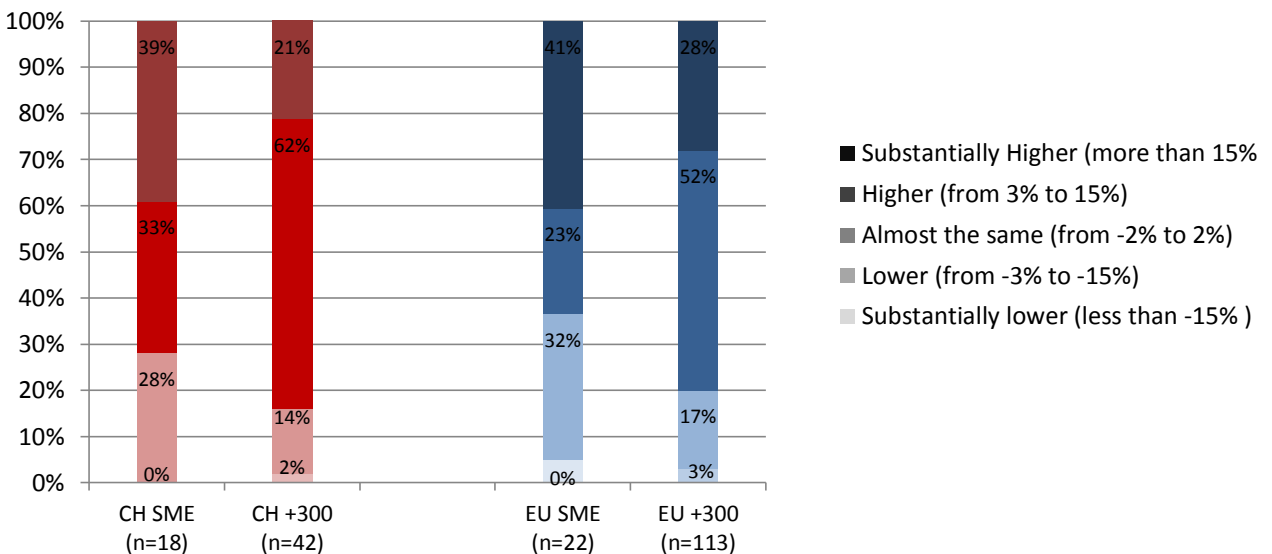
And while all companies see their sales and profits improving in 2014 on average, **respondents from SMEs see their sales increasing significantly faster than their colleagues in larger firms.**

SMEs vs. LARGER FIRMS - HOW DO YOU EXPECT YOUR COMPANY'S CHINA PROFIT FOR 2014 COMPARED TO 2013?



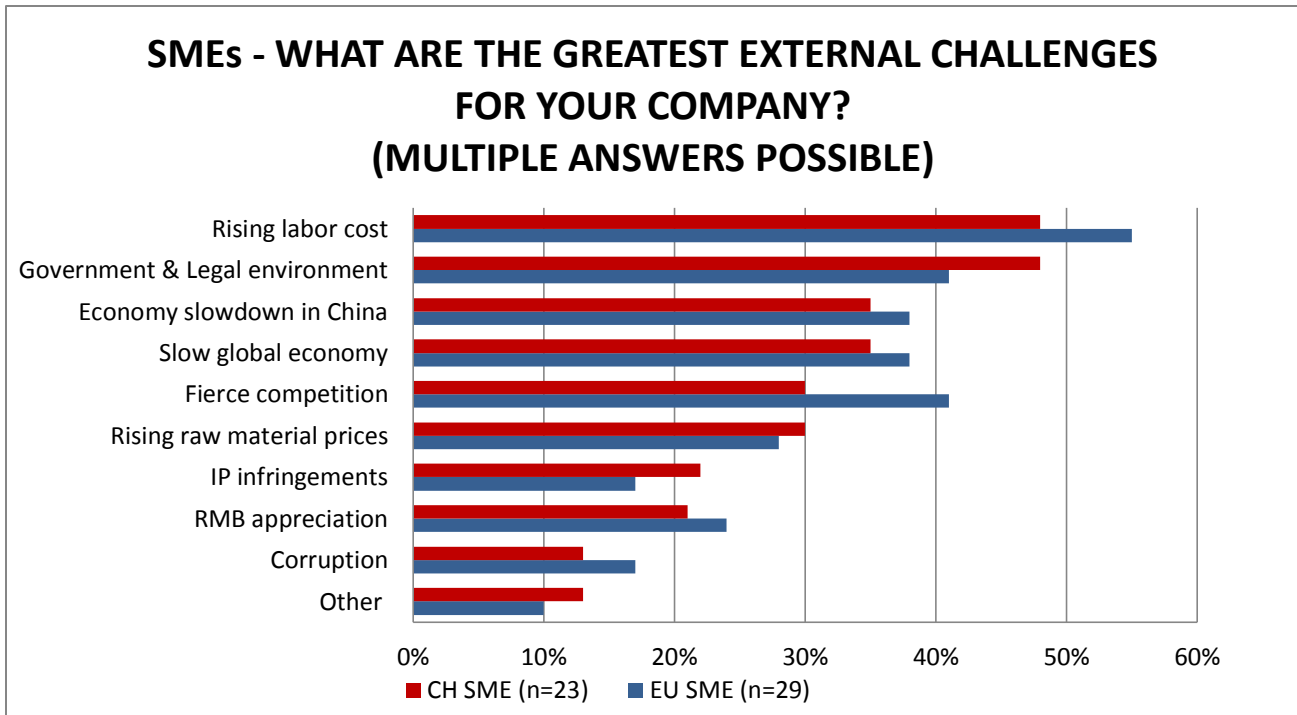
In terms of sales growth the picture is more uneven with more SMEs doing much better than larger firms while at the same time a larger number are not doing as well.

SMEs vs. LARGER FIRMS - HOW DO YOU EXPECT YOUR COMPANY'S CHINA SALES FOR 2014 COMPARED TO 2013?



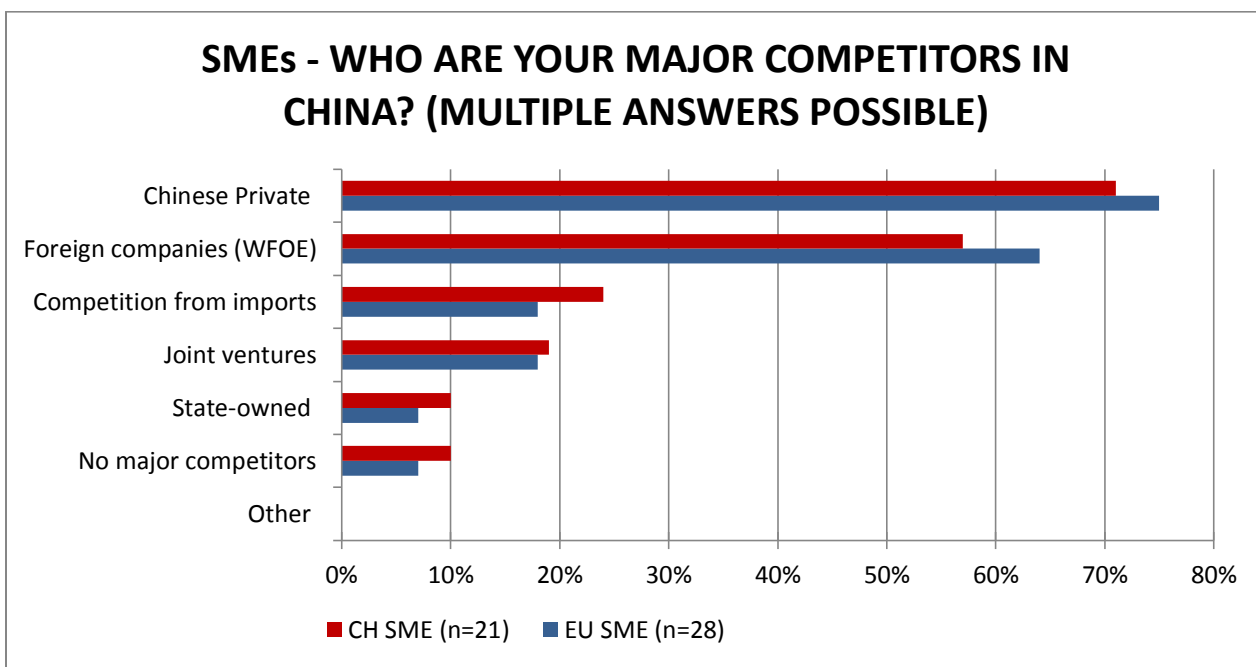
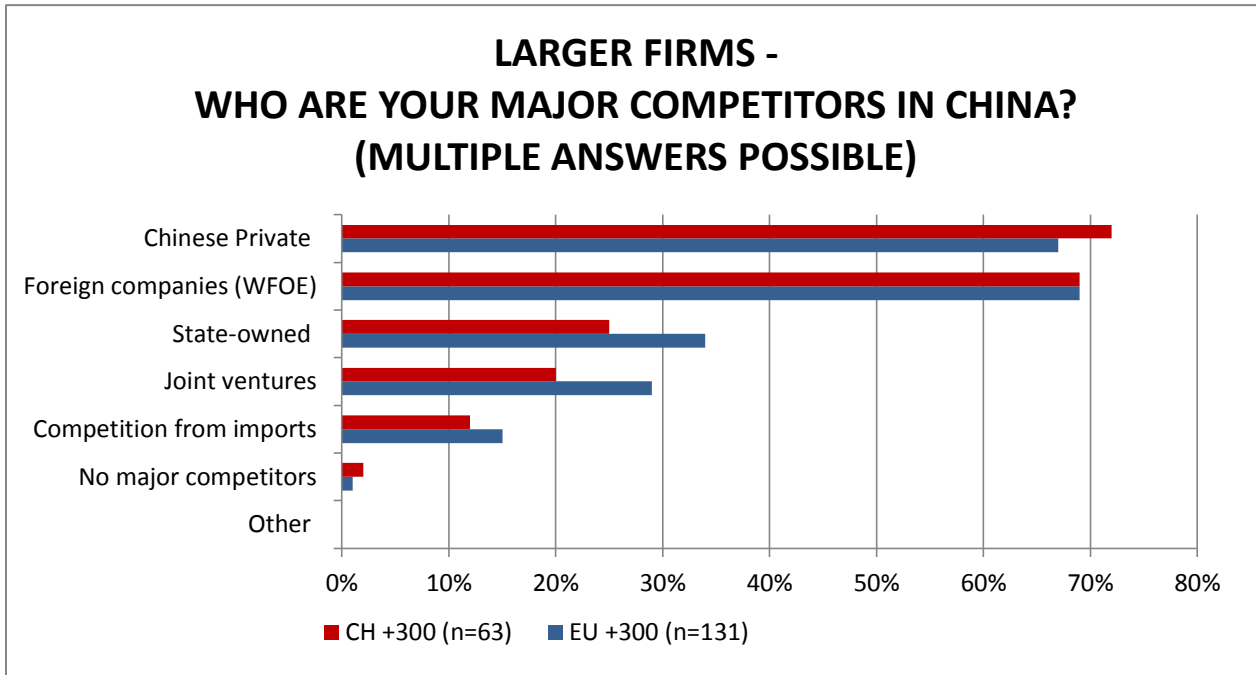
A possible reason for the success of SMEs is an environment that is less competitive for them. Indeed **“Fierce Competition”** comes quite a few steps lower in the ranking of external challenges they face when compared to the larger firms. In addition and very interestingly, SMEs rank their external challenges lower than their larger counterparts, with the exception of **“Government & Legal Environment.”**

For example **“Rising Labor Costs”** is mentioned as a challenge by 50% of SMEs but close to 60% of larger firms. **“Economy Slowdown”** is mentioned by less than 35% of Swiss SMEs but by close to 50% of larger firms.



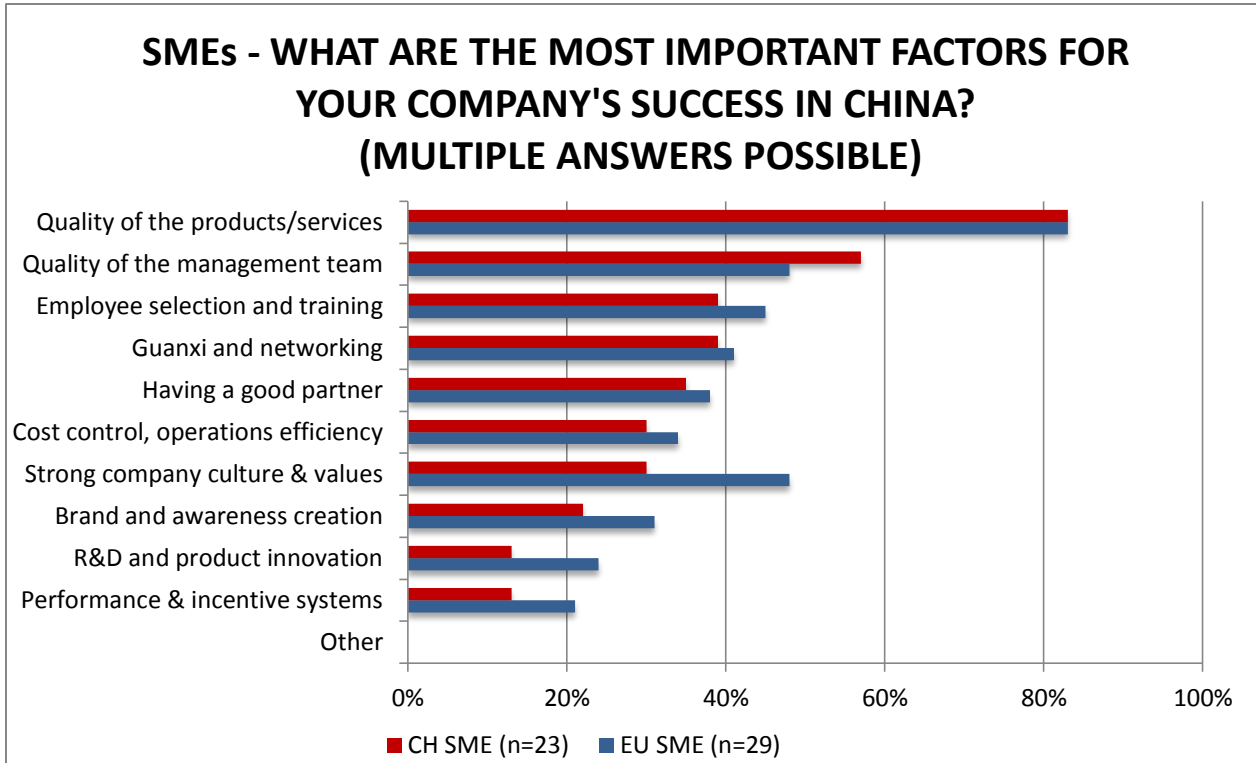
This lower level of competition and challenges could well be due to the SMEs very nature of doing business: focusing on niches. Indeed, China’s mass market is very attractive, but therefore also terribly competitive, but niches are less crowded.

This is generally confirmed by the competition picture (below): it is not fundamentally different for SMEs and larger firms with the exception that more SMEs don't have major competitors, which is typical of niche businesses.



In terms of success factors, SMEs and larger firms do not differ fundamentally either, which again speaks in favor of the niche business advantage to explain the better success level.

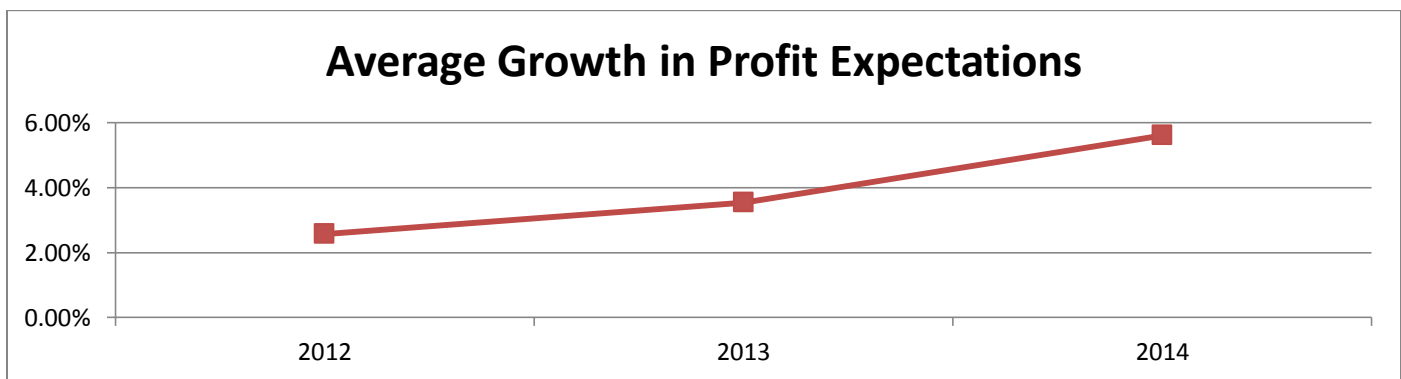
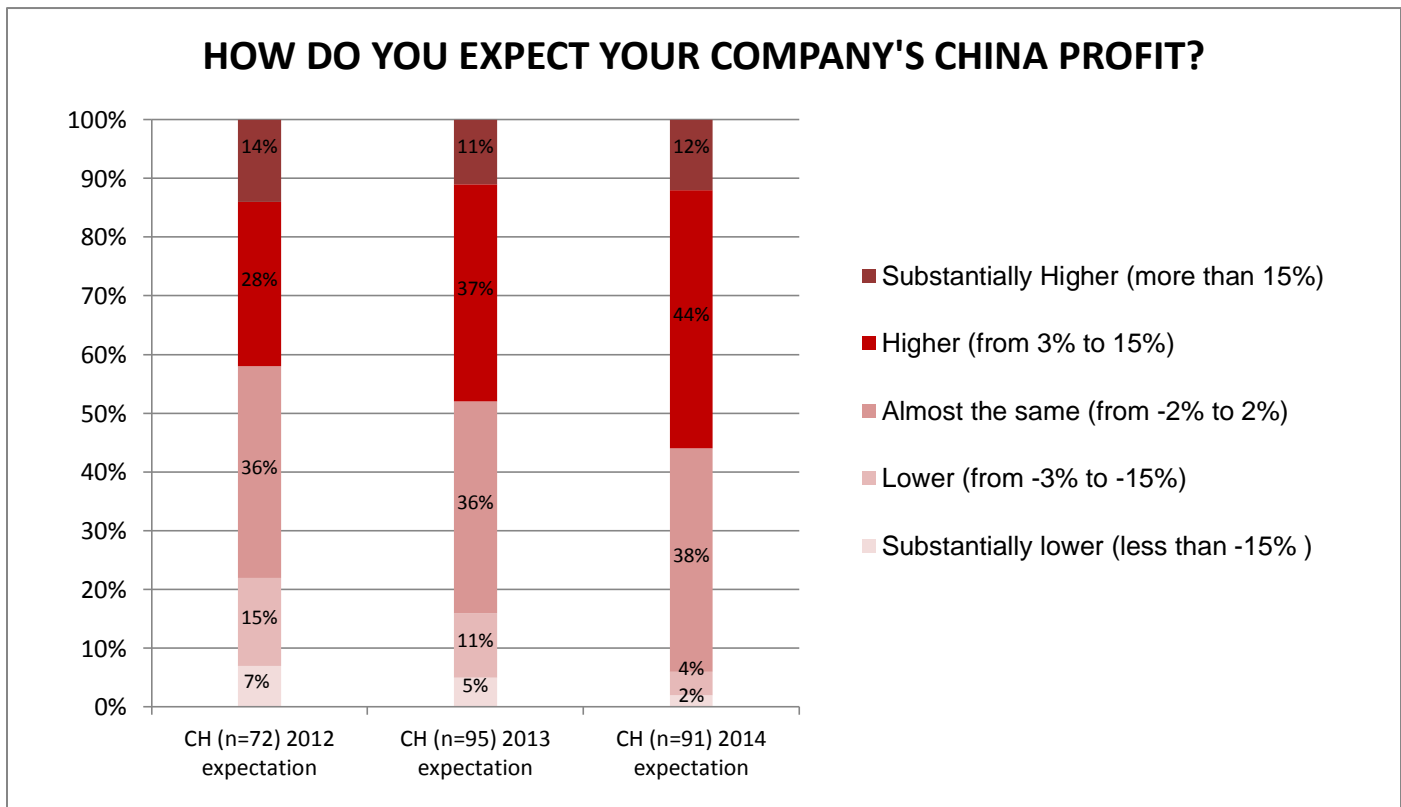
However, SMEs pay even more attention to the quality of their products and management team and they tend to rely more on their network and partners. But the latter is probably natural anywhere for smaller companies.



INCREASING REVENUES, PROFITS, INVESTMENTS AND CONFIDENCE ACROSS THE BOARD

Expectations of annual profit increase has doubled for Swiss companies since 2012

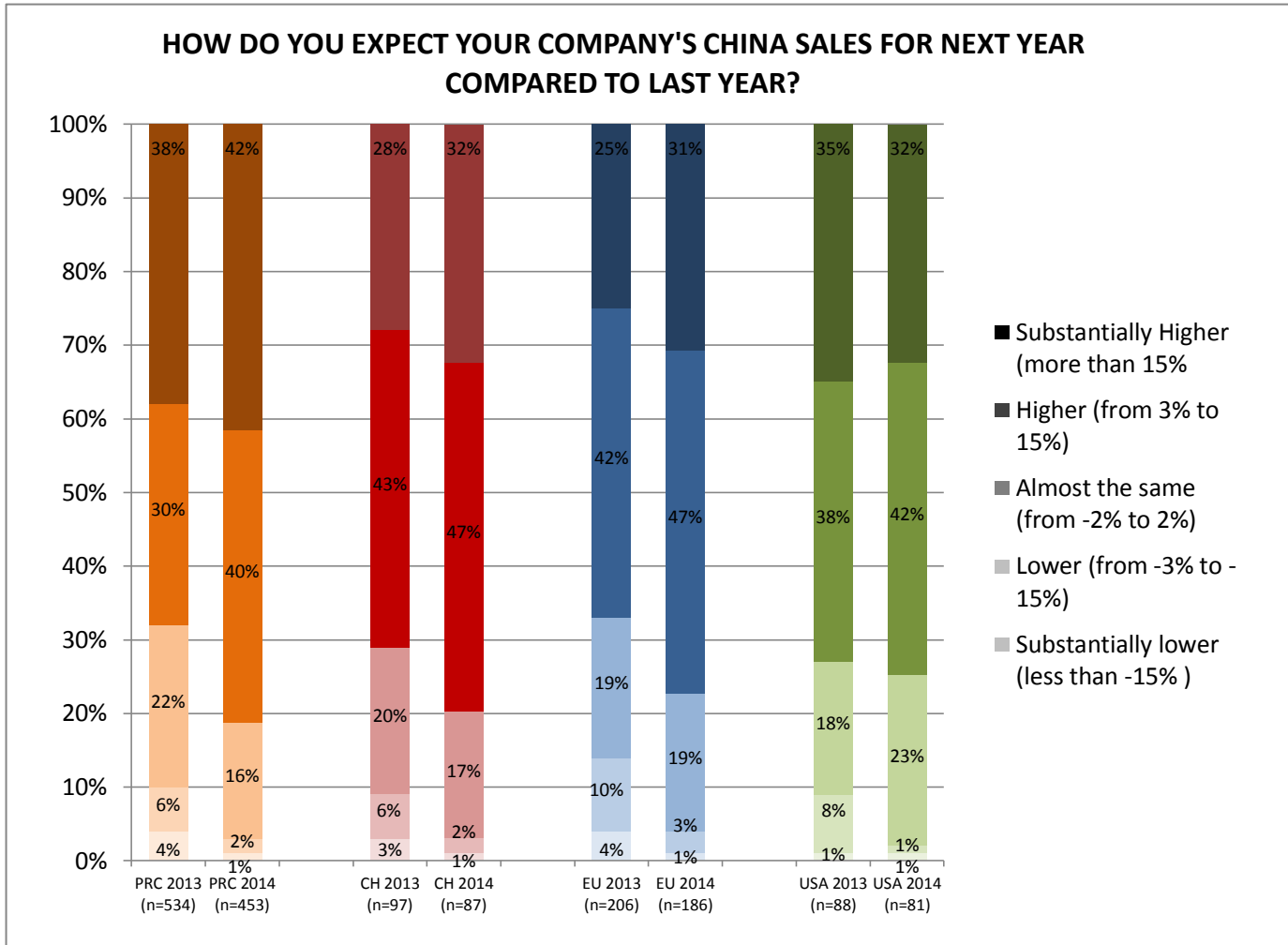
In 2014, sales and profits of Swiss and foreign companies are in continued acceleration. In 2014, Swiss firms in China expect profit increases of 5.6% on average compared to 2013. In comparison, the figure was 3.5% in 2013 and 2.6% in 2012, so that profit increases have been every year higher since 2012.

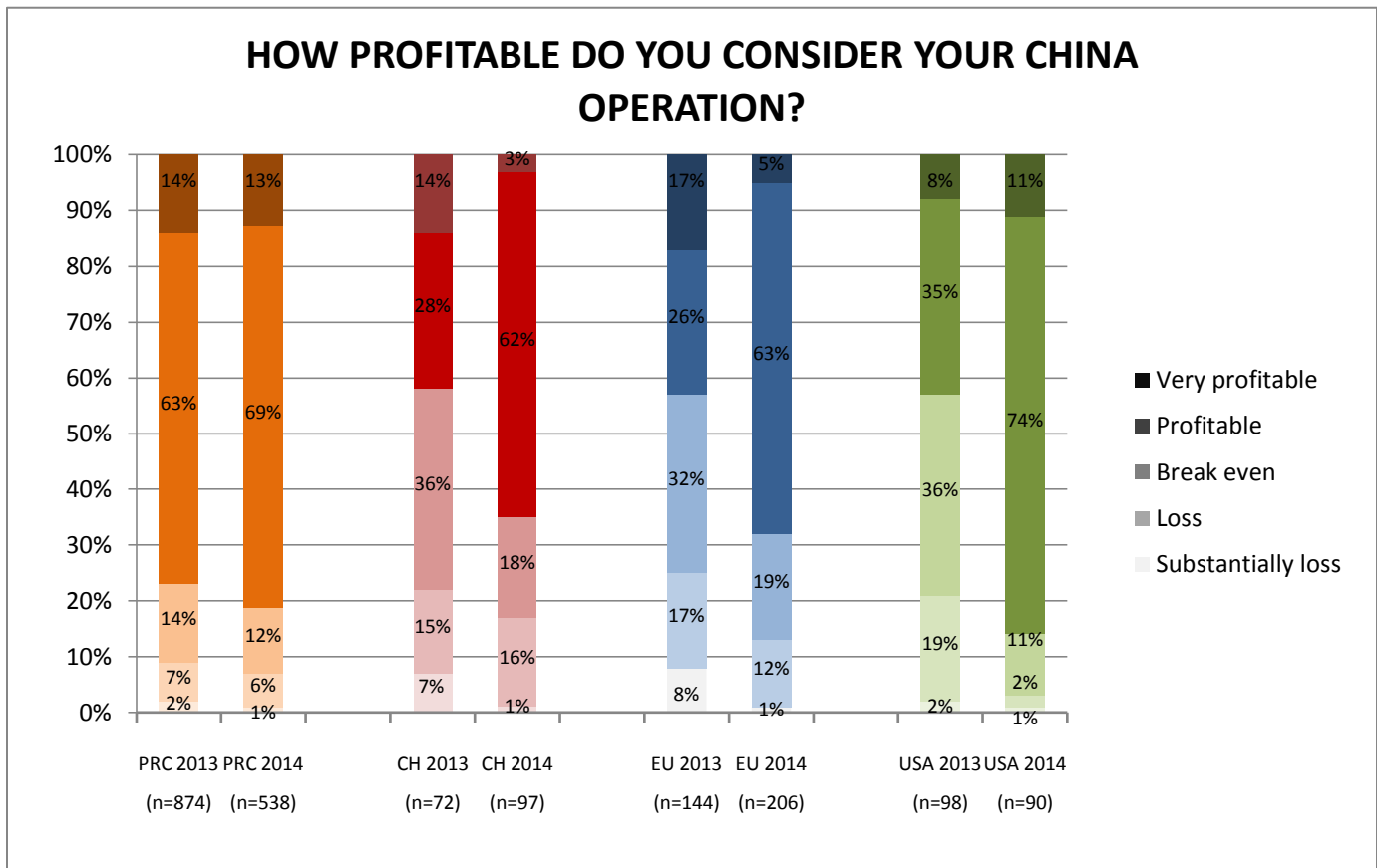


The sales growth situation is the same: **companies of all origins surveyed expect on average a stronger increase in sales in 2014** compared to 2013 and compared to the previous year.

This result may appear extraordinary in light of the media reports constantly commenting on China’s decelerating growth.

For an explanation of this paradox so read our “**Additional Analysis: What Growth for Businesses in China in the Coming Years**” at the end of this report ([Page 34](#))





While American (USA) companies are increasing their profitability rather than their sales, the answers of Swiss (CH) and European (EU) respondents are tightly matched both on revenue and profits.

Investment plans in China naturally follow profits and remain a top priority

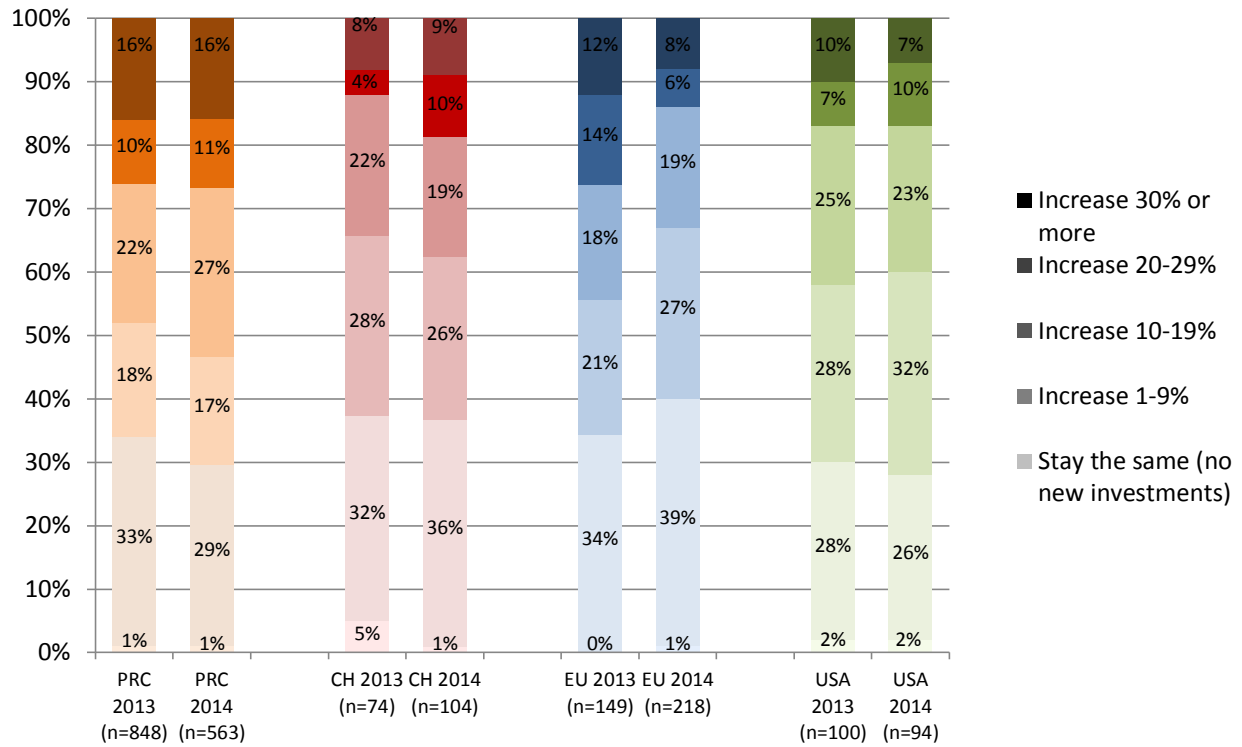
Based on the profit and revenue picture, **it is not surprising to see that growing investment plans and investments in China command a high priority.**

64% of the Swiss companies surveyed plan to increase investment in China in 2014 and more than half of them consider China as a top 3 investment destination.

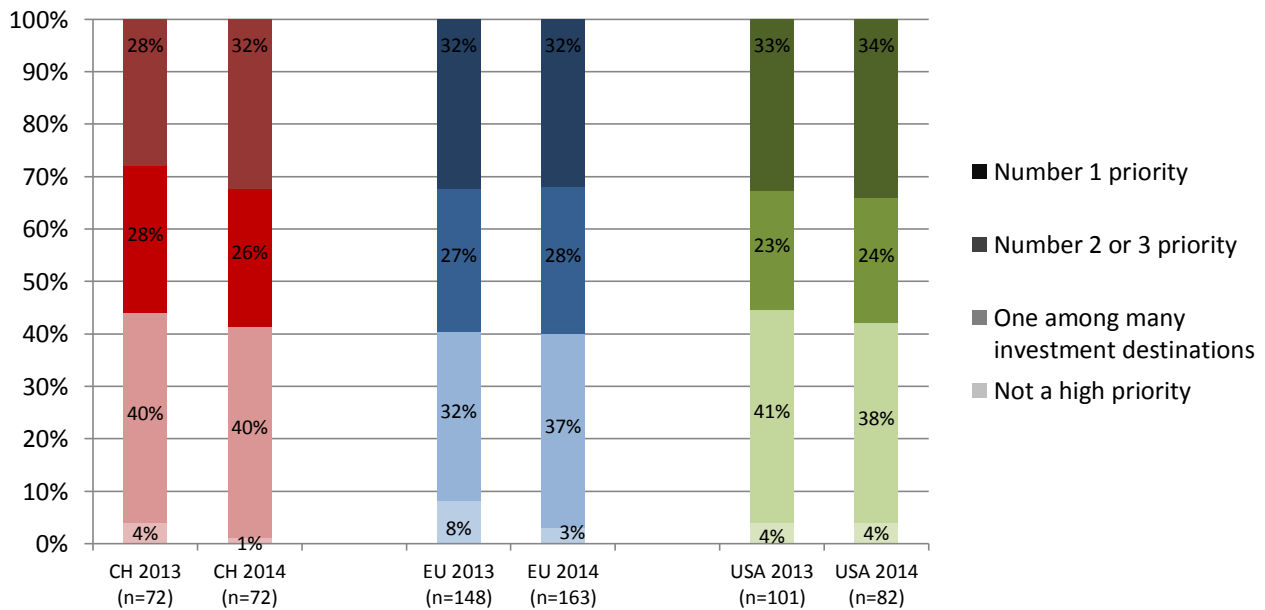
Despite their lower level of confidence, the **Chinese firms are clearly the most aggressive investors**, planning to accelerate their investments importantly in 2014 compared to 2013.

Although Chinese respondents' confidence is lower than foreign firms, it is interesting to note that Chinese nevertheless intend to invest more than their foreign competitors. This indicates either more appetite for risk or a different way to rate confidence, but in any case it shows a definitely positive outlook from Chinese firms as well.

WHAT INVESTMENT DO YOU PLAN IN CHINA?

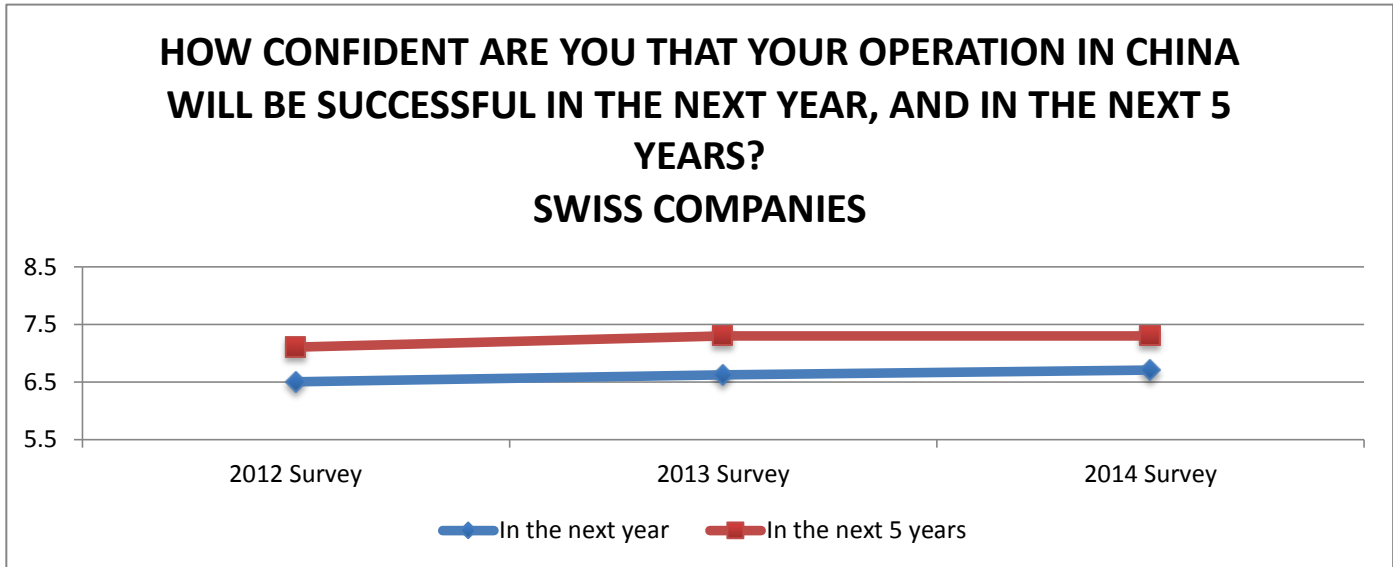


HOW DOES CHINA RANK IN YOUR GLOBAL INVESTMENT PLAN?

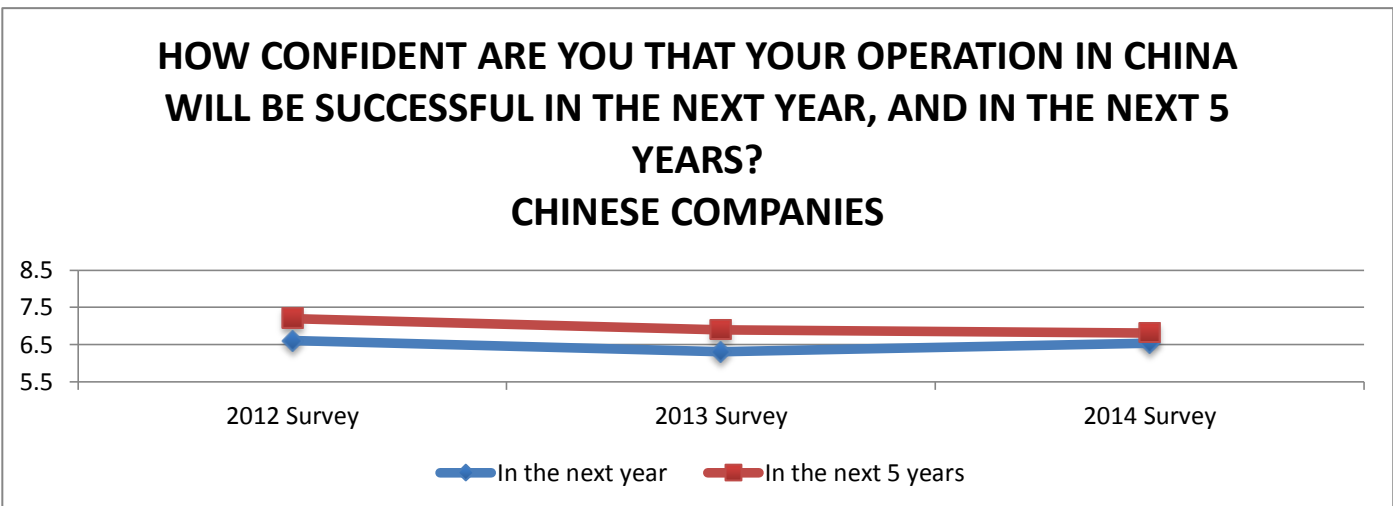


Swiss respondents remain the most confident

Swiss respondents are more positive than all others and particularly on the long term: for the next 5 years, respondents are more than “confident” (7 on the scale) on average that their operations in China will be successful.



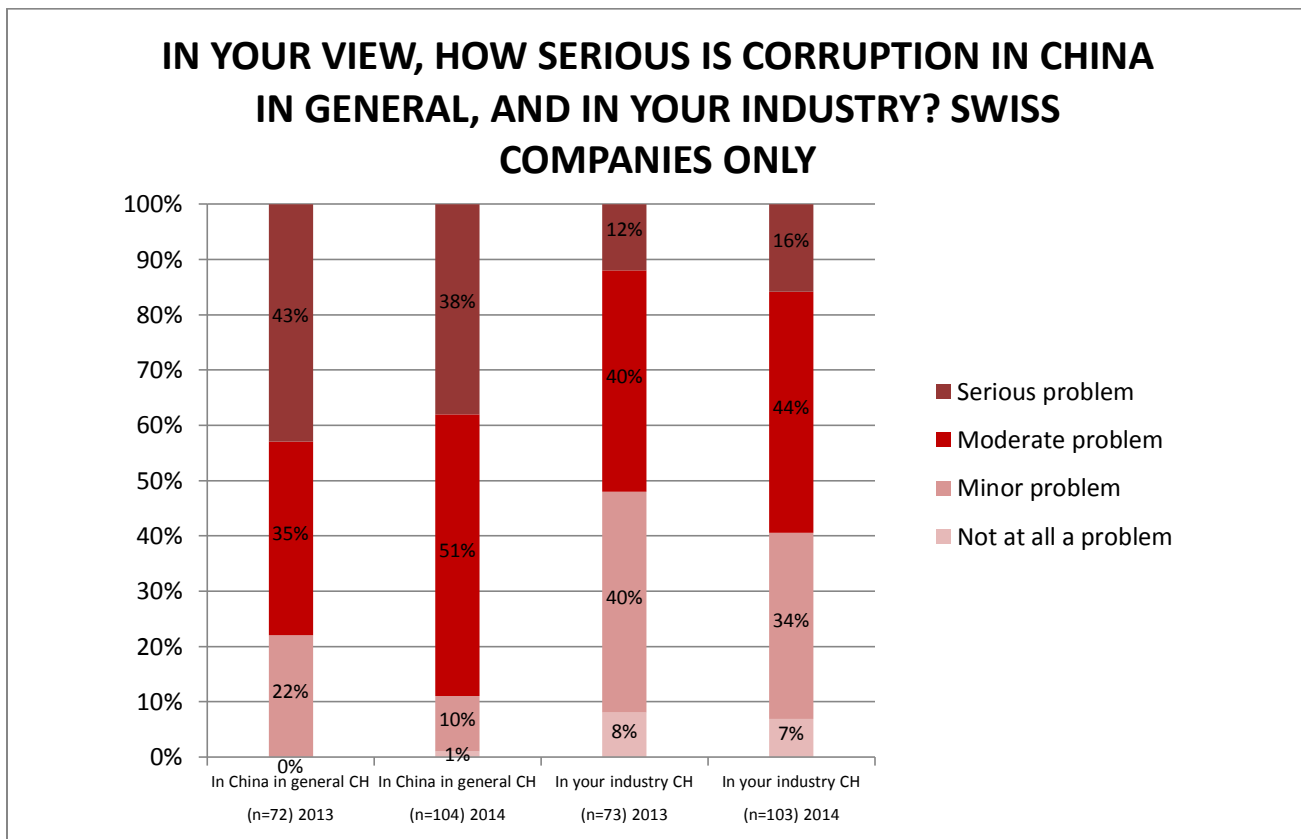
Other companies are quite confident (the Chinese are charted below, the EU and US firms confidence level is very similar) but they don't expect as good results as the Swiss do in the long term.



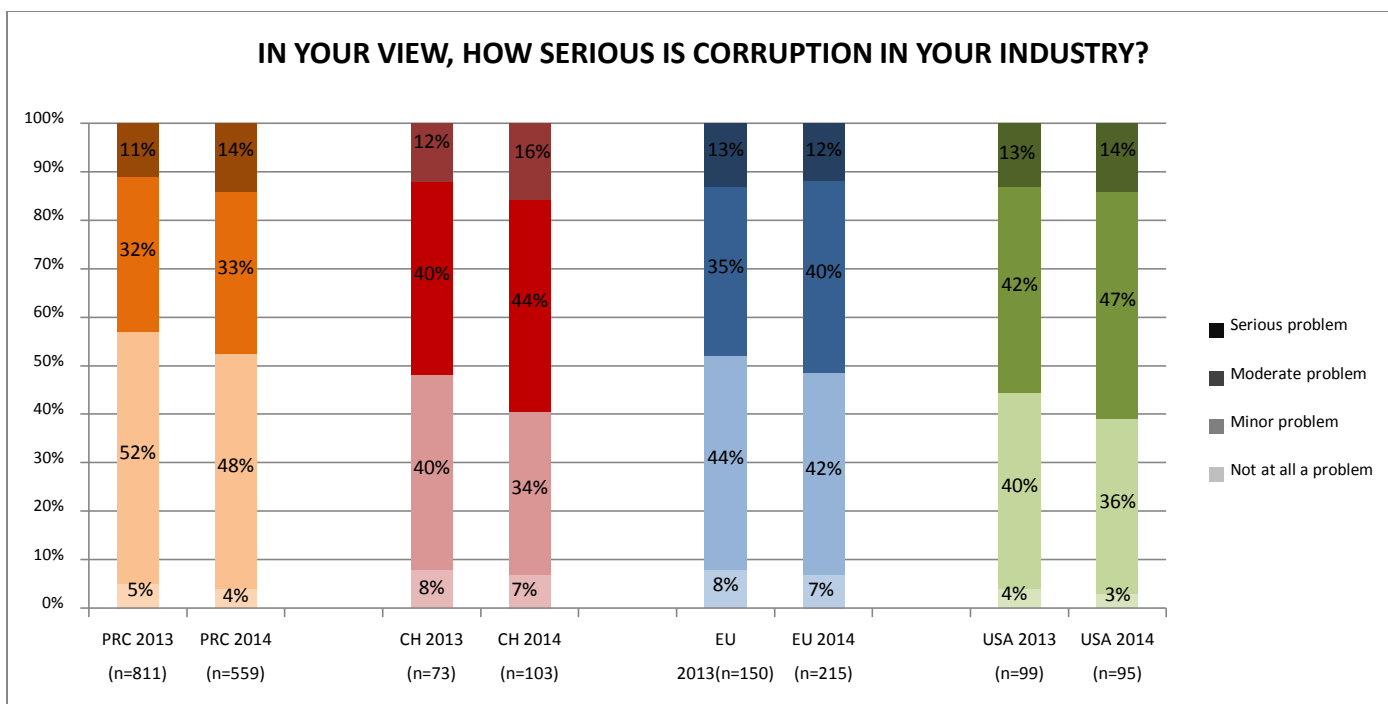
A WIDE PERCEPTION GAP BETWEEN VIEWS FROM CHINA AND SWITZERLAND

Corruption & legal environment

When asked if **corruption** is important **in China in general**, a sizeable proportion (**38%**, almost 2 out of 5) of Swiss companies see it as a “**serious problem**.”



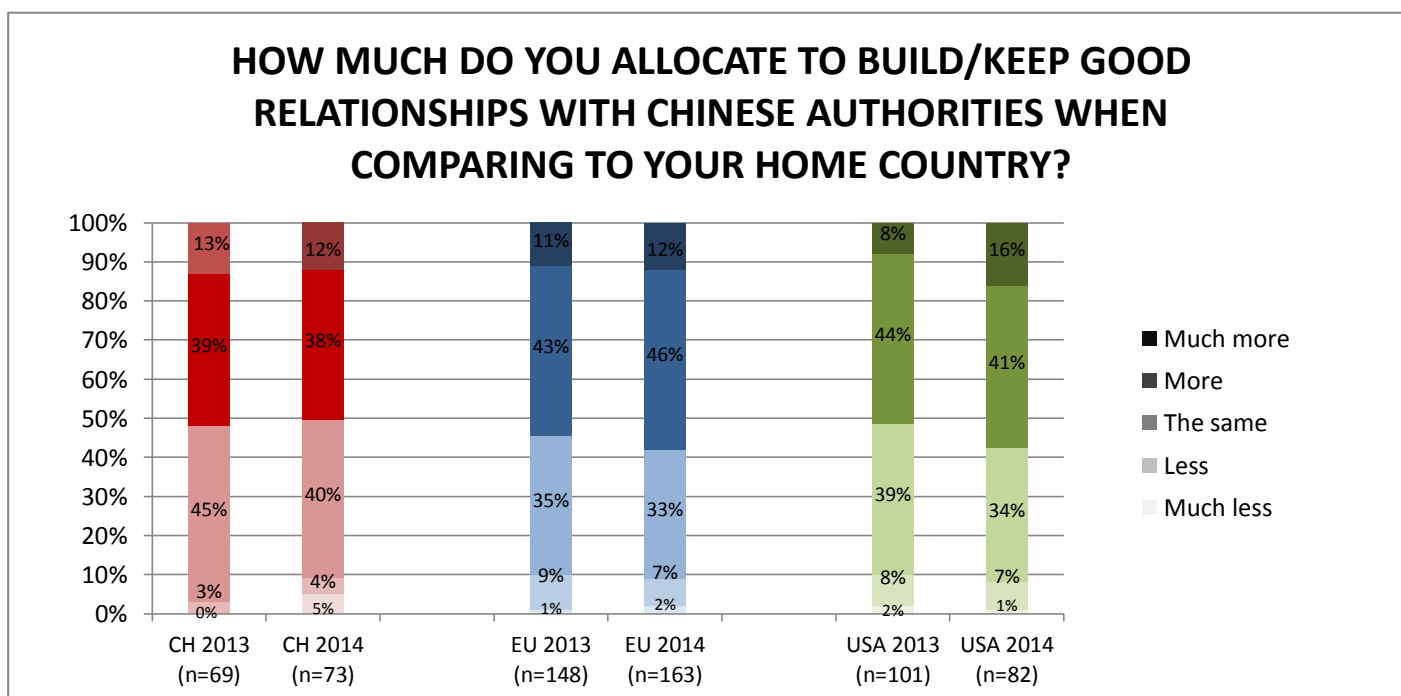
However, when asked how serious corruption is **in their industry**, around 78% of the respondents see it as a “moderate” or “minor problem.” **Only 16% (1 out of 7) Swiss companies** say that corruption is a **serious problem** in their industry. Interestingly, the picture is very similar for other foreign companies **as well as for Chinese companies**.



These paradoxical answers highlight a critical phenomenon. On one hand, there is the general feeling that “China is corrupt”, fueled by scandals and countless anecdotes, which is also the aspect that foreign media report on.

On the other hand there is the reality of doing business in China, where corruption is one of many issues to deal with, though certainly not the most important one as shown by **the low ranking of corruption in terms of challenges** (See “Challenges to Overcome for Success”, [Page 21.](#))

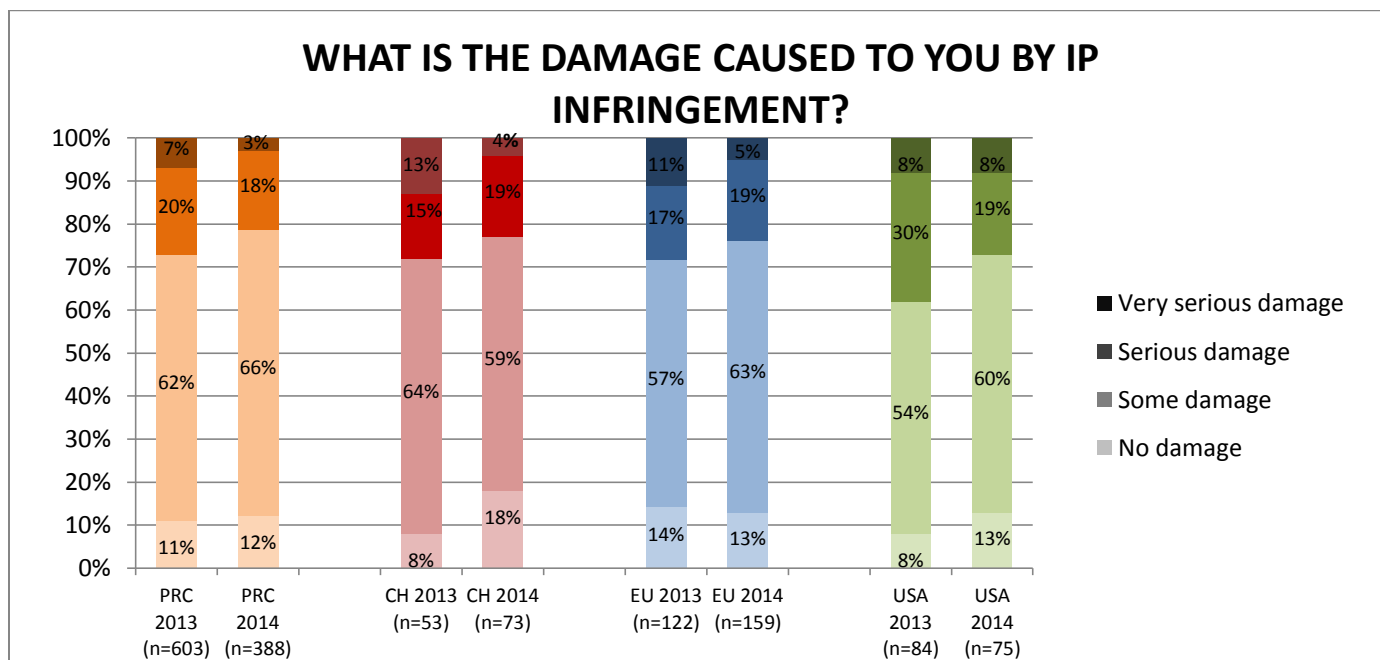
In terms of evolution, the perception of corruption has increased in 2014 compared to 2013, despite the anti-corruption drive of the government. On the other hand, companies allocate fewer efforts to deal with the government than previously, so that we may expect corruption to go down in the 2015 survey.



Intellectual property

A strong misperception that foreign companies are seriously affected by intellectual property infringements in China also prevails in home countries. While it is true that IP infringements occur in China more than elsewhere, the damage they generate is not as serious as one would expect. Close to **80% of Swiss companies report “some” or “no damage.”**

More importantly, all companies, regardless of national origin, including the Chinese, suffer from IP infringement in very similar ways. Moreover, **the trend clearly shows an improving situation** for all respondents.



Contrary to the general perception, **there is clearly no discrimination against foreign companies in the protection of IP.**

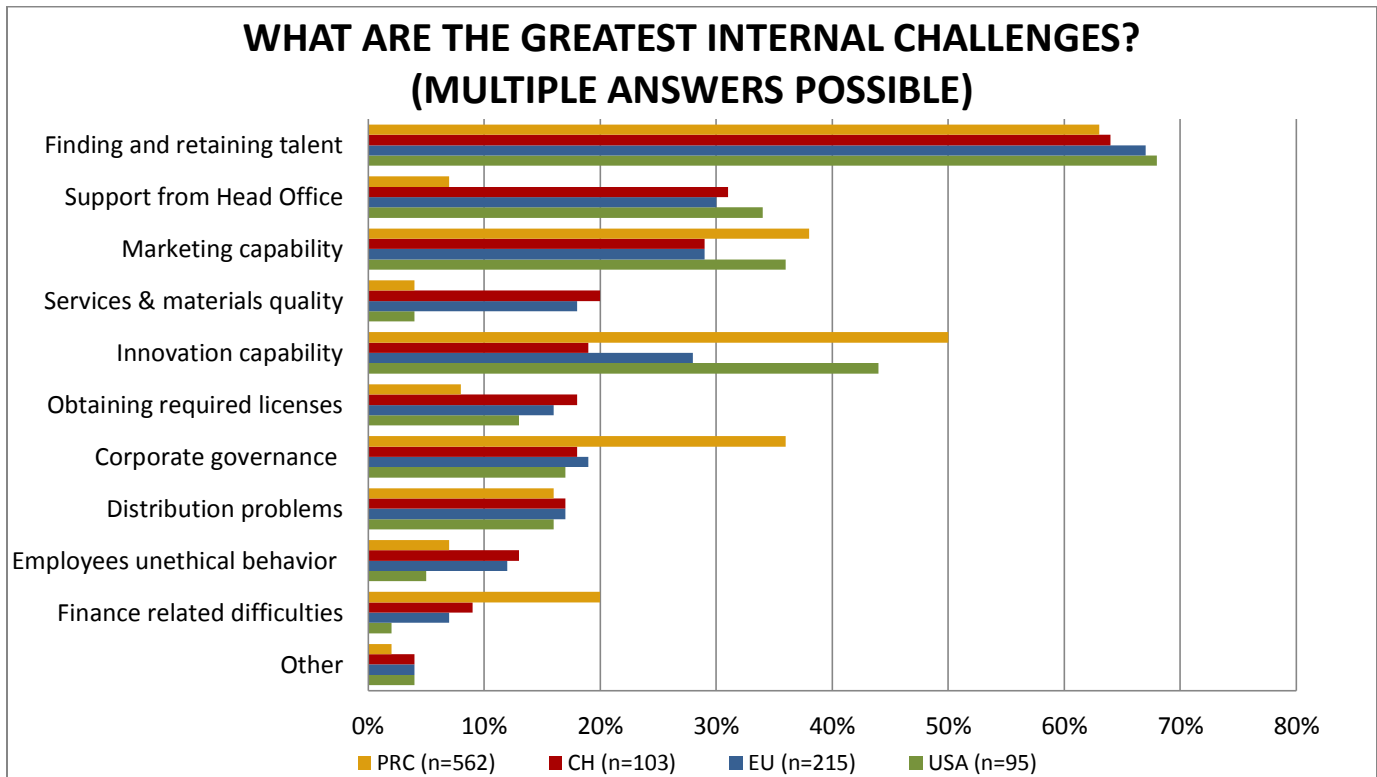
Again, these survey results highlight the widening gap between the perception of China from abroad and the actual situation for managers on the ground.

Challenges to overcome for success

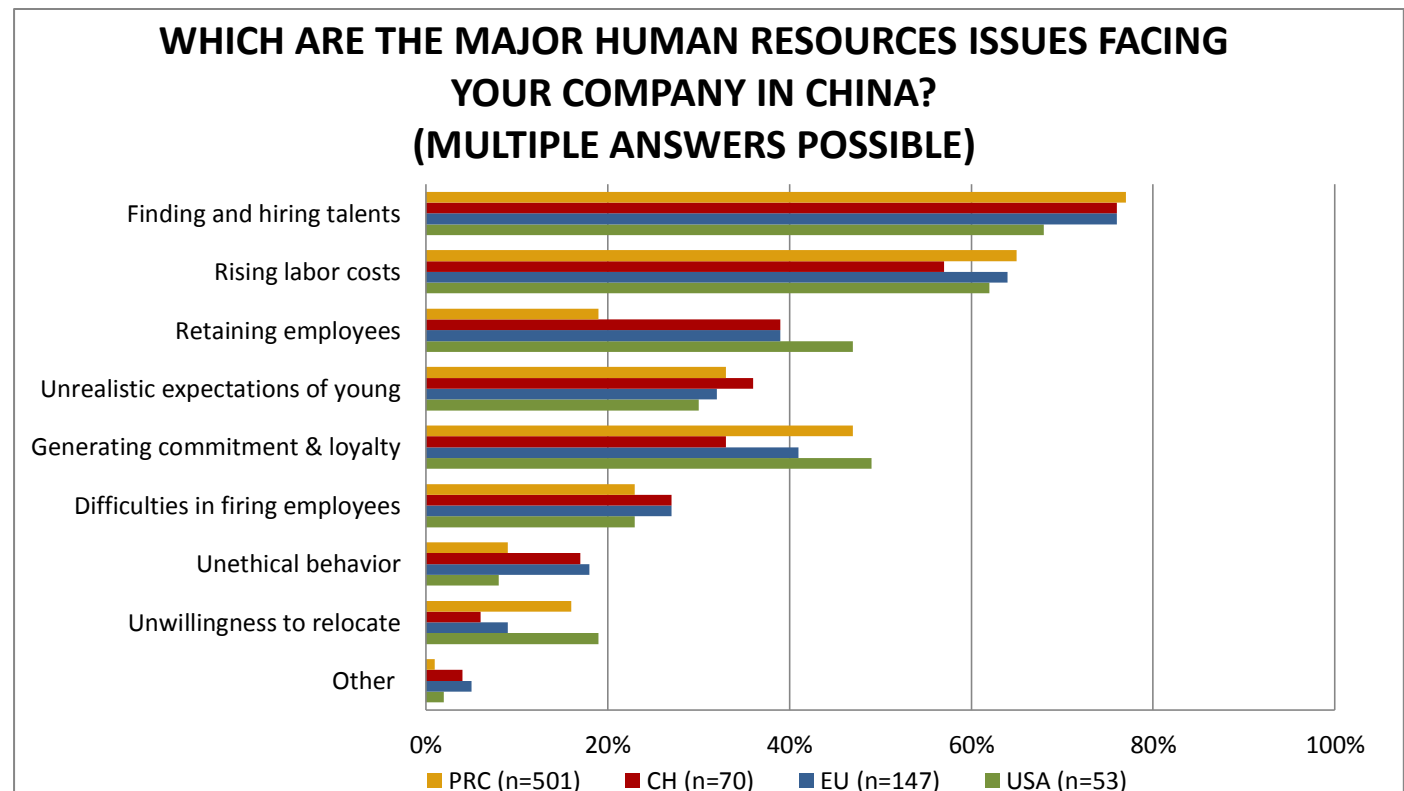
The key management challenge remains finding and retaining human resources (HR). As a consequence, **human resources remain a central element for success**, as it has been since we started surveying companies 7 years ago. **The HR challenge has, however, eased** since last year: a bit over 60% of Swiss companies mention it while they were close to 80% a year before.

However, for the second year in a row, “Lack of understanding and support from the head office” is the second most important management challenge for international companies and an issue for 30% of them, confirming the perception gap when seeing China from abroad and managing in China. This also indicates that bridging this understanding gap will support the business development of Swiss and foreign companies in China.

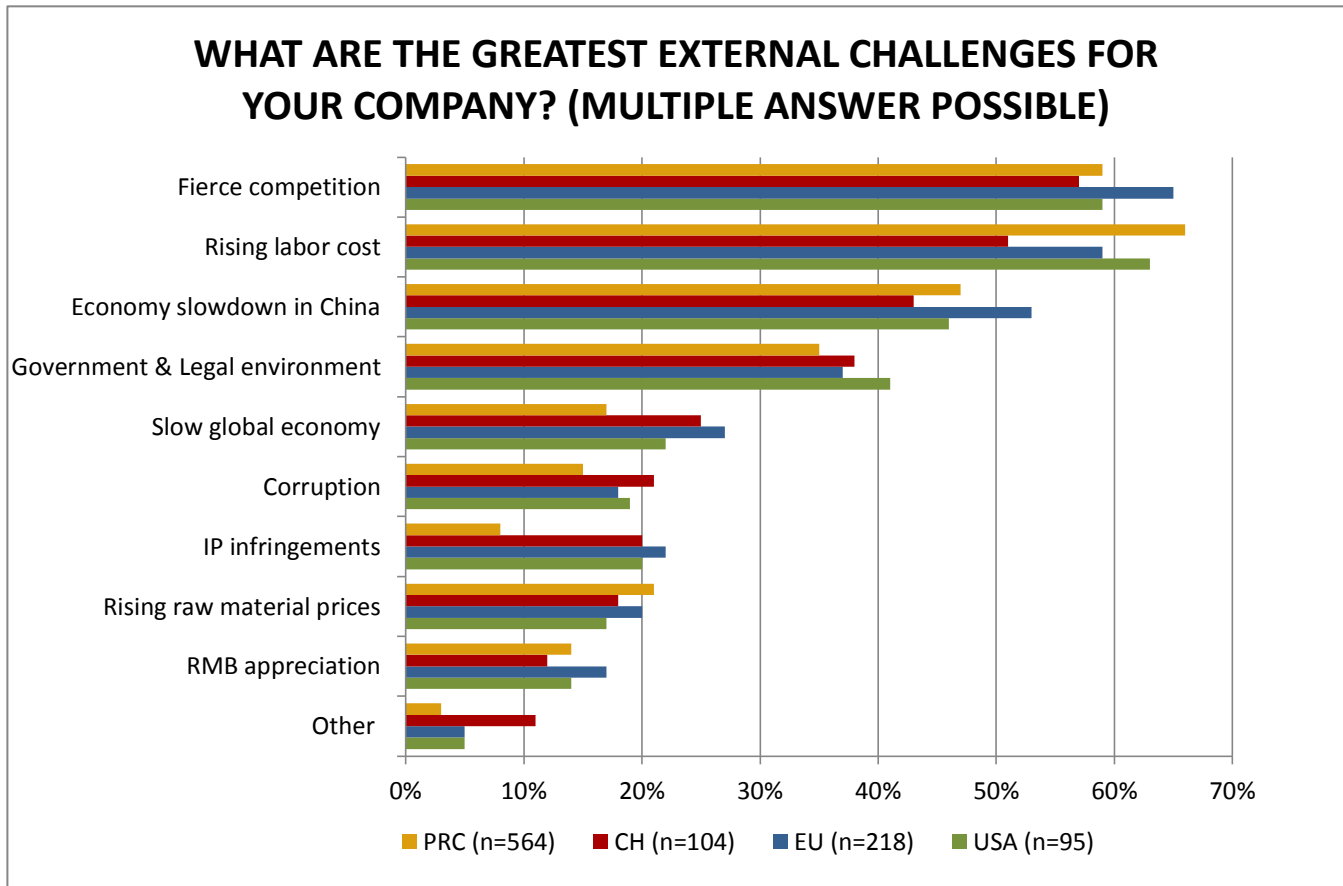
Marketing capabilities are also an issue for close to 30% of Swiss companies.



HR issues in general, while critical, are perceived less acutely by respondents and particularly Swiss companies. Our last survey had 80% of them mentioning “Rising labor costs” as an issue while in 2014 it is less than 60%. The same is true for “Retaining employees”: over 50% last year and less than 40% today.

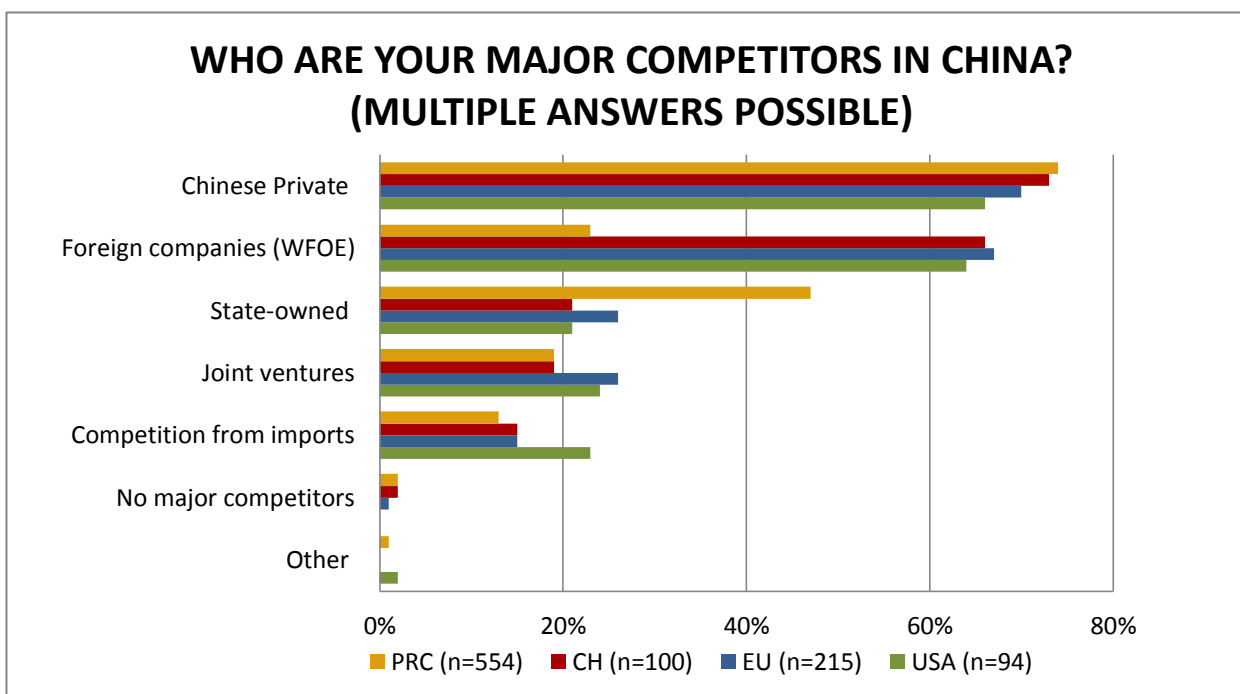


In terms of external challenges, when compared to last year, competition is further intensifying while the rising costs of labor affect companies a bit less.



A first: private Chinese players pose the most competition

Most interestingly, international companies in China perceive local private players as their greatest competitors, a marked shift from the past years where such companies reported international companies as posing the greatest competition.



This perspective is shared by Chinese companies that see Chinese private companies as their most important competitors by far.

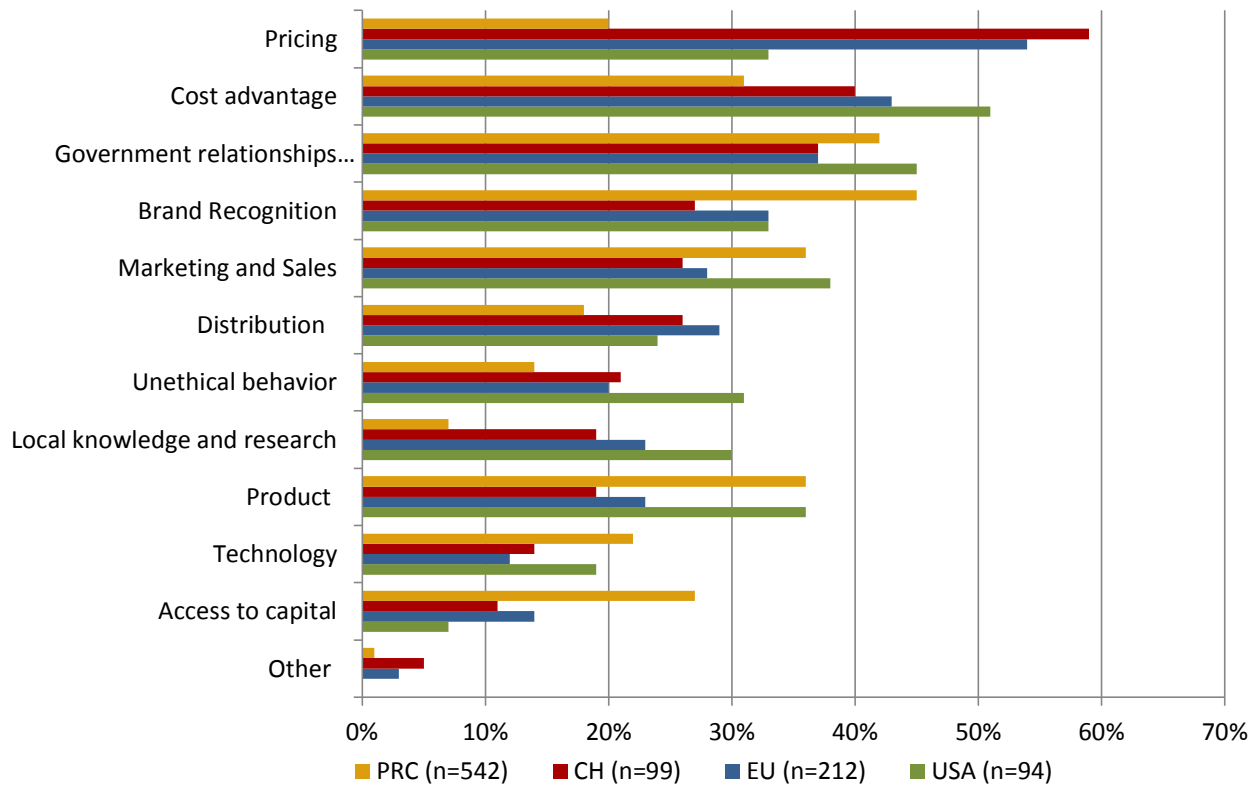
Besides, **competition from Private Chinese companies is only likely to become fiercer** as the Chinese government is due to support the private sector with more incentives as part of its economic reform agenda.

For Swiss companies particularly, the very competitive landscape is once more highlighted by the fact that “pricing,” “cost advantages,” and “government relations & network (guanxi)” are clearly perceived as the competitors’ main advantages.

The picture is very different for Chinese companies however, who see the main advantages of their competitors to be “brand recognition”, “government relations & network”, “marketing and sales” as well as “product.”

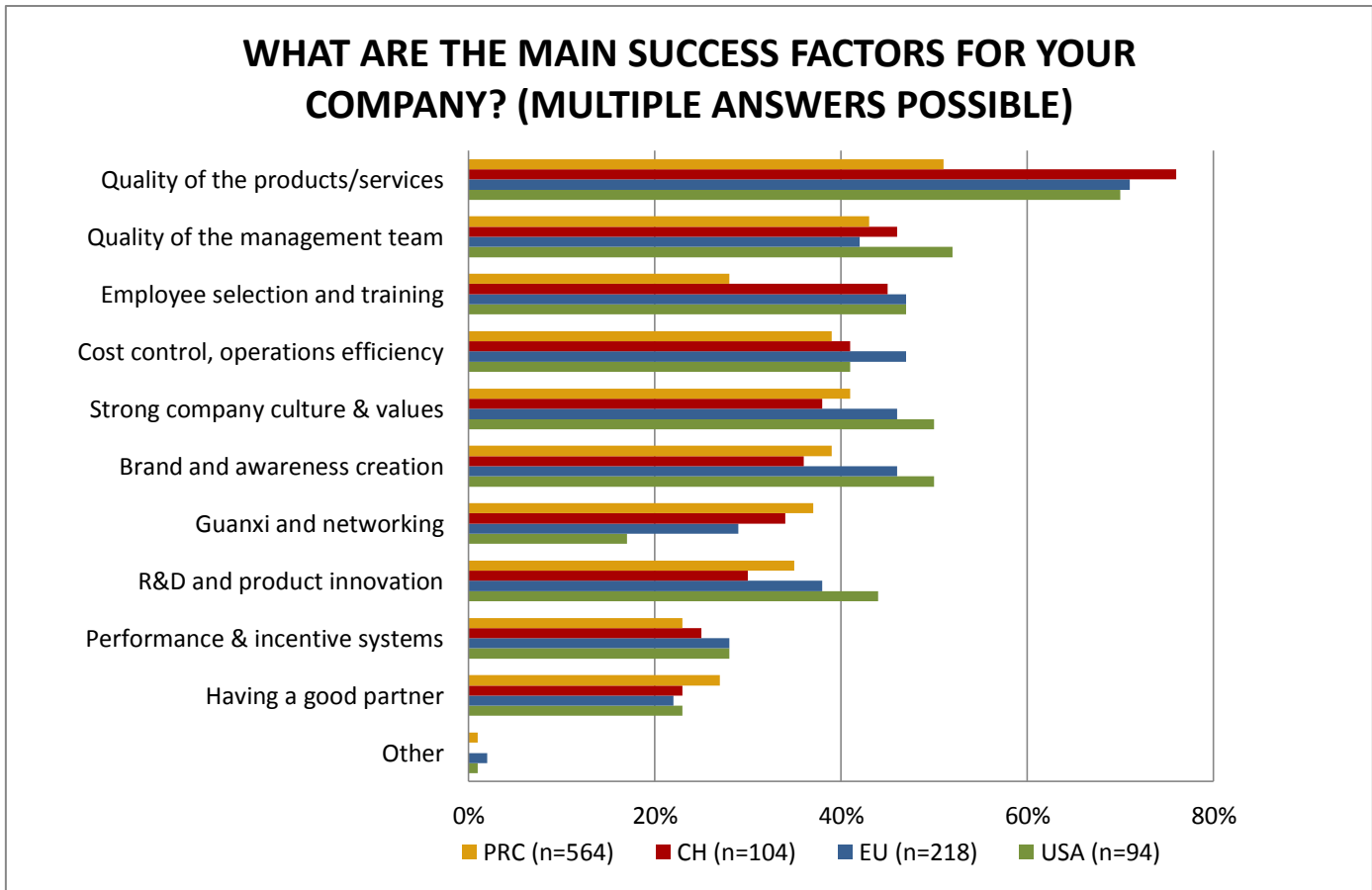
All in all, **foreign companies still compete on product and brand performance against their Chinese counterparts having cost and relationship advantages.**

WHAT ARE THE COMPETITIVE ADVANTAGES OF YOUR MAIN COMPETITORS IN CHINA?



The key success factors: superior product quality and human resources

Key factors of success clearly are first the “**superior quality of the products/services**” and **human resources** (HR) with “Employee selection and training” and “quality of the management team.” This is naturally coherent with HR being singled out as the greatest management challenge.

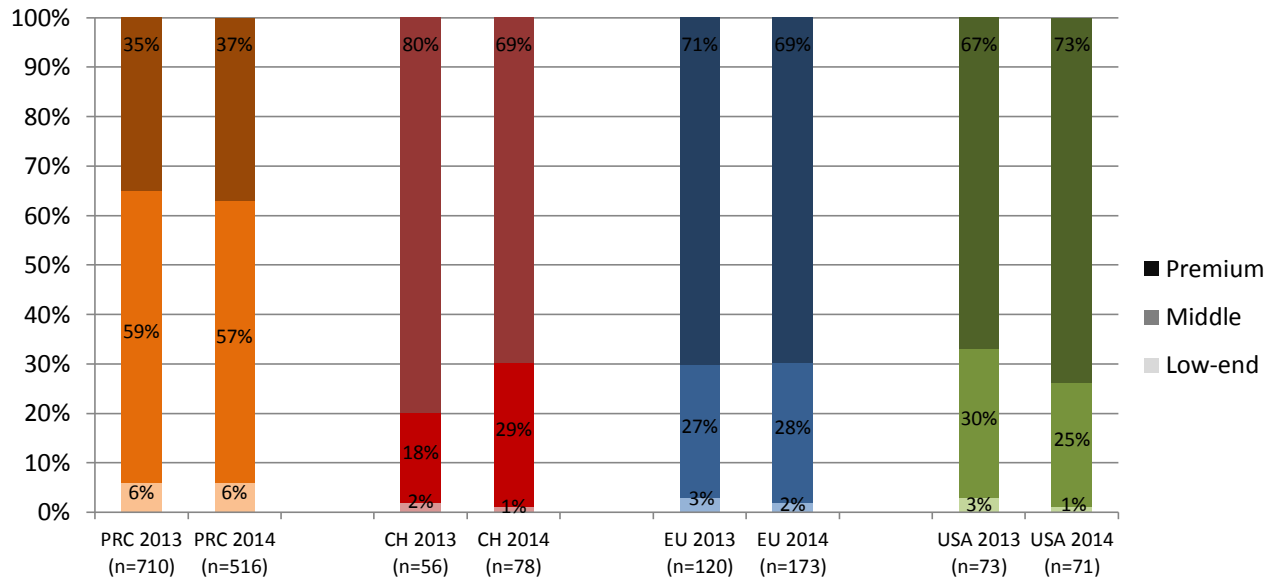


The focus on superior products/services by foreign companies is understandable when keeping in mind the heavy competition and the need for differentiation through quality versus price.

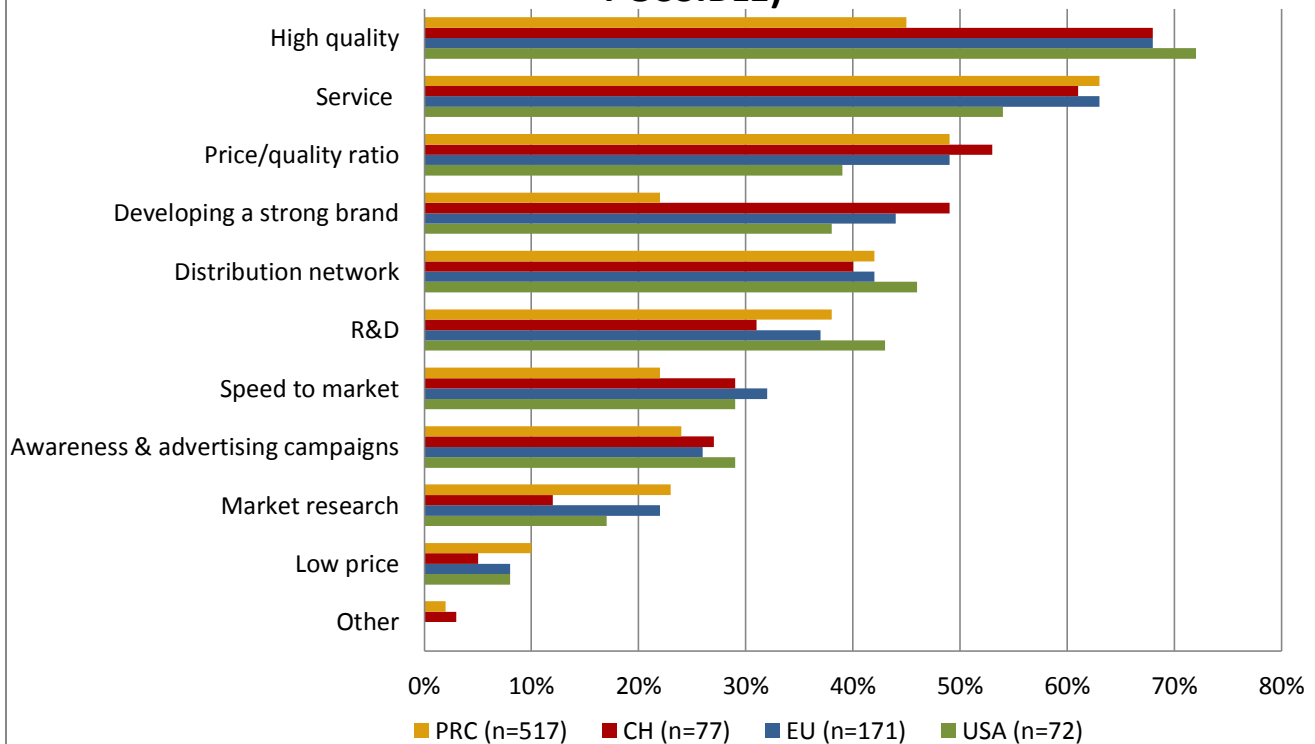
Foreign companies maintain and grow market shares and profits by offering products that Chinese companies will find difficult to offer in terms of quality. This also explains why foreign companies in China have been competing as much with foreign competitors as with Chinese ones.

The high-end focus is also clearly illustrated by the market segments targeted by the different companies. **Foreign players are by far mostly focused on the premium segments.**

WHICH IS YOUR MAIN MARKET SEGMENT IN CHINA?

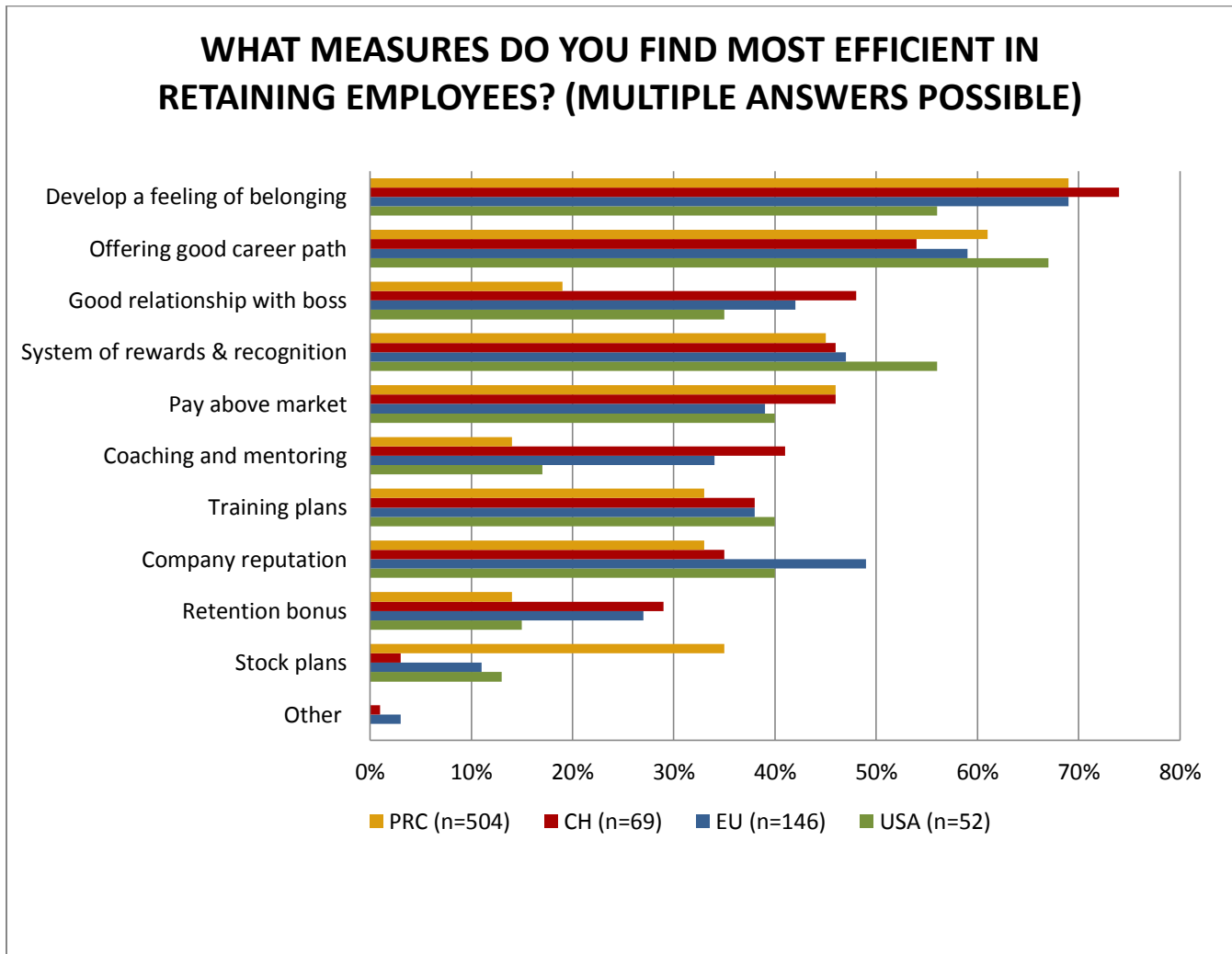


WHAT ARE THE MOST IMPORTANT FACTORS ON THE SUCCESS OF YOUR SALES IN CHINA? (MULTIPLE ANSWERS POSSIBLE)



To deal with the critical HR issue and in order to retain employees, “paying above the market” is not the main solution used by foreign companies. Actually, “**offering a good career path**” and “**develop a feeling of belonging**” appear to foreign and Chinese companies alike as a more efficient tool for retaining employees, as it offers opportunities for promotions and the perspective of substantial salary improvements. Almost as important is to provide “**rewards and recognitions**” to those who deserve it.

Swiss companies stand out by considering “**good relationship with boss**” as another efficient tool to retain employees.

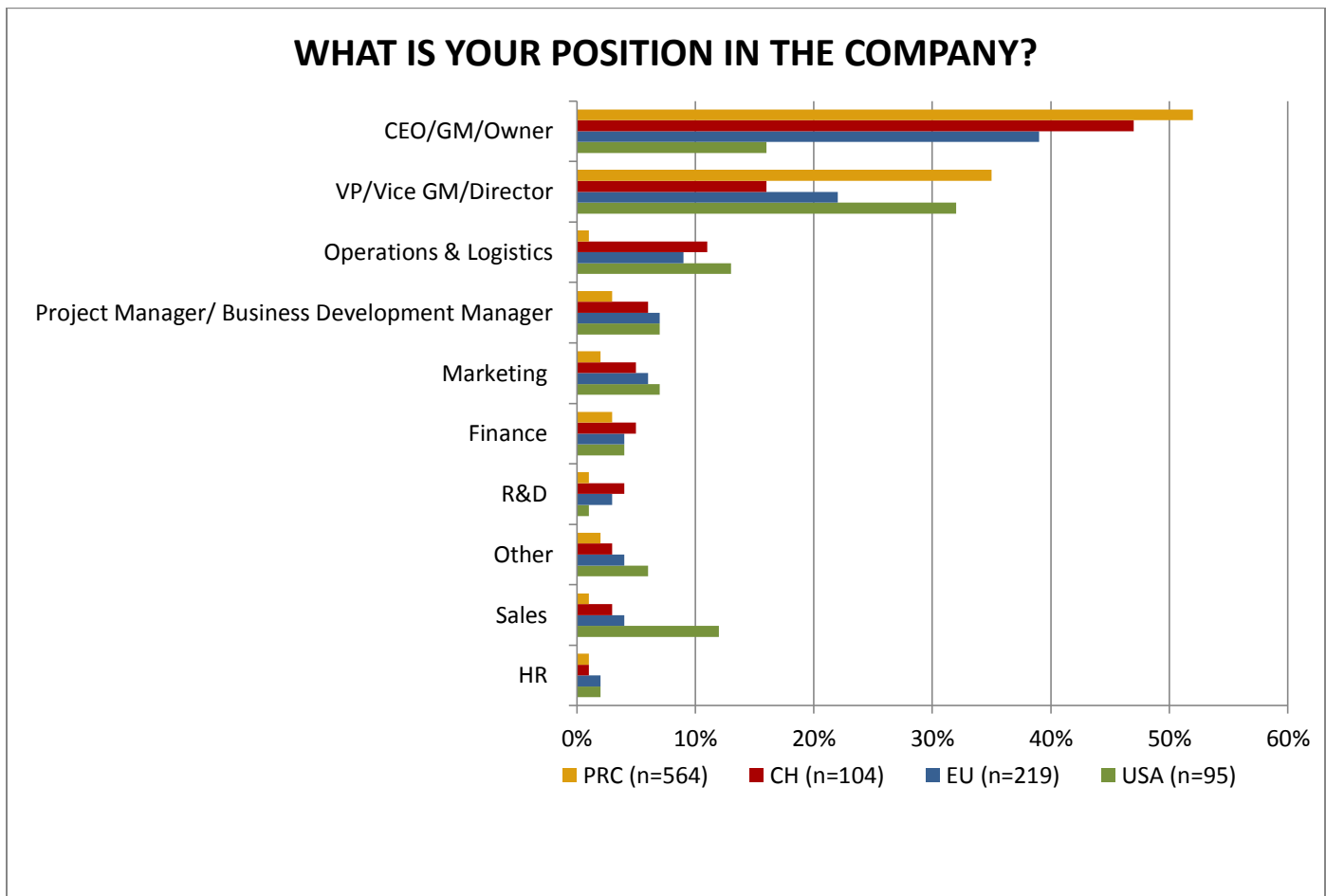


RESPONDENT COMPANIES DEMOGRAPHICS

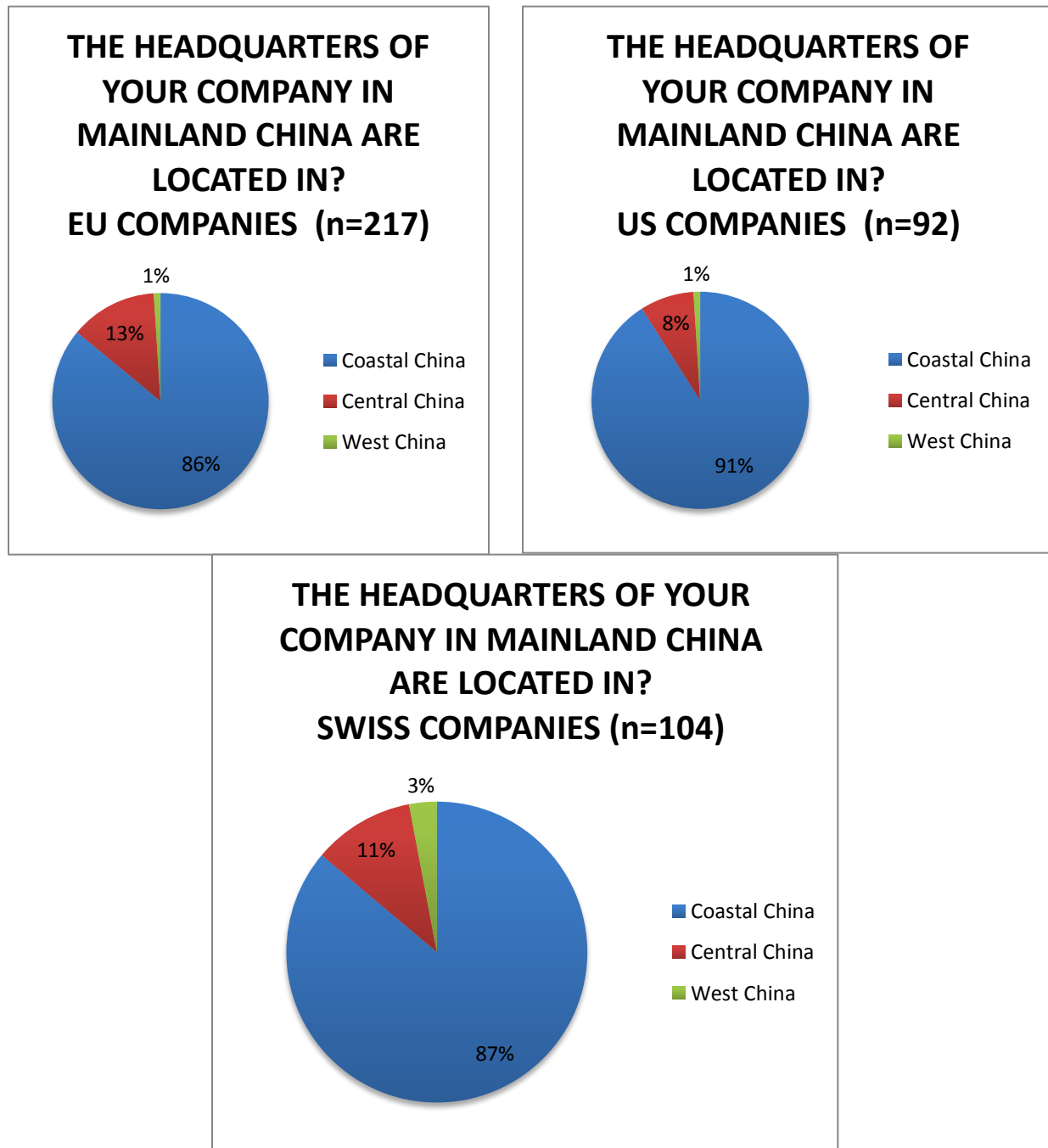
With 104 Swiss respondents out of the 419 foreign-owned company respondents, the Swiss sample is well represented in the overall CEIBS survey.

Compared to the 254 different companies registered with SwissCham China (not counting separate subsidiaries of the same company), this represents a strong sample of the affiliated Swiss firms in China.

Additionally, with 63% of top managers (Owner/CEO/GM & VP/Vice-GM/Director) answering the survey, the data from Swiss companies is reasonably credible. Respondents are noticeably more senior than those from the American (48%) and European companies (61%). Only Chinese companies' respondents have a higher percentage of top managers answering (87%).

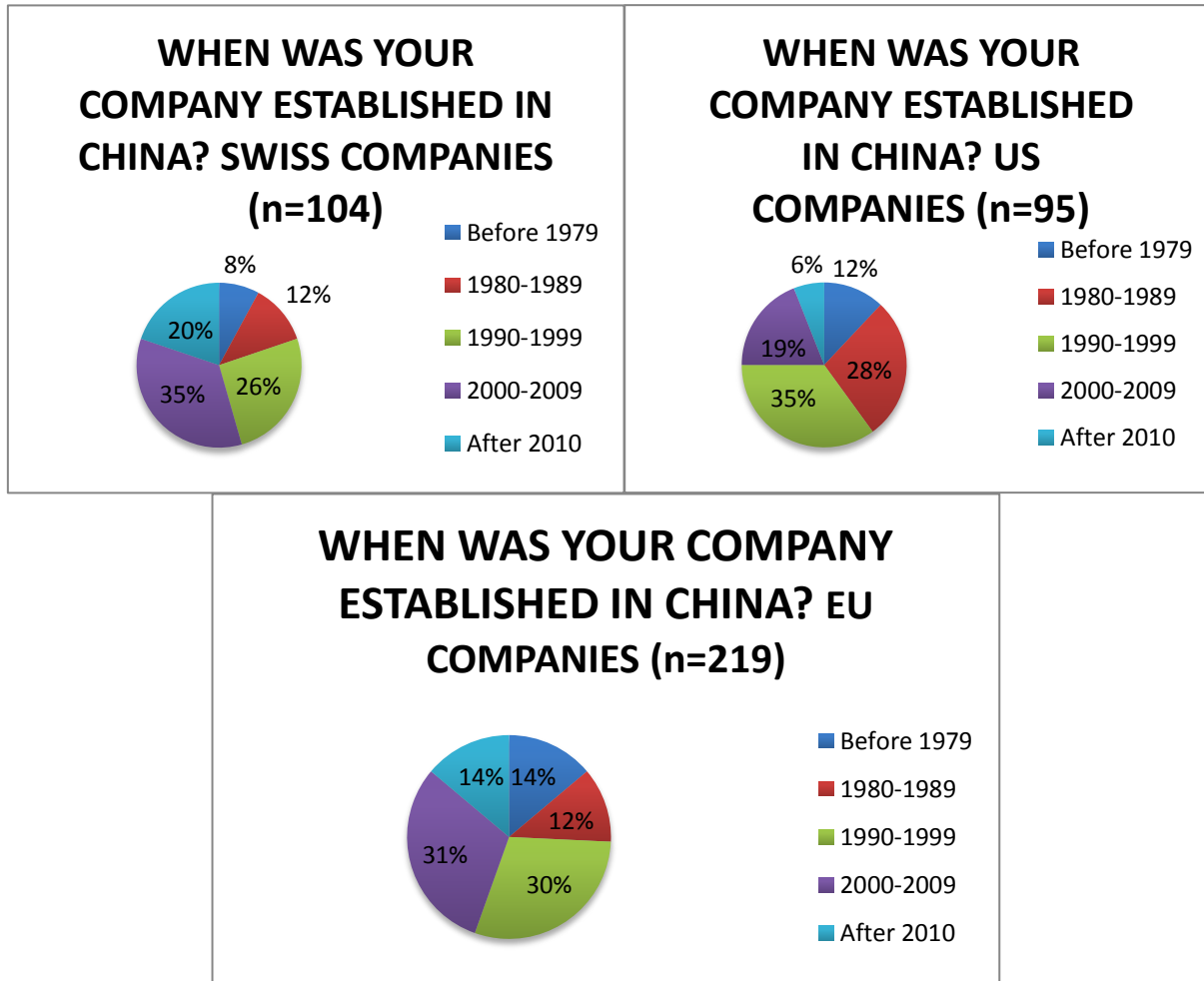


Interestingly enough, American and European respondents' geographical representation is also quite similar:



When looking at the establishment year, we see again pretty similar distributions among Swiss European and American companies, though there are proportionally slightly more answers from Swiss companies that have been more recently established in China.

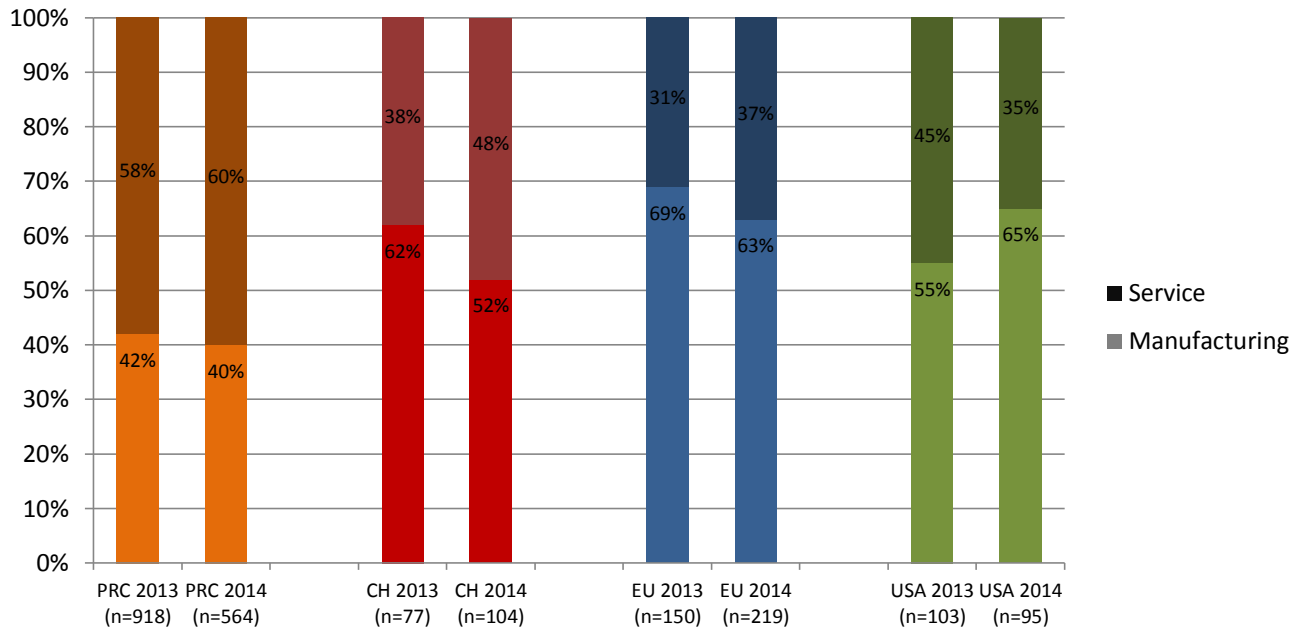
When was your company established in China?



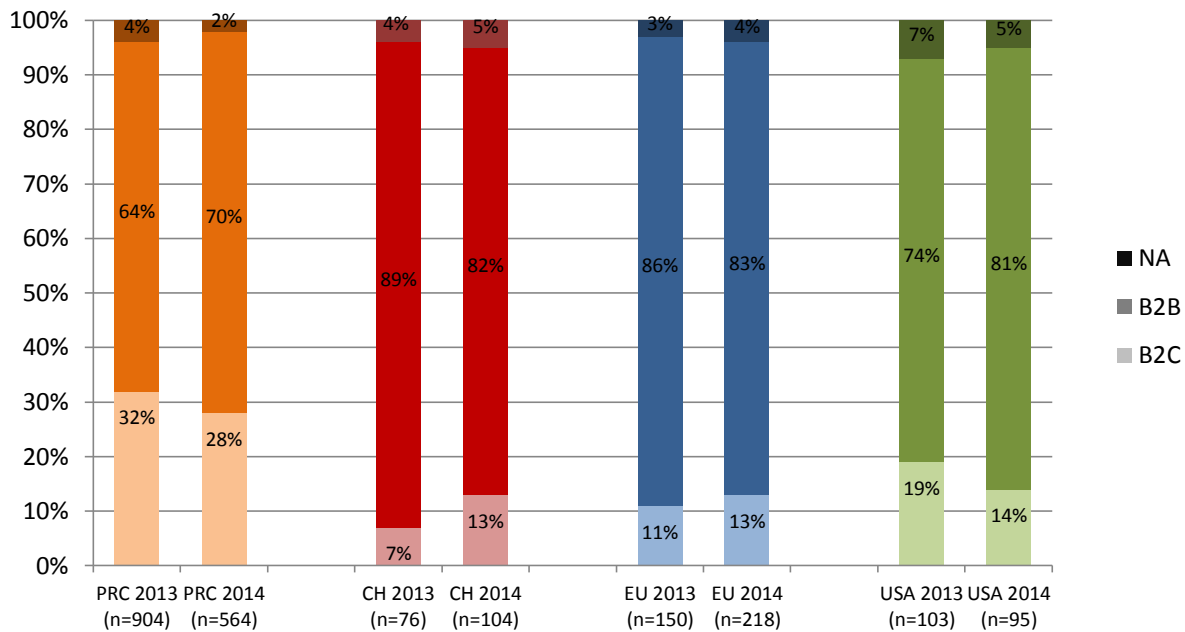
More than half of Swiss firms represented in the survey are manufacturing companies. This is again quite similar to American and European companies, while the Chinese companies answering are predominantly in the service sector (60%).

A similar situation occurs when looking at the customer base: Chinese are selling significantly more to the consumers segment than the western respondents, who are more strongly focused on B2B clients, with Swiss companies predominantly in B2B (82% of the Swiss companies in our sample).

WHAT IS YOUR COMPANY MAIN ACTIVITY IN CHINA?



WHO ARE YOUR CLIENTS IN CHINA?



While the above already provides good reasons to think that the sample of Swiss respondents to this survey is representative, we believe that the general similarity between the Swiss and EU data gives additional credibility to the results obtained for Swiss companies.

However, in this year's data US companies have more significant differences than in 2013. This may be explained by the fact that, proportionally, a much larger number of US respondents are in sales and a lower number of US respondents are from the top management. Still, since a reasonably large number of European companies – about 220– report patterns and trends in consistent and similar ways, **we believe that the results for the Swiss (and EU) companies are generally correct**. In addition, the significant differences between Swiss and European firms' answers do make sense when analyzed along with the current EU economic sluggishness and well-known particularities of Swiss companies.

As a consequence, we are convinced by the general representativeness and value of the results and hope that they will be seen as such.

ADDITIONAL ANALYSES: ACCELERATING GROWTH & REFORMS

What growth for businesses in China in the coming years?

A number of media have suggested that the current restructuring will be made at the cost of fast economic growth, but we are experiencing instead an acceleration of business results for international companies here in China. On the eve of Chinese New Year, we felt that it was timely to review the widely discussed growth and “slowdown” figures of China’s economy in order to understand their meaning for our businesses.

While it is true that China’s real GDP growth is not any more in the double digit range and that it is likely to decrease from 7.8% in 2014 to 7.2% in 2015, GDP growth, as a macro-economic measure, this does not actually capture China’s business potential for foreign enterprises.

Indeed, what matters to companies doing or intending to do business in China, is the amount of GDP the economy will be adding in the coming years in terms of Euros, US dollars or Swiss francs. To understand China’s business potential better and how it is changing, one must first compare how much GDP the Chinese economy is projected to add in the future with the amount it has added in the past. To get a global picture, it is also useful to compare this absolute increase with the amount of GDP growth generated by other countries in home currency values.

As with every other country, China’s real GDP is reported as the added growth in economic value in Chinese Yuan, minus local inflation. This growth rate makes complete sense, inasmuch as it captures the real economic progress (with inflation deducted) that the country is making with respect to its previous year’s performance.

This said, because companies throughout the world account for their growth in their local currencies, without deducting inflation from their performance results, they measure a country’s market potential in absolute volumes (millions or billions of USD) and not in growth percentage.

To illustrate this, take the case of Mongolia. With a 2013 real GDP growth rate of [12.5%](#), Mongolia is considered by the IMF to be “[one of the fastest growing economies of the world.](#)” This growth, however, is based on a 2012 GDP of about USD 10 bil. Taking inflation (approx 10%) and currency devaluation (approx. 27%) into consideration, in 2013, Mongolia only added slightly more than one billion USD to its economy. In comparison, the USA, which only grew by [1.9% in the same year](#), has added approximately USD 500 bil to its GDP.

Ultimately, when managing a company, the absolute growth of a market is the useful figure to evaluate how much more business can be generated in the future.

From this business point of view, it is striking to note that **the Chinese market is actually growing faster than it ever has.**

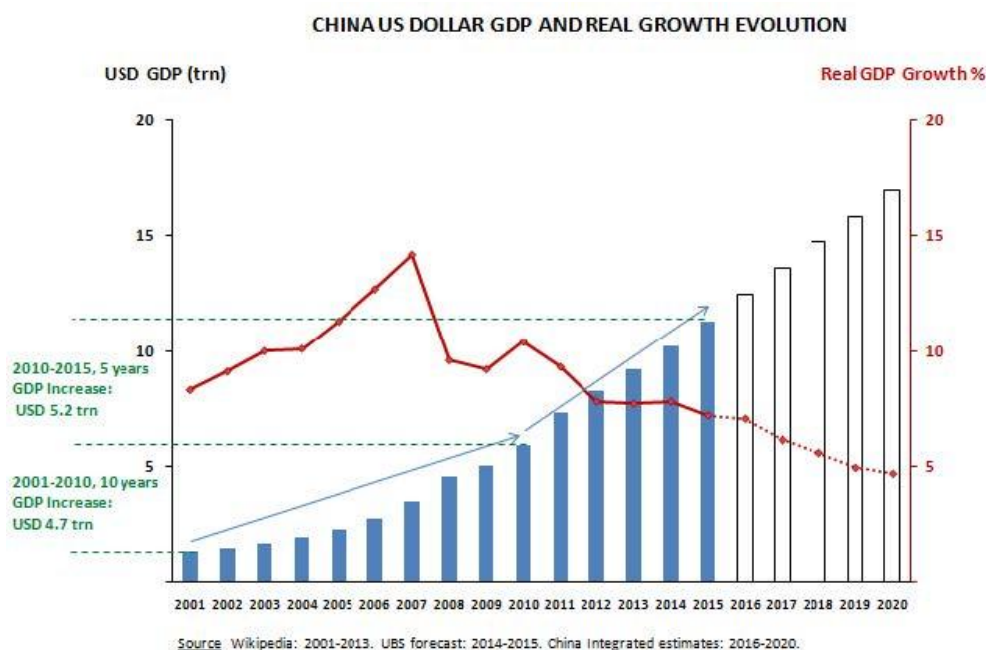
To illustrate this fact, the chart below, shows a clear acceleration of China’s GDP growth in USD terms.

Even though China is only projected to grow by 7.2% in 2015, it will likely add more GDP in USD terms in 2015, than it did in each of the years of 2012, 2013, and 2014, which saw growth rates of 7.8%, 7.7 % and

7.8 % respectively. Indeed, should China sustain constant percentage growth rates, its GDP would increase exponentially.

As it stands, however, even with slowing percentage growth, China's GDP will carry on accelerating (though not exponentially). Ultimately, it is this continuous acceleration in absolute GDP growth that has an impact on businesses potential.

Most importantly, between 2011 and 2015, China has and is projected to add more than USD 5 trillion to its GDP, compared with USD 4.7 trillion in the whole decade of 2001 to 2010. **In terms of business opportunities and in USD terms, this means that China is growing on average twice as fast today, than it did the previous decade.**



When compared to other countries, China, which is adding approximately USD 1 trn more per year to its GDP, represents by far the greatest business growth opportunity in the world. **In 2013 alone, the business opportunities offered by China were twice as large as the USA's**, which is the second biggest growing market in absolute terms.

If we are to apply the same GDP calculations to other countries such as India, Brazil or Russia, it becomes clear that China's economy is the largest business opportunity in today's globalised world. Ultimately, the Chinese economy keeps accelerating in absolute GDP terms and this is what actually matters to businesses.

In light of the constant reminders of a Chinese economic slowdown conveyed by the media, we felt it was necessary to explain the situation in greater detail.

This business acceleration has been confirmed by the 2014 "Swiss Business in China" Survey ([pages 14-17](#)): sales, profits, and worldwide share of sales for foreign companies in China grew faster in 2013 than in 2012 and are generally expected to grow even higher in 2014.

Now what are the implications for businesses and how can we benefit from these trends?

The first conclusion we can reach from this, is that international companies may not be ambitious enough in China. If accounted for in USD terms, business in China should have grown by 13.4% only to keep up with market growth, without gaining any market share. (This figure is obtained by taking 7.7% growth, plus 2.7% inflation, plus 3% currency appreciation.) By comparison, business in the US would have had to grow by only 3.4%, or 1.9% growth plus 1.5% inflation to keep up with the USA's market growth.

For those measuring China's GDP in Euros or Swiss francs, there is a 2 to 3% difference that must be accounted for due to the appreciation of the Euro, which would bring the average market growth of China to 11%.

In 2014, the minimum rate of business growth necessary to keep up with China's growing market will stand at approximately 11.3% in USD. (Growth will still differ across industries and that is just a general average.) This figure takes into account an expected inflation rate of 3.5% and a steady USD/Chinese Yuan exchange rate.

Another important point to keep in mind is that the expected growth will come more from the private than the state-owned sector.

Indeed the Chinese government will be providing incentives to the private sector, as a measure to increase domestic consumption and productivity (private enterprises are doing much better than the state sector in terms of return on investment). (See one of our [analyses](#))

While an increasingly privatized Chinese market with greater domestic consumption will be a welcome development for the world economy, it also means that competition in China will intensify. Local market players will therefore become more efficient and resourceful.

In fact, results from the "Swiss Business in China" survey ([pages 24-25](#)) also point to the fact that international companies in China perceive local players as their greatest competitors. (This is a marked shift from past years where such companies reported international companies as posing the greatest competition.)

In other words, opportunities will increase considerably, but competition will be all that much hotter!

Under these circumstances, managers have two paths to follow: **improve operational efficiency** (to deliver more with the same resources) and **move up the local value chain** (improve products and technologies to command better margins).

Harnessing the productive potential of technology will be a crucial step towards achieving these goals. Indeed, for companies to improve internal efficiency, it will be essential for them to implement greater automation (using more automated machinery to produce goods or using better software and IT systems to improve business processes).

Moreover, in this very competitive environment, improving or adjusting products and services to sell with higher margins will also require, more often than not, the use of technology.

However, in the context of such a competitive Chinese environment, being successful will also mean having the right mix of imported and **locally developed** products, equipment, and IT. Indeed, local capabilities are improving considerably and if the world top math score in 2013 of Shanghai's 15 year old students is a pointer to the future, those capabilities will keep improving.

China is at a turning point - Reforms 2.0

China has reached the limits of its current “business model” and must reform in order to continue to grow in ways that are sustainable in the long term. A change of model, as business leaders know, necessitates far reaching changes in an organization. In China’s case, this calls for not only decisive overhauls of economic policy but also fundamental changes in the leadership culture. Considering the size of the country and the importance of the vested interests, particularly in the state sector, the efforts underway to carry out the new reforms are assuredly as challenging and intense as the opening up of China that Deng Xiaoping launched 35 years ago, with the success that we all witnessed.

An unsustainable development model

Under China’s current growth model, which aims to maintain rapid economic development at virtually any costs, the environment has deteriorated in alarming ways; air, water, and soil pollution, coupled with the public health risks caused by them increasingly drawing the ire of China’s populace. Moreover, unabated greed prevails to the extent that food safety has become the number one concern of the population and good medical care depends on direct cash payment to doctors.

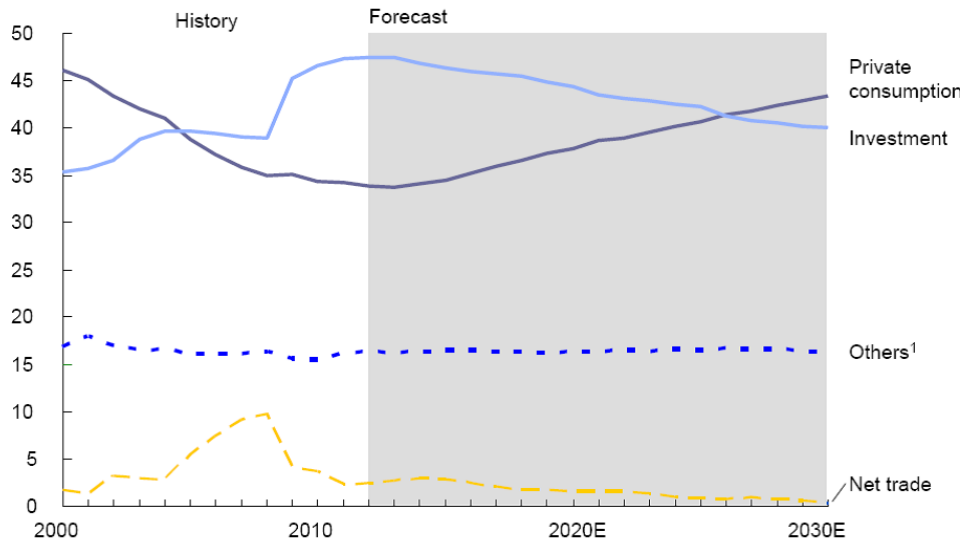
Rumor has it that 225'000 officials have been or will be arrested in China through the current anti-corruption drive, another 18'000 who are currently abroad are being actively pursued. The total amounts embezzled are said to have reached USD 2-3 trillion, about 70% of which are expected to be recovered, adding high profitability to a good policy move!

In addition, investments have become increasingly prominent as a share of China’s GDP, resulting in a galloping government debt, which, if unchecked, could be the cause for a financial crisis.

Needless to say, such developments have alienated a sizeable portion of the population which cares about its health as much as it cares about its material wealth.

The charts below demonstrate the degree to which China's development model of the last decade has relied on favoring investments carried out by the state sector at the expense of private enterprises and domestic consumption. From 2000 to 2012, consumption decreased from 46% as a share of GDP to 33%. (By comparison, in the USA and Switzerland, the private consumption share of GDP is slightly under 60% and 70%, respectively.)

Share of components
%

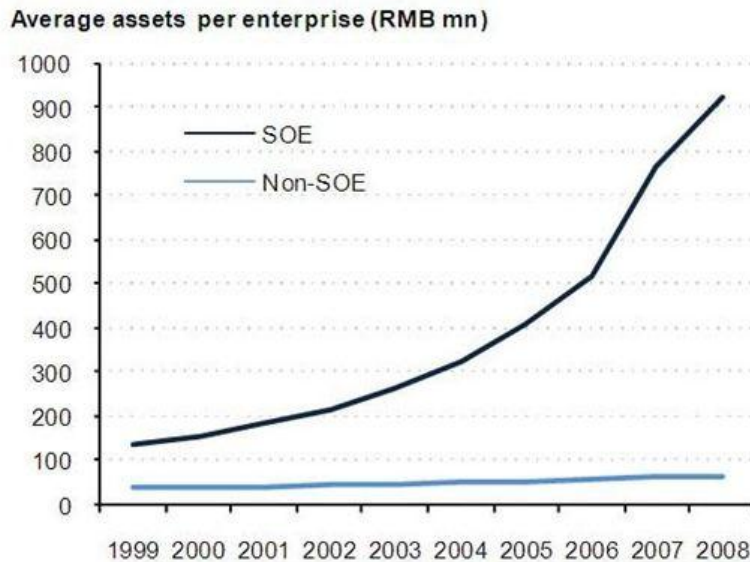


¹ Others include government consumption and inventory.

Source: Global Insights; McKinsey Insights China macroeconomic model update (2012)

Meanwhile, state-owned companies grew exponentially bigger, using their size and political connections to maintain their advantages, strengthen their monopolistic positions, and resist change.

Figure 2. Average asset size of SOEs and non-SOEs



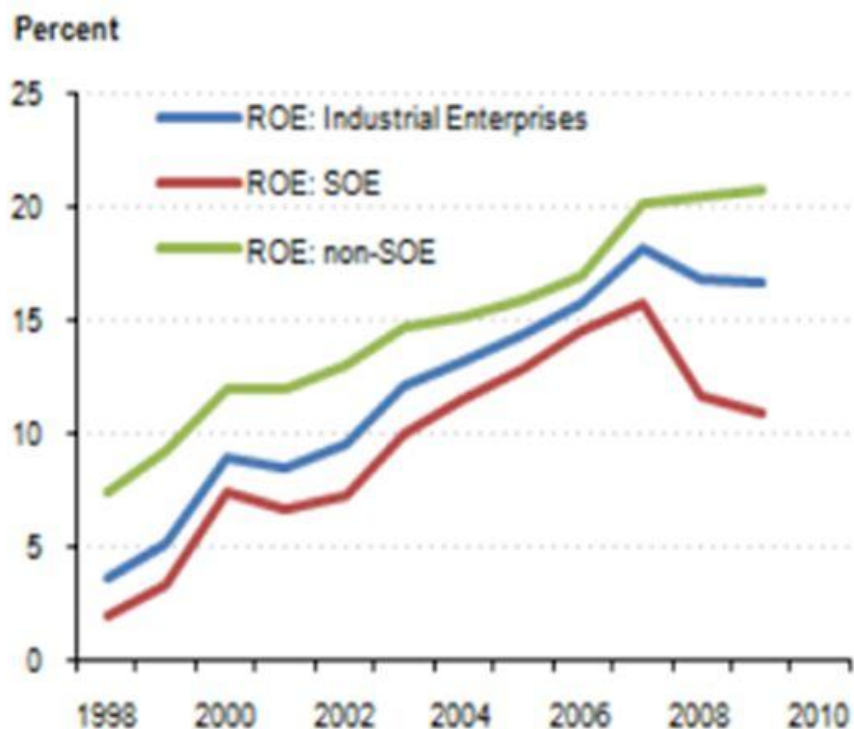
Source: CEIC, and author's calculation.

After the courageous reforms of the 1990s, which reduced the size of the state sector and freed the natural entrepreneurial spirit of Chinese individuals, the “fourth generation” of Communist leaders, Hu Jintao and Wen Jiabao, turned to a form of state capitalism, under which growth and economic development became increasingly dependent on state investments financed by state banks.

With interest rates fixed by the state, Chinese citizens today have no better choice than to deposit their savings into state banks that yield interests often lower than inflation. This process has funded the state’s investments cheaply and at the expense of its citizens.

All the while, families and friends of politicians and past leaders took advantage of their privileged relations to obtain contracts from state-owned companies or to buy shares in these companies at the right time. They enriched themselves easily via the state system which, despite its advantages, returned steadily lower profits than the private sector.

This trend accelerated after the financial crisis which forced the government to further accelerate investments, giving State-Owned Enterprises (SOE) the opportunity to continue growing.



Unsurprisingly, this investment-based growth model led to a sharp surge in government debt. In the first 6 months of 2013, total (including local government's) debt was evaluated by a state audit and found to have increased by 13%, or 26% if accounted for annually. From 2010 to June 2013, the total government debt grew by 6.6 percentage points as a share of GDP.

With a total government debt of only 56%, China remains far healthier than all but some small Western countries, but the trend is definitely alarming.

Clearly, China's growth model has become unsustainable for the long-term and would likely result in a financial crisis or very slow growth if not addressed properly. Additionally, in a depressed world economy, exports can no longer be counted on to contribute significantly to GDP growth.

What is to be done?

Sluggish growth (or a financial crisis which would ultimately turn into a recession) is an unacceptable outcome for the population. Indeed, such a situation would erode the unspoken contract that binds the Chinese government to its people, whereby the leadership continuously provides improved living conditions while the population accepts not to be directly involved in the political decision-making process.

The obvious solution is to turn China's growth model away from its current reliance on investment towards greater domestic consumption and private investments. This means encouraging citizens to spend more of their money on setting up businesses and improving their lives, instead of having to lend their savings to the government who spends it on infrastructure projects or lends it further to state-owned companies.

Increasing private consumption and investments is only part of the solution to achieve sustainable growth. Since the working population (the number of people generating GDP) is reaching a plateau, productivity needs to improve to maintain a growing economy. Without more people joining the workforce, each person working will need to generate more economic output to deliver overall growth.

Given that state-run companies are less profitable and efficient, encouraging the private sector to expand and providing opportunities to entrepreneurs is the obvious way to swiftly increase productivity and private consumption while keeping the increasing government debt under control.

Corruption must be stopped

The solution is evident, but its implementation goes against the vested interest of the state-owned sector, the politicians who control it, and their entourage who derives gains from it.

A telling example of the pre-eminence of SOEs' vested interest is the fuel and oil industry. In 2009 the State Council (China's Cabinet) issued the China III Diesel Standards, which were simply ignored by the

(state-owned) oil companies¹ in order to maintain their profits. These SOEs would not have been able to do so without the patronage of high level officials such as Zhou Yongkang, a former Standing Member of the Politburo and a former Head of China National Petroleum Corporation.

Clearly, to ensure long-term sustainable growth and eventually **nothing less than the future of China**, there was no alternative than to reduce the influence of the state sector and therefore the power of those who benefit from it. Government clampdown on graft, bribery, and embezzlement was an absolute necessity for a number of reasons, not the least of which was to prevent large State Owned Enterprises (SOEs) to operate under de facto immunity from government prescribed policies.

It is no wonder then, that China's new President warned in his acceptance speech that corruption had become a threat to the Communist Party and its leadership of the country, and that he made fighting corruption his first priority.

From then on, a key question that would decide China's future was whether the current government could be strong and determined enough to eradicate the politicians' traffic of influence and rein in the state sector.

Fortunately enough, events of the past year have provided room for quite some optimism.

A clear indication of both the new government's determination and the support that it commands is the decision to arrest top level officials (including the Army's No 2) and to investigate the former security Czar (Zhou Yongkang) for "serious disciplinary violations." Remarkably, **it is the first time in the history of the People's Republic of China that a former Standing Member of the Politburo is investigated**. Though the move is certainly part of power-consolidation, it is also to show that in today's China, no one is untouchable. What's more, it warns officials that no former leader will be strong enough to protect allies and former subordinates against their unethical behavior. As a result, any official that wants to feel safe will have to apply policy ethically.

This in itself is a strong indication that corruption at high levels will be considerably reduced (if not eradicated) in the short term. By ensuring discipline among officials, this drive is empowering the Chinese administration and fulfilling the first necessary step for the success of the much needed reforms.

¹ [The situation is detailed in New York Times article "As Pollution Worsens in China, Solutions Succumb to Infighting", of March 21, 2013](#)

What is next? Building a level playing field

It is also important to note that Zhou Yongkang was most recently in charge of China's internal security which includes the police and judiciary, a department endowed with a bigger budget than China's military. The internal security system's first mission is to maintain social stability, the Chinese government's overarching priority. Fairness and equality of economic opportunity came at a distant second in terms of objectives of the legal system.

Yet, once unethical civil servants are out of the way, reforming the legal system towards impartiality is a natural next step. A well-performing and ethical judiciary is needed, first of all, to ensure that corrupt practices do not resurface, but it serves additional purposes too. Social fairness is the only sure avenue to win back the hearts and mind of the population at large, without which the Party's legitimacy would remain in doubt. Not least, it is the essential tool to bring about equal economic opportunities for companies small and large, private or state-owned. This economic fairness is the best instrument to motivate the private sector, and to generate confidence and individual consumption.

It is therefore no surprise that the main themes of the coming October plenum of the Communist Party have been announced to be “**Rule by Law**” (the officially sanctioned term for the role of the law in China's constitution) and the **economy**.

While the new set of reforms clearly intend to instill dynamism in the private domestic economy rather than encourage foreign investment as was the target 30 years ago, foreign companies will still benefit from further opening up to foreign investments but most importantly from the more level playing field that will undoubtedly be built.

The testing ground: Shanghai pilot FTZ

To realize how urgent the new reforms are perceived by the government, one may remember that the Shanghai Pilot Free Trade Zone (Pilot FTZ) was officially opened at the end of September 2013, **prior to** the third plenum of the Communist Party, which debated and issued the new reform policies. It is rumored that that the Prime Minister, facing opposition from the bureaucracy, literally banged on the table to push the project through.

In addition to opening the education, healthcare, and financial industries to foreign investments, the pilot FTZ is changing the current concept of approving new companies to one of simply registering them. While for many, this is the normal understanding of how the law should work, what is being experimented in the pilot zone is turning around a basic principle of Chinese law.

In effect, what is not explicitly allowed in China is forbidden. However, in Shanghai's new pilot zone, a “negative list” has been set out, outlining the list of business activities that are not allowed. Anything falling outside of it should now be automatically authorized. This is a major philosophical change for China, since it will no longer allow the government to micromanage business.

What is happening in the Shanghai Pilot FTZ is particularly significant precisely because of the zone's "Pilot" status. Indeed, once the new policies are tested in this framework and become successful, they will be rolled out to the rest of China.

The current edition of this Survey includes questions on Shanghai Pilot Free Trade Zone (Shanghai FTZ) awareness, interest and expectations. See this survey in pages 6-11 of the 2014 CEIBS China Business Survey in the second part of this report.

As a conclusion, one cannot help but draw parallels between the establishment of the Shanghai Pilot Zone and the policies that were tested in Shenzhen in the 1980s by Xi Zhongxun, none other than the new President's father. These were the policies that launched China into becoming one of the world's economic giants.

The direction is clear. The new government and the new set of reforms aim at enabling China to continue to grow fast but at the same time sustainably.

This is good news for the world: should the new reforms succeed as it seems they will, we can expect both **economic opportunities the size of China and a much more favorable environment for private and smaller size enterprises!**