
December 6, 2004

The Two Faces of China

By KEITH BRADSHER

Correction Appended

GUANGZHOU, China

FEW business executives watch the growth of the Chinese economy as closely as Michael R. P. Smith, the chief executive of the Hongkong and Shanghai Banking Corporation.

Yet even Mr. Smith was startled when his staff recently projected that in 2034, bank assets in China would surpass those in the United States.

"When I saw that, I said, 'That can't be right,' and I went back to the economics guys," who confirmed the projection, Mr. Smith recalled.

Much the same surprise is cropping up in industry after industry and in country after country. From steel to oil to cars to credit cards, China is poised to become the world's biggest producer and market for many goods and services.

Along the way, China has come to terrify many foreign business executives and attract others - and sometimes both at the same time, depending on whether they see the country as a competitor, a cheap source of supply, a market, or all three.

Companies across many industries are facing enormous pressure to match prices that are available in China or lose their customers. That can mean deep price cuts of 25 to 50 percent, leading in some cases to job losses, cutbacks and even closings. At the same time, American and European companies are taking advantage of China's vast and inexpensive labor force by moving some of their operations there - and by offering their products to a country whose role as a consumer continues to grow.

China is already the largest user of steel and cement and is poised to overtake the United States in consumption of everything from copper to

soybeans. These goods are needed in a fast-growing economy with many highways, factories and office towers to build - and with 1.3 billion mouths to feed.

China has become the world's largest market for cellphones, and it is catching up with Germany and Japan as a market for cars, although it considerably trails the United States in its appetite for new vehicles.

Businesses reaping the biggest rewards include companies that supply China's need for infrastructure, like the [General Electric Company](#), which sells large turbines and aircraft engines. G.E. currently ships roughly \$3.5 billion worth of goods each year to China from other countries, mainly the United States, while exporting \$2 billion of merchandise from China, mainly to the United States.

But companies like G.E. are the exception. American imports from China exceed exports by more than five to one, as retailers like [Wal-Mart Stores](#) buy immense and growing quantities of goods from China. With as many people as the entire industrialized world combined, China has tens of millions of unskilled workers willing to work for less than \$100 a month.

During the Democratic primaries this year, Senator John Kerry repeatedly denounced "Benedict Arnold C.E.O.'s" who moved jobs overseas. Those statements drew strong objections from the business community, including Democratic business leaders, and Mr. Kerry's comments about trade were relatively tame during the general election campaign.

YET many corporate executives wonder how much longer a big American trade deficit and the moving of jobs overseas can persist without becoming the subject of strong protests by Americans who say that foreign workers are taking away their jobs

"China kind of got a pass in this campaign; that may not always be the case," said Benjamin W. Heineman Jr., G.E.'s senior vice president for law and public affairs.

Even trickier could be the Chinese relationship with the European Union, another big market for exports. Powerful European labor unions could force limits on Chinese exports, much as they forced tighter restrictions on Japanese automobile exports in the 1980's and 1990's.

"I'm quite gloomy about Europe - the big industrial countries like Germany, Italy and France," said Frank-Jürgen Richter, the president of Horasis, a

consulting company in Geneva. "How do you keep growth in these countries if everything is moving to China?"

Like Japan from the 1950's through the 1980's, China has shown that a country can sustain high growth rates for many years by combining hard work with a closed financial system that channels very high household savings into countless industrial projects and other ventures selected partly by government bureaucrats.

Japan's stagnation since the early 1990's suggests that such policies may have limitations. Predicting when China might hit such a wall has become something of a cottage industry. This has been particularly true in the last year, as Beijing has imposed fairly strict controls on bank lending. The government has raised bank reserve requirements three times and increased the benchmark interest rates for bank loans and deposits once, in response to evidence that the economy may be overheating.

Climbing prices for industrial commodities like steel, bid up around the world mainly because of China's rapid growth, have alarmed manufacturers across China. Xin Yumei, an export manager at Yangquan Metals and Minerals in China's north central Shanxi Province, said the price of steel for the company's scissors and pocketknives had jumped close to 20 percent in the last year.

"The price is going up, and I have to raise our prices soon," she said.

Overhanging every assessment is the question of how much more competitive China can become globally if its domestic economy slows, freeing even more goods for export at ever cheaper prices while trimming China's demand for imports.

Most executives say they see no sign of this yet, but they are still cautious. "We don't see the danger of a huge collapse that would cause them to export huge tonnage," said Nicholas Tolerico, the president of ThyssenKrupp Steel Services, the trading and distribution arm of the German giant. Still, he warned, "If there were even a slight downturn, probably the first thing that would be adjusted is the amount they import."

Worries that the recent boom in the Chinese economy might be followed by a sharp bust have receded considerably since last spring, when ships were waiting up to a month to unload at clogged Chinese ports, and many Western economists were predicting that Beijing would have to impose draconian measures to prevent an inflationary spiral.

But some experts point out that the biggest imbalance in China's economy - the fact that most of its growth depends on often-speculative construction spending - may not be sustainable. Morris Goldstein and Nicholas R. Lardy, two experts at the International Institute for International Economics, contend in a new paper that instead of a "hard landing" or a "soft landing," China may be due for a "long landing" of slower economic growth that could last for years, as few additional apartment buildings and office towers are built until recently erected ones are fully occupied.

China experienced slower growth in the mid-1990's, as it struggled with the effects of a frenzy of construction that reached its peak in 1993. But China did fully recover from that episode. Optimists point to a flourishing of entrepreneurial energy that has long been part of the culture of overseas Chinese communities and has now emerged with full force in mainland China, with productivity improvements that are still being felt.

One such entrepreneur is Chen Chenmei, who started making shoelaces in her home a decade ago in Wenzhou using a machine that cost \$50, and delivered them on her bicycle to shoe factories. Now, she and her family own a small shoelace factory, rent a car and employ a driver to make deliveries to factories and have their own stall at a wholesale shoe market here.

Laces in many hues and lengths, from brown bootlaces to pink laces for tennis shoes, filled the stall up to the rafters on a recent morning. Yet Ms. Chen was wearing cheap tennis shoes that had scruffy white laces with the tips broken off.

Savings are important to keep the factory growing, and sometimes for loans to family members who want to start their own businesses, Ms. Chen said, adding that "money flows all around among relatives."

The biggest question hanging over China is its political stability. Historians point out that the prosperity in China now has coincided with nearly three decades of the greatest social and political stability that China has seen in more than a century.

How long that will endure is anyone's guess. A big problem for China is how to address the wide gap in incomes between urban and rural residents. In countries across Asia this year, voters have shown considerable concern not just over expanding economic output but over how the gains are distributed.

"In all these countries, the verdict the electorates have given is: strengthen the inclusiveness of growth," said Ifzal Ali, the chief economist of the Asian Development Bank.

While China, a one-party state, does not allow free elections, public opinion still counts for something. Hu Jintao, the leader of the Communist Party for the last two years and China's president since early last year, has taken some steps to improve the lives of China's poor.

Letting food prices rise steeply has helped considerably, as farmers have taken in more money for their crops. The Chinese government has also tried to improve worker safety. Many small protests have bubbled up in numerous Chinese cities, often over unpaid wages, but there has been no sign of their spreading to become a national problem.

Corporate executives, politicians and economists generally agree that if China does suffer a sharp economic reversal, the results will be severe - both within China and far beyond its borders. A downturn could lead to severe unemployment, social and political unrest and large-scale emigration. The effects could also include plunges in financial and commodity markets if China's demand for foreign goods dried up and it unloaded unneeded items on world markets.

Western Europe helped maintain Russia's stability in the mid-1990's with big infusions of financial assistance, but China's larger economy and much greater population make it impossible for the outside world to offer nearly as much aid, said P. Christian Hauswedell, Germany's top diplomat for Asian and Pacific affairs.

"The thought of a failure of this modernization just makes us all shiver," he said. "We would not be able to support China if it failed."

For the Record - Dec. 7, 2004

An illustration on the front page of the special Outlook section of Business Day yesterday, with an article about China as a producer and a consumer, incorporated a banknote erroneously. It depicted Taiwan's currency, not China's.



December 6, 2004

U.S. Automakers See China as the Land of Opportunity

By **DANNY HAKIM**

ETROIT

AMERICAN automakers see China as the world's biggest growth opportunity, even though the country's auto sales boom has slowed in 2004.

Despite the slowdown, China propelled [General Motors'](#) Asian operations to earn more than G.M.'s three other geographic regions combined in the third quarter. While that was partly a sign of the company's struggles in the brutally competitive landscape in North America and Europe, it also explained the industry's bullishness on China.

Auto sales grew more slowly in China mainly because the government took steps to temper the overheated economy, including tightening credit policies and reducing its own vehicle purchases. Sales of cars and small sport utility vehicles, which rose more than 80 percent in 2003, are expected to rise less than 20 percent this year.

Auto executives said this cooling was expected and necessary, and would not diminish the long-term allure of China. Analysts are forecasting stronger, if less overheated, numbers next year.

"The long-term fundamentals still remain very positive," said G.M.'s chairman and chief executive, G. Richard Wagoner Jr., during his company's quarterly earnings conference call in October. "Coming off the boil in the near term is not necessarily a bad thing. The last thing in the world we want is this market to overheat and go through a boom-bust cycle."

Ken Zino, a spokesman for [the Ford Motor Company](#), said, "We haven't changed our position that it is a significant and growing market."

Despite the sales boom in recent years, only a minority of the Chinese population own cars. Chinese vehicle sales, including passenger cars and

larger vehicles like vans and buses, are expected to reach about 5 million this year, less than one-third the more than 17 million vehicles sold in the United States. Some analysts predict that sales in China will as much as double by the end of the decade.

In addition, automakers see potential for fatter profits as the country's expanding middle class trades up from small cars, like a popular version of the [Volkswagen](#) Jetta sold in China, to somewhat larger, higher-margin vehicles, like the Volkswagen Passat or the Buick Regal.

"A lot of people buying Jettas will upgrade in two or three years," said Yale Zhang, an analyst at CSM Worldwide. "This is a big mainland country so they like something bigger, but not so much bigger like the Ford F-150 - some reasonable big sizes."

Paul Ballew, the chief industry sales analyst for G.M., said: "As vehicles become more affordable, people are buying up. In the U.S., that's the growth of the luxury vehicles. In China, it's growth in midsized sedans" and larger small cars, he said.

If China represents a huge growth opportunity, it is far from unfettered. Foreign automakers are required to pair up with domestic companies, a situation complicated by accusations of piracy against some Chinese companies. For example, the Chery Automobile Company, one of China's largest automakers, has been accused of mimicking the designs of General Motors and Volkswagen. Demand from China's rapidly growing industries is also driving up prices of commodities like steel, increasing automakers' costs.

And from a regulatory standpoint, China is another pressure point on the industry to produce cleaner cars. This year, the Chinese government imposed its first fuel economy regulations, a development that automakers greeted unenthusiastically.

Buying cars on credit is in a nascent state in China, and foreign automakers are just now setting up lending operations. The government is also faced with soaring fatalities as the number of automobiles increases, a situation that could lead to more regulation.

Still, the allure involves more than sales. China is the new Mexico: Labor costs are a tiny fraction of those in the United States - low enough that they are putting pressure even on plants in Mexico.

If Chinese cars are not yet being exported, auto parts are, and suppliers around the world are facing the choice of shifting at least some of their operations to China or no longer being competitive. And the labor pool is not limited to factory workers.

"Our pool of available talent gets much deeper if we think globally," said J. T. Battenberg III, the chairman and chief executive of the [Delphi Corporation](#), one of the largest auto suppliers, in a speech this year.

Delphi has been rapidly expanding its operations in China and recently broke ground on a research and development center in Shanghai.

"China's Ministry of Education reported 700,000 engineering and technology graduates last year," said Mr. Battenberg, adding that "the U.S. graduates only 62,000 engineers each year."

With the United States hemorrhaging manufacturing jobs, it is no surprise that union leaders do not share his enthusiasm.

"With the rise of China as a major auto-producing country, being competitive means compensation as low as a dollar an hour, no independent union rights and broad government intimidation of the pursuit of workers' legal rights," said Ron Gettelfinger, president of the United Auto Workers union, in a recent speech. "These conditions have become the new standard of competition for companies around the world, to the detriment of workers everywhere."



Reuters

A shop in Beijing that sells imported car parts. Some analysts expect that automobile sales in China will double by the end of the decade.

December 6, 2004

Untapped Market for Credit Cards Is Ripe for Foreign Lenders

By JENNIFER A. KINGSON

NYONE looking for signs that China is edging its way into Western consumer culture should consider this: The Bank of China, the oldest indigenous Chinese bank, now issues a Great Wall platinum Visa credit card, and it comes with a frequent-flier rewards program.

Today, only about 1 percent of Chinese citizens hold Western-style credit cards, and they tend to be the wealthiest of urban sophisticates. A majority of people use cash for all transactions; either they do not have bank accounts, or they have never been offered credit by a bank. What little personal lending occurs in China usually consists of informal arrangements among friends, family members or business associates.

But major changes are taking shape, and conditions in China have grown ripe enough to attract investments from the world's biggest credit card issuers in the last year. [Citigroup](#), [American Express](#) and [HSBC Holdings](#) have signed credit card partnerships with Chinese banks. Other foreign lenders, including some from Australia and Japan, are staking out exploratory positions.

At present, foreign banks are barred from offering loans or banking services directly to Chinese citizens, but that will change in 2007, when China is to lift these restrictions in accordance with agreements it made when it joined the World Trade Organization in 2001. Also on the horizon are the Olympics in Beijing in 2008, which will bring large numbers of plastic-carrying visitors. Anticipating a burst of activity, companies that process payments and sell card-swipe terminals have been busy setting up shop.

"It's a nascent business which is really beginning to explode," said Jim Allhusen, executive vice president and general manager of Visa International for China and the Philippines. "Consumers want your products; banks want to get into the market."

Numbers may still be small, but hopes are high. At the end of June, there were 704 million bank cards in circulation in China, with 650 million of them debit cards used primarily to withdraw cash from A.T.M.'s, according to the Asian Banker, a research company based in Singapore that tracks the financial services industry. Only seven million were what Westerners consider to be credit cards, offering an unsecured line of credit, the Asian Banker said. Most of the others were lines of credit secured by bank deposits.

On the supply side, only 2 percent of merchants were equipped to handle card transactions, though the number in some cities was much higher - in Shanghai, for example, it was 30 percent.

But momentum is building rapidly, in part because the Chinese government has gradually been relaxing restrictions on domestic banks, and in part because lenders view China's growing middle class as an attractive customer base.

"Even though the first credit card was introduced in 1986, it has just started to catch on recently," said Henry Tseui, president for the north Asian region for the [First Data Corporation](#), which sells credit card processing services to banks. "Consumer credit in general is fairly new" to China, he added.

China's state-owned commercial banks have recently begun issuing a dual-currency card because the local currency, the yuan, which is also called the renminbi, cannot be exchanged for other currencies. Cardholders can use the dual cards within China to buy items in yuan, and outside the country to buy things in dollars.

For the moment, foreign banks can participate only from the sidelines, giving their Chinese banking partners expertise in running credit card operations - how to manage risks, market products and handle customer service, for example.

Several lenders have already made their aspirations clear. The Citibank division of Citigroup spent \$67 million last year for a 5 percent stake in its partner bank, Shanghai Pudong Development Bank, and it has options to increase its ownership to 24.9 percent. In February, the companies introduced two Visa cards, including a gold one that comes with Citibank World Privileges, a discount program. American Express teamed up with the Industrial and Commercial Bank of China in March, and HSBC, based in Britain, has card-issuing arrangements with both the Bank of Communications and the Bank of Shanghai, and equity positions in them.

Other credit card issuers are proceeding more cautiously. [MBNA](#), for example, the second-biggest card lender in the United States after Citibank, said in April that it had set up a representative office in Shanghai to study the market.

Some will hold off until the market develops and restrictions are cleared. Standard Chartered, a London-based bank, which has done business in China since 1858, considers services like wealth management and small-business banking to be higher priorities than consumer credit, said Alex Thursby, head of client relationships for Standard Chartered's wholesale bank in northeast Asia. "While in the longer term consumer credit will be an avenue in which the foreign banks will want to go, right now for international banks wholesale banking is the big prize, and that will continue for the next couple of years," he said.

One big obstacle is the lack of a large national credit bureau to supply the type of information banks rely on in evaluating loan applicants. One small bureau was set up in 2002 to cover Shanghai and plans call for more bureaus in more large cities, said Yuwa Hedrick-Wong, MasterCard International's economic adviser in Asia/Pacific. "The data collected is very good because it includes utility payments and cellular phones, so it's actually more advanced than very developed countries," he said. "The challenge is to replicate the Shanghai success across the board." MasterCard is optimistic: it predicts there will be 50 million to 75 million credit cards issued in China by 2010.

Other problems are the lack of merchant acceptance and a spotty infrastructure for card processing. In 2002, the Chinese government created an agency called China Union Pay to set up a national processing network and make sure merchants and banks are connected to it.

The 2008 Olympics in Beijing are being viewed as a deadline of sorts. "The government wants the world to see them as top tier," said Christopher S. Alexander, chairman and chief executive of the [Hypercom Corporation](#), a Phoenix-based card terminal maker that has a contract with China Union Pay. "They're going to be installing literally millions and millions of terminals because they're going to want the tourists to come in and spend money, and nobody is going to carry around a wheelbarrow full of renminbi in order to buy something."



An Tu/Imaginechina via Bloomberg News

Citigroup is one of the few foreign banks that offers credit cards in China. Only about 1 percent of Chinese citizens hold Western-style credit cards, but that number is expected to grow significantly.