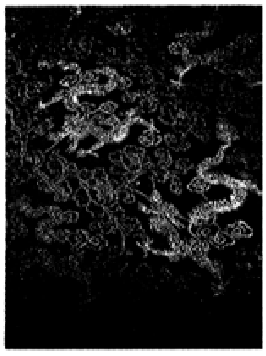


BIG AND GROWING

- **China's real GDP is expected to grow by 7% a year for the next 10 years.**
- **China is now the world's fastest-growing economy and is the sixth-largest economy.**
- **China is Australia's third-largest merchandise trading partner, up from ninth in 1990.**
- **Hundreds of Australian firms invest in China, but most are small.**
- **Australia is a major destination for Chinese foreign direct investment.**
- **China has 18% of the global textile trade.**
- **China is the largest exporter of goods to the US.**
- **120 of the *Fortune 500* companies have operations in Shanghai.**
- **12 million cars were registered in Shanghai last year; there were six million accidents.**

SOURCE: DEPARTMENT OF FOREIGN AFFAIRS AND TRADE / BRW

Most international companies are already in China, positioning themselves for what will almost certainly be the most important source of new demand for the next 20 years. Their main object is Chinese consumers and producers, not more opportunities to increase trade. China will be, like the United States, a continental economy: too big to rely on trade as a route to wealth in the manner of Japan and Korea. And, as is the case with the US, the traded sector is likely to remain no more than 10% of the economy.

Realising this, China's leadership is aspiring to be "born global": to open its economy to modernise its domestic market and integrate it into world production. The country is quickly becoming the world's factory; it must also become the world's fastest-growing capital market if it is to rescue its ailing banking system (which still tends to operate along semi-communist lines).

The figures are well known. When the Bank of China, regarded as the soundest of the nation's banks, was being prepared for public listing in 2001, Liu Minkang, the bank's president, announced that its non-performing loans (NPL) portfolio equalled 28.8% of loan assets. This was a nasty surprise, especially as many of the NPLs had been transferred into an asset management company, suggesting the original size of the NPL portfolio was, before the transfer, the equivalent of more than half of the bank's assets. This is probably the level of NPLs in most of China's state banks.

Because they are state-owned, however, the issue of the Chinese banks' solvency becomes a matter of the entire country's solvency.

Ross Garnaut, professor of economics at the Australian National University says: "The risks in the banks are really public finance risks, so the question is whether the Chinese budget can manage if a lot of those bad debts in the state banks are collected. The answer is that it is not going to bring Chinese growth to an end. It is manageable."

The asset management companies, set up by the Chinese Government to shift bad loans out of the banks, have so far had only limited success. They are in fact a re-nationalisation of non-performing loans. The real question is whether the Chinese state is solvent. Peter Bottelier, former chief adviser to the World Bank in China, estimates that the present value of China's total state liabilities is about 3.8 trillion yuan (about $760 billion). Most of that is the remaining non-performing loans and state-owned enterprises' re-capitalisation requirements. China's assets are about 5.4 trillion yuan, most of which is the market value of government-owned shares in listed state-owned enterprises and the supposed market value of those enterprises to be listed in the next five years.

In other words, assets exceed liabilities, although not if China's unfunded pension liability of 4.5 trillion yuan is included. (Many developed nations, however, would be insolvent, if pension liabilities were included.)

The suggestion is that China can deal with its bank debts, but will have to realise the equity in its state-owned enterprises. This, in turn, means there will be enormous pressure on the Chinese leadership to develop a deep and internationally attractive stockmarket.

There will also be pressure on foreign investment banks that want to operate in China to help raise capital — cash. In prospect is a substantial diversification of China's savings (which are very high, at about 40% of GDP) into equities and eventually bonds. In short, the establishment of a developed capital market.

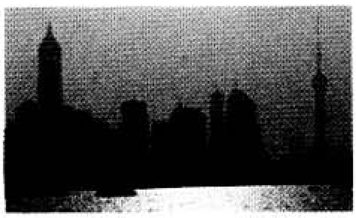
A cynic might say that no sane investor would put money into China's inefficient state-owned enterprises. But China has another ace up its sleeve: government-owned property. Private ownership of property has been allowed only since the mid-1990s, and it is growing at lightning speed. In Shanghai, for example, private ownership of residential property, negligible five years ago, has risen to more than 50%, according to Jock McGregor, the Shanghai general manager of ANZ Banking Group. The Chinese Government's massive property holdings will make it possible for it to manage bad debts.

Anyone who is confident that China will not be able to manage this prodigious transition would do well to study the nation's extraordinary growth of the past 20 years, which has been described by the British author Peter Jay in his book *The Wealth of Man* as the most sustained period of wealth creation in history. Richard David, chief executive officer of First China Property Group, says: "People doubt the sophistication and the business acumen of Chinese Government and business people at their peril."

But not everyone agrees about China's economic performance. Tim Harcourt, chief economist for Austrade, says: "China's economic performance since 1978, impressive as it is, is not in the same rank as Japan's rise or that of the Asian Tigers or newly industrialising economies."

The greater challenge for China will be to maintain the financial disciplines of capitalism. Asian countries, especially Japan and Korea, have been poor at meeting the cost of capital; Japan's decade of recession and a collapsing banking system demonstrate the financial price of such laxity. Chen Zeng, the chief executive of CITIC Australia, a subsidiary of China's state-owned investment bank, says that China's cost of capital is half that in the West.

This is a problem and an opportunity: it gives Chinese enterprises a short-term advantage, but in the long term



it will damage the Chinese economy unless China begins to meet the international price of capital. In 2002, China was the main destination for foreign direct investment (ahead of the United States), but to reap long-term economic benefits, the country will have to translate that into sound returns.

Why do Australian corporations fare so badly? The list of casualties is long. It includes CSR, Boral, HIH and Foster's. The most obvious reason is that Australian corporations operate locally in a soft, oligopolistic market, and are ill-suited to China's more difficult competitive conditions.

Lesley Chi, a Chinese national who did graduate training in Australia and then worked for Boral (whose Chinese operations were eventually sold to the French group, La Farge) says Australian companies suffer for being big fish in a small pond. "Australian companies don't have the fight and the ability to sustain effort. In Australia, you have three players in each major industry sector; in China you have 100. The Australian market is like a pie: one company gets this slice, another company gets that slice, and we talk about who gets a share of the rest. So when they come to China, they keep asking: 'When is the enemy going to withdraw?' And of course, the enemy never withdraws."

It need not have been this way. Australians tend to be regarded positively in China. Xiao Zuogo, president of BHP Steel in Shanghai, says the Australian style of management is attractive because employees are trusted more. "There are some differences between Chinese managers and Australian managers. Chinese people in general do not like to plan; they prefer to respond according to the time and situation. Australian managers like to plan, they think that is the professional way. Is it correct to manage tightly or loosely? It depends on the situation. I think the best way is to join both the [Western and Chinese] ways together; you should plan, but leave a big space."

Lack of preparation is one reason Australian companies do poorly. Robin Chambers, senior partner of the international law firm Chambers & Company, says Australian companies do not prepare in the way that American companies in China do. "A lot of Australian companies are very short-term in their attitude. If you don't make the initial investment in relationships, the rest will never follow."

In 1987, Chambers was involved in the negotiation of communist China's first foreign joint-venture: the Hamersley Iron Channar joint venture. He says that since then the Chinese have tended to look favorably on Australia; the country is the destination for China's largest foreign investment. "Zhu Rongji [China's former premier] has always been very favorable to Australia."

Few advances have been made on those early gains. Doug Anderson, chief executive of the business consultancy Lee Anderson, says the Chinese will allow foreigners in, but their success will be contained. Australia, he says, is well regarded. "Western technology in China has a life of two to five years maximum before they learn to replicate it. So whatever you think is leading-edge technology today, they will have worked out how to do it themselves within three years and you will no longer be a relevant player in business.

"There is a defined number of people who make pot-loads of money out of China: traders, people who take technologies in, and people who establish wholly foreign-owned companies in a specialist area where they are able to control that technology all the time." ●