The Economist

Special report:
Business in China

Business in China

Back to business

Despite China's recent troubles, the prospects for its entrepreneurial private sector remain bright, says Vijay Vaitheeswaran

Sep 12th 2015 | From the print edition

SHANGHAI'S WUKANG ROAD has a long history. In 1897 John Calvin Ferguson, the American head of what is now Jiao Tong University, had it built in the city's French concession so students could get to class. The road boasts several dozen listed buildings, among them a graceful mansion that is the old family home of Marjorie Yang, China's cotton queen. Its interior garden is sheltered by tall trees that have survived Japanese occupation, civil war and the

Cultural Revolution.

Ms Yang's family has proved just as resilient. Tsai Shengbai, her grandfather, began his studies at America's Lehigh University in 1915, the same year that the British and American Chambers of Commerce opened in Shanghai. Inspired by Frederic Taylor's theories on scientific management, he took over Mayar Silk Mills, founded by his father-in-law (Ms Yang's great-grandfather), and turned it into one of China's largest silk firms by introducing modern machinery and professional management.

A century ago Shanghai was a cosmopolitan city bursting with entrepreneurial energy. Then came the years of upheaval. The family moved to Hong Kong and started again. It gave up its mansion and its factories but kept its knack for business. In time, a younger generation set up Esquel, a new textile firm, and as soon as China opened the door to private investment in 1978 the family went back to the mainland. Esquel has since grown into one of the world's best thread-to-shirt textile firms, with some 56,000 employees and operations the world over. Among its clients are such famous brands as Ralph Lauren, Hugo Boss and Nike. Privately held, it has annual revenues of more than $1 billion. Ms Yang has even managed to get back the mansion in Shanghai.

Esquel has invested around $200m to transform its manufacturing complex in Gaoming, in southern China, and spent a further $30m on wastewater treatment. In one giant room warping machines made in Europe are creating enormous spider's webs of yarn. Each of the $500,000 Staubli drawing-in machines in another room saves 12 workers. Mechanisation improves efficiency and quality and cleans up the dirty processes of dyeing, weaving and finishing. The enormous sewing rooms are air-conditioned. The seamstresses think their work is better and safer than most factory jobs. Ms Yang insists that "industry is not just about labour input…knowledge has value." She teaches her workers a simple software-coding game developed by the Massachusetts Institute of Technology to encourage logical thinking.

Esquel's story challenges three widely held beliefs about China Inc: that the outlook for business in China is gloomy because the economy is set for a long period of stagnation or worse; that China's economic miracle was the result of large-scale planning by the state, not private-sector enterprise; and that Chinese firms are mere copycats that cannot innovate. This special report will argue that all these contentions are wrong.

"The Chinese economy is faced with the onset of a permanent slowdown. To mitigate its adverse effects, the Chinese government needs to change its old ways," according to an annual assessment of the economy by the European Union Chamber of Commerce in China, released in the wake of recent turmoil in the stock- and currency markets. The country's growth rate has dropped from double digits to around 7% (according to official data) and the debt-to-GDP level has soared. China's clumsy devaluation in August, coming at a time of tumbling oil and commodity prices, unnerved many investors. The subsequent plunge in the Shanghai stockmarket, and the government's ham-fisted policy response, set off a global rout in shares. Doomsters are already predicting a long period of stagnation, reminiscent of Japan's "lost decade", or even an economic collapse.

The power of numbers

There is cause to worry about China's economy, but this special report will show that there are plenty of reasons to be hopeful as well. Growth may be sagging, but even if, as many believe, it is only 5% today, that represents more economic output than the 14% seen in 2007 because the economy is so much bigger. And as Louis Kuijs of the Royal Bank of Scotland points out, China's income per person at market exchange rates in 2013 was only 13% of America's, so there is plenty of scope for catch-up growth, particularly if the government adopts reforms that free up the private sector.

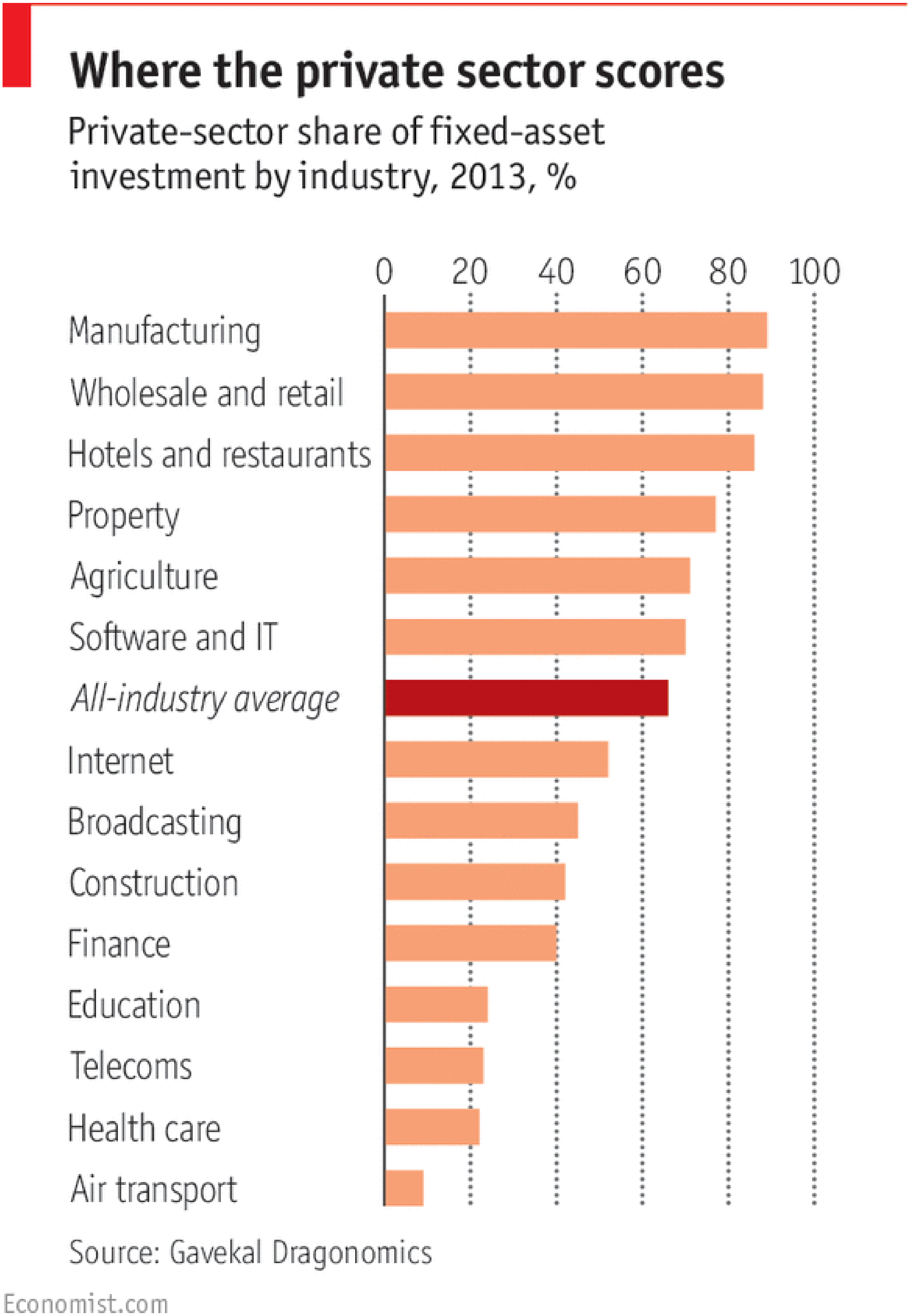
And many of China's people are getting richer all the time. McKinsey, a consultancy, estimates that by 2020 the proportion of urban households with annual incomes of $15,000-33,000 (a rough definition of the country's middle class) will be 59%, against only 8% in 2010. Manufacturing, far from being on its way out, is benefiting from investment in labour productivity, automation and regional supply networks. And the underdeveloped services sector represents a huge opportunity.

Even Jörg Wuttke, the boss of the EU Chamber of Commerce in China that has just delivered such a critical assessment, remains guardedly optimistic: "China's economy is headed for a rough year or two, but the longer-term outlook for business remains positive. Our members are staying here and investing in China's future growth."

John Rice, the vice-chairman of GE, accepts that the easy gains in China have been made, but reckons that "many firms haven't tried hard enough." With a population of 1.4 billion, China packs such a punch that even niche markets like online dining and nail salons can amount to more than the entire car industry in a smaller country.

Up to now, China's leaders have relied on state planning and heavy investments in infrastructure and property. To its credit, President Xi Jinping's government has acknowledged that this model has run out of steam, and has introduced reforms to encourage a shift to growth driven by consumption and services. But there is much more to do. China's control-obsessed planners were never going to find it easy to give free rein to market forces, and many of the recent policy stumbles and resulting financial panics reflect their ambivalence about market reform.

At first blush, the



argument for state capitalism seems plausible. China's investment-driven model has produced lots of infrastructure that ties this vast country together. State-owned enterprises (SOEs) control a large share of assets in important industries. Gavekal Dragonomics, a consultancy, estimates that SOEs account for perhaps a third of China's capital spending, against 5% or less in most developed countries.

Yet on closer inspection the SOEs' achievements look less impressive. The private sector, it turns out, is responsible for perhaps two-thirds of all economic output today and almost all of the 250m-plus jobs created in cities since 1978. It also accounts for nine-tenths of exports. Its investment is growing far faster than that of the SOEs. China's best chance of weathering the current storm lies in the resilience and dynamism of the private sector.

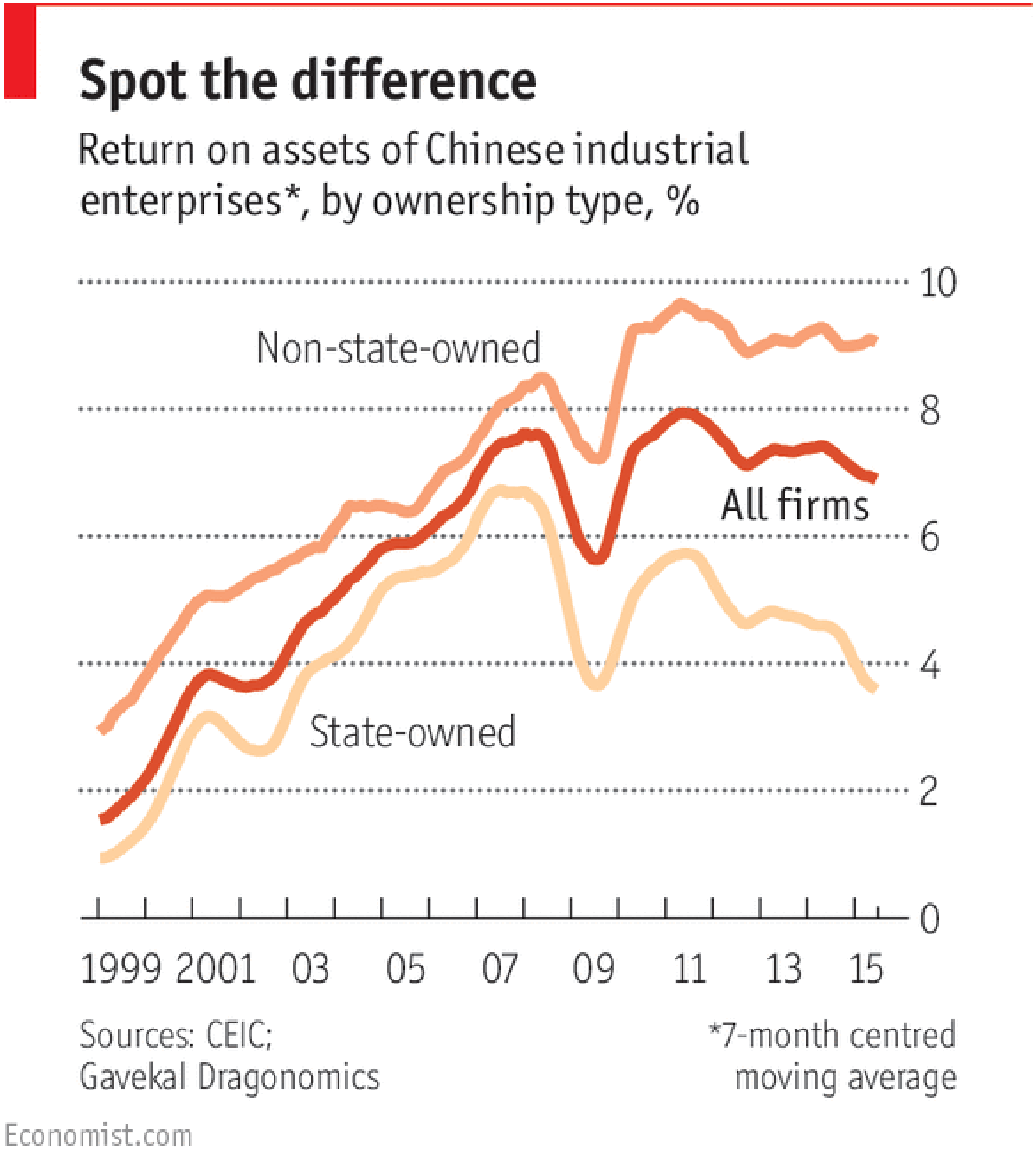
The late Ronald Coase, a Nobel prize-winning economist, noted in a paper entitled "How China Became Capitalist", co-written with Wang Ning, that "the fact that the Chinese Communist Party has survived market reform, still monopolises political power and remains active in the economy has helped to sell the statist account of reform." But, he continued, what really fuelled the economy were the "marginal revolutions" that enabled entrepreneurship and markets. Private farmers, rural enterprises and small urban entrepreneurs did more from the fringes to advance the economy than did central planners in Beijing.

The distinction between China's state-owned and private firms is not always as clear-cut as it might seem. A company's formal status can be misleading (see article (http://www.economist.com/news/special-report/21663334-telling-state-controlled-private-firm-can-be-tricky-how-red-your-capitalism)). And the Communist Party is everywhere: article 19 of China's company law states that a party cell must be set up in every firm above a certain size, public or private. Still, on the whole SOEs and private firms behave very differently, and the entrepreneurial energy now in evidence in China is largely confined to the private sector.

Edward Tse, a former boss of the Chinese operations of both the Boston Consulting Group (BCG) and Booz & Company (now part of PwC), identifies four entrepreneurial waves that have defined the modern Chinese economy. The first arrived in the 1980s, when the end of Maoism enabled private-sector firms to take off. Zhang Ruimin took control of Haier, Liu Chuanzhi launched Legend and Ren Zhengfei set up Huawei. Most new entrepreneurs at that time had little business experience.

The second wave began in 1992, when Deng Xiaoping's "southern tour" rekindled reforms. A number of entrepreneurs from this period—which produced Liu Jiren at Neusoft and Guo Guangchang at Fosun, among others—were well-educated. Many had left academic or government sinecures to start their own businesses.

The third wave started to roll when China joined the World Trade Organisation in 2001, which



opened it up to global business. Many internet pioneers, such as Pony Ma at Tencent, Jack Ma at Alibaba and Robin Li at Baidu—date from that period.

Now the fourth—and highly disruptive—wave has arrived, bearing entrepreneurs like Lei Jun of Xiaomi, a smartphone-maker. Many are using the mobile internet to challenge inefficient domestic incumbents. They are more global in outlook, more willing to accept outside investors and more innovative.

"I challenge you, name me one innovative project, one innovative change, one innovative product that has come out of China," harrumphed Joseph Biden, America's vice-president, last year. And in the past Chinese firms have indeed often copied from the West. But this is changing fast as local entrepreneurs come up with innovative products, services and technologies.

Innovation nation

China has a long history of invention. All diligent schoolboys know about gunpowder, papermaking, printing, the compass and the waterwheel. The harder-working ones may also be aware of cast iron, the ploughshare, the stirrup and the clockwork mechanism. But historic Chinese innovation did little to improve the lives of ordinary people. The emperor and his officials sometimes confiscated inventions and prevented their spread. David Ahlstrom of the Chinese University of Hong Kong points out that inventive entrepreneurs not only lacked protection for their intellectual property but also had little social status in a society that put bureaucrats on a pedestal.

Now Chinese leaders have started to praise innovation. Reluctantly, they are beginning to accept that their top-down approach may not be up to the challenges ahead. One of the biggest of those is that, largely thanks to the one-child policy first adopted in 1980, China has begun to age before becoming comfortably rich. The country's labour force is expected to peak this year and shrink by 16% by 2050, and the ranks of pensioners are swelling. So China will have to squeeze more output from fewer people.

McKinsey calculates that if the country is to maintain GDP growth of 5.5-6.5% a year to 2025, a third to half of that growth must come from improvements in total factor productivity. SOEs have grown inefficient and indebted, so most of that productivity growth will come from the private sector. Inventors are now encouraged to commercialise new technologies, and protection for intellectual-property rights is being strengthened.

China's leaders need to stop coddling bloated state enterprises and let them be managed by professionals in competitive markets. They must also ease their grip on academia and the internet so that China's bright sparks can benefit from the free flow of ideas needed to sustain world-class innovation. In their book, "Can China Lead?", William Kirby of Harvard University and his co-authors observe that Chinese entrepreneurs enjoyed freer markets for most goods than any nation in Europe as late as the early 19th century; and the private-sector boom in the early 20th century in Shanghai, as well as in other parts of China, set the foundations of modern capitalism. It lay dormant in the years of war and upheaval that followed but is now reviving. The spectacular rise of China's private sector can be seen as a renaissance.

This report will argue that private firms have been responsible for the vast bulk of modern China's economic advance. They are agents of change, risk-takers and, these days, true innovators that take full advantage of the potential of new technology. They are delivering not only ever better manufactured goods but also increasingly sophisticated high-tech-based services. More and more of them are venturing abroad to increase their reach and improve their offerings. As long as the government does not interfere too much, there is every reason to think that they can help deliver the required growth and turn the Middle Kingdom into the world's largest and most dynamic economy.

From the print edition: Special report