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MNC Localization 2.0

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Sell to China
China's population size made it an attractive market for MNCs and their production stayed out of China.

Make in China
MNCs started to produce in China as China's labor force expanded in size and improved in quality, China aggressively built up its infrastructure, and import tariffs were high.

Supply from China
MNCs began exporting their products from China to other markets because of the production cost efficiency in China and low import and export tariffs.

In China, for China and the World
The China market itself became so large and so competitive that MNCs started to tailor some of their products for the China market. At the same time, China remained a production hub for MNCs' supply to other markets.

China + 1 or 2
Increasing export cost to the US combined with China's plan of expanding its domestic market accelerated some MNCs' progress of moving part of the production out of China.

What's next?
Increasing uncertainty in the China market in a more fragmented world imposes increasing operation risk for MNCs in China. How should MNCs reshape their China strategy?

Total GDP of China in 1978:
$364.39 billion

Total GDP of China in 2021:
$15,802.91 billion

- **1978** Reform and opening-up
- **1992** Pudong New Area established
- **2001** China joined WTO
- **2008** Global financial crisis
- **2010** China became the World's second largest economy
- **2015** Made in China 2025
- **2018** US-China trade tension
- **2020** Covid-19 pandemic
- **2020** Dual circulation
- **2022** Russia-Ukraine war

MNCs' journey in China

- **Phase 0: Sell to China:**
  China began its reform and opening up in 1978. In the following decade, a large number of MNCs, such as Coca-Cola, Procter & Gamble and Nestle, flooded into the Chinese market. Although a small number of MNCs (e.g. Schindler Elevator and Volkswagen) set up joint venture factories in China, the majority of MNCs in China at that time focused on sales and kept their manufacturing outside of China.

- **Phase 1: Make in China:**
  By the early 1990s, both China's infrastructure and the quality of its labor had improved. The establishment of the Pudong New Area in 1992 demonstrated China's commitment to its reform and opening up. With uncertainty about China's future greatly reduced, many MNCs began to bring their production lines to China.

- **Phase 2: Supply from China:**
  After joining the WTO in late 2001, China' s import and export costs were dramatically reduced. China also began to expand its college enrollment in 1999, and the number of college graduates almost doubled in 2003 compared to 2002. With a larger talent pool, better infrastructure, and cheaper trade costs, MNCs started to expand the variety and scale of their production in China, and began to use China as a manufacturing hub to serve other markets.

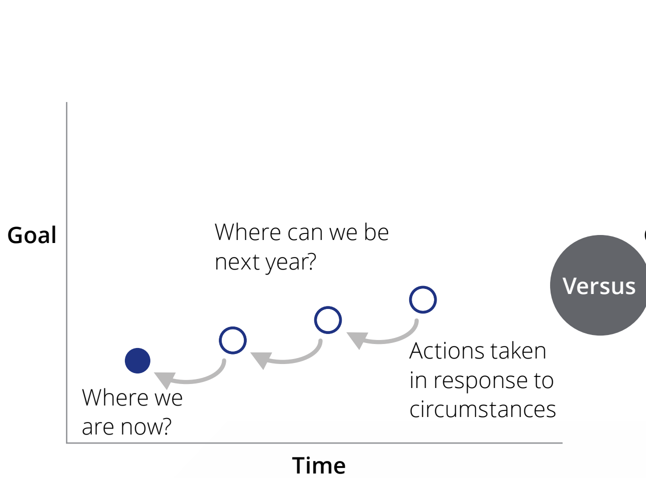
- **Phase 3: In China, for China and the World:**
  During the 2007-09 global financial crisis, China's ￥4 trillion stimulus package helped the global economy recovery. In 2010, China surpassed Japan to become the 2nd largest economy in the world. The rapidly expanding Chinese market and the rise of local competitors led many MNCs to begin seriously localizing their operations in the China market, including product design, marketing, and senior management teams. Some MNCs explicitly adopted a "in China, for China" strategy and most MNCs' Chinese operations became an important component of their global supply chain, serving customers across the world.

- **Phase 4: China +1 or 2:**
  As the Chinese economy strengthened, , the nation set its eyes on moving up its position in the global value chain. In 2015, China initiated its "Made in China 2025" plan, targeting to become one of the world's strongest manufacturers in ten key high-tech sectors by 2025. In 2018, the Trump administration imposed a series of punitive tariffs on Chinese exports to the US, which started the US-China trade tension that continues to this day. The COVID-19 pandemic that started in 2020 brought unprecedented disruptions to global supply chains. In the same year, China announced its dual circulation strategy, aiming at growing its domestic market and reducing its reliance on foreign markets, especially the US market. Rising export costs to the US, supply chain disruption risk, and China's push for self-sufficiency led some MNCs to move part of their production capacity out of China to other markets.

- **Phase 5: What's next?:**
  2022 has turned out to be no less challenging than 2020. The ongoing Russia-Ukraine war has not only pushed up global inflation while hampering global growth, but also –and more importantly – dragged the world into further fragmentation and division. The future of globalization seems to be much less certain than before, and China's position in this future globalization is also shrouded with uncertainty. In the face of these new challenges, how should MNCs reshape their China market strategy?

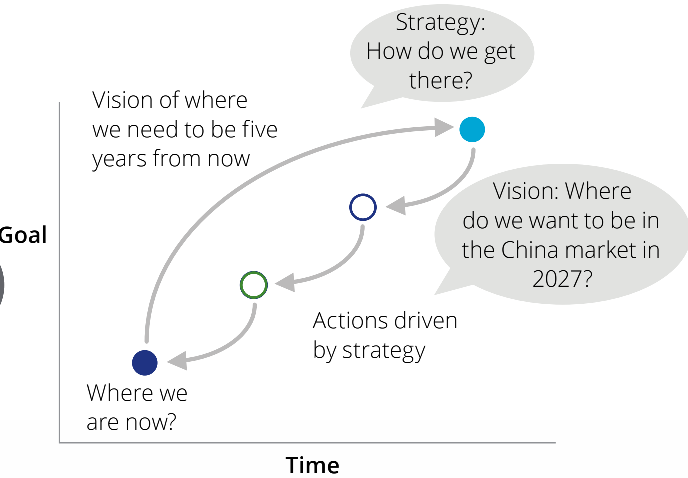
MNCs' desired position in the China market should be based on their global strategy, and some MNCs may choose to win the China market in the next five years while some others may not. The Chinese economy is evolving, which means that new challenges will always emerge from time to time. For those that have decided to win the China market, they need to have a vision into the next five years and develop their strategies accordingly and to strategically respond to the changing circumstances. From the experiences of successful and unsuccessful MNCs in China, this sort of "focused" approach works far better than an "incremental" approach where MNCs only take short-term actions.

Incremental planning process



Incrementalism
[One reason why companies fail in the China market]

Backward strategic planning process



Focus
[One reason why companies thrive in the China market]

New Challenges for MNCs determined to win the China market

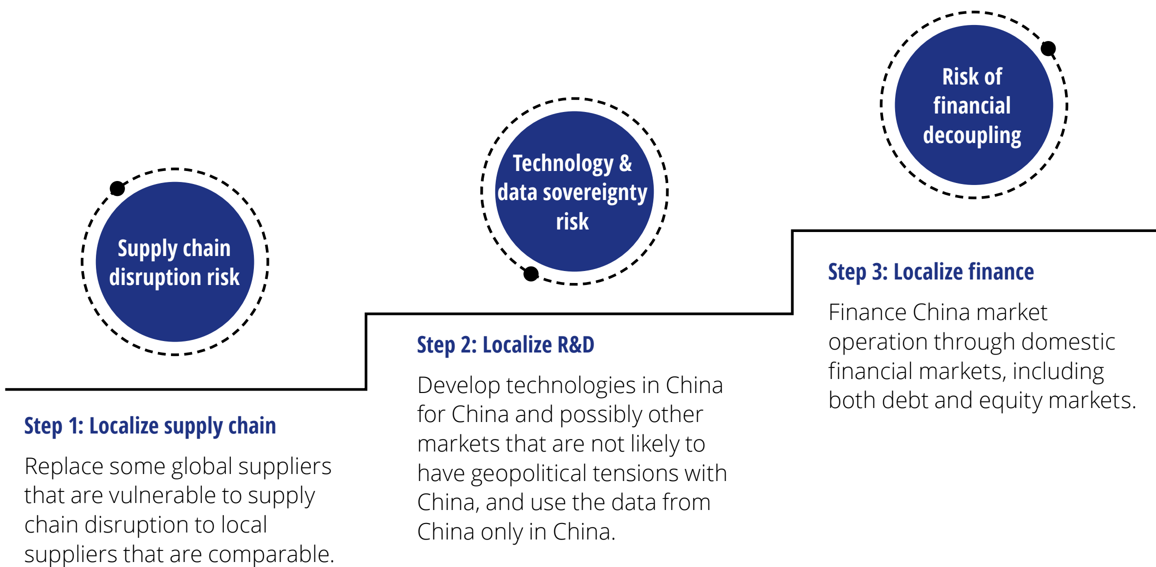
MNCs operating in China have always faced challenges, alongside the opportunities. Some of these challenges are long-standing, e.g. rising local competitors. Others are not new, but have become increasingly tricky in recent years, such as the alignment between headquarter (HQ) and the China corporate. Because of COVID-19 travel restrictions, most MNCs' global leadership team have not been able to visit China for over two years. Effective communication and mutual trust are more difficult to achieve without face-to-face conversation, especially when the HQ is exposed to negative media coverage on China. Another challenge is to understand and respond to China's policy changes, which have become more frequent and more dramatic since 2020. Compared with local enterprises, especially SOEs, MNCs in general lack a thorough understanding of the impact of such policy changes and are slower to respond accordingly.

In addition to these existing challenges, there are new challenges that demand long-term strategic solutions:

01. *Supply chain disruption:* In the last two years, COVID-19-related restrictions and continuous geopolitical tensions have imposed serious threats to MNCs' supply chains, which often span across the globe.
02. *Technology and data sovereignty:* Countries in the world, including but not limited to the US and China, are paying closer attention to advanced technologies and data that is potentially relevant to national security. MNCs operating in China face an expanding US entity list on technologies to be transferred to China, as well as China's enhanced regulation of cross-border data transfers.
03. *Financial decoupling between China and the US:* Although not an eminent threat at this moment, the financial decoupling is nevertheless a real risk with increasing likelihood.

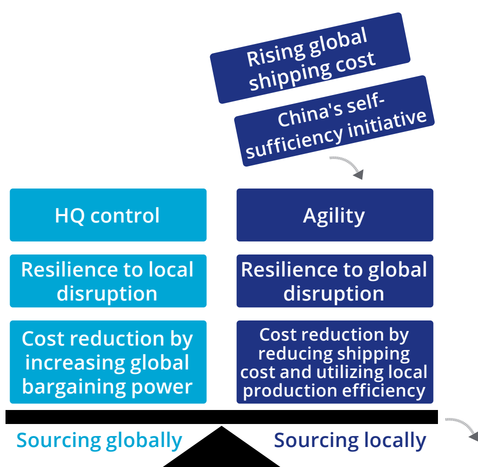
Localization 2.0: MNCs' strategy to resolve the above three new challenges

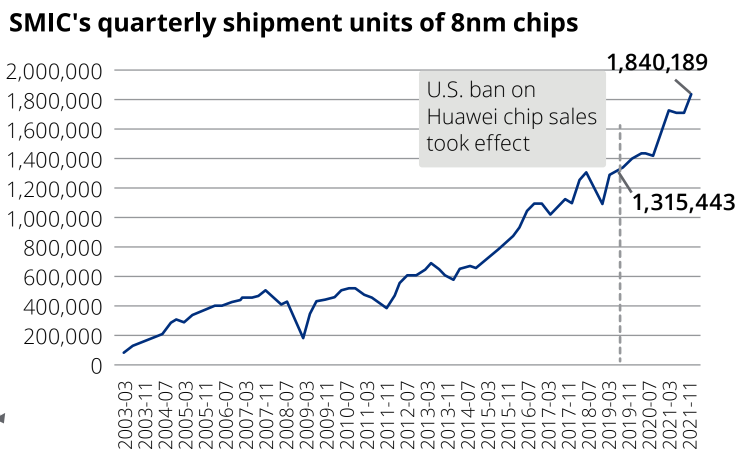
To strategically resolve these three challenges, or control the corresponding risks, MNCs need to deepen their localization in the China market. To manage supply chain disruption risks, MNCs need to increase localization of their supply chain by replacing certain global suppliers that are vulnerable to supply chain disruption with local suppliers that can supply with a comparable quality. To control the technology and data sovereignty risk, MNCs need to localize R&D by developing technologies in China for China (and possibly other markets that are not likely to have geopolitical tensions with China), and using the data from China only in China. To control the financial decoupling risk, MNCs need to localize their finance by financing their China market operation through domestic financial markets, including both debt and equity markets.



Supply chain localization

Most MNCs manage their supply chain using a combination of *just-in-time* and *just-in-case* strategies. As supply chain disruptions increase, the just-in-case strategy is gaining more and more popularity. However, for global supply chain disruptions of the magnitude of the COVID-19 pandemic, even the just-in-case strategy is not sufficient.





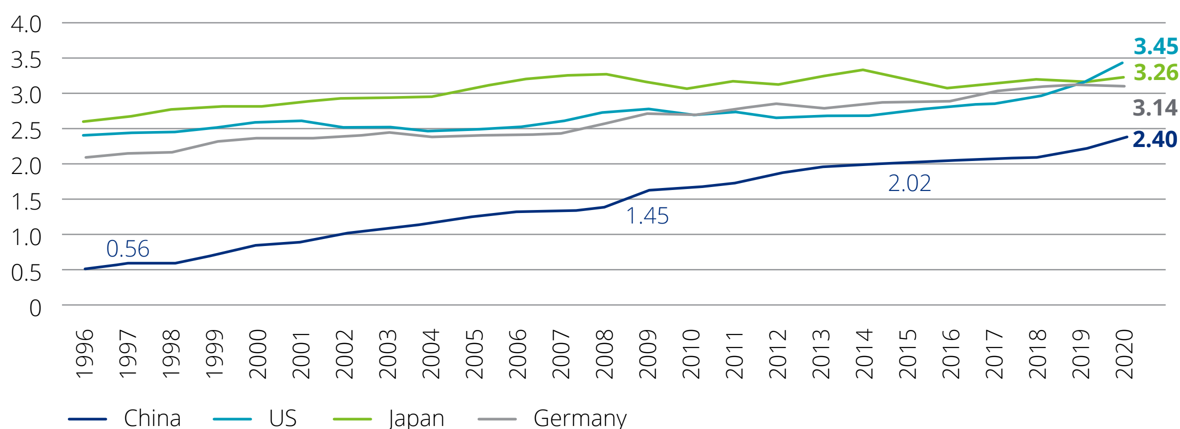
Data source:WIND

To be prepared for another worst case, MNCs operating in China need to increase localization of their supply chain. Sourcing globally and sourcing locally both have their own merits. Sourcing globally gives HQ more control over the operation to ensure global standards, brings more resilience to local supply chain disruption, and reduces procurement costs by enhancing bargaining power. Meanwhile, sourcing locally gives local operations more agility, increases resilience to global supply chain disruption, and reduces procurement cost by saving shipping cost and utilizing local production efficiency. Over the next five years, there are two important trends that will shift the balance towards sourcing locally. The first trend is rising global shipping costs. Because of rising fuel prices, geopolitical tensions, as well as the increasing awareness of ESG, shipping costs are likely to be higher and higher. The second trend is China's self-sufficiency initiative that will significantly extend the options for local procurement. Take chips for example, China's largest domestic chip manufacturer SMIC produced 1,840,189 units of 8nm chips in 2021 Q4, up from 1,315,443 units in 2019 Q3 when the US banned selling chips to Huawei.

R&D localization

For a long time, technical advantages have been the primary edge of MNCs over their local competitors in China. And in the foreseeable future, MNCs will still have to rely on advanced technology to secure their market share in China. However, this will be increasingly difficult as local Chinese companies have been spending relentlessly on R&D and are rising quickly in the technology front. In the last 25 years, China's R&D spending to GDP share has risen from 0.56% to 2.4%, and is likely to surpass Japan and Germany in the next decade given its current momentum.

R&D spending as a share of GDP(%)



Data source: WIND

Due to increasing competition in the China market, many MNCs have been expanding their Chinese-based R&D. But most are still hesitant when it comes to putting core R&D in China for various reasons, such as IP protection. Over the next five years, increasing emphasis on technology and data sovereignty will make it a must for MNCs to develop core technologies in China, not just for winning in the local market but also for risk control. Geopolitical tensions will continue, if not worsen, in the foreseeable future. As China becomes increasingly competitive in many technology areas, the frequency and scope of the US and European bans on technology transfer to China are likely to increase. To minimize risk exposure to this regard, MNCs that have large market presence in China need to move more core R&D into China.

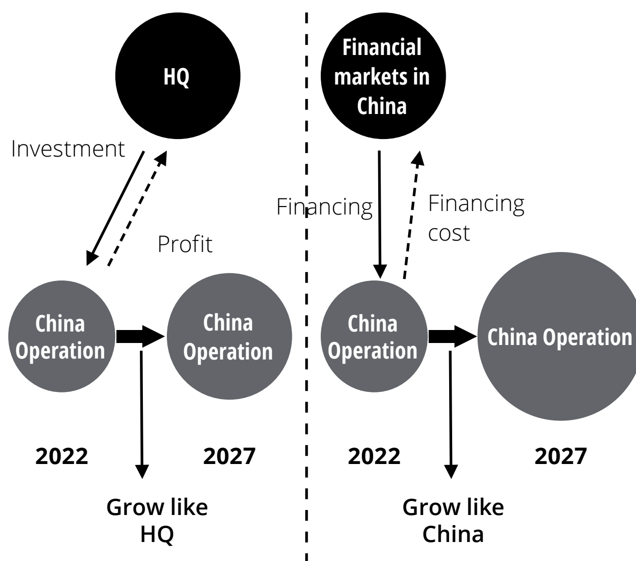
Another risk is China's enhanced regulation on cross-border data transfer. R&D in sectors such as healthcare technology and AI applications rely heavily on analyzing large scale data. As more and more public and personal data is required by law to stay in China, such R&D will need to be moved into China if their purpose is to serve the China market.

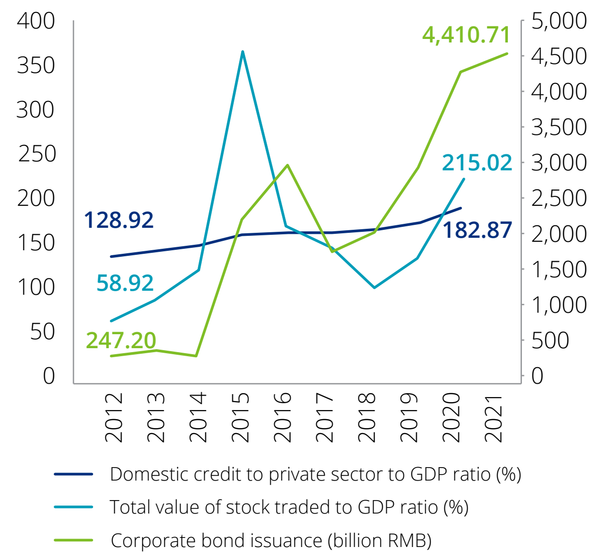
China currently has the world's largest talent pool, which also makes it a very efficient place to undertake R&D. There were over 10 million college graduates in China in 2021, and this number is expected to keep rising over the next five years. More importantly, China has the world's largest group of Science, Technology, Engineering, and Mathematics (STEM) graduates. In 2020, China had more than 1.65 million college graduates from STEM majors while the US only had 0.43 million. Moreover, China has provided aggressive policy support for domestic R&D. For instance, the corporate tax rate for enterprises officially recognized as "high-tech enterprises" was reduced by more than half to 15%. Many MNCs in China, despite aggressively investing in technology, are not qualified to receive such recognitions as most of their R&D occurs outside of the country.

Finance localization

A financial decoupling between the US and China, although not an eminent threat, is a real risk. More and more Chinese companies are being delisted – some passively and some others actively – from the US stock market. There is also increasing pressure in the US on restricting investment in China. MNCs headquartered in the US need to be prepared for the risk of financial decoupling.

Another force that calls for the MNCs to localize their finance in China is the need to support growth locally in China. Traditionally MNCs' operation in China has relied on investments from HQ as well as retained profit, which has its limitations in both investment size and investment speed. Especially in the fast-growing industries such as healthcare technology and EVs, local companies are actively investing in their own R&D as well as investing in (or fully acquiring) innovative enterprises, while MNCs remain relatively slow. To capture the growth momentum in those sectors, MNCs need to turn to local financial markets to finance their operation in China.





It is also increasingly more convenient and cost-efficient to finance locally in China. China's financial deepening is a continuing process. In the last ten years, China's ratio of domestic credit to the private sector to GDP has risen from 128.92% to 182.87%. The total value of stock traded to GDP has also risen from less than 60% to over 215%. The size of China's corporate bond issuance was only RMB 247.2 billion in 2012, but reached RMB 4,410.71 billion in 2021. China also has various policies on utilising financial markets for the purpose of promoting innovation in China. For example, there is strong policy push to channel more and cheaper bank loans to innovative enterprises. In light of this, the Shanghai Stock Exchange established the Science and Technology Innovation Board in 2018, which has already played an important role in financing China's innovative enterprises.

Conclusion

Localization has been a continuous theme in MNCs operating in the evolving China market. We are now at a point where MNCs need to localize not just to compete in the China market but also to control the increasing risks surrounding supply chain disruption, technology and data sovereignty, and US-China financial decoupling. MNCs that have decided to win the China market in the next five years need to deepen their localization strategies along these three directions.

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