

Beyond Tiananmen: Is There a Future for Foreign Business in China?

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The recent events in China's Tiananmen Square sent a deep shudder through the boardrooms of many firms in the United States, Western Europe, and Japan. While most foreign companies doing business in the People's Republic of China (PRC) have felt somewhat uneasy about making significant commitments of resources to China, their confidence had been increasing with each passing year of China's „open door“ policy. This confidence had been reinforced by efforts at all levels of the Chinese leadership to improve the investment climate. Much of this growing confidence, however, was shattered by the actions of the Chinese leadership on June 4, 1989. Today the future of foreign investment in China is uncertain, as many foreign companies once active in China adopt a wait-and-see attitude.

The irony of the Tiananmen event is that prior to the violence and the political crackdown that followed, the general business environment for foreign firms seemed to be on a path toward increased normalization. The bilateral investment treaties concluded between China and Japan in September 1988 and between China and New Zealand in November 1988 reflected the substantial progress the Chinese had made toward a viable investment climate and supportive legal infrastructure for foreign corporations. In their efforts to regularize China's investment and tax procedures, Chinese officials had issued more than 200 pieces of legislation and had signed 22 bilateral investment agreements with 23 countries. By the end of 1988, more than 15,000 ventures with foreign capital had been approved, and the contract value of direct foreign investment in China had reached \$28.2 billion, with \$11.6 billion in paid-in capital.

Despite these achievements, a number of serious business-related problems remained. Perhaps most important to foreign firms were China's increasingly severe economic issues. While the role of the Tiananmen affair should not be downplayed, a dangerous fiscal and monetary crisis had been brewing in the Chinese economy for some time before Tiananmen.

China's Economic Situation:

The Macro-Environment

Recently China has been one of the fastest-growing economies in the world. In 1988, GNP grew by 11.2 percent (to 1,385 billion yuan), while industrial output grew by more than 20 percent. This impressive but overly brisk growth sparked a rapid and sustained overheating of the PRC economy. There have been severe strains throughout the economic system on both the demand and the supply side. A number of fundamental economic problems have emerged, including high levels of inflation – perhaps the highest since the inception of the Chinese Communist regime in 1949 – and critical shortages of raw materials for both energy and production. At the end of 1988, many factories had to suspend production for three or even five days a week due to frequent power cutoffs caused by the diversion of large quantities of coal to projects outside the state plan. Moreover, the country's inadequate transportation and communications infrastructure prevented goods and services from moving about as efficiently as necessary. These problems were exacerbated by a dramatic rise in corruption, profiteering, and nepotism throughout all levels of the economic system.

While quantitatively the Chinese economy seemed to be doing quite well, the composition or quality of that growth left much to be desired. Issues included a growing foreign trade deficit (\$3.09 billion at the end of 1988), growing foreign debt (approximately \$45 billion by mid-1989), and shortages of critical supplies. In 1988 and 1989, the Chinese leadership reined in credit and scaled down the overextended capital construction program. It also selected certain areas to receive particular attention and support (e.g., agriculture, energy, and transportation) while other sectors would be restricted in terms of new investment and imports (e.g., color televisions, refrigerators, and wool- and cotton-spinning products). Retrenchment, rather than reform, was designated as the watchword for the rest of the year, if not longer, as virtually all new construction projects were to be postponed or cancelled. This retrenchment would have significant consequences for foreign business.

Doing Business in China

Many foreign firms that rushed to China during the period immediately following the announcement of the open door policy found themselves thwarted by the imprecision of Chinese laws and by mixed attitudes toward the entire question of foreign participation in the economy. Despite multiple warnings, many companies, dazzled by the „market of one billion,“ entered China on the basis of poorly conceived or inadequately specified contracts in the hope of preempting the arrival of a competitor. According to one sinologist, „Many U.S. CEOs have been caught up in the Westchester County syndrome. They rush over to China simply to score points at the country club.“¹ In other cases, firms ended up with the wrong Chinese partner due to their inability to sort out the various players involved in the development of a business relationship. In still other cases, firms failed to take

seriously Chinese policies that limited access to the local market, emphasized technology transfer, and stressed exports. Foreign firms often failed to appreciate the degree of control retained by China's investment regime. Clearly, misperception and mis understanding were at work on both sides.

The situation for foreign enterprises was summarized well in an article in May 1989 regarding the Tianjin Economic Development Zone (TEDZ), one of the zones that has developed a fairly good reputation for business facilitation.² The article cites six main issues that have affected the business climate in Tianjin.

Difficult Operating Conditions. The general operating conditions for foreign firms leave much to be desired. The telecommunications and transportation infrastructure are inadequate, investment laws and policies incomplete, and local labor and capital markets undeveloped. In addition, many projects have encountered great difficulty because their original feasibility studies were incomplete. As a result, the article suggests, wary investors have kept most projects both small and low-tech. Only about 7 percent of the technologies imported by foreign firms into the TEDZ fall into the advanced category, and less than 50 percent of the equipment is up to 1980s levels. In some instances, foreign investors have had only limited marketing and distribution capabilities, and those who have had abundant market access have monopolized the opportunities while leaving their Chinese partners to sit on the sidelines. Furthermore, most ventures have been managed by people who do not possess the required managerial tools or know-how.

Missed Targets. Many of the joint ventures in the zone have been unable to meet planned targets, resulting in significant losses for the enterprises and the Chinese government alike. The causes of this failure to meet targets include the difficulty of acquiring raw and semifinished materials, but also the poor quality of imported equipment, inadequate maintenance and servicing, and poor labor-management relations.

Ineffective Directors. The boards of directors of many joint ventures are not functioning as specified in either the PRC joint-venture legislation or the contracts that have been drawn up based on these regulations. There is much confusion regarding the functions and responsibilities of directors vis-a-vis enterprise managers. The article suggests that „with respect to managerial organization, quality of available personnel, and intellectual concepts, the Chinese side of the investment is not yet suited to instituting [the] system of management by boards of directors.“

Technology Integration Problems. Because the majority of production-oriented joint ventures are primarily in light industries, often textiles, most of the technology involved is mature. The implementation of this technology has caused a number of complications for the joint ventures in terms of production operations. For example, in contrast to Soviet diagrams and blueprints, which tend to be extremely detailed, American and European documentation is generally less explicit and assumes a high degree of specialized knowledge on the part of the labor force. From the Chinese point of view, lack of detailed information about specific shop-floor tasks and processes causes serious integration problems.

Labor Difficulties. Like many local enterprises in China, foreign-invested firms are plagued by labor/management relations problems. Even though joint venture firms operating in the TEDZ are more fortunate than those in some other parts of the country, three issues seem to stand out: the fixed number of workers per shift is still unacceptably high, probably due to a combination of inefficiency and nepotism; work discipline is still relatively lax and productivity low; and the quality of worker performance remains uneven. Discipline is a significant issue. In some instances, Chinese managers are fearful of being accused of being „slaves to the Western firms“ or „enemies of the workers.“

Marketing Issues. The overseas marketing of products remains a key problem in the management of joint ventures. Many joint ventures have failed to meet their projected levels of export sales. In some instances, the original feasibility studies were not done properly or the figures in these studies were inflated. More important, however, has been the tendency of many factories to produce substandard products at very high cost. Many factories just cannot meet the scheduling and quality requirements necessary to be competitive in world markets, especially when they encounter uncertainty in the supply of high-quality components and raw materials. To make matters worse, their Chinese partners rarely have access to the information needed to adapt products to foreign tastes and desires.

In considering the attractiveness of China as a site for foreign investment, it is important to realize that the Tianjin zone is regarded as one of the more progressive and successful sites for foreign investment, and that the issues cited above predated the events in Tiananmen.

Tiananmen and China's Future Investment Climate

In the spring of 1989, with the economy facing severe problems, there already existed an atmosphere of crisis in Beijing as well as in other key cities. In fact, while no one could have predicted either the formal declaration of martial law in late May or the massive violence that took place on the night of June 4, pressures were mounting as the ability of the leadership to retain the confidence and support of large numbers of intellectuals, workers,

farmers, and students seemed to be declining. The ensuing political crisis represented, among other things, the culmination of an effort by a number of conservative leaders to discredit further the reform program of former Party Secretary Zhao Ziyang, while at the same time ensuring Zhao's removal from power.

Clearly, the political crisis did nothing to alleviate the serious economic problems facing the Chinese leadership, though some foreign observers have suggested that the Tiananmen events gave PRC leaders the excuse needed to reassert control in a more deliberate and comprehensive fashion than might have been possible otherwise. If so, the impact of the Tiananmen political crisis, at least in the short term, may be to moderate the country's economic crisis. This assumes, however, that the new leadership under Party Secretary Jiang Zemin will in fact succeed in curbing inflation and stabilizing the economy – outcomes that are by no means certain.

There is little evidence to suggest that the country can easily or quickly recover from the damage wrought by the Tiananmen events, both at home and abroad. At home, although it appears that the pace of economic growth may have been slowed by the leadership's austerity measures, the economic crisis has not subsided. In fact, the economy may be headed for an extended period of difficulty. During the first half of 1989, for example, price hikes in most parts of the country exceeded the state's designated targets, reaching well above 20 percent in some cases. In addition, many Chinese enterprises are still strapped for capital, as bank credit remains unavailable.

Moreover, during the first quarter of 1989, despite stricter controls over the foreign trade sector, imports rose by 21.3 percent, while exports grew only by 9.4 percent, resulting in a deficit for the quarter of \$1.9 billion. By mid-year that imbalance had grown to \$5.7 billion, four times the total for the same period in 1988. This trade imbalance was caused primarily by shortages of domestic supplies, which both disrupted exports and necessitated sharp increases in imports of raw materials and consumer goods. The impact of the retrenchment is likely to make itself felt even more extensively throughout the economy over the next two to three years.

Abroad, the Tiananmen events clearly destroyed confidence, especially among the foreign commercial community. The immediate impact of Tiananmen was the decision of almost all major foreign creditors, including the World Bank and the Asian Development Bank, to delay decisions about whether to extend new loans to China. Led by the United States, several creditor countries followed suit, including the United Kingdom, Italy, France, Belgium, and Japan. The United States also imposed a number of economic sanctions against China, including a curtailment of high-level visits and suspension of military cooperation. Tourism also declined sharply, causing losses in foreign exchange earnings of more than \$1.0 billion.

Even more critical, however, was the response of the foreign firms already operating in the PRC. For companies such as Volkswagen, Foxboro, and Pilkington, all of which have sizable ventures in China, there was little to do but sit and wait. Many joint ventures could not get needed supplies as the economy ground to a halt, especially in major cities. A host of firms, perhaps as many as half, removed their expatriate staffs to Hong Kong until stability was restored in Beijing and other parts of the country. The halt in production of many of these joint ventures could not have occurred at a worse time for Beijing, which already faced serious economic management problems. Other companies suspended negotiations in progress, pending some clarification of what was happening. With capital already in short supply, the decision of some foreign investors to withdraw from planned projects further deepened the country's financial crisis.

The response of most U.S. and Western European firms was fairly clear and consistent. Many Taiwanese firms, too, quickly pulled back from their growing investment links with the Chinese mainland. Among Japanese companies, however, there seemed to be significant differences in attitudes about what to do. With some notable exceptions, such as Matsushita, Japanese firms wanted to get on with business. There was a strong desire to return to China as soon as it was feasible. Japan has about \$2 billion – 1 percent of its total overseas direct investment – invested in China. In 1988, \$300 million of Japanese investment flowed into China, about 0.6 percent of Japan's worldwide total. Even more important, however, Japan's large trading firms carry on a sizable trade relationship with China (approximately \$20 billion in 1988).

Japan sees a stable, economically developing China as critical to peace and stability in the East Asia region. Moreover, due to rising wage costs in Taiwan and South Korea, the limited availability of markets in Singapore and Hong Kong, and the appreciation of the yen, China has steadily become a more important investment site for Japanese firms. Accordingly, although the Japanese government focused its concerns on Japan's image in the world and thus was reluctant to encourage a quick return to China, an appreciable number of Japanese companies sought a swift comeback, as one Japanese executive put it, „to put unsettled matters in order.“

Even in Hong Kong, where a strong unified population seemed to coalesce during the initial weeks of the student demonstrations in Beijing, the outrage dissipated as many managers sought to return to their operations, especially those with activities in South China, where the initial political spillover from the events in Beijing was limited. Given the economic and technological interdependencies forged between Hong Kong and China over the last several years, Hong Kong businessmen with links to China have had little choice but to re-engage.

Whither the China Market?

Many companies have now returned to China. The majority are assuming very low profiles, at least in part to deflect political attention back home. Some are concerned that the Chinese authorities may use their presence for propaganda purposes. At the same time, a large number of these same firms opposed the use of sanctions by their home governments. Some U.S. firms, for example, believe that their presence in China serves as a point of leverage for keeping China open to the outside world. Despite repeated affirmations by Chinese leaders that the open door will remain open, things are far from normal in China, even in cities such as Guangzhou, where Beijing's reach has gradually extended since the political crackdown in the aftermath of the Tiananmen events. Many firms are reluctant to pursue various business-related issues with Chinese officials under the present circumstances. This reticence, combined with the lingering effects of the government's austerity program, especially in the area of credit and money, suggest that foreign firms' ability to operate in China will be increasingly constrained.

Prior to the Tiananmen events, there had been a growing sense that despite China's pressing economic difficulties, it was finally on its way to becoming a more central and influential actor in global product and technology markets. In this context, the three-way economic integration process among Taiwan, Hong Kong, and the Chinese mainland has been particularly significant. Hong Kong firms have plugged into Chinese R&D units to develop new products and improve their manufacturing processes. Taiwan-based firms have shifted production to southern China and in the process transferred substantial amounts of basic manufacturing know-how. If these trends continue – and if the turmoil generated by the events in Tiananmen Square does not lead Chinese leaders to return their economy to the centralized monolith of the 1950s – the steady joining together of China's appreciable scientific and technological capabilities, labor, and raw materials with the money and marketing skills of Taiwan's entrepreneurs and the financial and communications network of Hong Kong are certain to have a significant effect on the structure of economic relations in the region and beyond.

Similarly, as China becomes more embedded in the East Asian economy, Sino-Japanese relations will take on even greater long-term significance. In particular, China is likely to play a larger role in competition between the United States and Japan, the United States and Western Europe, and Western Europe and Japan. China will be significant as a source of raw materials, a base for or source of manufactured exports, a market for capital goods and technology, a buyer of consumer goods and light industrial products, a market for services, and an exporter of technology (e.g., software and space launching services).

Sophisticated foreign firms will be entering into new forms of partnership with China. For example, McDonnell Douglas, which is manufacturing complete airplanes in the PRC, is no longer looking at China simply as the market of one billion. Rather, the firm is apparently helping to build up Chinese manufacturing capabilities in order to involve Chinese engineers in designing and manufacturing airplanes for selected third-country markets. As China expands its reliance on Western standards, measurements, designs, spare parts, and managerial procedures, it will become difficult and costly for the Chinese to extricate themselves from the web of relationships they have developed with the firms from the industrialized world – although, as the Tiananmen Square incident suggests, it is possible that China may have to choose to bear such economic costs to support its political priorities.

The most plausible scenario is that in most areas the Chinese economy will continue muddling through. In this light, the events associated with the pro-democracy demonstrations may ultimately represent no more than a small „blip“ on the screen as far as the future of China's modernization drive and open door policy are concerned. All Chinese leaders will, of necessity, have to confront the ethnocentric nature of their culture; at the same time, all foreigners will have to learn to deal with China's uneasiness in the socio-political sphere. This uneasiness tends to surface when dealings with the West become excessively intimate. From the perspective of foreign firms, however, the larger issues will be linked to the performance of the economy, and, unfortunately, there are no easy answers to most of China's economic problems.

Nonetheless, two developments with special relevance for the foreign business community are likely to emerge from the current economic difficulties and political uncertainties. First, in the aftermath of the Tiananmen events, officials in Beijing are likely to press internally for more discipline in terms of the ways Chinese practitioners work with foreign companies. This discipline is unlikely to take the form of new legislation, which would further confound the negotiation process or the operation of foreign companies. Rather, if the so-called „conservatives“ have their way in organizations such as MOFERT, there will be more careful deliberation and assessment before a PRC entity enters into a project with a foreign counterpart. This deliberation may deter some foreign corporations from investing in China because it may reflect an even bigger gap between official regulations and the reality on the ground.

On the other hand, this development may actually mean fewer constraints and more opportunities for firms that meet Chinese criteria for preferential treatment and market access. Whatever leadership is in power in China, it must recognize that the imperatives of modernization require a substantial dose of foreign capital, foreign

technology, and foreign management expertise. Firms that support either China's export drive or its infrastructure development efforts will likely benefit from a more predictable atmosphere in terms of tighter guarantees. For example, in large cities such as Shanghai, key joint venture projects have already been singled out to receive special perks. The quid pro quo for doing business successfully in China will be much clearer to everyone, transforming the current „zero-sum“ environment for foreign investment into a „win-win“ setting. Of course, such a scenario presupposes that the present leaders – as well as any post-Deng leadership – will be able to maintain economic stability and political order. If they are unable to do so, all bets are off.

If the post-Tiananmen economy does attain a modicum of normalcy, even at the expense of a more rapid and comprehensive program of economic reform, a number of „pockets of excellence“ are likely to emerge within the PRC economy. These pockets of excellence may be defined either geographically or functionally, in terms of particular categories of products or technologies. Their identity is likely to be shaped by a combination of central government efforts and foreign business participation. Initially, they may include products essential to the development of the infrastructure, such as transportation development or power-generating equipment. Over time, however, they are sure to involve some of the more advanced technology categories such as electronics and new materials.

Prior to Tiananmen, it appeared that one new source of technological dynamism in the PRC would be the growing number of small, *minban* (quasi-private) companies such as the Stone Corporation. Now, however, the prospects for entrepreneurial firms of this kind appear doubtful as more and more economic control reverts to the central government.

Our advice to foreign firms interested in operating in China is to proceed cautiously, paying particular attention to the areas in which the Chinese are most eager to support foreign enterprise. Think of investment in China as R&D investment, to be undertaken carefully, without expectation of short-term reward, but with an eye to significant long-term opportunities.

¹ Lucian Pye, „*The China Trade: Making the Deal*,“ *Harvard Business Review*, July-August 1986, pp 74-80.

² Pi Qiansheng, et al., „*Problems and Ideas Concerning the Management of Foreign-Invested Enterprises: An Investigation of Foreign-Invested Enterprises in the Tianjin Development Zone*,“ *Jingji Lilun yu Jingji Guanli* (Economic Theory and Economic Management), #3, May 28, 1989, pp. 63-68.

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