TOMORROW'S CHALLENGES

WHY NEW POLICY SHIFTS AND CORPORATE DIRECTION IS NEEDED IN CHINA

ADJUSTING TO CHINA'S NEW NORMAL

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It is increasingly clear that China's "new normal" presents dramatic opportunities and challenges. It follows that senior executives at multinationals working in China as well as policy planners in Beijing will need to adjust their strategies to China's slower, more sustainable economic growth rate. While the current prediction is for annual growth averaging around 7%, the IMF suggests that the real rate for 2016 could be anywhere from 6.8% to 6.3%. Some analysts think it could drop even lower to slightly more than 5%. The IMF's recent decision to include the renminbi as one of the global reserve currencies, effectively cutting into the troubled euro's territory, means both that China will have less flexibility in controlling the exchange value of the renminbi in the future, and also that the rest of the world is likely to be far more sensitive to sudden fluctuations. As the furor over last summer's devaluation showed, Beijing will be under pressure to show more transparency in its decision making process.

While the era of double-digit growth may be a thing of the past, 6% growth for the second largest economy is not too bad. An important consideration is the fact that the annual figure for growth is only an average that covers a number of different sectors that are expanding at different rates. Some sectors continue to grow rapidly, while others drag the overall average down. For instance, China's e-commerce grew by 37% in the first six months of 2015 despite disappointing growth in other sectors. Chinese innovative giants such as Huawei, Haier, Xiaomi, and Tencent continue to introduce world beating new technologies. DJI, a manufacturer of camera-equipped drones that sell anywhere from $500 to $4,000, now controls 70% of the global market. Alibaba and its subsidiary, Taobao, have expanded their distribution network to more than 100,000 villages in rural China, effectively creating a new gold rush.

On the downside, *The Economist* noted that Shanxi Province, the formerly bustling center of China's coal mining industry, registered a growth rate that hovered at around 4.9% in 2014, and slowed to 2.8% in the first nine months of 2015. In the heady days of 2001, Shanxi experienced a boom thanks to the demand for energy in China's rush to build new infrastructure. Those days are past. Air pollution and environmental degradation have made coal less popular, and the benchmark price in China has dropped by 27% so far this year. In a natural reaction, the government picked up the slack and some of the privately held mines were taken over by state-owned enterprises. SOEs now account for three fourths of Shanxi's output. While government intervention provided monetary relief, the management emphasis in Shanxi's mining industry shifted from maximizing production efficiency to politics, job-preservation and inflated payrolls. The inevitable result was a growing dependency on government bailouts. The result was that losses from the coal industry dragged down and effectively masked the more promising growth statistics from two high-tech factories installed in the province by Foxconn. China's recent announcement that it will cut some 500,000 jobs in the steel industry and 1.3 million jobs related to coal production is a promising indication that the government is finally ready to deal seriously with the problem.

The trick for both investors and Beijing policy planners is to identify which sectors are most likely to grow sustainably while gradually weaning the economy away from industries that have only a limited future. Continuing China's reform process, which was launched in 2013, is essential to moving the economy forward. Although managing the transition from a dying, or at least contracting, industry to those that are more sustainable, such as the service industries, can be painful, the process is essential to creating a solid economic foundation. The danger of quick solutions that rely on government intervention is that they risk preserving an unsustainable status quo.

Until now, China's investment in gigantic infrastructure projects has been enough to create an unprecedented economic boom, but as the US and Europe discovered painfully, booms don't last forever. The temptation is to deal with the current challenge by creating an even larger and more massive series of infrastructure projects. The preliminary draft for the 13th 5-year Plan which was previewed at the 5th Party Plenum in November, visualizes the creation of a new Silk Road, informally dubbed the "One Belt, One Road." It is essentially an extended series of Chinese rail, highway and port projects stretching across Asia to Europe. The plan will help bail out Chinese companies facing market saturation at home, but it will also substitute government intervention for a badly needed adjustment to market realities, not to mention exposing China's investments, projected so far to be around $890 billion, to unpredictable risks. The record so far has not been very promising. The American Enterprise Institute estimates that roughly a quarter of China's foreign investments and building projects launched since 2005 have either been stalled by serious difficulties or failed outright.

To succeed in China's "new normal," multinational corporations will also need to revise their strategies and to become far more nimble. Last summer, American automobile manufacturers began drastically reducing shipments to China. The problem was not a sudden collapse of the Chinese market, but rather the fact that Chinese purchases had been slowly decreasing over a number of months. American manufacturers had failed to spot the new market trend and Chinese distributors were unexpectedly saddled with too much inventory. A McKinsey survey queried top executives at 70 multinational corporations with operations in China, but with global headquarters in Europe or the US. At least 40% of the top executives in China were Chinese, but less than half were authorized to make critical decisions about pricing or product strategy without prior approval from their global headquarters, and two out of five said they had difficulty responding in time to China's rapidly changing market conditions. A number of executives said they spent about 20% of their time trying to explain the unique context of Chinese markets to their headquarters.

In fact, as Alibaba and Toabao are showing China's second and third tier markets in its fast developing inner cities and rural areas could provide a new gold rush, but if multinationals want to compete with Chinese companies on their own turf, they are going to need to develop new, more responsive strategies, and they will ultimately need to assign more responsibility and decision-making authority to their executives on the ground.

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