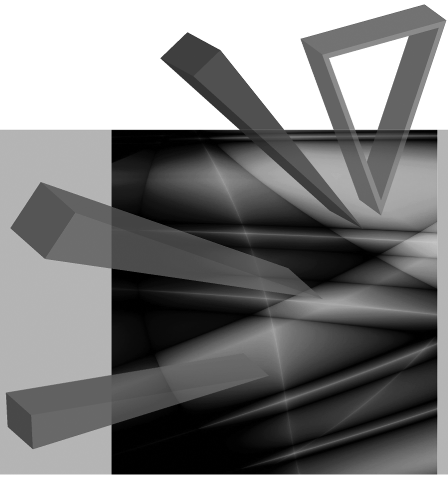
Faces of Competitiveness in Asia Pacific



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COMPETITIVENESS OF CHINESE MNEs. INNOVATION VERSUS IMITATION, BRANDING VERSUS PRICE, ACQUIRING VERSUS DEVELOPING?

Summary: China's rapid rise to world's top exporter enabled the emergence of its competitive companies. In the second phase of China's internationalization its exploding outward foreign investment (OFDI) raises questions about the competitive advantages of its multinational enterprises. The paper aims to shed light on the factors determining competitiveness of Chinese multinationals. Most enterprises in the leading export and OFDI industries build their competitiveness on innovation. China's image as an exporter is based on low-tech consumer products and intermediate products for medium and high-tech industries carried out by foreign companies. China's MNEs seems to "buy" international competitiveness by an aggressive M&A strategy. The new Five-Year Plan stresses the increase of the domestic demand and Chinese government seems to be aware of the necessity to improve Chinese MNEs' competitiveness by supporting development of innovative, marketing and organizational capabilities.

Keywords: competitiveness, innovation, multinational enterprises, China.

1. Introduction

China is the most populous country in the world. In terms of economics, it is not surprising that its competitiveness results first of all from cheap labor. The innovativeness of labor-intensive products is usually low except when innovation leads to a successful transformation into knowledge-intensive products.[1] So far this upgrading has not played an essential role for China because its significant international labor cost induced price competitiveness, which gets further tailwind by the undervalued Chinese currency. Therefore, incentives for creating

[1] M. Dilling-Hensen, S. Jensen, Lifestyle production: Transformation from manufacturing to knowledge based production using innovation, *International Journal of Economic Sciences and Applied Research* 2011, Vol. 4, No. 1, pp. 35-54.

product differentiation are low because this would reduce the economies of scale of mass production. According to the Heckscher-Ohlin model of international trade, international competitiveness can be best achieved by using the domestic comparative advantages and exploited by exporting labor-intensive products.[2] Under its assumptions, there is no room for establishing multinational companies. According to the theory of multinational enterprises, international competitiveness on goods markets is complemented by establishing plants in foreign countries if, firstly, monopolistic competition, differentiated products and economies of scale exist and, secondly, firm-specific inputs such as R&D can be transferred free of cost.[3] China's trade pattern followed the Heckscher-Ohlin model, at least in the two decades after the opening-up started in 1978: capital-intensive goods dominated China's imports, labor-intensive goods its exports. In recent years the high overall growth has been accompanied by a significant increase in wages, especially in the areas with high concentration of the labor-intensive industries. The low domestic inter-regional mobility of labor has proved a barrier to softening the wage increases.

As long as a large part of innovation is embedded in inward foreign direct investment (IFDI) respectively created and owned by foreign MNEs, it is to be expected that China's enterprises will lack sustainable sources for achieving innovation-based competitiveness, which makes multinationalization attractive. However, statistics seem to contradict this theoretically-based argumentation. Dunning's eclectic FDI theory,[4] which puts former attempts at explaining outward foreign direct investment (OFDI)[5] under the umbrella of the "OLI Paradigm" may provide a more pragmatic approach to interpreting China's emerging MNEs and their competitiveness, especially by linking it with the basic motivations of OFDI, namely resource seeking, market seeking, efficiency seeking and asset seeking.[6] Gaining, exploiting, and maintaining international competitiveness is a plausible strategy for enterprises that are domestically under strong pressure from foreign MNEs. Market

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[2] B. Ohlin, *Interregional and International Trade*, MIT Press, Cambridge, MA, 1933.

[3] See E. Helpman, A simple theory of international trade with multinational corporations, *Journal of Political Economy* 1984, Vol. 92, No. 3, pp. 451-471; E. Helpman, P. Krugman, *Market Structure and International Trade*, MIT Press, Cambridge, MA, 1985; J.R. Markusen, Multinationals, multi-plant economies, and the gains from trade, *Journal of International Economics* 1984, Vol. 16, pp. 205-226.

[4] See J.H. Dunning, Trade, location of economic activity, and the MNE: A search for an eclectic approach, [in:] B. Ohlin *et al.* (eds.), *The International Allocation of International Activity*, MacMillan, London 1977, pp. 385-418; J.H. Dunning, The eclectic (OLI) paradigm of international production: Past, present and future, *International Journal of the Economics of Business* 2001, Vol. 8, No. 2, pp. 173-190.

[5] S.H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment*, MIT Press, Cambridge, MA, 1976; R. Vernon, International investment and international trade in the product cycle, *The Quarterly Journal of Economics* 1966, Vol. 80, pp. 190-207; P.J. Buckley, M.C. Casson, *The Future of Multinational Enterprise*, 25th anniversary edition, Palgrave MacMillan, London 2002.

[6] J.H. Dunning, *op. cit.*

seeking OFDI relies on labor cost advantages[7] as well as on acquired ownership advantages by co-operating with foreign MNEs and/or benefiting from spillover effects of Special Economic Development Zones.[8] Compared with exports OFDI offers Chinese enterprises a more in-depth insight into the functioning of "western" markets. Seeking new markets in foreign countries is one of the strategic choices. On the input side, the increasing Chinese demand for scarce natural resources is heating up global competition on securing energy and raw material input. Location advantages are mainly spread over African, Arabian, and Latin American countries. OFDI are an appropriate strategy to create internalization advantages. In China's important export markets complaints about Chinese "unfair" competition in low-tech products create a sensitive climate for imports of medium-tech (and in the future high-tech) products. Chinese enterprises tend to respond by OFDI, which creates location advantages. Being localized on foreign markets could be considered the most efficient learning-by-doing strategy to cope with all the facets of global competition if government institutions promise to insure against risks. Following the political guidelines put forward in the 12th Five-Year Plan, Chinese enterprises should gain stronger positions in domestic medium-tech and high-tech market segments. Asset seeking OFDI seem to be an appropriate strategy to acquire knowledge and new technologies in a rather short period of time.

Theoretical reflections on the emergence of Chinese MNEs deliver arguments of "WHY" this internationalization strategy is gaining importance compared to the export as the traditional foreign market entry mode. An in-depth analysis of their competitiveness shall allow insights into the future trend of China's "going global". The remaining part of the paper is organized as follows: after presenting a brief overview on the emergence of Chinese MNEs (Section 2) a detailed analysis of the entry modes allows drawing conclusions on their motivations (Section 3). The latter leads to the factors which create, develop, maintain competitive advantages of Chinese MNEs (Section 4). Evidence of close links between the business sector and the government makes it seem reasonable to devote a separate part to the role of China's government in supporting Chinese MNEs (Section 5). Finally, conclusions will mainly call for future empirical research on the topic of this paper.

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[7] Cost advantages in medium-tech products mainly result from low wages for skilled workers (engineers) and low costs for other R&D resources, see B. Zhu, *Internationalization of Chinese MNEs and Dunning's Eclectic (OLI) Paradigm: A Case Study of Huawei Technologies Corporation's Internationalization Strategy*, master thesis, Lund University, Lund 2008, p. 39.

[8] Empirical studies provide evidence of spillover effects between Special Economic Development Zones and Science and Technology Industrial Parks. The former are dominated by foreign MNEs, the latter by Chinese enterprises. See B.J. Liu, Y-Y. Wu, Development zones in China: Are STIPs a substitute or a complement to ETDZs? *Taipei Economic Inquiry Journal* 2011, Vol. 47, No. 1, pp. 97-146.

2. The emergence of China's MNEs (by OFDI flows, industries, locations)

The introduction of "go out" policy in 1999 marks the start of rapid foreign expansion of Chinese MNEs. The reasons for the government's active support of internationalization of domestic companies are efficient use of its huge foreign exchange reserves, preparation of domestic companies for the global competition that would enter Chinese market as a consequence of China's entry into the WTO as well as Chinese leaders' ambition to establish world class corporations and brands. Chinese OFDI flows increased from USD 5.5 billion in 2004, to USD 55.9 billion in 2008 and USD 56.5 billion in 2009 (the latest available data) in spite of the global financial crisis.[9] In 2010, the investments from China and Hong Kong accounted for a tenth of the world's total by value.[10]

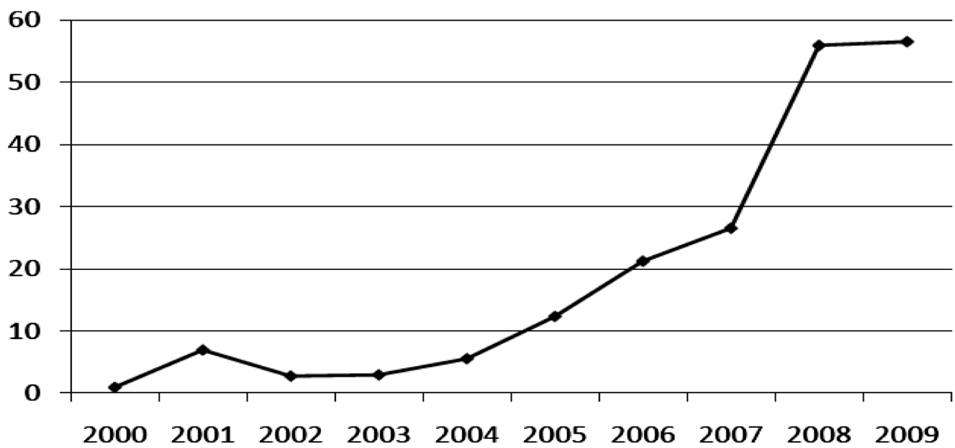

Figure 1. China: outward FDI flows, 2000-2009 (USD billion)

Source: MOFCOM, *2009 niandu zhongguo duiwai zhijie touzi tongji gongbao* [2009 Statistical Bulletin of China's Outward Foreign Direct Investment], 2010; K. Davies, *Outward FDI from China and Its Policy Context*, Columbia FDI Profiles, 2010.

Responding to the government's policy and aiming at securing natural resources for the needs of the domestic economy companies from mining, quarrying and petroleum sectors were most active in foreign markets and thus attracted world's attention. Their overseas investments in recent years have been growing rapidly and

[9] MOFCOM, *2009 niandu zhongguo duiwai zhijie touzi tongji gongbao* [2009 Statistical Bulletin of China's Outward Foreign Direct Investment], 2010.

[10] Chinese takeovers. Being eaten by the dragon, *The Economist*, 11 November 2010.

amounted to 16.5% of China's OFDI stock in 2009.[11] In this sector companies such as Chinalco, Sinopec, and China National Petroleum (CNPC) are already among world's leaders (BCG, 2009; Fortune Global 500, 2010).[12] In the last five years we can observe a change in sectoral representation of Chinese OFDI with dynamic growth of foreign investments undertaken by companies from lease and business services sector (29.7% of China's OFDI stock). FDI in wholesale and retail was slightly decreasing from 19.7% of total OFDI in 2006 to 14.5% in 2009.[13] The study on new Chinese MNEs for years 2005-2009 conducted by PricewaterhouseCoopers shows that more of them are engaged in industrial machinery, equipment and tools, electronic components, business services and consumer products. Chinese companies from value added sectors start competing on a global stage: in telecommunication (China Mobile Communications, China Telecommunications, China United Network Communications, Huawei, ZTE), electronics (Galanz Group, Gree Electric Appliances, Haier, Hisense, Johnson Electric, Midea Group), IT (Lenovo), green energy (Suntech Power, Trina Solar Ltd.), medical equipment (Mindray), cosmetics (Herborist), automotive (Geely, BYD).

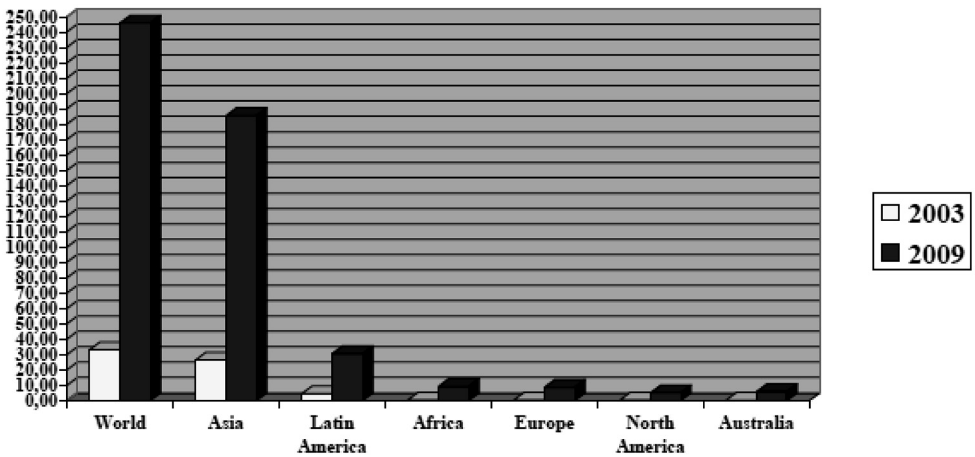

Figure 2. China: geographical distribution of outward FDI stock, 2003 and 2009 (USD billion)

Source: K. Davies, *Outward FDI from China and Its Policy Context*, Columbia FDI Profiles, 2010, p. 10.

The majority of Chinese outbound investments (75.5% in 2009) goes to Asia. However, 63% of that investments go to Hong Kong and are related with round-

[11] MOFCOM, *op. cit.*

[12] BCG 2009, www.money.cnn.com, Fortune Global 500.

[13] MOFCOM, *op. cit.*

tripping – reinvesting in Mainland China in order to benefit from preferential policies directed at foreign investment. Thus, it is difficult to estimate the actual size of Chinese outbound investments. According to MOFCOM (Ministry of Commerce People's Republic of China), Chinese investments in Hong Kong are directed mainly at business services, wholesale and retail industry. Chinese OFDI in Africa (3.8%), Australia (2.6%), Central Asia (no data available) and Latin America (12.5%) is mainly aimed at securing natural resources. Investments of Chinese companies in developed countries of North America (2.1%) or Europe (3.5%) are significantly smaller; however, they show growth trend and are a cause for concern as Chinese investments are related with the search for advanced technology and knowledge.[14]

3. Entry modes of Chinese MNEs

M&As are dominant entry mode of Chinese companies in developed markets (55% of all cross-border purchases in 2007). As latecomers they use the "buy-in strategy" to speed up their internationalization, i.e. obtain immediate access to technology, knowledge, brands, markets and distribution networks.[15] Moreover, M&As allow Chinese firms to avoid trade barriers as well as acquire knowledge necessary not only for successful competition in international markets, but also on the Chinese market, where competition has become especially fierce. Chinese companies engaging in M&As in manufacturing or assembly plants may also benefit from host countries policies aimed at supporting domestic industries, e.g. in the U.S. requirement "Buy American" in the case of some government contracts.[16] However, "most M&A deals in 2007-2009 were in the energy and minerals sectors, but the largest transactions tended to be purchases of minority stakes in global financial institutions".[17]

Greenfield investments are undertaken mainly by Chinese companies from energy, raw materials, automotive, and real estate industries.[18] This entry mode is preferred mainly in developing countries, where Chinese companies rely on their competitive advantages.

Joint-ventures seem less popular among Chinese companies as they prefer to have full control over company and avoid problems resulting from co-operating with a foreign partner. Besides, they often do not bring expected results in terms of technology and knowledge transfers. This trend is also confirmed by the study of 97

[14] Only in Poland Chinese trade missions in 2011 are expected to double in comparison to 2010 (information given by Chinese Ambassador in Poland, Sun Yuxi, during his lecture on "China in World Economy" at Vistula University, 28 February 2011.

[15] Y. Schüler-Zhou, M. Schüller, The internationalization of Chinese companies. What do official statistics tell us about Chinese outward foreign direct investment? *Chinese Management Studies* 2009, Vol. 3, No. 1, pp. 25-42.

[16] Chinese companies expand to U.S. soil and markets, *Business Week*, 28 December 2010.

[17] K. Davies, *Outward FDI from China and its policy context*, Columbia FDI Profiles, 2010, p 3.

[18] *Ibidem*.

Chinese MNEs conducted by Wu Xiaoyun where only 14% of companies engaged in joint-ventures.[19]

Chinese companies from consumer product industry enter markets of developed countries through international retail chains, for example Herborist brand owned by Shanghai Jahwa Group entered Western European market through Sephora.[20] Wu found out that most common entry modes to foreign markets are through exports (81% of analyzed companies) and direct investment (40%).[21]

4. Main factors of Chinese MNEs' competitiveness

In the last decades China emerged as the world's largest manufacturer and exporter of cheap-labor products. Despite the fact that China's higher education sector is delivering the highest number of engineering graduates and China's public and private spending for R&D is among the highest in the world, innovation mainly results from foreign MNEs via IFDI and/or licenses. When it comes to the search for the causes of the low innovativeness, it is argued that important institutional preconditions are missing which channel entrepreneurial spirit into innovative results. This refers to the weak intellectual property rights protection, the dominance of state-owned enterprises in industries with high innovative potential as well as in relative low incentives for innovation compared with rewards for imitation.

Similarly to other developing countries, Chinese MNEs' competitiveness does not result from innovation or branding which is clearly demonstrated by a study on Huawei's internationalization path. "Huawei does not possess comparative advantages over MNEs from developed countries in terms of technology and brand. Therefore, Huawei deploys catch-up strategy in the internationalization process. Through investing in developed countries and forming alliance or cooperation, Huawei acquires technology and brand resources to offset the defects, and gradually forms its own technology superiority and establishes brand influence".[22] Opposite to theoretical predictions that OFDI results from strong ownership, location and internalization advantages, the Chinese market seeking MNEs aim to transfer technology from abroad back to the headquarter. This implies a non-aggressive ambition to reduce transaction costs. "Huawei is more interested in *enhancing transaction value* and *exploring* technology R&D resources and potential large markets rather than *reducing transaction cost* and *exploiting* the existing advantages".[23] Chinese MNEs are obviously able to transfer at least parts of their cost advantages to

[19] X. Wu, *Zhongguo kuaguo gongsi quanqiu yingxiao zhanlue* [Chinese MNCs Global Marketing Strategy], Gaodeng Jiaoyu Chubanshe, Beijing 2006.

[20] www.zhenji.info/2010/09/herborist-an-innovative-beauty-brand-in-china/ (official website of Zhenji).

[21] X. Wu, *op. cit.*

[22] B. Zhu, *op.cit.*, p. 65.

[23] *Ibidem*, p. 66.

subsidiaries and plants even in developed countries. But it is doubtful whether this cost advantage can compensate, in a longer period of time, for the backwardness in innovation. Resource seeking OFDI in developing countries may help to prolong the cost advantages. Regarding efficiency seeking OFDI Chinese MNEs seem to make use of the Free Trade Agreement between China and ASEAN which came into force on 1 January 2010.

To summarize, Chinese MNE's invest abroad in order to learn and transfer back technology. This strategy holds as long as cost advantages can be transferred to subsidiaries/plants in developed countries. The most aggressive strategies are unfriendly M&As, which provoke resistance in several developed countries. The large amount of currency reserves is facilitating this strategy from the Chinese point of view. Depending on the implementation of the government's plan to upgrade the general technological level of Chinese industry, it is to be expected that Chinese MNEs' OFDI in industrialized countries will contribute to a gradual development of a special mix of technology advantages and slow fading cost advantages.

5. The role of the Chinese government

The Chinese government actively supports internationalization of Chinese companies with its "go global" policy launched in 1999. The aim of that policy is to prepare Chinese companies for an intensified competition on the domestic market after China's entry into the WTO and opening more to international business. Another reason is the Chinese leadership's ambition to transform the economy from low-skilled labor production to more value added one as well as making Chinese national champions world-class corporations. The role of government is even more pronounced as approximately 90% of MNCs are state-owned or state-controlled companies.[24] Moreover, after 1978 Chinese government through its policy on inward FDI (obligatory joint-ventures with domestic state controlled firms etc.) raised competitiveness of Chinese firms by providing them with access to the western technology, knowledge, managerial skills as well as knowledge about international markets.

The government supports and encourages Chinese companies to expand abroad and helps them leverage their ownership and location disadvantages by providing: (1) privileged access to raw materials and other inputs, subsidies, (2) fiscal incentives (e.g. tax incentives, tax deductions, low-interest loans), (3) insurance against political risk, (4) assistance to private sector in international expansion through government agencies (e.g. Chamber, or Ministry, of Commerce, National Business Council, etc.), (5) signing double taxation avoidance agreements, (6) enacting bilateral and regional treaties to protect investment abroad, (7) relaxed approval procedures, information on

[24] MOFCOM, *op. cit.*

foreign investment environment, management training of OFDI related international regulations.[25]

The Chinese government's "The National Program 2006-2020 for the Development of Science and Technology in the Medium and Long Term" encourages domestic companies to engage in R&D activities in order to enhance their competitiveness and innovation capacity. The program's incentives include tax deductions, "soft loans" as well as public procurement of products or services developed independently from foreign technology.

State's role in the internationalization of Chinese companies is significant in terms of financial support but it could be much stronger and effective, providing more flexibility to conduct foreign ventures and training on management of international operations, marketing, risks involved with cross-border M&As, etc.

6. Conclusions

The impressive growth of Chinese OFDI is not based on innovative or branding competitiveness. Chinese companies still, to a large extent, rely on cost advantages in their global expansion. To an increasing degree, OFDI in Asia seems to contribute to maintaining the cost advantage. The concentration on Asia also demonstrates that geographic and cultural proximity matters. OFDI in the Middle East, Africa and Latin America are motivated by securing the supply of energy and natural resources. Overall, M&As are the preferred mode of entry. If applied in industrialized countries, this strategy creates access to technological and brand resources, internalizing organizational knowledge and thus transfers competitive advantages from abroad to the home market. The government plays an active role in supporting Chinese MNES' OFDI strategies by reducing risks and/or complementing aid strategies. China's high amount of currency reserves allows for this private-public co-operation. Firm-specific competitive advantages are complemented or even substituted by government-specific competitive advantages. It has to be questioned whether this model is sustainable. States control of SOEs is also perceived to be an obstacle to successful growth of these companies as they are governed by the old generation that lacks international education and experience.[26] Generally, Chinese MNCs' competitiveness in closely contested markets is hindered by their lack of knowledge of international markets, practices, laws etc., which is confirmed by Jason Ding from Roland Berger Strategy Consultants who claims that "Chinese companies should strengthen themselves at two levels: first, acquire deep understanding of international markets in terms of business environment, clients, branding and channel; second, enhance capabilities to consolidate resources on a global basis for cross-border

[25] Y. Luo, Q. Xue, B. Han, How emerging market governments promote outward FDI: Experience from China, *Journal of World Business* 2010, Vol. 45, pp. 68-79.

[26] Chinese takeovers..., *op. cit.*

production and operations".[27] However, with the government's financial support and ambition as well as entrepreneurial drive of Chinese managers, we should see more and more Chinese companies competing internationally with advanced technologies, products and more and more recognizable brands.

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[27] www.rolandberger.com/news/2009-11-06-rbsc-news-chinesecompanies.html (official website of Roland Berger Strategy Consultants).

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KONKURENCYJNOŚĆ CHIŃSKICH PRZEDSIĘBIORSTW WIELONARODOWYCH. INNOWACJA KONTRA IMITACJA, BRANDING KONTRA CENA, PRZEJĘCIA KONTRA ROZWÓJ ORGANICZNY?

Streszczenie: Chiny, osiągając pozycję światowego lidera w eksporcie, jednocześnie stworzyły własne konkurencyjne przedsiębiorstwa. Dynamicznie rosnące chińskie bezpośrednie inwestycje zagraniczne rodzą pytanie co do przewag konkurencyjnych ich firm. Celem artykułu jest przedstawienie czynników determinujących konkurencyjność chińskich przedsiębiorstw. Wiodące firmy eksportowe i BIZ budują swoją konkurencyjność na innowacjach. Jednak wizerunek Chin-eksportera opiera się na towarach konsumpcyjnych o małym zaawansowaniu technologicznym i półproduktach średnio i wysoko zaawansowanych wytwarzanych przez inwestorów zagranicznych. Chińskie firmy wydają się "kupować" międzynarodową konkurencyjność poprzez agresywne fuzje i przejęcia. Nowy plan 5-letni kładzie nacisk na popyt wewnętrzny i chiński rząd wydaje się świadomy konieczności poprawy konkurencyjności krajowych przedsiębiorstw poprzez rozwój ich możliwości innowacyjnych, marketingowych i organizacyjnych.