"REIN MASTERFULLY CAPTURES WHERE [CONSUMERS] HAVE BEEN AND WHERE THEY DREAM OF GOING." —*FORTUNE*

REVISED AND UPDATED

THE END OF CHEAP CHINA

ECONOMIC AND CULTURAL TRENDS THAT WILL **DISRUPT THE WORLD**

SHAUN REIN

FOUNDER AND MANAGING DIRECTOR, CHINA MARKET RESEARCH GROUP

WILEY

Contents

- Prologue
  - Chapter 1: Chinese Billionaires Outnumber American Ones
  - Chapter 2: Cheap Chinese Labor? Not Anymore
  - Chapter 3: Stability Is the Key to Happiness
  - Chapter 4: The Modern Chinese Woman
  - Chapter 5: Why Chinese Consider Kentucky Fried Chicken Healthful
  - Chapter 6: Understanding Corruption in China
  - Chapter 7: China’s Real Estate Sector
  - Chapter 8: Chinese Neo-Colonialism in Africa and the End of American Hegemony?
    - Australia
    - Pakistan
    - America
    - Chinese Soft Power
  - Chapter 9: China’s Educational Sector
  - Chapter 10: What the End of Cheap China Means for the Rest of the World
    - China: The World’s New Hegemonic Power?
    - Economic Growth Hitting a Wall
    - Reforming the Political System
- Epilogue
- Postscript
- Acknowledgments
- Index

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Tom Tom, May life bring you many bright lights.

Love, Ba Ba

PROLOGUE

The year was 1998. Steve Jobs was years away from introducing the iPod to the world, and audiences were packing cinemas across the globe to see Leonardo DiCaprio's love affair with Kate Winslet in *Titanic*.

I turned off the lights in my grubby hotel room in Changchun, a dingy industrial city in northeast China famous for being the capital of Manchukuo, the Japanese-controlled puppet state during World War II. I had been sitting upright on a hard, wooden train seat for 18 hours all the way from Tianjin, and my back ached. The room's air conditioner unit wheezed loudly, and a potent mixture of smells emanated from the bathroom, but I was so exhausted I started to drift off to sleep anyway.

Then the calls started.

The first time I answered, a giggly, cutesy voice on the other end playfully asked, "Do you want some fun?" I knew what "fun" meant. No, I told the voice, not my style, and I hung up. Undeterred, the girlish voice called back every five minutes. "Do you want some comfort?" she cooed. I hung up. The phone rang again. "Do you have any aches I can massage away?"

I fumbled around in the dark trying to disconnect the phone, without success. Finally I ripped the phone out of the socket. It was damaged, but I figured I'd just settle up with the hotel manager the next day—after all, everything in China at that time was cheap.

Then there was a knock on the door. I opened it, and standing in front of me was an absolutely stunning girl. She had a slender, lithesome body; mesmerizing coal-black eyes; and a perky nose. Her hair flowed in dark waves to her shoulders, and she wore a deep-blue cocktail dress that hinted at what was underneath but didn't reveal too much. A fruity perfume scent hung in the air around her. I remember thinking how gorgeous she was. She easily could have been a cover model for a fashion magazine, maybe *Teen Vogue*.

She smiled. "Twenty dollars," she said and mimed with her hand and mouth what that amount would buy me. Then she told me what 25 bucks would get. I stared at her blankly for a few moments, sweat beading on my palms and brow, then finally said no and crawled back to bed alone. Seemingly as soon as I started to drift off, the knocks started again. It was the start of a long, lonely, sleepless night.

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When I first arrived in China in the mid-1990s to study Chinese at Nankai University, gorgeous young prostitutes like the one that stood at my door in Changchun that night were everywhere. They were in hotels, saunas, karaoke bars, even coffee shops. They would sit, elegantly, waiting for traveling businessmen—mostly middle-aged white foreigners with bulging guts—and saunter over to them to make their pitch for a little "comfort." They were easy to spot because, unlike most of the rest of the population that dressed in conservative old clothes, they carried Motorola mobile phones and Louis Vuitton bags. What amazed me was that practically all of them were dazzlingly beautiful.

Now, 15 years later, as the founder of China Market Research Group (CMR), a market research firm that helps companies as varied as Apple, Kentucky Fried Chicken, Richemont, LG Electronics, and DuPont develop their strategies for China, I have witnessed a total turnaround in the labor pool and how people dress and eat.

No longer do you find gorgeous prostitutes everywhere. On a trip to Beijing in 2011, I stayed at one of the ritziest hotels in the capital. Glancing around the lobby, I could still spot the hookers easily enough, only now they were middle aged and ugly. They wore too much makeup and had paunches like many of the aging Western businessmen they serviced. As I stood in the elevator on the way up to my room, I realized I couldn't remember the last time I'd received a call at night in a hotel room and it was becoming rare to even be approached by a hooker. What had happened?

The explanation is simple enough. In the mid-1990s, job opportunities were scarce in China, so even the most beautiful young girls had become desperate enough to work as prostitutes, selling their bodies to feed themselves and send money home to their families in the countryside. But China's economy and job market have seen dramatic changes in the past decade and a half. As more attractive, better-paying job opportunities increased, pretty young girls took advantage of better options, and the pool of prostitutes got uglier as a result. The uglification of Chinese prostitutes is part of a broader trend that is the subject of this book, *The End of Cheap China*.

Many Americans have an idea of China as possessing a limitless supply of cheap labor. It is easy to understand why. From the data points most readily available to the average American— the ubiquitous "Made in China" tag on products filling the shelves at Walmart and Target and China's world's-largest, 1.3-billion-strong population—it is quite natural to conclude that there must be swarms of Chinese ready to jump onto a factory floor and make more products for Americans to consume.

But despite China's massive population, jobs are now abundant, and gender equality in general is improving. In fact, one of the biggest obstacles that companies operating in that nation now face is the lack of available workers—there are more job openings than employable workers in many cases. Huge foreign investment has resulted in the creation of millions of new jobs, and because of the one-child policy, when workers retire there are fewer and fewer young people to replace them in the labor force.

The mentality of Chinese workers also has shifted from even a decade ago, when good jobs were hard to come by and people would accept harsh conditions if it meant having a steady job, a roof over their head, and food to eat. The younger generation's optimism about their futures and career prospects is palpable. They have witnessed China's rise to economic superpower status, come through the financial crisis stronger than any other nation, and have yet to live through a downturn.

Filled with electric optimism and seeing opportunities to get rich everywhere, they are no longer willing to debase themselves in humiliating work, slave away in factories thousands of miles away from homes and families, or toil in jobs that do not empower them to achieve their white-collar dreams. In turn, they have started to buy the products that they used to produce, making the Chinese consumer growth story one of the most exciting and important for the next decade. It is an opportunity for companies trying to offset dwindling growth in the developed world and poses problems for policy makers who need to deal with inflationary pressures as Chinese people eat more meat, buy more cars and air conditioners, and live in larger homes.

Using interviews with billionaires, government officials, executives of Chinese and foreign firms, poor migrant workers, and even prostitutes, I will explain the larger phenomenon of why Chinese workers are no longer willing to slave away for cheap wages to assemble Apple iPhones and Nike Air Zooms and what that means for the rest of the world. China's evaporating cheap-labor pool will disrupt supply chains and consumption habits around the world. Executives and policy makers need to prepare to be ahead of the curve, to evolve and take advantage of the changes—or face extinction.

Companies can no longer manufacture cheaply in China and may need to rethink their strategies and shift manufacturing to lower-cost production centers like Vietnam or Indonesia—or even reshore back to the United States in some cases. As thousands of factories in China have already done, they might have to automate production lines and produce higher-value goods or face the prospect of shutting down completely if margins are squeezed too tightly. Only one thing is for certain: Rising labor, real estate, and commodities costs in China will cause prices for everyday Americans to rise and crimp our consumption-oriented way of life.

I will further examine the political and sociological reasons why Chinese incomes are soaring so fast, how that is affecting domestic Chinese consumption, and what that means for businesses. Instead of the market to *produce in*, China has become the market to *sell into*. Although famous for making Nike shoes, China is now Nike's second-largest market in the world, generating $2.1 billion in revenue in 2011 and boasting Nike's fattest margins anywhere in the world. Nike expects to double sales there by 2015. In 2013 China became the largest market for automobiles, with more than 22 million sold, up from 17 million in 2010. It has become Buick's largest market after the Detroit carmaker reinvented itself as a must-have brand for rising Chinese executives, and there are half-year waits to buy Porsches. Yum! Brands, the parent company of Kentucky Fried Chicken, generates more than 40 percent of its global revenue in China, and hour-long lines to get into Pizza Hut are a common sight at the malls sprouting up across the country. Chinese people are the second-largest buyers of luxury products, buying $22 billion worth in 2013 despite the crackdown on corruption led by new President Xi Jinping. China has become the must-win market for consumer product companies.

Finally, I will show how rising consumption by China’s 350-million-strong middle class—who all want homes, air conditioners, cars, and a piece of the good life—will strain commodities markets around the world, further adding to inflationary pressures. Their increasing demand will cause inevitable tensions as Chinese investment expands into other countries like Canada and continents like Australia and Africa to secure access to limited natural resources. China’s demand for commodities will further disrupt the international status quo as the Chinese government cements deals with countries like Iran and South Sudan that are viewed as unsavory and often have divergent interests from the United States.

As America adjusts to having a true rival economic superpower for the first time since the end of the cold war, it is critical for the world to understand what China was, what it is now, and what it could become in the coming decades. Too often the rise of a new power, combined with a weak global economy, creates conditions disposed to military movement. The first half of the twentieth century devastated the world and left tens of millions dead and hundreds of millions displaced, as Germany, the United Kingdom, the Soviet Union, Japan, and the United States competed over a new world order in the face of weak economic growth and limited access to natural resources.

Rarely do major shifts in global power go smoothly, as many predict will happen with America and China. One must know history and never forget it. Yet outright conflict is not inevitable between the world's two superpowers, and the world now has better global institutions in place for arbitration, such as the World Trade Organization and the United Nations. China also has a different culture, one less based on missionary zeal than those of many traditionally Christian nations like the United States and the United Kingdom that might make it less likely to wage ideological and military battles far beyond its own borders.

Fear mongering, misinformation, and hysterics about China's rise are hitting the American airwaves on a daily basis, clouding rational discourse. Nobel Prize–winning economist and *New York Times* columnist Paul Krugman and Senator Charles Schumer from New York feed the flames of fear and anger by arguing that China is stealing American jobs by keeping its currency low and asserting that America should take an aggressive approach with it. Celebrity businessman, entertainer, and billionaire Donald Trump agrees and thinks America should slap a 25 percent tariff on all Chinese imports. President George W. Bush's former counterterrorism and cybersecurity advisor, Richard Clarke, argues that America needs to beef up its cyber warfare capabilities because it is under daily attack by Chinese assaults that could threaten America's security just as much as conventional weapons.

Rising anti-China rhetoric is gaining currency and is dangerous and misguided—the last thing anyone needs is the world's two superpowers in conflict, and strong rhetoric has a way of being self-fulfilling. In a study run by Professor Orville Schell, the nonprofit, New York–based Asia Society estimated that America could lose up to $2 trillion in Chinese investment because of anti-China hysteria, as Chinese firms look to Europe, South America, Africa, and other investment climes more welcoming to Chinese money.

More urgently, factions with chips on their shoulders within China don't want to be pushed around by America anymore. They are demanding a more muscular Chinese military presence that is willing to flex its muscles to demonstrate to its neighbors and the rest of the world there is an end to American hegemony and a new world order. In 2011 China launched stealth airplanes and an aircraft carrier and took a more aggressive and nationalistic stance in disputes with Japan and in the South China Sea with the Philippines and Vietnam. Although China does not have a history of straying far beyond its borders in military exercises, preferring to stay closer to its orbit, a meek, inwardly focused China is not a foregone conclusion as threats to its stability from internal issues diminish while threats from the outside increase.

It does not matter if you are a businessman, politician, teacher, student, or just someone curious about China and changes in the world today: It is important to understand, by using objective data points rather than red herrings and phantom facts, how the end of cheap China will affect all our lives. I aim to do just that by tracking my own experiences in China, from my time as a teenager in the mid-1990s until now as an entrepreneur and consultant and how I came to learn about and understand the country.

CHAPTER 1
CHINESE BILLIONAIRES OUTNUMBER AMERICAN ONES

I was sitting on a leather couch in an opulent meeting room in Shanghai's five-star Okura Garden Hotel in the former French Concession in 2010. Above my head dangled a chandelier of such scale that it would fit in at Versailles. I imagined former supreme leader Mao Zedong sitting in the room, as he did decades earlier when the hotel was his stomping ground on visits to Shanghai.

A man who appeared to be in his early forties was standing in front of me and doing tai chi. He was thin, had a fully shaven head, and wore a simple white oxford shirt unbuttoned at the collar. He had a serene aura about him that commanded the respect of everyone else in a room that included some of the most successful businessmen in China; he seemed to be the king among kings. He smiled at me, asked me to sit, and gently requested that someone pour me some tea as he continued his routine.

Looking around, I knew that most of the others joining us were worth tens if not hundreds of millions of dollars. A few might have crossed the billion-dollar mark. All were entrepreneurs who had built up brands every Chinese person knows. There was Chen He Lin, the slight and gregarious founder of ASD, a kitchenware company known by Chinese housewives for durable, safe, and affordable crockery. He had looked at me curiously, perhaps because I was the youngest and the only foreigner in the room or perhaps because I was the only face he didn't recognize. After looking me up and down, he, too, grinned at me and handed me his business card.

Sitting to my right was a tall, bald man chain-smoking furiously. He stuck out because he was dressed in an all-white athletic suit while everyone else was wearing dress clothes. Like the king of the room, he, too, had a shaved head, although unlike his friend he did not offer me his card. He pretty much ignored me when I asked him a question about his business. He told me his name was Shi Yuzhu. He was famous for losing his entire fortune before building it back up again when he took his online game company, Giant Interactive, public on the New York Stock Exchange. Shi Yuzhu became infamous among Western investors several months later for ultranationalism when he publicly sided with Alibaba's founder, Jack Ma, in his public dispute with Yahoo! over the ownership of the online payment service Alipay by calling Ma on his Sina microblog a "patriotic hooligan."

On Shi Yuzhu's right sat Zhou Xin, a towering man with short, cropped hair who reminded me of Yogi Bear. He was the cofounder of E-House, an online and offline real estate brokerage firm that was also publicly traded on the New York Stock Exchange. He beamed at me with a mix of pride and humility when I told him that consumers my firm had interviewed had responded they were very happy with his company's products and services.

While the rest of us listened, the man doing tai chi started to talk about the business environment and the economic problems facing the country as a result of the financial crisis in America and Europe. The man's name was Guo Guangchang, the founder of the Fosun Group. The *Hurun Report*, which tracks the net worth of the Chinese rich, estimates Guo's wealth at nearly $5 billion.

As I listened to Guo and the others discuss the business climate, I looked around the room at their faces. All seemed to have the intensity of Olympic athletes about to compete.

Optimism and confidence, born from being raised with nothing but making it big through their own sweat and grit, seemed to ooze from their pores. They knew they could overcome any challenges with enough hard work and patience.

To my left a number of the executives gathered to talk about joining forces to lobby the government more. They were worried about a credit crunch hitting small and medium enterprises, and they wanted to band together to present their case to the government to remedy the situation. Concerns about underground banks, loan sharks, really, calling in loans was starting to become a topic of conversation.

As I listened to the discussion, it was clear these were some of the savviest businessmen not just in China but in the world. I have advised chief executives of Fortune 500 firms and trailblazing entrepreneurs whose innovations change the world, but these Chinese entrepreneurs were as impressive as any executive or thinker I had ever met and perhaps even more so, considering the filthy poverty and chaos they had grown up in just a few decades before.

Despite intellectual property problems, uneven government regulation, corruption, poorly trained labor forces, and difficulty raising capital, these battle-hardened executives had all taken risks and built up groundbreaking organizations in the past 10 years. It was also clear that these entrepreneurs were building up strong Chinese brands. None of them was simply copying Western business models or stealing intellectual property as many Westerners think all Chinese do—they were creating new ones.

Not only were these businessmen building brands in China, but many of them were also growing abroad organically and competing on foreign turf. Some had even begun buying up iconic foreign brands. Guo's Fosun Group had started scooping up stakes in foreign firms. He had acquired 7.1 percent of Club Med, the French resort company known for opening all-inclusive resorts in exotic locales, to cater to more of the 50 million Chinese tourists who travel abroad every year. Guo had also bought the rights to *Forbes* magazine in China and had signed several major deals with foreign investment firms. His company had set up a $600 million joint investment fund with Prudential Financial to invest in foreign and Chinese firms that have significant growth potential in China. He had also launched a cobranded fund in renminbi (China's currency) with the politically well-connected Carlyle Group, the private equity firm that once had former President George H. W. Bush and British Prime Minister John Major on its payroll, for investment in China.

As I looked at these executives, it became clear that too many Western observers of China foolishly discount the management and branding abilities of Chinese companies, much as many American companies discounted Japanese firms such as Toyota and Sony in the late 1970s. Aggressive, confident, and capital-rich Japanese firms quickly took advantage of bloated American firms such as General Motors and forced American companies to reassess their business models. Japanese firms went from making cheap, tacky products to defining quality in some industries. Chinese firms might similarly disrupt entire industries if American companies are not forward thinking enough to react to evolving Chinese companies and stay ahead in innovation before the business threat materializes.

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When you walk along the aisles of your local Walmart or Best Buy, most products are marked with a "Made in China" label. Trying to keep costs down, many multinational companies established direct-owned manufacturing operations in China or began sourcing from Chinese-owned factories through intermediary firms such as Li & Fung. Even in your own home, you would be hard-pressed not to find at least some products in each room touting this sticker.

You would also probably be hard-pressed to name any Chinese brands, despite China being the factory of the world for the past two decades and having the world's second-largest economy. Unless you had observed the rise of Chinese brands in the past decade, the absence of these brands in Walmart might lead you to agree with the many Western analysts who think that Chinese companies simply do not have the ability to build brands.

Atlantic Monthly journalist James Fallows is one of those observers. He calls the 44 percent of Americans who think China is the world's leading economic power, according to a 2009 Pew Center poll, "crazy" because he does not think Americans can "name even 10 [brands] from China." Fallows, disparaging the research ability of Chinese scientists, continues: "Name the most recent winner of a Nobel Prize in science from a Chinese university or research institution." That was a trick question because there have not been any winners.

Fallows believes Chinese companies cannot create their own brand and that its leading minds in the sciences do not have the innovation and creativity to win a Nobel Prize in the sciences. He seems to agree with the conventional wisdom of Western analysts that Chinese are better at copying what worked in America, building a clone of it, or simply ripping off intellectual property to make money. After all, many of China's publicly traded companies, such as search engine Baidu or e-commerce auction site Taobao, seem to be rip-offs of Google and eBay. Are analysts like

Fallows right, or are there deeper explanations why Americans cannot name many Chinese brands?

At first glance, Fallows is right. Few Americans would be able to name more than 10 Chinese brands. The ones Americans might know, such as information and communications technology provider Huawei, tend to be more focused on selling products and services that are good enough but cheap to businesses. They tend to focus more on business-to-business clients, rather than on more fickle and brand-conscious end consumers. Or Americans might know brands like Huawei not because of their quality but because of fears they are fronts for the Chinese military and pose security risks, which make them a frequent target in the Western media and of members of Congress on the campaign trail. However, everyday Americans' lack of knowledge about Chinese brands does not really mean that Chinese companies cannot brand and build global champions. A deeper glance, and a basic understanding of recent Chinese history, will show that underestimating Chinese businesspeople as Fallows does would be foolish.

Not having a Nobel Prize winner in science does not mean Chinese scientists cannot conduct leading research. Such awards are usually conferred for work done decades earlier. Japanese scientists Ei-ichi Negishi and Akira Suzuki won the 2010 chemistry Nobel Prize for research conducted in the 1960s and 1970s—the same period when the Cultural Revolution was ravaging China, as we will explore in Chapter 3.

If Chinese scientists have not won a Nobel Prize by 2050, one could then argue Chinese researchers in a Chinese institution cannot do groundbreaking research—but I bet one will. After all, when I was a student at Harvard's Graduate School of Arts and Sciences at the turn of the millennium, more mainland Chinese were enrolled there than from any other country except America, and many of my classmates have been lured by government initiatives to recruit mainland scholars to return to Chinese universities rather than stay in America.

Fallows is also correct that few Americans know Chinese brands, but once again he is wrong about the reasons. He would be correct if it were still the 1990s, when Chinese management teams were weak and focused on the short term, but surprisingly, Fallows seems to have missed China's business evolution in the past decade.

Today's Chinese brands are quickly moving up the value chain to compete on branding and innovation rather than just on price. They have had to figure out earlier than foreign competitors how to deal with the end of cheap China. Rising labor and real estate costs and demanding consumers are forcing them to think more long term about building sustainable brands and changing manufacturing operations to command the fatter margins they need to stay alive.

Those entrepreneurs sitting with me at the Okura Garden Hotel are all developing strong brands—in fact, it is directly because of branding efforts that they have been able to beat local competitors over the past decade to emerge as domestic powers. They defeated state-owned enterprises, with their easy access to credit and political patronage, because they offered the market what it demanded and stayed ahead of trends. None had made their riches by being the stereotypical cheap Chinese original equipment manufacturer, squeezing razor-thin profits. They had created brands that had earned Chinese consumers' trust, and they had become rich in the process.

A decade ago, most Chinese brands competed on price, but not because Chinese inherently lack creativity or the government stifles creativity and innovation. Executives' focus on planning was more short term for several reasons.

First, incomes were still low. The dramatic, sustained rise in incomes and purchasing power that China has seen was only beginning, so it did not make sense to compete on anything but price. In the 1990s, China was steeped in real poverty. The average per capita gross domestic product (GDP) was less than $1,000 a year, and the majority of the country earned less than $300 a year, below the World Bank's definition of extreme poverty. Meat was often a luxury, and eating at a restaurant like McDonald's or KFC was reserved for special occasions. Hot showers were rare —most people still stood outside in full view of neighbors and passersby and used a bucket of water to wash themselves or went to company shower facilities on weekends. The lack of running water explains why even today getting your hair washed at a salon is an essential part of the hair-cutting process; in those days, a visit to a salon for a warm hair wash was a real treat.

Competing on anything other than price in that climate would have been foolish. Global brands took this strategy, launching global brands in China and investing for the long term. One Kodak executive told me in the 1990s they were investing not for short-term profits but to "make a lot of money 20 years from now." Fewer than 10 percent of Western brands selling into the Chinese market in the 1990s actually made money there, in part because no one could afford their products. Another reason was that Western brand positioning often did not fit the aspirations and needs of everyday Chinese people. It is hard to relate to Ralph Lauren, with its preppy lifestyle image of summering in the Hamptons, when you dream of indoor plumbing and eating meat for dinner.

The lack of profits and price sensitivity on consumers' part changed in less than a decade. In its 2010–2011 report, the U.S. Chamber of Commerce in Shanghai found that 79 percent of American companies now make money in China and 87 percent reported revenue growth in 2010, up from 47 percent in 2009. A thriving middle class, with the desire and the money to sustain brands that focus on more than just price, is fueling these profits.

Brand managers must cater to the demands and sophistication of the market into which they are selling, and in the China of the 1990s, levels of sophistication were pretty low. Few consumers had the money to buy real brands. It was natural that most Chinese companies and executive teams focused on maintaining low operating costs and sales channels to compete on price when consumers could not afford to care about branding and when labor and real estate costs were low enough to follow that strategy. Likewise, it is a natural progression that they are now evolving along with rising consumer sophistication to focus on building strong brands.

A second reason brands did not emerge earlier is the importance of connections during the disruptive shift in the late 1990s toward encouraging private enterprise. Executives used governmental and other business connections to grab quick profits. It did not make sense to spend money and time building a brand when it was so easy to make gobs of fast money through these connections.

Well-connected executives could lobby the government to erect a building, get a lucrative supply contract, or buy assets that the government wanted to divest on the cheap. One son of a government official who became a real estate magnate and head of a large import-export firm told me that in the 1990s, local officials literally gave away land

and sweetheart deals to well-connected people in an effort to bring business and investment dollars to undeveloped areas because everyone was so poor.

In such market conditions, why would smart executives try to establish brands? It takes decades, huge budgets, and patience to build brands that resonate with consumers. Sony and Toyota took decades to gain a true foothold in the imaginations of American consumers as anything but cheap alternatives to American brands such as General Electric and General Motors. Even Korean companies such as Samsung and LG Electronics still lack the same premium brand positioning as Japanese firms and are often seen as cheaper versions. Like Taiwanese brands such as phone maker HTC and computer maker Acer, they suffer from a perception of cheapness, even though their products rival the quality of any technology brand in the world.

Western businesspeople in China still love to tell one another about the quasimystical importance of *guanxi*, which many define as “connections,” when doing business with Chinese. But although good relationships are still important, as they are anywhere in the world, they do not have nearly the importance they once did and are not nearly as vital as creating sustainable businesses that fit consumer needs and aspirations. Women don’t buy lipstick because the owner of the brand is the son of some government official; they buy it because it makes them feel beautiful and vibrant. Nobody buys a shirt because a government official’s wife owns the company; they buy it because it fits their body type and aspirations.

Even in real estate, where connections are often paramount, the government is now making land-leasing processes more transparent as a result of a renewed government focus on raising tax revenue and sustainable development. Domestic real estate developers such as

ShiMao Group, Vanke, and SOHO China are grabbing market share because their branding and style attract Chinese home buyers; it's not because of connections. Many of the current political leaders' offspring are looking to Africa and other nations for investment because it is easier to leverage connections in those markets than back at home, where quick moneymaking schemes are harder to come by.

Branding has become critical for Chinese firms as the combination of product safety scandals and increasing wealth has forced consumers to become sophisticated, skeptical, and less trusting. Well-branded firms that build trust with consumers are the ones grabbing market share and charging premiums for their products and services. Domestic firms like medical device company Mindray, herbal beverage maker Wang Lao Ji, dairy products company Mengniu Dairy, travel services firm CTRIP, and sports apparel firms Li Ning and Anta have emerged in the past decade as serious competitors to Western brands in China and even slowly abroad. These domestic firms understand this brand-oriented shift toward value in consumer demand. Retail sales have been growing 16 to 18 percent a year for the past five years. Mindray's competitor, General Electric X-Ray, even relocated its business unit to Beijing from Waukesha, Wisconsin, in 2011 because it expects China to be the fastest global growth market for medical devices.

Numerous domestic companies have already established their brands within Chinese consumers' minds and are stepping into the global market. It would be shortsighted for Western brands to discount the abilities of domestic Chinese firms and their potential to compete globally, as observers such as Fallows do. To help lobby for its America-based initiatives and contracts, communications technology provider Huawei hired Amerilink Wireless, whose board includes retired U.S. Admiral William Owens, a former vice chairman of the Joint Chiefs of Staff; former U.S. House Majority Leader Richard Gephardt; and former World Bank President James Wolfensohn. Sports apparel maker Li Ning has set up design facilities near Nike's headquarters in Beaverton, Oregon.

One inevitable trend in the coming decades—now that rising costs and the end of easy money are forcing Chinese companies to become long-term strategic thinkers and look for new revenue models—is that more Chinese companies will go abroad. Western consumers had better get used to seeing Chinese brands, not just the "Made in China" stickers, on the shelves of America's retailers. Likewise, Western brands will have to start fending off competition from new emerging Chinese brands that will disrupt the world's markets and the global pecking order, much as Japanese firms did in the 1980s.

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The consumer market has risen so fast in China that Chinese brands have focused for the most part on capturing the domestic market. During the financial crisis my firm interviewed 500 senior executives with 100 of China's largest companies across 10 sectors. Many executives told us they have not made much effort to become global players because the Chinese domestic market is growing so fast and the best opportunities are still at home, explaining in part why Americans have never heard of their brands. They also worry they do not have enough talent at the middle-management level to grow well abroad. They do not want to lose long-term viability by making the same mistakes as Western brands did when they first went into China, so they often move into markets like Africa, Southeast Asia, or Eastern Europe, where local competition is weak and stakes are not as high if they misstep. A new focus on the Western world is emerging; as companies get more ambitious, they create a professional middle-management layer, and the central government supports the rise of national champions through low-interest loans and tax breaks.

Many companies have started to invest abroad for future growth, too, as Guo Guangchang's Fosun Group has done. More than 70 percent of executives told us that they would take advantage of the financial crisis to accelerate their international expansion plans into America and Western Europe by capitalizing on lower evaluations and cash-strapped competitors. They have been hiring leading advertising firms like Ogilvy & Mather and JWT to help shape their long-term positioning.

Branding is not an easy and short-term initiative. Chinese executives know this, so they often buy brands rather than build them. They have seen how long it took Sony, LG, and Samsung to become global players, and they do not want to wait so long. Instead of being second- or third-generation leaders, Chinese powerhouses still tend to be run by their founders, who made their success by conquering the impossible. Others run state-owned enterprises and are driven to make high-profile investments to help get promoted in the Communist Party ranks.

For example, under the stewardship of its founder, Li Shufu, auto manufacturer Geely bought the Swedish Volvo brand. Home appliance giant Haier bought the domestic and Southeast Asian operations of Japan's Sanyo. State-owned conglomerate Bright Food, China's second-largest food company, was rumored to have been in talks with Yoplait and nutritional supplement maker GNC before deals fell through, but it is still on the lookout for such megadeals. After buying Australian firm Manassen, Bright Food Chairman Wang Zongnan announced that he hopes 30 percent of its sales will come from overseas by 2016 and that he is actively looking to acquire more European or Australian companies in the food-distribution and sugar industries.

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As I said good-bye to those leading entrepreneurs in the Okura Garden Hotel that night, it became obvious that the rise of Chinese firms will disrupt world markets in a way most never could have imagined just a decade ago and that the country was as far from Mao’s vision of China as it could be. The end of cheap China means that Western executives need to be prepared to fend off increased competition from their aggressive, battle-hardened, well-capitalized counterparts. Western consumers will get used to choosing products at Best Buy or Target with prominent Chinese brand names, or brands owned by Chinese investors, instead of just those bearing “Made in China” stickers.

I was also left with some questions that I wanted to examine more closely. If these entrepreneurs had moved so quickly to build brands, what exactly had caused that change in such a short time? What changes in the labor force are forcing Chinese companies to go upstream? Was it because of soaring real estate prices, commodity markets, or something else? Visits to Chinese factories answered my questions.

CASE STUDIES WHAT TO DO AND WHAT NOT TO DO IN CHINA

Do Not Underestimate Domestic Chinese Brands' Quality

Western executives often foolishly scoff that Chinese brands could never compete with Western ones on anything but price. "They do not have the branding ability or focus on quality like the Japanese have," one global executive told me. He is underestimating the competition—never a smart thing to do.

Not only has the day arrived when many Chinese firms offer products that are as good as Western goods, but many compete head to head on quality and innovation. The Chinese business landscape is littered with global number one brands that failed when they hit China's shores. Critics complain that the government creates an uneven playing field by supporting domestic firms over foreign ones, but the reality is that search engine firm Google lost to Baidu because Baidu's technology for Chinese-language search was far better. Internet auction site eBay lost to Taobao because Taobao adopted an escrow-like pay system called Alipay that limited fraud, whereas eBay used Paypal.

Among the Chinese product companies starting to compete against Western brands is telecom giant Huawei, poised to overtake Ericsson as the world's largest network equipment maker. Huawei was recently chosen by Tele2 and Telenor over Ericsson in Sweden to install a 4G telecommunications system. Construction manufacturer LiuGong sells similar products to Caterpillar and Terex for 20 percent less. In interviews with dealers and end customers that my firm conducted,