Marketmap

How emerging markets change the global economy

2011
Issue 1

China: Pearls, pitfalls and possibilities

pwc

Contents

East Asia's balancing act

"Emerging economies like China, India, and Brazil are growing at rates that far surpass the developed nations. The shift in the economic balance of power creates challenges for CEOs in deciding how and where to invest in facilities, people and innovation. Companies that understand and capitalize on the diverging growth patterns of the developed and emerging economies will be the winners in the years ahead."

— Dennis M. Nally, Chairman of PwC International

Today's China has become virtually synonymous with global possibilities. And companies in advanced markets, eager to shake free of mature home turf to explore the potential of the BRICS[1] and beyond, are making serious forays into East Asia's flashiest attraction.

The intrigue doesn't stop with Beijing. As China expands its horizons from its coastal cities to its traditionally rural interior, opportunities seem as bright and bountiful as a Chinese Lantern Festival in celebration of an autumn harvest. Those eager to rise along with China's growing economy will need to illuminate their way forward on an ongoing basis, or risk costly stumbles on unfamiliar terrain.

China's ascension, while impressive, has not followed a straight trajectory — an insight that often gets overlooked amid the hoopla. Some substantially stalwart businesses have forged successful paths. But the sheer magnitude of their operations and depth of their pockets have been significant in enabling them to overcome what can often be a daunting slog through a nascent and unfamiliar market.

The challenges are myriad, complex, and often interrelated. The government's role in business life looms large; the lack of separation between government and business is the Chinese way. Business partner pedigrees are at a premium. Due diligence is indispensible, yet elusive. Those in search of transparency often find translucency at best. And intellectual property protection and surer safety standards remain works in progress.

The resulting environment can be rife with risk. To assess and mitigate these challenges, it's not enough to ask questions. It's no exaggeration to suggest that mastering the Socratic method can become business as usual for the sharpened business person around Shanghai.

The Chinese have long said that a journey of a thousand miles begins with a single step. If you're among the many who are intrigued by the possibilities that can be found along this path, your first step should include getting to know the ins and outs of doing business in today's China. As you'll see, China surely beckons with the luster of pearls. But astute entrepreneurs will take measured steps to string together a tightly bound strand of high-quality gems.

Read on to learn more about the rewards and realities of China today and how best to position your enterprise to share wisely in the emerging wealth.

1 Brazil, Russia, India, China, South Africa

China rises

"Pearls lie not on the seashore. If you desire one, you must dive for it."

— Chinese proverb

China has come a long way since embarking on economic reform in 1978 under Deng Xiaoping. And it has done so quickly, albeit not always in a linear fashion. Since the late '70s, its economy has grown tenfold, industrialization supplanting agrarian trade — not over the course of 200 years, as in Europe, but in three decades. China's cumulative real GDP growth is projected to outpace that of developed economies and the rest of the world by 2015.[2] Along with one of the hardest-charging income level increases in history, China's economic awakening has resulted in the largest poverty decline ever.

The interest in China among investors is a long-term secular one. One dramatic indication of the global rebalance: China, which in 1980 didn't rank among the top 10 global economies by size, looks poised to top the United States as the world's largest economy by the time babies born today embark on their careers in the mid-2030s.[3] The current economic cycle is a major factor influencing nearly 85% of CEOs we surveyed to shake up their business strategy in recent years.

China has surpassed Japan as the second-largest economy in the world, behind only the United States.[4] In the near term, China's growth is projected to continue at a robust clip of about 8% a year over the next five years,[5] as prosperity unfolds like a fan, wafting consumption growth through an economy that will continue to seem more inspired by Wall Street than the Great Wall — complete with cyclical fits and starts.

Among emerging markets, China has unleashed performance and prospects that outpace Brazil, Russia, India, and South Africa as well as up and comers such as Mexico, Egypt, and Taiwan. China's 10% average growth per year between 1999 and 2009 is highest among the emerging markets, and topped 14% in 2007. Its 2010 GDP was second only to the United States, landing it ahead of Germany, Brazil, India, Russia, Mexico, and Indonesia.

CEOs responding to our 14th Annual Global CEO Survey liked what they saw. Many pointed to China as the most important country for future growth; of the 1,201 CEOs surveyed, 39% saw the greatest opportunity there, well ahead of the United States (21%), Brazil (19%), and India (18%).[6] China also tops the list as the most important venue for meeting future sourcing needs, with 37% of leaders surveyed planning to shift sourcing there, primarily inspired by the potential for cost competitiveness.

Market growth has long been China's golden goose, as the country's workers grow increasingly capable of buying the goods and services that were once

2 Building a presence in today's growth markets, The experience of privately held companies, PwC, 2011
3 The World in 2050, PwC (January 2011 update)
4 The World in 2050, PwC; View, issue 13, Doing business in a changing China, seeking similarities, respecting differences, PwC, 2010-2011

5 Building a presence in today's growth markets, The experience of privately held companies, PwC, 2011
6 Prospects in emerging markets drive global CEO confidence to pre financial crisis levels and 14th Annual Global CEO Survey, Growth Reimagined, PwC, 2011; created in cooperation with the Economist Intelligence Unit (EIU). The findings presented in the main report are based on a survey and analysis conducted in 2010 by the EIU on behalf of PwC.

designed solely for other markets and demographic groups. The transformation is readily apparent, and businesses large and small have noticed. The experience of one international hotel illustrates the transformation; Starwood Hotels & Resorts Worldwide opened the Sheraton Great Wall in Beijing in 1985 to serve Western travelers seeking familiar surroundings in China. At the time, less than a decade into China's economic awakening, the only local Chinese nationals who could be seen around the facility were staff members. Today, local Chinese visitors comprise 60% of the Sheraton's guests.

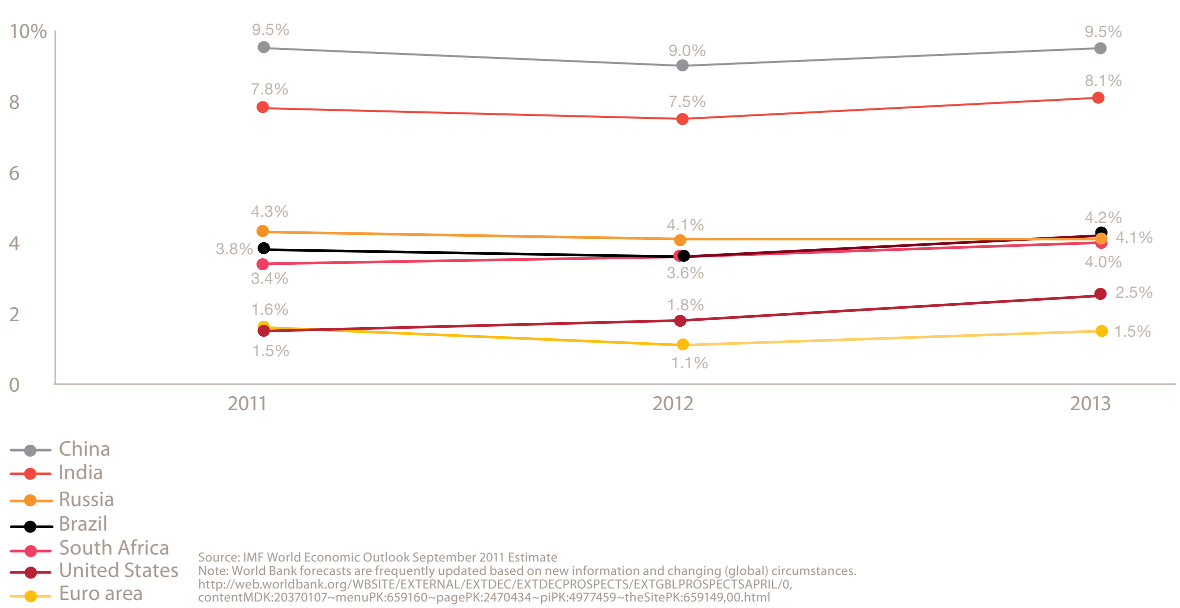
Private companies, too, want in on the action. More than 60% of the 158 non-financial private company leaders PwC recently surveyed say they're already doing business in China or are considering such a move, citing the selling of goods and services as their top opportunity in China. By comparison, the other BRICS hover around the 40% mark. Business leaders are eyeing emerging markets, countries such as Colombia and Argentina, which represent a second wave of overseas markets, to a lesser extent, with about 20% of company leaders venturing into countries such as Mexico and South Korea, or contemplating it.

Doing deals: Robust times for China

China's recent deal market might remind one that it is, after all, the country that invented fireworks. Deal volume in China shot up more than 15% and deal value rose nearly 30% in 2010 as compared to 2009. In contrast, US deal volume around that time remained relatively flat, with deal value edging up less than 10%.[7]

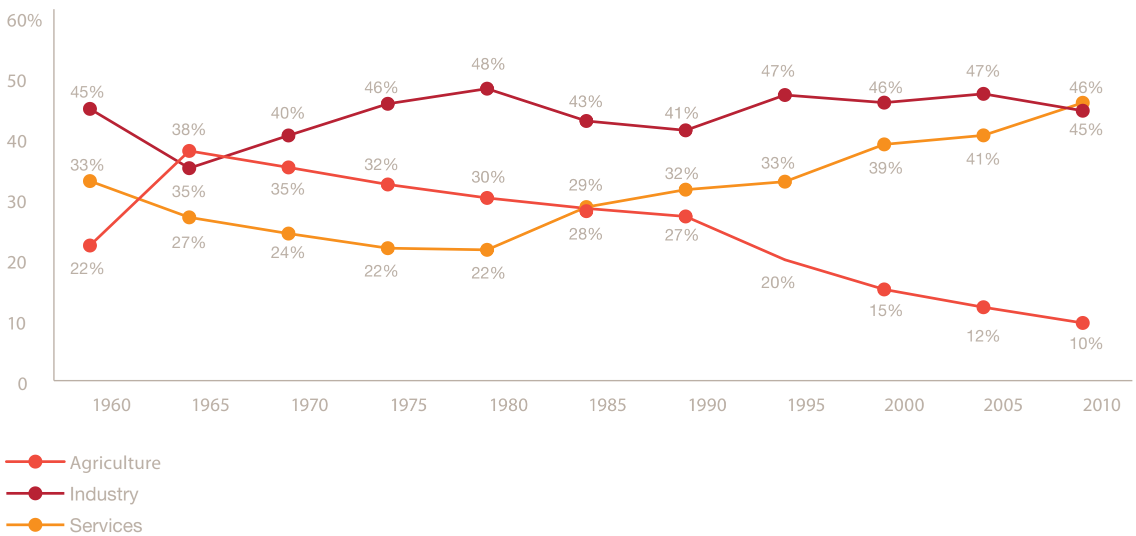
7 Ten minutes on doing deals in China, PwC, 2011

IMF Projections for percentage of GDP growth, September 2011



Source: IMF World Economic Outlook September 2011 Estimate
Note: World Bank forecasts are frequently updated based on new information and changing (global) circumstances.
http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGBLPROSPECTSAPRIL/0,contentMDK:20370107~menuPK:659160~pagePK:2470434~piPK:4977459~theSitePK:659149,00.html

World Bank : GDP Contribution by sector: China's rapid industrialization

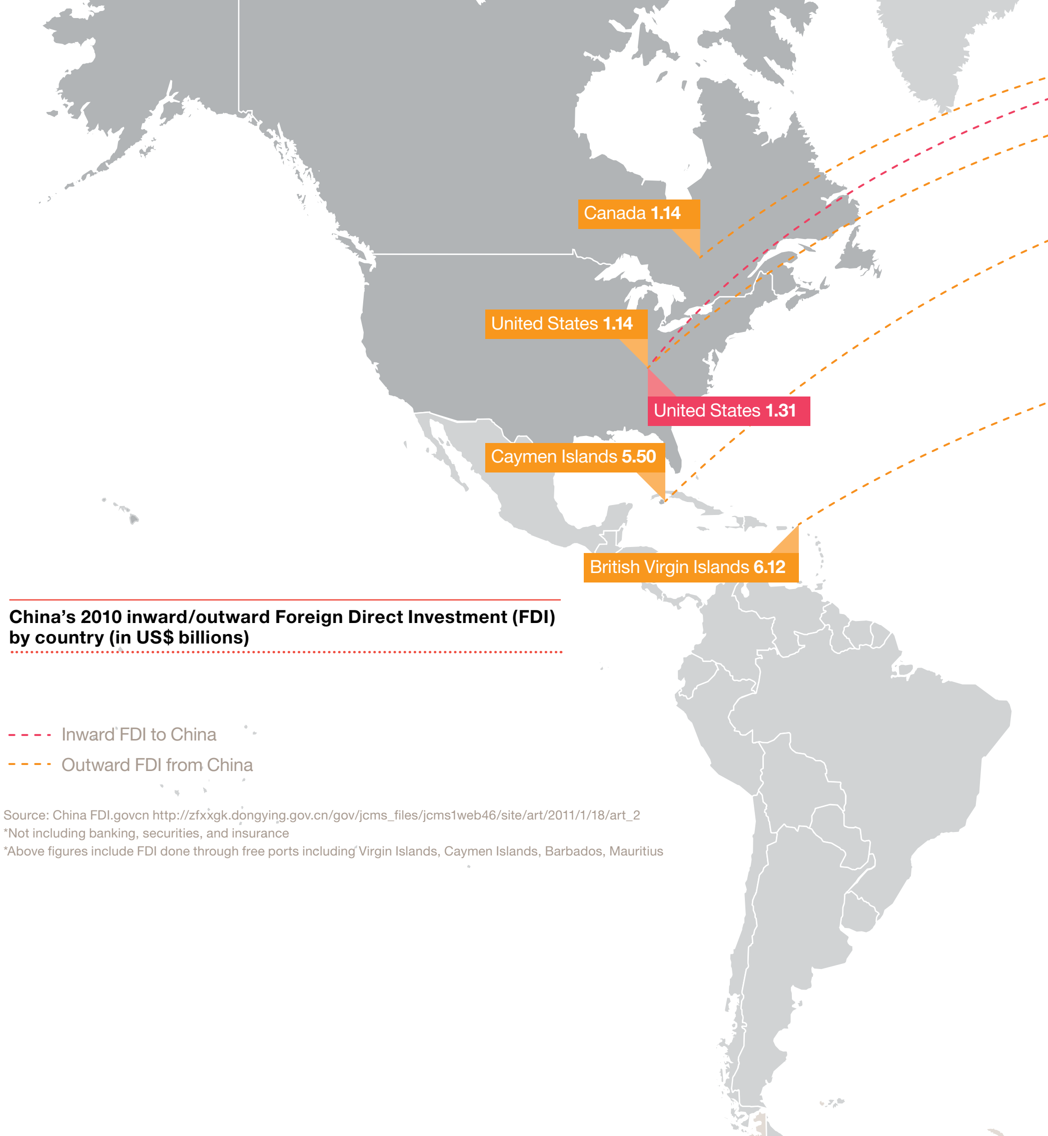


Source: World Bank Database http://data.worldbank.org/indicator

We're seeing an evolving global and domestic M&A picture, with China at the forefront of change. Amid a flurry of inbound and domestic deals, critical sectors such as auto parts, cement, and metals are coalescing around numerous smaller enterprises. At the same time, Chinese companies are acquiring resources through megadeals in Africa and South America and expanding globally into sectors such as automotive and chemicals.

We also see a trend toward a growing number of joint ventures (JVs) formed in China; companies are increasingly using local partners' market knowledge and relationships with customer and the government to adapt to an 'in China, for China' strategy. Multinationals should recognize that local partners need a distribution network to realize market penetration and intellectual property (IP) to enable them to appeal to the local consumer base.

Asia's largest private equity (PE) market resides in China — and it's in a state of flux. PE transactions there grew to 580 in 2010, an increase of more than 65% over the previous year, with more than two-thirds initiated by domestic funds. Almost half of the funds raised by private equity were in Chinese currency, the renminbi (RMB) with yuan the basic unit. It's a significant challenge, but some foreign funds are teaming with Chinese municipal governments and private entities in RMB funds to further penetrate the market. China's market holds significant 'dry powder'; the emergence in RMB funds has fostered substantial fundraising, fueling continued upward pressure on deal valuations.



China's 2010 inward/outward Foreign Direct Investment (FDI) by country (in US$ billions)

Source: China FDI.govcn http://zfxxgk.dongying.gov.cn/gov/jcms_files/jcms1web46/site/art/2011/1/18/art_2
*Not including banking, securities, and insurance
*Above figures include FDI done through free ports including Virgin Islands, Caymen Islands, Barbados, Mauritius

For multinationals whose sights are set on long-term growth in China, indigenization is crucial. Business models must be adapted to accommodate a dual perspective: one, the traditional multinational context (focused, for example, on shareholder value and corporate citizenship), the other, the domestic Chinese view. To grasp the latter, businesses must cultivate an understanding of and respect for the views of a number of Chinese stakeholders, including central and local governments, suppliers, customers, employees, and universities. Success will be largely predicated on their ability to fuse business-as-usual with business-as-usual in China, which can be distinct, but not necessarily mutually exclusive, approaches.

While Chinese investors have been providing capital to gain access to global markets, Chinese businesses and their partners are thinking more creatively about mutually beneficial arrangements. For example, some Western companies are making inroads into China's domestic market by providing Chinese businesses with an entree into the global marketplace. Some observers see outbound Chinese investors gearing up to acquire sizable stakes in Western markets, but Chinese investors going abroad face steep learning curves in executing and integrating their acquisitions, a development that closely parallels the Japanese history of investing in the United States.

Despite inroads, some investors question whether China remains too economically nationalistic to truly

seek such relationships, as many deals still flounder far short of success. Others view these disappointing forays as part of the country's economic growing pains rather than investment isolationism. Through any lens, China's economy delivers significant opportunities; their realization requires foreign investors to identify mutual touch points for strategic growth while identifying, managing, and cutting risk.

Where the industry action is

China's admission as a full World Trade Organization (WTO) member in November 2001 spawned a boom period for foreign investors in sectors such as distribution, logistics, financial services, and telecommunications, as well as a customs duty cut.

Thanks to its strong export platform, China is already a preferred destination for the relocation of global manufacturing facilities. It's also cited along with the United States and India as among the most important future sources for products and raw materials by participants in PwC's CEO survey. And although the cost of manufacturing there is rising as Chinese workers enjoy higher wages and a growing consumer footprint, the export platform remains the most appealing opportunity in China among the private company leaders we polled. This factor is now being challenged by China's rapidly growing domestic markets.

Amid China's increasingly invigorated market, the country's robust manufacturing base, building steadily since the economy began opening up a few decades ago, is spreading from the coastal regions to the second- and third-tier cities inland, where lower-cost labor and property are still the norm. In fact, some 60% of the Chinese government's 4-trillion-RMB stimulus package has been allocated to developing transportation, affordable housing, and rural infrastructure in the central and western regions, according to some estimates, yielding significant opportunity.[8] Foreign investors in heavy industries such as steel manufacturing are eyeing inland China's immensely rich stock of iron ore and other natural resources.

China is also casting its eyes beyond its own borders. In the past decade, China's presence in Africa alone

8 View, issue 13, Doing business in a changing China, seeking similarities, respecting differences, PwC, 2010-2011

has spread across the continent, from Angola to Zimbabwe and beyond, including business interests in energy, mining, infrastructure development, and financial services.[9] It's also emerging as a prime investor in energy around the world, notably green energy, standing alongside the United States as a global cleantech leader, aggressively backing emerging industries in the hope of boosting its economy, environmental performance, and brand.

China's economic climb, with its inherent reliance on energy-intense industry and infrastructure development, thrust it past the United States as the world's largest energy consumer in recent years — a position the homeland of Henry Ford had held since the early days of the 20th century. And it did so in the fast lane. A decade ago, the United States consumed twice as much energy as China. But several years of double-digit growth rates in China and the recession's deeper dig in the United States accelerated this dynamic. (On a per capita basis, China remains at about one-third of the Organisation for Economic Co-operation and Development [OECD] average.)

While China's increased energy demand is not largely a reflection of consumer behavior, the country's recent dominance of the automotive sector is. China has grown into the world's largest automotive market, with sales surpassing the United States in 2009 and more automotive assembly plants than any other country. Automotive CEOs are revving their engines in response to opportunities there,

9 For more information, please see China and India go to Africa, New Deals in the Developing World, Foreign Affairs, published by the Council on Foreign Relations, by Harry G. Broadman, March/April 2008

with 64% naming China as important to their business growth, well above the global average. PwC expects that some 80% of global growth in the sector by 2017 will come from emerging markets — 34% from China.[10]

As China's economic rise continues, Far East neighbors such as Malaysia, Vietnam, Cambodia, Bangladesh, and Thailand all stand to prosper. Already, Indonesia, Malaysia, and Vietnam have been prettying themselves up for small and mid-sized businesses with loosened permitting and property registration and more fluid credit information sharing. At the same time, China's rising labor costs have some businesses looking toward these less-conspicuous destinations for more affordable manufacturing support. Malaysia, with its history of British rule and law, has drawn interest among those wary of one of China's perceived Achilles heels: less stringent IP protections, particularly in the technology field, where IP risks remain a paramount concern.

10 PwC Autofacts, March 2011

60 years of strategy

The Twelfth Five-Year Plan, recently endorsed by the National People's Congress, lays out economic, social, environmental, geographic, regulatory, and legal strategy. The plan looks to these strategic industries to provide 8% of GDP by 2015 and 20% by 2020:

- Alternative energy
- Next-generation information technology
- High-end equipment manufacturing
- New materials
- Clean-energy vehicles
- Energy conservation and environmental protection
- Biotechnology

According to the current vision, the China that emerges over the next five years will embrace a 'softer' side of the growth agenda, with a commitment to issues such as social equality, environmental consciousness, and resource availability. The plan looks to:

- Lessen discrepancies between coastal and interior regions
- Target 7% economic growth (versus prior 7.5% goal)
- Enhance social infrastructure
- Increase and spread wealth
- Cut reliance on exports and boost household consumption
- Balance growth and sustainability

Growth and change in today's China

Rapid growth and change can have its drawbacks. Just ask any teenager. Or take a closer look at today's China; beneath the shimmer of economic metamorphosis, vigor, and burgeoning opportunity, we also find that the underpinnings of this new paradigm remain unrefined in many respects, as does the understanding of many who are looking to do business in any emerging market. China presents its own distinct challenges. These needn't be deal-breakers. But neither should they be ignored.

For those who would seek their fortune in a land where time runs 12 hours ahead of any given New York minute, the adjustments don't stop when you reset your watch. Operating on the other side of the world can be as puzzling as a trip through the looking glass. Once the jet lag dissipates, savvy business leaders will awaken to a new world of cultural, operational, and regulatory realities. Many investors cite challenges in navigating a general lack of transparency, an unreliable legal system, industrial policies that can be skewed in favor of local businesses, and concerns about corruption and IP, which is a characteristic challenge of emerging markets generally.

Much of this reflects the reality that China's economic strides have been a hemispheric hybrid, incorporating Western economic ideals alongside steadfast loyalty to China's political, historical, and cultural roots. As we've seen, the resulting entity has been spectacularly effective in pushing China into the major leagues of economic expansion — a rapid transformation that can belie the implications of governmental involvement and influence in business affairs.

Transitioning markets, intransient rules and roles

Like its climate, tropical in the south, subarctic in the north, China is a land of dramatic contrasts. The nascent nature of China's role as a global economic power means its financial markets are still young while its banks are still working through rebalancing issues. Maintaining social and economic stability is a top objective of the Chinese government and its officials in the current transitional environment.

China's one-party government (the Chinese Communist Party or CCP) wields substantial influence as

the country's leading corporation, regulatory, and pricing body. It's a degree of influence that may present a challenge to many Westerners striving to develop positive working relationships with local stakeholders in markets while remaining in compliance with anticorruption laws, engendered by policymakers intention of creating clearer separation between government and commerce.

Because the notion of privatization in China doesn't jibe with the assumptions of businesses accustomed to operating in mature markets, success will hinge on the ability to understand the government's role and China's operating environment while remaining poised to keep operations clear of corruption through assiduous risk management.

The government's reach is evident in potential investment restrictions, which are far broader than those seen in the United States and other developed nations. China's legal and regulatory framework enables its leaders to exercise authority over the direction of investment money, targeting the regions and industries deemed ripe for development. While this has presented challenges for some foreign companies, others have been successful in recognizing it as an opportunity to collaborate with local players and develop mutually beneficial China strategies that are aligned with Chinese stakeholder interests.

It's not what you know

Yes, of course, it's who you know. But in China it's also what you don't know, or know enough about to ask what you need to know. That's why it makes sense to strive for a real understanding of Chinese culture and the way business there gets done. 'Guanxi', the notion that cultural differences can be bridged by building and maintaining relationships can be a two-way street rife with potholes for the uninitiated and raising questions even for those who have experience. Many corporations and their legal advisors struggle to determine the right balance between the appropriate deference to guanxi on the one handand anti-corruption regulations, such as the FCPA, UK Bribery Act, and the OECD, on the other. For example, although expense reporting for such forays as business meals remains a fundamental practice, Chinese government officials might not want their names recorded on such documentation. And some companies look the other way in the interest of building the relationship.

No one wants to alienate one's business associates. But the prospect of the hammer falling from a foreign investor's home country anti-bribery law liability is hardly appealing either.

China challenges: A closer look

Corruption crackdown, regulatory renovation

Corruption can cause business aspirations to fizzle like fireworks in a monsoon. Investors need to remain attuned to FCPA and UK Bribery Act restrictions, along with local anticorruption regulations. A significant segment of China's population is involved in governmental activities, which can increase the potential for both local an home country bribery violations.

While corruption can undermine any business environment, how it's perceived is subject to cultural translation and transformation, much like attitudes toward diversity or smoking. As China increasingly takes its place on the world stage, the government has been cracking down.

Reform efforts have met with mixed results, but in recent years, the government has gone so far as to execute public officials convicted of bribery, embezzlement, and abuse of power. Chinese officials haven't shied away from punishing corporate players perceived to have bent or broken such laws. High-profile arrests of foreign employees accused of bribery and IP infringement have raised flags for businesses around the world as to where the lines are drawn when it comes to acceptable versus criminal commercial behavior in China.

Once viewed as lagging in regulatory reform relative to its growing global importance, China has lately embraced a more stringent anticorruption stance. Along with anti-bribery regulations, companies operating in China need to remain in step with numerous laws governing taxes, labor practices, exports, trade, and the environment.

China's own anti-bribery law, based on Article 16 of the United Nations Convention Against Corruption, recently took effect when The Standing Committee of China's National People's Congress passed an amendment to China's Criminal Law. This criminalizes bribery of officials of public international organizations or foreign government officials by Chinese individuals and companies.

The development reflects an ongoing evolution, coming in the wake of China's WTO accession a decade ago and creating an ongoing impetus for investors to remain nimble and able to adapt their operations and structure. By 2007, China had enacted its own antimonopoly law, which took effect the following year and is enforced by the Ministry of Commerce (mergers and acquisitions); the National Development and Reform Commission (anticompetitive conduct pertaining to pricing); and the State Administration for Industry and Commerce (other anticompetitive conduct). More recently, the US Department of Justice's (DOJ) Antitrust Division signed a memorandum of understanding with those agencies as a nod to ongoing communication and cooperation.[11]

Enhanced regulatory guidance for M&A activity in China can be challenging for investors, even as it brings increased transparency to decision making. Some see the new guidance on China's national security reviews as a parallel to the Committee on Foreign Investment in the United States, a multiagency national security

11 US Department of Justice, http://www.ftc.gov/opa/2011/07/chinamou.shtm

group that reviews transactions that could result in control of a US business by a foreign person.

China's tax authorities are also moving to tighten the enforcement and consistency of related policies. Tax policy perks, such as tax holidays and reduced income tax rates, have served the government's aim to attract foreign investors. These investors also are protecting themselves from picking up sellers' tax liability amid fallout from anti-tax avoidance measures, which often requires intensified due diligence and the ability to demonstrate legitimate business operations among special purpose vehicles that are sometimes used to mask tax avoidance.

An often unreliable business tax documentation system poses another challenge. While the system is heavily bureaucratic, it's also subject to abuse. And completing the necessary paperwork by Chinese standards is no panacea. That's because the onus for requesting business tax invoices, known as 'fapiao', remains not with the business service provider, but with the consumer, injecting the process with considerable variance and vulnerability. In the last decade, Beijing introduced cash incentives to induce more consistent and reliable reporting and boost tax revenue. But corrupt practices persist; it's not unheard of for such documents to be forged, or even crafted on a street corner. As such, home country enforcement agencies often look upon this paperwork with a healthy dose of skepticism.

Where piracy meets progress: Intellectual property rights and wrongs

As China's business environment continues to undergo transformation, we can expect an ongoing parade of regulatory shifts, some of which

will gain better traction than others. Regardless, the pace of change will no doubt be brisk, at times sudden, with considerable implications for business operations; it will be crucial to stay tuned in to the changing tides and tuned up operationally.

Perhaps nowhere are China's crossroads between old and new, public good and private profit, more evident than in its attempts to rein in IP infringement.

China began shoring up its IP protection enforcement efforts, passing patent, trademark, and copyright protection laws in the early 1980s, shortly after Deng Xiaoping unleashed economic reform. That was followed two decades later, in 2001, by China's WTO accession, along with refinements to IP laws to comply with the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS).

More advances followed. In 2007, China signed onto further global initiatives, including the World Intellectual Property Organization (WIPO) Copyright Treaty and WIPO's Performances and Phonograms Treaty. It's also involved in organizations such as:

- Paris Convention for the Protection of Industrial Property
- Berne Convention for the Protection of Literary and Artistic Works
- Madrid Trademark Convention
- Universal Copyright Convention
- Geneva Phonograms Convention

Along with these global IP protection efforts, the government has also worked to curb violations and boost enforcement, seeking to raise awareness of IP issues among the public while expanding the State Intellectual Property Office (SIPO), State Copyright Bureau, and similar agencies, and assigning IP protection roles to other state organizations.

But such strides have often come with setbacks and caveats. According to the US DOJ, a WTO dispute settlement panel found that some elements of China's intellectual property rights (IPR) regime are 'inconsistent with its obligations under TRIPS'.[12] And software, entertainment, and consumer goods groups report ongoing — and often high-profile — piracy incidents.

Violations continue to outpace enforcement. Lack of government agency coordination hampers efforts to quash IP abuse, and regional enforcement inconsistencies create an environment in which some areas offer relatively stringent IPR protection while others remain relatively lax.

This is an area in which the would-be seller must be wary. Patent and copyright infringement, piracy and counterfeiting, and product diversion can cost you dearly in the marketplace and in the media. Chances are your IP is your most valuable asset, as a source of revenue outright or as the basis for competitive advantage. As such, it must be carefully cultivated and tightly guarded. Protecting these assets against unauthorized use and finding trustworthy potential partners will be crucial to maintaining a successful IP strategy and running a successful business in China.

12 US Department of State, 2011 Investment Climate Statement, Bureau of Economic, Energy and Business Affairs, March 2011, http://www.state.gov/e/eeb/rls/othr/ics/2011/157258.htm

Despite progress, improvements often remain insufficient for many multinational corporations (MNCs), which should focus on IP value management strategies to preserve IP value by leveraging the core operations of the enterprise.[13] We see a trend toward sector-specific risk profiles to determine an appropriate level of entry into China. If the decision is made to enter the market, companies need to ensure their understanding of the legal, commercial, and stakeholder interests, particularly as they relate to the government. They also must maximize the use of the company's existing IP protection laws and practices and pursue both commercial solutions and legal remedies, for example, through such means as local IP co-development, bimodal product strategy, and minority cross-ownership.

Indeed, from IP to JVs, the ability to identify solid business partners is a critical challenge. Unwary investors who choose poorly can find themselves in a league with the wrong crowd, setting up the venture for failure and jeopardizing their brand and bucks. Affirming partner integrity is a critical and challenging endeavor in China, where gaining a foothold in the market depends on high-touch, high-stakes business relationships. Though success can ride on the ability to tap the right partners, outdated or elusive financial and ownership data can compromise otherwise seemingly thorough due diligence, making it tough to assess intermediaries, agents, JV partners, and other liaisons on whom so much can depend.

13 Redefining Intellectual Property Value, The Case of China, PwC, 2005

The made-in-China brand: The drive to revive damaged goods

Product quality is not an issue reserved only for those with IP concerns. Although China has moved closer to mature market comfort zones in some crucial ways, US and EU leaders recently expressed concern that China's efforts to shore up product safety have not gone far enough. In response, China recently announced plans to tighten regulations, stop defective and dangerous exports, and soothe potentially trade-defeating doubts.

China's consumer-protection officials vowed in 2010 to hold Chinese manufacturers accountable for product safety, to work with its counterparts in advanced economies to set safety and testing standards, and to keep dangerous materials such as lead out of products made in China.

The issue came to international notoriety when, in 2005, tainted Chinese-manufactured drywall made its way into post-Hurricane Katrina construction projects on the US gulf coast, at a time when many eyes were cast upon the devastated region. More was to come. In 2007, toxins were found in other products made in China, including wheat flour, frozen fish, and toothpaste. The flour, contaminated with the industrial chemical melamine, made its way into pet food, reportedly killing thousands of dogs and cats worldwide.

As if all of this wasn't damaging enough to the made-in-China brand, numerous 2008 recalls amplified trade jitters further when toys exported from China to the United States were found to contain dangerous amounts of lead. Again, the timing may well have exacerbated trade tensions;

Pinyin: A method by which Chinese ideograms are transcribed as Roman-style words.

just as the global economy had started to sour, it seemed that even toys could sow apprehension and doubt. The impact was significant, as toys associated at least in part with Chinese manufacturing comprise 80% of the US kid market.

That year also saw alarming reports that melamine had surfaced in baby formula made by more than 20 manufacturers in China, where it sickened thousands of children and even resulted in some fatalities. Although this threat didn't cross borders, it did nothing to burnish China's image as a trustworthy producer and partner.

A spokesman with China's Administration of Quality Supervision, Inspection, and Quarantine recently cited international standards as a means of mitigating these concerns. At the same time, the onus could simultaneously be shifted away from regional determinations, which can stir up disparities and hike costs — never welcome circumstances and less so in a volatile economy with unpredictable demand.

Shoring up supply chain integrity

Vendor and supply chain integrity issues have emerged from the margin squeeze on Chinese vendors based on input cost inflation and pressure from Western buyers for higher pricing, which has accelerated amid the economic slowdown.

This is often more of a systemic problem that requires a systemic solution. US companies frequently try to address the matter by keeping an arms-length relationship with suppliers and assessing quality only on the back end. But sheer volume and gaps that enable Chinese vendors to evade such controls increasingly erode the effectiveness of these reviews.

When proper due diligence has been performed, greater collaboration with vendors can increase supply chain transparency, accountability, and quality. Many companies are now trying to build:

- Greater supply chain visibility so they can understand the cost structure for themselves and better assess vendor quality and integrity up front
- Collaborative, not arms-length, relationships in which they work closely with vendors to improve quality and cost efficiency; for example, providing more favorable contractual terms for vendors that provide greater transparency
- Increased traceability for sectors, such as auto parts, in which quality is of higher importance

With these measures in place, we see an emerging trend toward the transfer of accountability for maintaining supply chain integrity to vendors. This is distinct from the arms-length approach, as the focus is on enlisting vendors' help in improving transparency and opening access to the production process.

Alphabet soup in Pinyin spells 'anticorruption'

China's growing significance as a player with global deal appeal is reflected not only in emerging regulatory vigor, but also in an improved showing in assessments conducted by international organizations such as Transparency International (TI), the Economist Intelligence Unit (EIU), and The World Bank.

Regardless of which measure one looks at, these indices should not be viewed as having great precision, but rather as assessments of orders of magnitude; they tend to be correlated with one another and paint a picture of China as a country that has been improving but remains at a comparatively low level of good governance overall.

TI, which publishes an annual Corruption Perceptions Index (CPI), uses survey participants' insights to identify public sector corruption hot spots, scoring countries on a scale from 10 (very clean) to 0 (highly corrupt). For compliance decision-making and risk assessment purposes, entities often assign a threshold risk level, typically 4 or 5 on TI's CPI scale. Some companies have broken the rankings down even further, identifying corruption as rampant in countries that score 0 to 3 and presuming a high likelihood of experiencing corruption in countries that score between 3 and 5.

In the 2010 CPI ranking of 178 countries, China scored a 3.5 and ranked 78th, tying with Colombia, Greece, Lesotho, Peru, Serbia, and Thailand. Although this placed China in the bottom half of the index, it demonstrates a marked improvement since 1995, the first year TI produced the survey; at that time, China scored 2.16, finishing next to last, sandwiched between Indonesia (1.94) and Pakistan (2.25).[14] For the sake of comparison, the United States ranks 22nd with a 7.1 rating, while the United Kingdom ranks 20th with a 7.6 rating.

EIU's ratings, which date back to 1982, show similar improvement in China's legal and regulatory risk profile since 2002, especially with respect to fair competitive practices and prompt and

14 Transparency International and the University of Goettingen

EIU's assessments are based on information related to numerous risk indicators, including:

1. Security: armed conflict, terrorism, violent crime and unrest, organized crime, kidnapping and extortion
2. Political stability: social unrest, disorderly transfer of power, excessive executive authority
3. Government effectiveness: excessive bureaucracy, cronyism, corruption, human rights abuses
4. Legal/regulatory: investment protection, contract enforcement, fast and fair judicial process
5. Macroeconomic: recession, inflation, currency, and interest rate volatility
6. Foreign trade/payments: capital controls, trade restrictions, discriminatory tariffs
7. Financial: availability of local financing, liquidity of local markets, bank risk
8. Tax policy: tax rates, predictability, and transparency, risk of retroactive taxation
9. Labor market: trade union power, labor unrest, right of free association
10. Infrastructure: port facility quality and reliability, air transport, distribution, utilities, the Internet

fair judicial proceedings.[15] However, this analysis also indicates ongoing concerns about contract disputes, corruption, and corporate governance.

The organization's business risk framework scores 180 countries on a scale of 0 to 100, with 0 being least risky, in an effort to quantify business profitability risks. The current EIU analysis, for example, deems Switzerland as presenting the lowest risk with a score of 10; Somalia is assessed as holding the highest risk to profitability, at 83.

China falls somewhere in between, with an overall score of 46, reflecting its improved business climate, substantial social change, and complex bureaucracy. Specific risk ratings for China include a 60 in regulatory risk and a 55 in political stability risk on the higher (riskier) end; and, on the lower (safer) end of the risk scale a 47 in infrastructure, a 38 in tax policy, and a 36 in foreign trade and payments.EIU's findings reflect advancements in business law that are undercut by socioeconomic changes that could threaten stability; rapid infrastructure advances; and high tax rates relative to international levels. Although China has increased imports, access to some sectors remains an uphill climb because of government restrictions in the high-tech industry, petroleum, and certain mineral resources that are crucial to the country's manufacturing base; foreign companies can face challenges in setting up direct subsidiaries in these industries. At the same time, the government might seek an ownership stake.

15 Building a presence in today's growth markets, The experience of privately held companies, PwC, 2011

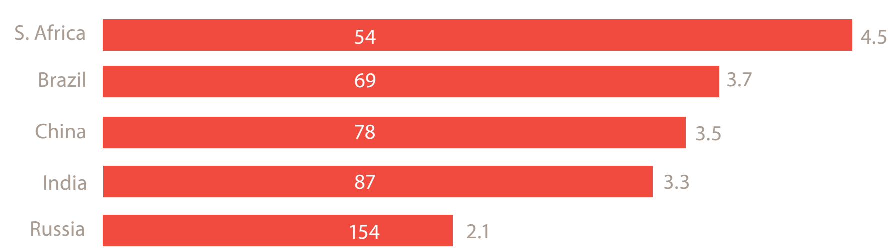
Similarly, The World Bank, which rates countries on ease of doing business, ranks China 91 out of 183 economies in its 2011 report.[16] Note that a more nuanced picture of China's commercial environment emerges when one considers its scores on specific elements of doing business there as shown to the left.

In contrast, Hong Kong is ranked second, while Singapore earns the top spot and the United States is fifth, based on a set of regulations affecting nine stages of the business life cycle, from getting started to closing up shop and pivotal points in between: managing construction permits, registering property, obtaining credit, protecting investors, paying taxes, cross-border trading, and contract enforcement.

16 Doing Business 2012, Making a Difference for Entrepreneurs, A Copublication of The World Bank and The International Finance Corporation, 2011
17 Doing Business in Hong Kong, PwC, 2010
18 http://www.gov.hk/en/about/abouthk/facts.htm

Transparency International Corruption Perceptions Index 2010

Overall corruption score (1 = highly corrupt 10 = very clean)
Overall ranking (178 countries surveyed)



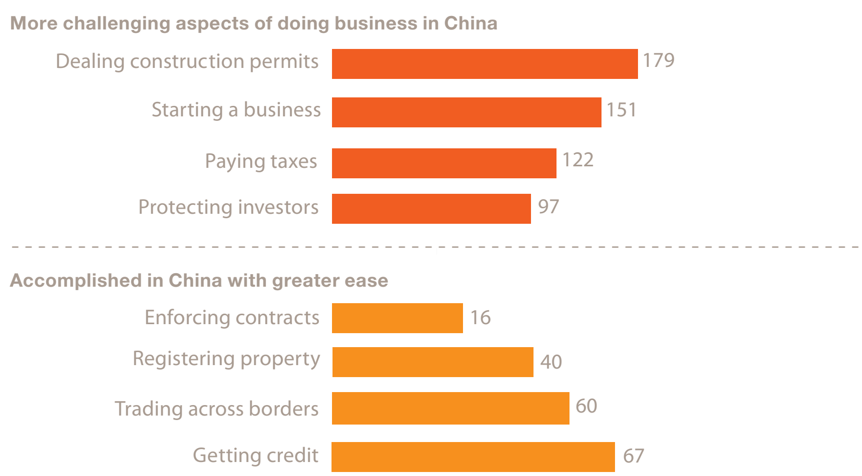
The 'World's Freest Economy'

Hong Kong has actually been ranked the 'World's Freest Economy' for nearly two decades in a report issued annually by The Heritage Foundation. A regional business hub with international business chops, Hong Kong simply could not be any closer to China geographically, linguistically, or culturally. As such, it's a great place from which mainland investors can enter regional and global markets. The Hong Kong government embraces a policy of 'market driven with minimal government interference', in which foreign investment is welcome. It's devoid of policies protecting local industry against foreign competitors.[17]

A Special Administrative Region of the People's Republic of China, Hong Kong was under British rule from the mid- 1800s to 1997, when China took over sovereignty under a 'one country, two systems' model. The Basic Law, the Hong Kong Special Administrative Region's constitutional document, ensures that the political situation will remain in effect for 50 years; individuals' rights and freedoms are based on the impartial rule of law and an independent judiciary.[18]

China's overall ease of doing business ranking of 91, the World Bank rated China as follows in these categories

Ease of doing business: 1 = easiest; 183 = most difficult



Complex, yes. Compelling, probably. Inscrutable?

"Deep doubts, deep wisdom;
small doubts, little wisdom."

— Chinese proverb

Are you ready to take a bite of the pomegranate? You can enjoy the fruit without choking on all those small seeds — if you can tie profit to disciplined, risk-based decision making.

Seven ways to protect your reputation, from your home base to the streets of Beijing and beyond:

1. Prevent, control, and contain direct and indirect losses related to corruption.
2. Choose your partners wisely and protect your intellectual property like a mother panda.
3. Remain aware of local, regional, and jurisdictional quirks and nuances.
4. Keep a watchful eye on operating model efficiency when navigating the challenges of sustaining profits amid pressure to salvage margins.
5. Bring local Chinese talent into the business and bring your leadership to the streets.
6. Bring your market savvy: Know your customers and partners in China.
   - Know their income levels, their cities, provinces, and towns.
   - Know whether they work for or with the government.
   - Understand how they do business.
7. Be a model of unflinching business ethics on the world stage.

The first step: safeguard your operations from corruption with a thorough review of economic opportunities and a risk analysis.

Anticorruption starts at the top with the board of directors and senior management. These efforts also demand support by rigorous internal and external communication and ongoing monitoring. A risk-based approach to your anticorruption program can help steer program focus and maintenance on an ongoing basis.

Be sure to perform enhanced due diligence before you head for the airport. Independent business intelligence collection and stepped-up due diligence gives leaders critical information to sharpen risk-based decisions. It also shows regulators that the company takes its commitment to integrity and corporate governance seriously.

Addressing anticorruption, home-country regulations and related provisions means increased collaboration across the risk, compliance, finance, operations, IT, HR, and business development functions. It also means building and maintaining an understanding of international anticorruption frameworks, monitoring how policies and enforcement are changing, and assessing the implications for business strategy. Leading Multi-national corporations (MNCs) have successfully developed and implemented strategies to reconcile Chinese commercial practices and FCPA requirements.

China is not inscrutable. But if you don't ask the right questions, of your operations and your aspirations, of your partners and your prospects, you won't successfully complete the journey that began so hopefully with that first step. When it comes to corruption and corporate crime, strive to be a rat — the kind described by the Chinese zodiac: wise, perceptive, focused on the big picture, exercising good judgment, and poised to solve problems proactively.

Acknowledgements

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