



American Companies Building Success in China; Significant Issues Remain

Results of the 2005 USCBC Member Survey

August 30, 2005

Each year since 2001, the US-China Business Council (USCBC) has surveyed its members to provide a snapshot of the business environment in China and to gauge China's implementation of its World Trade Organization (WTO) commitments.

Among the key findings from this year's survey:

China is a top global priority for American companies...

- Seventy-one percent of respondents report that China is their company's top priority or within the top five priorities globally, indicating the growing importance of China in worldwide operations.
- Reflecting that importance, 74 percent of responding companies will increase their resource commitment to China this year, in terms of investment, expenditures, or executive time.

...with growing revenues and profitability

- A clear majority report growing China revenues: 67 percent report China revenues increased in 2004, and 68 percent report they expect a revenue increase in 2005.
- Countering perceptions that American companies' China businesses are not profitable, 44 percent report that profitability rates in China exceed profitability rates of their operations globally; another 22 percent say their China profits are in line with profits elsewhere.
- An overwhelming 94 percent of respondents stated that their company is optimistic or somewhat optimistic about their China business over the next five years.

China has done a "fair" job of fulfilling its WTO obligations...

- Three-fourths of survey respondents stated that China's WTO entry has been important to their business.
- Fifty-seven percent give China a "fair" grade in implementing its WTO obligations, while 38 percent said that China has done a good job.
- Tariff reductions and market openings top the list of important changes attributable to China's WTO entry.

...though significant issues remain

- Overall, the top five issues (which include WTO and non-WTO concerns) cited by companies operating in China are inadequate IPR enforcement, incomplete realization of distribution rights, insufficient regulatory transparency, human resource challenges, and remaining barriers to market access in service sectors.
- For many of the remaining top concerns, the most frequent complaint was that China appeared to have made limited progress in resolving outstanding issues in the last year, reflecting the need for stepped-up engagement in these areas.

The full report of survey responses follows.

Importance of China to Worldwide Operations

As part of our effort to gain a broader understanding of our members' involvement in China, the 2005 survey asked several questions to gauge the importance of China to companies' operations globally. These factors were not polled in 2004.

China as a business priority

USCBC asked companies how prominently China currently figures in their overall strategic planning (see Figure 1). More than half of respondents (58 percent) indicated that China was within their companies' top five priorities, and another 13 percent said that China was their top priority. Only 5 percent of respondents noted that China was not a priority for the company overall.

Resource commitment to China

The survey also asked respondents to estimate the level of investment, expenditure, and executive time that would be committed to China over the next 12 months (see Figure 2). The results show a clear trend toward increasing resource commitments to China operations, with three-quarters of respondents stating that their resource allocation to China will increase during the next 12 months.

Financial results from China operations

Next, USCBC inquired about companies' revenue from China operations in the previous year and their projected financial performance for the coming year (see Figures 3 and 4). The responses clearly show growing financial returns and optimism about future profits.

Almost 70 percent of respondents indicated that their revenue from China operations increased from 2003 to 2004. Eighteen percent indicated that revenues were unchanged. No companies indicated that revenues decreased in China in 2004.

For 2005, about 70 percent of respondents indicated they expect their companies' revenue from China to increase. Ten percent of companies predicted that 2005 revenues would remain unchanged.

The survey also asked companies to assess their expected profitability in 2005 against their 2004 results (see Figure 5). Again, nearly 70 percent

Figure 1: Prominence of China in Overall Company Strategy

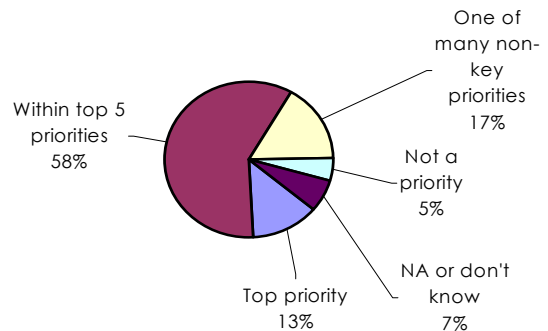


Figure 2: Company Resource Commitment to China in Next 12 Months

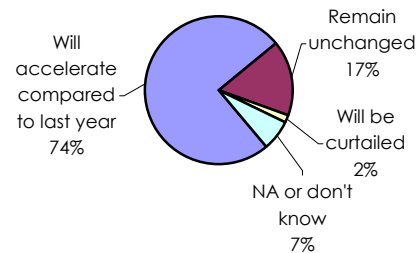


Figure 3: Revenue from China in 2004 vs. 2003

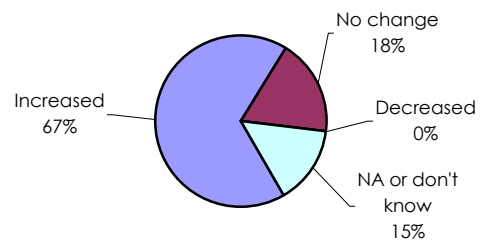
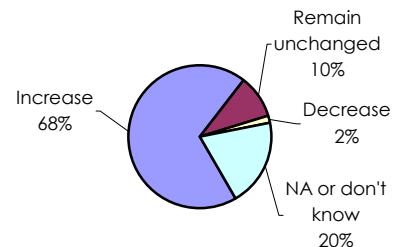


Figure 4: 2005 Revenues Are Expected to...



expect profitability in 2005 will be similar to or better than 2004 levels.

Next, the survey polled how companies' China operations fared as compared to operations as a whole (see Figure 6). Countering perceptions

Figure 5: Profitability of China Operations 2004 vs. 2005

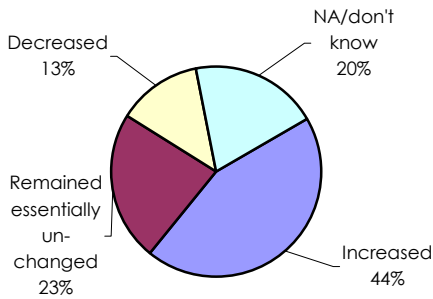


Figure 6: Profitability of China Operations vs. Company as a Whole

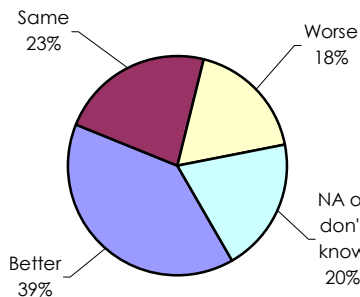
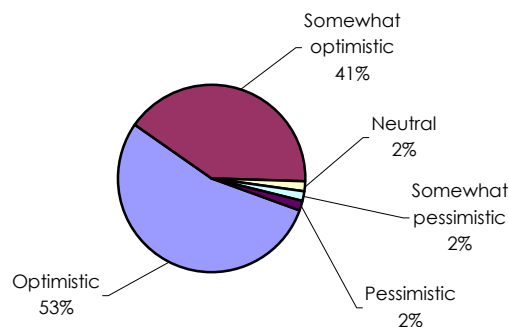


Figure 7: Five-Year Outlook for Your Company's Business in China



that American companies' China business is not profitable, nearly two-thirds of respondents stated that their profitability in China meets or exceeds profitability rates for their company as a whole.

Finally, respondents were asked to provide a sense of how their companies would fare in China over the next five years (see Figure 7). Ninety-four percent indicated they were optimistic or somewhat optimistic about their companies' prospects in China.

Top Operating Issues in China

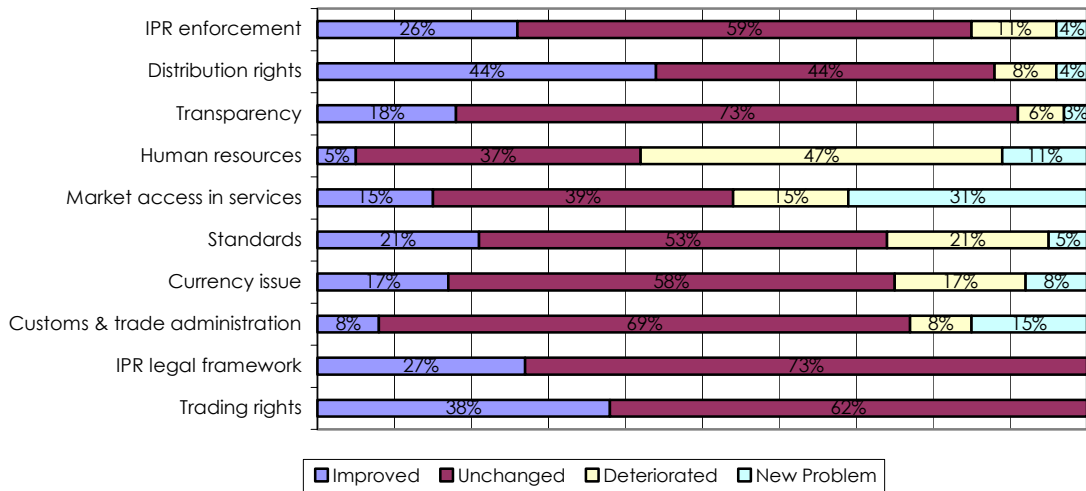
The survey asked respondents to rank the top five issues of importance to their companies in China. Respondents were then asked to assess the progress that China had made in addressing those issues in the past year (see Figure 8). The results are listed below and ranked in order of importance. Unsurprisingly, the top two issues for respondents were IPR enforcement and distribution rights, though the ranking of these two issues reversed in the last year.

Inadequate IPR enforcement moved up to become the top issue this year. The majority of respondents felt that the IPR enforcement situation had not changed since 2004, though a quarter said that enforcement had improved during the year. A minority felt that enforcement had deteriorated (11 percent) or noted that new problems had arisen (4 percent). Last year's survey found that 65 percent of respondents thought there had been some progress, and the balance said no progress had been made.

The survey also asked respondents' views of China's December 2004 judicial interpretation of IPR law, which introduced tougher criminal and other sanctions (see Figure 9). Responses were almost equally divided between those who said IPR protection had improved in areas covered by the interpretation (36 percent) and those who said there had been no resulting change (39 percent) so far.

Distribution rights was the second-most frequently cited issue. "Distribution rights" refers to a foreign company's right to sell in China product it imports or sources from third parties; previously, foreign companies could only sell in China what they made in China. Under China's WTO entry terms, the country was to allow foreign-invested companies to engage in distribution activities beginning December 11, 2004.

Figure 8: Degree of Progress of Top 10 Issues



In this year's survey, of respondents citing distribution rights concerns, 44 percent said implementation had improved and a similar number said there had been no change. Less than 10 percent of respondents noted that distribution rights had deteriorated over the past year or identified new problems. These results reflect some progress in the government's granting of approvals to foreign firms for distribution activities. But the responses also reflect the fact that several related issues remain to be addressed that would allow full realization of this commitment.

The issue with the largest jump in importance for companies this year is policy and regulatory transparency. Lack of transparency creates an uncertain environment for companies that attempt to do business in China. In 2004, it was the sixth-most-important issue for members; this year it ranked third. More than three-quarters of respondents in 2004 said transparency had improved in China. In 2005, 73 percent said there had been no improvement in the last year.

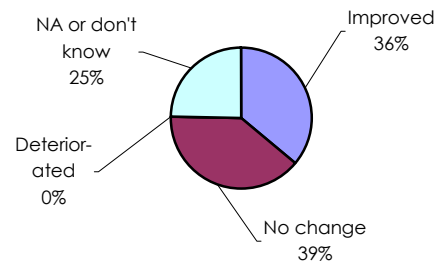
Two new issues jumped into the ranks of this year's top 10 concerns, although neither reflect regulatory matters: human resources, ranked fourth; and currency, ranked seventh. With regard to human resources, the most frequently cited problem was competition for qualified employees. The demand for talented workers continues to affect recruiting and retention, leading to higher turnover on the one hand and increased costs for training and retaining staff on the other. Nearly half of respondents identifying human resources as

a problem said the situation had become more challenging in the last year.

Currency was cited as a source of strain on the political relations between the United States and China. Most respondents indicated the situation remained unchanged in 2005, although the survey took place prior to China's late-July adjustment of its exchange rate policy. Only two companies cited the exchange rate as a factor affecting their costs or competitiveness; most respondents are more concerned about potential legislative actions coming out of Congress.

Market access in services ranked fifth in importance to USCBC members; in 2004, the issue was seventh. In 2004, about half of respondents felt China had made progress in implementing its services market access commitments. In 2005 that number fell to 15 percent; more important, 31 percent indicated that new problems had arisen,

Figure 9: IPR Protection after December 2004 Judicial Interpretation



the highest such response for any of the top 10 issues. Industries in which market access is an issue include insurance, construction, direct sales, and telecom services.

The setting of product standards moved up two spots in importance, to sixth, in 2005. Last year, almost three-quarters of respondents felt there had been progress in China's implementation of internationally accepted standards. This year, roughly half said no progress had been made.

Trading rights and China's IPR legal framework dropped notably in this year's rankings. Trading rights moved from the third-most-important problem in 2004 to tenth this year, as China issued rules for foreign companies to obtain import and export rights. China's IPR legal framework dropped from fifth to ninth place, reflecting that the main IPR concern now is over enforcement of regulations, not the regulations themselves.

WTO Impact and Implementation

USCBC's 2005 survey also polled companies about the impact of China's WTO entry on their operations in China and their assessment of China's progress in fulfilling its WTO commitments.

General views of WTO entry

First, the survey asked members whether China's WTO accession had been relevant to their companies (see Figure 10). In a clear indication of the importance of China's WTO entry, 75 percent of respondents responded affirmatively.

Next, respondents were asked to grade China's efforts in implementing its WTO commitments (see Figure 11). More than half of the respondents gave China a grade of "fair," and another 38 percent said implementation had been "good." Only 5 percent graded China's efforts as "poor."

These findings are consistent with last year's survey results. In 2004, most respondents gave China's implementation efforts a "5" on a 10-point scale, which is roughly equivalent to a "fair" grade.

Most important WTO commitments

Respondents were asked to identify the most important commitment China made in its WTO accession agreement (see Table 1).

Tariff reductions were noted as China's most significant WTO commitment. China's average

Figure 10: Was China's WTO Entry Relevant to Your Company?

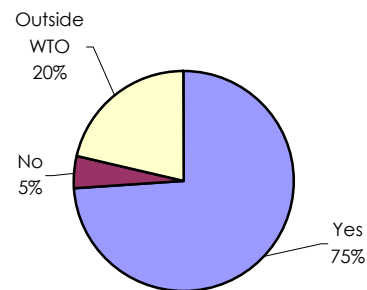
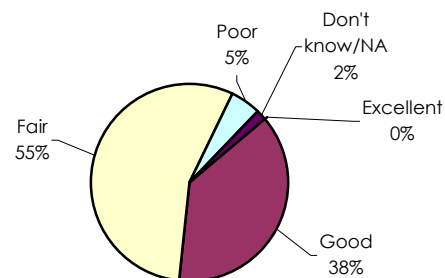


Figure 11: WTO Implementation Grade



import tariff rate dropped from 15.3 percent when China entered the WTO in 2001 to 9.4 percent at the beginning of this year.

China's financial services openings were cited as the second-most-important set of WTO commitments. Close behind were trading and distribution rights. Fourth in importance was China's set of IPR commitments.

Most significant WTO implementation shortfall

Next, the survey asked respondents to identify the issues that China had not implemented in accordance with its accession protocol (see Table 2).

Members cited inadequate implementation of China's commitments on trading and distribution rights by a margin of 10 percentage points ahead of problems in IPR enforcement.

Table 1: Most Significant WTO Commitments

Commitment	% of Responses
Tariff/duty reductions	28
Financial services	19
Trading/distribution rights	14
Intellectual property rights (IPR)	9
Foreign ownership/investment	6
Direct selling rights	3
Energy beyond petroleum	3
Market access generally	3
Right of establishment	3
Transparency	3
Other	9

Table 2: Most Significant WTO Shortfalls

Shortfall	% of Responses
Trading/distribution rights	32
IPR enforcement	19
Local content requirements	13
Market access	6
WTO commitments still pending	3
Construction	3
Direct selling	3
General barriers to trade & competition	3
Lack of bankcard law	3
Local branching	3
Transparency	3
Other	9

Local content requirements and market access were cited as the next-largest areas of concern.

Demographics of Respondents' China Operations

Respondents' location

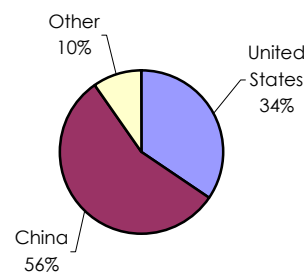
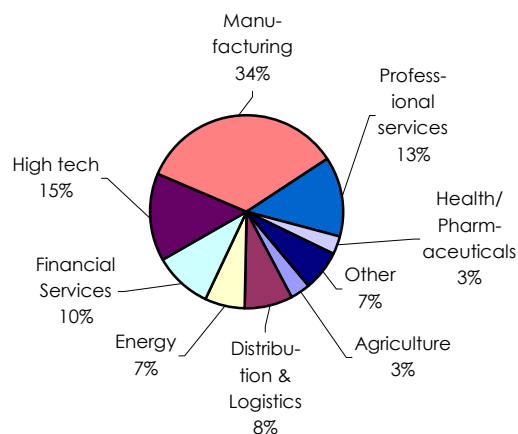
Slightly more than half of the 61 respondents of this year's survey were based in China (see Figure 12). Another 35 percent were based in the United States, and the remaining 10 percent were in other locations, such as Hong Kong or Canada.

Respondents' business sector

This year's survey participants were more evenly spread across manufacturing and service sectors than in previous years (see Figure 13).

Manufacturers made up the largest category of survey respondents, totaling 34 percent of all responses. High-tech and professional services companies were the two next-largest concentrations of companies. Responses from financial services companies ranked fourth in this year's survey.

In 2004, manufacturers (45 percent) were also the most heavily represented, but no other sector came close to their level of participation. The increasing proportion of service sector responses vis-à-vis manufacturers is likely to continue as

Figure 12: Business Location of Respondents**Figure 13: Business Sector**

more service sectors are opened to foreign investment.

Legal vehicle for China operations

The variety of options for doing business in China continues to expand as China opens up its economy to foreign participation (see Figure 14). To gauge this development, the 2005 survey asked USCBC members about the types of legal vehicles their companies have in China. Multiple responses were accepted. Similar data was not collected in previous surveys.

The top three types of vehicle were, in descending order, 100 percent foreign-owned companies (also known as wholly foreign-owned enterprises or WFOEs), joint ventures (JVs) with Chinese partners, and representative offices. Other vehicles include holding companies, research and development centers, regional headquarters, foreign-invested companies limited by shares (FICLS or FISC), branch offices, and law offices. No respondents indicated they had yet established, at

the time of the survey, a foreign-invested commercial enterprise (FICE) – a new vehicle introduced this year for retail, wholesale, and other distribution purposes.

These numbers are consistent with the rise of WFOEs in China. Beginning in 2000, WFOEs surpassed JVs as the most popular investment vehicle in China, and WFOEs accounted for 70 percent of approved projects in China in 2004. As China continues to implement its WTO commitments, more sectors will be opened up to full foreign ownership, and the shift from JVs to WFOEs will likely continue.

Length of time in China

The respondents report a solid history of doing business with China (see Figure 15). Seventy-one percent of respondents indicated their companies have been actively engaged in or with China for more than 10 years. Another 17 percent have been working with or in China for 5 to 10 years.

Direct employees in China

American companies are increasing their workforces in China as they establish themselves in the market (see Figure 16). Five percent of respondents now employ more than 10,000 workers in China. Another 22 percent have between 1,000 and 10,000 employees. Yet roughly 70 percent still employ fewer than 1,000 staff in-country, indicating that many American companies remain in the early stages of market development.

The US-China Business Council is the leading organization of US companies engaged in business with the People's Republic of China. Founded in 1973, the USCBC provides extensive China-focused information, advisory, and advocacy services, along with comprehensive events, to nearly 250 US corporations operating within the United States and throughout Asia.

Figure 14: Legal Vehicle

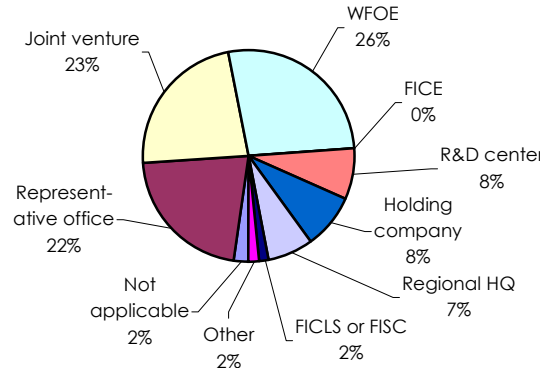


Figure 15: Time in China

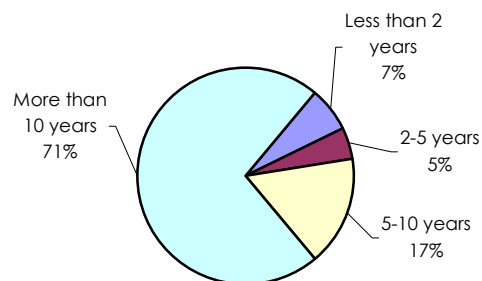


Figure 16: Direct Employees in China

