

UNDERSTANDING

CHINA.EU



WINNING CHINA'S MARKETS

AN SME INVESTMENT GUIDE



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by Jonathan Story
and the China Advisory Council



TABLE OF CONTENT

POLICY RECOMMENDATIONS	4
INTRODUCTION	10
ABOUT THE AUTHOR	10
EXECUTIVE SUMMARY	11
CHINA ADVISORY COUNCIL SURVEY ON REGIONS AND SECTORS IN CHINA	12
MOST PROMISING REGIONS IN CHINA	12
MOST PROMISING SECTORS IN CHINA	16
WHY MANAGERS HAVE TO LEARN ABOUT CHINA'S TRANSFORMATION	17
WHY GO TO CHINA? FACTORS COMPANIES SHOULD TAKE INTO ACCOUNT	20
CONDITIONS FOR SUCCESS OF SMEs AND LARGER BUSINESSES IN THE CHINESE MARKET	23
BECOMING A LEARNING ORGANISATION	23
CHOOSING THE RIGHT LOCATION	23
GOVERNMENT RELATIONS	24
A SUITABLE BUSINESS STRUCTURE	25
GETTING HUMAN RESOURCES RIGHT	26
FIRST THINGS FIRST	27
THE CORPORATE LIFECYCLE IN CHINA: FROM MARKET ENTRY TO CONSOLIDATION	31
THE EUROPEAN COMMISSION'S ROLE IN HELPING TO FOSTER A FAVOURABLE CLIMATE FOR EU BUSINESS OPERATING IN CHINA	33
EU ATTEMPTS TO INFLUENCE CHINA	34
EU-CHINA POLICY AND THE INTERNAL MARKET	37
CONCLUSION	43
UNDERSTANDING CHINA	44

POLICY RECOMMENDATIONS

The China Advisory Council, part of the 3-year Understanding China programme, is composed of 17 China experts with academic and practical experience. It is a forum for relevant stakeholders to discuss current developments on EU-China economic relations.

The China Advisory Council develops and proposes policy recommendations to policymakers in the European Commission and in European member states and acts as a sounding board for European economic and SME related policy issues *vis-à-vis* China.

On Thursday, 27 May 2010, the China Advisory Council discussed EU-China investment links and proposed the following policy recommendations:

1. The first recommendation is to make all information centres and support units in China multi-hatted to represent EU member states as well as the EU as a whole. This includes expanding the notion of 'European Houses' into a brand name. Though some elements of these European Houses already exist to one degree or another, more direction and patronage is needed from the European Commission, in partnership with relevant stakeholders such as the EUCCC, EUROCHAMBRES, etc.

This should not necessarily mean building physical structures. Instead, the focus should be on developing a flexible framework to achieve the 'Europeanisation' of already well-established national activities and services. Generating a European presence in the provinces and cities of China where this is lacking provides the opportunity to offer national and European information and support to SMEs from all EU member states.

To realise the full potential of the EU, the European Commission needs to create an exhaustive list of all existing national offices in the regions and identify key people and facilitators in China (as for example Mandarin speaking Europeans from underrepresented EU member states). These people need an efficient network to improve the exchange of information and facilitate collaboration. Ideally, this will include joint meetings between the EU delegation, member state representatives and the European Union Chamber of Commerce in China.

To encourage the 'Europeanisation' of national centres, the European Commission, together with the support of interested Chinese provinces, should offer incentives in the form of extra funds or detached specialists. This could also involve expanding the European Commission's Erasmus for Entrepreneurs programme to China and use 'European Houses' as training centres specifically designed for European SMEs interested in investing in China.

2. Secondly, the China Advisory Council identifies potential growth and attractiveness of regions and sectors in China and recommends focusing European activities on coastal area tier 1 cities and inland regions that dispose of good infrastructure. Concerning boom sectors, the highest potential for European business is in luxury brands, high-tech industry, and the environmental sector.

The following table suggests a simplified analysis to determine a SMEs choice to settle in tier 1 regions¹ on the coast or inland depending on their sensitivities to specific factors for business success. The solution depends on these sensitivities.

FACTORS DETERMINING THE CHOICE OF REGIONS FOR EUROPEAN BUSINESS

	Tier 1 cities in coastal areas	Tier 1 and tier 2 cities inland
<ul style="list-style-type: none"> ▪ Language skills ▪ Business culture ▪ Know how ▪ Stable GDP per capita growth ▪ Proximity to consumers and world markets 	Sensitive	Non-sensitive
<ul style="list-style-type: none"> ▪ Labour costs ▪ Proximity to suppliers ▪ Proximity to resources ▪ Profitable government initiatives and policies 	Non-sensitive	Sensitive

Figure 1: China Advisory Council (2010). The information is based on a survey with China Advisory Council members on *Growth potential of regions and sectors in China*.

Chances to successfully start up a business where many Europeans have settled before are greatly increased. Possible tier 1 cities are Beijing, Shanghai, Guangzhou and the surrounding regions. Infrastructure plays a fundamental role. Coastal areas thus have a decisive advantage over other areas. This does not apply to Chongqing, however, because of a wealth of resources, a good industrial base and an important access to world markets through the Yangtze River. Another argument in favour of Chongqing is a local government that is committed to offering a transparent and efficient platform to European investors.

A rapid increase of labour costs in the coastal areas is an additional argument in favour of western cities, such as Chongqing and Chengdu. However, SMEs entering the Chinese market in these areas will face more challenges in terms of language, know-how, and business culture.

Knowledge of the central governments priorities may prove very profitable as the five-year plans and peoples' congress reports might involve 'go west' initiatives and the local governments' future development plans may foster a specialisation and concentration on certain economic sectors.

¹ A tier 1 city or region is one of the major metropolitan areas in a country. Tier 1 cities or regions are particularly attractive to investors and the categorisation is based on a broad basket of factors such as infrastructure, human resources, and the industrial base etc.

PROMISING REGIONS IN THE SOUTHEAST OF CHINA

No	City (Province)	City characteristics	Opportunities (sectors)
1	Hangzhou (Zhejiang)	<ul style="list-style-type: none"> • good infrastructure and facilities • low labour costs and availability • low energy costs • good manufacturing infrastructure • good infrastructure • easy access to seaport • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • banking • environment • renewable • energy • construction • electronics and IT
2	Suzhou (Jiangsu)	<ul style="list-style-type: none"> • good infrastructure and facilities • good manufacturing infrastructure • good infrastructure - easy access to seaport • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • Banking (consumer products/ loans, legal services, outsourcing solutions) • environment • tourists • urban regeneration construction • electronics and IT
3	Shanghai	<ul style="list-style-type: none"> • very good infrastructure (roads, metro, railways, airports, seaports). The largest seaport in China. Two airports with the biggest potential in China. • skilled labour availability. Large pool of university educated workers. • concentration of high technology development zones, • concentration of multinational companies 	<ul style="list-style-type: none"> • automotive industry • electronics and IT • shipping industry • metallurgy • construction • biomedicine (pharmaceutical R&D, biotech manufacturing high-tech medical devices) • environment protection
4	Ningbo (Zhejiang)	<ul style="list-style-type: none"> • good infrastructure. Easy access to seaport (one of the largest seaports in China) • educated workers • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • medicine (R&D, high tech medical devices), component manufacture, • tooling and machine • financial services
5	Wuxi (Jiangsu)	<ul style="list-style-type: none"> • good logistic network, • labour availability, • preferential government policies. 	<ul style="list-style-type: none"> • engineering • financial services
6	Foshan (Guangdong)	<ul style="list-style-type: none"> • environment protection 	<ul style="list-style-type: none"> • manufacturing bases
7	Zhuhai (Guangdong)	<ul style="list-style-type: none"> • environment protection 	<ul style="list-style-type: none"> • manufacturing bases

Figure 2: Marek Plecinski (2010). *Promising regions in the southeast of China.*

OTHER PROMISING REGIONS IN CHINA

Region	City (Province)	Opportunities (sectors)
Northeast	Dalian (Liaoning)	<ul style="list-style-type: none"> • information, communication and technology • engineering • concentration of foreign and domestic businesses in financial sector
Bohai gulf	Tianjin (Tianjin)	<ul style="list-style-type: none"> • energy (wind turbine generators) • shipping industry • environment protection
	Qingdao (Shandong)	<ul style="list-style-type: none"> • financial and professional services (important seaport offer good opportunities in maritime finance) • engineering (machinery, automobile manufacture components) • shipbuilding.
	Weifang (Shandong)	<ul style="list-style-type: none"> • agriculture machinery (tractors)
Central	Hefei (Anhui)	<ul style="list-style-type: none"> • automotive sector • passenger cars, buses • automotives spare parts
	Zhengzhou (Henan)	<ul style="list-style-type: none"> • cluster of the automobile components • energy (mining industries)
	Wuhan (Hubei)	<ul style="list-style-type: none"> • environmental technologies • iron and heavy steel manufacturing, • optics-electronics
Southwest	Chengdu (Sichuan)	<ul style="list-style-type: none"> • outsourcing activity, • energy (has rich oil and gas resources)

Figure 3: Marek Plecinski (2010). *Other promising regions in China.*

Concerning boom sectors, the highest potential for European business is in luxury brands, high-tech industry, and the environmental sector. It is very difficult for European market entrants to compete against entrenched Chinese competitors with lower cost structures and established brand names. Notwithstanding, luxury brands with a global brand identity as well as the automobile sector with full supply chains continue to have good prospects

High-tech investments are more promising but are particularly prone to intellectual property disputes and have to be taken much more seriously because of the tendency in

China to receive transfer of technology with the aim of being completely independent in the medium term. Other high-tech sectors that are of particular interest include the chemical industry and machinery and safety devices for the mining industry and the energy sector. From a SMEs point of view, the automobile and aircraft industries are interesting due to large market potential paired with ample opportunities to supply to a number of European multinationals active in China.

Clean technology and energy sector is booming due to consistent environmental challenges. China successfully invested in so-called 'hard' infrastructure of better mobility of goods, services, people, and capital, primarily to attract foreign investors. Today China heavily invests in so called 'soft' infrastructure seeking to ameliorate living standards, working conditions and basic services such as medical care, social security, schools, hospitals, and training centres.

This hybrid of a centrally planned economy with very limited market economy features is still dictated by and will evolve according to the Chinese central government's development plans. China disposes of special economic development zones and the central government introduces new labour, tax, and company laws. It is therefore of utmost importance to pay close attention to the central government's agenda and future targets in order to predict greater market and investment potential.

3. Concerning Chinese investment in Europe, the final recommendation is that the European Commission continues to pursue a single European investment policy to connect the different initiatives, ideas and policies from the separate Directorates General and secondly, to de facto create a role for itself to build consensus between the 27 member state capitals and Brussels and capitalise on best practices from existing bilateral investment treaties with China in order to produce one single coherent EU investment policy.

The EU investment policy *vis-à-vis* China should include as a central element those areas where there is little reciprocity between EU investment in China and vice versa.

Finally, the question of reciprocity should be placed in the context of global economic fora, such as the WTO or the G20, with an emphasis on the EU agreeing internally on a clearly defined and positive inward direct investment plan before consulting with other major players on the global level.

INTRODUCTION

This Policy Brief is written from the perspective of European small and medium-sized enterprises considering operation in, or already operating in China. However, it also takes into account the wider context of EU-China relations, as they may influence Chinese company policy. This brief starts off from this wider horizon, beginning with the observation that senior management is advised to invest time and resources in learning about the country's complex transformation. The brief indicates the reasons why doing business in China should be carefully thought through, and spells out necessary conditions for success, before ending with some remarks regarding the Commission's role in helping to foster a favourable climate for EU businesses operating in China.

The brief has been written by Jonathan Story, Emeritus Professor of International Political Economy at INSEAD, on the basis of replies to questionnaires sent to all China Advisory Council members as well as on the book 'China UnCovered: What you need to know to do business in China' (FT/Pearson's, 2010).

The Policy Brief was first produced as a background paper for the China Advisory Council meeting on Thursday, 27 May 2010. The brief was then further developed on the basis of the debate during the China Advisory Council as well as China Advisory Council experts' replies to a survey on promising growth regions and sectors in China.

ABOUT THE AUTHOR

Jonathan Story holds the Marusi Chair of Global Business at The Lally School of Management & Technology, Rensselaer Polytechnic Institute (USA) and is Emeritus Professor of International Political Economy at INSEAD. Prior to joining INSEAD in 1974, he worked in Brussels and Washington, where he obtained his PhD from the Johns Hopkins School of Advanced International Studies. He is author of '*China Uncovered – What you need to know to do business in China*' and is an acknowledged China expert who contributes to the *Wall Street Journal*, the *Financial Times*, and *Le Monde*.

EXECUTIVE SUMMARY

- China is simultaneously a pressing challenge and a major opportunity for the European Commission. The EU's image in China is dispersed. The European Commission needs to confederate the different European advisory, corporate and member state presences in the world's largest emerging economy. The EU model to date has been characterised by 27 national China policies. The united EU foreign direct investment imprint on China is massive while China's investment imprint on the EU is only nascent. Therefore, the solution is to leverage the EU's combined economic clout as China's prime trade partner and inward investor, in order to increase the European Commission's effectiveness with regard to relations with China. EU China policy must include effective and long term policies regarding the promotion of European single market standards as well as a truly common European external policy.
- China's emergence is now part of the EU political landscape. In European SME policy, which this Policy Brief specifically addresses, China is not an easy negotiating partner. China is a massive, self-regarding entity that tends to look at the EU as a loose combination of not always like-minded member states. Beyond the European Commission's role of reminding member states that their negotiating position is strengthened when the EU manages to "speak with one voice", the European Commission should seize the opportunity to use China as an opportunity to foster an 'EU-reflex' among member states. The European Commission's slogan should be: 'Use China to promote the EU as a coherent actor'.
- The EU should develop a European chambers of commerce presence across China. These can be national chambers that should have a European and a national hat and would serve as hubs to liaise with all EU investment promotion agencies, other national chambers, trade associations, and SME trade centres. Thereby, the EU can create a China-based EU network that is profiting from national expertise and helps to pool and make available information and advice of direct relevance to SMEs. As one China Advisory Council member put it: "the EU should pool all the information from EU member states and provide an overall European information platform for all SMEs."
- EU SMEs need the best practical guidance they can get to operate in China. This includes advice on China's economic and political transformation, reliable marketing studies, legal advice and access to people and organisations with know-how on value-chains, human resources, Intellectual Property Rights (IPR) or finance in China and its many different regions and sectors.

Shanghai is the best known example of the coastal city clusters that symbolise both China's economic emergence and its attraction



CHINA ADVISORY COUNCIL
SURVEY ON REGIONS AND SECTORS IN CHINA

MOST PROMISING REGIONS IN CHINA

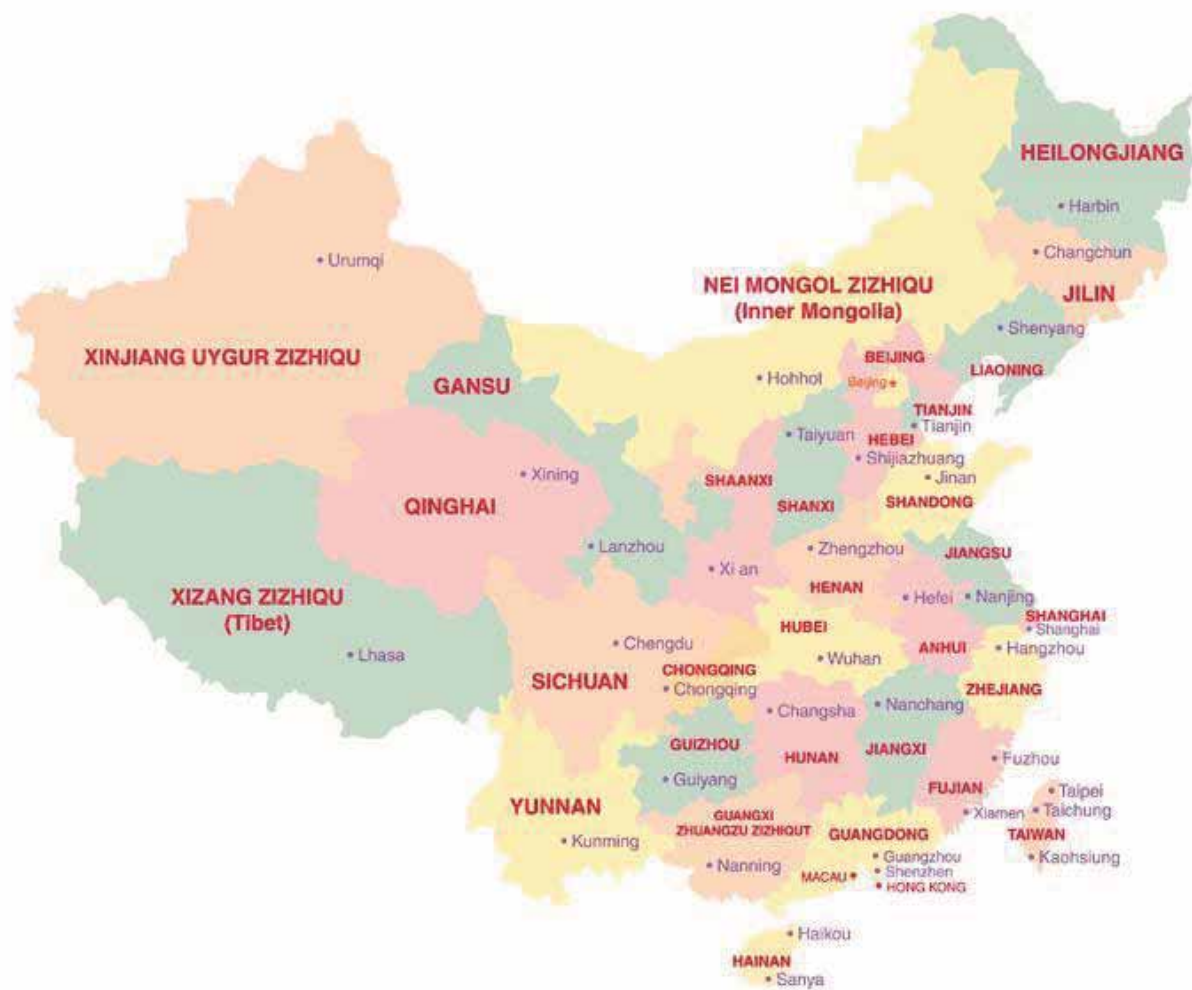


Figure 6: Map of China (2010). *Provinces and Cities.*

Following a survey among the experts of the China Advisory Council, there is a general consensus that it is difficult to generalise about the potential growth and attractiveness of regions in China. **Patrick Horgan**, Counsellor for Education of the British Embassy in Beijing and Director of Programmmes at the British Council China, suggested that “ any guidance of value needs to be focused on the specifics of the individual business, the sector and the model being proposed.”

It is important to understand that China is a highly competitive market environment. Therefore, a systematic evaluation of market and growth potential for SMEs and other business in the various regions is strongly encouraged. However, China Advisory Council members were able to identify some regions that are more promising than others.

SMEs and other business are advised to settle in the most developed regions in the east, especially if they are dependent on factors such as:

- language skills;
- proximity to Chinese consumers as well as world markets;
- dependence on support and know-how of national and European chambers;
- familiar business culture.

Indeed, **Joachim Bitterlich**, Executive Vice President for International Affairs at Veolia Environnement, points out that chances to successfully start up a business where many Europeans have settled before are greatly increased. Possible tier 1 cities are Beijing, Shanghai, Guangzhou and the surrounding regions.

Davide Cucino, Chief of China Operations at Finmeccanica Group, pointed out that infrastructure and transport plays a fundamental role. Coastal area tier 1 cities such as Beijing, Shanghai, and Guangzhou thus have a decisive advantage over other tier 1 cities. Chongqing, however, does not have this disadvantage because of a wealth of resources, a good industrial base and, most importantly, an access to world markets through the Yangtze River. Another argument in favour of Chongqing is a local government that is committed to offering a transparent and efficient platform to European investors.

Richard Mohr, Managing Director of EastInfo China, agrees that the regions around Chongqing, but also Chengdu, are a particularly interesting market environment for Eastern European SMEs that primarily focus on investment in rural areas and rapidly developing cities. Hungary supports this focus and has established a Consulate General in Chongqing in 2010.

A rapid increase of labour costs in the coastal areas is an additional argument in favour of the western cities of Chongqing and Chengdu and the agenda of the central government might also influence the decision to settle inland. Proper market analysis and knowledge of the central governments priorities may prove very profitable. Five-year plans and peoples' congress reports might involve 'go west' initiatives and the local governments' future development plans may foster a specialisation and concentration on certain economic activities.

However, SMEs entering the Chinese market in these areas will face more challenges in terms of language, know-how, and business culture. The following table suggests a simplified analysis to determine a SMEs choice to settle in tier 1 regions on the coast or inland depending on their sensitivities to specific factors for business success. **Christina Söderström-Nilsson**, Managing Director of the Enterprise Europe Network at the Stiftelsen Europa Institutet, suggests Nantong Region outside of Shanghai as a balanced solution bearing in mind these sensitivities.

	Tier 1 cities in coastal areas	Tier 1 and tier 2 cities inland
<ul style="list-style-type: none"> ▪ Language skills ▪ Business culture ▪ Know how ▪ Stable GDP per capita growth ▪ Proximity to consumers and world markets 	Sensitive	Non-sensitive
<ul style="list-style-type: none"> ▪ Labour costs ▪ Proximity to suppliers ▪ Proximity to resources ▪ Profitable government initiatives and policies 	Non-sensitive	Sensitive

Figure 7: China Advisory Council (2010). The information is based on a survey with China Advisory Council members on *Growth potential of regions and sectors in China*.

This analysis also suggests that good transport infrastructure, such as port facilities and water roads, fundamentally changes the equation and transforms the city of Chongqing, connected to consumers and the world market via the Yangtze River, into the 'number 1 choice' among the China Advisory Council members.

The British Council has undertaken an analysis to prioritise new urban growth markets in China. The selection focuses on the four tier 1 cities Beijing, Shanghai, Guangzhou and Chongqing. These four cities are the same four tier 1 investment destinations that were prioritised by other China Advisory Council members. European SMEs and other business that are sensitive to language skills, business culture, know how as well as proximity to consumers and world markets and stable GDP growth, should opt to invest in these tier 1 cities and the regions surrounding them.

However, tier 2 cities and the regions surrounding them increasingly offer investment opportunities as well. **Marek Plecinski**, Director of the Chinese Market at POL MOT Holding, has identified a number of tier 1 and tier 2 cities that are particularly interesting for European investors.

PROMISING REGIONS IN THE SOUTHEAST OF CHINA

No	City (Province)	City characteristics	Opportunities (sectors)
1	Hangzhou (Zhejiang)	<ul style="list-style-type: none"> • good infrastructure and facilities • low labour costs and availability • low energy costs • good manufacturing infrastructure • good infrastructure • easy access to seaport • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • banking • environment • renewable • energy • construction • electronics and IT
2	Suzhou (Jiangsu)	<ul style="list-style-type: none"> • good infrastructure and facilities • good manufacturing infrastructure • good infrastructure - easy access to seaport • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • Banking (consumer products/ loans, legal services, outsourcing solutions) • environment • tourists • urban regeneration construction • electronics and IT
3	Shanghai	<ul style="list-style-type: none"> • very good infrastructure (roads, metro, railways, airports, seaports). The largest seaport in China. Two airports with the biggest potential in China. • skilled labour availability. Large pool of university educated workers. • concentration of high technology development zones, • concentration of multinational companies 	<ul style="list-style-type: none"> • automotive industry • electronics and IT • shipping industry • metallurgy • construction • biomedicine (pharmaceutical R&D, biotech manufacturing high-tech medical devices) • environment protection
4	Ningbo (Zhejiang)	<ul style="list-style-type: none"> • good infrastructure. Easy access to seaport (one of the largest seaports in China) • educated workers • concentration of multinational manufacturers 	<ul style="list-style-type: none"> • medicine (R&D, high tech medical devices), component manufacture, • tooling and machine • financial services
5	Wuxi (Jiangsu)	<ul style="list-style-type: none"> • good logistic network, • labour availability, • preferential government policies. 	<ul style="list-style-type: none"> • engineering • financial services
6	Foshan (Guangdong)	<ul style="list-style-type: none"> • environment protection 	<ul style="list-style-type: none"> • manufacturing bases
7	Zhuhai (Guangdong)	<ul style="list-style-type: none"> • environment protection 	<ul style="list-style-type: none"> • manufacturing bases

Figure 8: Marek Plecinski (2010). *Promising regions in the southeast of China.*

OTHER PROMISING REGIONS IN CHINA

Region	City (Province)	Opportunities (sectors)
Northeast	Dalian (Liaoning)	<ul style="list-style-type: none"> information, communication and technology engineering concentration of foreign and domestic businesses in financial sector
Bohai gulf	Tianjin (Tianjin)	<ul style="list-style-type: none"> energy (wind turbine generators) shipping industry environment protection
	Qingdao (Shandong)	<ul style="list-style-type: none"> financial and professional services (important seaport offer good opportunities in maritime finance) engineering (machinery, automobile manufacture components) shipbuilding.
	Weifang (Shandong)	<ul style="list-style-type: none"> agriculture machinery (tractors)
Central	Hefei (Anhui)	<ul style="list-style-type: none"> automotive sector passenger cars, buses automotives spare parts
	Zhengzhou (Henan)	<ul style="list-style-type: none"> cluster of the automobile components energy (mining industries)
	Wuhan (Hubei)	<ul style="list-style-type: none"> environmental technologies iron and heavy steel manufacturing, optics-electronics
Southwest	Chengdu (Sichuan)	<ul style="list-style-type: none"> outsourcing activity, energy (has rich oil and gas resources)

Figure 9: Marek Plecinski (2010). *Other promising regions in China.*

MOST PROMISING SECTORS IN CHINA

According to the experts of the China Advisory Council, predictions as to which sector can realise the greatest growth in China is even more difficult to identify than promising regions. Nevertheless, the aggregated answers of the China Advisory Council members provide indications on the potential of luxury brands, high-tech industry, and the environmental sector.

The competitive and regulatory environment in China has to be taken into consideration argues Patrick Horgan. It is very difficult for European market entrants to compete against

entrenched Chinese competitors with lower cost structures and established brand names. Notwithstanding, luxury brands with a global brand identity as well as the automobile sector with full supply chains continue to have good prospects.

Davide Cucino emphasises that high-tech investments are more promising but have to be taken much more seriously because of the tendency in China to receive transfer of technology with the aim of being completely independent in the medium term. Thus, high-tech investments are particularly prone to intellectual property disputes and have to be prepared in detail, ideally before entering the market.

Other high-tech sectors that are of particular interest include the chemical industry and machinery and safety devices for the mining industry and the energy sector. From a SMEs point of view, the automobile and aircraft industries are interesting due to large market potential paired with ample opportunities to supply to a number of European multinationals active in China.

Christina Söderström-Nilsson emphasises that the clean technology and the energy sector is booming due to consistent environmental problems, especially in regions with environmental challenges such as Anhui.

Herman Vandaele, President of Bekaert Regional Headquarters Asia at Bekaert Management, agrees and explains that China successfully invested in so-called 'hard' infrastructure of better mobility of goods, services, people, and capital, primarily to attract foreign investors. The China of today, however, heavily invests in so called 'soft' infrastructure seeking to ameliorate living standards, working conditions and basic services such as medical care, social security, schools, hospitals, and training centres.

This hybrid of a centrally planned economy with very limited market economy features is still dictated by and will evolve according to the Chinese central government's development plans. China disposes of special economic development zones, Research and Development centres, and the central government lately introduced new labour, tax, and company laws. It is therefore of utmost importance to pay close attention to the central government's agenda regarding future targets in order to predict greater market and investment potential.

WHY MANAGERS HAVE TO LEARN ABOUT CHINA'S TRANSFORMATION

For small and medium-sized enterprises (SMEs) thinking of going to China, or developing their operations there, a necessary but not sufficient condition for success is for senior management to learn about the country's transformation and what that means for business. In a nutshell, China is different, and in a number of crucial ways that impinge directly on corporate policies.

First, China is building a "socialist market economy", deeply interdependent with the rest of the world. China is also undergoing a transition from a rural to an urban society, and actively participating in global governance. Developments in China occur at break-neck speed, raising an anxious debate as to whether China is "becoming 'more like us' in Europe and the U.S., or whether China is on its own path to develop a unique business system of its own."²

What can certainly be said is that China's business system, at the time of its policy of opening up in 1978 compared to the present is as good as unrecognisable: then, nearly all production was in the hands of state-enterprises, whereas in the past decade private business accounts for 70% of China's GDP, and 75% of its workforce.³ Moreover, China is run by the Chinese Communist Party (CCP) and, as one senior manager observed, 'the Communist Party is still communist.'

Combined, these factors make for complex and contradictory political and market conditions in which to conduct business. Despite stunning economic growth, China remains a low income country, with per capita income by purchasing power parity (PPP) of less than 20% of that in the U.S. or 23% of that in Japan. On the domestic side, the party-state has launched a massive infrastructure development programme, which makes pan-national market access easier as it is rolled out, but undoubtedly accelerates the pace of social change in rural and urban areas. Given the minimum provision of public welfare, the bedrock of social policy is in effect economic growth, with all the ills such a policy entails.⁴

As a trading state, China has recently surpassed Germany, but approximately two-thirds of its exports are in fact goods manufactured or reprocessed from imported parts and components, and subsequently sold under the names of foreign companies. The party-state leadership wants price stability, but also increasing exports in order to sustain high growth rates as a means to absorb the growing labour force and avoid unemployment in rural and urban China. A managed exchange rate feeds through, however, to inflationary pressures, while ensuring Chinese hyper-competitiveness on world markets. This in turn makes China a number one target for trade retaliation, while piling up vast foreign exchange reserves. This invites accusations that the country operates as a mercantilist wrecker of the global trade regime.

China's party-state is omnipresent, complex and opaque. There are five different levels of administration, with often overlapping responsibilities and a lack of coordination. There is frequent competition and party-state initiatives affecting enterprises can be introduced without prior warning.

The party-state is a major customer for many companies, and the prime investor in infrastructure. In fact, along with exports, it is one of the two main driving forces behind the

2 G. Redding (2002). The capitalist business system of China and its rationale. *Asia Pacific Journal of Management*, 19, 221-249. 2002.

3 Financial Times (2006). *Private sector: thriving but faced with uncertainties*. December 12, 2006.

4 For a summary, see R. C. G. Varley (2005). *The World Bank and China's Environment 1993-2003*. The World Bank's Evaluation Department. The World Bank, Washington D.C. 2005. Also, M. S. Ho, C. P. Nielsen, eds (2007). *Clearing the Air: The Health and Economic Damages of Air Pollution in China*. MIT Press, 2007. And especially, E. Economy (2005). *The River Runs Black: The Environmental Challenge to China*. Council on Foreign Relations Book. Cornell University Press, 2005

country's near double digit growth record, and has at its disposal a battery of policy tools to regulate or control business.

The party-state owns all the land of China, issues and revokes leases, controls where people live, regulates raw material exploration and pricing, influences the economic conditions that prevail in each location through targets for economic growth and productivity, sets and revokes taxes, runs the whole financial system as a policy tool, and draws up its own, sometimes skewed statistics.

The party-state also decrees free trade zones, manages non-tariff barriers or decides - for instance in the venture capital field - to open markets. It runs the official trade union, has a monopoly on the political system, makes appointments to corporate boards, appoints the judges, and is determined to maintain control over the media and the internet.

Unsurprisingly, this can lead to intense conflicts of interest, for instance in the financial system, as the party-state owns both corporate assets and controls the markets in which they are traded.

A number of implications for business flow from these observations. The business context changes fast and there are unusual risks facing businesses not found in such combinations elsewhere. The political, legal and business systems are idiosyncratic, and the future looks sunny from afar but cloudier up close. Senior management teams have to be clear about what factors are under their control, and what factors are beyond, while remaining aware that it is sometimes difficult to tell them apart. It follows that if you think of going to China, you have to do your homework, and there is plenty to do. Hence, the key question is 'why go to China in the first place?'

The China Advisory Council A Case Study on olive oil and trademarks

During the China Advisory Council meeting, Adam Dunnett, General Manager of the European Union Chamber of Commerce in China (EUCCC) argued that there are many stories of investors who go to China without adequate preparation. A Greek olive oil company, for instance, was approached by a Chinese vendor who offered to market the oil in China. Olive oil sales were going well, and eventually the Greek firm made an exclusive deal with the vendor. However, the Greek firm failed to register its trademark, and the Chinese partner did it himself. Thereupon, he began selling inferior products under the Greek trademark. The Greek firm had the choice between suing the partner or buying back their own trademark. Given little chances of a successful lawsuit, the firm eventually bought back its own trademark. The lesson to be learned is simple but of utmost importance. If you don't register your trademark in China, you don't own it.

WHY GO TO CHINA? FACTORS COMPANIES SHOULD TAKE INTO ACCOUNT

In a nutshell, companies should only go to China if they have already developed what looks like being a feasible business proposition, and for no other reason. At the time of writing, many well informed observers consider that tensions between the Chinese authorities and the foreign business community have never been so high. Out of a long list of concerns, the following stand out: Chinese government certification schemes, particularly the China Compulsory Certification (CCC) mark (see below), the indigenous innovation catalogue, which prompts discriminatory policies; general market distortion policies, such as the 'Buy China' policy; and the high capital requirements to set up shop.

Such difficulties facing foreign businesses are not a temporary phenomenon. China is not an easy place to do business. Take, for instance, the World Bank's six governance indicators

- voice and accountability,
- political stability and absence of violence,
- government effectiveness,
- regulatory quality,
- rule of law
- control of corruption.

These indicators are based on what business experts and analysts in western and emerging markets consider important for good business conditions in the World Bank members countries around the world. It is no surprise to find that the 2008 results indicate that China is far behind the OECD countries on all six indicators (see figure 10).

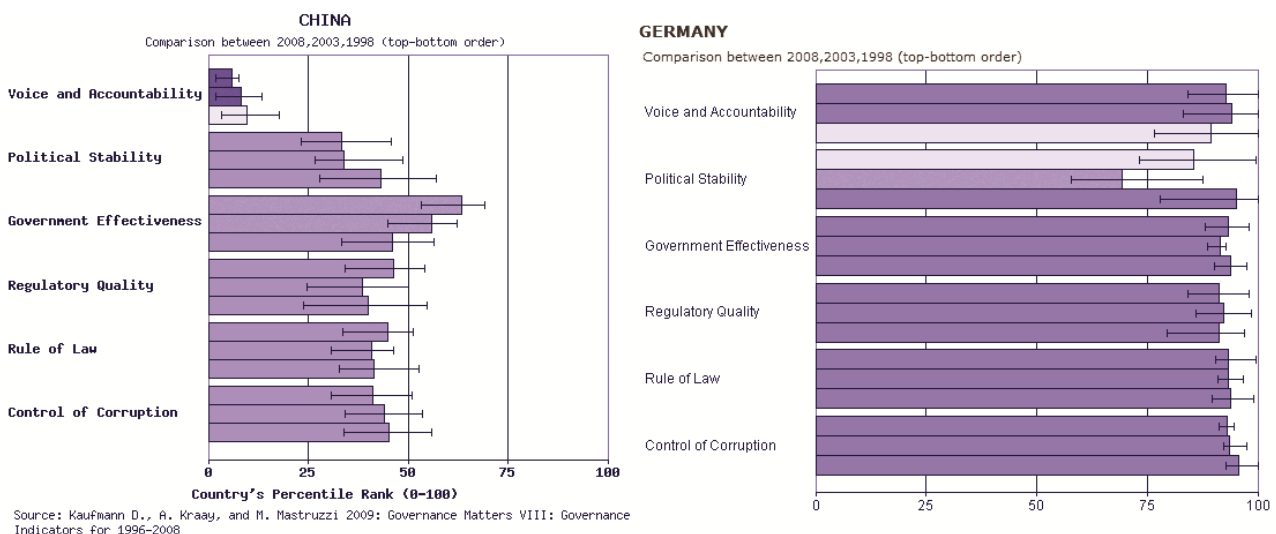


Figure 10: D. Kaufmann, A. Kraay, and M. Mastruzzi (2009). *Governance Matters VIII: Governance Indicators for 1996-2008*.

For voice and accountability, China scores among the lowest at 5.8%, compared to rankings of 90% for countries such as Australia and the UK, confirming the obvious – that the party-state likes to make decisions behind closed doors. The government is effective (63.5%), but far less so than in Australia (97.2%). The indicator for political stability (33.3%) shows a downward trend. On regulatory quality (46.0%), rule of law (45.0%), and control of corruption (30.9%), China does better than Nigeria, but has a long way to go to catch up to other OECD countries.

The prime reason for European businesses going to China is that China is an essential place to be, the fastest growing market around, and with great potential for future decades. That is why a lot of energy and information sharing has to be devoted to this market. In just over 30 years, China has gone from number 32 on the world exporters league to number one, and more than 400 million people have been lifted out of poverty. The party-state's current 'Go West' strategy to develop the *hinterland* of the northern and western provinces only accentuates this trend. Even so, China's per capita income in PPP in 2009 was 14% that of the U.S., 20% that of Japan and 24% that of Taiwan. In other words, China is still a low-income country, with low productivity per head and therefore is in a good position to achieve a rapid catch-up.

Double-digit growth and market transformation have made it no longer just the place for cheap labour and raw materials, but also home to a rapidly growing consumer product market. Going to China also enables companies to profit from China's new role as a regional manufacturing hub for the production of consumer goods in the wider Asia Pacific region, with China being the central link between Asian trade partners and industrial countries' markets.⁵

In agriculture, China's low tariff rates, modest farm subsidies, and widening quotas allow growing markets for farm product exports from the Americas, the EU and Australia, as well as from rice suppliers, like Thailand and Vietnam.

China's rapid growth has provided major export opportunities to raw material suppliers, such as South Africa and Brazil, and the oil exporting countries. Most of the hard bargaining between China and its trade partners in the World Trade Organisation (WTO) accession negotiations concerned telecommunications, financial services and the delivery of professional services, where rich country corporations have a comparative advantage, as well as widening market shares in China – despite the problems they face in the form of party-state determination to keep control over financial flows, media and communications.

China, however, should not be considered by investors as simply a cheap labour country. Skills, particularly managerial skills, are scarce, and public policies ensure that while China's comparative advantage is in abundant labour, labour shortages are widespread, especially in the coastal regions. Admittedly, unit labour costs can be up to 30 times lower than those in Europe or the U.S., but total operational costs are more telling.

5 M. Yoshitomi (2003). *Post-crisis development paradigms in Asia*. Asian Development Bank, Manila, Chapter 3.

These include:

- the time spent searching for an appropriate location,
- learning to deal with the party-state,
- hiring, training and retaining the right people,
- the need to regularly audit suppliers to ensure that system, process, quality and regulatory requirements are met,
- and the possible damage to the brand if poor quality products are shipped.

Indeed, many companies report that the peculiarities of the Chinese market require specific metrics. For new market entrants, given the learning costs involved, breaking even can only be achieved in the long-run. China is not the place for a 'quick buck' artist. The key question for corporate management to ask is: not "will China make us money" but "will we last in China long enough to make money?"

If a major commitment is made to the market, then a decision must be made on whether the metric is long-run profits, growth in sales, or increased market share. As Steve Gilman, B&Q's Chief Executive Officer for Asia stated, "our margins are now approaching half of what the European margins are. We've practically doubled them from the early days. Our plan has always been to improve net margins by about 1% a year and we've always been there or thereabouts."⁶

In short, you go to China because you have a clear idea of what you wish to achieve; because China has great potential, and because you will eventually need to learn about operating there. These are not necessarily readily compatible. Companies need to know what it takes to be successful in China.

⁶ S. Gilman (2006). Shaping China's home-improvement market: An Interview with B&Q's CEO for Asia. *McKinsey Quarterly*, June 2006.

CONDITIONS FOR SUCCESS OF SMES AND LARGER BUSINESSES IN THE CHINESE MARKET

BECOMING A LEARNING ORGANISATION

The first requirement for a firm to succeed in the Chinese market is to realise that it requires a big investment of time and effort by the firm's personnel. Getting the strategy 'right' is step one. If the decision is to go, what matters is execution.

Companies thinking of going to China have to become real learning organisations, recognising – as Edith Penrose taught ⁷ – that each firm is unique in the combination of resources it develops to serve the market. Firm-specific knowledge is built up over time through the firm's collective learning process, as projects are completed and new horizons and opportunities open up in light of the knowledge acquired.

When a firm goes to China, Russia, Brazil, or anywhere 'abroad', what changes is the existence of international borders, and the need for more learning. In this context, learning includes different cultures, languages, institutions and customs that affect firm-specific markets. Acquiring this knowledge again takes time and involves a process of trial-and-error, of learning by listening to other firms and managers and of diffusing that knowledge through the firm.

This is all the more relevant for firms entering a country like China, which is undergoing its own massive learning process while exiting from the inherited party-state system towards what the regime has described as a 'socialist market economy'.

CHOOSING THE RIGHT LOCATION

China is far from homogenous, so choosing the right location is high on the list of priorities. Local administrations scout for inward investment, offering favourable leases, tax breaks, waivers on recognising the official trade union and privileged access to finance and support on patent protection. However, these offers must not, business people advise, run contrary to what the company is seeking to achieve.

The politics of the Chinese Communist Party has created a heterogeneous set of distinct markets. Rules handed down from Beijing are implemented differently across the length and breadth of the country. What sells in a first-tier city such as Beijing or Shanghai may not sell in a second- or third-tier city such as Wenzhou or Dalian. Infrastructure and human capital varies considerably across the country. Thus, finding the best location takes time, due diligence, and careful planning.

7 E. Penrose (1995). *The Theory of the Growth of the Firm*. Oxford University Press, Revised paperback version, 1995.

GOVERNMENT RELATIONS

Business people are unanimous in stressing the importance of government relations at all levels. Given the importance of personal relationships, the many tiers of party-state structures, and the intricate nature of centre-local relationships, firms must devote resources on a permanent basis to cultivate officials from Beijing's ministries right down to municipality and township levels.

Getting to know the right officials can be a challenge in itself. A multi-national company making a large investment might find the red carpet rolled out with alacrity, but SMEs making a relatively small investment might struggle to make contact with the people they need to meet.⁸

The China Advisory Council's advice on managing corporate-party state relations

SMEs should not under-estimate the importance of corporate party-state relations, and should not over-estimate promises that have been made. SMEs must ensure that they cultivate a network of relationships up and down the party-state apparatus, but need to remember that there are limits to what a political apparatus can achieve in a competitive market place. Given the likelihood of long-term involvement, SMEs should remain polite but firm about the results they wish to achieve. In particular, they should be prepared to turn down business offers which do not live up to corporate standards, and the values which the management back home may expect.

8 S. Kennedy (2005). *The Business of Lobbying in China*. Harvard University Press, 2005.

A SUITABLE BUSINESS STRUCTURE

If you choose to enter the market, you have to choose which business structure is best. China's growth has gone hand in hand with a rapid evolution in policy, so that a variety of routes to enter the Chinese market have evolved over time. SMEs may now opt

- to open a representative office in Hong Kong,
- to license their technology,
- to enter a joint venture with a local partner,
- for a wholly foreign owned enterprise (WFOE),
- to create a holding company.

These modes became available at least a decade before China's entry to the WTO, not least because neither investors nor the Chinese authorities were satisfied with the record of failures among joint ventures. With 7 out of 10 joint ventures ending in failure, it was clear that the conditions for a successful joint venture were very demanding. As soon as the party-state introduced the wholly owned enterprise formula, WFOEs became the most popular vehicle. Meanwhile, the party-state has drawn up a regularly updated list of restricted sectors, where the joint venture format is obligatory.

On the plus side, a Chinese partner may bring local knowledge, the all-important *guanxi*, market access, resources, and perhaps unique competences. They will expect the European partner to bring managerial skills, financial assets, technical capabilities, and a willingness to share expertise. On the negative side, these expectations can be asking for more than European companies are prepared to give away.

In particular, European companies are advised to negotiate majority ownership, at least in the early stages of the venture; control over appointments of directors and general managers; control over the corporate seal or "chop" as whoever controls it can make binding contracts on the firm's behalf; in particular, detailed attention has to be paid to the tax implications and to the financial conditions of the venture. Ultimately, what matters in a joint venture is the creation of trust between the partners;

The China Advisory Council's advice on joint ventures

When searching for a joint-venture partner, SMEs should do their homework and investigate the partner's background, get information about the partner's credit standing, get outside expertise to draw up a risk assessment review, and take Chinese law seriously. SMEs should take an imaginative leap and enter the Chinese mindset, to understand where Chinese partners are coming from. In short, SMEs should 'be Chinese'.

Taking into account the non-financial dimensions of the accord, such as technology transfer, training and - not to be forgotten - visits to Europe are very important. In the letter of intent, and later in the contract, SMEs should be clear about both sides' objectives, be substantive – particularly on know-how and technology transfer – go for 51% ownership to ensure ultimate control, emphasise the decision-making process, as well as the split of responsibilities, including the review and termination procedures.

A number of precautionary notes are of particular importance: SMEs should not accept local government pressures to put family members on the staff of joint-ventures, and it is a clear sign that a joint-venture is on probation, when substantive contributions start to fade. For Chinese partners, a contract may be considered as the first step in an on-going negotiation.

GETTING HUMAN RESOURCES RIGHT

The key to success in China is hiring the right people. As one senior manager expressed it, 'if you cannot make the people issues work, forget it.' Culture, language, style and communication permeate everything, including recruiting, retaining, motivating and managing issues that are unique to China. There is much to say on this subject, but the main point to remember is that every investor has to manage the gap between two (or more) cultures. This will entail investment in training for skills as well as for cross-cultural relations, for Chinese employees, for senior management staying in the home country as well as for senior management staff going to China. This might be costly, but will help those in the headquarters to understand the challenges that their expatriate staff may be facing and also facilitate effective communication with Chinese staff.

Opening up the prospects for local, white collar employees to reach board level in the longer term is a *sine qua non* to retaining them. Chinese people work hard for the benefit of their ancestors and for their progeny, and their progeny's progeny. The first step for them along this path to the top involves bringing senior Chinese staff to other sites around the world as part of their career development programme.

The China Advisory Council's advice on people

To start learning about China, SMEs need to get a door-opener, i.e. local expertise that can offer corporate advisory services with personnel, is fluent in Mandarin and has a deep knowledge about doing business in China. They will have to rely on key local personnel for finance, legal affairs, human resources or sales. Beyond pay, a necessary precondition for retaining employees is the provision of training, career opportunities, personal recognition, and retention packages. The overall approach should be to make employment in your firm as attractive as possible, in other words to raise the barriers to exit.

FIRST THINGS FIRST

A further requirement for success is to remember that when setting up operations, not everything can be done simultaneously. The first thing to focus on is quality, which is the foundation of the premiums which a foreign investor will tend to be charging in China and that is a prerequisite for retaining the loyalty of your customers in the rest of the world. Getting quality right involves not just the products, but also taking vigorous steps to implement the UN Global Compact, and to be constantly aware of the problem of 'quality fade' among suppliers.

Danfoss and the UN Global Compact: Good Corporate Citizenship⁹

Good corporate citizenship requires that efforts are made in a wide range of areas. At Danfoss, the work is divided into seven areas. Danfoss' overriding goal within Corporate Citizenship is to "keep our own house in order".

- **Labour Rights**, which deals with conditions of Danfoss employees and a decent work environment.
- **Society relations**, which deals with the way Danfoss handle responsible procurement.
- **Human Rights**, which represents a wide spectrum of initiatives to ensure a health and good environment for all human beings.
- **Anti-corruption**, which means that Danfoss does not tolerate or support any forms of corruption or bribery.
- **Environment**, which means that Danfoss focuses on the production having the best possible impact on the environment;
- **Climate**, in which Danfoss, via the development of environmentally friendly technologies, supports the work to improve the global climate.

After quality come costs and engineering issues, followed by delivery. A Swiss China survey, published in 2006, stated that "suppliers rarely deliver properly on first order."¹⁰ Delivery problems included varying purity of chemicals and not just lower, but sometimes higher purity than required, which was assumed by the supplier to be 'better'. Many problems also relate to incorrect labelling, incomplete or wrong packaging, incorrect packing lists, substitution of one material for another, and a drop in quality in order to meet delivery deadlines.

As if this was not a sufficiently awe-inspiring list, there is also the problem of intellectual property protection, which, as Professor Daniel C K Chow stated in his written testimony to the U.S. Senate in 2006, "despite the intense international attention focused on the counterfeiting problem in China for the past decade, counterfeiting in China appears to be getting worse, not better."¹¹

⁹ Danfoss (2010). Corporate Citizenship. Retrieved on 26 May 2010 from: <http://www.danfoss.com/AboutUs/Corporate+Citizenship/>.

¹⁰ Swiss Chinese Chamber of Commerce (2005). *Behind the Kaleidoscope: A Guide to China Entry*. china.com, 2005. p.448.

Given the very varied record of the party-state in implementing its own intellectual property laws, precautionary measures have to be taken in house, rather than outsourced to the public regulatory system prevailing in China. Such measures include a decision about how much research and development stays at home. To accentuate intellectual property strategies to stay ahead of the local competition is no easy task given the skill shown by Chinese companies in re-engineering, and in the rapid learning curve they have gone through in developing their own corporate counterfeit strategies.

Depending on the choice of location, it may be possible to have local government support in policing patents, trademarks and copyright. This may involve taking the official route through the court system, using the official hand to catch and jail the miscreants. Of course, if the miscreants are public officials, or in the extended business family of public officials, the chances of success are low to non-existent.

On the other hand, it should not be forgotten that foreign business people should seek to avoid developing paranoia about their Chinese counterparts and employees. Quite the contrary, Chinese employees appreciate working in well managed European companies, with top rate human relations policies in place. For all the problems relating to sub-contracting, many Chinese companies such as the auto-components manufacturer Wanxiang have developed in-house knowledge and savoir-faire on the back of their relationships with western corporations.

Not least, it should be remembered, as Gordon Redding and Michael Witt point out in their book on China's business system¹², that Chinese culture, in its multiple blends, is low trust, with people limiting trust to their families or clans. Redding and Witt argue that China's low trust culture is a prime explanation for the prevalence of family-based networks; for authority relationships within the firm; and for the preference among Chinese business people in dealing with private owners, by comparison to corporate managers. A similar argument may be developed to explain the behaviour of large state enterprises, which remain key components of the extended communist party-state family. 33 of 37 Chinese companies in the latest Fortune 500 belong within the ambit of the party-state.

A firm entering, expanding and consolidating its operations in China and ultimately integrating them into its world-wide operations, will have to adapt its policy and strategy as conditions change and corporate *savoir-faire* about the Chinese market grows.

The same set of questions can be asked at each stage in the process.

- **What** are the key resources to draw upon if deciding to enter the Chinese market? On entry, SMEs will be leveraging their home market expertise and as they settle in they will be adapting products to local customer requirements. Down the line, SMEs will be using the China subsidiary to produce for global customers.

11 U.S.-China Economic and Security Review Commission (2006). *Hearing on Intellectual Property Rights Issues and Counterfeit Goods*. Testimony of D. C. K. Chow, 8 June 2006.

12 G. Redding and M. Witt (2010). *The future of Chinese capitalism*. Oxford University Press, 2010.

- **How** should the SME enter the Chinese market, and what instrument should it chose – plain sales into the market, a joint venture, or a greenfield site? First, SMEs must build up local organisation and subsequently, they need to integrate the subsidiary into global operations.
- **Where** should SMEs start their operations in this huge country, and what are the criteria they should use to choose entry method and then location for the prospective operations? Once the SMEs have decided, they will face the challenge of growing China-wide. During the whole process, and especially as SMEs start facing the global market, they will need to consider time-to-market, quality, and corporate responsiveness to changing conditions.
- **Human relations:** How can SMEs select, train and retain their personnel? As explained below, nothing will work if SMEs don't get human resources right. Making the Chinese subsidiary part of global operations means abolishing all glass ceilings on promotions. This is key to a successful retention strategy.
- **Production:** How can SMEs ensure quality, timely delivery, cost control and protection of know-how? As SMEs settle in, they will be strengthening their value, involving transferral of knowledge, sticking to company standards, and learning about local skills.
- **Sales:** What do SMEs know about the Chinese market, and what should they be selling to whom? The management will have to learn about Chinese customers, the pitfalls of developing their brand, and fitting themselves into global networks.
- **Organisation:** How can SMEs establish their brands, and what is the importance of China operations relative to other business units, the product managers or regional and global headquarters?
- **Manager's profile:** What is the profile of the ideal manager SMEs need to endow with running the China operations from entry through to consolidation, bearing in mind that as the operations in China develop, the typical profile will evolve?

Europe's existing representations can act as a door opener for European companies by representing both national and EU interests to develop the 'brand of Europe' in China



THE CORPORATE LIFECYCLE IN CHINA: FROM MARKET ENTRY TO CONSOLIDATION

Questions for management	Entry	Market development	Global integration
What	Leverage home market	Develop & market local products	Produce within global web
How	Wide range of instruments	Build up local organisation	Integration into global operations
Where	China in many localities	Need to get China-wide	Time to market, quality, responsiveness
HR	Language, retention	Develop pride, 'soft' knowledge	No glass ceilings
Production	Quality, delivery, costs, know-how	Strengthen value chain	Tied into global value chains
Sales	Dual strategy advisable	Get close to client, build brand	Serve global & local markets
Organisation	Establish brand, provide services to business units	Co-ordinate business unit & HQ relations	Integrate China/Regional/Global ops
Ideal manager	Experienced, needs direct CEO support	Senior, good HQ contacts, talk to corporate barons	Senior, manage multi-dimensionality

Figure 11: Jonathan Story (2010). *The corporate lifecycle in China: From market entry to consolidation*.

One final point may be made. Given the idiosyncrasy, present size and future potential of the Chinese market, the 'imperial' model, with global headquarters setting standards and procedures, can seriously hamper China operations, where the key to success can often be speed of response. Such a formal structure, where headquarters assumes the world is one market (as it ultimately is) and operates according to one logic (which it does not), may be 'a powerful but blunt weapon for effecting strategic change'.¹³

However, processes that work perfectly well elsewhere will have to be adapted, because what may be best practice in Germany or the U.S. might not work so well in China.

13 C. A. Bartlett and S. Ghoshal (1989). *Managing across borders: The transnational solution*. Harvard Business School Press, Boston 1989.

Products, branding and design will all need to be developed 'on the ground' rather than in an HQ building on the other side of the world. Logo, name and pricing cannot be decided in a meeting room thousands of miles away, possibly by people who have never even been to China.

If the China operation is to be fully integrated, then how it reports upwards will be an important reflection of how China fits into the organisation as a whole. Some companies view China as part of the Asia-Pacific region and the Chief Executive Officer for China reports to Asia-Pacific rather than directly to global headquarters.

Other companies take the view that China is virtually a region in itself, with all its different markets and massive geography, so the management team in China reports directly to the central organisation. For instance, the head of Samsung in China is one of the three top decision-makers for the entire company. The position of China in the organisation does not go unnoticed by your Chinese hosts, and the stronger the connection to HQ the more the company will be respected in China.

To summarise, the lessons for companies operating in China are that they must develop their corporate learning capabilities; they must choose the 'right' locations, and the 'right' people; they must manage the complex tangle of operational issues; they must be, indeed, they will be aware of intense competition; getting government policy 'right' is crucial, and the counterpart to that is adopting in-house precautionary measures. Those measures start and end with the loyalty of your workforce.

Ultimately, the calculation on the cost side is not the rock-bottom wages you find now in the rural parts of China, but the total operating costs involved in learning how to manage the complex process of doing business in China. Your profits horizon recedes into the future, while the future presses on the present in the form of highly competitive markets, often competitive in ways that infringe on the Chinese government's commitments to implement the terms of its WTO accession. It is time to ask the question: in the light of the points mentioned above, what may be the Commission's role in helping to foster a favourable climate for EU businesses operating in China?

THE EUROPEAN COMMISSION'S ROLE IN HELPING TO FOSTER A FAVOURABLE CLIMATE FOR EU BUSINESS OPERATING IN CHINA

The Commission has an impressive list of policy successes in relation to China, beginning with the China European International Business School (CEIBS), located in Pudong, Shanghai. CEIBS is a joint venture, with ownership split between the Shanghai city government and the European Commission. It has rapidly emerged since its creation in 1992 and ranks in the top 30 business schools in the world, providing MBAs, EMBA's and executive training courses for both Chinese and international clientele.

More recently, the Commission has been charged with the task of helping to develop an EU instrument, or package of policies, designed to facilitate EU-based SMEs operating in China. Its main counterpart in this task is the European Union Chamber of Commerce in China (EUCCC), the EU Chambers of Commerce and Eurochambres. The driving idea behind this initiative is that EU-based businesses of all sizes will be globalising their operations - an idea which has won widespread support in the European Parliament, but which requires some fleshing out in detail if it is to be effective.

One of the key problems which has to be addressed in implementing such a programme is the standard EU problem of dealing with national attitudes: SMEs are primarily national in origin, as are the variety of promotional agencies involved in EU-China business. As one of the Advisory Council members stated, "the closer we get to fine tuning, the more we approach the question of how 'Europeanisation' is for their benefit". The timetable suggests that proposals for an action plan will be tabled by spring of next year.

In drawing up an EU SME policy, it is worth recalling the institutional context within which EU policy is elaborated. As was pointed out, to get an action plan up and running, the European Commission has to ensure the backing of national governments, business representatives, and other interested parties to EU-China relations. This is particularly the case in dealing with the multiple interfaces between EU institutions, with member states as stakeholders in the EU policy process and business with very particular requirements and interests.

The European Union should develop a successful European SME policy *vis-à-vis* China, building on the European Union Chamber of Commerce in China, national chambers of commerce in China, the SME IPR Helpdesk of the European Commission as well as the Understanding China programme.

Beyond this direct focus on business, a European Commission policy on EU SMEs in China has to consider a broader set of issues, which may impact EU firms operating in China in indirect ways. We can consider these by dividing them into the two central dimensions of EU-China relations: attempts by EU institutions to influence the Chinese one party-state; and EU policies on the internal market, that impinge on EU-China relations.

EU ATTEMPTS TO INFLUENCE CHINA

The Commission faces demands from many stakeholder in the EU to register support for or dissatisfaction with a broad scope of Chinese policies. As far as these impinge on SMEs, the rule of thumb for Commission policy suggested in this Policy Brief is to deploy its scarce political capital in attempting to influence¹⁴ the China party-state carefully. The primary aim should be to be effective. Being effective is easier said than done. One precaution is not to choose to engage the Commission's political capital, where there is little to be gained, such as making the China-EU trade imbalance a priority.

As China Advisory Council members observe, EU companies are heavily invested in China and much of EU-imports from China come from EU companies active there. The trade imbalance merely reflects a Chinese comparative advantage. On the other hand, the EU institutions may bring to the attention of the Chinese authorities their concern about the disadvantages involved in the managed exchange rate, and most notably its domestic inflationary impact. Talking to the party-state in terms of its own logic of keeping control over China, while pointing out the contradictory implications of its policies, has more chance of being listened to by such a self-centred actor, than making complaints about policies where little can be effectively done.

That does not mean that the EU institutions have to kow-tow¹⁵ to effectively influence China. Quite the contrary, though this remark is outside the immediate focus of this Policy Brief, it should be constantly remembered within EU institutions that the Chinese leadership is concerned with achieving status in world affairs, and is quite prepared to do so at the EU's expense.

The cancellation of the EU-China summit of December 2008 is an indicator of this and was followed by the Chinese leadership's eager acceptance of the US-China summit a few days later. Whatever the present problems facing the EU, its representatives have to be constantly reminded that the EU is a massive entity within the world system—much more prominent than is China.¹⁶ In this regard, China Advisory Council members broadly agreed that the EU should not meet the Chinese authorities' request to recognise China as a market economy. Recognition should only be granted once a long list of EU demands are met, such as equal treatment in the public procurement process; adequate IPR protection; and freedom of press, speech and internet.

14 For the problems relating to attempts to influence the interstate system, see D. Baldwin (1985). *Economic Statecraft*. Princeton University Press, 1985.

15 Kow tow (2010). In *Merriam-Webster Online Dictionary*. Kow-tow is a Chinese word that describes an act of deep respect shown by kneeling and bowing so low as to have one's head touching the ground. Retrieved 1 July 2010, from <http://www.merriam-webster.com/dictionary/kowtow>.

16 Jonathan Story (2010). *Europe's soft power versus China's brute force in the global marketplace*. *Europe's World*, Summer 2010, pp.32-35.

The Commission must also be aware in drawing up an EU SME policy towards China that the complexity of EU-China relations regarding EU firms operating there creates a problem of focus. Take for instance, a list of measures which hinder corporate access to the market:

- capital requirements for establishment,
- ownership caps,
- obligatory joint ventures,
- unpredictable Mergers & Acquisition policies,
- theft of intellectual property,
- licensing requirements.

Which should the Commission focus on most? China Advisory Council members consider that, marginally, IPR theft is the most damaging to enterprises. They considered the second most damaging hindrance to market access to be capital requirements for establishment. As was pointed out, however, these different barriers to market access have different policy communities (structural linkages between corporate, public and private actors involved in the same or overlapping 'issue areas').

In China, the issues will vary geographically in impact. For instance, Tianjin authorities have a good record of policing intellectual property theft. The various hindrances thus raise the matter of centre-locality relationships, as indicated above. They have a different impact on companies, depending on size, sector, technology, and other criteria. Capital requirements may be a barrier to a small firm, but not so to a large one. SMEs may not be affected by ownership caps, whereas IPR theft may be more damaging to large multinationals. Clearly, the Commission faces an on-going conundrum of where it can most effectively deploy its scarce political capital on behalf of EU companies.

Then, there is considerable difficulty for any external player attempting to exert influence on the hydra-headed party-state, and its extended family of corporate interests. The starting point is to observe that when the party-state wants to get something done, it can be very effective. The corollary supposedly being that ineffective implementation of intellectual property commitments is purposeful, and thus, requiring retaliation. The risk is that retaliation may have unintended consequences. An alternative corollary is that a lack of implementation is a fundamental problem to the party-state, which in effect is one vast insider trading network. There are, for instance, official institutions to implement international commitments regarding intellectual property theft.¹⁷ Still, even if Chinese officials have good intentions, they are not the only ones influencing intellectual property policy. Judges may be retired People's Liberation Army officers, not trained in the law. The

17 These include the Intellectual Property Office for patents, Customs, the State Administration of Industry and Commerce (SAIC) for trademarks, and the National Copyright Administration for copyrights, plus the specialist IP panels set up to advise the Intermediate People's Courts.

New Property Law, providing the legal basis for ownership and intellectual property questions, remains intentionally vague, because of initial opposition within the party. Therefore, damages awarded in court may not be worth the trouble of pushing charges. Not least, enforcing intellectual property law is impossible in areas where the local economy is driven by the production of counterfeit goods and vested interests hold sway.

What can be done to protect EU corporate intellectual property? The Commission may state clearly that EU companies have to move much of intellectual property protection in house. It may use the complaints mechanism or it may delegate a good part of intellectual property policy to the European chambers of commerce in Beijing, and encourage national chambers of commerce to co-operate. The Commission may also support organisations that help train administrators, lawyers, and Chinese business people in the significance of respecting intellectual property rights. This includes Chinese companies, which are the major losers in intellectual property theft.

The difficulty of the European Commission exerting effective influence over party-state policies is mirrored by the limited scope of policies to sanction party-state measures, even when other trading powers are adversely affected, and available as partners in protest. The Marxist-Leninist-Maoist party-state is only too aware that the 'contradictions' between the advanced industrialized country governments and corporations are there to be played upon. Consider, for instance, the China Compulsory Certification (CCC) mark, introduced in its new form in early 2003. It applies to 19 product groups divided into 132 product categories. These products can be held at the border, and are subject to other penalties, such as inspection by Chinese laboratories.

In April 2009, Beijing announced that 13 newly defined categories of "IT security products" would be subject to CCC treatment the following day. The U.S., Japan, Korea and the EU immediately demanded that the measures be retracted; fearing that Chinese customs authorities would leak the products source codes to Chinese competitors. This measure was part of an on-going struggle between western technology companies and the Chinese government over a wide range of policy areas relating to market access.

Typically, Beijing makes 'concessions' which allow it to claim the moral high ground, but fail to convince foreign companies, which look to their own governments or chambers of commerce for representation. Thus, in March 2010, Beijing rolled back a plan aimed at giving Chinese companies an advantage in government technology purchases. The companies were not impressed, but the office of the United States Trade Representative took a muted stand. At the same time, the Chinese authorities posted a statement regarding the CCC-mark on the official website to the effect that foreign enterprises "must conform and obey Chinese rules and regulations." Both the office of the United States Trade Representative and the European Commission are reduced to requesting that China follows global norms.

The China Advisory Council's advice on the CCC-mark

Strict reciprocity should be applied, making China Compulsory Certification (CCC) a priority in negotiations. The EU's longer-term future is as a centre of high value-added industries, and must not allow officialised theft to go unopposed. Measures include: taking steps to ensure source codes are not made available; use the resources of the European chambers of commerce in Beijing; disseminate information to SMEs confronting the CCC-mark; turn down Chinese official demands to on-site factory inspection in the EU; and use the European standards process with regard to Chinese companies. Another proposal is to introduce a policy of mutual recognition, whereby companies which have already obtained similar standardization certification in their home-country are spared from the CCC mark.

EU-CHINA POLICY AND THE INTERNAL MARKET

China's reforms since 1978 are predicated on the notion of developing market mechanisms to serve the purpose of the party-state, to fulfil the century-old ambition of China's modernisers to convert China into a modern nation-state. By contrast, the objective of the EU is to create a new international politics beyond the nation state, predicated on the notion of a shared sovereignty between the 27 member states and the peoples of the EU.

What both share in common is the idea of becoming: the Chinese leadership's ambition is to have China join the restricted society of great powers, not just in the formal sense of being a permanent member of the U.N. Security Council, but with the full scope of great power capabilities, including that of global reach. The EU's ambition is also to become a great power, but a great power which promotes the practice of co-operative governance on the world stage, that it aspires to promote within its boundaries.

In practice, the EU, if we accept the judgement on the Lisbon Treaty by the German Constitutional Court, has not gone beyond the stage of building its foundations on an international treaty between sovereign states, whose sovereignty is underpinned by their membership in the international society of states. In practice, too, Chinese ambitions for great power status remain an aspiration, given the multitude of domestic tasks which the party-state faces at home.

Meanwhile, in preparation for the time when China becomes de facto a great power, its diplomacy is behaving much as if it already were. There is a meeting of EU and Chinese minds in terms of supporting the development of suitable processes for global governance, but there is much less about the immediate implications of China's and the EU's longer term ambitions.

China is a major target for inward investment, and also the world's prime trading power, the way it organises its domestic economy impinges directly on EU markets through the competition generated by a global market for products, labour, management and technology. China has thus become an integral part of the EU political landscape. In particular, Chinese diplomacy continues to look at the EU as an international organisation, incorporating a loose collection of individual states, with distinct interests, negotiating positions and very varied positions with regard to global affairs.

EU member states remain the prime focus of their citizens' loyalties, and because the natural tendency of all EU member states is to practice the art of diplomatic polygamy—married through treaty commitment to the EU, but determined through the web of national external linkages, to retain national representations around the world.

Therefore, the prime tool of the Commission is a modest reminder to member states that as stakeholders in the EU, their negotiating position is strengthened when the EU manages to "speak with one voice". And even when they do, as was attempted at the December 2009 Copenhagen summit on climate change, non-EU states such as China, the United States, Russia, Brazil and South Africa, are as often as not prepared to accept the EU position, in case of having a binding commitment to achieve certain objectives with regard to climate change.

Most non-European states defend the notion of national or state sovereignty in international law against the pretensions of imperial powers. Europe's domestic attempts to overcome the drawbacks of sovereignty are not taken over-seriously by external powers, and EU attempts to export this internal process to EU foreign policy initiatives is regarded with frank suspicion.

This debate about China-EU relations in the broader context of global affairs holds much wider implications than can be dealt with in this Policy Brief, but it bears directly on EU SMEs policy towards China. In China, the EU is in aggregate represented by EU representations, the European Union Chamber of Commerce in China, EUROCHAMBRES, national embassies and consulates, national chambers of commerce, a massive presence of European-based multi-nationals, a host of European SMEs, and corporate service shops, many of which are manned by Mandarin-speaking experts providing a range of corporate services. There are also a host of arrangements between European and Chinese universities, growing exchanges in tourism, arts and a host of other areas.

By contrast, China's footprint in the EU is much more modest. There are Chinese representations from the centre and from the provinces with the EU and the member states, but compared to the EU aggregate presence in China, the Chinese foreign direct investment footprint in Europe is still at a very early stage. The bulk of Chinese overseas investment is in Asia-Pacific, Latin America, Africa and the Gulf. The motives for outward investment are: priority to the search for access to minerals and raw materials; the benefits to investors of tax -havens; and the development of service facilities.

Overseas manufacturing operations are still modest. The EU receives only 8% of the total outward stock to date, originating from 480 companies. The top destinations in “old” western Europe are: Germany, the UK and the Netherlands. Poland and Czech Republic are the main recipients in “new” central Europe. Service operations tend to be allocated to “old” Europe, but not exclusively so. Belgium, for instance, hosts Chinese auto components companies whereas manufacturing tends to go to “new” Europe. In short, western Europe is targeted mainly for distribution, and central Europe for production.

Why is the EU not a larger target for Chinese inward investment? One reason is no doubt the lengthy and well-known liturgy of inefficiencies in EU markets. In this regard, it is notable that Chinese investors are clearly sensitive to cost differentials, not surprisingly if one bears in mind that most of the investment into the EU comes from one province, Zhejiang, where private, family-owned businesses thrive. One way of attracting Chinese foreign investment is to look at Chinese practice around the world: following their own success in the 1980s of building up free-trade zones within China, China has exported the experience to building up their own foreign investment network abroad.

Out of the 15 industrial zones the Chinese have created, 7 are in Africa—a token of the significance they attach to the continent. On a much smaller scale, a Chinese company established a business centre in Antwerp, that has been joined by a further four Chinese firms. The difference with the pattern of Chinese investment in Africa to that in Europe is that for the moment, Chinese investment in Africa is largely-but far from exclusively-in the hands of party-state affiliated mineral corporations.

Indeed, it was Zhejiang-based Geely that signed a deal in late 2009 to buy the Volvo auto-manufacturing brand from Ford Motor Company, reflecting a trend noted by observers of China’s outward investors that what Chinese firms lack is global brand names. Looking ahead, though, it may be expected that Chinese corporations will become more active in the EU, and that many of these corporations are likely to be tied through ownership and other ties into the party-state family.

Party-state enterprises are heavily represented in downstream industries, such as coal, steel, aluminium and chemicals, all sectors whose growth elasticity measure roughly 1:1 with Chinese GNP. Because Chinese heavy industry conglomerates are likely to experience high but diminishing growth rates over the coming decades, and because they are flush with cash from the massive share out of their labour force in the years 1998-2003, they may be expected to scout for lower growth European heavy industry groups, whose shares are held by a dispersed public and “underperforming” relative to shares in higher growth industries. But whereas the Anglo-Dutch-Indian Mittal was able to acquire the EU steel champion, Arcelor, without much public resistance, this may not be the case if, and when Chinese corporations from within the party-state family move to becoming active on the EU’s market for corporations.

The reaction in Germany and France to the prospect of the official Sovereign Wealth Fund the Chinese Investment Corporation (CIC) acquiring shares in their large corporations may be an indicator for future developments. The prospect of China, Russia or Arab countries acquiring significant holdings in sensitive industries—industries which member states continue to consider as national champions—could pose a threat to the EU's delicate internal market mechanisms.

For the moment, though, inward Chinese investment to the EU is small in aggregate, tends to be private and family based, and has a long way to catch-up to even begin to equal the EU-corporate footprint in China. This Policy Brief suggests that this longer term perspective should be incorporated into the design of policy towards China overall, and towards EU SMEs and China in particular.

The longer term interest of the EU, it may be argued, is to draw China ever deeper into the inter-dependent global polity and economy, and to do so in a manner which maximises EU advantages. That is why good external relations begin at home, deepening the internal market, possibly developing an "economic governance" as a counterpart to the European Central Bank, and cultivating where possible an "EU reflex". All three initiatives, if effectively implemented, would have a direct bearing on EU SME policy and China.

- One major asset at the EU's disposal in relations with China is the internal market, and in particular the spread of European norms and standards. Chinese manufacturers setting up in, or selling to Europe, have to meet them; the more they are promoted in Europe, the more they may be deployed in China in competition with U.S., Japanese, or Chinese standards, the idea being to encourage Chinese manufacturers in China to adapt European standards for their own commercial advantage. Such a development could only intensify Europe's attraction as one, if not already, the pillar of the global economy.
- The way out of the impasse in the present design of EU financial market and bank institutions is to develop what the French have long called "economic governance", i.e. a fiscal counterpart to the European Central Bank. The present divide between more rapid growth in productivities in northern continental Europe relative to southern Europe can only be overcome by a deal, involving northern Europe accepting expansive policies for demand, and the southern European member states, accepting more flexible labour markets, bank purges and fiscal rectitude. Marrying growth to stability is vital for a flourishing SME sector.
- Specifically in the EU SME policy area, it may be interesting to expand on Europe's experience with the ERASMUS programme (and the Bologna process on Higher Education), and apply this to the world of entrepreneurs. Already, there is much in place in terms of training, China-EU exchanges among business schools and universities. These could be supplemented by a Erasmus Mundus programme, open to EU- and China-based entrepreneurs, and designed for their specific purposes of getting to know more about each others business contexts, practices and systems.

The external and China end of the EU's internal market policy is for the Commission, the member states, their industries and relevant chambers and associations to consort efforts in building an "EU-reflex" with regard to China. In broad outline, the appropriate division of labour would have the Commission focus on public policy issues, with the Chambers specialising—as they already do—on business-related matters. Both public policy and business-related issues have spill over effects that require a pragmatic approach to be embedded in the EU China SME policy. Both would be part of a broad policy approach - which can only succeed with strong political backing among member states, corporations, chambers and associations - to aggregate and diffuse the pre-existing and extensive European knowledge-base about business conditions in China.

Overall, the most promising line of action is to develop the European Union Chamber of Commerce in China as well as European chambers of commerce as hubs for EU-related China information. This initiative could help foster the development of an 'EU-reflex' among member states, which would be the best antidote to efforts by China and other non-EU countries, to play on EU divisions.

Thus, in addition to legal, fiscal and location advice, European chambers of commerce would liaise with all EU investment promotion agencies, national chambers, trade associations, and SME trade centres. Such a network would undoubtedly help to pool and make available information and advice of direct relevance to SMEs. Examples include access to reliable marketing studies, legal advice or access to people and organisations, knowledgeable about value-chains, human resources, Intellectual Property Rights (IPR) or finance in China and its provinces, cities and townships. As one China Advisory Council member put it: "the EU should pool all the information from member countries and provide an overall European information platform for all SMEs."

If we accept that the world has long been living in a knowledge economy, then it follows that the processes whereby the EU overcomes its own internal segmentations along national or functional boundaries by networking, should be extended to its external relations, and in this case to aggregating and diffusing the extensive sum of knowledge already available about business conditions in China. What this requires to be translated into realities in China is highly efficient, i.e. low cost, and effective mechanisms to be created for the sharing of information. Such a policy holds a number of dimensions:

- One idea is to create European Houses across the provinces where EU business representation is low or absent. In order to avoid expensive investment in bricks and mortar at a time when budgets are dry, national chambers, associations, or private service providers – which meet the high standards required to be able to effectively provide effective business services – could be awarded an "EU-hat". Because national chambers are often restricted by their mandate only to serve nationals, and because the Euro-chambers have budget constraints, that means that many "Euro-hats" would be awarded to private service providers. Private service providers in China have often originated on national lines, and continue to serve their home country nationals. But

they are also in business, look for clients regardless of nationality, and are only inhibited in taking business to the extent that they do not have specific services in-house. A well-structured programme would facilitate them by being able to pass on clients to those with specific knowledge – a practice they have long been pursuing, in any case.

- Another idea is for the EU-chambers to extend and deepen their relations with the national chambers, associations etc of those 4 to 5 member states with extensive representation in China. This could be facilitated by mandates of overseas representations being changed back home to allow them to provide services to other EU-based companies. This is particularly needed for those member states from central- and south-eastern Europe, which do not have developed representative capabilities. As the skills and capabilities of national chambers will vary considerably, often as not in relation to their own knowledge-base about the national business systems, it is all the more important that “Euro-hat” private business providers be made accessible through shared information platforms to entrepreneurs who need their services.
- A final example of developing an EU presence is to draw on the examples of similar programmes which have been operating in Japan or in Korea. The EU Gateway to Japan and Korea has helped EU business to develop a foothold in two difficult markets at times when the EU suffered serious trade deficits with those countries. It organises missions, which enable entrepreneurs to get a sense of the market challenges and opportunities. A “Gateway to China” could provide a useful vehicle for European SMEs facing increasing challenges to market access. On the plus side of such initiatives is that they are focused on specific categories of issues, and they have earned a reputation; on the other hand, the type of services they provide are also provided by private service providers. Therefore, any duplication and overlap between EU and private services should be avoided.

CONCLUSION

To summarise, doing business in China requires plenty of due diligence by firms, and poses interesting challenges for the EU institutions. EU SME policy should be conceived as one important component of a broader framework; that framework for policy should be conceived as a long term initiative. Good external policy begins at home, the groundwork for a sound China policy begins with promotion of the internal market, promotion of EU standards, getting the EU back to long term growth and stability, and organising top level political support to promote an EU-reflex for external relations, in this case using the example of China as a key testing ground.

Such top level support involves taking effective steps to making it easier for national chambers to wear EU hats. In China, the EU chambers should be strengthened as hubs for information across the length and breadth of China. Strengthening implies further development of existing institutional capabilities, the promotion of an EU-reflex among national chambers and associations there, and use of private service providers. EU representation should be a question that those on the ground should be allowed to respond to. Knowledge is dispersed in the market, and may only be imperfectly aggregated in bureaucracy.

The task of the European Commission is to join up the dots of EU bureaucracies and to align them on achieving the desired result through cultivation of an EU-reflex. That means using the European experience of a highly interdependent group of states bound to co-operate because of proximity and a shared, if divisive history, but eager to practice polygamy on the world stage. It means using national attitudes more cleverly, and more effectively, than any non-EU player can. In short, despite the prevalent gloom in Brussels about where the EU is heading, the upbeat message is that the China challenge provides the EU with a major opportunity to improve the inter-EU flow of information, exchanges, and resources. The EU may not know it, but it is the prime pillar of the world political economy. Using the weight of China to its own advantage may bring it a whole step further.

UNDERSTANDING CHINA

The Understanding China programme is co-funded by the European Commission and implemented by EUROCHAMBRES, *Friends of Europe* and other partners.

A 3-year programme, it is planned to continue until mid-2012, and consists of the following initiatives:

1. One high-level Policy Summit per year
2. An annual training cycle
3. Eight SME Roundtables across Europe
4. An interactive website community
5. The China Advisory Council

The Understanding China programme features an annual high-level Policy Summit that is policy-oriented and focuses on economic and political cooperation between Europe and China. The Policy Summits provide a platform to communicate on political and economic challenges for both trading blocs.

The Understanding China training programme focuses on training thirty executives from business organisations each year, in order to better support their local enterprises in Chinese markets. By training the trainers, the Understanding China programme disseminates and multiplies knowledge on China across Europe. The second training cycle began on Monday, 14 June 2010.

Several SME workshops, organised with European SMEs, discuss what works and what does not in the context of Chinese markets, and provide feedback on what the EU can do to improve EU-China business relations.

Finally the Understanding China website focuses on the needs of SMEs' for practical information on the ground. The website serves as an intelligence hub for practical, business-related information on China. It is developing into a one-stop shop for SMEs and provides an online portal for exchange.

China Advisory Council

The China Advisory Council is composed of 17 China experts with academic and practical experience. It is a forum for relevant stakeholders to discuss current developments on EU-China economic relations.

The primary role of the China Advisory Council is to contribute to the policy process on the European level. China Advisory Council members use their considerable experience in EU-China relations to provide the European Commission and European member states with policy recommendations and advice on the economic and political needs of business, especially SMEs, in China. The China Advisory Council reports these recommendations to the European Commission.

The China Advisory Council can also act as a forum for discussion and as a sounding board for European Commission policies *vis-à-vis* China.

China Advisory Council members provide input and initiate discussions on the interactive website.

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