THE US-CHINA BUSINESS COUNCIL
美 中 贸 易 全 国 委 员 会

USCBC 2012 China Business Environment Survey Results:

Continued Growth and Profitability; Tempered Optimism Due to Rising Costs, Competition, and Market Barriers

1818 N Street, NW, Suite 200, Washington, DC 20036 Tel: 202.429.0340 Fax: 202.775.2476 Email: info@uschina.org www.uschina.org

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Executive Summary

» **US companies continue to see strong growth and profitability in China.** Two-thirds of companies surveyed said revenue from their businesses in China grew by 10 percent or more in the past year. Seventy-five percent said profit margins from their China operations were the same as or better than their company's global margins.

» **Despite market growth, company optimism is tempered by rising costs, domestic competition, and continuing regulatory and market access barriers.** Although 90 percent of respondents said they are optimistic or somewhat optimistic about business prospects over the next five years, a sizeable number—45 percent—said they are less optimistic than three years ago.

» **Companies' top 10 challenges are related to both daily business operations and government policies.** Talent recruitment and retention remained the top challenge for businesses in China; administrative licensing hurdles—including obtaining business licenses—ranked second. Though cost increases ranked fourth, companies said such increases were the number one restraint on profitability growth.

» **Issues related to favoritism toward Chinese companies appear in five of companies' top 10 challenges.** Those issues include administrative licensing, competition with Chinese enterprises, uneven enforcement and implementation of laws and policies, investment restrictions, and standards and conformity assessment.

» **The survey debunks widely-held assumptions.** Despite all the rhetoric about China's exchange rate harming the competitiveness of US companies in China, currency once again failed to make the top twenty five issues of concern. Over 90 percent of respondents say they are in China to reach the China market, not offshore production to export back to the United States.

USCBC Members' Top 10 Issues

1. Human resources: Talent recruitment and retention
2. Administrative licensing
3. Competition with Chinese enterprises (state-owned or private)
4. Cost increases
5. Intellectual property rights enforcement
6. Uneven local enforcement and implementation of laws and policies
7. Investment restrictions
8. Competition with foreign companies in China
9. Competition with foreign or Chinese companies not subject to US Foreign Corrupt Practices Act
10. Standards and conformity assessment

» **Unique and authoritative respondent profile.** The survey incorporates a mix of manufacturing, services, agricultural, and resources companies; China- and US-based executives; and global CEOs as well as in-country managers. Eighty-one percent of the participating companies have over 10 years of experience in the China market.

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Table of Contents

USCBC 2012 China Business Environment Business Survey

The China market continues to deliver sales growth and profitability for US companies, but rising costs, increasing competition, and persistent market access and regulatory barriers are tempering the optimism of US companies doing business with China.

Each year, the US-China Business Council (USCBC) surveys its member companies to gauge the business climate in China and assess the top challenges of doing business there. In the midst of continued uncertainty in the global economy, China's comparative economic success remains attractive to US companies. According to USCBC's most recent survey data, 94 percent of respondents rank China as either their top global market priority or among their top five priorities [figure 2].

USCBC estimates that China is a $250 billion market for American companies. Fully 94 percent of companies report that they are doing business in China to primarily access the domestic Chinese market, not develop an export platform. The importance of the China market at a time when the global economy remains weak is reflected in the survey:

» More companies were profitable last year—89 percent, the highest rate to date in the seven-year history of the USCBC member survey [figure 3];

» Two-thirds of respondents saw their 2011 revenue from business in China increase by double digits—including 30 percent who reported revenue growth greater than 20 percent;

» Nearly three-quarters of respondents indicate that they expect 2012 revenue to increase [figure 4];

» Seventy-five percent of respondents report that their China operations have profit margins greater than or equal to their company's global profit margins [figure 5];

» Sixty-six percent of respondents plan to increase investment in China in the coming 12 months.

Despite continued market growth and overall optimism, companies are somewhat less optimistic about their China operations than in prior surveys:

» Forty-five percent of respondents are less optimistic today about the business climate than they were three years ago, even though 90 percent say they are optimistic or somewhat optimistic about the outlook for the next five years [figures 6, 7];

» Profit margins are getting squeezed due to rising costs and competition in the market, but companies also noted that the Chinese government's policies and regulations limit their profitability in China [figure 8];

» While two-thirds of respondents plan to increase investment in China in the next 12 months, 17 percent of respondents said they had halted or delayed planned investments, and fully half of those cited market access and investment barriers as the primary reason [figures 9, 10].

Fig. 2 China's Prominence in Overall Company Strategy

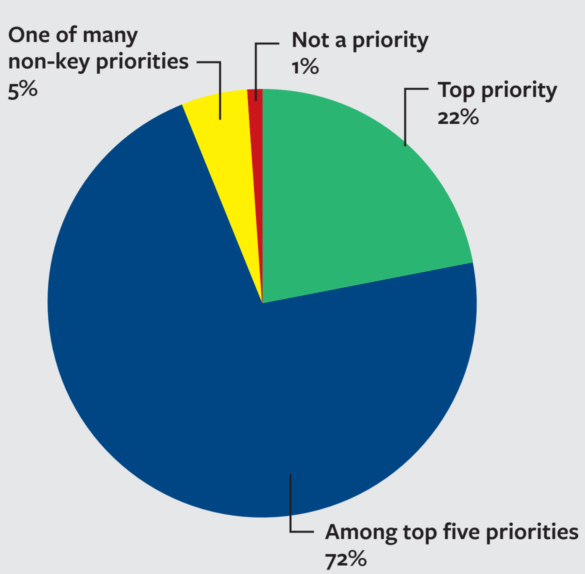


Fig. 3 Are Your China Operations Profitable?

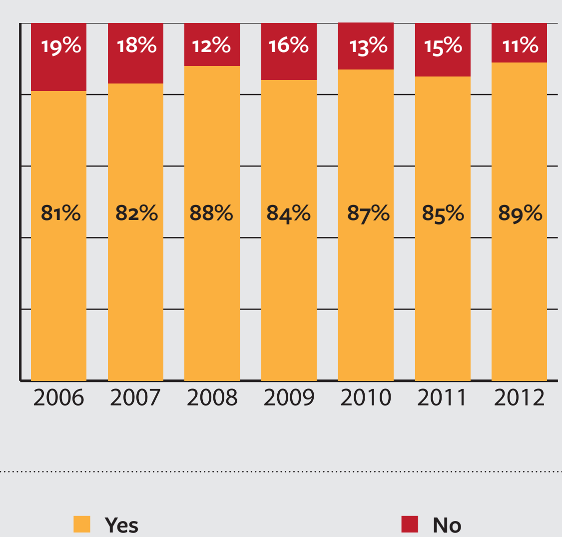


Fig. 4 Expected 2012 Revenue from China

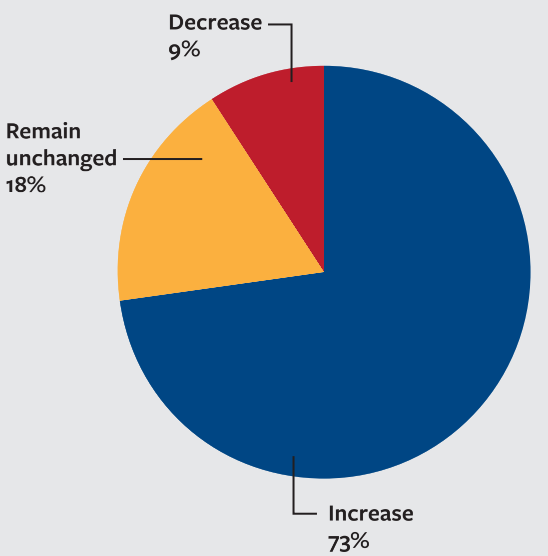


Fig. 5 Profit Margin of China-based Operations Compared to Overall Operations

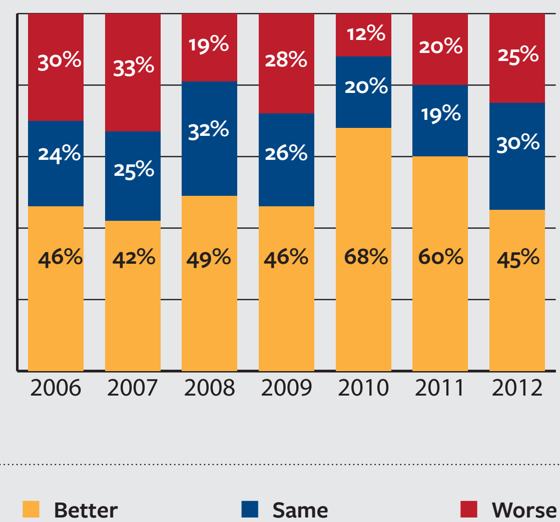


Fig. 6 View of Current Business Climate in China Compared with Three Years Ago

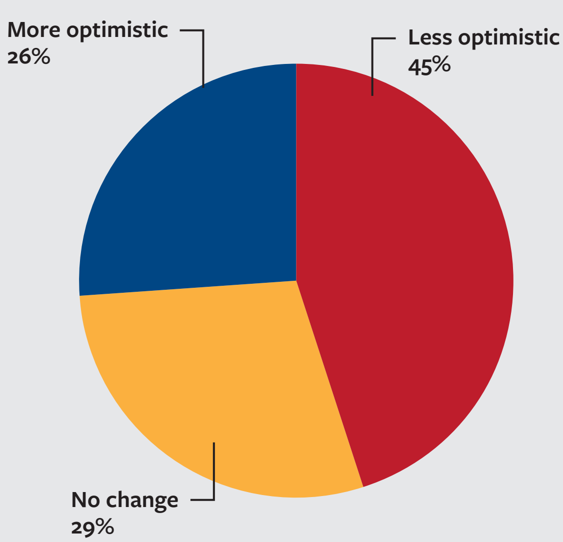
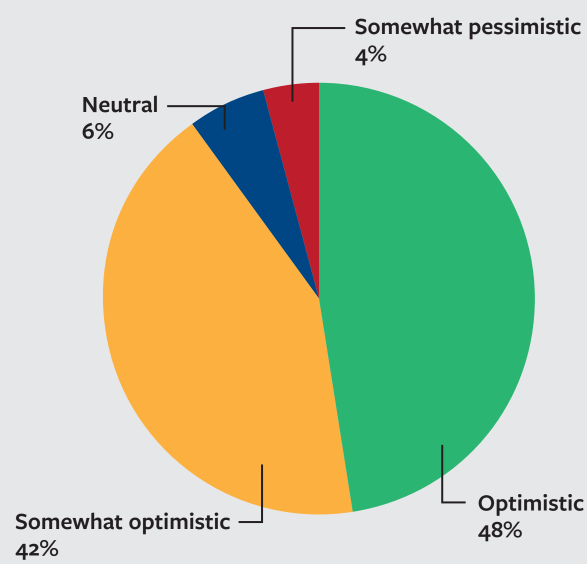


Fig. 7 Five-Year Outlook for Business in China



In summary, companies' priorities, resource commitments, revenue growth, and profitability numbers for China are largely in line with previous years and once again firmly underscore the importance of the China market. Companies remain generally optimistic in their five-year outlook on China, though slightly less so compared with responses from the previous five years. The biggest change is in viewpoint: Almost half of companies reported that their view of the business climate in China is less optimistic than three years ago. The shift, however, is not from optimistic to pessimistic—it is from optimistic to somewhat optimistic. The change likely reflects a variety of causes.

Fig. 8 **Primary Restraint on Increased Profitability in China**

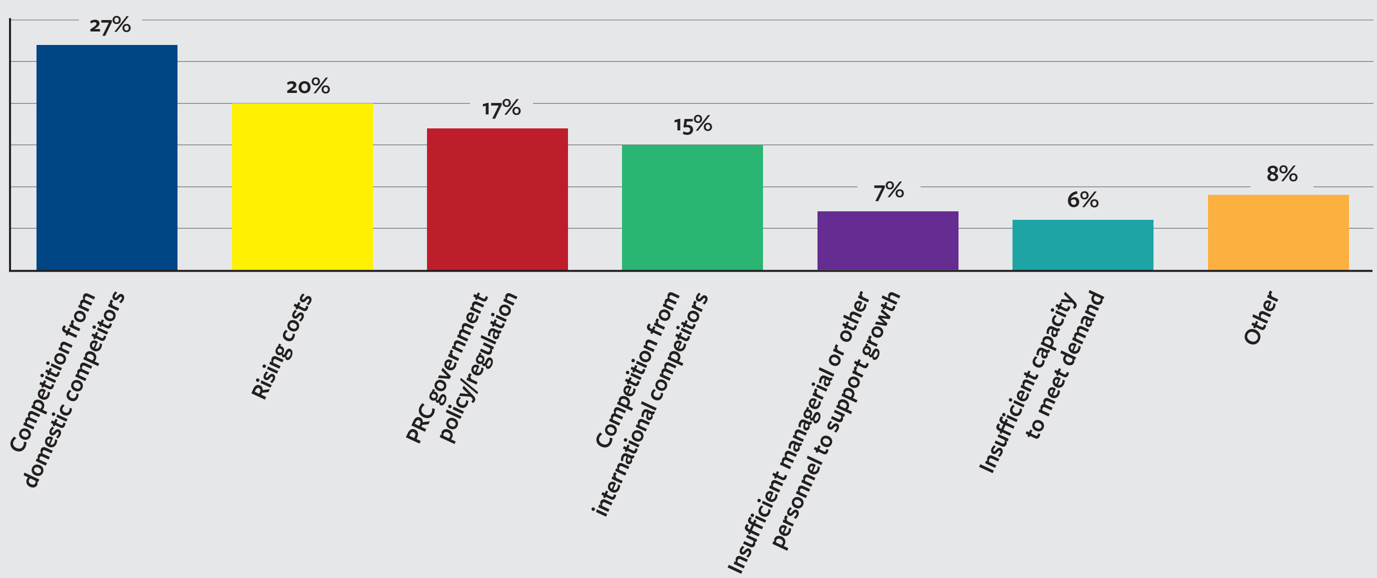


Fig. 9 **Did Your Company Reduce or Stop Planned Investment in China in the Past Year?**

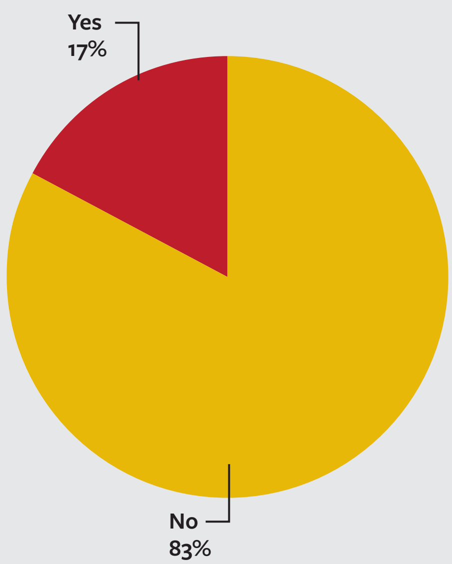
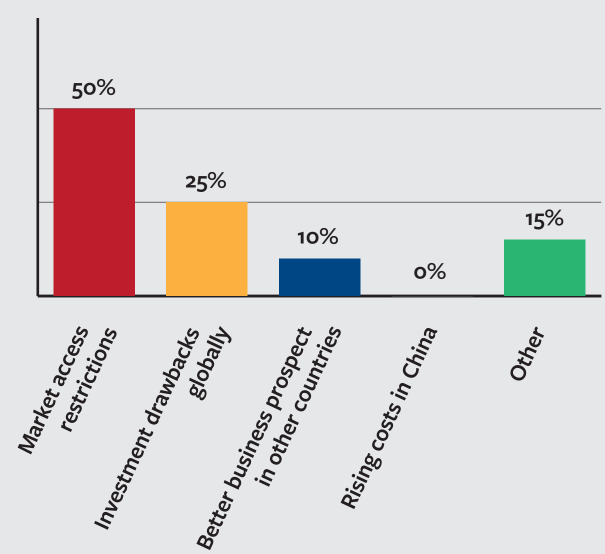


Fig. 10 **Why did Your Company Reduce or Stop Planned Investment in China in the Past Year?**

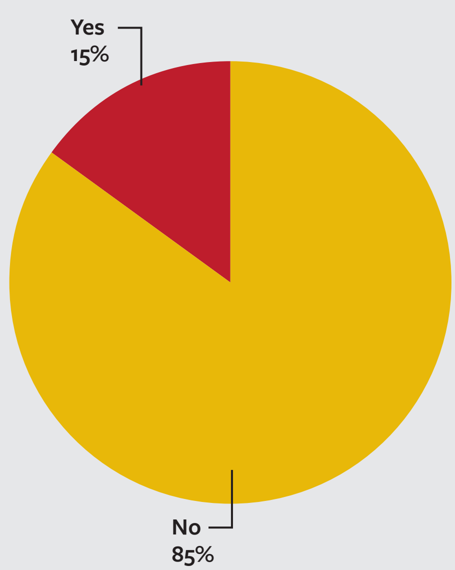


Many of the challenges that companies report are closely related to the running of daily business operations and are frequently interconnected with other challenges on the list. For example, the top challenge—talent recruitment and retention—has a direct correlation with the fourth challenge—cost increases—as companies increase compensation and benefits packages to retain employees. Increased competitive pressures (mentioned in challenges #3, #8, and #9) place added burdens on companies trying to rein in rising costs. Companies overwhelmingly reported concern about rising costs, citing this issue as the number one restraint on profitability growth.

Along with these business realities, there are challenges specific to China that can influence the perception and resolution of the challenges that US companies face there. For example, a potentially straightforward procedure, such as getting a business license, which ranked second in the list of challenges US companies face, can be a tool of government policy—in appearance or in fact—to restrict foreign entrants. With the Chinese economy growing less robustly than in previous years, the real or perceived threat of facing unfair competition, protectionism, and limits on market access become more serious deterrents to pursing business opportunities in China (challenges #3, #6, and #7).

Concern about Chinese policies among US companies has had a tangible outcome: Half of the 17 percent of companies that reduced or tabled a planned investment in China said their decisions were a result of increasing market access restrictions. These restrictions were also a likely contributing factor in the 20-plus percent reduction in US investment in China that was seen in the past year, along with companies generally reduced investments around the world due to global economic uncertainties. The lower number of respondents who express optimism or whose companies are planning new investments could also be attributed to concern about how open China is to foreign investment.

Fig. 11 **Have You Seen Any Positive Impact as a Result of China's 2011 Pledge to Delink Indigenous Innovation and Government Procurement?**



Among respondents' top challenges, concerns about favoritism toward Chinese companies can be seen in five separate top categories: administrative licensing (#2); uneven enforcement of Chinese laws and policies (#6); investment restrictions on foreign companies (#7); and standards and conformity assessment (#10).

Among these concerns, however, progress was made in the past year on a few issues. Regulatory transparency and protection of intellectual property continue to make slow improvements, even as both issues remain top concerns.

But it is essential to note that the central government also missed important opportunities to show its commitment to opening markets. Although central and many local governments have responded to foreign complaints and issued notices that end discriminatory "indigenous innovation" preferences in government procurement policies—a top issue in recent surveys—85 percent of respondents say they have yet to see any impact of the change [figure 11]. Most prominently, China's revised Catalogue Guiding Foreign Investment, which took effect on January 30, 2012, opened few new sectors to foreign companies and did little to reduce existing foreign investment ownership restrictions in other sectors. At a time when bilateral investment is gaining more attention in the broader relationship, continued restrictions on US investment in China may become a point of tension in the US-China relationship as Chinese companies seek greater investment opportunities in the United States.

Not in the Top 10

The challenges ranked highest by survey respondents include many familiar themes. Other issues that observers may hear about frequently did not make the top 10 challenges, however. China's currency policies and exchange rate once again failed to make the top 25 issues, showing that this issue is not a factor in US competitiveness in the China market. "Forced" transfer of technology, a topic raised in several recent bilateral meetings, ranked 16th in the survey responses. Technology transfer concerns are more likely to be reflected in more specific issues, such as foreign ownership restrictions, IP protection, and standards setting, all of which made the top 10.

Services sector market access also did not appear in this year's overall top 10. However, when results are filtered to show responses from services sector companies, market access barriers were the fourth-ranked issue, following licensing, employee retention, and domestic competition challenges.

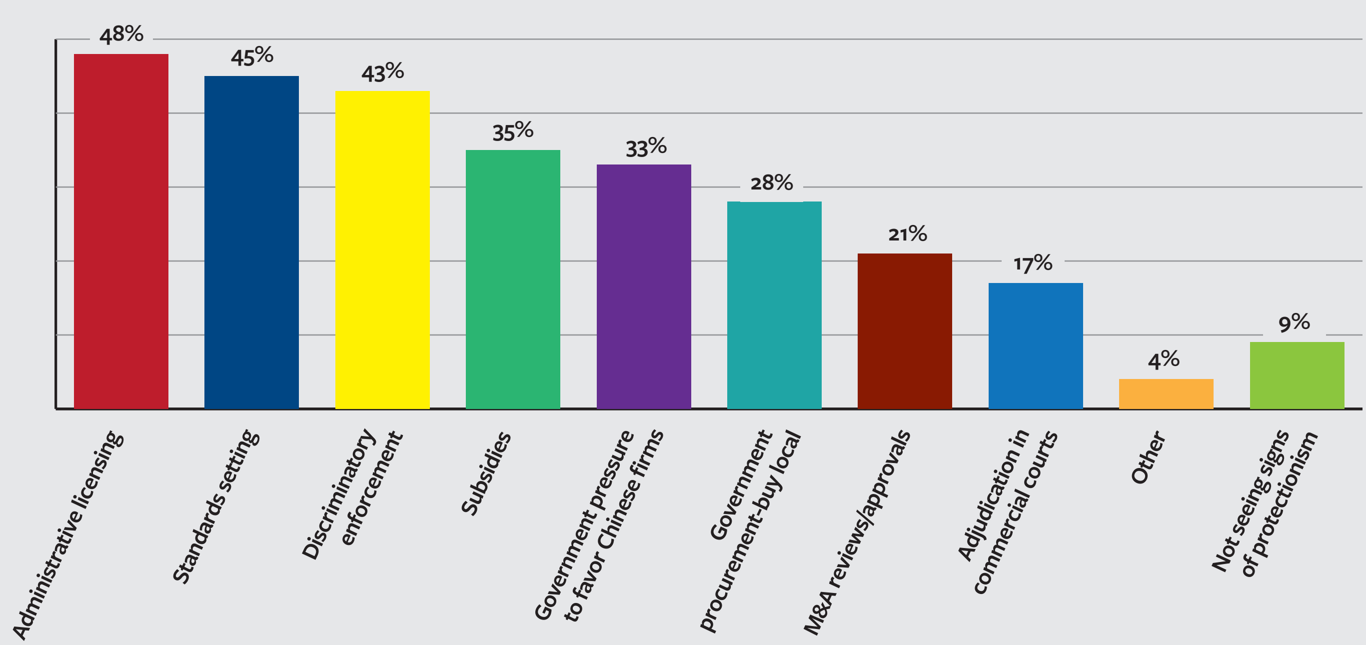
What's Next?

Addressing the wide variety of challenges identified in this year's survey requires an array of approaches. Some top concerns do not lend themselves to policy fixes and are part of China's business environment for the time being. Two of the top four issues, human resources shortages and cost increases, for instance, have no quick policy fixes.

Other business challenges can be influenced by policy and regulatory choices. Respondents note that they see signs of protectionism in how the business licensing and approvals system operates; in how standards are set and administered; in how Chinese regulations are enforced more strictly against foreign companies; and in how Chinese companies appear to have easier access to financing and government subsidy or funding programs [figure 12]. China's top political and government leadership will transition this year and next, with a turnover in officials that is anticipated to be more significant than at any time over the past 10 years. In addition, there is an active debate in China about economic reforms, with some government leaders and domestic policy analysts calling for greater competition and market influences, including the promotion of private capital into sectors dominated by the state. The outcome of the policy debate is unclear, as is whether foreign companies will find their specific concerns addressed.

Sweeping policy changes are unlikely, however,—a point made often by senior Chinese officials in meetings with USCBC. While the leadership transition provides an opportunity for reforms, it is more likely that companies, US government officials, and other stakeholders will need to continue to do the hard work of analyzing the problems underlying the issues identified in this survey and come up with specific solutions. This requires constant engagement with the Chinese government and the use of trade tools, such as dispute settlement through the World Trade Organization, when necessary. While some pundits and officials may view dialogue as an ineffective way to resolve problems, developments in the US-China relationship have proven that direct engagement with China and close coordination with other trading partners produces meaningful results on issues that impact US workers and businesses.

Fig. 12 Signs of Protectionism in China



Challenge #1

Human Resources: Talent Recruitment and Retention

Progress on Issue in Past Year: Unchanged
Rank in 2011: .1
Rank in 2010: .1 (tie)
Rank in 2009: .3
Rank in 2008: .1 (tie)
Rank in 2007: .1
Rank in 2006: .1

Companies face significant challenges in finding, hiring, and retaining employees in China's highly competitive environment. Demand for qualified employees frequently outstrips availability, especially for skilled technical and managerial talent, pushing wages up to global levels for some positions. Companies note that:

» Labor costs are the rising cost of most concern;

» It is increasingly difficult to attract and retain employees at stable salary levels;

» Employees are particularly focused on their salary figure, often showing much less regard for the total compensation and benefits package, thus making it very difficult for companies to develop benefits packages in line with global best practices;

» In spite of the higher pay, retention of qualified talent is still difficult. Turnover rates of 10 to 20 percent are not unusual.

Survey respondents summed up the overall situation well:

> *"The competition and cost of talent is outrageous."*
>
> *"Operational cost in China is getting serious especially for pay and benefit and yet still [there is a] lack of qualified talent in the market."*
>
> *"It is getting harder to attract people at reasonable salary levels."*

Challenge #2

Administrative Licensing, Business and Product Approvals

Progress on Issue in Past Year: Unchanged
Rank in 2011: .2
Rank in 2010: .1 (tie)
Rank in 2009: .1
Rank in 2008: .1 (tie)
Rank in 2007: .2
Rank in 2006: .2

Licenses or approvals are required for each aspect of doing business in China, governing everything from the specific products or services the company can provide, to the testing and approval of the product itself, to reviews of business transactions, including both greenfield investments and mergers and acquisitions. Some companies can secure licenses to operate across the entire country; other companies have to secure licenses city-by-city. Some approvals are granted at the municipal level; in other instances, companies must submit their documentation through a chain that stretches all the way to the State Council, China's cabinet.

In many cases, China's licensing and approval process slows investment and company expansion. For example, according to public sources one recent review of an acquisition took over seven months even though regulations stipulate it should take only four months. Companies note that:

» The licensing process is highly restrictive and they have to reapply for an operating license for even the slightest change to business scope;

» The product registration process is slow, and can be delayed through duplicative testing requirements;

» Time and money are unnecessarily spent on navigating the various licensing regimes, resulting in fewer resources being available for productive business pursuits;

» Licensing regimes are notoriously inconsistent, even within the same city.

Finally, licensing is the top area in which USCBC members say they experience protectionism, with nearly half of respondents saying they see protectionism in the way the administrative licensing process is managed. One company put it this way: *"Favorable treatment of local firms in licensing applications, faster approval for local firms, restrictions placed on foreign companies."*

Challenge #3

Competition with Chinese Companies (state-owned or private)

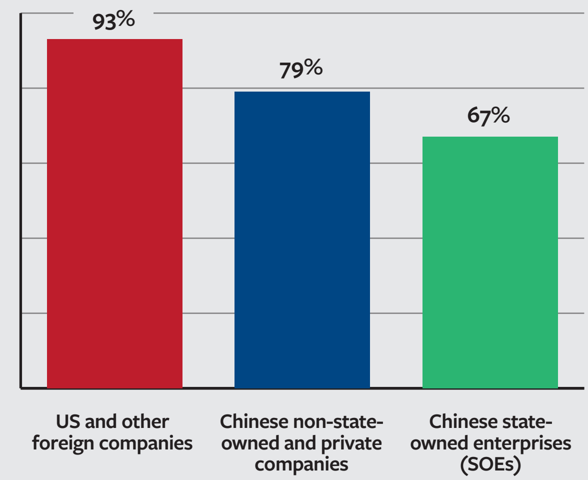
Progress on Issue in Past Year: Unchanged/Deteriorated

Rank in 2011: .4
Rank in 2010: .1 (tie)
Rank in 2009: .4
Rank in 2008: .7
Rank in 2007: .4
Rank in 2006: .4

USCBC members continue to face stiff competition from Chinese companies, both state-owned and private. Most respondents (79 percent) report they compete with non-state Chinese companies; 67 percent also say they compete with Chinese state-owned enterprises [figure 13]. On the one hand, the competitive challenge that US companies face is similar to what they face anywhere: Competition is based on market determinants, such as product, service, quality, innovation, etc. On the other hand, survey responses suggest that both state-owned and privately owned Chinese companies may have preferential access from licensing approvals to government contracts to financing and other areas, giving them a competitive edge. Companies note that:

- In some instances, Chinese companies can operate without the requisite licenses but foreign companies cannot;
- Chinese companies may be favored in local public tenders;
- Public statements from some central agencies appear to direct provincial officials to favor domestic products.

Fig. 13 **Who are Your Competitors in China?**



Challenge #4

Cost Increases

Progress on Issue in Past Year: Deteriorated
Rank in 2011: 3
Rank in 2010: 5
Rank in 2009: 13
Rank in 2008: 3
Rank in 2007: . . . . Not asked
Rank in 2006: . . . . Not asked

Companies reported across-the-board increases in labor, raw materials, land, and utility costs. As in past years, labor costs remains the greatest concern, and almost 60 percent of companies report that wages increased between 5 and 10 percent for 2012 [figures 14, 15]. These trends match those across the Chinese labor market, as companies have noted increases in minimum wages, province by province, over the last several years – and even sharper increases in salaries for skilled labor. The general outlook for inflation in China was also cited by 50 percent of respondents. As one company notes, *"Inflation, salaries, cost of offices, cost of raw materials are making it difficult to consider China a low-cost region."*

Fig. 14 **Wage Increases by Percentage in 2012**

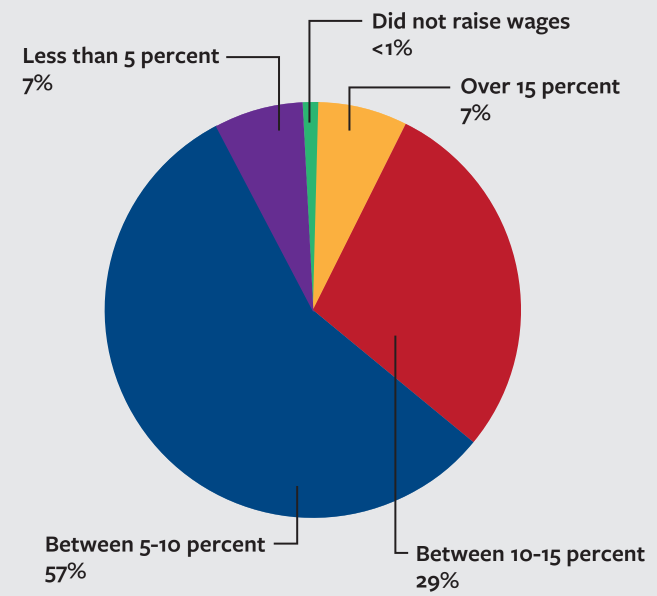
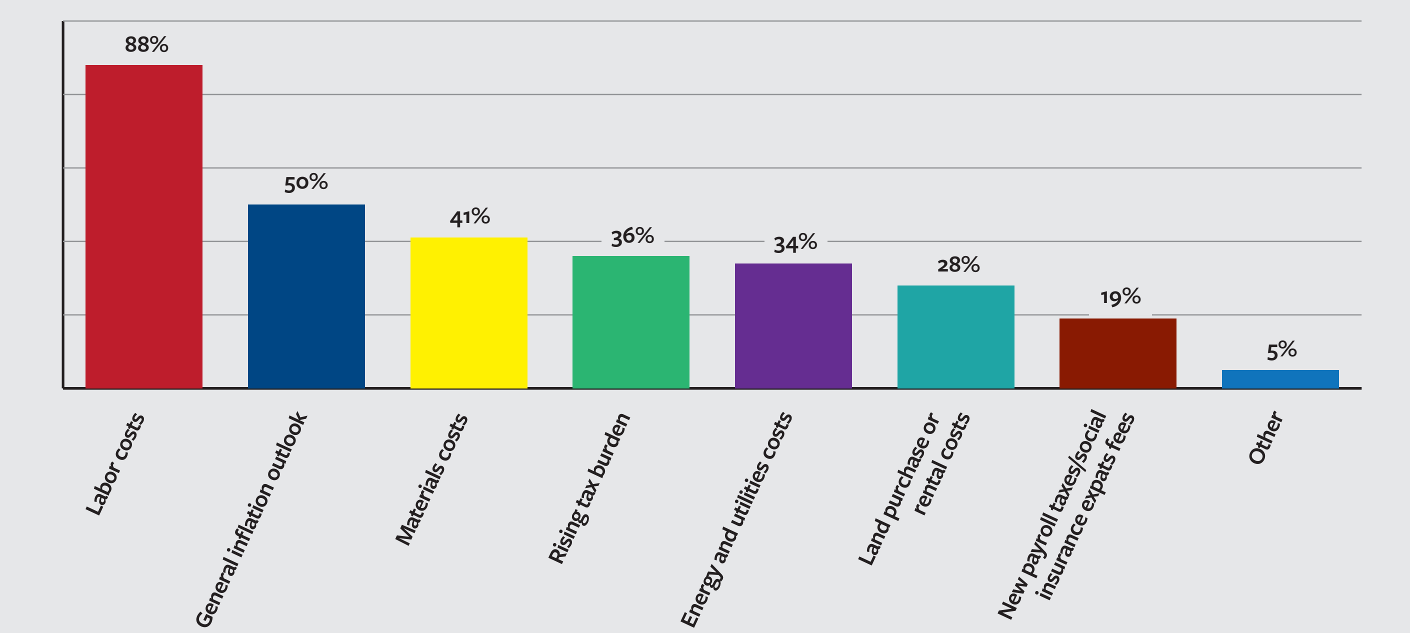


Fig. 15 **Top Cost Concerns**



Challenge #5

IPR enforcement (trademark, patent, copyright, trade secrets)

Progress on Issue in Past Year: Improved/Unchanged

Rank in 2011: 5
Rank in 2010: 4
Rank in 2009: 8
Rank in 2008: 6
Rank in 2007: 3
Rank in 2006: 3

Companies continue to face challenges in enforcing their intellectual property rights (IPR) in China. Of those surveyed, 95 percent indicated they are either somewhat or very concerned about IPR enforcement. Despite that concern, over half indicated that they had seen some improvements in IPR protection in the past year. The continued difficulties have negatively affected company operations: The majority of companies report that IPR enforcement challenges limit the types of products they develop, make, or sell in China [figures 16, 17, 18, 19].

Companies report that the lack of a meaningful criminal deterrent is a significant roadblock to China developing a robust IP protection regime. USCBC has consistently called for the elimination of thresholds for an IP case of commercial scale to be considered under the criminal system.

Fig. 16 Level of Concern about IPR Enforcement

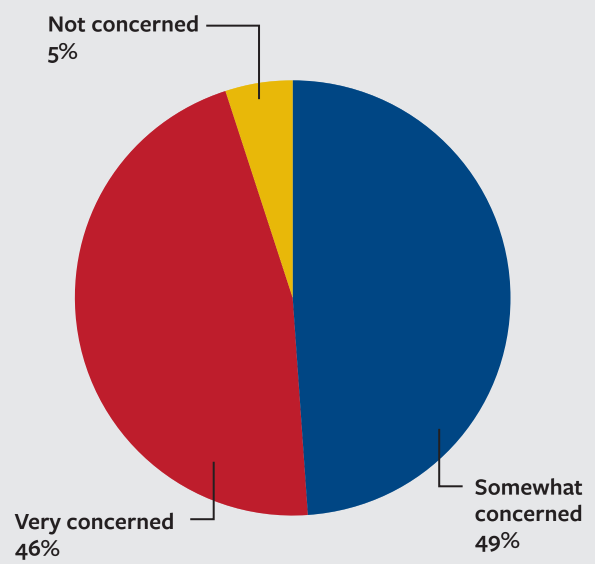


Fig. 17 Over the past year, China's Protection of IPR...

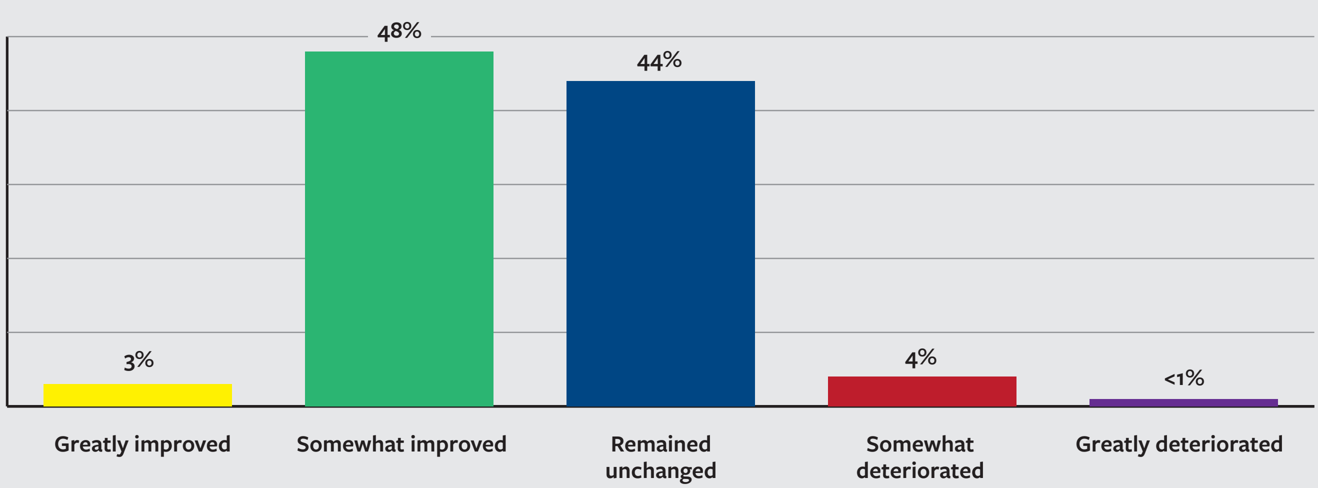
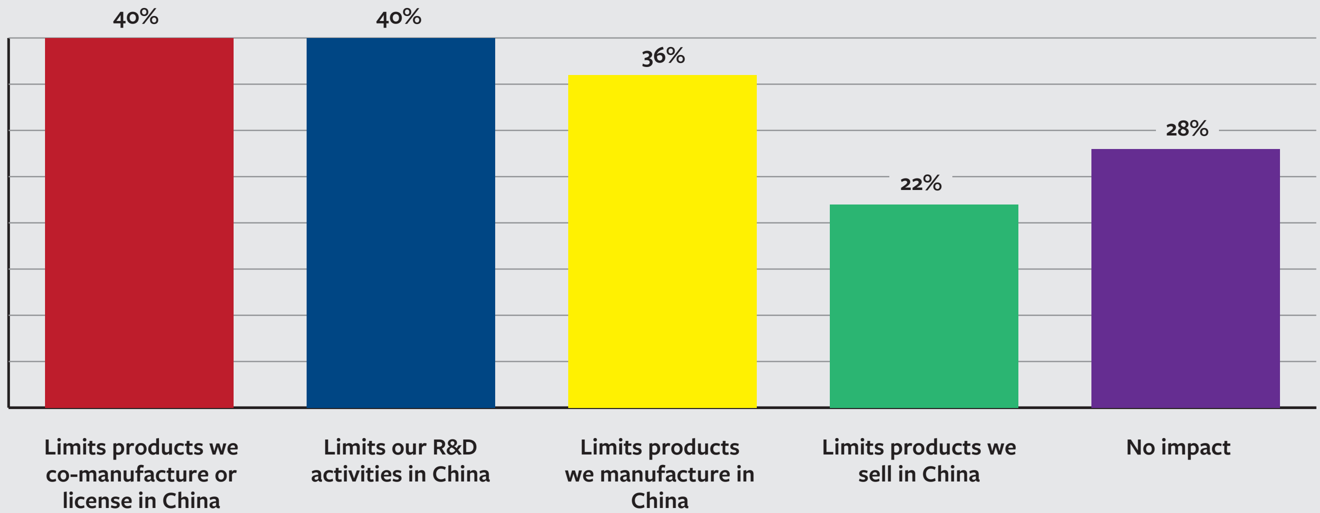


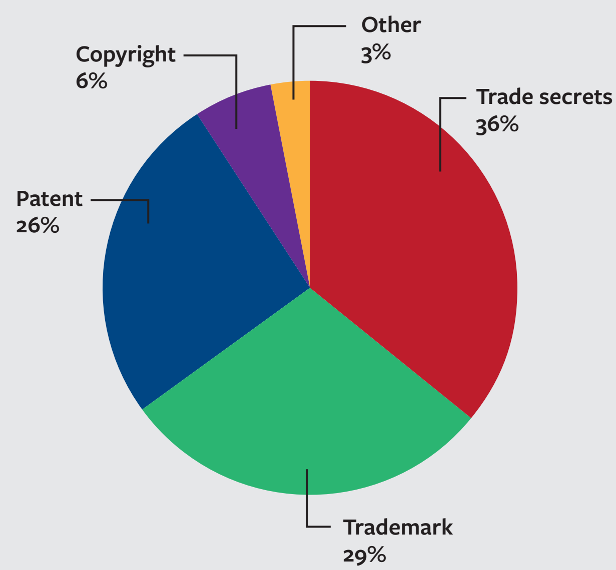
Fig. 18 Impact of Level of IPR Enforcement on Activities Undertaken in China



Companies report that:

- *"Enforcement actions to date are mostly civil fines which amount to a cost of doing business for the pirates; we want criminal penalties comparable to other parts of the world."*
- *"Huge amounts of money and time have been spent every year on hundreds of cases, while lots of cases are not being tackled due to limited resources."*
- *"Laws against counterfeiting and trademark infringement are unevenly and slowly enforced."*
- *"Fear of loss of critical IP creates a huge cost to create elaborate plans to protect IP needed to bring technology to China."*

Fig. 19 Intellectual Property Infringement of Greatest Concern



Challenge #6

Uneven Enforcement/ Implementation of Chinese Laws

Progress on Issue in Past Year: Unchanged	
Rank in 2011:	13
Rank in 2010:	13
Rank in 2009:	11
Rank in 2008:	5
Rank in 2007:	Not asked
Rank in 2006:	Not asked

While China's laws and regulations are largely determined by the central government, implementation and enforcement is handled at the provincial and local levels. Frequently, different localities have different interpretations of rules, leading to patchy enforcement. In addition, companies have ongoing concerns that foreign companies face stricter enforcement than their domestic competitors. As a consequence, this issue returned to the top 10 for the first time since 2008.

Companies report experiencing uneven enforcement in a wide variety of areas, such as tax audits, product quality testing, and workplace safety inspections. For example, American companies bring their global environmental health and safety standards to their China operations and comply with local laws and regulations, but frequently compete against domestic companies that do not, raising the costs for foreign companies versus their competitors.

Company experience is telling:

» *"While the [joint ventures] (JVs) with foreign partners follow regulatory requirements, local manufacturers are not very much complying with them. Moreover, they are not accused of non-compliance while our JV could be. Enforcement and implementation of PRC laws and regulations has increased and we feel that as foreign-invested enterprises we are singled out as the authorities' focus area. Our experience is that local Chinese companies can continue to ignore laws."*

» *"[As a law firm], we are taxed at close to a 60 percent rate in China, whereas local PRC partners are taxed officially at a 16 percent rate."*

Challenge #7

Restrictions on Foreign Investment

Progress on Issue in Past Year: Unchanged	
Rank in 2011:	7
Rank in 2010:	14
Rank in 2009:	Not asked

Opportunities for foreign investment are uneven across business sectors, and China's most recent Catalogue Guiding Foreign Investment did little to address lingering concerns in this area. In fact, 17 percent of companies report that they reduced or stopped planned investment in China in the past year, with half of those companies reporting that they did so due to increasing market access restrictions in China [figures 9, 10 at front of report].

Market access in services is a key component of these restrictions, particularly given the lack of progress in this area in China's latest foreign investment catalogue, despite public statements by the Chinese leadership on their intent to open this sector to further foreign investment. Companies reported the same concerns in the services sector that companies see across the board in China: difficulties in licensing; competition from Chinese companies; lack of equal treatment with domestic companies; and the direction of Chinese policies favoring domestic companies over foreign ones.

Chinese restrictions inhibit foreign investment in key sectors, such as agriculture, express delivery, financial services, and autos, preventing the full economic benefits of foreign investment from being realized. At the same time, such restrictions on foreign investment run counter to repeated calls from senior Chinese government officials to upgrade the quality of the country's industry and build a services-oriented economy. With full market access, foreign companies would be well positioned to help China achieve these goals.

Separately, as Chinese companies invest more in the United States, reducing or eliminating ownership restrictions faced by American investors in China would be a positive way to build broader support for Chinese investment in the United States.

Some examples the companies cited:

» *"More restrictions to foreign investment in agriculture and food processing industry in the new Catalogue Guiding Foreign Investment."*

» *"Our market is open only to Chinese companies and we cannot access the domestic Chinese market."*

» *"The Ministry of Justice refuses to deal with the market access issues for international law firms, and there is no way for us to dialogue with the PRC authorities on this."*

Challenge #8

Competition with Other Foreign Companies

Progress on Issue in Past Year: Unchanged
Rank in 2011: 11
Rank in 2010: . . . . Not asked

American companies not only encounter stronger competition from China's domestic companies, they also are competing against other foreign companies from the United States, Japan, Europe, and other countries for market share in China. The vast majority of US companies—93 percent—compete against foreign companies, and those who ranked the issue as one of their top challenges note that the competition is intensifying. Respondents said:

> *"Competition with Chinese and foreign companies has become tougher."*

> *"Competition is more intense, cost is higher."*

Challenge #9

Competition with Other Foreign or Chinese Companies Not Subject to the Foreign Corrupt Practices Act (FCPA)

Progress on Issue in Past Year: Unchanged
Rank in 2011: 16
Rank in 2010: 15
Rank in 2009: 21
Rank in 2008: 22
Rank in 2007: 11
Rank in 2006: 17

American companies operating abroad are required to comply with the US Foreign Corrupt Practices Act, which makes the payment of bribes illegal across the globe. Such provisions require US companies to carry out careful oversight of a variety of activities that support company operations in any country, including government relations, sales, and marketing activities. American companies reported that their competitors in China—both domestic and foreign—may be subject to less-rigorous laws in their home countries or may be skirting Chinese laws on corruption to gain market advantage.

Challenge #10

Standards and conformity assessment

Progress on Issue in Past Year: Unchanged

Rank in 2011:	6
Rank in 2010:	10
Rank in 2009:	6
Rank in 2008:	14
Rank in 2007:	6
Rank in 2006:	6

Standards and conformity assessment provide critical ground rules for products entering the China market as companies determine how products are designed, manufactured, sold, used, and disposed of, and how they are certified in compliance with each of these steps. Most companies that participate in China's standards-setting process report that they have some difficulty in getting information on the process and are only occasionally included in setting standards [figure 20]. Companies said:

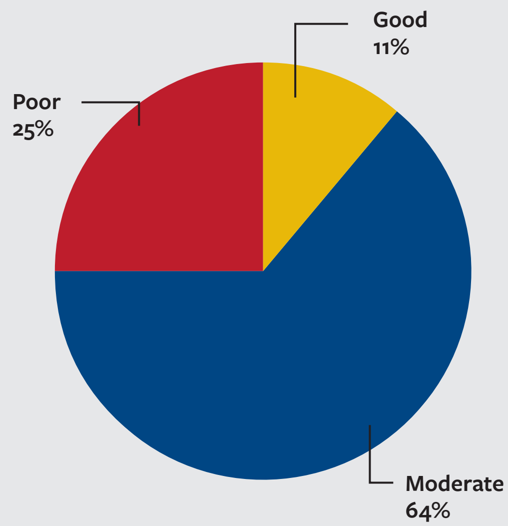
> *"The Chinese government holds the conflicting roles of being both the regulator and fee-collecting provider of quality and safety services (or in essence the referee and player). Government-affiliated providers monopolize large sections of China's quality and safety services market largely due to regulatory bodies restricting independent providers from offering their services to the market through various administrative mechanisms."*

> *"Increasing forced disclosure of proprietary information for market access under China RoHS [China's rules on the handling of hazardous substances in manufacturing]."*

> *"Though China has a mandatory requirement of public consultation of new policies and standards, multinational companies are normally kept out of the consultation loop. In specific, a few Chinese companies take the advantage of influencing standards development to lower the bar of technology competition."*

> *"A global industry is most competitive and efficient when global standards and processes are adopted and followed in a timely manner."*

Fig. 20 **Ability to Participate in China's Standards Setting Process**



Respondent Profile

US and China-based executives

USCBC's survey incorporates a unique mix of US- and China-based executives. Half the respondents are based in China, and 40 percent are based in the United States. The remainder are located elsewhere in Asia or other locations [figure 21].

In addition, respondents range from CEOs of global corporations to executives based in the field. Survey results incorporate both strategic and tactical perspectives.

Cross-sector representation

USCBC members who completed this year's survey represent a cross-section of US companies doing business in China. Fifty-seven percent of respondents represent manufacturing companies, and 44 percent represent service providers—and many respondents' companies are active in both sectors. Nine percent work for companies in primary industries, such as agriculture and oil and gas [figure 22].

Respondents' companies represent small-, medium-, and large-sized enterprises, with the largest number of respondents (42 percent) having between 1,001 and 10,000 employees in China [figure 23].

Fig. 21 Respondents' Location

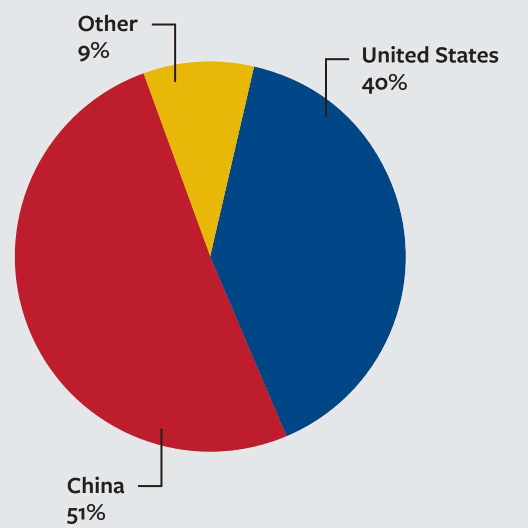


Fig. 22 Type of Business Operations in China

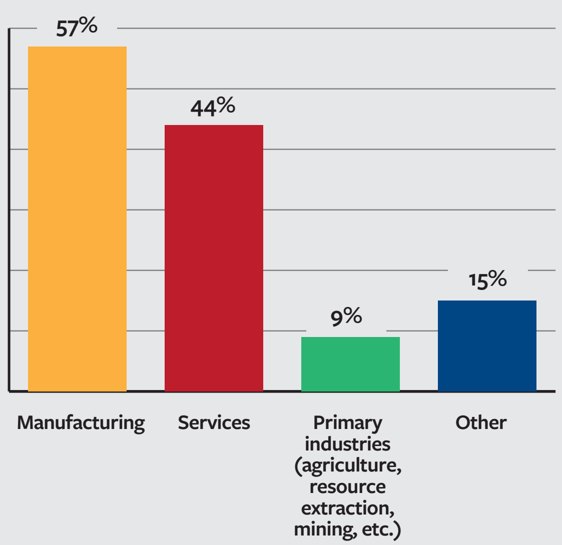
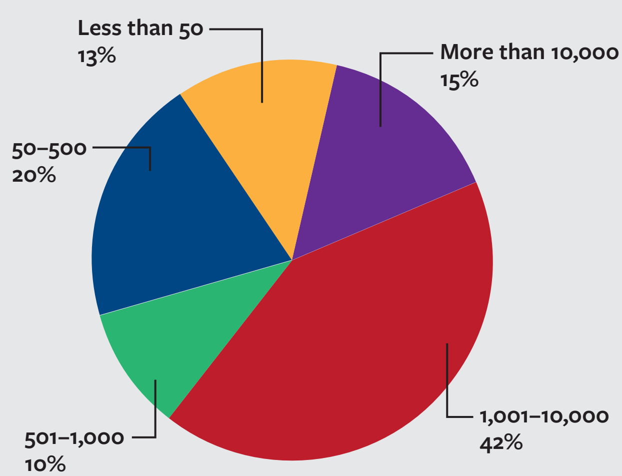


Fig. 23 How many people does your company directly employ in China?



Long experience in the China market

USCBC member companies have a long history of doing business in China: 53 percent of respondents' companies have been in China for more than 20 years, and 28 percent have been in China for 11–20 years. By the end of 2012, almost a quarter of respondents note that their company will have more than $1 billion invested in China, and 58 percent will have more than $100 million invested [figures 24, 25].

In China to access Chinese customers

As in past years, the vast majority of USCBC member companies report that they are doing business in China to access China's domestic market. Fourteen percent use China as an export platform to reach other markets around the world, though only 12 percent use their China operations to produce products that are shipped back to the United States [figure 26].

Fig. 24 Years Doing Business with China

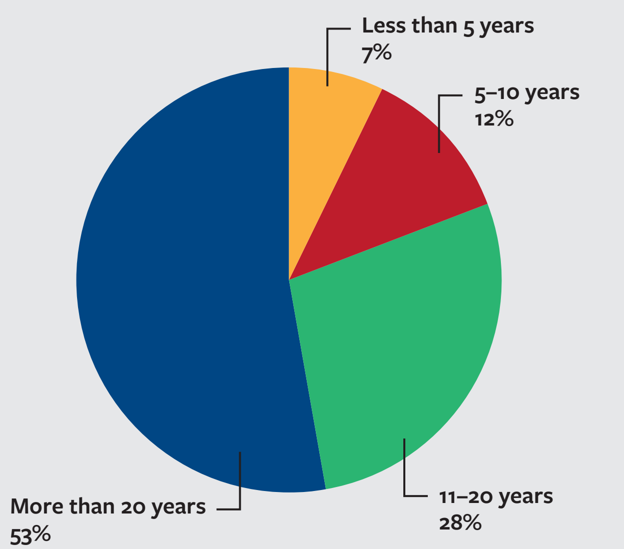


Fig. 25 Total Direct Investment Committed to the China Market

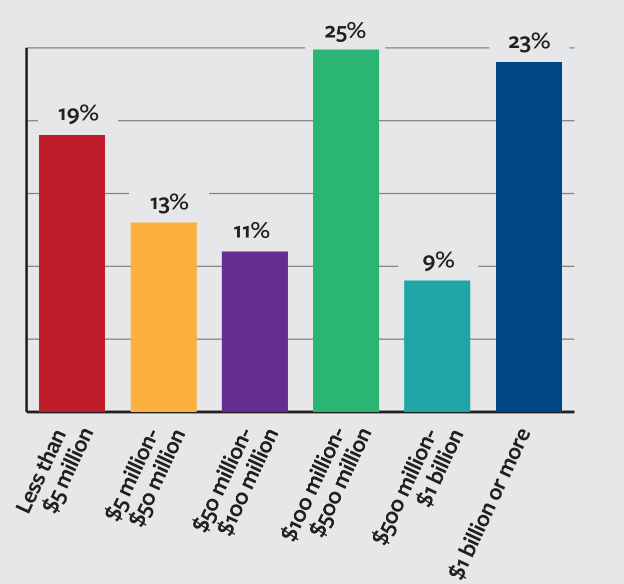


Fig. 26 Objectives for Existing and Future Investments in China