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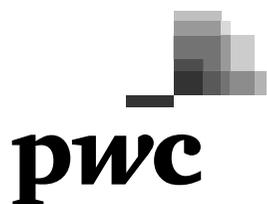
Stockholm, Sweden

Dagens Industri

Understanding China's Economic Reforms

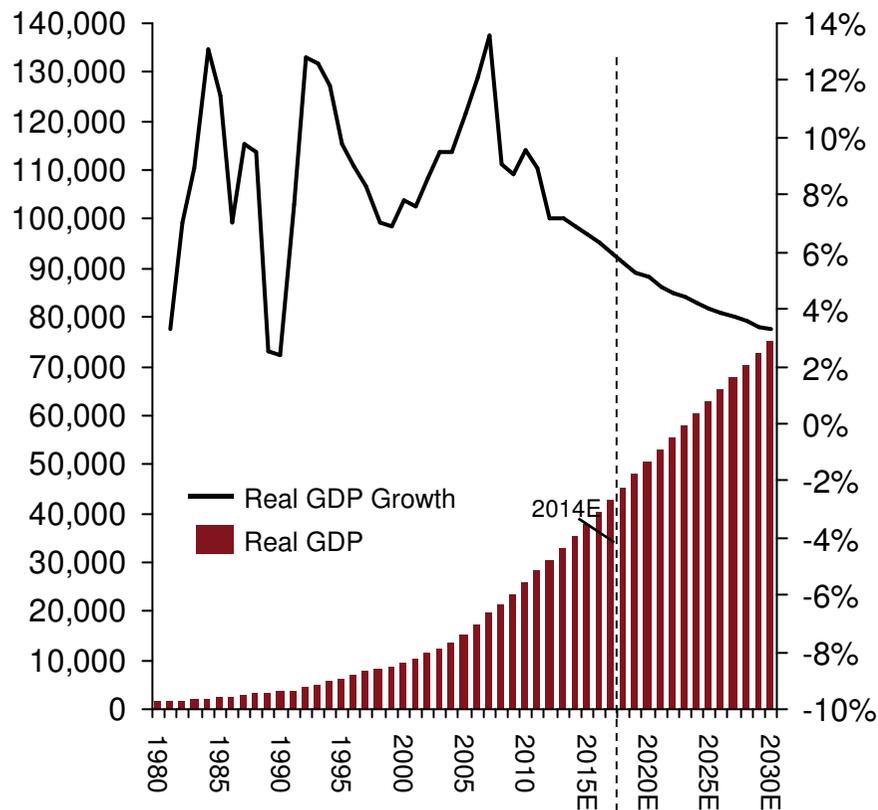


2014 China Conference



Following 30 years of unprecedented growth, China now faces significant economic, social, and political challenges

Chinese Real GDP, 1980 – 2030E, RMB, bn



Source: The Economist Intelligence Unit

Major Challenges

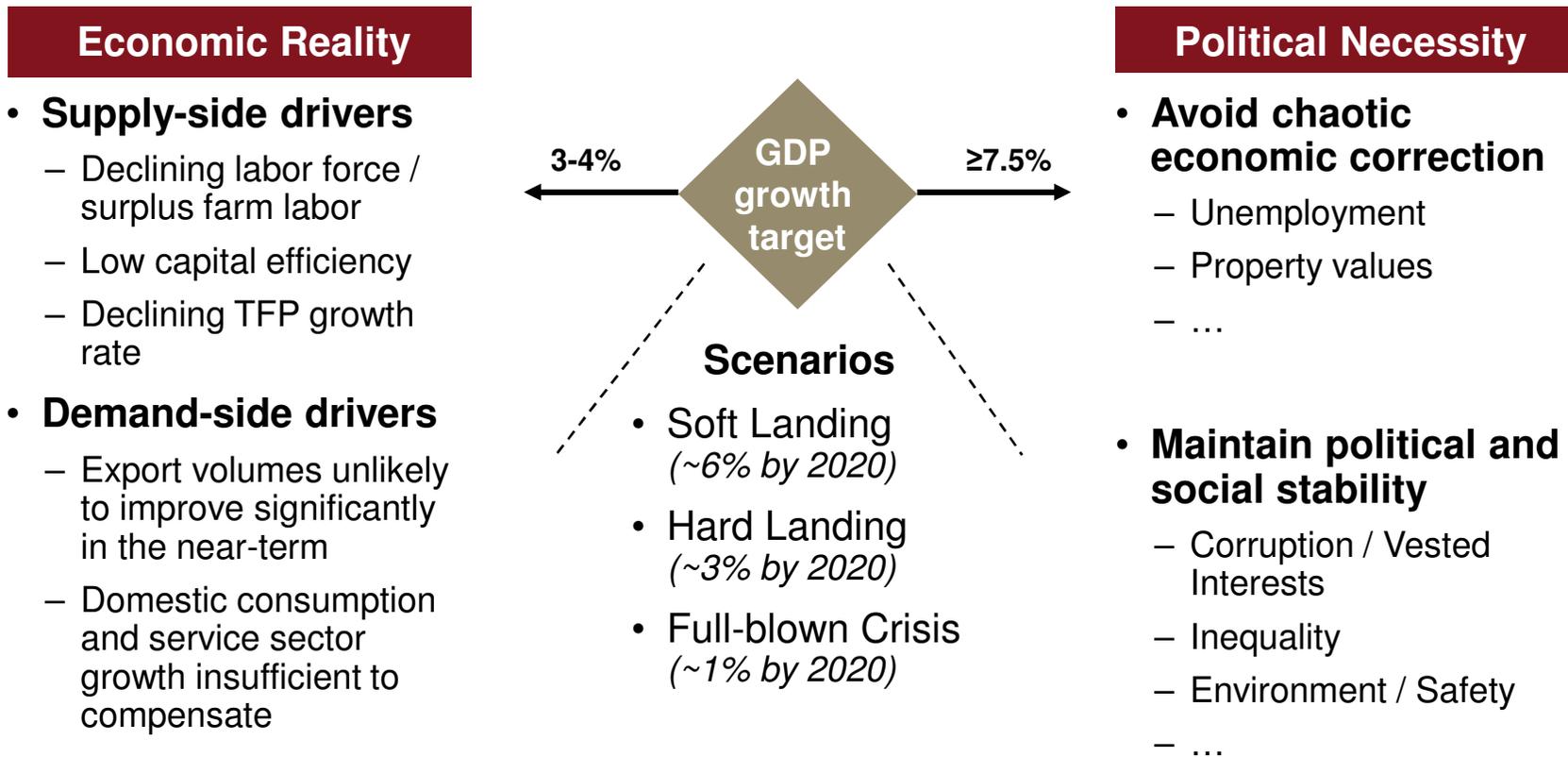
- **Economic**
 - Potential GDP growth rate declining
 - Increasing structural imbalance
 - Slow recovery elsewhere (e.g., EU)
- **Social**
 - Rising inequality (Gini coefficient)
 - Pollution / Environmental degradation
 - Safety issues (e.g., food)
- **Political**
 - Endemic corruption at all levels
 - Domestic unrest (e.g., HK, Xinjiang, Tibet)
 - Geopolitical tensions (e.g., Taiwan, Senkaku / Diaoyu, South China Sea)

China has no choice but to implement a comprehensive reform program – the next 3-5 years will likely be decisive

- 1 Slow Down** Further investment-led growth will only exacerbate China's financial, environmental, natural resources, and other problems
- 2 Clean Up** While highly successful, China's current growth model also produced numerous negative side effects - including endemic corruption, rising inequality, safety issues, severe pollution, and environmental degradation
- 3 Implement Structural Reforms** The role of the government must change from direct intervention to facilitating the ongoing transition to a more market-based economy
- 4 Increase Domestic Consumption** While domestic consumption has actually grown at a healthy rate, much more must be done to free up latent disposable income
- 5 Upgrade Industrial Base** China must become more competitive in higher value-added industries through top-down policy and bottom-up firm-specific initiatives

Source: "Will China's New Leaders Step Up to the Plate?", Jullens, Strategy+Business, Nov 2013

China's dilemma is how to balance the political necessity of high growth with the economic reality of low(er) growth



Source: "Will China's New Leaders Step Up to the Plate?", Jullens, Strategy+Business, Nov 2013
"China's Outlook – Now and in 2020", Rosen and Snyder, Rhodium Group, Aug 2014

There is little consensus on how to best solve these problems – even in China itself

Schools of Thought Within the Chinese Elite

Economics

New Left - challenge neoliberal economics and call for a return of the state (e.g., Cui Zhiyuan)

vs.

New Right - Pioneered gradualist reforms of the '80s and '90s and favor restarting pro-market reforms (e.g., Justin Yifu Lin)

Politics

Neocons - Feel that limiting the state leads to collective government, unable to take tough decisions or challenge vested interests (e.g., Pan Wei)

vs.

Liberals - Want to place limits on the power of the state, either through elections, the rule of law, or public participation (e.g., Sun Liping)

Foreign Policy

Internationalists - Want China to merely play a role in existing global institutions and emphasize prudence (e.g., Wang Yizhou)

vs.

Nationalists - Want China to (re-)assert itself on the global stage (e.g., Yan Xuetong)

Source: "What Does the New China Think?", Leonard, ECFR Policy Report, Nov 2012

However, the new leadership team's own perspective under Xi Jinping and Li Keqiang, is becoming increasingly clear



Economic Reforms

+

Political Stability

+

The Chinese Dream

The 60-point plan outlines Xi's economic reform agenda

SOEs

Increase public ownership

- Create SOE management companies
- Increase social security fund transfers to 30%
- Encourage non-public enterprises to invest in state projects

Market

Let the market play a decisive role

- Introduce financial market reforms
- Push forward price reforms in utilities, transport, and telco sectors
- Explore national treatment of foreign investors
- Explore creation of IP courts

Government

Adjust government's role

- Reduce intervention in economy
- Correct officials' appraisal system from GDP growth to an index including resource consumption, overcapacity, and incremental local government debt

Fiscal

Deepen fiscal reform

- Improve budget and tax system
- Gradually adjust revenue sharing between local and central government by a local tax system (but central government will have more power and responsibilities)

Rural / Urbanization

Improve rural development and continue urbanization process

- More property right for farmers, including limiting rural land acquisition by local governments
- Reform Hukou system (e.g., fully opening for towns and small cities)

Economic System

Further open up the economy

- Liberalize investment access and develop additional free trade zones to experiment with new policies - following the model of the new Shanghai Free-Trade Zone

Source: "China reform plan: in summary", Lydia Guo, Financial Times, Nov 2013

Xi has given himself until 2020 to implement the planned reforms – early indications are reasonably positive



“Xi Jinping is walking on Deng Xiaoping’s path, as a strong reformer” – People’s Daily

Positive Early Indications

- New reform plan considerably more ambitious than previous versions
- Implementation not left to the government, but overseen by a special party committee, chaired by Xi himself
- Unexpectedly strong crackdown on corruption and vested interests in the status quo
- No major financial stimulus (yet)

... however, greatest challenges lie ahead

The planned reforms, and other macro trends, will have a significant impact on the general business environment

Reform Impact

- **Slower growth**
 - Greater competitive intensity among both foreign and domestic firms
 - More heterogeneous customer demand
 - Significant supply-side cost pressure and resulting need to improve productivity and efficiency levels
 - Lower demand for natural resources from other countries (e.g., Australia, Brazil, Russia)
- **Closer scrutiny**
 - Much tighter operational control in response to anti-corruption, anti-monopoly, and other government initiatives
- **New opportunities**
 - Financial services
 - Green technology
 - ...

Other Trends

- **Shifting demographics**
 - China's population is aging; under-40 segment is shrinking
 - New growth opportunities to serve the unique needs of older consumers
 - However, much tougher competitive dynamics in under-forty consumer segment, including head-to-head competition and price/margin pressure
 - Need for domestic and foreign firms to optimize operations and re-think strategy and investment plans
- **New technologies**
 - China is at the cutting edge of the digital era with the largest online population
 - Digitization helps increase connectivity between urban and rural markets with exponential growth of consumer choice
 - Foreign multinationals not necessarily advantaged

The new environment will present both domestic firms and MNCs with operational challenges but also opportunities

Domestic Firms

- Improve core capabilities and move up the value chain
 - *Innovation, Operational Excellence, Go-To-Market*
- Start expanding into international markets
 - *Market access*
 - *Technology / know-how transfer*
 - *Exposure to world-class performance levels*

Foreign MNCs

- Develop much more granular understanding of growth opportunities and challenges
- Re-assess domestic operations to improve productivity and efficiency
- Significantly tighten operational control
- Defend position against increasingly capable Chinese competitors - both in China and elsewhere

Foreign MNCs have four potential strategic options – many will have no choice but to “Play to Win” in China

Four strategic options for MNCs

- 1** “Stay at home”
Remain focused on home market and leave China to other competitors
- 2** “Wait it out”
Wait for (mid-market) demand in China to catch up to (premium) demand elsewhere
- 3** “Play to Win”
Develop required products, capabilities, and other resources to compete successfully in China now
- 4** “If you can’t beat’ em ...”
Partner with one or more Chinese competitors and develop the Chinese and global (mid-)markets together

Source: “China’s Mid-Market: Where “Good Enough” Just Isn’t”, Jullens, Strategy+Business, July 2013

Winning in China is a function of at least eight trade-offs

- 1 China business model** – Rethink business model to support unique local requirements, including product, price, branding, marketing, distribution, and operations
- 2 Low-price products** – Develop “low-priced” products specifically designed for Chinese (mid-market) customers, as opposed to merely introducing “low-cost” versions of existing world-class products
- 3 Value chain migration** – Transfer core activities to China to narrow cost gaps with domestic entry-level market competitors through local product development, sourcing, and manufacturing
- 4 Selective partnerships** – Consider entering into partnerships with local suppliers to fill gaps in entry-level market product portfolio, develop optimal distribution footprint, and navigate China’s unusually complex regulatory environment
- 5 Multi-brand strategy** – Consider developing a multi-brand strategy to successfully operate across premium and entry-level market price points as well as multiple product categories
- 6 Multi-channel strategy** – Develop cost-effective ways of selling across multiple channels and price points
- 7 Strong local organization** – Ensure that management is capable and sufficiently empowered to enable fast decision-making and sensitivity to local market requirements. Clarify decision rights and put in place a strong governance structure
- 8 Global mindset** – A firm’s success is tied to the mindset of its top managers. At a minimum, ensure that headquarters has at least a basic understanding of China’s unique business and regulatory context

Source: “China’s Mid-Market: Where “Good Enough” Just Isn’t”, Jullens, Strategy+Business, July 2013

Summary

- China has no choice but to implement a comprehensive reform program – the next 3-5 years will likely be decisive
- There is little consensus on how to best solve these problems – even in China itself. However, the new leadership team’s own perspective under Xi Jinping and Li Keqiang, is becoming increasingly clear
- The planned reforms and other macro trends will have a significant impact on the general business environment - and present both domestic firms and MNCs with operational challenges but also opportunities
- Foreign MNCs have four potential strategic options – many will have no choice but to “Play to Win” in China
- Winning in China is a function of at least eight key trade-offs, including whether and how to adapt the firm’s business model, where to locate core value chain activities, and how to allocate decision rights between HQ and the local Chinese organization

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Relevant Publications

Harvard Business Review

- *“How Emerging Giants Can Take on the World”*-- Harvard Business Review, Dec 2013
- *“Is China the World’s Next Rust Belt?”* -- Harvard Business Review China, Apr 2013

CEIBS Business Review

- *“Choose Your Capability Path”* -- CEIBS Business Review, Mar 2014
- *“Modern Zorro is Out”* - CEIBS Business Review, Feb 2014

Strategy + Business

- *“It’s a Race to the Bottom in China’s Auto Market”* – Strategy + Business, Sep 2014
- *“How Firms in Emerging Markets Can Play Catch-Up”*- Strategy + Business, Jan 2014
- *“Why Strategy Matters in Emerging Markets After All”*-- Strategy + Business, Dec 2013
- *“China’s Mid-Market: Where “Good Enough” Just Isn’t”*-- Strategy + Business, July 2013