

# **Responses by Japanese Companies to Business Risks in China**

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Currently, the Chinese economy is strong and its growth mechanism from the perspectives of five to ten years is still functioning soundly. While the economy continues to grow, the severity of the environment surrounding business operations in China is increasing more rapidly than anticipated. Examples are competition involving three parties, i.e., foreign capital, state-owned and private companies, constant oversupply and strong pressure for price reduction, shortening of product life cycles and zealous competition in acquiring skilled personnel.

The issue of feelings regarding Japan has emerged as a new business risk. Because this issue has a complicated background, it is expected that this problem will persist for a long time.

In dealing with these risks, it is essential to study new China strategies that are totally different from those that were adopted for past business operations. The suggested new strategies include: (1) strengthening organizational ability to respond to change, (2) reviewing business structure by selection and concentration, (3) establishing a crisis management structure and (4) strengthening strategic public relations activities.

# I Strong Economy and Megatrend of Growth

## 1 Steadily Growing Chinese Economy

The Chinese economy has continued to be exhibiting high growth rates, with the real GDP (gross domestic product) growth rate for the first half of 2005 being 9.5 percent (Table 1). The primary driving force of this somewhat overheated rate of growth is investment. The rates of economic growth at a level of 9 percent, which have continued since 2003, have been supported by the high growth of fixed asset investment (including real estate investment) in urban areas. For the first half of this year, this investment was still at the same high level, with a year-on-year increase of 27 percent as compared to that of the same term in the previous year.

When we break down the investment growth, priority investment fields designated by the government such as energy and infrastructure have been showing high increases, e.g., coal (year-on-year increase of 82 percent), electric power, gas and water (year-on-year increase of 36 percent) and railways (year-on-year increase of 48 percent). However, the growth of housing investment, which was previously the principal driving force, has remained at 20 percent as partly influenced by regulations on speculative trades for high-priced housing. For example, even in Shanghai where the highest increases in real estate prices have been seen, the growth rate of fixed asset investments for the first half of this year was limited to 15 percent. This represents a decline of more than 10 points below the growth rate in the same term last year. Moreover, the growth of investments in the so-called overheated industries, such as steel and aluminum, also slowed to the one-digit level. While improvements are being made to remedy overheated investing, the government, which intends to achieve a soft landing with a growth rate of 8 percent in terms of overall industries, will continue to adopt restraining economic measures in the future.

Exports during the first half of 2005 showed a high growth rate of 33 percent. The increase of imports was limited to 14 percent due to inventory adjustments mostly among production goods in the domestic market. Consequently, investments as well as exports substantially supported growth during the first half of the year.

While the yuan was revalued against the dollar on July 22, the small increase in value of 2.1 percent had almost no effect on exports.

## 2 No Changes in Megatrends in Mid- and Long-Term Perspectives

As stated above, the current Chinese economy is strong, and Nomura Securities Financial & Economic Research Center has projected the real GDP growth rate for 2005 at 9.1 percent, as shown in Table 1.

While the Chinese government intends to gradually decelerate economic growth, major risks are involved such as a sharp decline in real estate prices, deflation due to declines in consumption, decreasing company revenues, etc. if the government adopts economic restraints that are more than necessary. Accordingly, the government must take a subtle approach in taking the lead for economic activities. While the government is expected to deal with its foreign currency exchange policy by adopting the “gradual progress principle,” how to respond to the pressure of other countries such as the United States for further revaluation of the yuan will also have a major impact on economic growth for the immediate future. It is projected that the real GDP growth rate will fluctuate between 7 – 9 percent: it will decrease to 8 percent in 2006, will increase in 2008 because of accelerated growth toward the Beijing Olympic Games, and will again decrease after the games.

However, the megatrends of growth of the Chinese economy from the perspective of 5 – 10 years are expected to remain the same. In the past ten years, China’s real GDP has grown by a yearly average of 12 percent.

The consistent driving force of economic growth consists of the coexistence of two economic systems, “mountainous China” and “seaside China,” as shown in Figure 1, and the Chinese Communist Party administration supporting these systems, which serves as a social stabilizer.

Recent reports indicate that the number of workers who come from the inland areas to the coastal areas has decreased due to increases in the income of the inland area residents, and that the advance of foreign capital factories has slowed down due to a rise in labor costs in the coastal areas. Actual foreign capital investments showed an unprecedented two-digit drop for two consecutive

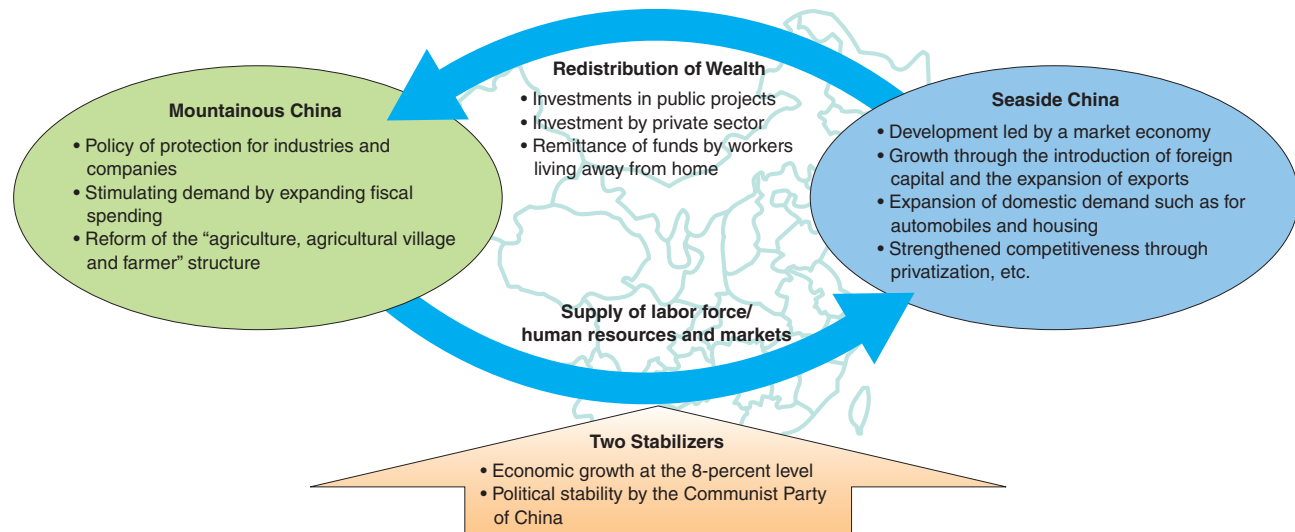
**Table 1. Macroeconomic Trends in China (Year-on-year increases)**

(Unit: %)

	2000	2001	2002	2003	2004	2005 First half	2005 Estimate	2006 Estimate
Real GDP growth	8.0	7.5	8.0	9.5	9.5	9.5	9.1	8.5
Growth of nominal fixed asset investments	10.3	13.0	16.1	27.7	25.8	27.1	19.0	15.0
Increase of consumer prices	0.4	0.7	-0.8	1.2	3.9	2.3	2.7	2.2

Note: GDP = gross domestic product.

Source: Nomura Securities Financial & Economic Research Center.

**Figure 1. Cycle between Seaside and Mountainous China**

months: April 2005 recorded a year-on-year decrease of 27 percent and May recorded a year-on-year decrease of 22 percent. Consequently, foreign capital investments that were made from January to July of this year recorded a minus 3.4 percent as compared to those of the previous year. Because the investment amount on a contract basis that serves as a leading economic indicator shows a plus 19 percent as compared to that of the previous year, it cannot be said that the brakes have been applied to investments from overseas. Nevertheless, the pace of the boom of entering the Chinese market for which up to now only the accelerator has been applied is likely to slow down.

Some negative views predicting the limitations of growth have started to emerge. These include: Do low labor costs continue forever? Can the growth mechanism of China enabling the coexistence and cooperative prosperity of seaside and mountainous China be maintained? Could the distortion accumulating in a society such as the expansion of the wealth gap result in the form of demonstrations or riots?

If many factories such as those now existing are constructed by foreign capital companies in a short period, the balance between supply and demand might collapse, resulting in increased labor costs. However, "mountainous China" has a population of as many as 750 million. The desire of these poor people to catch up with the more wealthy members of society might not be weakened easily. Moreover, as was the case in Japan, if the living standard increases, various social desires may emerge and demonstrations may occur. Yet, it is out of the bounds of possibility that social unrest would be so great that the government would be overthrown.

We do not think that the growth of the Chinese economy will reach its limits within the next five to ten years. Rather, we think that newly industrialized areas in Asia including India will continue to exist as the most attractive areas for future growth from the global perspective.

We believe that China is still the center of these areas of growth.

## II Delays in Responding to a Shift from Factories to Markets

Many Japanese companies have moved into China as the Chinese economy has grown. Due to the yen appreciation in the 1980s, many companies constructed factories in China in quest of inexpensive labor. While investments in China temporarily dropped around the Tiananmen Incident in 1989, the rush of investments into China resumed when we entered the 1990s. Around this time, the so-called "taking-back type business" constituted the mainstream in which products assembled in China are exported to Japan and third countries. However, when two-digit growth was achieved for four consecutive years, from 1992 to 1995, companies emerged that moved into China by regarding China as a market for sales operations targeted at the domestic Chinese market.

At the beginning of the 2000s, China joined the World Trade Organization (WTO) and the domestic Chinese market was opened. This has led to a consumption boom chiefly in the coastal areas. Recently, most Japanese companies moving into China intend to conduct sales activities with the domestic market as their target.

The construction of factories in China in a "taking-back type" business style essentially means the operations of factories in China, even though such operations are part of the management of a company moving into China. Accordingly, many Japanese companies have been achieving excellent performance by utilizing experience and expertise accumulated in Southeast Asia. However, the management style of sales activities for the

**Table 2. Differences between Factory Management and Company Management**

	Factory Management	Company Management
Role	Expanding exports by production at low cost	Expanding sales in the local market
Function	Not completed in local areas	Completed in local areas (production, sales, technology)
Personnel	Inexpensive, plentiful labor force (labor management)	Personnel with high sales and development skills (human resource development)
Location	Port access (Guangdong, Dalian, etc.)	Promising market, human resource access (Shanghai)
Top executive	Person who has experience in serving as the general manager of a factory (a top Japanese executive is possible)	Person who has experience in company management and who knows the local area (the top executive must be a local person)
Revenue	Reducing cost, rather than increasing profits	Pursuing profits by covering total operations, i.e., production, sales and technology
Performance	Profits are determined by the payment amount	Market share and profits in local areas are clarified
Priority	Priority is placed on the head office, not on local areas	Priority is placed on local areas and winning competition

domestic market is significantly different from the taking-back type business style (Table 2). To promote sales activities in the domestic market, so-called management localization must be resolutely implemented. With respect to personnel management as well, a shift from the labor management type to the human resource development type is also necessary. There are many cases among Japanese companies in which successful experience in the taking-back type management is too strong, and which conversely caused delays for companies in becoming aware of the need for localization and for creating mechanisms for the development of human resources.

While this is not the only issue, many Japanese companies are facing tough challenges in the business of selling products in China's domestic market. In other words, although China's attractiveness as a market is increasing as the result of a growing economy, many Japanese companies are not benefiting from such growth. They should lose no time in drastically changing their management style.

### III Decreasing Country Risks and Increasing Business Risks

Risks related with the conduct of sales activities in the domestic market have been growing year by year.

A declining trend has been seen with respect to country risks, such as political stability, stability and continuity of structures and policies, stability of macroeconomy, regulations regarding foreign exchange and investment, etc., through the penetration of the policy of reform and opening up of the markets and China's accession to the WTO. While pessimism is also increasing, such as concerning corruption and bribery of government officials, issues of energy and the environment in urban areas, and the possibility of the liberalization of the capital market

and the upvaluation of the yuan from the long-term perspective, China is certainly moving towards stability and prosperity from the point of view of 10 to 20 years, and this major direction is firm and impregnable.

Conversely, business risks continue to increase: (1) intense competition involving three parties, i.e., foreign capital, state-owned and private companies, (2) constant oversupply and strong pressure for price reduction, (3) shortening of product life cycles, (4) rapid changes in the competitive environment and (5) zealous competition in acquiring skilled personnel.

Regarding intense competition involving three parties, state-owned companies that have survived for ten years after many state-owned companies were reformed have some degree of strength and a competitive edge. Some companies are growing as private companies in actual terms through MBO (management buyout), which means that an executive of a state-owned company purchases shares of stock and acquires control of the company. In addition, rapidly growing private companies have also emerged. Private companies not only have a high level of cost awareness and a strong interest in profit and loss, but are also quick in adopting the latest technology. In addition, they have competitive strengths that are not available among state-owned companies and foreign capital companies. Such strengths include sales management expertise (how to deal with risks in collecting accounts receivable) that is different depending on the area and the ability to flexibly respond to unclear laws and regulations.

Competition among foreign capital companies is also intense. While the competitiveness of domestic companies in China (state-owned and private companies) has increased remarkably in the past two or three years, the participation of foreign capital companies has continued as before in pursuit of the growing Chinese market. While such competition involving three parties has further intensified in the past several years, an escalation of competition is expected in the future. Unsurprisingly, besides the weeding out of domestic companies, cases

will emerge where foreign capital companies are forced to withdraw.

The second issue of constant oversupply and pressure on price reduction is deep-rooted because it is firmly related to China's economic structure. In China, priority is given to social stability and solidarity and, in particular, employment is the most important issue for local governments. Accordingly, if the performance of a local state-owned company worsens, the local government usually takes measures to implement large-scale support from the perspective of securing employment opportunities. This has given birth to the flawed thinking of expecting government support whenever the necessity arises, causing problems because the appreciation of pursuing profits is not strongly rooted among the executives of state-owned companies.

Actually, there is an oversupply of many products and services and a strong pressure for price reductions. According to China's Ministry of Commerce, from January to May 2005, oversupply was evident in 87 percent of all items of clothing, 88 percent of all items of electric home appliances and 100 percent of all items of metal and electronic materials among the products for which the balance between supply and demand was monitored.

Under the socialist market economy, China has to deal with two aspects: the socialist aspect in which state-owned companies exist and the market economy aspect as represented by the rapid growth of private companies (Figure 2). Many foreign capital companies face problems that stem from these characteristics. On one hand, foreign capital companies are forced to engage in price competition with state-owned companies that take no account of profitability, while on the other hand, foreign capital companies cannot recover their investment for introducing new products and services because private companies immediately sell imitations.

In addition, the framework of competition changes rapidly in China. For example, (1) the life cycle of a product is extremely short in China because imitations and counterfeit products immediately emerge on the

market; (2) a rapid reorganization of the distribution channels has occurred due to deregulation and (3) entrepreneurs with absolutely no experience quickly enter the market one after another if the market is at all growing.

Moreover, while this has become common, Japanese companies in particular face a major problem of hiring and retaining skilled personnel. Although some reports indicate that difficulties have been encountered in hiring workers, there is a more than abundant simple work force even in the coastal areas as represented by workers from the rural areas. Rather, the serious problem is how to secure human resources having the necessary expertise and high level of technical background. The struggle among companies to obtain skilled personnel will become increasingly intense.

For business operations in China in the future, these business risks are far greater than any country risks.

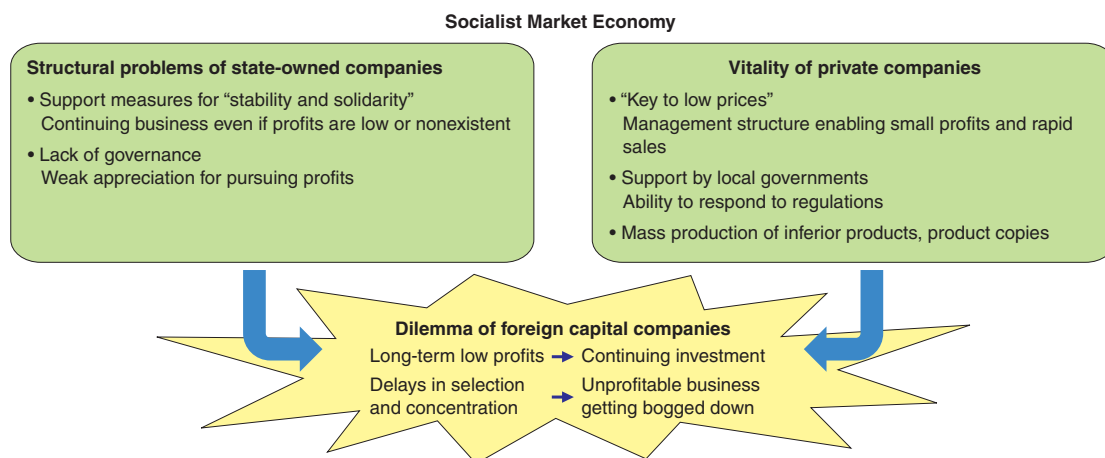
## IV Feelings about Japan Emerged as New Risks

### 1 Young Chinese People's Complicated Feelings about Japan

An anti-Japan demonstration occurred in Beijing on April 9, 2005. It then spread to Shanghai, Tianjin and Hangzhou on April 16, and to Shenyang, Xiamen, Guangzhou and Shenzhen on April 17, causing great bewilderment among Japanese people. Following these incidents, there remain some influences such as boycotts of Japanese products, sporadic labor-management disputes and the avoidance of order placement for especially public goods with Japanese companies.

For the past two years, we have repeatedly pointed out that such anti-Japan feelings may emerge and become a major risk to the management of Japanese companies in China. We also indicated that one of the important features of this issue is that the people who took the lead in the anti-Japan protests were members of the young generation in their twenties and thirties. Some professors in

Figure 2. Socialist Market Economy and Foreign Capital Companies



Responses by Japanese Companies to Business Risks in China

Chinese universities also observe their students' feelings about Japan using the keyword "contradiction."

In China's history education, Japan is referred to as a nation that invaded China during wartime and, at the same time, as a model of success in the modernization of Asia during the postwar restoration. In fact, many Chinese people have studied in Japan, and their experience in Japan was used as a model in numerous fields such as politics, economy, diplomacy and science and technology in the modernization process in China. In addition, Chinese students have favorable images about the Japan they see on an everyday basis, such as that Japanese people are diligent, keep their promises and create excellent products and culture (movies and music).

Conversely, news and articles about Japan's political leaders reported by the Chinese media regarding political issues are contrary to such favorable images, making it difficult for young people to understand the contradictions posed by these aspects.

Many young Chinese are not anti-Japan as far as every particular aspect is concerned. They joined the anti-Japan demonstrations with mixed feelings. For example, many students purchase Japanese products in the electronics district of Zhongguancun, which is called the Akihabara (the famous electronics district in Japan) of Beijing while, at the same time, participating in the demonstrations. The slogan of "do not buy Japanese products" used in the anti-Japan demonstrations was to express criticism of the Japanese government and, particularly, the issue of visits to Yasukuni Shrine. When these same people actually purchase goods in their daily lives, they continue to favor Japanese products because of their good quality.

It is said that the most widely read books written by foreign writers among young Chinese people in the past ten years are those of Haruki Murakami, a Japanese writer, rather than a writer from Europe, the United States, or other Asian countries, and that the overseas literature most frequently introduced in China is from Japan. Overall, young Chinese people discriminate between political activities and daily activities. It is not the case that the majority of young people are influenced by anti-Japan education and practice blind nationalism.

In addition, it is said that: (1) young people who joined the demonstrations are in the single-child generation and are prone to indulge in self-centered ideas, (2) young Chinese people are not so simple that they are inclined to anti-Japan sentiment only by history education and (3) self-confidence arising from China's rapid rate of growth as compared to Japan's relative depression is increasing a Sinocentrism-like ideology.

As such, young Chinese people have convoluted feelings about Japan. In Japan, some people tend to attribute all of the feelings about Japan to a patriotic education provided by the former Chinese government. However, the "contradiction" may be further expanded if this phe-

nomenon is too greatly simplified in dealing with the issue. In considering future Japan-China relationships and business activities of Japanese companies in China, it is necessary to expand the understanding of the feelings about Japan further among young Chinese people as described in this section.

## 2 The Prolonged Issue of the Feelings about Japan

Complicated political issues that are difficult to deal with exist between Japan and China, such as historical issues, Japan's bid to become a permanent member of the United Nation's Security Council, marine resource/territorial disputes and issues related to Taiwan. These problems are not ones that can be settled if one party compromises, and cannot be settled easily. In other words, the issue of anti-Japan feelings derived from these problems as a background situation will persist for some time. In fact, if no action is taken to improve the current situation, these problems may become even more serious in the future.

Fundamental solutions to these problems will come from deepening mutual understanding. Learning from history is the work of learning from the past and, at the same time, is the work of burying past evils. From the perspective of China, the period from 1931 (Manchurian Incident) to 1945 is the period of the anti-Japan war. However, what is frequently talked about in Japan is the Pacific War from 1941 to 1945. Accordingly, it cannot be said that Japan fully understands the ten years from 1931 to 1941 when China suffered most. Conversely, as compared to the 50 years after 1894 (the Sino-Japanese War), Japan's 60-year post-war history is not fully known except for its economic development.

While relatively friendly relationships continued between Japan and China after the normalization of diplomatic relations in 1972 on into the 1980s, these relationships are thought to have entered a transitional period after the 1990s. This era of friendly relationships (the honeymoon period) in the past was based on such a balance as that consisting of a war-winning country and a war-losing country as well as a developing economy and a major economic power. After the 1990s, China entered a period of rapid economic growth. At the same time, Japan rectified various distortions caused by the postwar system and continued to experiment with new economic and social systems. As such, the balance of power between the two countries changed significantly, and a new stable balance has not yet been attained.

In addition, changes in the environment have rapidly taken place, such as the retirement of the generation that built the past friendly relationships between the two countries and politicians who were born after the war taking leadership roles. It is likely that the period of such an unstable balance may continue for 10 to 15 years. It is also likely that an assortment of contradictions and

tensions may commonly occur until a mature relationship can be established based on a new balance after such an unstable period is overcome.

The relationship between Japan and China is that of coexistence and cooperative prosperity. Until a new stable relationship can be established, special attention should be given to the creation of opportunities to promote mutual understanding. China does not have an interest in Japan to the same extent that Japan pays attention to China. Japan should increase its efforts to deepen its understanding of China. At the same time, it is extremely important to provide support to promote various studies of Japan in China to disseminate a correct and actual picture of Japan, rather than the superficial images reported by the Chinese media.

### 3 Impact on Japanese Companies

No cases have been reported in which the issue of feelings about Japan exerted a major impact on the business activities of Japanese companies in China. However, in assuming that this issue will continue for a long time, attention should be paid to the following items, among others, on a regular basis.

- Potential consumer boycotts
- Barriers to participate in public works
- Damage to a corporate brand image
- Destabilization of relationships with partner companies
- Difficulties in recruiting skilled human resources and acceleration of job turnover
- Difficulties in developing mutual trust between local employees and employees dispatched from Japan
- Problems in business transactions and/or personnel/labor affairs becoming “political issues”

In April, when the anti-Japan demonstrations took place, sales representatives of a Japanese manufacturer went the rounds of stores in response to information that its prod-

ucts were being withdrawn from stores. They found that other competing foreign companies and domestic companies were strongly urging storeowners to “withdraw Japanese products from their shelves” and passing out leaflets.

In the case of tenders for some public works to which high political attention is paid, Japanese companies sometimes receive disadvantageous treatment. There are also cases in which various daily disagreements occurring at a local site in conducting business activities (e.g., discord with partner companies or customers, personnel and labor affairs within a company and customer complaints) are expanded because the company is Japanese.

Even if these issues do not cause fatal damage, it is important to prepare remedial measures and manuals during ordinary times by assuming that these problems might occur. It is also important to build social trust and confidence in a company in its daily activities as a measure for avoiding risks.

A Chinese professor noted, “We hope for the realization of a superior Japanese management model in China. A model in which labor and management are united to conduct business operations can serve as an important direction that Chinese companies should pursue in the future. This is because we have major concerns over labor-management problems in China. If a Japanese company can achieve pioneering management techniques in terms of these aspects and can provide a model, such a company will be highly regarded.” The most effective preparatory measure for avoiding potential risks is that individual Japanese companies generously exercise the expertise and skills they can be proud of in China and earn respect in China.

Additionally, employees dispatched from Japan are, of course, required to take the lead and to provide examples for other employees. At the same time, they must be provided with adequate preliminary training regarding the historical issues between Japan and China. It is also necessary to deepen the understanding of not only past history but also the special feelings of the Chinese people relative to the calamity of war, and the rise of nationalism among young Chinese (Table 3).

**Table 3. Major Historical Incidents Taken Up in Anti-Japan Movements in China**

Incident	Year of occurrence	Place	Outline
9.18 incident	1931	Shenyang	This is known as the Manchurian Incident in Japan, but is called as “the day of shame” in China.
1.28 incident	1932	Shanghai	This is known as the First Shanghai Incident in Japan. Japanese troops stationed in Shanghai invaded a communal foreign settlement and had a fierce battle with Chinese troops.
12.9 movement	1935	Beijing	A student demonstration against Japan’s attempt to govern North China (patriotic student movement).
7.7 incident	1937	Beijing	Marco Polo Bridge Incident; this triggered a full-scale war between Japan and China.
8.13 incident	1937	Shanghai	This is known as the Second Shanghai Incident in Japan. In addition to Japanese troops stationed in Shanghai, reinforcements from Japan that landed at Jinshanwei invaded Shanghai and Jiangnan.

Because many Chinese people have confidence based on the economic development they have achieved in the past ten years or more, attention should also be given to such confidence. In Shanghai alone, more than 30,000 Japanese people live if people with long-term assignments are included. On a daily basis, they are required to behave in a manner that will earn the respect of the local society.

## V Management Directed toward Avoiding Risks

### 1 Strengthening Organizational Ability to Respond to Changes

In order to improve the ability to respond to business risks in China, what is first needed is to equip an organization with the ability to flexibly respond to sudden environmental changes. For example, measures to deal with the shortening of a product life cycle include the diversification of production methods. Specifically, these include increasing the operating rate of production facilities to recover investment as quickly as possible, reducing plant investment as much as possible, and utilizing outside companies by use of OEM (original equipment manufacture) components if appropriate.

Moreover, in order to strengthen the ability to respond to changes in distribution channels such as a shift from existing channels to major volume retailer channels, measures required include strengthening a company's commitment to distribution channels and increasing the control of the information flowing in distribution channels. For example, in not a few cases a manufacturer does not know its actual distribution inventory because of excessive dependence on other companies for its distribution channels. In order to compete in the Chinese market, the thought is also important that greater priority must be given to investment in highly competitive distribution channels rather than to investment in production facilities.

To improve the ability to respond to such changes, it is necessary to establish a structure enabling quick decision-making according to situations based on information collected at the local site by strengthening management and planning functions at the local site. This requires the provision of integrated management functions covering development, manufacturing and sales to the local site and localizing the planning functions (by developing Chinese managers).

### 2 Reviewing Business Structure by Selection and Concentration

By using total investment as a denominator and annual sales as a numerator, the average values of the top 500 foreign capital companies in terms of sales (excluding

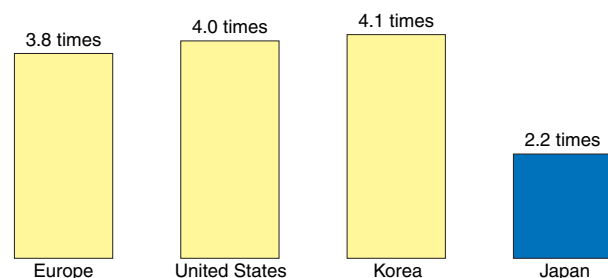
automobile sales companies) by country were obtained. While the value obtained for European, US and Korean companies was almost four times, the value for Japanese companies was extremely low and was only slightly more than two times (Figure 3). This means that Japanese companies are investing twice as much to achieve the same sales amount as compared to European, US and Korean companies. Generally, the ratio of profit to sales is considered lower in Japanese companies than that in European and US companies. If so, the ROA (return on assets) of Japanese companies is likely to be less than half that for European and US companies. This means that investment by Japanese companies does not lead to results (sales and profit), and that additional time is required to recover investment.

It is likely that lax management of Japanese companies lies behind this problem, such as (1) the erroneous belief prevails that "advance investment is justifiable" for the reason that this is China; (2) from the beginning, local management has no strong will to recover investment and (3) while investment is being expanded substantially, the management structure encompassing the recruitment and development of human resources and financial management that are necessary for expanded investment has not been established.

Another background factor is the fact that business with no perspective of growth potential for the current or near future is retained. In other words, it is likely that no structural review in terms of business selection and concentration has been implemented. In making the decision to move into China, most businesses carefully conduct feasibility studies. Most strategies and plans are formulated to secure competitiveness. However, once the decision to move is made, the involvement of the corporate planning division of the head office in Japan generally declines sharply, leaving everything that remains up to "the local site" and/or "the responsible department."

If the business environment changes, a feasibility study should be initiated again from scratch. If the performance is not as good as anticipated at the initial stage, the reasons for not achieving the goals set out under the initial plans should be carefully examined, and future performance

**Figure 3. Multiplying Factors of Annual Sales/Total Investment (2003)**



Note: The figures represent the average value of 32 European companies, 50 US companies, 36 Korean companies and 71 Japanese companies among the top 500 foreign capital companies in terms of sales (excluding automobile sales companies).

should be reevaluated. Based on the new evaluation of each business, strategies should be reviewed.

For example, even if a company had enjoyed technological predominance at the time it moved into China, the company should make a decision on a shift of production to OEM or on withdrawal if such predominance is lost due to reasons such as catch-up by Chinese companies (Figure 4).

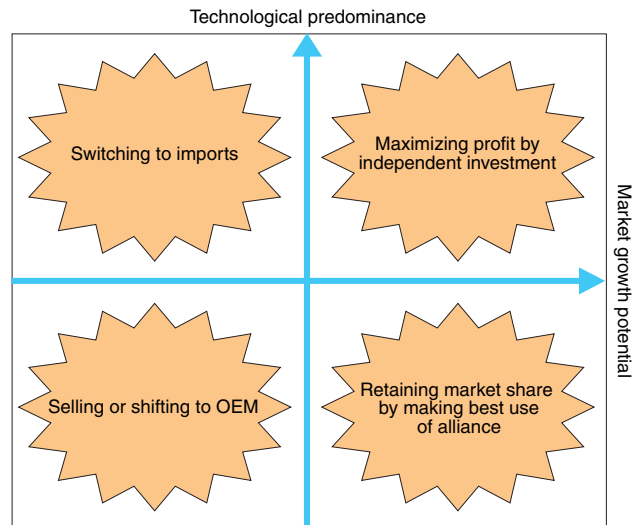
There are cases where Japanese business in China is continued on a leisurely basis without making any distinct decisions under the peace-at-any-price principle or based on wishful thinking even if the future growth potential is already lost. Such reasons for this attitude include: “the understanding of the other party in the joint venture cannot be obtained for termination of the joint venture,” “the scale of loss is small as compared to those of some departments at the head office,” or “the market share can be recovered some day by introducing new products.” However, China’s intense competitive environment is unparalleled, and the loss will increase as long as the situation is allowed to remain.

If the growth potential of the market remains even if technological predominance is lost, measures to survive should be considered by examining the possibilities of an alliance or joint venture with a company with which supplementary relationships can be established in terms of development and production by reviewing self-sustaining measures. Conversely, if a company has technological predominance, and the growth potential of the market is promising, a shift toward independent investment by purchasing the shares owned by the Chinese partner should be considered. This action could maximize the profit of the principal company and speed up management decisions. Furthermore, if a company has technological dominance although the market has matured, it is possible to consider strategy conversion, such as switching from production in China to imports, if appropriate.

While the two axes of Figure 4 represent technological predominance and the growth potential of the market, there are many other indicators available for evaluating the future prospects of a business. What is important is to evaluate a business objectively without being impeded by delay factors caused by past circumstances or expectations of the parties concerned, and to make a drastic shift in strategy, if necessary. For this purpose, studies should be made by an organization that is free to make objective decisions and that is close to top management, such as a corporate planning department or a local management company.

Siemens faced a crisis of substantially declining business profit in China in 2001 in spite of having made aggressively expanded investments. To deal with this situation, Siemens took the radical step of shifting the direction of its business in China under the initiative taken by its head office. Actions included considerable restraint on investment with the exception of extremely

**Figure 4. Business Evaluation and Rearrangement of Portfolio**



Note: OEM = original equipment manufacturer.

limited growing businesses such as electric power systems, and giving priority to investments for strengthening sales functions and human resources. Consequently, in 2004, Siemens achieved a 28-percent year-on-year increase in revenue, while restraining investment.

If selection and concentration from the perspective of overall business in China is not implemented and if business in China is based on the individual judgment of a single department or the peace-at-any-price principle at the local site, investment in China may never be recovered.

### 3 Establishing a Crisis Management Structure

In light of the response to the feelings about Japan as discussed in the preceding chapter and the past SARS (severe acute respiratory syndrome) outbreak as well, it is important to “establish a crisis management structure for unexpected situations” as a method of helping to deal with risks in doing business in China. The fundamental factor of crisis management is to instantly collect accurate information at the local site and to make a quick decision at the local site. This calls for the localization of an organization. Moreover, an instruction manual should be prepared that indicates the actions to be taken by each organization if a problem unfortunately occurs. This manual should be systematically disseminated throughout the company by means of internal company communications.

In May 2005, a problem occurred in the operations of Johnson & Johnson in China in relation to the quality of a product used for measuring blood sugar. However, because the method to deal with the occurrence of such a problem had penetrated all levels of the organization, the company was able to announce recall efforts to collect all affected products two days after this problem was

publicized by the media. The company provided thorough explanations to all agencies to prevent any further expansion of the problem.

In contrast, during the same month, the issue of the safety of Nestle's powdered milk in China was publicized by the media. Because the company took two weeks before announcing an apology and recall, criticism in the mass media expanded, and Nestle lost the trust of many of its customers.

In addition to the need to increase organizational sensitivity with respect to the possible occurrence of a problem, the degree to which advance studies were made on a series of remedial measures demonstrated basic differences between these two companies. These differences included measures to deal with distribution channels, consumers and the mass media.

A Japanese company is studying remedial measures within such organizations as crisis management committees consisting of local and head-office members established for business in China by detecting indications of risks on a routine basis rather than when a problem occurs. The involvement of top management in risk issues has brought about the effect of increasing overall organizational sensitivity to risks in this company.

#### 4 Strengthening Strategic Public Relations Activities

In addition to a structure for crisis management, it is also important to work through the media to obtain a correct understanding of business activities by consumers in China.

The media environment in China is extremely complicated with many TV stations and newspapers. There are about 300 TV stations (about 3,000 channels), about 2,000 newspapers and about 9,000 magazines. While circulation of official organs as represented by the *People's Daily* is decreasing, the circulation of evening papers, tabloids and amusement papers carrying TV programs and entertainment and sports information is increasing.

With the number of users exceeding 100 million people, the Internet has come to have vital power in forming public opinion. While past use was limited mostly to some younger people and people in the higher income brackets, the Internet is now being used by people at numerous age segments. The number of users is increasing not only in the coastal areas but also in the inland areas; the number of female users is also increasing. If negative information about a company is posted, the article is transmitted through the Internet and copies are instantly made available. Consequently, information (which is most often negative) is disseminated in an instant. Recently, there have been many cases where a consumer's complaint about a company spread through the Internet from one area to all of China.

The organs carry the official views of the government, and the tabloids surprisingly have only limited sources of information, and are under the management of the government. However, countless pieces of information flow through the Internet because of the advantage of anonymity. Recently, a bribery case was prosecuted with an indication through the Internet serving as the initial reason for such prosecution.

While keeping daily relationships with the media is costly, any widespread damage caused by the dissemination of negative information may be enlarged to several dozens of ten times the public relations cost of telling the company's side of the story. Accordingly, it is important that a company establish relationships with the media on a daily basis at least to ensure that the articles are written based on accurate information.

In particular, strong Internet contact should be a part of any company's public relations activities. First of all, information should actively be disseminated in China concerning the company's management policy, business activities and contributions to the local community. This can be done through a company's website to promote an understanding of the appropriate company image. Moreover, by constantly monitoring websites through the Internet, a company should understand the "sentiment" (direction of moves in public opinion) concerning the feelings about Japan and consumer behavior, and accurately establish the goals of public relations activities.

The representative measures through assuming increased business risks are discussed above. However, while measures to deal with risks must be carefully prepared, they have no meaning if the mindset of dealing with business in China becomes passive. Recently, conversations have emerged that critical feelings and/or opinions about China have started to appear among management executives at head offices in Japan, and this atmosphere is propagated to their local organizations in China. However, the total amount of trade between Japan and China has already surpassed that between Japan and the United States. The relationships between Japan and China have developed into one that can be called community. The development of China under international rules such as WTO will benefit many Japanese companies.

With the growing scale of risks, many of the measures against risks cannot be implemented without commitment of the head office in Japan. I hope that the head offices are united with their local offices to re-establish a strategy for China that is appropriate for the new competitive era.

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