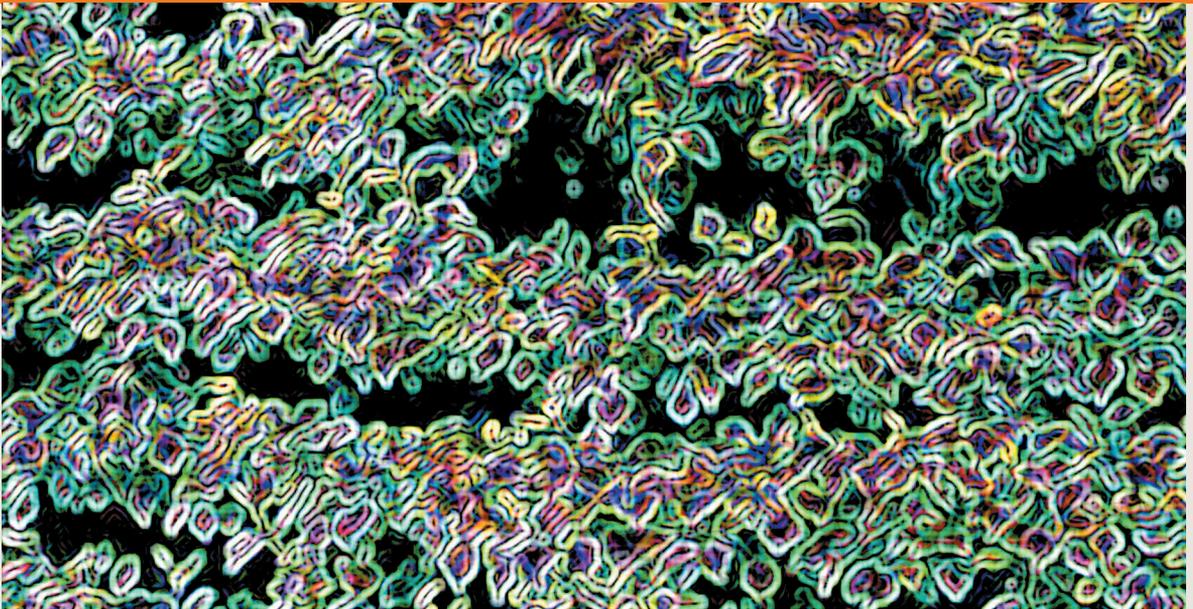


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BASQUE INSTITUTE OF COMPETITIVENESS

Basque Chair of
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Series

The Basque Firm in China



The Basque Firm in China

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**Jon Azua
Mikel Navarro
Iñaki Peña
María Astigarraga
Beatriz Tejedor
Miren Madinabeitia**

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This book was written by Jon Azua, Mikel Navarro and Iñaki Peña, Senior Researchers at Orkestra-Basque Institute of Competitiveness and Basque Chair of Competitiveness lecturers; by María Astigarraga and Beatriz Tejedor of B+I Strategy and by Miren Madinabeitia, Director of the Shanghai SPRI office.

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Mundaiz 50, E-20012, Donostia-San Sebastián
Tel.: 943 297 327. Fax: 943 279 323
comunicacion@orquestra.deusto.es
www.orquestra.deusto.es

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Prologue

This Report is the first attempt by the Basque Chair of Competitiveness in China to identify the factors involved in being competitive “in” and “from” China. It was conceived as a key tool to facilitate strategic decisions that Basque companies and institutions have to take in order to deal with the challenge of competitiveness.

At the same time, this Report is a response to the commitments inherent to the Chair. It is in keeping with our double target of understanding and interpreting the keys to competitiveness throughout the world, as well as the design and implementation of our model of competitiveness (2020 Basque Competitiveness Model) in an intense ongoing learning process.

The Basque Chair of Competitiveness (BCC - Basque Chair of Competitiveness) is the “nodal tool” that Orkestra-Basque Institute of Competitiveness has endowed itself with to spread its ideas and practices throughout the world in those areas of relevant interest for our evolving model of competitiveness. It also gives support to our businesses in their globalization and growth strategies from their head offices in the Basque Country. In the case of China, the Chair will have its base in the CEIBS (China Europe International Business School) with SPRI-Basque Government sponsorship, responding to the basic criteria of “nodal antennae”:

1. Support for interrelated sponsors who guarantee their activity in the medium-long term
2. In partnership with a local body of maximum prestige and local and international recognition.
3. A clear platform for the triple task of insight, instruction and interaction (the “3i”) in the bid for competitiveness, which impregnates the Institute’s value proposal.

This Report has been developed as a starting point to facilitate understanding of a complex reality (“the thousand faces of China”, in the words of Professor David Gossett, at CEIBS) and the role that Basque companies have to play in China to strengthen competitive strategies in the increasingly complex process of economic *glokalisaton*. A major new step in our learning process, the Report is part of our firm commitment to updating and making progress on a regular basis.

Finally, I would like to thank everyone who has worked on the draft and, in particular, B+ Strategy, the group of teachers from the seminar “Being Competitive *in/from* China” held in Shanghai last July (2008) as part of our Chair’s activities and, of course, SPRI (with the prominent role of its Shanghai office), the sponsor of the Chair—and of Orkestra-Basque Institute

of Competitiveness itself—without whose active participation this initiative would never have been possible.

Jon Azua

*Basque Chair of Competitiveness
at CEIBS, Shanghai*

Donostia, March, 2009

1. A view of the Chinese economy

1.1. Introduction

The importance of this first Report on competitiveness *in/from* China resides in the growing interest awakened throughout the world by the high growth rate and omnipresence of this major player. China is present either voluntarily, as a result of a clear strategic option that leads our firms to opt for the country, or simply because China introduces itself in our firms and markets. Either way, we simply have to know and understand the keys to the country's Competitiveness. It is not just a question of identifying the way to be competitive in China, but also of formulating strategies that will improve the competitive structure of our resources *in/from* China itself.

This chapter seeks to explain the critical factors that underlie competitiveness and welfare in order to place the complex reality of China in its proper context. Prior knowledge is essential for defining successful strategy.

Nevertheless, over and above the different lessons the indicators offer us in evaluating the relevance of China in the current world competition context, we should also consider a series of critical factors that help us to understand "China Fever" (a factor Marco Polo had already heralded), by integrating the two sides of the "yellow" coin: the Chinese **threat** and the magnificent "El Dorado" of **opportunity**.

To proceed with the analysis of these considerations, it is worth mentioning a series of highly enlightening observations made by professor David Gosset¹:

1. The best approximation to the knowledge of China is made by breaking down its long process towards rebirth (its re-emergence as world leader, its political transformation, the intellectual reinterpretation of its culture and values), with a background of high quality debate.
2. We non-Chinese are a problem: our imagination means we get a predetermined, distorted image.
3. China is, first and foremost, a complex reality. We think of China as a "Nation-State" when the best approximation would be to see it as a "Far-eastern European Union". There are "One Thousand Chinas".
4. We cannot understand China without looking at her on the map. Behold its 10 million square kilometres and the 14 different countries that border it, including its 56 ethnic

¹ David Gosset. "Being Competitive in/from China" July 2008. Prof. at CEIBS. Director of Simica Academy in Europe.

groups and the mass of foreigners that live within its frontiers (for example, two million Koreans, 30 million former inhabitants of the ex-USSR, 25 million Mongolians, 9 million Turks and other Muslims, to give just a few examples).

5. China is organised in concentric circles, like a network of networks (not only within its own physical space, but also throughout the world, around 4 Municipalities, 22 Provinces, 5 Autonomous Regions and 2 Regions of Special Administration). Each one of these has its own powers, competences, make-up and differential strategies.

With these basic considerations in mind, we now need to explain and work—in an open, cooperative fashion—on the construction of our own competitive space in a country that is now impacting on our entire economy (whether we are aware of this or not).

1.2. Wellbeing and competitiveness

In the early nineties, the Organisation for Economic Cooperation and Development (OECD) published the well-known report *Technology and Economy. The key relationships*, which argued that a country's competitiveness basically consisted of its capacity for keeping up a sustained increase in the wellbeing of its citizens. In many analyses (even the OECD report quoted), wellbeing or prosperity tends to be made equivalent to material wealth and thus tries to assimilate or equate to indicators such as *per capita* GDP. With a view to approaching the standard of living of citizens in a broader way than usual, the United Nations Programme for Development drew up and began to publish the Human Development Index (HDI), inspired by the works of Indian economist and Nobel Prize-winner Amartya Sen. It offers a measurement made up of three dimensions of human development: a long and healthy life (measured in terms of life expectancy at birth), education (measured in terms of the literacy of adults and the gross rate of matriculation in primary, secondary and higher education) and a reasonable standard of living (measured in terms of the *per capita* GDP in purchasing power parities). However that may be, some key aspects of human development have still not been introduced into this indicator, as in the case of the respect in society for Human Rights, Democracy or Equality.

As Table 1.1 shows, China, at 82, is in an average position regarding the 177 countries for which the United Nations calculates the HDI. Of the larger emerging countries and countries of the EU enlargement with which it competes, only India ranks in a lower position: 129. Latin American countries (especially Argentina) and Russia are ahead of her, as are the four countries of the enlargement (4PA) belonging to the OECD (Poland, Hungary, Czech Republic and Slovakia). The differences are still greater if we compare them with Spain (to say nothing of the Spanish autonomous community, or region, of the Basque Country (BC)). On the other hand, the position of China in the HDI ranking is slightly better than that for *per capita* GDP, an aspect in which it differs from India, Russia and Brazil. This must basically be put down to the good figures it has for life expectancy.

In any case, the simple, definitive nature of *per capita* income (measured as *per capita* GDP in purchasing power parities) makes it the best measurement. It is, furthermore, easily available to any country when it measures its competitive impulse. Let us see, then, the relative position occupied by China when using this approach.

Table 1.1 shows that in 2007, China's *per capita* income was about 5,000 PPP-\$, which, although practically doubling the figure for India, was almost half that of Brazil, and between 2.5 and 3 times less than Mexico, Argentina and Russia. China's *per capita* income is still a long way from the figure for the 4PA countries, and is almost 6 times less than Spain's, and 7 times less than the Basque region.

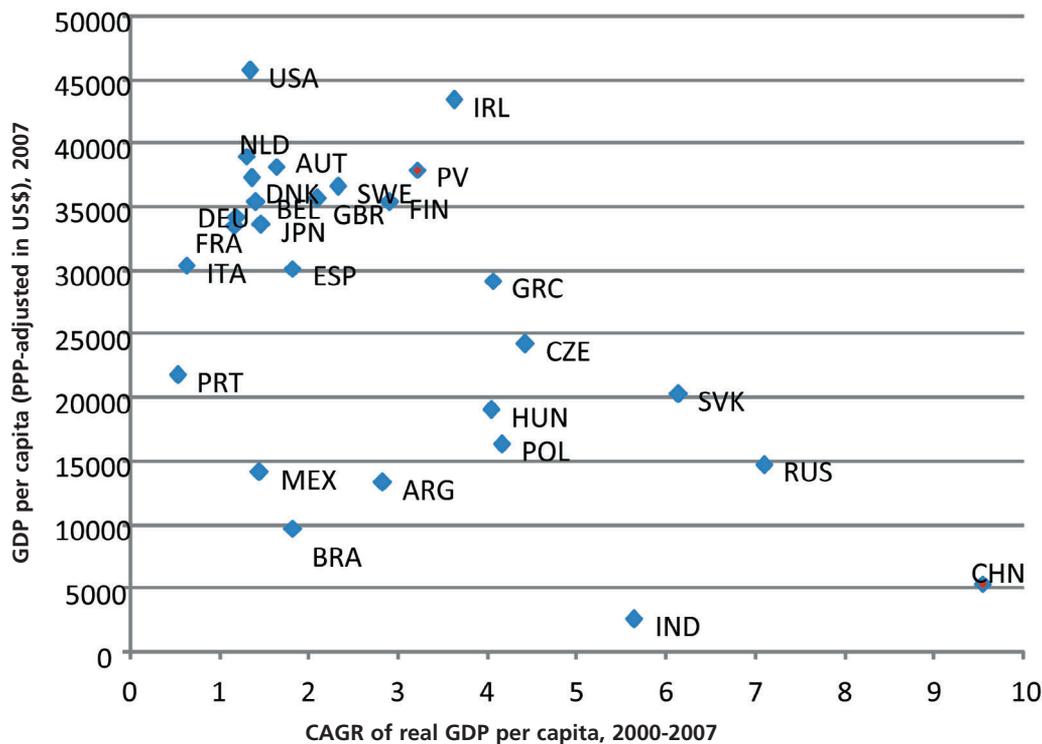
Nevertheless, if we take account of the evolution (rather than the actual level), China had the highest growth in *per capita* income in the 2000-2007 period, followed by Russia (where growth is largely due to the rise in energy prices) and India. China in fact registered better results than India not only in the growth rate of *per capita* income, but also began to take off earlier: China in the late seventies, and India in the early nineties. The take-off in India suffered a delay with regard to China and has still not reached the latter's impulse. After these countries comes the 4PA group, whereas emergent Latin American countries have shown a poor recovery of their *per capita* income in the present decade. As regards the more advanced countries, growth was high in Ireland, the BC and Finland, followed by Sweden and United Kingdom. Three of the biggest EU-15 countries (Germany, France and Italy) performed poorly, bringing down the figures for the EU-15 group as a whole.

Table 1.1. Human Development Index for 2007

Country	HDI Rank	Human development index (HDI) value	GDP Rank	GDP per capita (PPP US\$)	GDP per capita (PPP US\$) Rank minus HDI Rank	Life expectancy index	Education index	GDP index
Iceland	1	0.968	5	36,510	4	0.94	0.98	0.99
Norway	2	0.968	3	41,420	1	0.91	0.99	1.00
Basque Country	-3	0.964	(8)	34,026	5	0.93	0.99	0.97
Australia	3	0.962	16	31,794	13	0.93	0.99	0.96
Canada	4	0.961	10	33,375	6	0.92	0.99	0.97
Ireland	5	0.959	4	38,505	-1	0.89	0.99	0.99
Sweden	6	0.956	13	32,525	7	0.93	0.98	0.97
Switzerland	7	0.955	6	35,633	-1	0.94	0.95	0.98
Japan	8	0.953	17	31,267	9	0.95	0.95	0.96
Holland	9	0.953	12	32,684	3	0.90	0.99	0.97
France	10	0.952	18	30,386	8	0.92	0.98	0.95
Finland	11	0.952	14	32,153	3	0.90	0.99	0.96
United States	12	0.951	2	41,890	-10	0.88	0.97	1.00
Spain	13	0.949	22	27,169	11	0.93	0.99	0.94
Denmark	14	0.949	8	33,973	-6	0.88	0.99	0.97
Austria	15	0.948	9	33,700	-6	0.91	0.97	0.97
United Kingdom	16	0.946	11	33,238	-5	0.90	0.97	0.97
Belgium	17	0.946	15	32,119	-2	0.90	0.98	0.96
Luxembourg	18	0.944	1	60,228	-17	0.89	0.94	1.00
New Zealand	19	0.943	24	24,996	9	0.91	0.99	0.92
Italy	20	0.941	21	28,529	1	0.92	0.96	0.94
Hong Kong, China	21	0.937	7	34,833	-14	0.95	0.89	0.98
Germany	22	0.935	20	29,461	-2	0.90	0.95	0.95
Israel	23	0.932	23	25,864	3	0.92	0.95	0.93
Greece	24	0.926	25	23,381	5	0.90	0.97	0.91
Singapore	25	0.922	19	29,663	-6	0.91	0.91	0.95
Czech Republic	32	0.891	27	20,538	2	0.85	0.94	0.89
Hungary	36	0.874	28	17,887	2	0.80	0.96	0.87
Poland	37	0.870	30	13,847	11	0.84	0.95	0.82
Argentina	38	0.869	29	14,280	9	0.83	0.95	0.83
Mexico	52	0.829	32	10,751	7	0.84	0.86	0.78
Russia	67	0.802	31	10,845	-9	0.67	0.96	0.78
Brazil	70	0.800	33	8,402	-3	0.78	0.88	0.74
China	82	0.777	34	6,757	5	0.79	0.84	0.70
India	129	0.619	35	3,452	-11	0.65	0.62	0.59

Source: United Nations and Eustat.

Graph 1.1. 2007 GDP *per capita* (PPP US\$) and Compound annual growth rate (CAGR) of real GDP *per capita*, between 2000 and 2007



Source: IMF and Eustat. Authors' analysis. Authors calculations.

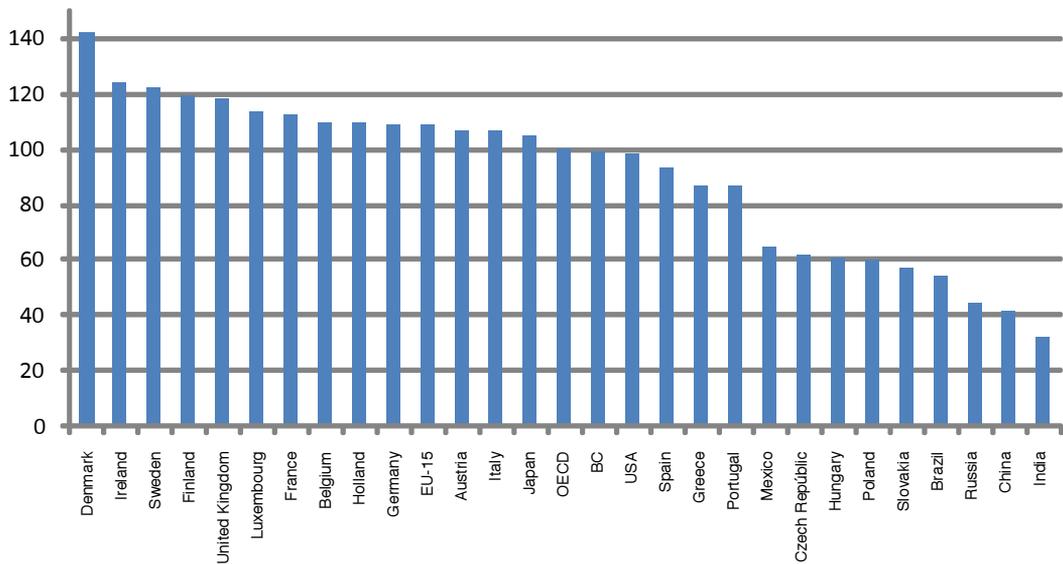
The fact that *per capita* income should have grown more in emerging countries and those in transition than in the developed countries in the table has permitted a certain process of convergence in living standards, although differences are, of course, still very significant.

Per capita income was expressed in the graph above in purchasing power parities in dollars. The reason for this is that short-term changes in the market do not reflect differences in the general level of prices; with the same amount of dollars or euros, the quantity of goods or services that can be acquired will vary from country to country. With a view to correcting this factor, international bodies tend to calculate the purchasing power parities, which enable the conversion of values expressed into market exchange rates for different general levels of prices as they exist in each country. In the case of the BC, it is normal to apply the same PPP value as applied to Spain, because the differences in the general level of prices vary substantially from one autonomous community to another. That is why, in the case of BC, we have corrected what is generally given for Spain by OECD with the difference in the general levels of consumer prices, which, by Spanish autonomous communities or regions, is usually published yearly by *Cuadernos de Información Económica*. In Graph 1.2 these differences are included in the general cost levels.

In general, differences in overall cost levels reflect the differences in the costs of inputs, in the efficiency of the use of these inputs by the domestic sector and in indirect taxation. The graph in question shows that the general cost level in China, though superior to India's, is low.

It is followed by Russia, and at a slightly higher level, by the emerging Latin American countries and those of the 4PA group. As regards the triad, USA and Japan have general cost levels slightly lower than the EU-15 average, in which Scandinavian and Anglo-Saxon countries stand out for their high levels, whereas countries in southern Europe have lower levels. With the aforementioned correction, the general cost level for the BC is practically identical to the OECD average.

Graph 1.2. Comparative Domestic Cost Levels



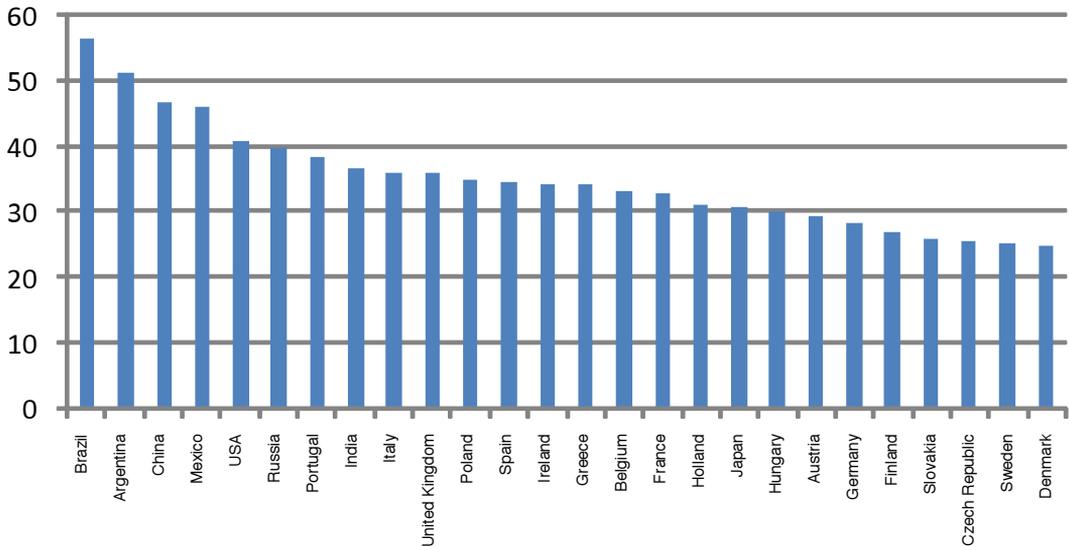
Source: OECD and *Cuadernos de Información Económica*. Authors' analysis. Authors calculations.

From the former we gather that *per capita* income levels for China are comparatively much lower when expressed, instead of in PPP-\$, without correction in dollars or euros. This discrepancy will also be present in any variables expressed in market exchange rates and in PPP. For example, the GDP for China, which measures the size of her economy, is 10.8% of the World GDP, as expressed in PPP-\$, but only 6% as expressed in dollars. But if we see country rankings in terms of GDP, China would be fourth, after the USA, Japan and Germany, when GDP is expressed in dollars or euros. But China would be a clear second in the ranking, behind the USA, if the GDP were measured in PPP.

Although *per capita* income reflects, in a simple and direct way, the wellbeing of the population, we must not overlook the fact that the value it gives us is only the country's average. Although the average is a major indicator, the standard deviation is also important. Indeed, rather than strive to increase the average level of its *per capita* income, a country should also ensure that income distribution is balanced, without undue inequalities that may be criticised from an ethical point of view and also for their effect on social cohesion and stability. They may also be taken as indicators of an equal opportunity deficit that affects the efficiency of the system negatively, by not taking full advantage of talent and having a negative effect on investment levels in education. A traditional indicator of inequality in income is the

Gini index, which is calculated in accordance with the distribution of consumption or income in population quintiles: a value of 100 indicates a maximum rate of inequality and a value of 0 indicates a maximum level of equality.

Graph 1.3. Gini's inequality index



Source: World Development Indicators 2008.

Note: Most recent Gini index data available for each country. The year for each country varies.

Graph 1.3 shows that the degree of inequality is generally greater in less developed countries than in developed ones; and of the developed countries, it is greater in Anglo-Saxon and southern European countries than in Scandinavia. In general, the 4PA group have low levels of inequality, although the fact that (for some) the values are quite old and refer to the mid-nineties may affect this reading.

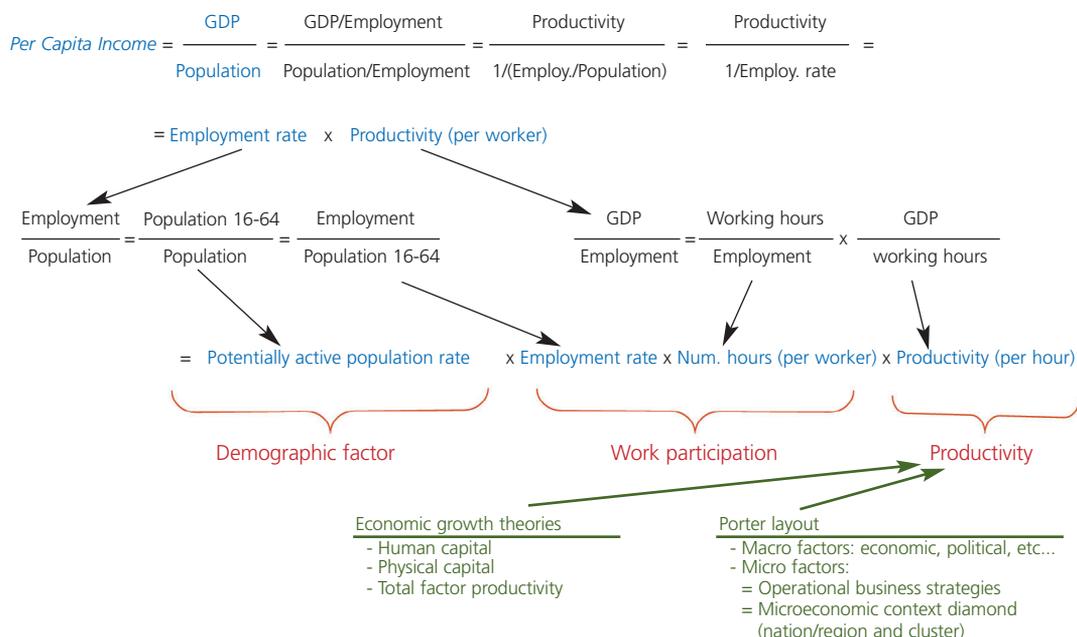
If we focus more closely on China, the graph shows that income is unequally distributed there. 1% of the population with the highest incomes hoards 10% of all income in China; 5% of the population with a higher income concentrates 25% of the income; and 10% of the population has 35%. Nevertheless, the growing level of inequality has run parallel to a reduction in the levels of severe poverty.

This inequality in income is reflected territorially in differences in income between coastal and interior zones, and between urban and rural zones. The difference was the result of the strategy followed by the Chinese Government as regards “permitting some regions to become rich first”, with the idea that scarce resources should be concentrated in places where maximum benefit could be reaped. Nevertheless, faced by the huge differences encountered, from the beginning of this decade the Chinese Government has introduced measures to correct these differences, and, as from 2001, the growth of *per capita* income in non-coastal provinces has been greater than in coastal ones.

1.3. Decomposing *Per capita* income

The level and evolution of *per capita* income can be explained both in terms of the GDP and population and by the employment rate and productivity (for more details, see Table 1.2). In this section we discuss the different variables into which *per capita* income can be broken down.

Table 1.2. Decomposing *Per capita* income



1.3.1. Population and GDP

If we analyse the breakdown on the basis of population and GDP levels, Table 1.3 shows that China and India are two huge countries, accounting for 20% and 18% of the world population respectively. Even countries such as Brazil or Russia, which are more than large enough to attract capital investment, have 7 times less population. China and India have five times more population than the USA, and 3.5 times more inhabitants than the EU-15. Faced by such giants, the Spanish population is approximately 30 times less than that of China, and that of the BC does not even reach 2 per thousand. For certain types of analyses, it is better to consider these two giants as continents rather than as mere countries.

China and India become much less significant if, instead of considering population, we take GDP as a reference. Although this is the most suitable way of measuring the size of an economy, with this latter measurement, relative significance is quite different depending on whether it is expressed in terms of GDP, with purchasing power parities, or in dollars: in the first case, the Chinese economy still stands for 11% of the world GDP (second only to the USA and overtaking Japan and Germany); whereas, in the second case, the economy of China only stands for 6% of the world's (overtaken by the Japanese economy, and practically at the same level as Germany). This is due to the lower general level of prices in China. Similarly, in terms of GDP, the other Asian giant, India, falls some way behind China when GDP is expressed in dollars: China's GDP tripled India's in 2007.

Table 1.3. Population and GDP (in thousands of millions of dollars and PPP\$) in 2007

	Population		GDP			
	millions	World %	mm of \$	World %	mm of PPP-\$	World %
Japan	128	1.9	4,382	8.0	4,292	6.6
USA	302	4.5	13,808	25.3	13,808	21.2
Austria	8	0.1	371	0.7	316	0.5
Belgium	11	0.2	454	0.8	377	0.6
Denmark	5	0.1	312	0.6	204	0.3
Finland	5	0.1	246	0.5	186	0.3
France	62	0.9	2,594	4.8	2,068	3.2
Germany	82	1.2	3,321	6.1	2,812	4.3
Greece	11	0.2	314	0.6	325	0.5
Ireland	4	0.1	261	0.5	188	0.3
Italy	59	0.9	2,105	3.9	1,788	2.7
Luxembourg	0	0.0	50	0.1	38	0.1
Holland	17	0.2	777	1.4	648	1.0
Portugal	11	0.2	223	0.4	231	0.4
Spain	45	0.7	1,440	2.6	1,352	2.1
-BC	2.1	0.0	90	0.2	81	0.1
Sweden	9	0.1	455	0.8	335	0.5
United Kingdom	61	0.9	2,804	5.1	2,168	3.3
Czech Rep.	10	0.2	175	0.3	250	0.4
Hungary	10	0.2	138	0.3	191	0.3
Poland	38	0.6	422	0.8	622	1.0
Slovakia	5	0.1	75	0.1	110	0.2
Russia	142	2.1	1,290	2.4	2,090	3.2
Mexico	105	1.6	1,023	1.9	1,486	2.3
Argentina	39	0.6	260	0.5	524	0.8
Brazil	189	2.8	1,314	2.4	1,837	2.8
India	1,169	17.5	1,101	2.0	2,997	4.6
China	1,321	19.8	3,280	6.0	7,035	10.8
World Total	6,671	100.0	54,585	100.0	65,281	100.0

Source: IMF, Economic Outlook database October 2008, and Eustat.

To show how these variations (in real terms) in GDP and population explain the alterations (also in real terms) of *per capita* GDP, Graph 1.4 clearly shows that in most countries, the variation in *per capita* income may basically be put down to growth in GDP. Although in this period the population of some countries significantly increased (which acts against growth in GDP), increases in *per capita* income were generally determined by increases in GDP. This is particularly true of China, a country which (in the decade covered by the Graph) had a real average yearly GDP growth rate of over 10%, with an average yearly accumulative population growth rate (0.6%) lower than the world rate of 1%.

Growth rates in other emerging countries have also been significant. Behind China come India and Russia, with yearly growth rates of 6-7% (in Russia's case, largely thanks to the rise in energy prices), the 4PA group (with rates between 4-6%) and, further down the list, the emerging Latin American economies (with rates between 2.5-4%). Real GDP growth rates in

the USA and in EU-15 countries were moderate: approximately 2.5% yearly, and even lower in Japan (1.5%).

Table 1.4. Variation, in real terms, of GDP *per capita*, GDP and population (between 2000 and 2007; CAGR)

	<i>Per capita</i> GDP	Real GDP	Population
Japan	1.5	1.6	0.1
USA	1.4	2.3	1.0
Austria	1.6	2.1	0.5
Belgium	1.4	2.0	0.5
Denmark	1.4	1.7	0.3
Finland	2.9	3.1	0.2
France	1.2	1.8	0.6
Germany	1.2	1.2	0.0
Greece	4.1	4.3	0.2
Ireland	3.7	5.6	2.0
Italy	0.6	1.1	0.5
Luxembourg	2.9	4.2	1.3
Holland	1.3	1.9	0.6
Portugal	0.5	1.1	0.6
Spain	1.8	3.4	1.6
- BC	3.2	3.6	0.3
Sweden	2.3	2.8	0.5
United Kingdom	2.1	2.6	0.5
Czech Rep.	4.4	4.6	0.1
Hungary	4.0	3.8	-0.2
Poland	4.2	4.0	-0.1
Slovakia	6.1	6.2	0.1
Russia	7.1	6.6	-0.5
Mexico	1.5	2.5	1.0
Argentina	2.9	3.8	1.0
Brazil	1.9	3.3	1.4
India	5.7	7.3	1.6
China	9.6	10.2	0.6
World total	3.0	4.0	1.0

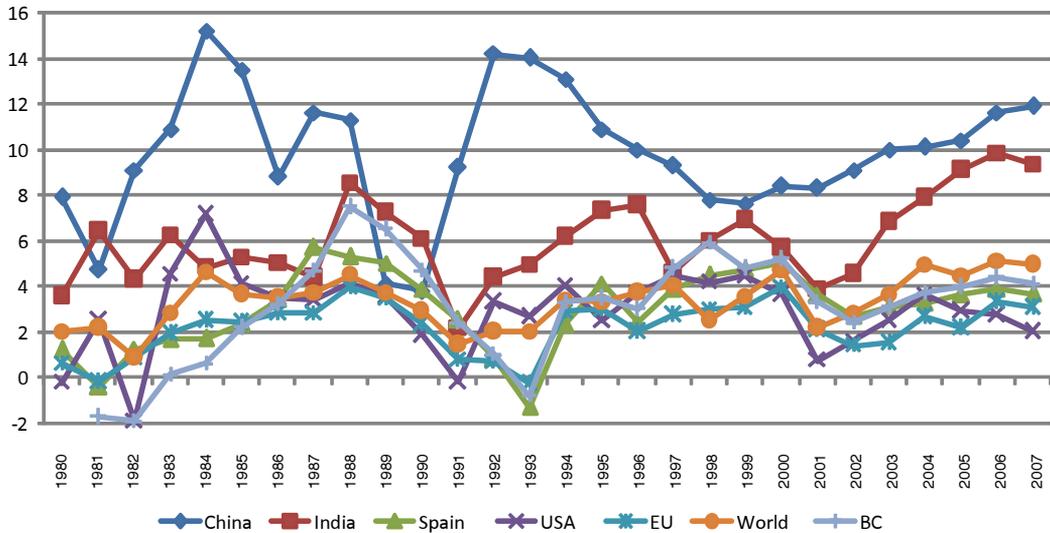
Source: *IMF, Economic Outlook database* October 2008, and Eustat.

CAGR: Compound Annual Growth Rate

Graph 1.4 shows the spectacular economic growth of China was not limited to the last decade, but began at the end of the seventies with the reforms introduced by Deng Xiaoping. With the exception of a few years of deceleration (between 1981 and 1989-90), rates have been maintained. Throughout this period, the Chinese economy grew at an annual average rate of 9.9% (i.e. three times the rate of the world economy). This is a growth rate without parallel, in terms of intensity, duration and the size of the economy involved, in world economic history. No country has ever had such an impact on the global economy as China.

Even India, the only country comparable to the Chinese giant, had a growth rate one third lower than China's, despite a greater increase in population.

Graph 1.4. Annual Real GDP growth rate between 1980 and 2007



Source: IMF, Economic Outlook database October 2008, and Eustat.

In comparison with the relative drop in the population curve for China, India shows the opposite tendency: the population grew significantly (an average of 1.6% annual accumulation), a much higher rate than the whole world's (1%). In the short run, this reduces the rhythm of growth of the country's *per capita* income, but in the long run gives India a younger population and, therefore, one with greater dynamism and capacity for growth in comparison with the relative ageing which, as we shall see, is beginning to take place in Chinese society. In general, both Russia and the 4PA group have greater similarities with the demographical dynamics of China, population growth rates being low (accentuated in the case of the 4PA by emigration to EU-15 countries), while emergent Latin American economies have major demographical growth, though still short of India's rate. Demographic evolution in the USA is quite dynamic, in contrast with almost null growth in Japan and small growth in the EU (including the BC), where only Ireland and Spain have shown significant growth, largely based on immigration.

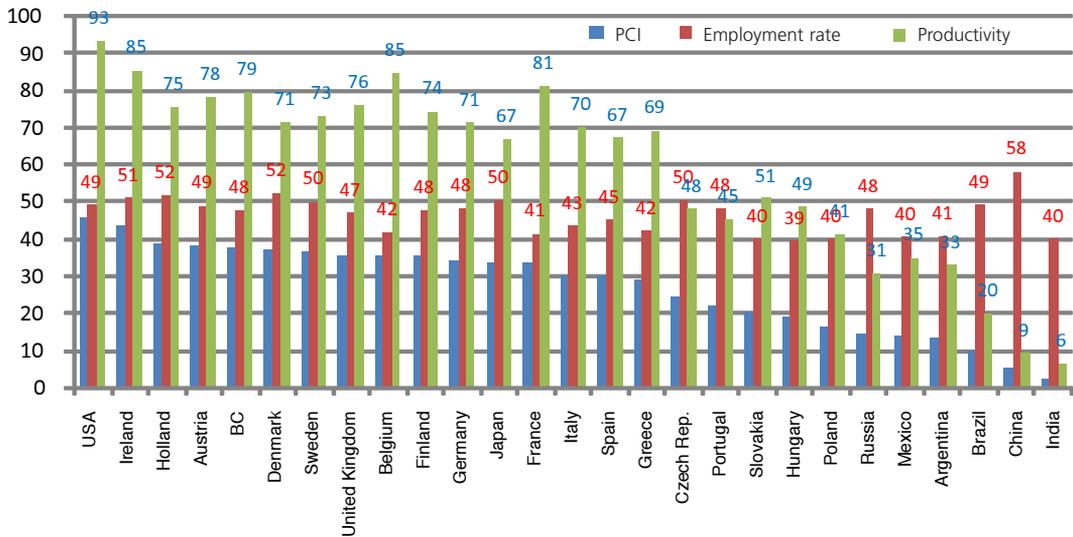
1.3.2. Productivity and employment rate

Per capita income can also be explained in terms of productivity and the employment rate (the latter, in turn, may be decomposed into a demographic factor and the deployment of the work force).

Graph 1.5 explains *per capita* income in terms of the employment rate (how many people do I put to work?) and productivity (how much income is generated by each one of those workers?). Graph 1.5 shows the countries ordered from left to right according to their *per capita* income rate. Differences in terms of productivity are superior to differences in employ-

ment rates, and differences in *per capita* income between territories are basically explained by differences in productivity.

Graph 1.5. *Per capita* Income (thousands of PPP-\$), employment rates (%) and Productivity (thousands of PPP-\$) in 2007



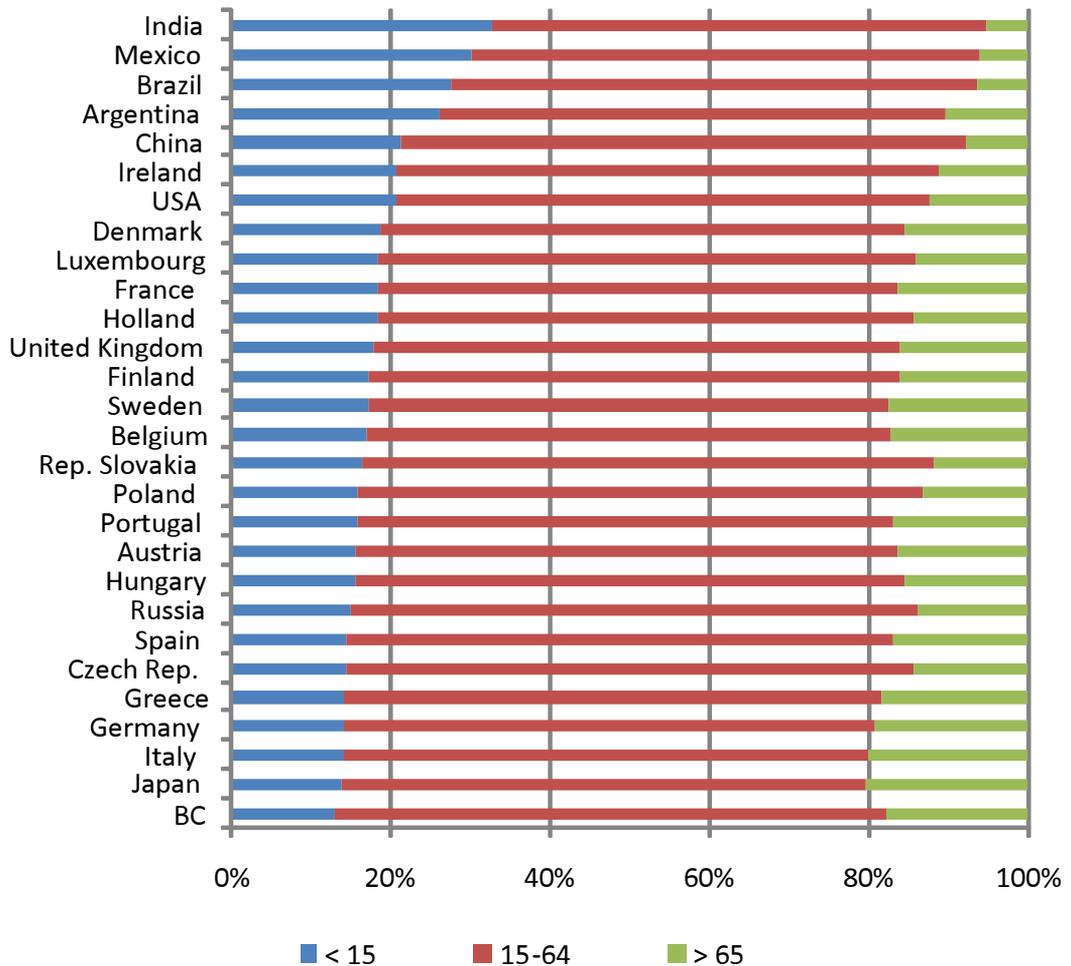
Source: IMF, Economic Outlook database October 2008; The Conference Board & Groningen Growth and Development Centre, Economy Database, September 2008; and Eustat.

However, to begin the analysis by differences in the employment rates, we must indicate that such differences are related both to demographic factors (ageing and dependence rate), and to social and cultural factors (young people and women coming onto the labour market and retirement or pension systems) or even to purely economic factors such as the labour market situation and unemployment (meaning that people willing to work are unable to do so). In the case of China, the combination of a less developed social security system (especially in the rural world) which means people have to continue working, and the promotion (by the Government) of women onto the labour market and the lower percentage of young people going on to higher education after secondary education, has led to record employment rates. The unemployment rate should reduce somewhat as the social security system develops, as more young people go on to higher education and ageing proceeds. We find the opposite situation in India, with the lowest employment rate of all the countries included in the graph, and one in which the deployment of the labour force would mean a considerable increase in the country's *per capita* income. In general, emergent Latin American economies and ones in the 4PA group (with the exception of Brazil and the Czech Republic) have higher levels of labour deployment; and in EU-15 something similar occurs in southern European countries.

Graph 1.6 takes a closer look at the demographic component referred to above. Indeed, the graph shows that a very high percentage of China's population is of working age (from 15 to 64). On the other hand, the percentage of the population aged 65 or over is very low. As regards population under the age of 15, due to the "single child" model promoted by the

Government, China is a long way from the high percentages of young people in the populations of other emerging economies in Asia and Latin America. At 21%, it is well below the worldwide figure of 28%. Nevertheless, compared with EU-15 countries, Japan or the 4PA group, a high percentage of its population is young. Whatever the case, of all the economies included in the graph, the BC has the lowest percentage of young people. Although in the short term this may enable the region to have a high percentage people of working age, in the future it raises serious ageing and labour availability problems.

Graph 1.6. Population distribution by age groups in 2006 (%)

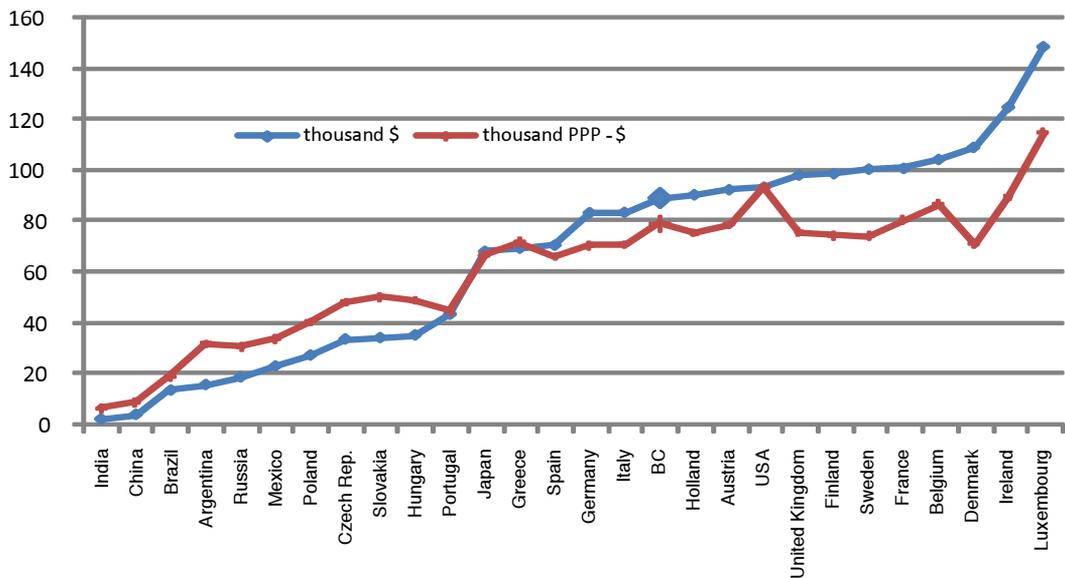


Source: World Bank, *World Development Indicators 2008*. Eustat.

Next, we classified countries by groups according to the productivity levels shown in Graph 1.5. The USA came first, followed by EU-15 and Japan; after that, the 4PA group and Portugal; Russia came next, followed by the emerging Latin American economies; and, finally, China and India.

However, productivity levels are highly conditioned by the way one expresses GDP as the numerator of the ratio. As we have seen, GDP may be measured in purchasing power parities or in currency units (dollars or euros). Although measurement in PPP enables one to better measure the quantity of goods and services generated by the country's workers, the second (in dollars or euros) better reflects the value acknowledged as generated output on the international markets. Thus, although the first is more appropriate for measuring the wellbeing generated by the worker's activity, the second is more common from the point of view of business competitiveness. In Graph 1.7, where both are reflected, emergent countries (including China) improve their positions when productivity is expressed in PPP, instead of in dollars or euros, whereas in more developed countries the contrary occurs. Even so, it is strange to see the small differences in productivity expressed in PPP between EU-15 countries and Japan (with the exception of Ireland and Luxembourg, closely linked to the contribution of production factors foreign to this result); in this set, the BC shows quite considerable productivity when expressed in PPP, but worse results, with regard to the EU-15 country average, when expressed in dollars.

Graph 1.7. GDP per employee in thousands of PPP-\$ and in thousands of \$, in 2007



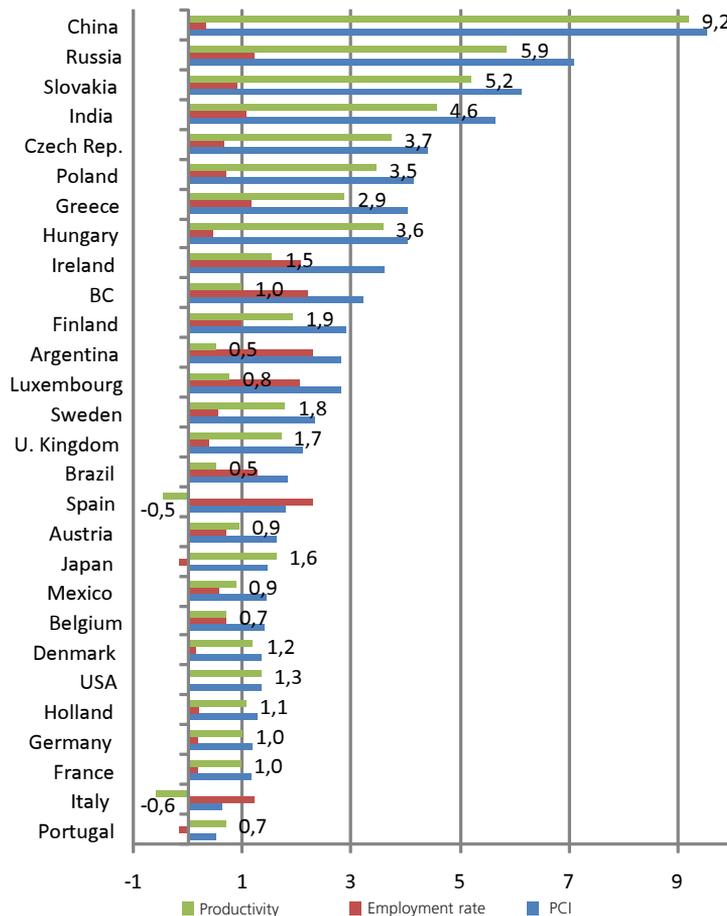
Source: IMF, *Economic Outlook database* October 2008; The Conference Board & Groningen Growth and Development Centre, *Economy Database*, September 2008; and Eustat.

Instead of focusing on levels reached by the employment rate and productivity in a particular year, we could turn our attention to the way they evolve in different countries.

Graph 1.8 shows that the models followed by countries to increase their *per capita* income differ greatly. In the case of China, spectacular growth in *per capita* income (9.5% a year) in the 2000-2007 period may be put down almost exclusively to increases in productivity (9.2%), whereas the contribution made by the employment rate is very small (0.3%). Indeed, once this country had reached employment rates that were as high as those shown above, it

was hardly possible to increase the percentage of employed population. Growth in income was thus achieved by increases in productivity obtained by transferring resources from less productive sectors and activities to more productive ones, parallel to the increase in efficiency and productivity in all sectors. Spain comes at the opposite end, with growth in *per capita* income (1.8%) basically a result of the increase in the employment rate (2.3%). Indeed, far from making a positive contribution, the variation in productivity actually made a negative one (-0.5%). This happened because, at the beginning of the decade, there were still plenty of unused human resources in the country (the activity rate was low due to limited access for women to the labour market and high unemployment figures), to which one must add the arrival of large numbers of immigrants in search of employment; and, in these conditions, new work was largely made up of jobs with lower productivity levels, apart from the fact that, in general, the new workers had less experience and human capital than workers employed until then. This made them less productive. Between these two extreme models are cases like Ireland, where growth in *per capita* income may be measured both in terms of the increase in the employment rate and productivity.

Graph 1.8. Compound annual growth rate of real GDP *per capita*, employment rate and Productivity between 2000 and 2007



Source: IMF, *Economic Outlook database* October 2008; The Conference Board & Groningen Growth and Development Centre, *Economy Database*, September 2008; and Eustat.

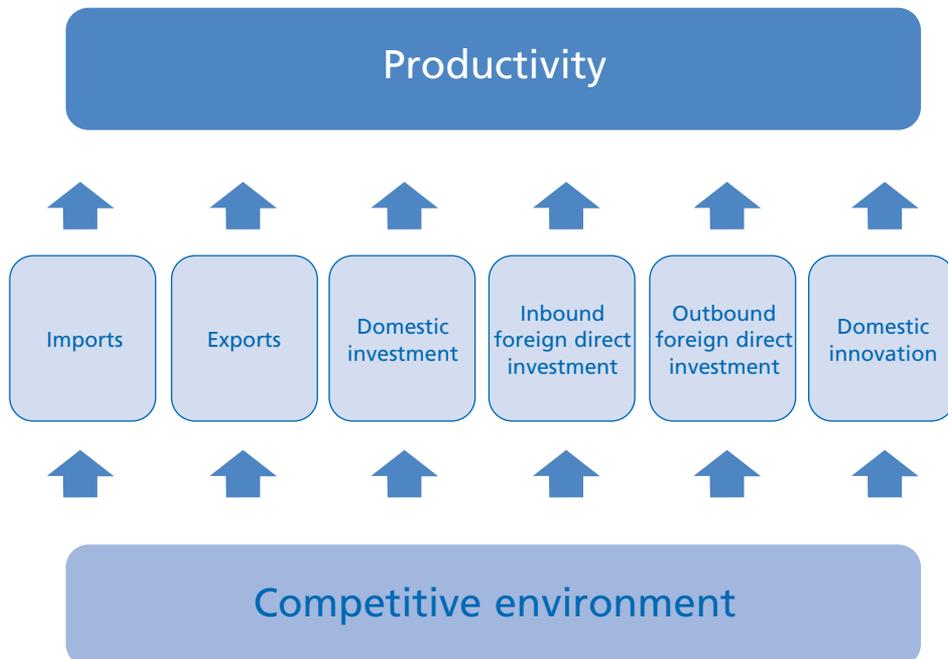
In general, the substantial increases in *per capita* income in emerging Asian countries and in the 4PA group may basically be ascribed to increases in productivity. In emergent Latin American countries, growth in *per capita* income was lower, and based more on increases in employment rates. In EU-15 countries, however, productivity grew substantially in Scandinavian and Anglo-Saxon countries (Finland, Sweden, Ireland and the United Kingdom), and negatively or insignificantly in southern Europe (Italy, Spain and Portugal), though the BC does not belong in this latter model. Finally, the USA and Japan enjoyed average growth in *per capita* income, compared with other advanced countries (although not with emerging countries), and was based largely on growth in productivity.

1.4. Intermediate Indicators or Enablers of Competitiveness

Given that there are physical and social limits to increases in employment rates and that productivity, insofar as it is increasingly based on knowledge, knows no limits to growth, it could be said that the only sustainable way of improving *per capita* income and, therefore, the wellbeing and competitiveness of a country, is through productivity. That is why so many authors, such as Porter, consider that, ultimately, competitiveness is the same as productivity.

Alongside productivity, Porter argues that there is a series of variables that can be seen both as cause and effect of competitiveness. He calls them intermediate competitiveness indicators, or enablers of competitiveness. These variables, which will be more closely analysed in this section, are the imports and exports of goods and services, inbound foreign direct investment and outbound foreign direct investment, investment and domestic innovation.

Inset 1. Intermediate Indicators or Enablers of Competitiveness

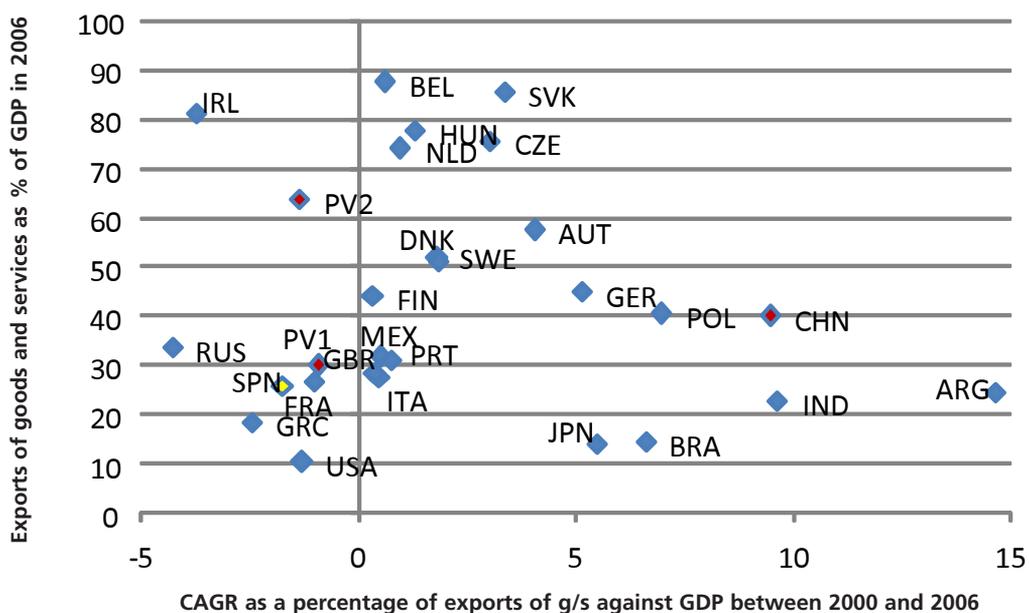


Source: M. Porter (2008). Microeconomics of Competitiveness.

1.4.1. Exports and imports of goods and services

It is worth noting, as David Ricardo pointed out, that considerable advantages for well-being and competitiveness arise from participation in international trade. As regards imports, apart from enabling access to particular goods difficult to substitute in the country (for example, energy, specific raw materials and even access to specific technologies unavailable in the country), trade enables one to specialise in what one does best, increases competence and breaks domestic monopolies as well as favouring the struggle against inflation. Exports, on the other hand, enable one to overcome the possible limitations of the home market, exploiting scale economies, specialising in niches and learning to respond to a greater variety of clients and demands, some of which are often highly demanding. On the other hand, the greater capacity for export and import is a reflection both of the existence of certain competitive advantages and of a relatively developed market for international operators.

Graph 1.9. Goods and Services exports as a % of GDP (in 2006) and CAGR of that ratio between 2000 and 2006



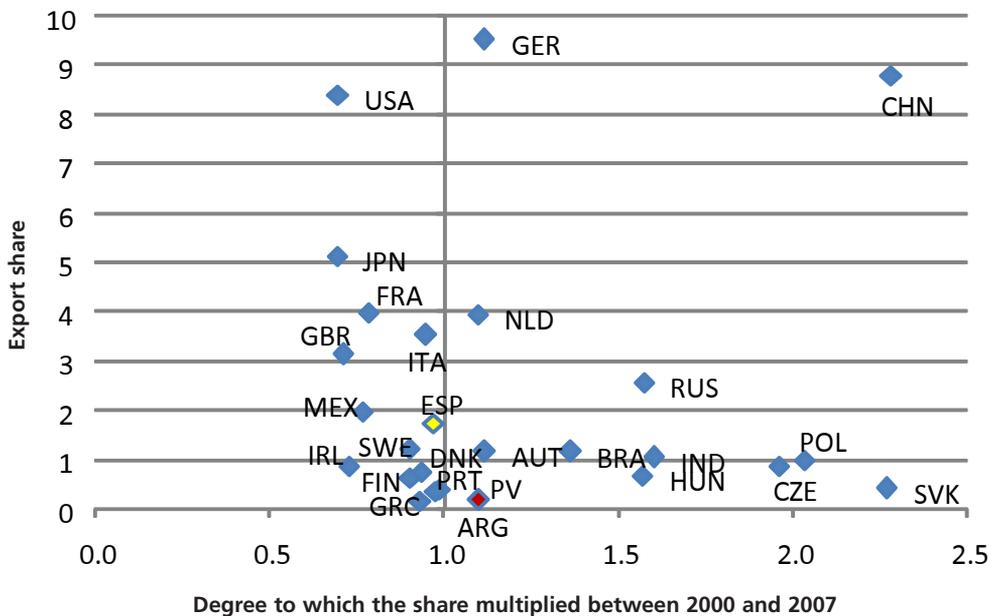
Source: World Bank, *World Development Indicators 2008*; and Eustat.

Graph 1.9 shows that a set of fairly small countries (Belgium, Slovakia, Ireland, Czech Republic, Hungary and Holland) have a higher percentage of exports with regard to their GDP and that a group of large countries (USA, Japan and Brazil) have the lowest percentage. This is not surprising because the theory demonstrates that a country's internationalisation has a lot to do with its size, and to a lesser degree with other characteristics such as its situation on the coast and its level of development. In any case, the example of China is surprising because, despite being so large, its exports of goods and services account for 40% of its GDP, a figure clearly above the ones for other, smaller emerging Asian and Latin American economies

(India, Brazil, Argentina and Mexico), for the USA and Japan and for most large countries and the EU-15 group (United Kingdom, France, Italy, Spain, Portugal and Greece). Furthermore, the internationalisation ratio for China even exceeds the BC's when for the latter we only consider as exports of goods and services those that are sent abroad (and not those sent to the rest of Spain). Indeed, from an evolutionary point of view, China actually comes immediately after Argentina and India as one of the countries in which the tendency to export grew most in the 2000-2006 period. The values for Spain and the BC (in the latter case, both considering/not considering as part of these exports goods and services sent to rest of Spain) are negative, a factor that probably has to do with the strong growth in their GDP and home demand.

Graph 1.10 offers another view of a country's tendency to export: the quota reached by the export of goods (excluding services) with regard to world exports and the variations undergone between 2000 and 2007. This Graph shows that the quota for China (8.8%) was higher than for the USA (8.4%) and that only Germany was ahead (9.5%). Some way behind these three countries were Japan (5.1%) and a series of large countries in the EU (United Kingdom, France, Italy and Holland). The other emerging economies considered in this project fall beneath the 2% mark, with the exception of Russia, due to energy exports.

Graph 1.10. Goods exports share with regards to world exports in 2007 (in %), and the factor by which that share multiplied between 2000 and 2007

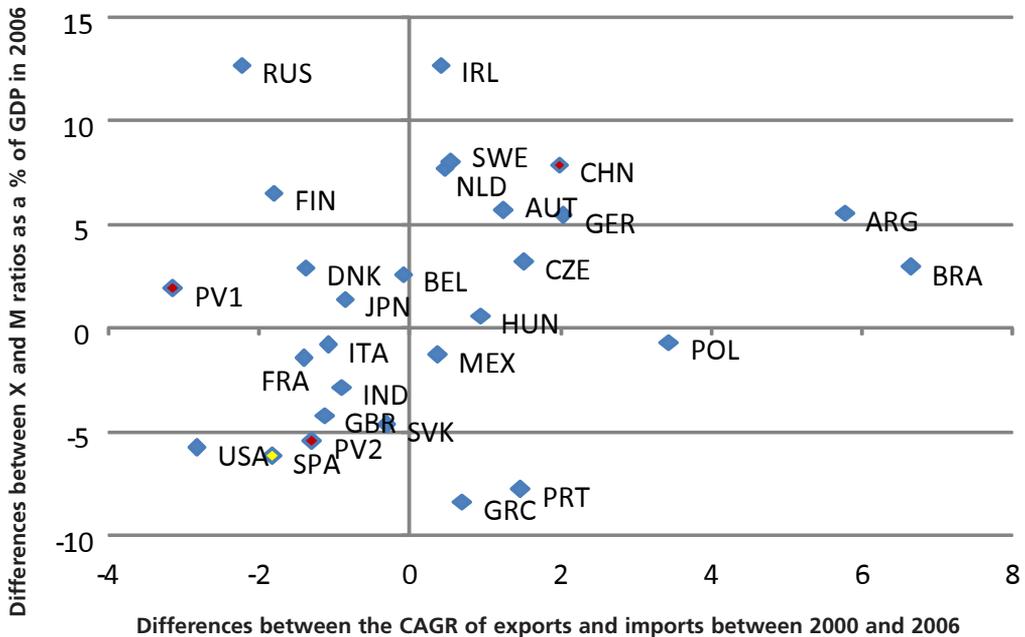


Source: Unctad, *Handbook of statistics* 2008; and Eustat.

From the evolutionary point of view, Asian and European emerging economies witnessed major increases in their quotas between 2000 and 2007 (China showing the largest absolute growth figure and with regard to its quota), whereas emerging Latin American countries were less dynamic (with a loss in quota in the case of Mexico). Among the developed economies, only Germany, Holland, Austria and the BC managed to increase their quota somewhat.

As regards the ratio of imports of goods and services in comparison with the GDP (given that it has a lot to do with that of exports) instead of reproducing and commenting on a graph equivalent to Graph 1.9, we created Graph 1.11. In it we included (along the vertical axis) the differences between export and import ratios for goods and services (in terms of the percentage of the GDP) for each country in 2006. On the horizontal axis, we placed the differences between the accumulated annual variation rates for these exports and imports in the 2000-2006 period. In the top part of the graph are the economies with most exports and imports and, thus, the best trade balance. Countries with negative trade balances are on the other side. In the first group, after Russia, Ireland and Sweden, we find China, which, in absolute terms, is the economy with the world's most positive trade balance. Most emerging economies have a positive goods and services trade balance, although the following stand out for failing to make the mark: Slovakia, India, Mexico and Poland. Among the countries with the greatest deficit in the trade balance are some countries in the south of the EU (Greece, Portugal and Spain), as well as the USA. The case of the BC is a little strange, because although it has a positive balance in its international trade figures, its general exterior goods and services trade figures (that is, including its relations with the rest of Spain) show a heavy deficit.

Graph 1.11. Differences between goods and services export and import ratios, in percentage of GDP (2006) and differences between accumulated annual variation rates for prior ratios, in the period 2000-2006



Source: World Bank, *World Development Indicators 2008*; and Eustat.

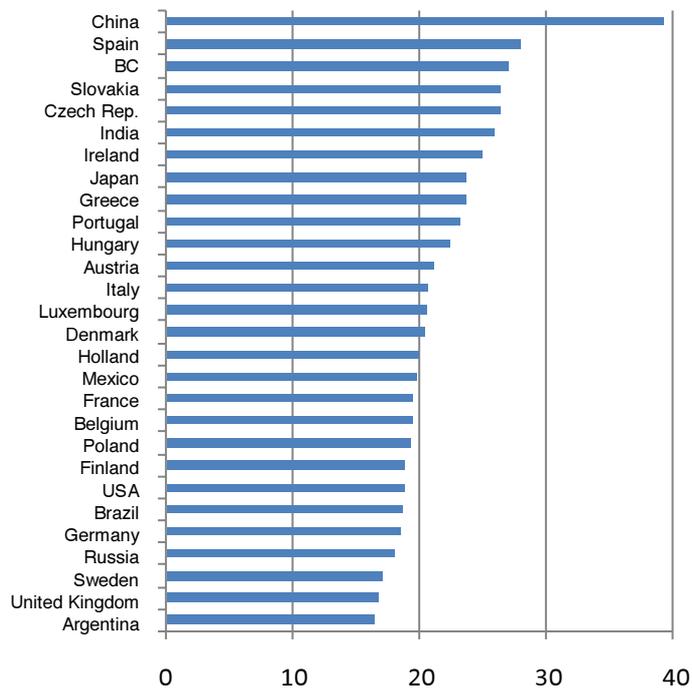
As the Graph shows, emerging economies generally show greater growth in exports than in imports, especially in Brazil and Argentina (countries which at the beginning of this period

were going through difficult periods). Despite its highly positive trade balance, China has made its exports grow more than its imports, making the profit margin even greater. The opposite occurs in the USA, Spain and the BC, where imports grow more than exports, despite the fact that they already set out from a position of high deficit (in the case of the BC, when its trade with all exterior territories is considered).

1.4.2. Domestic investment

Another variable the growth process shows to have a positive effect on the apparent productivity of the worker and the economy's capacity for generating wealth is the allocation of fixed capital. The increase or intensification of fixed capital takes place by way of investment. Investment is a flow of expenditure to maintain or increase fixed capital stock, and that is why economists call it gross fixed capital formation (GFCF). In some cases investment simply leads to an increase in production capacity; but, in most cases, investment is a way to bring about process innovation (producing a new product in a new or improved way) or production novelty (producing a new or improved product). Empirical studies show that a country which invests little is bound to have growth and employment problems and to fall behind on the competitive front. In this sense GFCF, an activity that encompasses the purchase of both material and immaterial fixed assets, is one kind of typical investment that makes a real mark on competitiveness. Given the traditional lack of data regarding fixed capital stock for so many countries, in this section we will have to base our analysis on GFCF data. Bearing in mind the strongly cyclical character presented by this variable, on estimating the country's investment ratio (obtained by dividing the GFCF by its GDP), we tend to take the average figure for the 2000-2006 period rather than the data for one year alone.

Graph 1.12. Gross Fixed Capital Formation as % of GDP (Average 2000-2006)



Source: Unctad, *Handbook of statistics 2008*; and Eustat.

Graph 1.12 makes the huge investment effort made by China very clear. The second investor country (Spain) is well behind the leader. This occurred despite the high investment rate figures for the latter country, caused mostly by the construction sector. In general, less developed countries must make a greater investment effort to reduce the infrastructures and capital provision gap they suffer with regard to developed countries. That is why we need to bear in mind the development levels of each country when making comparisons between them. However, in general, the emerging economies of Asia (especially China) and the 4PA group are really noticeable because of their investment effect, whereas other Anglo-Saxon countries and emerging Latin American economies have invested comparatively little.

1.4.3. Foreign Direct Investment (FDI) "in" the country and "from" the foreign country

To encourage foreign direct investment in a country, the country in question must offer some kind of location to entice the investor into making a direct investment there, instead of limiting himself to selling merchandise produced in some other place or selling his technological advantages under some kind of license, etc. As regards direct investment in the foreign country, according to Dunning's Eclectic Theory, such investment would be the result of the existence of competitive advantages in a given country's firms. These firms decide to exploit them to their own benefit by way of direct investment in the country (which is not the one it has its headquarters in) and thus gain the advantages of localization (for example, access to the market) that may exist in the target country.

From the point of view of the effects, rather than the causes, of direct investment on competitiveness, arguments have been given in favour of direct foreign investment in the country, which increases the country's investment as well as economic growth and employment. This enables improvements in the technological level, management system and business class. It also encourages competition, and, thus, economic efficiency. At the same time, it attracts foreign currency and helps to finance final deficit in the balance of payments. Regarding the country's direct investment abroad, one may argue that such investment becomes a source of competitive advantage for the country from which this investment flow stems, insofar as it enables specialization in activities in which this country is more competitive (they are, in general, those in which countries producing investment flows have the greatest degree of added value), as well as the obtention of different kinds of income (particularly in capital and technology), and even the inducement of additional export flow towards the country where the investment was made.

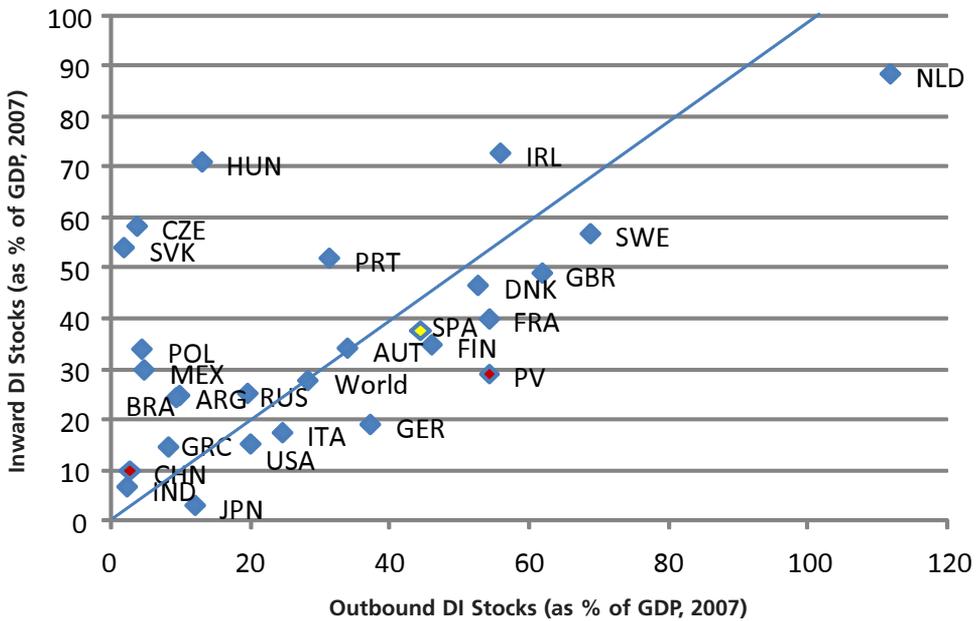
Having expounded the reasons for considering direct investment as an intermediate indicator and enabler of competitiveness, Graph 1.13 shows the percentage accounted for by FDI stock in the country (or the investment position) in 2007, both expressed in percentages of the GDP.² The bisecting line plotted on the graph divides countries that are direct net receptors of investment (those on the left of the line) from net investors (those on the right).

This graph shows that, despite the dominant impression to the contrary, the presence of foreign capital in the Chinese economy is still meagre, amounting to only 10%, despite reaching 28% worldwide. In fact, FDI is only 2.2% of the world figure, being clearly lower than the Spanish quota (3.5%). Apart from India, in all other emerging countries the percentage

² In the case of the BC, data corresponds to 2006 and is the result of our own estimates, carried out by comparing data regarding the investment position of Spain and its autonomous communities (regions), as published by the Secretary of State for Trade (*Secretaría de Estado de Comercio*), with GDP estimates made by INE for Spain and the autonomous communities and with those of FDI stock *in* Spain and *from* Spain abroad, as published by UNCTAD.

of FDI stock, as a percentage of the GDP, is higher than China's figure. This percentage is particularly high in the 4PA group. As regards developed countries, the extremely low presence of foreign capital is particularly noticeable in Japan, although the figures for the USA and Germany are also low. Spain has an average-high figure; and within Spain, the BC shows less power to attract FDI capital than the Spanish average.

Graph 1.13. Inbound and Outbound FDI stock as a percentage of GDP, in 2007



Source: Unctad, *Foreign Direct Investment 2008*; Secretary of State of Trade and INE.

Note: data for China does not include Hong-Kong, Macao or Taiwan.

The data for Holland is slightly distorted by its role as “go-between” in the flow of FDI (for fiscal and other reasons).

The graph clearly shows that the more developed countries (with the exception of Ireland) are the only ones that invest more abroad than they receive in investment from other countries. The imbalance between their positions as investors and receivers of investment is particularly outstanding in the BC, in Japan and in Germany (as net investors) and in the 4PA group (as net receptors). The role of China as a direct investment agent abroad is still low-key and has largely been aimed at the purchase of companies to enable the country to guarantee itself the supply and exploitation of energy resources and raw materials, though its quota is only 0.6% worldwide.

1.4.4. Innovation

As the literature on growth shows, innovation is the most decisive factor in achieving high productivity and growth. Simultaneously, though, innovative capacity is conditioned by the

wealth created beforehand and the productive structure of the country itself. In this section, with a view to facilitating comparison with other countries, we will refer to two typical indicators of innovative activity: expenditure in R&D and the percentage of GDP and the number of patents granted by the United States patents office to applicants from a given country (per million population).

Table 1.5. R&D Expenditure as a percentage of GDP in 2006 (or closest year) and patents granted in 2005 by the United States patents office to applicants of a given country (per 1 million population)

	R&D Expenditure as a % of GDP (2006)	USPTO patents granted in 2005
Japan	3.3	240.0
USA	2.6	257.3
Sweden	3.8	138.1
Finland	3.5	164.1
Germany	2.5	104.1
Austria	2.5	30.6
Denmark	2.4	60.7
France	2.1	42.9
Belgium	1.9	32.2
United Kingdom	1.8	32.7
Holland	1.7	105.8
Luxembourg	1.6	113.5
BC	1.5	8.0
Ireland	1.3	28.9
Spain	1.2	4.0
Italy	1.1	17.8
Portugal	0.8	0.9
Greece	0.5	0.9
Czech Rep.	1.5	1.0
Hungary	1.0	3.3
Poland	0.6	0.3
Slovakia	0.5	0.1
Russia	1.1	0.4
Mexico	0.5	0.8
Argentina	0.4	0.4
Brazil	0.9	0.3

Source: OECD and Eustat.

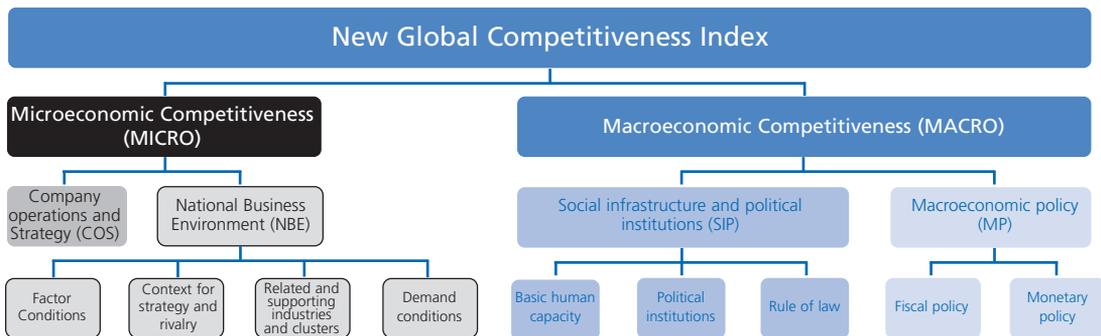
Despite considering possible waivers against EU countries, due to the comparison of patent data with the USPTO data, it is obvious that, in general, Japan and the USA are more active in innovation than EU-15, despite the efforts made by some northern European countries in this field. Particularly disappointing are the values for southern European countries (including the BC), which, in this context, are not too different to those of the more advanced economies in the 4PA group. In the rest of the emerging economies, only Russia and China have R&D expenditure of more than 1% (in proportion to their GDP), and, even then,

these countries have very low figures when we take the technological output (i.e. patents) into account, rather than the input indicator (for R&D). Nevertheless, we should not limit ourselves to a static perception, ignoring the evolution occurring locally: whereas expenditure in R&D in the OECD hardly grew at all between 1995 and 2006 (from 2.1 to 2.2%), the figure for China went from 0.57% to 1.43%, showing the enormous effort being made by China to overcome a competitive status based on the exploitation of factors or primary inputs.

1.5. On the competitive impulse

In previous sections we have tried to measure the competitive impulse of the Chinese economy, in comparison with that of leading advanced countries and a series of emerging countries with which it competes as a location. In this section, we attempt to apply a model to explain the competitive impulse. For this, we will focus basically on the model recently drawn up by Porter et al. (2008), on which the future new global competitiveness index will be based (see inset 1).

Inset 1. Components of the New Global Competitiveness Index



Source: Porter et al. (2008)

According to this model, the competitive impulse of a country may basically be defined in terms of both macro and micro factors. The importance and influence of these factors varies according to the competitive state of the country. In developing countries, macro factors are more influential (especially social infrastructure and political institutions), whereas in more advanced countries, the more decisive factors, when explaining the differences in *per capita* income, are micro.

1.5.1. Macro competitiveness

As occurs in the inset, within macro competitiveness we distinguish between macroeconomic factors and other macro factors.

To begin with the former, the existence of macroeconomic stability is a basic condition for the development of economic activity and investment. Four major points of macroeconomic balance are generally taken into consideration: price stability, budget balance, current account balance stability and unemployment. Though they are not strictly comparable and do not have the same influence, with a view to facilitating their overall evaluation, in Table 1.6 we added their values together to create two aggregated factors of imbalance: one with greater ties to

monetary and fiscal policies, and another more global one. The greater the latter's values, the worse the country's evaluation from a macroeconomic point of view. To Table 1.6 we added a column in which short-term interest rates are given (to some extent, this enables us to evaluate the "tone" of the monetary policy) and, in Graph 1.14, we also added the way exchange rates evolved.

Table 1.6. Macroeconomic indicators (2007 or nearest available year)

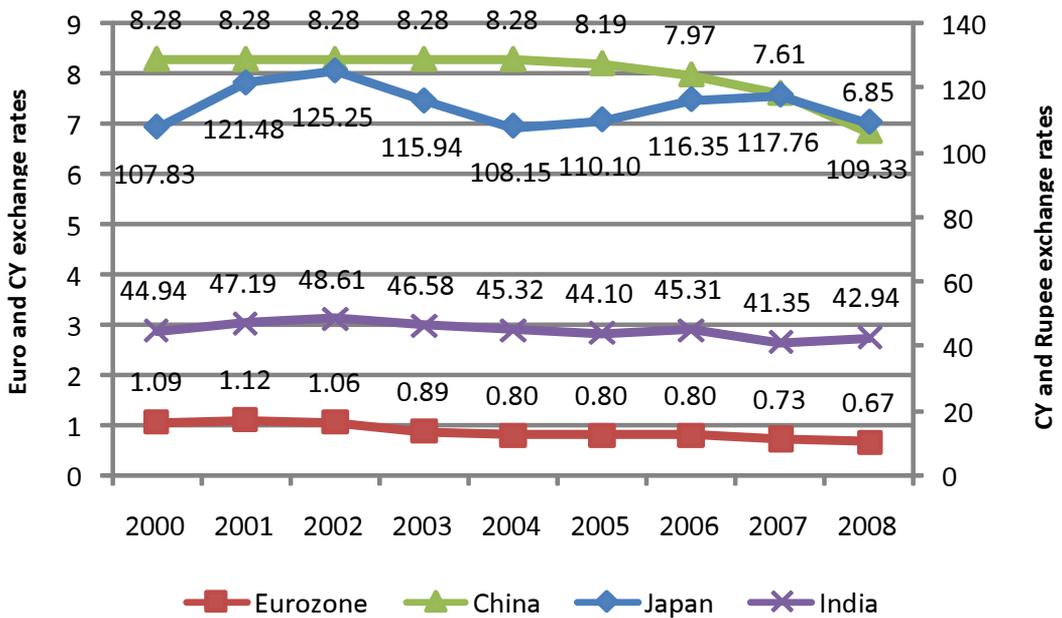
	Variation in consumer prices (%)	Balance of public budget (in % of GDP)	Current account balance (% of GDP)	Unemployment rate (%)	Partial macro imbalance [(1)-(2)]	Overall imbalance [(1)-(2)-(3)+(4)]	Short-term interest rates
USA	2.9	-2.0	-5.3	4.6	4.8	14.7	5.3
Japan	0.0	-2.4	4.8	3.9	2.4	1.4	0.7
Austria	2.2	-1.6	3.2	4.4	3.8	5.0	4.3
Belgium	1.8	0.3	2.1	7.5	1.6	6.9	4.3
Denmark	1.7	5.1	1.1	3.7	-3.4	-0.8	4.3
Finland	1.6	3.9	4.6	6.8	-2.3	0.0	4.3
France	1.6	-2.3	-1.2	8.3	3.9	13.4	4.3
Germany	2.3	-1.4	7.6	8.4	3.6	4.4	4.3
Greece	3.0	-4.5	-14.1	8.3	7.5	29.9	4.3
Ireland	2.9	2.7	-5.4	4.6	0.2	10.2	4.3
Italy	2.0	-3.3	-2.5	6.2	5.3	14.0	4.3
Luxembourg	2.3	0.9	9.9	4.2	1.4	-4.3	4.3
Holland	1.6	0.5	6.8	3.2	1.1	-2.5	4.3
Portugal	2.4	-3.9	-9.8	8.1	6.3	24.3	4.3
Spain	2.8	1.9	-10.1	8.3	0.9	19.3	4.3
Sweden	1.7	1.9	8.5	6.2	-0.3	-2.6	3.6
United Kingdom	2.3	-2.8	-3.8	5.3	5.1	14.1	6.0
Czech Republic	2.8	-4.3	-1.8	5.3	7.1	14.1	3.1
Hungary	7.9	-8.6	-5.0	7.3	16.5	28.9	7.6
Poland	2.5	-3.6	-3.8	9.7	6.1	19.5	4.8
Slovakia	1.9	-3.4	-5.4	11.2	5.3	21.9	4.0
Russia	9.0	8.1	5.9	6.1	0.9	1.1	6.7
Argentina	8.8	-0.5	1.7	9.5	9.3	17.1	n.d.
Brazil	3.6	-3.4	0.1	8.4	7.1	15.3	n.d.
Mexico	4.0	-1.9	-0.6	3.1	5.9	9.5	7.4
India	6.4	-2.8	-1.4	4.3	9.1	14.8	n.d.
China	4.8	-1.6	11.3	4.1	6.4	-0.9	3.5

Source: International Monetary Fund, World Bank, OECD.

As Table 1.6 shows, developed countries generally show a more stable macro than emerging countries, especially with regard to the macroeconomic aggregates more closely associated with monetary and fiscal policies. Focusing more closely on the particular case of China, this is highly positive, especially if we consider the set of indicators contained in the total imbalance index. China has certain problems with inflation, which are partly comprehensible given the enormous growth its economy is experiencing. But it may also be partially ascribed to the policy of low interest rates and the maintenance of its undervalued currency. The country's public accounts are not especially good. In the exterior sector, it has an enormous surplus, which may partly be ascribed to the undervaluation of the CY. The unemployment rate is low, although this is to some extent masked by overstaffing in several economic acti-

vities. However, the Chinese Government has begun to take measures to correct imbalances due to inflation and underestimation of the CY. Thus, for example, short-term exchange rates, which reached a minimum at 1.5% in June 2005, have risen in the last few years and in July 2008 stood at 4.5%; likewise, having followed a policy for years aimed at maintaining the PPP between the CY and the dollar, after 2004 the CY began to strengthen in relation to the dollar, shifting from an exchange rate of 8.28 CYs per dollar to 6.85 CYs per dollar. The Chinese currency has begun to cooperate in the correction of the United States' foreign deficit, a role until now apparently reserved to the euro.

Graph 1.14. Evolution of the exchange rate for the euro, yen, CY and rupee, compared to the dollar, between 2000 and 2008



Source: OECD.
 2008 data corresponds to values in the month of August.

The other block in the macro is social infrastructures and public institutions. In general, literature on competitiveness and development has in the last few years shifted from the analysis of macroeconomic policies to an examination of the institutions, a factor that (as regards the regressive functions that explain the differences in *per capita* income) obtains the highest values in countries with low and average income levels. Three types of indicators are included in this block on social infrastructure and political institutions. In the first place, indicators that affect human capacity, because of their relationship with primary education and health; secondly, indicators related to the quality of the public institutions; and thirdly, indicators concerning the application of the Law.

Table 1.7. Position of China in the different macroeconomic factors that determine the overall competitiveness index

INDICATOR	RANKING/134	
Macroeconomic Competitiveness		
Social Infrastructure and Political institutions	60	
<i>Basic Human Capacity</i>	61	
Quality of primary education	34	
Life expectancy*	55	
(Low) Malaria Prevalence*	71	
(Low) Tuberculosis Prevalence*	87	
(Low) Infant Mortality*	80	
Primary enrollment	5	
Secondary enrollment*	92	
<i>Political institutions</i>	55	
Public trust of politicians	36	
(Low) Wastefulness of government spending	36	
Favoritism in decisions of government officials	47	
Transparency on government policymaking	46	
Decentralization of economic policymaking	35	
Voice and Accountability	128	
<i>Rule of Law</i>	65	
Reliability of police services	50	
(Low) Business costs of crime and violence	56	
Prevalence and cost of crime	84	
Judicial independence	69	
Efficiency of legal framework	54	
Property rights	54	
(Low) Diversion of public funds	66	
Ethical behaviour of firms	60	
Control of corruption	82	
Rule of Law	80	
Macroeconomic Policy	42	
Government surplus/deficit*	49	
Government debt	22	
Inflation*	62	
Interest rate spread*	33	

Source: authors, based on Porter et al. (2008), World Economic Forum and World Bank.

As Table 1.7 shows, China's overall position in this block of factors (62nd), though more favourable than its position (88th) in the ranking of countries ordered from greatest to lowest as regards *per capita* income, is worse than China's position in the three other sets of competitiveness factors: macroeconomic policy (42nd), operations sophistication and business strategies (49th) and the domestic micro context (51st). China records its worst results in indicators associated with political liberties, corruption control and lawfulness, as well as in

secondary education enrollment. On the other hand, primary education enrollment and quality, as well as Public trust of politicians, are outstanding.

1.5.2. Microeconomic factors

In this section, two sets of items should be distinguished: one set involves internal business factors, which reflect operational and strategic sophistication; the other, national factors regarding the domestic scene and the clusters firms operate in.

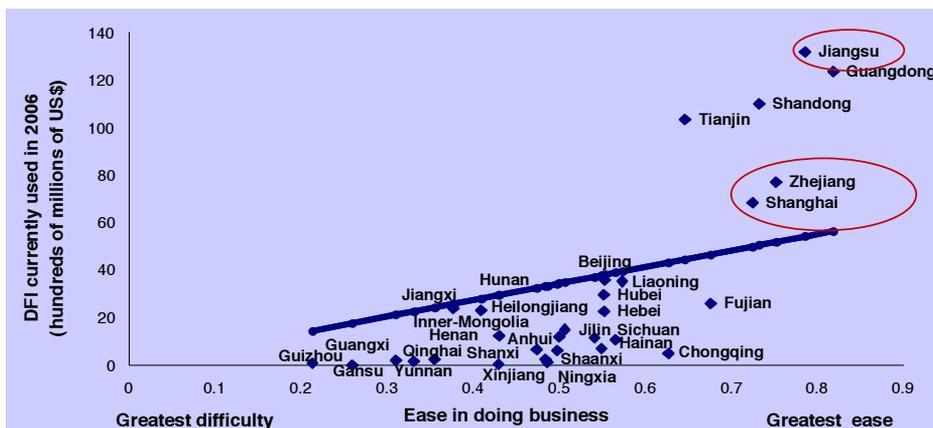
To begin with internal business factors, the overall position of China is generally positive, since it comes 50th out of 134 countries, clearly ahead of its position in the *per capita* income ranking. Furthermore, no items are found in which weakness is too marked. The weakest points are the nature of the competitive advantage (very much oriented towards competing in costs) and customer orientation. However, China achieves an advanced position in a couple of indicators associated with innovation: Company spending on R&D and Capacity of innovation.

As regards the domestic micro environment, if we group decisive competitiveness items together (according to Porter's diamond coordinates) China is in a position (on the vertex including the factor conditions) which, despite being more favourable than could be expected from its placing on the *per capita* income ranking, is globally worse than it is in other blocks. The principal weaknesses are in capital market infrastructure, in administrative difficulties for starting a new businesses, in ICT infrastructures (mobile phones, computers and internet) and in tertiary enrollment and the quality of management schools. On the other hand, the greatest advantages are again found in innovation infrastructures.

In the context of strategy and rivalry, there is a wide range of values. A major strength is the relationship between pay and productivity: relatively low salaries for the level of productivity achieved in Chinese firms. Likewise, the World Economic Forum report underlines the high degree of local competition. However, the degree of exterior aperture is still insufficient: there are considerable restrictions on capital flows; associated to this, the degree of foreign capital penetration is not so high; weighted customs tariff is too high; and the regulation of direct investment is restrictive with regard to technology transfer.

On the supporting and related industries vertex, China is of average strength, although this seems to have to do more with the quantity than the quality of suppliers.

Graph 1.15. Regional location of direct foreign investment and facilities for doing business in different regions of China



Source: Doing Business database; and Ministry of Commerce.

Table 1.8. Position of China as regards the different decisive factors in terms of global microeconomic competitiveness Index

INDICATOR	RANKING / 134	INDICATOR	RANKING / 134
Microeconomic competitiveness	49	Microeconomic Competitiveness	49
Business Operations and Strategy	41	Factor Conditions	64
<i>Strategy and operational effectiveness</i>	52	Logistical infrastructure	55
Firm-level technology absorption	43	Quality of roads	51
Company spending on R&D	24	Quality of railroad infrastructure	28
Nature of competitive advantage	71	Port infrastructure quality	54
Value chain breadth	56	Quality of airtransport infrastructure	74
Capacity of innovation	25	Quality of electricity supply	68
Production process sophistication	59	Communication infrastructure	67
Extent of Marketing	62	Internet access in schools	33
Degree of customer orientation	73	Mobile subscribers per 100 population	90
Organizational practices	49	Personal computers per 100 population	81
Extent of staff training	42	Internet users per 100 population	85
Willingness to delegate authority	58	Telephone lines	47
Reliance on professional management	46	Administrative infrastructure	64
Internationalization of firms	24	Burder of customs procedures	42
Control of international distribution	47	Burder of government regulation	23
Breadth of international markets	1	Easy of starting a new business	112
Demand Conditions	29	Number of procedures required to start a business*	108
Government procurement of advanced technological products	20	Time required to start a business	83
Laws relating to ICT	47	Doing business, Paying taxes, Payments number	13
Buyer Sophistication	21	Capital market infrastructure	85
Supporting and related industries and clusters	44	Regulation of securities exchanges	109
Availability of latest Technologies	83	Financial market sophistication	83
Local suppliers quantity	18	Soundness of banks	108
Local suppliers quality	62	Easy access to loans	99
Local availability of specialised research and training services	39	Venture capital availability	49
State of cluster development	19	Financing through local equity market	80
Context for Strategy and Rivalry	65	Protection of minority shareholders' interests	94
Cooperation in labor employer relations	65	Getting credit legal rights index	55
Pay and Productivity	9	Domestic credit to private sector	21
FDI and technology transfer	79	Innovation infrastructure	50
Impact of taxation on incentives to work and invest	36	Quality of scientific research institutions	37
Intellectual property protection	53	University-Industry research collaboration	23
Restrictions on capital flows	121	Quality of the educational system	55
Strength of auditing and reporting standards	86	Quality of math and science education	38
Prevalence of trade barriers	72	Quality of management schools	74
Prevalence of foreign ownership	105	Availability of scientists and engineers	52
Business impact of rules on FDI	55	Brain drain	36
Intensity of local competition	27	Tertiary enrollment	81
Effectiveness of antitrust policy	55	Utility patents	54
Extent of market dominance	39		
Efficacy of corporate boards	90		
Strength of investor protection*	67		
Rigidity of employment*	32		
Customs tariff as set by commerce*	122		

Source: Authors, based on Porter et al. (2008), World Economic Forum and World Bank.

Finally, the number of demand conditions items about which information is gathered is meagre, although in all of them the position attained by China is favourable. One particularly outstanding feature is Government procurement of advanced technological products and the buyer sophistication (especially when buyers are foreign firms).

In conclusion, the microeconomic environment of China varies substantially from one zone to another. Coastal zones have more favourable conditions than those inland. With a view to reflecting the changes in this environment, from some zones to others, Graph 1.15 shows how this factor is taken into consideration by FDI in China. Indeed, it is basically concentrated in zones that, according to the index drawn up by the World Bank, give greater facilities for business. In this Graph, red circles highlight regions where Basque firms are concentrated.

To complete the regional view, we add some basic data on the principal coastal and inland regions.

Table 1.9. Basic economic indicators of the principal Chinese regions

	Beijing	Shanghai	Guangdong	Jiangsu	Henan
Population (in millions)	14.93	17.42	83.04	74.33	97.17
Area (km ²)	16808	6341	179757	102600	167000
GDP (thousands of millions of CY)	428.331	745.027	1603.946	1540.316	881.509
GDP growth rate (%)	13.2	13.6	14.2	14.9	13.7
Per capita GDP (CY)	37058	55307	19707	20705	9470
Per capita income available (CY)	13882.62	14867.49	12380.43	9262.46	6926.12
Retail sales (thousands of millions of CY)	219.18	245.46	637.04	415.97	280.82
Railway mileage (in kms)	1124.6	263.5	2181.4	1606.4	4090.3
Motorway mileage (in kms)	10514	7805	111452	78262	75719
Foreign direct investment (millions of US\$)	2191.26	5468.49	7822.94	10563.65	539.03

	Sichuan	Guizhou	Yun´nan	Qinghai
Population (in millions)	87.25	39,04	44.15	5.39
Area (km ²)	485,000	176,168	394,139	722,300
GDP (thousands of millions of CY)	655.601	159,19	295,948	46,573
GDP growth rate (%)	12.7	11.4	11.5	12.3
Per capita GDP (CY)	8113	4215	6733	8606
Available per capita income (CY)	7041.87	6569.23	7643.57	6745.32
Retail sales (thousands of millions CY)	238.4	51,76	88,49	11,56
Railway mileage (km)	2958	1890.6	2328.1	1090.3
Motorway mileage (km)	11,3043	46,128	167,050	28,059
Foreign direct investment (millions of US\$D)	412.31	45.21	83.64	25.22

Source: CEIBS.

2. The process of setting up Basque subsidiaries in China: an exploratory analysis

2.1. Introduction

The process whereby a foreign firm gains entrance into the Chinese market is complex and full of difficulties. Apart from having to overcome strictly economic barriers (e.g. High stranded costs, appreciation of the local currency: C¥-Renmimbí-CNY-, etc.), firms face other kinds of obstacles. They may be of an institutional nature (e.g. restrictive norms at different levels of territorial administration), cultural (e.g. different language and habits) or linked to the irregular state of some infrastructures (e.g. roads, railroads, airports, ports, etc.). Despite the adversities that may be encountered in China when setting a business up, the country has prospered extraordinarily in recent years, and, in the wake of this growth, offers opportunities that can be of benefit to domestic firms from other countries. This chapter analyzes the process of introducing Basque firms into China.

With this objective in mind, this chapter offers general information on the process of setting up Basque subsidiaries in China, and gives information about the impressions and experiences of a representative sample of people managing Basque companies established in China. Although the introduction of Basque companies into the Chinese market cannot be considered a recent phenomenon, this process has without doubt been at its most active since the beginning of the 21st century. As a result, some preliminary study is required of the internationalization process of Basque firms. This exploratory analysis is a first approach to more systematised knowledge of the presence of Basque companies in China, geared towards the identification and comprehension of the keys to competition of Basque firms *in/from* China.

The relocation of firms occurring in the last few years in particular areas, or the reestablishment of firms outside the local economy, has centred the interest of scholars of the economy (Krugman and Venables, 1990), and caused a certain degree of concern amongst those responsible for the construction of a more competitive local environment. To explain this, many executives have spoken of the cost of resources (e.g. labour, raw materials, land, etc.), often accompanied by administrative advantages, to justify a new location for their respective organisations. Indeed, this reasoning can be ascribed to the advantage that is taken of benefits obtained by provisional situations. However, an increasingly widespread view holds that the key to business competitiveness, wherever a firm resides, lies primarily in its structural basis, rather than in short-term benefits (which, incidentally, should not only be seen in terms of lower costs).

This chapter contains three additional sections, apart from the introduction. In the following section, a brief description is supplied of nearly one hundred Basque businesses operating in China. In particular, we analyze the sector they belong to, the type of subsidiaries they

are (productive or commercial) and their location within the country. The third paragraph provides a series of considerations on the process of entering the Chinese market and on being competitive *in / from* China, based on the experience of a group of executives from Basque businesses. The next section provides a list of the strengths and weaknesses facing Basque firms arriving in China at the time their competitive advantages are developed. The chapter ends up with a summary of the main conclusions to be drawn from this exploratory analysis.

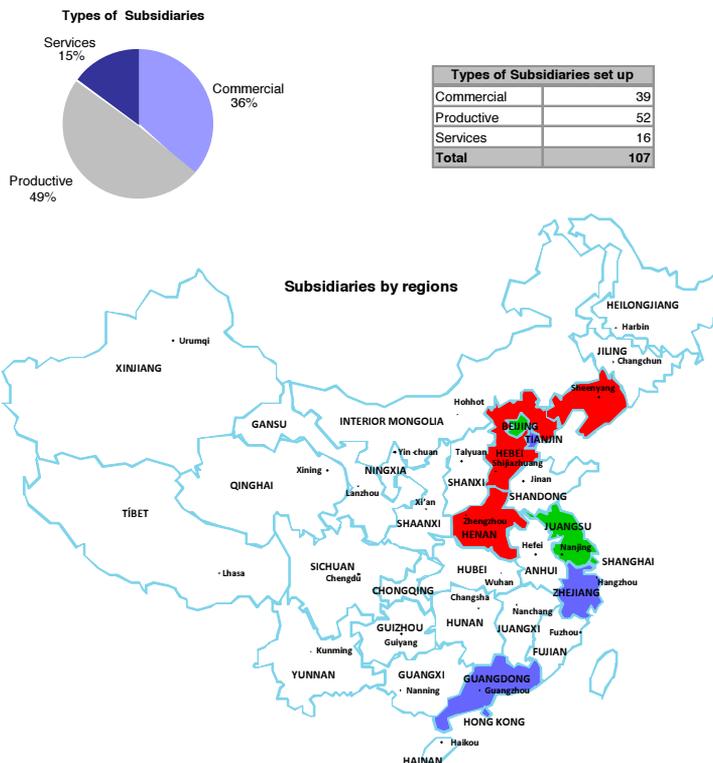
2.2. General description of the introduction of Basque subsidiaries in China

According to data provided by the SPRI office in China for the year 2008, there are 107 Basque subsidiaries in China. However, a truer figure for Basque firms in China would be 92, of which a few have more than one subsidiary, thus taking the total to 107 in all. Most of these subsidiaries are productive businesses (49%), followed by commercial subsidiaries involved in the merchandising of goods and services (36%). The rest belong to the services sector (16%).

2.2.1. Geographical distribution

Basque subsidiaries are basically situated in the coastal area, in eastern China. This area has experienced rapid development in recent years. However, economic expansion is gradually spreading inland. Shanghai (35 subsidiaries, 32% of the total) is the region with most Basque firms, followed by Jiangsu and Beijing (24 and 17 subsidiaries, 22% and 17% of total Basque subsidiaries in China respectively). This data suggests that seven out of ten Basque firms established in China are concentrated in these three areas (see Figure 2.1).

Figure 2.1. Setting up Basque subsidiaries in China



Distribution by economic activities is not uniform and follows certain patterns. So, depending on the nature of the economic activities involved, Beijing, Hong Kong and Shanghai (the major administrative and institutional centres) have the largest share of subsidiaries and commercial services. In particular, nine business subsidiaries are located in these three cities, and all the services firms are located in these three major regions.

Most productive subsidiaries are located in Shanghai and the two neighbouring provinces (Jiangsu and Zhejiang), followed by the provinces of Guangdong and Tianjin. The establishment of Basque firms in eastern China seems logical, considering the state of infrastructures and the level of economic development experienced so far in other regions of inland China.

As well as being enormous, China is also a very varied country, hosting more than 50 ethnic groups. Adapting to the social and business environment is complicated, particularly when we head towards the western (but least "westernized") part of the country. As some economists argue, the level of economic development is a key factor affecting business location (Gomory and Baumol, 2000).

2.2.2. Sectorial distribution

From the data provided by SPRI, we can classify the subsidiaries of Basque firms in China by way of the disaggregation of productive activities in various sectors of manufacturing (code D of the CNAE):

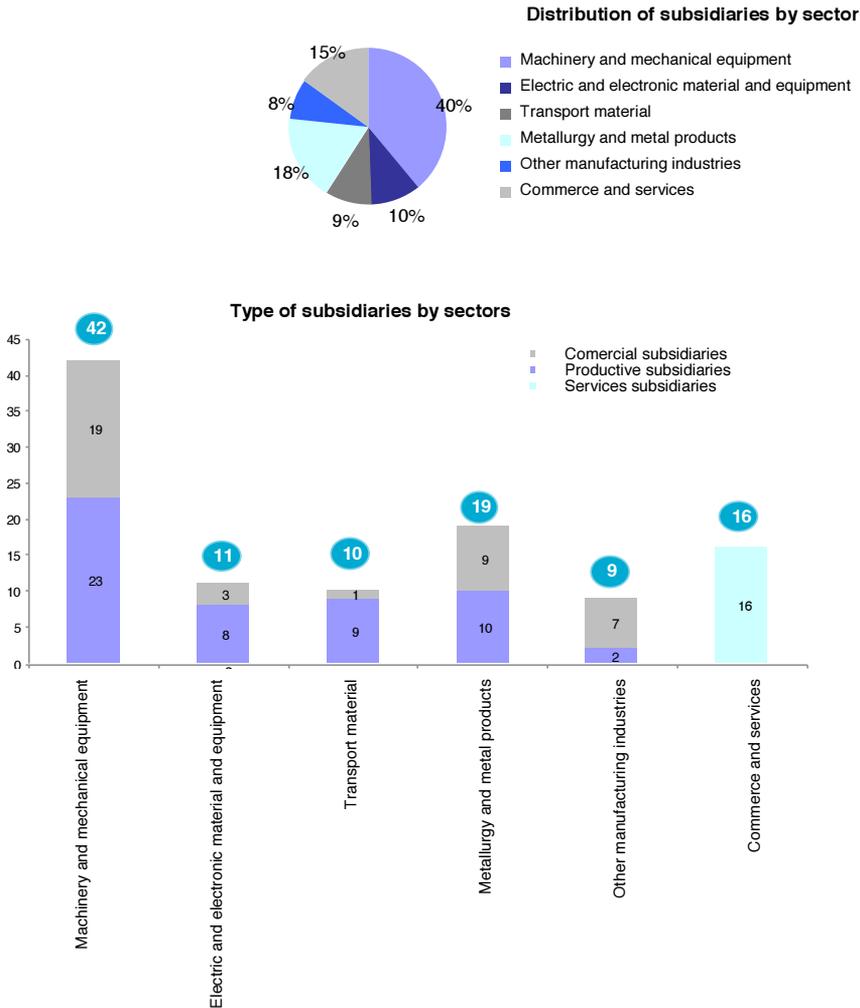
- Machinery construction and mechanical equipment industry (code DK): 23 productive subsidiaries (44% of all Basque productive subsidiaries in China).
- Metallurgy and metal product manufacture (code DJ): 10 productive subsidiaries (19% of all Basque productive subsidiaries in China).
- Electric, electronic and optical material and equipment manufacture (code DL): 8 productive subsidiaries (15% of all Basque productive subsidiaries in China).
- Transport material production (code DM): 9 productive subsidiaries (17% of all Basque productive subsidiaries in China).
- Diverse manufacturing industries (code DN): 2 productive subsidiaries (4% of all Basque productive subsidiaries in China).

Firms in the services sector may be classified as follows:

- Business services: 9 services subsidiaries (56% of all Basque services subsidiaries in China).
- Financial intermediation: 3 services subsidiaries (19% of all Basque services subsidiaries in China).
- Wholesale trading: 2 services subsidiaries (13% of all Basque services subsidiaries in China).
- Transport: 2 services subsidiaries (13% of all Basque services subsidiaries in China).

From the initial geographic and sectorial diagnosis of this sector, we can anticipate some provisional conclusions. The vast majority of Basque firms are located in the eastern part of China. A high proportion of subsidiaries (i.e. more than half) are productive, with particular prominence in the field of machinery and mechanical equipment manufacturing, in keeping with the industrial tradition of the Basque Country. However, many productive subsidiaries associated with one particular sector are also accompanied by trade subsidiaries, as *Figure 2.2* shows.

Figure 2.2. Setting up Basque subsidiaries in China by sectors



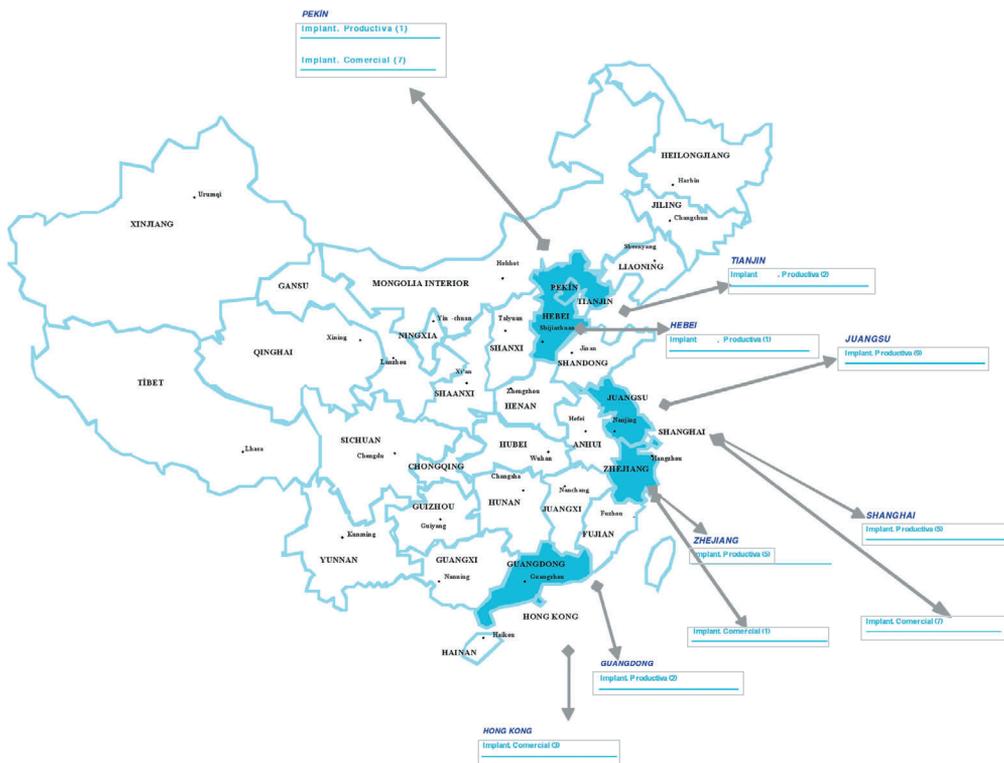
2.2.3. Geographical distribution of economic activities carried out by Basque firms in China

Basque subsidiaries are spatially distributed in different ways depending on the economic activity involved or the economic sector they belong to. An analysis of the geographical distribution of Basque subsidiaries for each economic sector is therefore of some interest.

One manufacturing activity worth analyzing separately is the sector of machinery and mechanical equipment, owing to the number of Basque subsidiaries from this sector in China (see Figure 2.3).

A very high proportion of productive subsidiaries are concentrated in the regions adjacent to Juangsu, Shanghai and Zhejiang. Oddly enough, the commercial subsidiaries, apart from in the Shanghai region, are concentrated in Beijing, where we only found one productive subsidiary. Included in the concentration are a large number of subsidiaries belonging to the cooperative group Mondragón Cooperative Corporation. Another interesting point is the geographical diversification pursued by the company Savera, which has subsidiaries throughout

Figure 2.3. Incorporation of Basque subsidiaries in China in the Machinery and Mechanical Equipment Sector



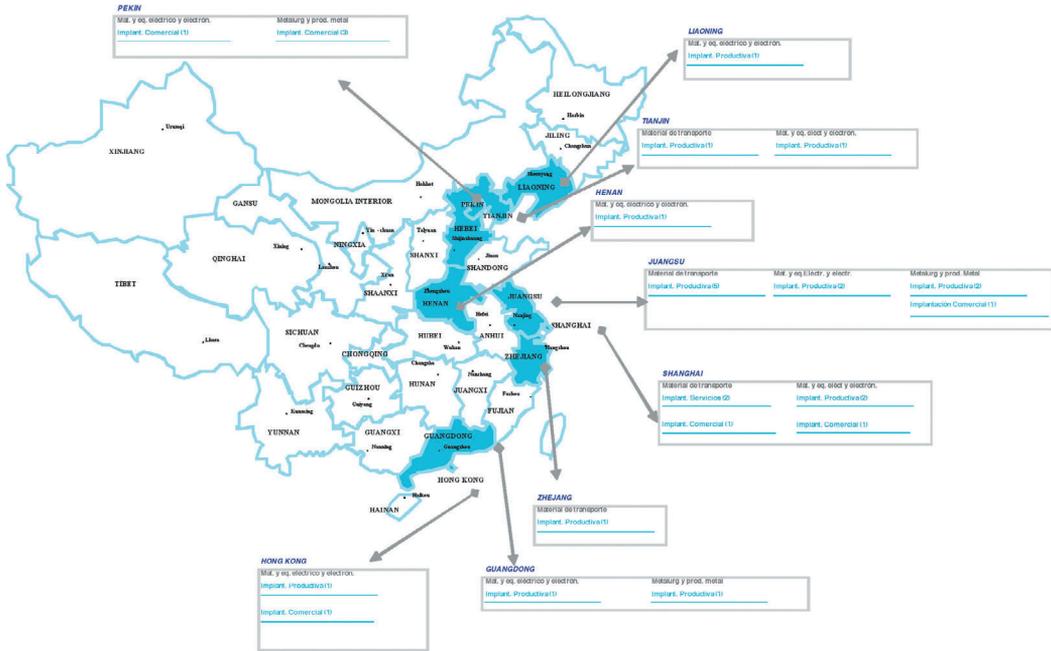
Source: Own elaboration.

the east from Guangdong (southern China) to Tianjin (northern China). Considering the dispersion (from north to south) of productive and commercial activities in machinery and mechanical equipment manufacture, instead of there being one sole geographical enclave for the development of a specific cluster in China, there appears to be several particular geographical areas hosting the development of several clusters in various parts of the country. Alternatively, it may also be that no intentional clustering existed in any area. In this case, there may be other reasons for the way Basque subsidiaries in this sector are distributed in China may be put down to, and not ones that favour clustering.

We now consider other manufacturing activities, for which it is more difficult to identify the existence of clusters. As Figure 2.4 shows, the spatial distribution of the location of subsidiaries is more pronounced than for the previous case, although the presence of Basque firms in provinces beyond those mentioned above is minimal.

Although the presence of Basque productive subsidiaries from the metal and metal products sector is strong in the south of the country, Guangdong, trade subsidiaries in this sector are concentrated in the Beijing area. Productive subsidiaries of the electrical material and equipment sector are much more widely distributed, from the north of the country (Liaoning) to the south, in the Guangdong and Hong Kong regions. Finally, productive subsidiaries involved in the manufacture of vehicles are mostly concentrated to the north of

Figure 2.4. Basque firm subsidiary establishment in China in the Electric Material and Equipment, Transport Material, Metallurgy and Metal Products Sector



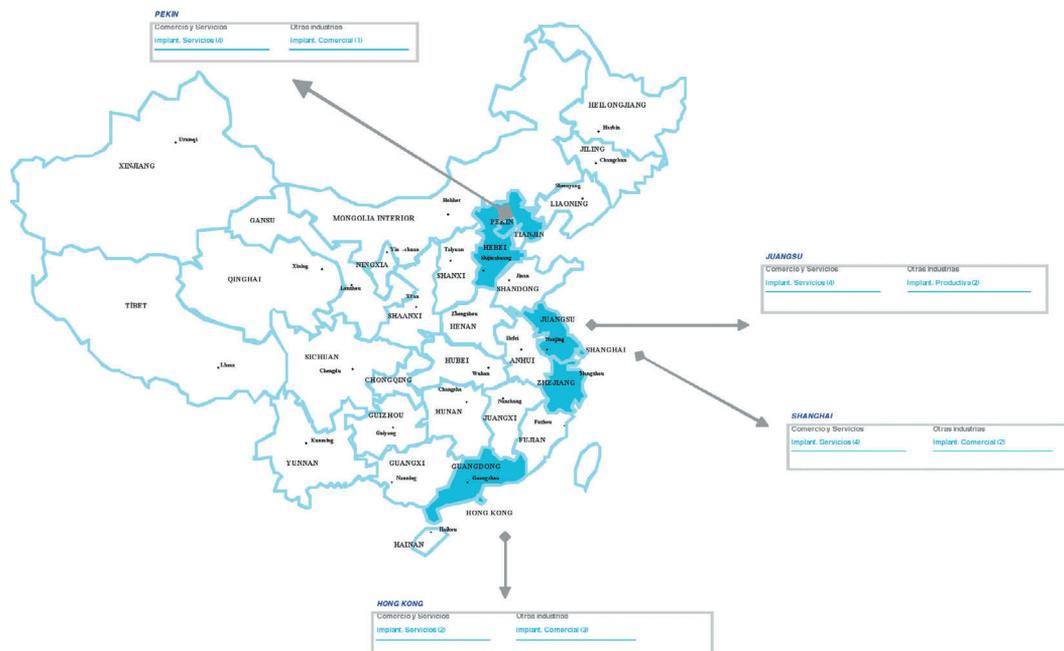
Source: Own elaboration.

Shanghai in an area called Juangsu. In short, the concentration of Basque productive sector subsidiaries in the metallurgy and metal products industry is significant in Guangdong (SE China). There is also another major concentration of Basque productive subsidiaries in the transport equipment sector in Juangsu (SE China). Basque productive subsidiaries in the electrical equipment and material sector are distributed down the eastern side of the country. Subsidiaries from commercial manufacturing sectors are largely concentrated in the province of Beijing.

Most Basque services sector subsidiaries in China are concentrated in the province of Shanghai, with a few in Beijing and Hong Kong (see Figure 2.5). All three cities are large, are major bureaucratic centres and have global outreach, given the major presence of multinational corporations and government agencies there, which makes the distribution of the Basque services subsidiaries in China less surprising.

By and large, Basque subsidiaries in China are located throughout the eastern part of the country, with a large proportion of productive subsidiaries. Some of the Basque productive subsidiaries in particular sectors (e.g. transport equipment, machinery and mechanical equipment) tend to be concentrated in specific regions (e.g. SE China), although we do not have enough evidence to show that this concentration occurs as a result of the development of specific clusters. Moreover, services are located in big cities such as Shanghai, Beijing and Hong Kong.

Figure 2.5. Basque firm subsidiary establishment in China in the Commerce and Services Sector and other Manufacturing Industries



Source: Own elaboration.

2.3. How to be competitive *in/from* China

There are many reasons for choosing China as a place to conduct certain economic activities (Dunning, 1977). Certainly, Basque firms in China have a wide range of explanations for the decision to enter the country. But besides having overcome the challenge involved in entering this market, Basque organizations accept the challenge of building a competitive firm “*in*” a foreign context, and, as far as possible, a competitive firm “*from*” a new and important node in the global arena. All these challenges, to a greater or lesser extent, are part of the strategic decisions that executives at both parent and subsidiary offices must continuously analyze to extend the overall value of their organizations.

As a complement to the diagnosis of the Basque business presence in China, as described in the preceding paragraph, and in particular as a way of finding out more about the process of introduction and development of Basque business projects in China, we conducted a study in which information was gathered from a total of 33 Basque firms. A questionnaire was designed and sent to executives from Basque firms located in China. Some were interviewed personally at their businesses for further details. Interviews with executives, as well as with staff responsible for certain administrative and educational institutions, were conducted in May 2008.

The questionnaires were filled in and returned between May and June of that year. The profile of companies in the sample was the one we believe to be representative of Basque firms with subsidiaries in China: 22 companies with production facilities in China (which

represent 40% of total productive subsidiaries in China), 8 companies with offices or commercial representation (representing 20% of total commercial subsidiaries in China), and 5 service companies (representing 30% of Basque services firms in China). Subjects covered by the questionnaire were:

- Reasons for setting up subsidiaries in China: The questionnaire includes questions about the main reasons why these Basque firms decided to opt for the Chinese market.
- Ways they entered the Chinese market: questions were asked about decisions to enter individually, or with a partner, the geographical location chosen for setting up subsidiaries, etc.
- Exploitation of competitive advantages *in/from* China: various kinds of subsidiaries were identified and information gathered for each one about expected sales and profits. Likewise information was sought about the activities of the productive subsidiaries (supplies, production characteristics in China, degree of adaptation to Chinese market, exchange system between Chinese firm and parent office).
- Management of human resources in China: questions were included about the generation of employment in Basque firms in China, the number and profile of executives (expatriates) in China, and recommendations for people management in China.

The answers given by our executives to each of the questionnaire’s four generic themes are described below.

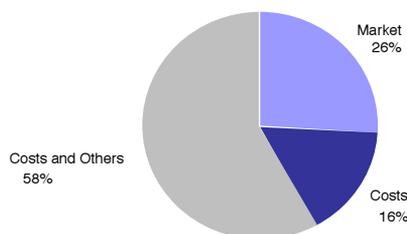
2.3.1. Reasons for setting up subsidiaries in China

There are two main reasons why Basque firms decide to go into China: lower costs (e.g. to buy or produce more cheaply) and the possibility of extending their market (i.e. to sell in China to its own customers who live there, to new Chinese customers and to exploit the enormous potential for market growth, and the potential of other neighbouring Asian countries). There could well be other reasons such as diversification of risk in the case of multinational companies with factories in various parts of the world, or as a response to the behaviour of other multinational companies which decide to set up in this market (i.e. firms imitate this behaviour so as not to miss an opportunity that competitors might use to improve their competitive position). Generally, executives tend to identify and defend additional reasons when arguing in favour of their activity in a foreign market.

As *Figure 2.6* shows, the following conclusions can be drawn:

- 26% of interviewees decided to go into China to expand their market and improve their annual sales revenues.
- 16% of interviewees said that setting up their subsidiary was justified by access to cheaper production factors.

Figure 2.6. Main reasons why Basque firms go into China



However, most executives argue that a combination of the two existed.

Other motives included:

- Increasing the capacity of the supply chain
- The need to be close to their habitual clients
- To take advantage of economies of scale
- To complete a product range
- Productive flexibility to keep up with changing market trends
- Logistics

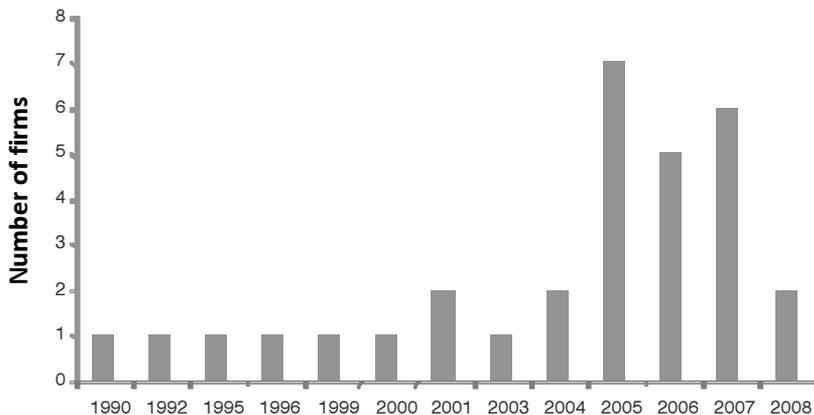
Comments at interviews showed that the main reason for companies to set up in China varied over time. At first, the main argument was cheaper production. In a second more recent stage, however, there was a growing interest in expanding market shares in China and in taking advantage of the strong growth in the market.

We found two approaches, one proactive, the other defensive, for entering the Chinese market. The defensive approaches included situations such as the aftermath of the parent company losing a high percentage of sales revenues or the demands of a major customer for a subsidiary to be set up near its own company in that country (under the threat of ending orders if no subsidiary was set up within a certain period). Under such circumstances, some Basque firms had little option but to go to China. But the approach can be more proactive. For example, companies want to become global leaders in their area of activity by taking advantage of the opportunities the market offers. They therefore have a stake in learning how to compete and strengthen their organizational skills globally, from China, or simply want to identify and exploit the high growth potential the Chinese market currently offers.

2.3.2. Entering the Chinese market

For nearly twenty years, Basque firms entered China in a gradual, fairly limited way. However, this process has changed recently. Almost two thirds of sample subsidiaries had been set up since 2005 (see Figure 2.7), indicating that this phenomenon has become more important in recent years.

Figure 2.7. Basque subsidiaries set up yearly in China



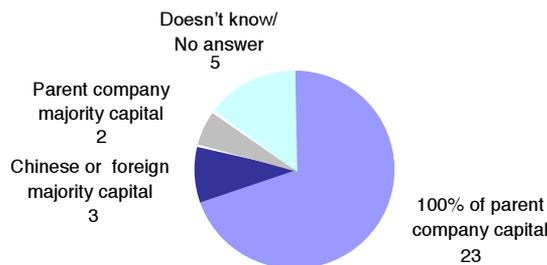
An important strategic decision facing executives is how and where to set up in China. Entrance into China can occur individually or with partners. But China is so big that it is hard to get location right first time. Executives taking part in our study were questioned about both issues. Their answers are described below.

Decisions on the possibility, and, where applicable, the convenience of entering the Chinese market depended on a range of factors:

- Chinese legislation restricts the establishment of subsidiaries of foreign companies that may wish to set up as WOFES (Whole Owned Foreign Firms). That is, in certain economic sectors, one cannot enter with fully autonomous capital, and the only way to go into the Chinese market is by way of a partner company in the country. In cases where the WOFE formula is feasible, and when market unreliability is low, the WOFE formula provides advantages for making decisions according to the criteria of the parent company, for freely extending the corporation's own organizational culture, and for preventing the leakage of know-how to the junior company when implementing new technologies.
- The contribution of the local partner. The local partner company may provide administrative agility to speed up the establishment of subsidiaries, access to important agents such as clients, suppliers, banks and public institutions, etc.
- The contribution of the Basque company to the partner. Many Chinese companies which have a good business record fail to show any great interest in joining up with a foreign company, except when they detect a source of increased value for their organization. The possibility of joining up with a Chinese partner, on this occasion, would be conditioned by the advantage of increased values offered by the Basque firm.

Figure 2.8 shows that the majority of Basque firms entered the Chinese market under the WOFE formula. In fact, of the 33 firms in our sample, 23 of them are considered "green field investment" subsidiaries with 100% capital belonging to the original firm. Five companies were established with mixed (majority or minority) capital.

Figure 2.8. Distribution of firms according to the different kinds of property involved in Basque subsidiaries in China



As regards the location of subsidiaries, interviewees stressed the following aspects:

- Proximity to suppliers and clients. Proximity to firms from which one buys or to which one sells, is an advantage as regards time, transport cost and the intensity of the relationship (*empathy*).

- Availability of qualified labour in the surrounding area. In more remote regions, such as the inland areas of the country, it is harder to find qualified labour. Of the existing critical mass, a large number of skilled people opt to move to big cities in search of better opportunities.
- Commodity and standard of living for executives of Basque firms (social interplay and leisure, medical care, etc.).
- Communications and infrastructures (nearness to ports, airports, etc.). Logistics have seen some profound changes in the last few years and offer hitherto unknown advantages.
- Taking advantage of cost reduction potential. Production factor prices are not the same throughout China. There are differences between Chinese regions, which may make a difference when choosing the place to set up a subsidiary.
- The public authorities (Government, local authorities or business parks) offer facilities as regards land, services, fiscal advantages, etc. to attract FDI.

Most companies have benefited from different kinds of support in the process of entering China. This support might be fiscal, financial, special information, etc. and come from Chinese institutions (province, state) or European ones (Basque, State, chambers of commerce). *Table 2.1* gives information on the distribution of support depending on the type available and the issuing institution involved.

- Support comes from various agencies, including the Basque institutions, which had in fact offered support to 75% of the companies of our sample. The Chinese authorities offered support to one third of the companies in our sample.
- Chinese support on tax issues is significant. For other forms of support (financial, information, etc.) the Basque authorities offer most support, usually information.

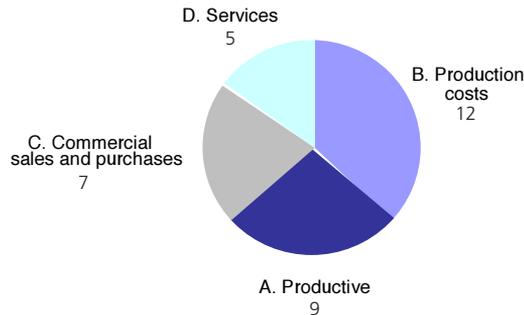
Table 2.1. Distribution of firms as regards different kinds of property associated with Basque subsidiaries in China

INSTITUTIONS	Fiscal support	Financial support	Information support	Training support	Others	Number of firms
Basque institutions	3	17	18	4	1	25
State institutions	0	8	12	2	1	17
Chambers of commerce	1	3	11	3	1	13
Chinese regional institutions	5	3	5	0	0	10
Chinese State institutions	2	0	0	0	0	2

2.3.3. *Exploiting competitive advantages in/from China*

The data gathered shows that companies set up in China to access cheaper production factors, are generally smaller, China being their only overseas subsidiary. In contrast, companies that come to the Chinese market to market their goods are often larger and have more facilities in other countries. To find out more about the profile of Basque firms in China, we classified these subsidiaries into four groups (see *Figure 2.9*):

Figure 2.9. Distribution of firms according to types A, B, C and D (number of questionnaires received for each type)



Type A subsidiaries: Firms that **produce** in China to **sell basically to the Chinese and Asian markets**, to new Chinese clients or to their multinational clients established in these regions. Of the 33 firms in our sample, 9 belonged to this group. Of these, a little over half (5 subsidiaries) sell exclusively in China and the other 4 subsidiaries sell over 60% in China. The rest of their sales are to other Asian markets or to the rest of the world. In all these cases, we are dealing with large companies (e.g. ones with between 250 and 11,000 employees) with subsidiaries in other countries. Most sales are to Chinese domestic companies except for the case of two companies that sell mainly to multinational companies based in China. Some companies take advantage of their facilities in China to supply components and equipment to the parent company or to customers throughout the world. The main competitors are multinational companies located in China and important Chinese companies. These companies are striving to exploit their competitive advantages *in/from* China.

Type B subsidiaries: Firms that **produce** in China to have access to **cheaper production factors** and supply mainly to their markets in Europe. We place most interviewees within this group (12 questionnaires received belong to this group). Only 5 of the 12 firms sell in China, and these companies' billing in China does not reach 30%. Except for one company, all are SME (e.g. subsidiaries with less than 250 employees). For the majority of these firms, it is their only productive subsidiary abroad. In this case, these firms basically make a special effort to exploit their competitive advantages *"from"* China.

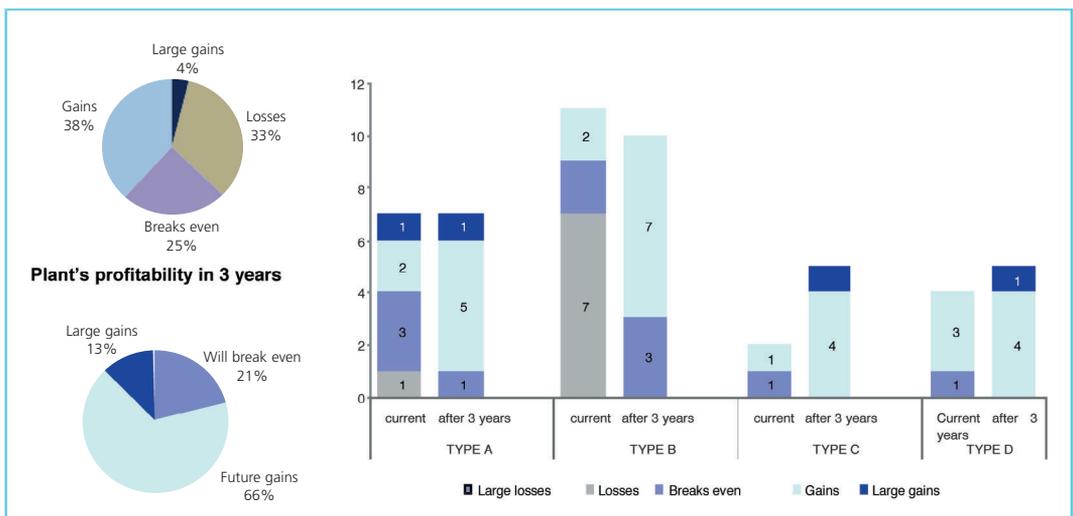
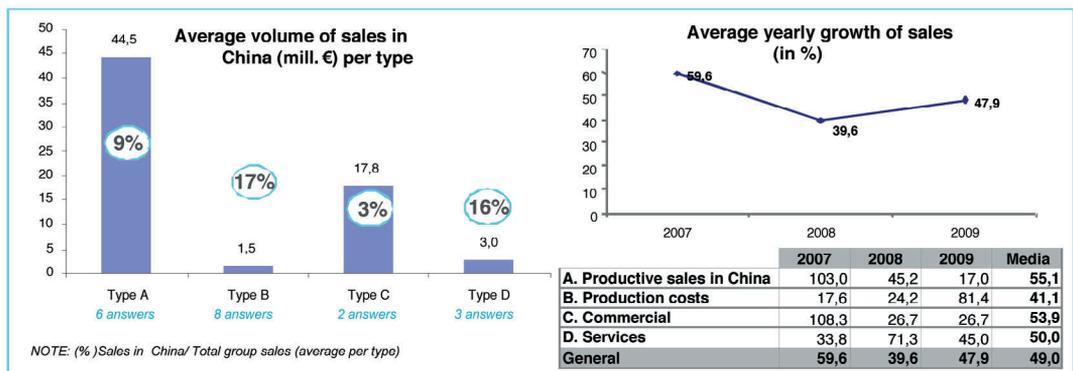
Type C subsidiaries: Firms with **a commercial office in** China aimed at selling or purchasing in this market. We differentiate firms that have an office set up for sales in China (4 subsidiaries). These firms are large organizations (i.e. companies with more than 250 employees) that have been operating in China since before 2004 and have subsidiaries in other countries. Most of their sales are made to Chinese customers. The business activities of these firms are geared to enable the organization to exploit its competitive advantages *"in"* China. Furthermore, we distinguish firms having purchasing offices in China (3 questionnaires received). These medium-sized firms, of between 100 and 250 employees, have a single subsidiary abroad (the China subsidiary itself) *"from"* which they seek to improve their competitive advantage.

Type D subsidiaries: Services firms, providing their services to European firms operating in China or to Chinese firms. 5 questionnaires received. Two subcategories can be made out depending on the type of target customers: firms providing services mainly to European clients in their operations in China; and firms which largely offer their services to Chinese domestic firms.

Basque subsidiaries in China (which took part in our study) record average sales of €30 million, with a minimum of €1 million and a maximum of €490 million. This figure represents an average of 24% of the total annual sales registered by the companies to which they belong. However, the percentage varies according to the type of subsidiary involved. As expected, firms of type A and C that sell their products in China, have the highest sales revenues figures and the best sales growth prospects (See Figure 2.10).

Prospects for the near future for sales growth are good, and in most cases exceed 20% annually. The impact of some newly established firms is worth noting. Their growth in percentage terms is very high. They therefore contribute significantly to increasing the overall average growth in sales.

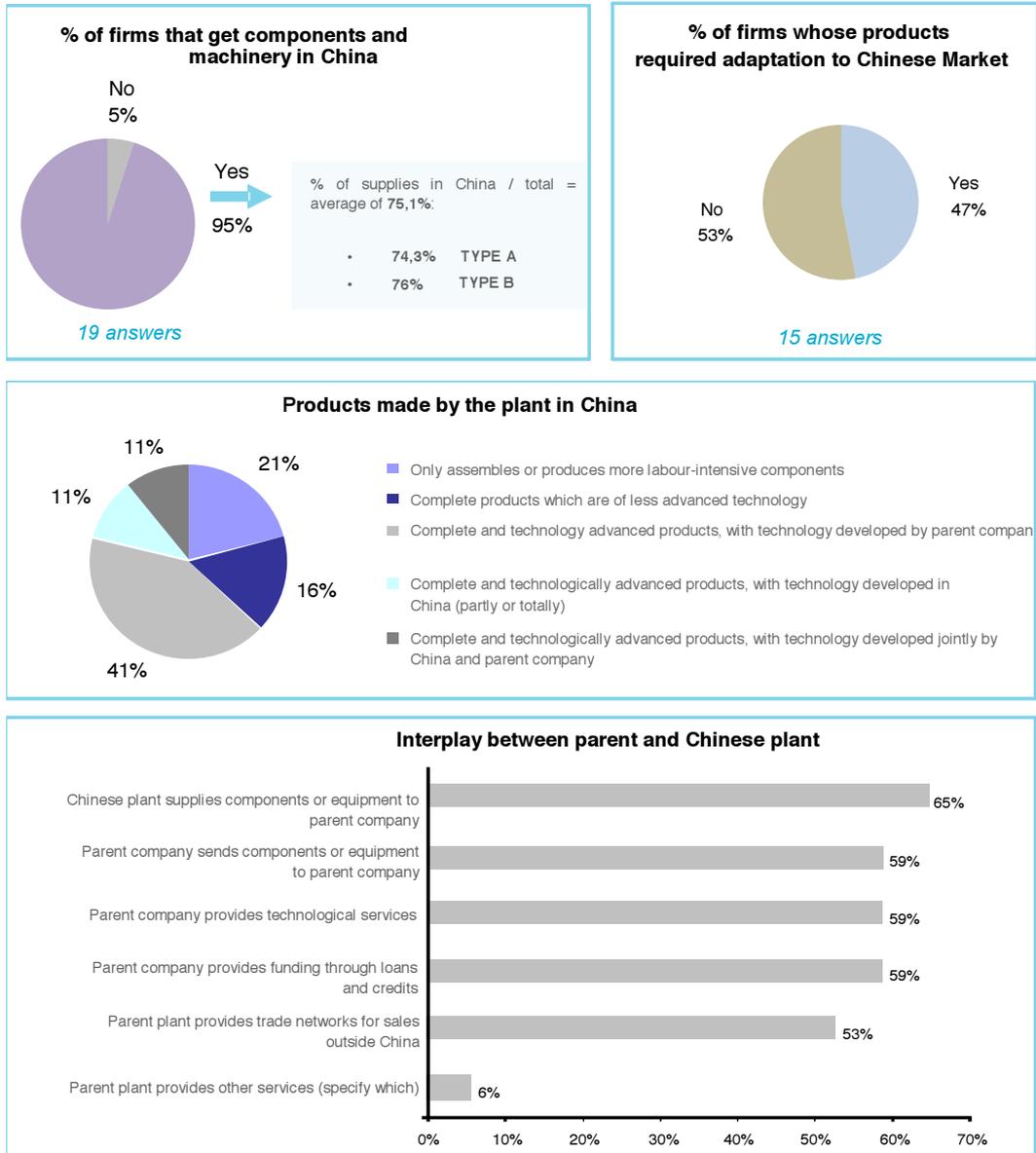
Figure 2.10. Sales and profitability of Basque Subsidiaries in China



Over 40% of the 24 executives who responded to the question of the organization's financial profitability said they made money, one third said that they lost money, and 25% broke even. Roughly eight out of ten executives expect their firms in China to increase profitability in the future.

Type A and D firms have the best rates of return at present. In contrast, type B firms, which decide to establish themselves in China attracted by the advantages derived from lower production costs show the worst profitability figures. Type A, C and D Basque subsidiaries are the most optimistic as regards obtaining a higher profitability in China today.

Figure 2.11. Supply, Products and Flow from Parent Company to Basque Subsidiaries in China



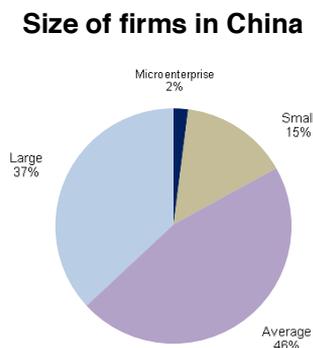
The vast majority of productive subsidiaries in China purchase machinery and components in China (see Figure 2.11). On average, supplies in the Chinese market accounted for 76% of the total. As regards product sales, less than half of the firms make changes in their products to suit the Chinese market. The majority of firms (63%) produce technologically advanced and complete products, mostly with technology developed by the parent company. However, in some cases, technology is developed in China or jointly by the parent and the Chinese company. Nearly 21% of productive subsidiaries only assemble or produce more labour-intensive products, while 16% produce complete products which are less technologically advanced than ones produced by the parent company.

In most cases there are constant streams of a different nature between the parent company and the plant in China. Thus, in 65% of cases, the Chinese plant supplies components or equipment to the parent company. In 59% of cases, the parent factory sends components or equipment to the company established in China. It also provides technology services and provides funding via loans or credits. In 53%, the parent plant provides commercial networks for sales outside China. In addition, some firms have indicated that the parent plant provides other services such as legal services, human resources, logistics, information systems, training or financial management. Despite the geographical distance, the link between the parent company and the subsidiary remains very close. In short, to be competitive *in/from* China today, firms analyzed were largely dependent on the extensive support provided by the parent company.

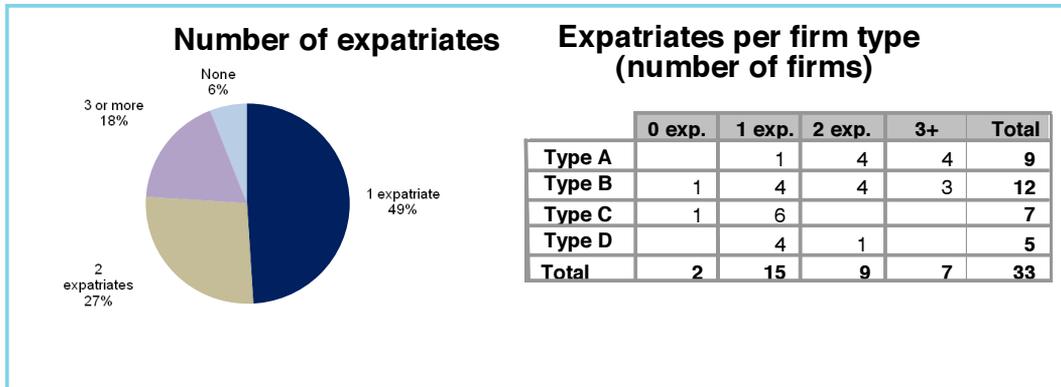
2.3.4. Human resources management in China

Executives from a little over one third of the firms that took part in our study said they had set up factories that generate over 250 jobs. In other words, apart from these exceptions, Chinese subsidiaries of Basque firms are usually small or medium-sized (See Figure 2.12). Productive subsidiaries are obviously larger than commercial or services subsidiaries. Among the productive subsidiaries, ones aimed at selling in China and the Asian market (Basque Type A subsidiaries) are in general bigger than those aimed at benefiting from lower production costs in order to sell on the home market (Basque Type B subsidiaries). In fact, Basque Type A subsidiaries have the greatest number of skilled workers on the payroll. On the other hand, the percentage of employees in Basque subsidiaries in China is high with regard to the total number of employees belonging to the business group (53%). These are generally Type B subsidiaries. This figure is 13% for Type A subsidiaries and 22% for Type D subsidiaries.

Figure 2.12. Employment and Human Resource Characteristics of Chinese Subsidiaries



	Av. employment in China	% jobs in group	Average skilled jobs	Average MOD
A. Production sales in China	203,1	13%	22,3	121,8
B. Production costs	39,0	53%	5,6	26,7
C. Commercial	7,2	2%	6,5	3,0
D. Services	11,0	22%	6,0	8,0



Only a minority of Basque subsidiaries in China have Chinese executives. In fact half the firms have an expatriate executive, 27% two expatriates, and 18% have three or more expatriates in China. Many executives interviewed felt staff management (both local and expatriate) was a crucial element for success *in* and *from* the Chinese market.

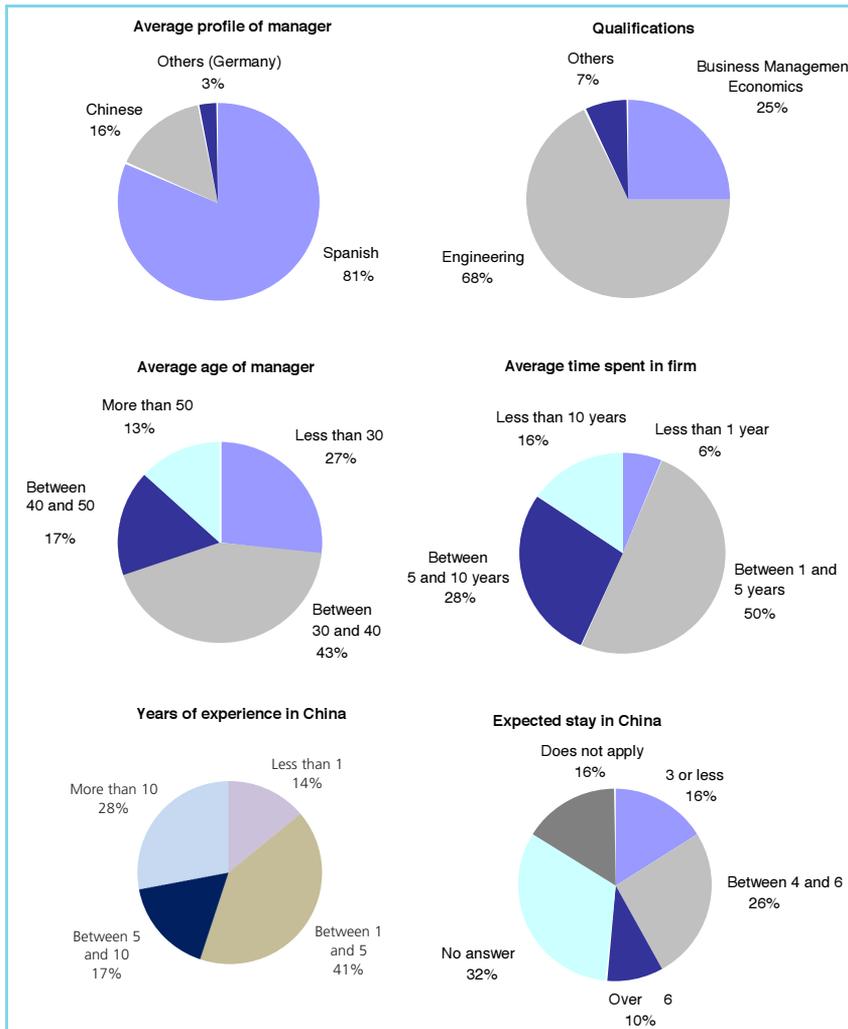
Management of the parent company need to be aware of how difficult setting up a Basque subsidiary in China is. The executives we interviewed appreciated the support of the parent company in the financial, logistical, and, above all, the moral aspects involved (e.g. the expatriate often feels helpless and faces constant pressure in an alien environment). Some of those interviewed considered it important for management to visit China regularly to give support and understand the Chinese scene. Likewise, they recommended Chinese employees should visit the parent company. The largest firms had defined clear ongoing mediation policies (e.g. establishing mechanisms to resolve problems immediately, choosing the best people to visit the subsidiary or parent firms, etc.).

Overall, the executives we interviewed felt there was room for improvement in the process of expatriate replacement. The length of a stay in China is sometimes negotiated in the absence of planned repatriation. In the opinion of several executives we interviewed, part of the management team must be of Chinese origin and have a good level of English. They must also have visited the company in the BC. Headhunters are a major problem for Basque subsidiaries in China. It is very important to retain junior executives of Chinese origin. In the first place, exercising leadership and creating a team (investing time in developing relationships inside and outside the company, taking special care not to criticize staff in the presence of other employees); secondly, providing balance for their personal life and attractive wages and other advantages (health security for the family, etc.); and finally, providing a motivating future career. Indeed, Chinese executives are attracted by jobs in international companies and learning about other languages, firms, cultures, and so on.

The profile of the executives at Basque subsidiaries in China is as follows:

- The vast majority are Spanish (81%), although 16% of the subsidiaries have Chinese executives.
- The majority are engineers (68%), followed by degree-holders in Business Administration and Management or Economics (25%).
- The average age is between 30 and 40 although 25% is under the age of 30.
- Half the interviewees had been working in the company between 1 and 5 years, and 44% more than 5 years (as against 6% of executives who have been there less than one year). Furthermore, most executives have had several years experience in China (almost 60% between 1 and 10 years, and almost 30% have been in China for over 10 years).

Figure 2.13. Employment and Human Resource Characteristics at Chinese Subsidiaries

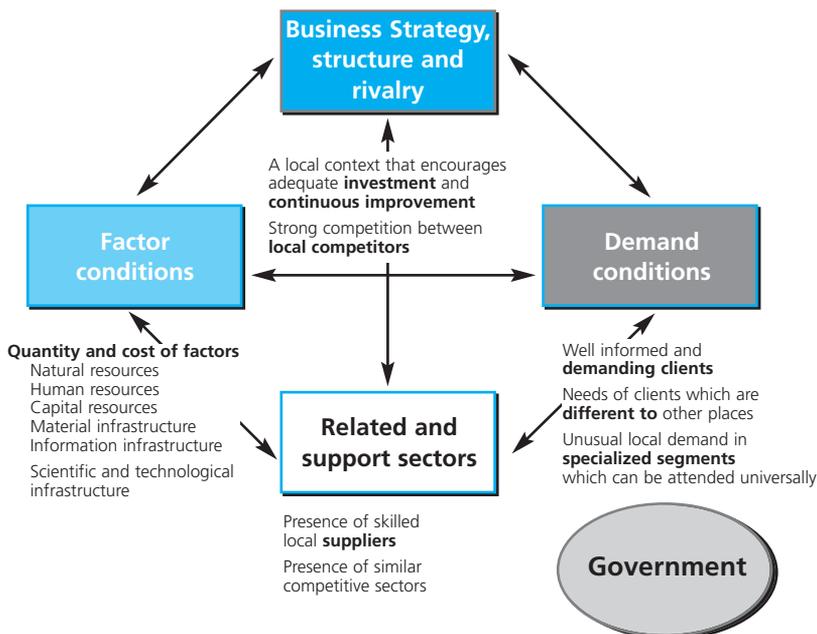


According to some executives, the success of the business project in China depends largely on the degree of personal adaptation to the situation. Executives must preferably possess a number of virtues. They have to be very adaptable and learn to live and work in a very different environment and need to understand the rules of the game and to adjust, to react capably, to act quickly and seize opportunities. They also need to be very tolerant and humble, though also persevering. Executives say that negotiations are usually slower and that the Chinese tend to be very persistent. Having prior international experience is considered an advantage, preferably in China (because learning the culture and habits of China is extremely useful). As well as being a highly valued merit, knowing or learning Chinese is greatly appreciated by Chinese workers and clients. It provides a means of cultivating relations for the “*Guanxi*” as well as establishing networks within the Chinese market. On the other hand, when conditions are not minimally respected within a negotiation, casual orders should sometimes be turned down, as should prototypes without contract etc.. To do so, one should have clear objectives. The business process in the Chinese market should be perfectly under control.

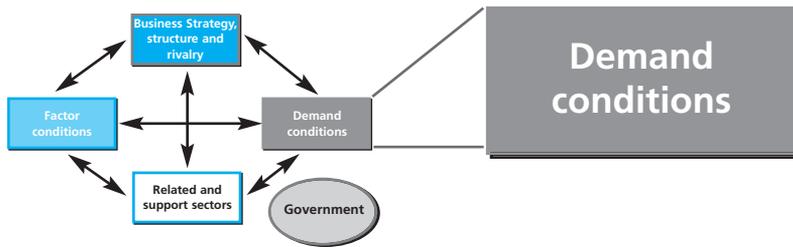
2.4. Principal strengths and obstacles for competing *in/from* China

Running a business in the Chinese market is a complex challenge, despite the continuous progress the country is making. In this context, new opportunities and threats crop up that Basque subsidiaries must deal with using their resources and strengths, while minimizing, whenever possible, their weaknesses. We based our summary of all these vitally important issues for analyzing the competitiveness of Basque subsidiaries *in/from* China on the *Diamond Model* (Porter, 1998). In particular, we briefly identified the main strengths and obstacles facing the Basque subsidiaries in relation to: demand conditions, Strategy-Structure-Business rivalry, related support sectors, factor conditions and the role played by the Chinese Government (see *Figure 2.14*).

Figure 2.14. The Porter Diamond Model



2.4.1. Demand conditions



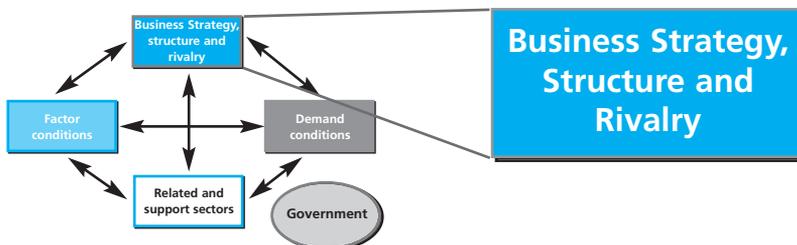
Principal strengths

- An enormous market with huge growth potential.
- China is engaging in the market economy and is taking great strides towards world leadership in terms of GDP.
- There are about 900 million Chinese awaiting their incorporation into the welfare state as their personal income rises.
- Great transformations are expected in many sectors (great projects in agriculture and the food industry, great energy and pollution control measures needed, etc.) which may increase the demand for intermediate goods and services.
- Presence of many multinational firms, which may also operate as suppliers of quality and technology.
- Different levels of demand sophistication. The greatest opportunities for European firms are with the most sophisticated clients.
- A good platform for selling to the rest of Asia.

Principal obstacles

- Difficulty in understanding the size and diversity of China (it is a country with many different faces).
- In general, Chinese firms offer worse conditions and are less formal in their payments than the average in Europe.
- Important cultural differences and in the way business is handled. "Guanxi" relations, which, along with the language barrier, make sales to Chinese clients difficult.

2.4.2. Strategy, Structure and Business Rivalry



Principal strengths

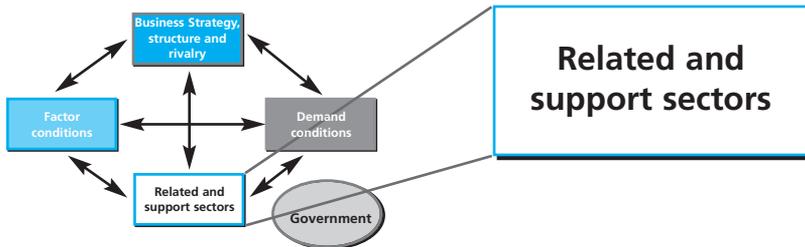
- Strong industrial tradition with firms that belong or belonged to the State.
- Great business dynamics.

- Firms with a great capacity for investment.
- Major competition from multinational and Chinese companies which are starting to compete in Europe and USA.
- Being in China should help Basque firms to learn to compete with Chinese businesses worldwide.

Principal obstacles

- Deficient quality control and technology levels at Chinese firms, although they are improving in both aspects steadily. It is an opportunity for European firms which are still able to contribute with technological improvements and better quality.
- Growing protectionism and different conditions for foreign firms. In general, an increase in protectionism is observed as regards simpler products and equipment, with an increase in customs duties, whereas facilities for the sale of advanced technology machines continue to exist.

2.4.3. Related and support sectors



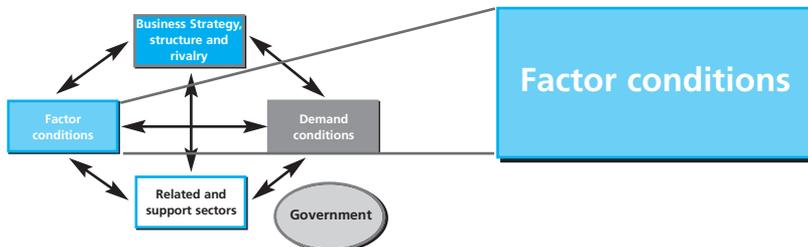
Principal strengths

- A wide variety of suppliers at competitive prices.
- Great opportunities for development of suppliers due to the wealth of capital that is being set aside for industrial investment.

Principal obstacles

- Difficulties in developing the supply chain with stable quality and prices.
- Gap in services suppliers (they have advanced much more industrially than in services).

2.4.4. Factor conditions



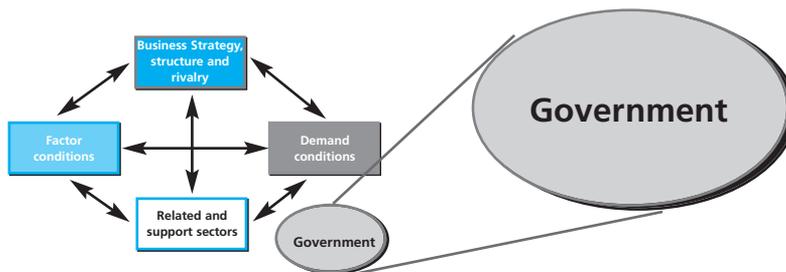
Principal strengths

- Very competitive costs (labour, materials, machinery, land, etc.), although they have risen significantly in the last few years.
- Abundance of labour and skilled workers. Dynamic nature of part of the population (they have a very business-like attitude). Chinese society is full of energy, and the young people full of optimism and faith.
- Good communications and infrastructures, with high competence and availability of logistics and transport operators. Major infrastructure works are planned (roads, high velocity trains, etc.).

Principal obstacles

- Difficulty in contracting and retaining skilled workers. Heavy foreign investment produces tension in the labour market, affecting the best professionals, from junior executives to the leading executive posts, with constant offers by headhunter enterprises. Those who know English and have training in high level management receive many offers and their salaries may be similar to those in Europe. Labour is volatile. By changing company, workers may double their salary in a year.
- Cultural differences: on the one hand, there are communication difficulties due to the language barrier and different reasoning patterns. On the other hand, there are difficulties in achieving the involvement and participation of employees in management activities. It is very important to lay down clear rules and procedures, and to work on interpersonal relations.
- Insecurity regarding the stability of an overheated economy, with a high inflation rate and some sectors (such as the building trade) affected by heavy speculation, leading to a great rise in prices. Other problems such as currency appreciation, social tensions between regions and serious pollution cannot be ignored.

2.4.5. Government



Principal strengths

- Major investment capacity
- Political stability, with relevant initiatives planned and carried out very efficiently. As one of the interviewee executives says, the Chinese Government has the great advantage of having: (a) a clear wellbeing objective (world's leading GDP); (b) a strategy (development at various speeds in a market economy), and (c) single leadership in a country of 1,300 million inhabitants.
- The provinces of China compete to attract investment (preferentially foreign) that brings new technology with it. For this reason, they favour foreign investment with advanta-

ges as regards the price of land, tax holidays, etc. However, they do not always deliver what they promise, and occasionally change the original conditions.

Principal obstacles

- Unwarranted bureaucracy, which slows things down and calls for more effort on the part of firms. In this sense, (a) there are complicated processes in the State and regional administration which slow down initiatives and operations which are generally simple in Europe; (b) there are certain limitations for firms to manage financial aspects (loans, changes in capital, etc.) and (c) the relation between the different offices is meagre or non-existent.
- Greater legal insecurity especially with regard to technological piracy or copying, and the lack of an independent and agile juridical system, so that if the firm has problems it is often best to try and arrange things or even put up with the harm done.
- Rapid change of laws without notice. The legal system is under construction and each year important laws come out (labour, industrial land allocation, etc.) with major consequences for firms.

2.5. Have we reached the turning point?

The exceptional period of transformation in China is accompanied by opportunities and challenges that are difficult to take advantage of. Approximately one hundred Basque firms, being aware of the advantages and adversities of this promising market, have chosen to take the risk of entering this country. Even in recent years, some of these firms have established more than one subsidiary in this powerful market. Until a few years ago, foreign direct investment of Basque firms in Asia was secondary (Navarro and Olarte, 2004). It is worth noting that this process has recently taken off in a big way, and that about two thirds of the firms in China today entered this market in the last three or four years.

Basque firms that have taken the decision to improve the competitiveness of their organization *in/from* China are fairly heterogeneous. Faithful to the legacy of the Basque industrial tradition, about half of the firms that are located in China belong to the productive sector of manufacturing. Seven out of ten of these firms are concentrated in SE coastal China (Shanghai, Beijing and Jiangsu). Different regions are more—or less—attractive depending on their level of development, tax advantages, and so on. Although some of these firms are concentrated in particular areas, there is no clear reason for thinking that the concentration process is due to clustering.

The decision to enter the Chinese market was taken basically to expand the global market for Basque firms by improving sales revenues in this market, and/or accessing cheaper production factors. Motivations for settling in China are usually plentiful and each company operates in response to its real situation and individual context. In certain instances, Basque firms feel “swept away” when entering this market, which they do because a major customer established in China demands it, or because it is a trend that Basque firms feel obliged to imitate the behaviour of other leading foreign firms in the sector. Normally, Basque firms enter with 100% of their own capital. Sometimes, though, they are forced to enter through alliances with Chinese partners to respect current legislation.

Basque firms in China are either productive firms or involved in marketing/services. Some companies (large firms with global presence) come to China to increase sales. Others (SME with foreign presence in China only) come to benefit from advantages associated with cheaper costs. According to our data, the first group appears to be more profitable than the latter one.

People who have moved to China to lead subsidiary establishment operations there are a major part of the success achieved in this process. Only two out of ten executives are Chinese, two thirds are engineers (aged 30-40) having 1-5 years' experience in the organization. Almost half of Basque firms send at least two people to take charge of setting up the new plant. One remaining challenge is to manage the processes of substitution and repatriation of these executives.

China is a vast and diverse country that offers a complex environment "in" which to compete, and to compete "from". There is no doubt that the competitive environment affects the success of an organization, and conversely, a competitive organization affects the prosperity of a region (Caves, 1996). In this study, we have analyzed some aspects that may affect the competitiveness of Basque subsidiaries. Thus, for example, market demand in this country is progressively acquiring greater levels of sophistication. Although the tastes and preferences of consumers are being progressively westernized, the demand of the Chinese market remains difficult to satisfy due to the existence of barriers (linguistic, different sales habits, etc.). Greater rivalry is seen in the market in general. This may well be the result of the ongoing liberalization of the economy through privatization processes. The entrance of multinational firms in China has increased competition between multinational firms and local and foreign firms, thus helping to increase efficiency and product contrast. This has led the support sectors to substantially improve the development of their activities with respect to quality, delivery deadlines, etc. Although production factors (raw materials, labour, etc.) have also experienced a marked improvement in terms of quality, the fact remains that costs have risen, a development that should be kept in mind for the future. Other concerns also affect factor conditions. One is environmental policy, (e.g. serious pollution problems, energy consumption). Others include respect for human rights and intellectual property. The Government plays an important role in this context. Apart from this legal insecurity, which is very strong in certain areas, and all the disadvantages that are associated with bureaucratic processes, the Chinese Government is committed to the economic and social development of the country, and invests efficiently in infrastructures. It has also promoted competition between regions. The Government certainly has problems with inter-ethnic tensions and wealth and energy supply imbalances. But China offers opportunities. Basque subsidiaries will have to develop their own basic core competencies to be competitive "in" and "from" this environment, progressing towards a rapidly changing world. It is in this environment that Basque firms must find and build up their capacity to compete globally. If the clusterization process has not yet taken root in China, we need to be aware that "every clusterization initiative will take place in a specific, unique and different area" (Azua, 2008). With careful management, this process might well become a never-ending source of value. The arrival of Basque firms in China and the levels of competitiveness they achieve in a promising environment develop in parallel to the growth experienced by the Chinese market. It is hard to tell where, when and how a turning point might be reached in this process, or if we are headed to greater growth or to a slowdown.

Final Considerations

This report sets out to give a fuller knowledge of competitiveness in China. It does so not as an exercise in pure academic research, but rather to facilitate internationalization strategies for Basque companies *in/from* China. Apart from going into the experience of SPRI in China, as well as that of about 100 Basque firms located in this key setting for the global economy, we have set out on an exciting exercise to build models of competitiveness for firms and territories (above all, for their citizens), so that they can carry out their activities.

This Chair needs to invest more time and effort before reaching final conclusions. The same may be said of our summary of the China experience. It is above all a pedagogical and experience-transmission exercise that needs gradually to become more robust.

Like any country in the world where firms are at work, China is a reality that requires comprehension. Its differences, strengths and weaknesses need to be identified. The process calls for the creation of value networks, the establishment of strategic partnerships and, of course, the need to overcome the tendency to penetrate these markets inadequately. In any case, China's strong commitment to the future, together with its size, capabilities and needs -as well as its history- grant it an important role in any scenario. There is a long road ahead, not without major challenges. These include the need to invent a new socio-political model that will allow cohesion and autonomy between its components, environmental improvements, sustainability, true social accessibility policies as applied to domestic demand, the suppression of regional imbalances, and so on. These challenges are not necessarily different to those of other players that make them "manageable challenges." The speed and intensity of the spectacular development China has the potential to make depends on the success or failure of this effort.

Whatever the case, the Basque Chair of Competitiveness will continue to be immersed in this process, gaining experience as it backs our firms on their long march towards competitiveness.

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