East looking west

ASIAN COMPANIES MAY BUY INTO WESTERN COMPANIES TO BUILD BRAND NAMES AND DISTRIBUTION NETWORKS FOR THEIR PRODUCTS. THIS COULD SIGNAL A MAJOR COMPETITIVE THREAT, SAYS **GILES KEATING.**

Over the last few years, China and increasingly India have exerted a major deflationary influence on the world economy, dragging down the prices of many goods through ultra-low cost production. This effect has been somewhat less marked in recent months as China's own inflation has risen, spurred on partly by severe capacity constraints in areas such as power generation and transportation. But it is likely to recover significantly in 2005 as major investments in areas such as bulk chemicals and steel come on stream. China is expected to turn from being a major importer to becoming a dominant exporter in some of these sectors. The resulting global supply glut will probably exert double-digit downward pressure on prices.

While this price reduction process is of crucial importance for the global economy, it tends to distract attention from a parallel process that could have an even bigger impact on businesses worldwide over the next few years. This is the progressive move up-market made by Chinese and, ultimately, also by Indian firms. Instead of competing merely on price, they will develop their own brands and distribution networks, backed up by huge advances in technology.

In the 1950s, companies in the US and Europe used Japan to manufacture their goods at a low cost to feed into their own distribution chains. In the 1960s, Japanese companies turned the tables, building up their own brands and distribution systems. They innovated products and production processes at such a pace that, by the mid 1970s, they were dominating American and European companies in sectors from automotive to consumer electronics.

When comparing 1960s Japan with China today, there are similarities and differences. An important similarity is that in both cases, young companies have benefited from rapid growth in a domestic consumer market that embraces new products and where obvious language issues make penetration by foreign firms difficult.

Chinese companies are exploiting this advantage strongly, rapidly developing a range of home-grown brands, in areas such as designer clothing, which are aimed at the top end of the market. Against this, there are crucial differences. In the 1960s, US companies opened up their technological know-how to Japanese companies relatively freely, partly because they simply did not recognise them as potential competitors, and partly because the Cold War background made it desirable to foster Japanese economic strength.

Nowadays, with the pain of that experience etched into the corporate memory of western firms, many Chinese companies have found their foreign counterparts to be very cautious when it comes to transferring their technology. In addition, the costs of establishing new brands in western markets are arguably much higher now in real terms, compared to the 1960s, given the very large accumulated expenditure on brand-building and distribution channels by incumbents.

Ultimately, these costs are likely to act more as a brake than an absolute barrier to the establishment of Chinese brands in the wider world, given the sheer scale of the domestic market that they can build on. But the effect could be to extend the process over many years, perhaps a decade or more. To speed things up Chinese and, eventually, Indian firms, may take a different and much more aggressive path, which is to acquire established western brands and distribution networks through outright takeovers, or by becoming the dominant partner in joint ventures with weaker partners. These would then provide a platform for the penetration of the western markets on a greatly accelerated timetable.

The announcement in September of the joint venture between ailing UK car company MG and a major Chinese automotive firm could be just such a deal. MG was once a powerful brand and it could be revived at much lower cost, and much more swiftly, than introducing a new brand name. The deal also allows for the sharing of technology and distribution networks.

One of the cornerstones of the world financial system over the last several years has been the financing of the US current account deficit by Asian nations. This has included China on a very large scale and, to a more modest extent, India. It was achieved essentially through official intervention, with the Asian central banks buying US securities, mainly treasury bonds. As the Chinese authorities progressively liberalise their capital flows regime – partly in anticipation of a possible move to a more flexible exchange rate regime sometime in 2005 – it is becoming easier for Chinese companies to acquire foreign assets. From their perspective, rather than using their capital surpluses to buy government bonds at very low yields, it is clearly much more supportive of long-term economic growth to buy foreign firms that provide brand recognition and access to western markets. It is likely that over the next two to three years these kinds of deals will become widespread.

This process could be derailed by a number of factors, notably the risk of overheating in the Chinese economy. This year has seen the authorities follow a roller-coaster policy to tackle this, imposing draconian credit controls which, by May, had almost brought the earlier boom to an abrupt halt. Fixed investment, for example, which had been growing at around 50% year-on-year in the early months of the year, slowed to well below 20%, and output growth also declined sharply. It became clear to Beijing that the policy was too harsh and there is good evidence that the controls were eased, leading to a re-acceleration of both investment and output during the third quarter. However, this was accompanied by a rapid pick-up in inflation, and it is clear that renewed tightening is now necessary. Hopefully it will be designed to make a more measured impact.

Executive summary

- China and India, for so long the domain for western companies looking to manufacture their goods at a low cost, are set to offer new competition to western companies.
- The recent move up-market by Asian firms means they will be able to develop their own brands and distribution networks.
- The cost of developing brands in the west is high. Instead, Asian firms are likely to buy into western markets or enter joint ventures with them.

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