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China the Next Technology Hub; Moves Away from Manufacturing toward Innovation

China today is characterized by a subtle yet powerful trend that is driving its economy from a simple labor-intensive market structure to an innovation and service-based model. The traditional manufacturing segment is losing its shine to a whole new generation of technology and service-driven business that has surfaced within the last decade. This seemingly dramatic shift from manufacturing is deeply rooted in the emergence of numerous small-scale, innovative enterprises, government initiatives and the simultaneous erosion in the operating cost advantage of the manufacturing segment in the past several years.

In a short time, several small information technology (IT) firms, software outsourcing, online education and other forms of service-based businesses have mushroomed and flourished in the urban and semi-urban centers of China. The phenomenal success of Chinese internet companies such as Alibaba.com, Baidu and Dangdang.com, all of which started as small-scale enterprises, have acted as positive catalysts and stirred a new trend for the Western educated Chinese citizen to return and open new, innovative start-up ventures.

The old generation of technology entrepreneurs such as Jack Ma (founder, Alibaba.com) and Robin Li (founder, Baidu.com) enjoy a rock-star-like status in China, and they inspire the next generation of entrepreneurs to take the plunge into the dynamic world of the internet-driven services market. Jack Ma has in fact single handedly created the e-commerce industry in China. This is comparable to the impact of Bill Gates, Paul Allen and Steve Jobs on the next-generation Silicon Valley entrepreneurs of the 1980s and initial 1990s in the United States.

To understand the magnitude of these home-grown internet-driven service companies, consider the example of Alibaba's Taobao.com, the online store that forced American giant e-Bay to exit China. Taobao.com has about 120 million registered users and 300 million products listed on its website. Today the website controls 80% of the total Chinese online consumer market and recorded gross merchandise volume (GMV) of nearly $15 billion in 2008. It is clear through examples such as Taobao that China no longer depends exclusively on manufacturing to grow but is transforming into a technology giant. Further testament to this fact is that world class American companies such as Google and e-Bay had to quit China because they could not survive the stiff competition from their Chinese counterparts.

China as a nation has come to realize during the last few years that it cannot rely solely on cheap labor and abundant resources to grow, as the rising prices of raw material and labor can weaken its competitive advantage. Against the backdrop of the global economic crisis, Chinese manufacturing today is facing its most threatening challenge since the beginning of the economic reforms of 1978. The manufacturing sector in China is haunted by increasing labor cost and weakening global demand. Low-cost production has been the main driving factor for the manufacturing boom in China for the last two decades, but that has been changing. According to the Deloitte Review 2009 report, in the last ten years (1998–2007) wages have been increasing at an annual rate of 11.8% in Shanghai, steadily eroding the China's low labor cost advantage. While increasing labor cost is the main issue, other factors such as rising real estate prices and fuel costs also play a role. Combined, these factors threaten to pull down the growth rate in the manufacturing segment.

At the same time, China has opened itself to new avenues of sustained growth in the form of services outsourcing and technology-based businesses. The government has been supportive and decisive in creating an environment for technology-driven businesses. China is one of the few countries in the world that has invested heavily in its infrastructure and now is poised to leverage that investment and build a robust services economy driven by information technology.

The People's Republic of China, in its blueprint for economic progress, the 11th five-year plan (2006–2010), has given a boost to this marriage of the manufacturing segment and services sector. To motivate the Chinese outsourcing industry, a $1 billion initiative called "1000-100-10 project" has been launched by the Ministry of Commerce. The aim of this initiative is to build 10 cities as outsourcing bases that will attract 100 international corporate customers to bring their outsourcing businesses to China and, at the same time, to develop 1,000 outsourcing vendors by the year 2010. This clearly reflects China's level of commitment and investment to becoming a significant outsourcing destination on the world map.

Lured by huge outsourcing opportunities, many foreign companies such as Indian software giant Tata Consultancy Services (TCS) have established their outsourcing divisions in China. As the focus of Chinese economic policies has shifted towards the services industry, the government now is promoting innovation through various channels such as offering tax-initiatives and other financial support. The government's budget for research and development has increased considerably in the last five years to encourage innovation-based businesses. The share of the services sector in China's total gross domestic product (GDP) is expected to increase to 43.3% by 2010 from 40.3% in 2005. Factors such as a vast talent pool, significant investment by the government and corporate segments, robust infrastructure and emergence of a home-grown entrepreneurial culture have caused a paradigm shift in favor of service-driven businesses.

As China moves away from manufacturing, it is the small cap companies that are driving the market rather than the big multi national companies (MNCs). The failure of e-Bay has well illustrated that size does not matter in China. There is a new generation of Chinese entrepreneurs ready to storm the market. In addition to software, internet and outsourcing, online education, biotechnology and solar industries have also emerged as new venues for small players in the new-age China. For example, small technology start-ups such as Askyaya.com and Dign9.com (both on-line comparison shopping websites) have crowded the Chinese internet space in the last five to seven years. Today, it is technology companies such as PingCo.com and Maxthon that are driving the innovation wave. PingCo.com specializes in mobile wireless internet applications, and Maxthon is a web browser developed by entrepreneur Jeff Chen. Even the traditional manufacturing companies like NIVS Intellimedia Technology Group (NYSE Amex: NIV), which till a few years back was into pure FMCG contract manufacturing play, has launched its intelligent audio and video products based on speech based interface that are Chinese language enabled.

There has been significant increase in venture capital activities in China during the last seven to eight years, indicating the presence of several high potential small-scale ventures. Many U.S.-based venture funds, especially from the Silicon Valley, have opened offices in China. Sequoia Capital, Kleiner Perkins Caufield & Byers and Accel Partners are just a few of the venture capital firms focusing on China. Local entrepreneurs with the help of innovation, government support, venture capital and a growing economy are gradually changing China's identity from "Made in China" to "Invented in China." Innovative, small-scale technology-driven businesses have changed the face of the Chinese market and are the forerunners of this shift from the manufacturing towards innovation. Although poor macro conditions have slowed down the pace of growth, the Chinese market is expected to rebound much sooner than any other market. A new era of innovation, technology and services has dawned in China, and the country is expected to develop into the next technology hub.