



China: Opportunity and Challenge

- Moderator: **F. Warren McFarlan**, *Global Business Summit Faculty Chair, T.J. Dermot Dunphy Baker Foundation Professor of Business Administration*

Overview

China's sustained economic growth will make it the world's largest economy by 2030. Its large and competent labor force, entrepreneurial culture, and massive infrastructure investments are making this growth possible. But there are also challenges which include maintaining social stability and dealing with environmental issues.

For companies seeking to do business in China, it is important to understand China's history, context, and culture (including the importance of relationships). Because of the importance of China in the world economy, HBS is investing to create cases, courses, and programs focused on China.

Context

Professor McFarlan discussed China's massive efforts to build an industrialized economy, the challenges and opportunities related to doing business there, and how HBS is focusing on China.

Key Takeaways

- **Doing business in or teaching about China requires understanding the country's history and context.**

China is an ancient civilization and a new country. The civilization has existed for 5,000 years. As recently as 125 years ago, China was the largest economy in the world. After the Dowager Empress died in 1908, there were 40 years of instability. In 1949, Mao took over and built the country by force, with a strong military state. Six years later businesses were nationalized. From 1967 to 1976, the Red Guard and Cultural Revolution occurred; all universities were closed, except for Tsinghua University. From 1948 through 1978 China was closed and the Chinese government basically took care of the population.

This history reflects several important aspects of China:

- *The role of the state.* China has a long tradition of strong central government, with military power being critical. China was built by/held by the gun. It is impossible to underestimate the role of the state in all activities. The role of the state has led to tremendous bureaucracy.
- *A sense of superiority.* China doesn't see itself as a newcomer to the global stage. It sees itself as the center of the world and superior to other countries. Professor McFarlan said that the Chinese see the West as an inferior civilization with a momentary technological edge.
- *Relationships.* China is a relationship society, far more than a law society. In particular, due to the prominent role of government, long-term relationships with government are critical.

"Relationships and connections—this is what China is all about."

— F. Warren McFarlan

- **China is in the midst of a powerful and sustained economic expansion, with no end in sight.**

Since opening up in 1978, China has enjoyed a 30-year period of sustained economic growth. During this time the country's economy has grown roughly 10% per year. And despite the economic crisis in the United States, China is projected to grow 9% in 2008 and 2009. Already the world's #3 economy (after the United States and Japan), it is expected that by 2030 China will be the largest economy in the world.

"China has experienced 10 to 11% growth per year since 1978. A bad year is considered 9% growth."

— F. Warren McFarlan

The reason that China is expected to continue to grow despite the financial crisis in the West is that the country's growth is now being driven by its domestic economy. While previously growth came from exports, now domestic growth is the main driver, with exports playing a less significant role. Also changing is the nature of the Chinese economy. China has been a low-cost manufacturing center. But China can't sustain this position as there are other lower-cost countries. This requires the country to move up the value chain into service and IT businesses.

Among the factors contributing to China's growth:

- *A large and capable workforce.* China is home to 20% of the world's population. Not only is the population large, but the Chinese are literate (the literacy rate is 93% compared to 61% in India) and hard working.
- *An entrepreneurial culture.* Despite the history of state-owned enterprises, the Chinese people have a long history of entrepreneurship.
- *A strong university system.* China has excellent universities which are producing a large pool of competent graduates.

- **While China's growth is tremendous, the country faces many significant challenges.**

With China's success come challenges and gaps.

- *Lack of infrastructure.* By all measures, China's infrastructure is far behind that of the United States. The lack of infrastructure could actually hinder growth. China recognizes this and is making massive investments in roads, ports, railroads, airports, electricity, and telecom.

"In many areas, the infrastructure runs 50-75 years behind the U.S."

— F. Warren McFarlan



- *Lack of raw materials.* China has an extraordinary need for raw materials and energy resources. To address this need, China has developed and continues to develop international relationships. For example, Australia has become “China’s quarry” and China has made investments in Africa to procure raw materials.
- *Environmental issues.* This includes air and water pollution. These problems are not unique to China. Other developing economies faced similar situations, including the United States.
- *Corruption.* On the one hand, China is very much a relationship society, where long-term, carefully nurtured relationships are tremendously important. However, the importance of relationships can result in corruption.
- *Income inequality.* Huge compensation and wealth gaps are visible. The distance between the top and bottom of the economic scale in China is greater than in the United States.
- *Social stability.* Related to income inequality, the “iron rice bowl” (which China provided for all citizens) has been broken. New wealth is developing quickly but deep inequalities have emerged. There are major imbalances between the eastern and western regions of the country, as well as between the rural and urban areas. Although national peace has existed since 1948 under the philosophy of “harmonious development,” incidents of civil unrest have grown 400%. An open question for China is whether building social pressures can be handled without an explosion.

“The ideology is harmonious development. China is terrified of social instability.”

— F. Warren McFarlan

- *Legal issues.* The laws are developing in China in areas such as protection of intellectual property. However, having laws on the books is far less important than whether the laws are enforced; enforcement is what makes laws real. To date, the laws in China have not been widely and consistently enforced.
- **Despite the challenges, many factors contribute to a positive business environment in China.**

The many gaps that exist in China provide opportunities for businesses to fill these gaps. For example, there is a gap in that restaurants still purchase their food in grocery stores; there are no wholesale distributors for restaurants like Sysco in the United States. This is a gap in the marketplace, which presents an opportunity.

To fill some gaps, local markets and brands are emerging. Gome Electronics, for instance, is a distribution chain that handles “no name” products. Because consumers trust the Gome brand, they are comfortable purchasing what Gome sells. Another example is Yili (a state-owned dairy), which has started using packaging that allows dairy products to be stored at room temperature for long periods of time,

since the infrastructure does not support a cold supply chain for food.

Another example is Dorm99.com, which was envisioned as a Chinese version of Facebook, enabling students to see their grades relative to the rest of their university and province. Within the first few hours of operation, almost 200,000 people signed up. But this venture offers a reminder of the power of government in China, and the unexpected way its power can be used. At 2:00 pm on launch day, the Ministry of Education ordered the company to stop operations because the business was not in the interest of a harmonious society. Despite this setback, the owners of Dorm99.com leveraged their relationships in the government to launch another business (showing again the importance in China of relationships).

- **China is a major focus area for Harvard Business School.**

Harvard Business School recognizes the powerful role that China is playing in the business world today and the role that China will play in the next 50 years as it makes its likely ascent to the largest economy in the world.

Harvard Business School’s first delegation went to China in 1979, led by Professor McFarlan. Since that time, Harvard’s work in China has expanded greatly. It includes:

- *Asia Pacific Research Center.* In 1999, HBS opened in Hong Kong its Asia Pacific Research Center. This center has written numerous case studies, focused on both Chinese state-owned enterprises and private companies.
- *Executive Education programs.* In January 2000, HBS launched a one-week executive program with Tsinghua University called “Managing in the Age of the Internet.” This was the school’s first dual-language program. HBS was responsible for 75% of the teaching, and Tsinghua professors performed 25% of the teaching. Simultaneous translation was offered, and every case was available in both English and Chinese. This program has evolved into a six-week program where two weeks are held at each of the following locations: Tsinghua University; the China Europe International Business School (CEIBS) in Shanghai, and HBS’s Boston campus. The executive program serves as an engine to drive field-based cases and research.
- *Teaching resources and curriculum.* In the area of teaching resources, HBS has developed a training program for Chinese professors. Within the Business School, there are now six Mandarin-speaking faculty members and a new MBA course titled Doing Business in China in the Early 21st Century.

“We are building a competency here because 50 years from now China will be the most important country in the world.”

— F. Warren McFarlan



Speaker Biography

F. Warren McFarlan, MBA 1961, DBA 1965 (Moderator)

Global Business Summit Faculty Chair, T.J. Dermot Dunphy Baker Foundation Professor of Business Administration

Warren McFarlan is the T.J. Dermot Dunphy Baker Foundation Professor of Business Administration, Albert H. Gordon Professor of Business Administration, Emeritus, and faculty chair of the Global Business Summit at HBS. He earned his BA from Harvard College in 1959 and his MBA and DBA from HBS in 1961 and 1965, respectively. He has had a significant role in introducing materials on management information systems to all major programs at HBS since the first course on the subject was offered in 1962. He was a longtime teacher in the Advanced Management Program, the International Senior Managers Program, the Delivering Information Services Program, and several social-sector executive programs. He now teaches the first-year Financial Reporting and Control course and the second-year elective Doing Business in China in the Early 21st Century in the MBA Program and several short Executive Education programs. He is cochair of the Senior Executive Program for China.

In 1973, shortly after his appointment to full professor, McFarlan and four other faculty members were sent to Switzerland to set up the School's International Senior Management Program. He returned from Switzerland in 1975 to become chairman of the Advanced Management Program, a position he held until 1978; he was chairman of all Executive Education programs from 1977 to 1980. McFarlan was senior associate dean, director of Research from 1991 to 1995; senior associate dean, director of External Relations from 1995 to 2000; and senior associate dean, director of Asia Pacific from 1999 to 2004.

McFarlan's book *Connecting the Dots*, with Cathleen Benko, appeared in 2003. That same year, *Seizing Strategic IT Advantage in China*, with HBS Professor Richard Nolan and Professor Guoqing Chen of Tsinghua University, appeared (available only in Chinese Mandarin). His newest book, *Corporate Information Strategy and Management: Text and Cases* (seventh edition), with HBS Professors Lynda Applegate and Robert Austin, appeared in 2006. *Creating Business Advantage in the Information Age*, also with Applegate and Austin, appeared in 2002. "Working on Nonprofit Boards: Don't Assume the Shoe Fits" appeared in the November-December 1999 *Harvard Business Review*, and "Information Technology and the Board of Directors," with Richard Nolan, appeared in the October 2005 *Harvard Business Review*. McFarlan is editor of *The Information Systems Research Challenge* (1984). He served a three-year term as senior editor of the *MIS Quarterly* (1986–1988). He is a member of several corporate and nonprofit boards, serving for over 10 years on hospital boards.