

# Jesa Investment & Management Consulting Ltd.

**NEWSLETTER**

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## In this issue:

- What is Jesa?
- Offshoring opportunities and challenges in China
- Causes and effects of Chinese monetary squeeze
- Hot Money threatens the Chinese market

## What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia). Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 engineers following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue. Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia. We also perform HR audit and investment analysis (trouble-shot analysis) to verify performances in support to enterprises already established in China.

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## Offshoring opportunities and challenges in China

A recent McKinsey research on offshoring and outsourcing in China—including interviews with officials at many Chinese government agencies, executives at Chinese leading services providers, and managers at Chinese services-outsourcing parks—unveils that by implementing an aggressive strategy to develop the sector and cultivate talent, China could capture opportunities worth \$56 billion a year by 2015. China is one of the favourite outsourcing destinations for manufacturers thanks to its low wages, but currently accounts for only 10 percent of the global market for the offshoring and outsourcing of services. Now the country is striving to acquire

a larger share of the global IT and back-office services. In fact China offers many of the same characteristics that have made India the top offshoring destination for IT and other services. Despite moves to open its economy over the past two decades, China remains economically far from the rest of the world, with wages that are lower than in most places and a cost of living that makes those wages possible. At the same time, central control over the education system has created a widely distributed skilled labor supply.

The nation's IT industry had until recently been focused on developing the domestic market and the business with Japan, as China's two million Japanese and Korean speakers should help it strengthen its position in the North Asian market for the "near-shoring" of IT application and business-process-outsourcing (BPO) services. Now the Chinese government is attempting to promote the country's IT parks and special economic zones for outsourcing from the United States and other Western countries. But there are many challenges to face. First of all, the lack of workers who can manage international projects and have strong English-language skills will make it harder for China to become a leading provider of services to companies in Europe or the United States. Only with strong government initiatives and an education system creating a larger skilled work force the country will be able to challenge India for dominance in offshoring. The Chinese government has been working to overcome the language obstacle with several campaigns launched since July 2001, when Beijing was awarded the 2008 Olympics. Beijing has made learning English a priority, and some experts of the sector argue that China could become a serious contender for IT and back-office outsourcing after the Olympics.

Another problem is the lack of protection of intellectual property rights. In the fairly new market for the offshoring of engineering

services, China could become an R&D hub, given its proximity to potential customers in the Asian semiconductor and consumer electronics industries. However, its relatively poor protection of intellectual property rights poses a significant barrier.

Then there is the obstacle of institutional differences: India is much closer to Western countries in an institutional sense, making it easier for U.S. and European companies to set up operations there.

Finally, problems can upraise form the lack of infrastructure in smaller cities. In fact going beyond the major cities has advantages, not only in terms of wages. In China, where family is highly valued, working closer to home is a substantial perk, even if the pay is lower. For this reason in smaller cities it could be easier to recruit and retain skilled workers, which is among the most difficult tasks.

Considering the opportunities and the challenges, before taking the decision to outsource their processes in China, companies

should think about three main points: strategy, source and governance. Firstly, a company should begin by looking at its processes and its ability to outsource them. Next, a company must look at the skill sets available in a particular country. If English is needed, China is probably not the answer, at least not yet; but for certain IT tasks - for example, software embedded on chips - China has the experience and skills. Companies need to match their long and short-term plans with abilities and trends in a country. Third, companies must commit to investment in ongoing management of the operation and the outsourcing supplier.

Finally, another strategic aspect for larger companies is presence. In fact, the cost advantage is only a part of the decision: if they want to sell in China, they have to be present in China, and outsourcing is one way to establish that presence.

The table below, taken from a Mc Kinsey research, shows where China stands relatively to success factors in the offshoring sector.

	Success factors	Where China stands
IT application services/ business process offshoring	• Talent pool with sufficient language skills in English, Japanese and Korean	• Many Japanese and Korean speakers, insufficient english
	• Access to customers	• Lack of access to end customers
	• Strong vendor capabilities, industry knowledge	• Leading vendors not yet at optimal scale
IT infrastructure services	• Excellent telecom infrastructure	• Well established, low cost telecom infrastructure
	• Strong legal protection of data privacy	• No data privacy protection; perceived reasonably as high risk country
	• Talent in IT infrastructure services	• Lack of specific skills
Engineering	• Proximity to market	• Huge manufacturing base for key verticals
	• Strong protection for intellectual property	• Weak protection, negative global reputation
	• Talent in domain knowledge- knowledge of operating system environments	• Fast growth in domain knowledge

## Causes and effects of Chinese monetary squeeze

China's money and credit growth will slow this year as the central bank is implementing a battery of tightening measures. The country has in fact changed the stable policy that has been applied since the Asian financial crisis in 1997. Why China has to restore a monetary squeeze after 11 years? In which ways is it implemented? What are the consequences?

The Chinese Prime Minister Wen Jiabao said that the application of a tight monetary policy is the result of the bounce in real estate investments, the excessive movement of capitals, the large concession of credit and the rising inflation. According to Jiabao, it is necessary to reinforce financial regulations in order to control the excessively rapid growth of money and credit supply.

Finance expert He Qiang said in an interview: "Before December 2006 the price level in China was pretty low, under 2%, with a "high growth - low inflation" scenario. According to many, that was the best period since the foundation of PRC. In 2007, prices kept growing. The recent inflationary trends are the reason of the application of tight monetary policy."

In the yearly government report the Prime Minister Wen Jiabao said that the Chinese Central Bank would correct the money supply through open market operations as well as through the increase of banks reserves rates and interest rates. He also underlined that the control measures on credit dimension are differentiated according to the principle of "guarantee and pressure": controlling credit growth in the medium-long term, in particular for companies with high energy consumption and for sectors with excessive production capacity, while reinforcing the sustenance to

agriculture, tertiary, environmental protection sectors.

However, the monetary squeeze is bringing about undesired collateral effects. Many critics have been moved to Wen Jiabao's policy because it has caused relevant problems to Chinese companies. On April 25<sup>th</sup>, the Economic Observer published a report entitled "Private Enterprise Tormented," which dealt with the difficulties faced by private enterprises under Wen Jiabao's strict credit and price controls. Of the 5.5 million private enterprises, less than 20 per cent can get bank loans; most have to get illegal financing from loan sharks. A front-page story in the Economic Observer on May 5<sup>th</sup> reported that also central state-owned enterprises are facing difficulties. Some large SOEs are threatened with breaks in their funding chains. The report also disclosed a Citigroup research estimating that from 2002 to 2006, Chinese enterprises' costs due to price distortions had been underestimated by as much as 3.83 trillion yuan, of which labor costs had been underestimated by 200 billion, commodity prices by 1.6 trillion and capital costs by 330 billion. For this reason, foreign companies which rely on Chinese suppliers should carefully check their financial situation, as in this period many Chinese enterprises could have insufficient working capital to fulfil orders. The well-known Chinese economist Lin Yifu, who will become Vice President and first economist in the World Bank, sustains Wen Jiabao policy but suggests that the central bank should use mainly the interest rate tool: "The monetary squeeze is based on two principal instruments: the increase of the reserve rate and of the interest rate. I sustain the application of interest rate policy, because with the continuous increase of the reserve rate, banks will have less capital for credit, excluding mainly SME and missing the country's objective to pursue a "positive and

fast" economic growth. Moreover, if interest rates remain at the current level, with the prices increase the actual interest rate on deposits will become negative, which will divert capital on the stock market and the real estate market, missing also the government objective of maintaining a stable development of the real estate and stock market."

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## Hot Money threatens the Chinese market

The People's Bank of China reported a record rise in foreign reserves in the month of April. The main source of this inflow, however, may not be foreign-direct investment (FDI) or related to China's trade surplus. According to Lehman Brothers, the mysterious gap between a narrowing trade surplus and rising foreign exchange reserves in China is due to "hot money". "Hot money" refers to large quantities of money that move quickly in international currency exchanges due to speculative activities.

"The trade surplus and FDI inflows explain only 33% of the surge in FX reserves," says Ron Subbaraman, analyst at Lehman in Hong Kong. In April, foreign reserves grew by \$74.5 billion, to a total of \$1.8 trillion. FDI and the trade surplus could account for only \$24.3 billion of this rise, Lehman calculates, suggesting \$50.2 billion of the reserve increase can't be readily explained.

According to Zhang Ming, from the Chinese Academy of Social Sciences, "hot money" inflows in China had been increasing since 2003, both in quantity and in speed. He estimated that between 2003 and the first quarter of 2008, a total of 561.8 billion dollars flowed into the Chinese market. Among that, a record high of 85.1 billion came in during the first quarter of this year.

This "hot money" is likely to head for risky investments, and in the past has been

destabilising to other countries because it can surge and then disappear quickly – as happened to other Asian countries in 1997-98. Massive outflows of hot money could make a country's financial system collapse.

Li Yang, a financial researcher at the Chinese Academy of Social Sciences (CASS) thinks that the interest rate gap between the United States and China and the foreign exchange arbitrage brought about by renminbi appreciation both have caused a greater influx of international speculative money. Li believes that simple speculation such as interest rate arbitrage and foreign exchange arbitrage could bring speculators profits of more than 10 percent.

After the Chinese A-share market had a series of tumbles just over a week ago, expectations grew that the government would intervene in the market once again. In Hong Kong, however, rumor spread among investment banks that the point now was not to save the market, but to prevent hot money from flowing either in or out greatly. "If supervisors take action to intervene, this hot money will retreat suddenly from the A-share market," said the chief of the Hong Kong office of a mainland securities company.

As a means of containing hot money, Zhao Qingming, a senior research manager at China Construction Bank, suggested that the government "reasonably control the renminbi appreciation expectation, strengthen efforts in trade investigation and sanctions and maintain asset prices at a reasonable level."

Zhang Ming, a financial expert at CASS, said that The State Administration of Foreign Exchange (SAFE) should cooperate with the Customs agency to crack down on fake trades. He also suggested keeping the China-U.S. interest rate difference at a reasonable level to curb arbitrage.

SAFE had stated that it would strictly control foreign exchange collections and settlements, tighten its supervision and investigations of

commodity and service trades, strengthen the management of the bank's short-term foreign debt quotas and improve foreign-invested companies' management of foreign debt. It also vowed to strengthen its efforts in checking cross-border capital flows and cracking down on underground banks and illegal foreign exchange trades.

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