Doing Business in China:
The Dragon Gathers Speed

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The breakneck speed of China's development and growth since the introduction of its „open-door" policy in 1979 has set the stage for what many believe will be the emergence of China as the next economic superpower. Already, the Chinese economy, measured in terms of purchasing-power parity exchange rates, is exceeded only by those of the United States and Japan. A market of 1.2 billion people with an estimated effective per capita income of $1,800 per year, a historically high savings rate of 3 5 percent of GNP (compared to a U.S. rate of 15 percent), real growth rates of 10 percent per year, and the need for major infrastructural investment does indeed present a very attractive proposition. Assuming a continued growth rate of 6 percent per year, China's economy would exceed that of Japan by the year 2000 and that of the United States by the year 2030. But can China continue on this path? Is the investment climate in China really ripe for serious consideration by foreign investors?

The Quick March

Before we address these questions, a bit of background. Between China's opening up to the outside world in 1979 and its much-publicized commitment to the „socialist market economy," enunciated by Deng Xiaoping in 1992, China's GNP grew 200 percent and its per capita income tripled.

Although the pace of foreign investment took somewhat longer to gain momentum, cumulative foreign investment in China in 1986-1991 totaled around $40 billion. Then, in 1992 alone, foreign investment pledged totaled $58 million – almost 50 percent more than in the previous 6 years combined. By year-end 1991, there were some 37,000 foreign-funded enterprises in China; in 1992, the government approved a further 47,000 enterprises.

By year-end 1993, according to reports in *The People's Daily,* more than 150,000 foreign companies had been approved for investment in China, with a total investment amount of approximately $200 billion. Of these commitments, some 50,000 foreign companies – accounting for a total of $50 billion in investments – are in operation. They currently account for at least 35 percent of Chinese exports.

Since the introduction of China's open-door policies, there have been two distinct waves of investment. The first of these was led principally by overseas Chinese (of whom there are some 55 million) who were primarily involved in developing export-oriented manufacturing activities, mostly in the coastal regions. These investors came principally to take advantage of abundant cheap labor and natural resources. Much of this investment came from Hong Kong, whose industrial labor force of 600,000 had become expensive and was soon dwarfed by an estimated 3 million people working in some 27,000 Hong Kong-owned businesses in the neighboring mainland province of Guangdong. Significant investment also came by way of Hong Kong from Taiwan, whose investments tended to be located across the straits in Fujian province.

The second, and overlapping, investment wave had a different character. Investors saw China as a market for their products and as a country in need of major infra-structural development. Moreover, these new investors looked beyond the coastal areas and began to spread inland to other areas, such as Wuhan and Yunnan.

Of the total funds pledged in 1992, the vast majority came from Hong Kong and Taiwan (Exhibit 1). Exactly how much of the „Hong Kong" investment originated in Hong Kong, as opposed to Taiwan or other sources, is unclear. Also unclear is how much of this investment was in fact „round trip" investment, i.e., money invested overseas by People's Republic of China companies and then reinvested in the PRC by the foreign entity in order to exploit the more favorable investment incentives offered to overseas investors.

Japan's investment in China, meanwhile, is growing rapidly. In 1993 alone, despite Japan's overall economic difficulties, investment in China totaled some $2 billion. Most Japanese investment to date has been by small- and medium-sized companies. Major investments in infrastructure and large-scale manufacturing, such as automobiles, will form the next wave and will have a major impact on China's economic performance. Half the Japanese investors surveyed by the Export-Import Bank of Japan at the beginning of 1994 selected China as the preferred location for their future overseas investment.

And, as foreign investment has increased, its nature has changed. For the first 10 years of liberalization, the most common form of foreign investment was that of joint ventures. However, the economic squeeze of 1988-89 placed a severe limitation on funds available for investment by potential Chinese joint-venture partners. Since that time, the government has pragmatically revised laws to permit a broader range of activities in which wholly foreign-owned enterprises can operate. These have now begun to proliferate in many activities.

Exhibit 1

Foreign Investment in China, 1992, by Source

(Imprecision due to founding)

Hong Kong	71.5
Taiwan	9.5
USA	5.4
Japan	3.7
Singapore	1.7
Thailand	1.2
South Korea	0.7
Other	6.2
Total	***100.0***

Incentives for Investment

Since 1979, the Chinese government has introduced a variety of mechanisms to stimulate an open, market-based economy. These include price decontrol, productivity incentives, increased private ownership of enterprises, and the development of a range of incentives to attract foreign investment.

Initially, incentives were oriented toward manufacturing industries, but other sectors have been opened up considerably, notably in finance, transportation, hospitality, and, most recently, retail. While some restrictions on foreign participation in certain key industries remain, these are gradually being reduced.

The opening up of China's financial markets has particular significance for both the psychological and the investment aspects of the economic reforms. Since the opening of the stock exchanges in Shenzen and Shanghai in December 1990, some 2 percent of the population, or 25 million people, have purchased stocks.

On balance, the reform measures have been a great success. Although state-owned enterprises still account for some 45 percent of industrial production (in part because the privatization program has been hindered by the lack of adequate social support programs to care for the unemployment caused), the socialist ownership structure has been changed to a very large extent.

Some Formidable Challenges

The present Chinese leadership, notwithstanding major internal differences of opinion, appears committed to the furtherance of liberalization reforms. However, it faces significant challenges. These include:

• *The lack of an obvious successor to Deng Xiaoping.* Will there be an orderly transition or factional disagreements that could undercut economic reform and progress?

• *The need to restore an orderly balance between the central power (Beijing) and the provinces.* The latter have become increasingly wealthy and thus more independent, and the central government's share of tax revenues has fallen from approximately 30 percent of GNP in 1978 to less than 15 percent currently. Whereas disintegration on the Soviet model is unlikely, China will require a significant effort to develop a system of government more akin to a federal system.

• *Growing tensions between the urban and rural populations.* The latter, having benefited in the early stages of liberalization at the time of agriculture price rationalization, now find themselves paid in vouchers and receiving lower incomes than their urban cousins, who are benefiting from the new reforms. High levels of urban immigration do not help tensions in the cities.

• *Difficulties encountered in reorienting old socialism-based state industries, many of them suffering high losses, into more efficient market-oriented enterprises.* Although a blend of price and management reforms has been introduced, the output of state enterprises is growing at just 10 percent per year, compared to 30 percent for local collective enterprises and 40 percent for the small private sector. The lack of social security systems to provide for the unemployed and the high social costs associated with housing and other facilities creates a significant burden, but recent legislation provides for these welfare functions to be handed over to local governments. Indeed, 100 of the country's largest enterprises have been designated as „model" enterprises and will become corporate entities with full control over their own assets and, except for certain strategic industries, the ability to sell shares to domestic and foreign private investors. This experiment will then be extended to the remaining 7,000 large state enterprises.

• *Excessive numbers of people in the bureaucracy at all levels.* This condition not only is costly and inefficient, but creates fertile ground for corruption at every transaction stage. Widespread corruption in government was a main cause of the Tiananmen Square uprising in June 1989, and evidence suggests that since that time corruption has not decreased but spread immensely. (The Hong Kong Independent Commission Against Corruption estimates that paying bribes in China adds 3-5 percent to the operating costs of companies doing business there. This figure is probably conservative.)

• *Severe lack of well-developed infrastructure of all types, coupled with critical energy and materials shortages.* Frequent electricity blackouts and lack of materials often force factories to shut down. Similarly, the country's rail system is inadequate for transporting the required volumes of coal and other key materials. The infrastructure bottleneck looks set to last for a considerable period. It could pose a major threat to China's rapid growth, even though the government has recently committed to spending $120 billion on railway, highway, port, pipeline, and air transport infrastructure through the remaining 1990s.

• *The uncertain role of the military.* Although military expenditure is increasing, some observers claim that this increase represents an attempt to keep individuals content with their incomes relative to other segments of the population while, as a fighting force, they remain technically backward. The post-Deng era and the way it evolves will determine to a large extent the future role of the military. With the demise of a strong unifying Communist rallying cry, will the military stick together? Or will a provincial Balkanization weaken the army's unity? Or, alternatively, might the temptation of foreign adventurism elsewhere in the Asia Pacific region prove to be a unifying force? For the time being, at any rate, the army appears to be looking at commercial options. It is determined to make money; the People's Liberation Army is believed to own over 20,000 companies and to be engaged in various activities, including airlines, farms, hotels, commercial telephone networks, and health spas.

• *The need for major financial reforms.* Although major tax, banking, and currency reforms were introduced in January 1994, following the 14th Central Committee of the Communist Party of China held the previous November, substantial reforms of the financial sector are still required. Further development of financial markets and the introduction of market-based interest rates are high among the priorities, but full currency convertibility is still a long way off.

• *Inflation.* Perhaps the greatest single challenge in the immediate future is the need to control rampant inflation – currently at well over 20 percent in urban areas – especially in the absence of an appropriate range of policy instruments. The inflation policy differences at the very highest levels of government are extreme, with reformers bent on lifting the moderating measures introduced in June 1993 as soon as possible. While inflation is nowhere near as severe as that in the former Soviet Union and Eastern Europe, the move from controlled prices to a market-oriented system has created disruptions and discomfort for many, especially in low-level urban jobs. The political as well as the economic management of this situation will require considerable skill. Indeed, the January 1994 reforms mentioned above are designed to further speed up growth while the government is trying to cool the economy.

• *Foreign policy concerns.* Especially as China becomes increasingly drawn into international trade and other areas, concerns range from the territorial (such as China's perceived role regarding the Spratley Islands and the South China Sea, and its handling of the Hong Kong and Taiwan questions) to China's stance on issues such as the environment, narcotics, and international crime.

The handling of these and other issues, such as trade restrictions, intellectual property rights, and human rights will undoubtedly influence the degree to which pressures – diplomatic, trade, or other forms – will permit China to adhere to its current growth policies.

The Next Phase of Development

Against this background of formidable policy challenges – and the inevitable series of policy changes that will be required of the Chinese government as it attempts to address the enormous problems it faces – foreign investors will be assessing their own plans for investment in China. As can be expected, there are both detractors and zealous proponents of China's future role as an economic powerhouse. It is reasonable to assume, however, that even though the development of the China market may be full of headaches and obstacles, in the long run a consumer market of 1.2 billion people is a market that few major companies can afford to neglect. Indeed, Robert Allen of AT&T has identified China as his company's top priority in the years ahead, while Jack Welch of General Electric, America's third-most-profitable company, sees India, China, and Mexico determining his firm’s future.

Indeed, the market potential is formidable. Consumer spending in China has been increasing at an average rate of 8 percent per year for the last 15 years. In certain regions, such as Shanghai, Tianjin, and Guangdong, the rate has been much higher. And we can add to this an estimated $200 billion in private savings. Already, the top five advertisers in the city of Guangzhou in the first half of 1993 were Rado watches, Marlboro cigarettes, Colgate toothpaste, M & M’s chocolate, and Martell VSOP brandy – hardly items of absolute necessity.

On the infrastructure side, as already suggested, virtually all categories are in need of replacement or greenfield investment: power generation, roads, railroads, postal service, and telecommunications. The Chinese authorities, in general, have proven flexible in their arrangements for foreign investment in these areas, encouraging, for example, Hong Kong-based Hopewell’s investments in toll roads and the P&O/ Swire purchase of 50 percent of the southern container port of Shekou. On the other hand, in telecommunications, the government plans to expand the number of telephones from 20 million to 80 million by the year 2000 (which is equivalent to 45 percent of the total installed telephone lines in the United States, but will still only produce about one-tenth of the U.S. telephone/population density), but key ministries are resisting foreign network operators.

Obstacles to Investment

Despite China’s huge market size, the very large number of companies that have made investments in China in recent years, and the impressive degree to which Chinese authorities have improved the business environment, China remains a difficult and frustrating country in which to do business. Formidable challenges include a mammoth, multilayered bureaucracy, the virtually all-pervasive practice of corruption, deep technical and cultural divides fostered by 40 years of virtual isolation from the West, and rudimentary accounting and legal systems. Combine these factors with linguistic and management differences of significant proportions, and the tasks of identifying, developing, and operating a business in China appear daunting. In addition to the foreign exchange difficulties mentioned earlier – which are diminishing as a result of the introduction of the monetary and controlled floating-rate system as a step towards convertibility – the most frequently cited difficulties are:

• Poor/inadequate infrastructure, noticeably power, telecommunications, and transportation

• High levels of bureaucracy and corruption

• Difficulties in recruiting and training both managers and workers (One Shanghai joint-venture hotel reports 90 percent annual staff turnover!)

• Intellectual property infringements

• Difficulties in sourcing raw materials and components

• Steeply increasing labor costs

• Very high costs of doing business for such things as office space and housing in rapidly developing areas, such as Shanghai

Early in 1993, leading foreign companies doing business in China drew up the following „wish list“ of improvements for the Chinese government:

• Achieving effective macroeconomic stabilization, particularly clarifying the roles of the central bank, commercial banks, capital markets, and various government agencies, as well as the relationship between the central and provincial governments

• Achieving convergence toward a unified exchange rate for the current official and market exchange rates

• Increasing the transparency of regulations to facilitate comprehension by all parties and, just as important, to improve civil awareness and enforcement

• Improving the enforcement of laws relating to intellectual property rights

• Facilitating and speeding the process for investment approvals

• Developing holding company regulations to permit a broader ownership pattern for companies engaged in a variety of activities

• Relaxing restrictions on the recruitment of local labor

• Permitting the increased mobility of local staff by facilitating the issuance of travel documents for Chinese staff

• Facilitating access to the domestic market for products manufactured by foreign companies

• Allowing portfolio investment in local markets by foreign individuals or entities

• Introducing improved incentives for capital-or technology-intensive projects

As previously indicated, a number of these issues were subsequently addressed, in some cases indirectly, by the measures adopted at the third plenary session of the 14th Central Committee in November 1993. However, in some instances, implementation regulations have yet to be spelled out in detail, and many of the measures included will be difficult indeed to implement.

Perhaps most important, the government will adopt a policy of using macroeconomic instruments, rather than administrative orders, as a means of guiding economic policy. The central bank will be given greater power, and the commercial banks will be relieved of making „policy" loans and will become more self-sufficient, i.e., less dependent on government support.

Some of the difficulties listed here, such as the poor levels of infrastructure, come with the territory and will simply take time to resolve – while providing significant investment opportunities. Other problems can, with careful forethought and planning, be minimized if not entirely eliminated. It's important to note that, once these are overcome, investors are usually highly satisfied with their Chinese operations.

Guidelines for Doing Business in China

Despite the evident challenges, there can be no doubt that China is both a major market and a major source (in terms of outright purchase, co-production, or production) for many big corporations. However, getting to the point of starting and operating a successful venture requires considerable care. We offer three basic observations and a number of general principles.

There is no single „Chinese market." China should be regarded not as one market but as 29 separate provincial markets, each with its own bureaucracy and its own industrial base. Accordingly, each province may require its own distributor and distribution network. Moreover, investors should not underestimate the logistical complexities of distribution to the various provinces, where the infrastructure is often poor and corruption rampant.

Furthermore, economic levels vary dramatically both between and within provinces. For example, the 1991 per capita GNP in Guangdong province was $519, versus $164 in inland Guizhou. Similarly, the per capita GNPs for the cities of Shanghai and Beijing, respectively, were $1,202 versus $959. Some provinces that have historically been left far behind in the growth race are now growing at 5 percent per year, a high rate by any standard.

Of course, careful targeting and marketing are important in China as in any other country. But here, the top-spending 20 percent alone comprises a market of 240 million people!

There is no single Chinese labor pool. Whereas hourly rates are, for the most part, extremely low by most international standards, they are far from uniform. In provinces such as Shanghai and Guangdong, labor rates have increased by 30-40 percent per year, exacerbated by the demands of the increasing numbers of foreign investors. Whereas wages in these areas still compare favorably with Hong Kong, their real competition is in Vietnam, Indonesia, and other potential Dragons. Investors considering China may well want to consider investments outside the much-vaunted coastal provinces, for example in Yunnan or Guangxi, where wage rates are much lower.

China needs to rejoin the GATT. The promotion of exports has been a major tenet of the Chinese government push for development. Exports, with a current value of over $80 billion, have increased 170 percent in 5 years, making China the world's 13th-largest exporting country. With the continuation of the „open door" policy and with its rapidly increasing level of trade, China urgently needs to reenter GATT. This move would reduce or eliminate the remaining trade barriers against China and increase levels of inward investment. It would also create pressure to „normalize" business practices within China, e.g., to introduce improved commercial legislation, improved accounting practices, and better arbitration procedures. In other words, if China rejoins the GATT, things should get a lot easier for the foreign investor.

With these observations in mind, it is possible to enter China effectively, as evidenced by the experiences of AIG (page 46) and AT&T (page 48). Here are our suggestions:

Select a partner with care. In any country, the selection of an appropriate joint-venture partner can truly make or break an operation. In China, where both risks and rewards are so large, it is especially important to proceed with caution. Before making this critical choice, the foreign investor should have developed full internal consensus and support for its strategy and should be quite clear as to what it expects from its planned project and from its potential partner. In general, be wary of venturing with municipal enterprises, as these – and the individuals who run them – are subject to political changes within the municipality. Also, make sure that the potential partner has the entitlement (to land, for example, or materials) that he or she claims; otherwise, there could be severe problems later.

Do not rush into an agreement. At the early stages, you should sign only a letter of intent stating general agreement on principles. Details should be developed only after you have determined your expected financial and other pre-dividend results from the proposed venture, as established in the project feasibility study. At this point, when establishment of a common vision or set of goals is paramount to the long-term success of the proposed venture, all facets of the project are still negotiable. Too often the impending visit of a CEO or the need to stick to a pre-agreed timetable has hastened the signing of an inadequate agreement – with disastrous results. Do not be hurried.

China does not yet have a well-developed system for settlement of contract disputes. Furthermore, renegotiation of contract elements is still possible after signature. Nonetheless, the set of agreements made between partners (such as a joint-venture contract, or financial, marketing, technical, and supply agreements) are a good means of measuring the complementarity of the respective parties' objectives. So too are the joint venture's side agreements with other key organizations, such as banks, tax authorities, customs, labor bureaus, and construction companies. Frequently, the Chinese partner will view a joint venture simply as a means of getting its hands on technology, equipment, and expertise, and thus will have totally different expectations from the foreign investor. This early stage is the best time to clear up differing viewpoints.

Do not compromise your business standards.

Generally speaking, sound rules for conducting business around the world apply equally in China. Nonetheless, a significant number of businesses have stumbled or failed because investors have departed from their normal practices in order to adapt to what they perceive as Chinese practice. Examples of this have included relying on verbal assurances that materials are readily available, not insisting on the right to fire incompetent staff, and not testing raw materials. A firm guiding principle should be, first, to develop an understanding of the local situation and then to assess whether it is really necessary to adapt to it by compromising any well-proven values or practices. In any case, rule out the payment of bribes.

To gain this local understanding, if you do not have your own Chinese-speaking staff, be sure to hire or retain a highly qualified interpreter who can come to understand your business. It can be a costly mistake to rely on locally provided interpreters who are unfamiliar with your business. Often, such people are afraid to admit that they do not fully understand a problem, and may attempt to please you rather than interpret correctly. Make your interpreter part of your team and listen to his or her assessment of local conditions, power moves, and the implications of seemingly strange decisions or requests from local parties.

American Insurance Group (AIG)

AIG, America's most profitable insurer, first founded its China operation in Shanghai in 1931. It left China in 1949, at the time of the People's Revolution, and reopened its business, again in Shanghai, in October 1992, as the first foreign insurer to sell life insurance in China. Its new office employs 300 mainland sales agents, with plans for expansion into Southern China and Beijing. These agents sell, on average, twice as many policies as their AIG colleagues in other rapidly developing parts of Southeast Asia.

AIG has adopted a number of measures that are worth replicating by others considering China investments:

• Planning for the long term, as evidenced by AIG's commitment to reinvest profits in China for a 10-year period.

• Making tangible investments, such as taking a one-third ($200 million) stake in the Portman Hotel-Shanghai Center complex.

• Introducing a commission-based pay system for their sales agents. This approach, despite initial resistance, has proven to be both highly effective and very popular. Chinese insurance companies, in comparison, only pay a basic salary.

• Recruiting people with no previous experience in insurance into the sales force, training them from scratch, and inculcating in them the company philosophy and values. The average age of the sales staff is under 30.

• Engaging in local development efforts by playing a leading role in the establishment of the International Business Leaders' Advisory Council for the Mayor of Shanghai.

Also, take time to develop an understanding of the „system“ within which both Chinese and foreign investors must maneuver and operate. The key players may not always be the most vocal in a negotiating team. They may not even be apparent. Negotiations may be frustrated by the fact that members of the local team may have widely differing agendas and aims. The understandings developed at this early phase will be as useful during venture operation as they are at the time of venture formation.

Recruit and develop good managers. This presents one of the greatest challenges to people doing business in China. Virtually all foreign investors insist on appointing foreign managers of their own choosing, at least for the initial few years. Ideally, even though the period between initial contact and commencement of operations may take several years (although this gestation period appears to be shortening), the manager selected should be part of the venture identification and negotiation team. He or she should be in top-level contact within the investing organization. In addition, this manager should be able not just to introduce foreign management operational practices, but to understand local practices and approaches and to adapt to or amend these where appropriate. Typically, this manager will face unqualified staff, poor motivation, and departmental rigidity in the new organization. All these characteristics need careful, sensitive management. In addition, the manager must maintain cordial, constructive relationships with local authorities. When a project is in difficulty, such relationships can be a lifeline – or a minefield.

Recruiting local managers from state enterprises can pose difficulties. Often, such recruits retain old practices and strong allegiances to former cronies. Too frequently, they feel only superficial allegiance to the new enterprise – and even this lessens when the going gets tough! Recent experience has shown that one of the most effective approaches is to hire bright graduates straight out of college. Not only are these young people unencumbered by old allegiances and practices, they are usually eager to learn the new ideas – and work for the higher financial rewards – offered by foreign companies. Also, they can be attracted by the promise of travel and, through carefully-developed long-term human resource policies, longer-term prospects for top management roles in the company. The common practice among foreign-financed joint ventures in China is to manage ventures themselves, without relying on the management they have inherited from their partners, until the new management they have hired and trained is in place.

AT&T

In late 1992, AT&T adopted a differentiation strategy to help it catch up with its competitors in China. The heads of the company's separate business units agreed that the company's real competitive strength was in its immense range of diverse activities across both equipment manufacture and service delivery.

China's State Planning Commission was receptive to establishing a comprehensive cooperation agreement between the Chinese Government and AT&T covering the entire range of the latter's capabilities. The subsequent Memorandum of Understanding, signed in February 1993, establishes a „long-term comprehensive partnership" by which the Chinese and AT&T plan to pursue business opportunities jointly. The Memorandum also establishes an advisory board comprised of both AT&T and State Planning Commission members to oversee execution of the agreement and to identify new opportunities.

The Memorandum of Understanding is important to AT&T's globalization strategy, which aims at earning 50 percent of revenues outside the United States by the year 2000. Two aspects of AT&T's China strategy may offer useful lessons:

• Establishing a China Business Unit – AT&T China – reporting directly to the AT&T Chairman and headquartered in Beijing. Prior to the Memorandum, each of AT&T's more than 20 business units was free to enter China (or any other country) independently, with its own profit and loss objectives. The Chinese were particularly interested in the services offered by Bell Labs, which might not otherwise have had an incentive to enter China on its own.

• Placing senior management in China to deal with officials at the highest levels and ensure direct communication on vital elements of the company's strategy to top levels of AT&T.

Observation of these basic guidelines can prevent considerable frustration. On balance, as long as the government is able to avoid severe unrest caused by hyperinflation, the future for investment in China looks rosy, both as an export base and increasingly as a market. While fortunes are already being made, the key to successful business in China is full commitment – and a great deal of patience.

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