

The Rise of the Chinese Multinationals

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IN EARLY June, hoping to ease growing trade tensions with the European Union, China agreed to place voluntary limits on the growth of its textile and apparel exports to Europe. The decision came hours before the EU was set to impose its own trade restrictions on China. A few days later, deep misgivings about China's rising economic and political clout fueled a fierce debate over a major Chinese oil company's bid to buy U.S. producer Unocal. Topping Chevron's original offer of \$16.8 billion, the \$18.5 billion bid from the government-controlled China National Offshore Oil Corporation (CNOOC) came under fire from U.S. lawmakers. These two incidents highlight the new economic reality: China is no longer just a destination for foreign direct investment (FDI)—it is the home for Asia's new multinationals.

Bamboo Networks to SEZs

SINCE THE 1500s, southern China has been a springboard for emigrants to Vietnam, Thailand, Indonesia and elsewhere in Southeast Asia.

These overseas Chinese have developed an informal "bamboo network" that transcends national boundaries and extends throughout the region, where entrepreneurs, business executives, traders and financiers of Chinese descent are major players in local economies.¹ Today, the array of complementary business relationships comprises more than fifty million ethnic Chinese, who control many of Asia's largest public companies and who have contributed to the rise of China's new multinationals.

When, a century ago, the first wave of globalization swept across the developed economies of western Europe and North America, East Asia enjoyed a boom of its own. Chinese capitalists launched operations outside China while investing in their home country.

After 1949 the People's Republic of China opted for a command economy in-

¹Murray Weidenbaum and Samuel Hughes, *The Bamboo Network: How Expatriate Chinese Entrepreneurs are Creating a New Economic Superpower in Asia* (New York: Simon & Schuster, 1996).

spired by the Soviet model. Despite rapid growth, productivity was dismal. The civil war and the communist rule that followed led to massive capital outflows to neighboring Hong Kong, Taiwan and Southeast Asia. Chinese “emigrant entrepreneurs” played a critical role in the industrialization of Hong Kong, contributing to the significance of the city as a global textiles and garment hub.² With the Cold War, capital outflows from China were replaced by two-way flows between Hong Kong and Southeast Asia. Postwar globalization arrived in mainland China only after the failures of the initial national modernization efforts (the Great Leap Forward in the 1950s and the Cultural Revolution in the late 1960s), which contributed to famine, devastation and dissension.

In January 1975 Deng Xiaoping and Zhou Enlai drafted the “Four Modernizations”, calling for modernization in agriculture, industry, science and technology, and national defense. The transition from import substitution to export orientation led to China’s “reform and opening.” Following the successful reforms of the agricultural sector, Deng moved on to the next stage of China’s modernization, industrial reform, in 1984. The government established Special Economic Zones (SEZs) close to Hong Kong and then opened the coastal provinces and major cities to overseas capital. The reformers saw the bamboo network of the overseas Chinese in the south as an asset through which the SEZs could be integrated with Hong Kong, Macao and Taiwan, as well as the rest of the world. Still, overall annual FDI averaged only around \$1 billion.

Chinese FDI abroad started even more modestly. In 1979 a chosen few companies began to invest overseas, typically on the basis of existing overseas trade linkages. A third of overseas operations were located in Hong Kong and Macao, another third in the United States, Japan and Thailand. The first multinational

was a Beijing restaurant in Tokyo, a joint venture of a Chinese and a Japanese company. Despite significant expansion in overseas investment, by 1985 only 143 Chinese enterprises had made the jump, investing \$170 million in 45 countries (less than 3 percent of China’s total inflow of FDI). These businesses were mostly in low-tech services, such as Chinese restaurants, located in the major cities or Chinatowns of countries like the United States, Japan and Thailand. Investment in other service sectors, such as construction and shipping, was located primarily in Hong Kong and Macao.

High-Tech Zones and Natural Resources

WITH THE initiation of industrial modernization in the coastal provinces, Chinese reformers also began to pay increasing attention to the modernization of science and technology, the third priority of the modernization program. The development of high-tech industries was seen as vital for boosting FDI inflows and attracting foreign multinationals. If the idea for the SEZs came mainly from other East Asian export processing zones and free trade zones, the model for the high-tech zones originated in Silicon Valley.

China’s high-tech development program was initiated in 1986, when the State Council called together more than 120 senior Chinese scientists to draft China’s strategic high-technology plan. To implement the plan, the State Science and Technology (S & T) Commission designed the Torch Program, which aimed at the commercialization, industrialization and internationalization of “high and new technology.” One of the program’s key components was to establish Science and Technology Industrial Parks and innova-

²Siu-Lin Wong, *Emigrant Entrepreneurs: Shanghai Industrialists in Hong Kong* (Hong Kong: Oxford University, 1988).

tion centers. Meanwhile, the program also became responsible for the “high and new technology industrial development zones” (HNTIDZs) focusing on a dozen strategic industries, including microelectronics, aerospace, biotechnology and, more recently, information technology. Concurrently, the government took steps to improve the investment environment, which triggered another phase of FDI, with annual inflows exceeding \$3 billion.

These measures were mirrored by the Chinese government’s bolder steps toward outward investment. In the latter half of the 1980s, 620 new Chinese businesses invested more than \$860 million in over ninety countries. Instead of restaurants, natural resource development projects, along with assembly and transport, dominated Chinese overseas investments. Large, state-owned enterprises, including trust, steel and chemical giants, joined in. Of the newly established overseas firms, 50 percent were in Asia and 18 percent were in Africa. However, it was the developed countries that attracted the attention of Chinese investors, with Australia targeted as the single most important host country for natural resource development projects. But though the growth rate of Chinese FDI was almost 50 percent greater than the growth rate of multinationals worldwide, Chinese FDI accounted for only 0.1 percent of the global total.

The tumultuous early years of reform contributed to inflationary pressures, unrest and, ultimately, the Tiananmen events. The momentum was recaptured only in 1992. Following his tour of the southern coastal provinces, Deng was now calling for “faster, better, deeper” economic growth.

Enter the Global Giants

AS THE Chinese government introduced market-oriented reforms to again attract U.S. and other

investors, capital inflows accelerated dramatically. Initially, this FDI phase led to the geographical expansion of Chinese firms from Hong Kong, Taiwan and Southeast Asia. Now China also showed up on the radar screens of U.S. corporations. After Deng’s southern tour, U.S. investment flows to China grew more than fivefold to \$556 million in 1993. Over the latter half of the decade, U.S. capital flows to China averaged \$1.1 billion annually.

Through foreign multinationals—the so-called foreign-invested enterprises (FIEs)—FDI played a critical role not just in China’s economic reforms and opening, but in the rise of Chinese multinationals. Until the late 1980s only 2 percent of the foreign multinationals in China were regarded as technologically advanced, and enterprises using advanced technology made up just 5 percent of total FDI in China. After the mid-1990s the FIEs replaced the small- and medium-sized enterprises of the overseas Chinese as major investors. Capital inflows soared from \$11 billion in 1992 to \$50 billion in 1999.

Located in the United States, western Europe and Japan, the FIEs are global giants, owned by institutional investors, engaged in worldwide operations and excelling in high-tech industries. Accounting for only 10 percent of total national industrial assets in 2000, they provided more than 27 percent of the gross industrial output value, 24 percent of the total value added and 29 percent of the total industrial profits. At the end of the growth years in 2001, more than 400 of the world’s top 500 manufacturing companies had invested in China. The FIEs accounted for an estimated one fifth of the GDP growth. In particular, the rapid export growth of China resulted from the dramatic expansion of FIE exports as a percentage of national total exports—from less than 16 percent in the early 1990s to more than 50 percent in the early 2000s.

For more than two decades, China has been the most attractive FDI host among all developing countries. China's accession to the World Trade Organization and selection to host the 2008 Olympics has accelerated investment initiatives. In 2004 the capital inflows amounted to \$60 billion. Still, these large absolute numbers must be put into perspective. Like the United States, China is actually a small recipient of FDI relative to its GDP, ranking 37th worldwide.

In the early 1990s the Chinese government encouraged manufacturing enterprises to deploy the so-called "two resources and two markets" strategy to target both domestic and international markets, while seeking resources (capital, know-how, raw materials) domestically and globally. The sectoral distribution of Chinese investment abroad shifted from resource development (more than 60 percent in 1991, 32 percent in 1997) to manufacturing (39 percent in 1997). Initially, this was the result of the government focus on several mature manufacturing sectors to establish overseas operations, particularly industrial machinery and electronics. Today, increasing competition maintains market discipline.

Absorbing Foreign Innovation

RECENTLY, GROWTH and development trends show technological innovation emerging as a major driving force. Through most of the 1990s, Chinese research and development (R & D) was an estimated 0.6 to 0.7 percent of GDP. Since the late 1990s, Chinese research and development has rapidly increased to an estimated 1.5 percent in 2005. In terms of its absolute level of R & D expenditure, China will rank in the top ten worldwide. In relative terms, its current proportion is still half that of Japan or the United States. On the other hand, many of the foreign multinationals are world leaders in information

and communication technology (ICT). Indeed, China's trade in ICT goods (imports and exports) more than doubled from just over 12 percent of total trade in 1996 to more than 27 percent in 2003. More than half of these stem from the Chinese affiliates of the FIEs.

As the momentum shifted toward high technology, increasing economic regionalization and foreign trade protection has encouraged Chinese multinationals to develop offshore plants to avoid the quotas imposed on Chinese goods by importing countries. Meanwhile, the policy of "grasp the large, release the small", defined by the 15th Party Congress in 1998, endorsed the sale of all but the largest state enterprises, seeking to consolidate the most thriving state enterprises into organizations mirroring Germany's large multinationals and South Korea's business groups (*chaebols*).

Unlike overseas Chinese in mainland China, few U.S. companies used China as an export platform. The bulk of the investment was drawn by local market opportunities. Until the early 1990s, overseas Chinese investment had focused on low-tech industries to create cheap manufactured goods for export. After the mid-1990s, two-thirds of U.S. investment in China was directed at the manufacturing sector, especially industrial machinery and electronic equipment—the very same sectors that the Chinese government was now promoting in overseas investment.

Initially, the FIEs regarded China mainly as a low-cost processing and assembling base, relying on imports of component parts. Upgrading their investments and asset quality, foreign multinationals began to shape the new technology infrastructure in China, particularly in the prosperous coastal provinces, by contracting and sub-contracting, and by pioneering retailing networks and distribution channels. In the process, the "spillovers" nurtured the rise of indigenous suppliers, which provided compo-

nents. By the late 1990s, foreign multinationals had become increasingly “localized”, giving rise to a growing ecosystem of indigenous firms.

Today, foreign multinationals are increasing investment in R & D, marketing and services, while intensifying penetration and integrating management. The consolidation of FIEs in China is mirrored by the increasing boldness of Chinese multinationals. Typically, companies go abroad seeking resources, markets, efficiencies and strategic assets. In competitive high-tech industries, Chinese companies often internationalize to acquire strategic assets (brands, sales channels, technology, managerial competencies) in order to respond to the challenge of foreign multinationals at home.

Since the early 1990s, computers and mobile communications have been the two high-tech industries with the highest growth rates in exports from China. Last December, Lenovo—a bold electronics manufacturer that today provides inspiration to Chinese challengers and new attackers worldwide—acquired IBM’s PC business for \$1.75 billion. The goal was not to devour the U.S. market but to support Lenovo at home, where it is being squeezed by the likes of Dell and Hewlett-Packard.

In the past, China has been “the workshop of Asia.” Now it is growing into the “innovation center of Asia.”

The Rise of Chinese Challengers

IF THE computer industry exemplifies ambitious internationalization, mobile communications illustrates the high drama of FDI-driven challengers. Five years after the first orders from China—at the peak of U.S. trade conflicts and catch-up efforts with Japan—Motorola’s chairman, Robert Galvin, made a long-term commitment to the market. Trading new technology for market access, foreign multinationals such as Mo-

torola transferred technology, provided training and exchange programs, and set up retail training centers in a number of cities. However, resource commitments were still low and, after Tiananmen, significantly reduced, while European firms such as Ericsson, Nokia and Vodafone were only happy to fill the vacuum.

Following in the footprints of the likes of Motorola, Nokia and Ericsson, Chinese tech giants are gradually maturing into world-class high-tech players. With modernization, the reliance on contacts, or *guanxi*, is being augmented with the global business culture based on contractual obligations. Concurrently, bold new attackers are challenging their idols.

In the 1990s Chinese equipment manufacturers had no market share in China’s mobile marketplace; in 2001 it was less than 10 percent; in 2003 an extraordinary 55 percent! Focused on building distribution networks that took them even into small cities, local handset brands like Ningbo Bird, Amoi, Panda and TCL were able to beat foreign MNCs and their global brands on prices and features that Chinese users appreciated the most, while pushing clever ad campaigns and developing product designs that appealed to local consumers. Rapid growth allowed Chinese firms to expand their presence in neighboring economies, which in turn has enabled the overseas Chinese to rejoin the changing production networks through market expansion, capability outsourcing and financial services. The rise of the Chinese mobile brands, for instance, was facilitated by outsourcing production from Taiwanese and South Korean electronics manufacturers, while gradually building in-house manufacturing capabilities.³

Once the technology-manufacturing

³Dan Steinbock, *The Mobile Revolution: The Making of Mobile Services Worldwide* (London: Kogan Page, 2005).

infrastructure was in place, Chinese firms excelled because, knowing the marketplace intimately, they were better able to deploy the right marketing channels to offer the right products, the right campaigns, and the right advertising and promotion. It was a critical turning point. But that is not where the story ends.

After the rise of the indigenous challengers, the foreign multinationals mounted their own counter-attack. As Chinese challengers rarely spend more than 5 percent of revenues on R & D, the spending gap provides a substantial competitive advantage to the FIEs, which now imitated their challengers, flooding the market with me-too products, aggressive marketing campaigns, comparable distribution channels and slashed prices. In 2004 the market share of the indigenous producers declined to 37 percent. But in the meantime China had become the world's largest mobile manufacturer.

During the past decade or so, similar dramas have been seen in industries as different as car manufacturing, detergents, oil, petroleum and petrochemicals. In the first act, foreign multinationals pioneer the high-volume markets. Then, indigenous challengers respond with imitation and low-cost strategies. In the third act, innovation and more sustainable quality strategies emerge as the keys to success. In this drama, low-cost strategies offer short-term benefits, but sustained leadership is inconceivable without innovation. This requires global scale capabilities that only global multinationals possess—but the boldest Chinese challengers are determined to catch up the “resource gap.”

Fierce Dragons or Cute Pandas?

AT THE first congressional hearing on the bid by CNOOC to purchase Unocal, the chairman of the House Armed Services Committee described the effort as “a strategic acquisition, just like the acquisition by the Chinese of these

Sovremenny-class missile cruisers that they purchased from the Soviet Union, which have just one role, that is, to kill American aircraft carriers.”

Are the emerging Chinese multinationals truly such fierce dragons, as many presume on Capitol Hill, or cute pandas, as others argue? After all, Chinese investments have gone hand-in-hand with high-profile state visits around the world by President Hu Jintao and Premier Wen Jiabao. Hoping to offset huge capital inflows into China by supporting the indigenous multinationals, Beijing has been keen to reinforce economic interest with diplomatic and political influence.

But let's look at the actual numbers. In 2004 the Global 1000 list by *Business Week* featured 423 U.S. companies with a combined market capitalization of \$10.8 trillion. Japan had 137 companies with a market capitalization of \$2 trillion; the UK, 73 companies with \$1.9 trillion. Hong Kong's 15 and China's six companies, meanwhile, had a market cap of \$190 billion and \$104 billion, respectively. China's top corporations were all energy and technology related. The latter included two giant mobile operators, China Mobile and China Unicom. In addition to CNOOC, the energy-related mammoths are China Petroleum and Chemical (Sinopec) and CITIC Pacific, PetroChina.

Global competitiveness indicators tell the same story. In business competitiveness, the United States leads worldwide. During the past few years, Japan (8th) has steadily improved its position, but China (45th) remains behind.

Last year, foreign investment by Chinese companies rose by almost one-third to \$3.6 billion, and Chinese capital outflow is gathering impressive momentum, coupled with the first major international merger and acquisition (M & A) efforts by emerging Chinese multinationals such as Lenovo and CNOOC. Some observers find associations with Japan in the late

1980s just too tempting to ignore (especially now that China's debut as a volume car exporter happens to coincide with the severe problems of U.S. car manufacturers). Still, the numbers should be kept in perspective. The FDI of Chinese multinationals abroad is barely 6 percent of the foreign capital inflow to China.

Electronics giants such as Huawei may herald the coming of "Chinese Matsushitas", but yesterday's Japan and today's China are at very different levels of economic development. More than half of Chinese investments come from energy and commodities companies, from oil fields in Sudan and natural gas in Iran to iron ore mines in Brazil and Australia. Most Chinese challengers are engaged in resource-seeking acquisitions to feed China's industrial revolution and rapidly rising domestic demand. Outside the resources sector, numerous Chinese manufacturers, such as TCL and Haier in electronics and white goods, and Chery and Geely in cars, have also planted roots offshore. They seek to embrace innovation while developing global brands.

Today, a few M & A-driven Chinese companies are often portrayed as China's Trojan horses conspiring to overthrow the U.S. economy. In the 1980s the boogeyman was Japan's Ministry of International Trade and Industry; today, China's government agencies play the same role. But competitive realities have not changed. Where the role of the government in China is most intrusive (state-owned enterprises), performance has been the least competitive. Where the government's role has been minimal (foreign multinationals in China), performance has been the most competitive.

The 21st Century's Greatest Opportunity

BETWEEN 1980 and 2000, the average person's income in China nearly tripled, from less than \$1,400 to close to \$4,000, while 170 million people

were moved above the poverty line. The task facing Chinese leaders is extraordinary in its history, scope and magnitude: How can they sustain economic growth for another ten to twenty years? In this strategic objective, leading companies in China play a critical role, whether they are owned by the FIEs, overseas Chinese or mainland Chinese. "It doesn't matter whether the cat is black or white", as Deng used to say, "as long as it catches mice."

Unlike Japan and the East Asian tiger economies, China has opened its domestic markets to foreign investment and is not building an export powerhouse behind a wall of protective tariffs. During the second half of the 1980s—at the peak of the Japanese M & A wave abroad—the outflow of Japanese investment amounted to \$36.5 billion, whereas the inflow was only \$2 billion. With contemporary China, however, inflow far outweighs outflow.

This massive and rapidly growing marketplace promises extraordinary opportunities worldwide. In the early 2000s it ensured growth for most high-tech industries while the economies of the United States, Europe and Japan stagnated. China's economic rise requires an extended period of international stability, not disruption and disorder; growth, not stagnation; openness, not protectionism. These objectives could not be closer to those prevailing on Capitol Hill and in corporate America. These are interests that the United States shares with China.

The "futility of trying to match the China price" is a stage in economic development, not an excuse for trade war. In the postwar era, cheap prices typified all catch-up nations; first in Europe, then in Japan and the tiger economies, now in China and India, tomorrow perhaps in Brazil or Russia. As the evidence already shows, when Chinese challengers begin to upgrade and innovate, they will engage more in outsourcing and offshoring, which can contribute to eco-

conomic development in all of Southeast Asia. Through the Marshall Plan, the transatlantic economy became the world's economic engine. Through economic integration, the United States can also partake in China's growth, which, along with the rise of India, will transform Asia. The true policy challenge is not engagement or containment, but integration.

Over the next decades, the center of gravity of the world economy will shift from the Atlantic, where it has been for the past three centuries, to Asia-Pacific, where it once was. American diplomacy for the 21st century has much to gain from deepening integration with the

emerging East Asian power axis, as do America's mightiest corporations. In our era of extraordinary historical opportunity, it may be wise to err on the side of calm and reason and, as Deng Xiaoping used to say, to "walk across a stream by feeling the stones underneath." □

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