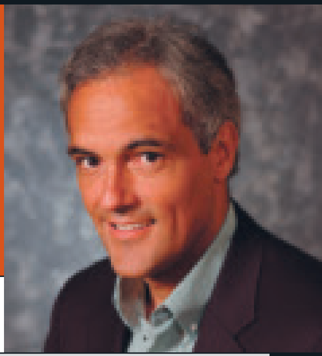
GEARING UP FOR CHINESE GROWTH

Are we ready for the fastest-growing economy on earth?



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For more than a century, China has conjured dreams of a seemingly endless market for Western goods, and recent rapid economic expansion has brought that dream closer to reality. Today, firms throughout the industrialized world are reaping the benefits of Chinese growth by selling products into China's surging markets, and moving factories there to capitalize on the country's competitiveness as a manufacturing platform. Reflecting these trends, Chinese imports and exports each soared from approximately US$13 billion in 1980 to more than US$450 billion in 2003. An astounding 55% of Chinese exports now originate from foreign-related enterprises. With the exception of the upward pressure it has exerted on input costs for raw materials, the rise of China has been overwhelmingly positive for foreign firms thus far.

The sheer scale and spectacular growth of China's markets has attracted hordes of foreign firms. Since 1980, China has amassed more than US$501 billion of foreign direct investment (FDI), the fourth-largest level in the world. Whereas much of the initial FDI was directed toward using China as a platform for exports, more recent investors have targeted China's booming internal markets: foreign auto firms have committed more than $12 million to China in the last year alone, and scores of others are investing heavily with a keen eye on China's consumer and commercial customers. China's tremendous size will make it one of the most important markets—and in many cases, the predominant market—for a variety of goods. China's consumers bought more than 70 million mobile phones in 2003, making China the second-largest mobile-handset market in the world, and Chinese now buy 16% of the world's refrigerators and 33% of its air-conditioners.

JUST THE START OF THE STORY

As startling as China's newfound market presence is the speed with which it has assumed this role and the growth potential still ahead. From DVD players to TVs, construction equipment and passenger cars, China has arisen as a significant market in many sectors in just a decade; in some cases, in just a few years.

From an investment perspective, however, the current benefits of Chinese growth veil the disruptive longer-term consequences of Chinese industrial expansion. Foreign firms may continue to shift production to China and increasingly look to Chinese markets for growth; however, they will not go unchallenged in their pursuit of Chinese markets. While many foreign firms have focused on the prospect of selling products to China's increasingly affluent population, few have paid enough attention to the fact that many of the products Chinese consume will continue to be made by indigenous companies. Fewer still have recognized that this consumption will provide fertile ground for those Chinese companies to grow and expand overseas. The coexistence of world-class foreign competition and booming domestic markets has compelled Chinese companies to develop technology, branding and marketing expertise. These companies will mature rapidly along with the Chinese economy, grow more sophisticated and eventually venture beyond China's borders.

"CHINA'S DOMESTIC SALES WILL NURTURE WORLD-CLASS COMPETITORS."

China's domestic sales will nurture world-class competitors, and these firms will eventually disrupt the status quo in a number of global industries. Consumers everywhere will undoubtedly benefit from this trend, gaining greater choice and probably lower prices. Foreign companies, however, face mixed fortunes: some may gain as rising Chinese companies and consumers demand their goods, while others may encounter intense competition from new Chinese entrants. For investors, the mandate is clear: they must keep in mind which incumbents will be helped and which hurt as Chinese companies gradually take their place on the global stage. ∎