



CASE

China—Complicated Risks, Big Opportunities¹

From 1949 to the late 1970s, China was autarkic, championing a self-sufficient economy that relied entirely on its own resources. Leaders of the governing Communist Party believed that interaction with foreigners would corrupt China's politics and pollute its culture; hence, they prohibited FDI and restricted foreign trade. Near the end of the 1970s, however, China's leaders began rethinking this strategy. Realizing it was lagging the world, China enacted the Law on Joint Ventures Using Chinese and Foreign Investment in 1978 and effectively began building a socialist market economy that opened the country to the global market.

Since then, Chinese economic policy has been marked by steady market liberalization that has fueled its accelerating global trade and investment. Undeniably, the Chinese Communist Party (CCP) maintains its absolute monopoly on political power. As one Beijing scholar observed, "The Party (CCP) is like God. He is everywhere. You just can't see him."² Free market principles, however, increasingly shape the country's business environment.

Transformation has yielded astonishing results. Over the past three decades, China has prospered more from globalization than any other country, outsmarting and outperforming many on the world stage. Many of its citizens have moved from mud huts to high rises. Companies have turned from woeful enterprises into world-class multinationals. The country has accumulated the greatest financial reserves in the world. Consequently, many see its ascendancy as a global event without parallel.

THE SIREN CALL OF CHINA

Compelling incentives attract foreign investors to China. Since the 1980s, MNEs have maintained a veritable gold rush there, ranging from manufacturing ventures and export processing to licensing agreements and service relationships. Total FDI in China—representing more than 600,000 ventures opened by companies from around the world—was nearly \$1.7 trillion in 2012, while literally nonexistent in 1980. Why have so many rushed to China? Quite simply, they see stunning opportunities:

Market Potential With 1.34 billion citizens, China resets conventional analytics. Consider that the Walt Disney Corporation is building a \$4.4 billion theme park and resort in Shanghai where 330 million people—more than the population of the United States—live within a three-hour drive or train ride. China's market scope steadily expands. Its

economic growth has reduced the number of poor by more than a half-billion since 1981. Hundreds of millions more, though poor, see a brighter future. In 2010, 91 percent of Chinese citizens saw their economic situation as "good," compared to 52 percent in 2002.³ Most domestic markets are in early high-growth stages. Many MNEs that came for low-cost workers stay for increasingly well-off shoppers.⁴

Market Performance Rapid economic development catapulted China from an also-ran in 1980 to the world's second largest economy in 2012; analysts see it becoming the world's largest sometime between 2016 and 2036.⁵ Growing income spurs consumer spending. During the U.S. and British industrialization in the nineteenth century, real incomes per capita doubled in 50 years. China's did the same in nine years. Said a China expert, "Never before in history has so much wealth been created in such a short time."⁶

Infrastructure In a multiyear program, China is investing trillions of renminbi on housing, offices, highways, airports, seaports, waterways, dams, power grids, high-speed trains, and communication networks. Despite tremendous progress, it has far to go. For example, it lags in the number of airports with paved runways: 452, compared to 713 in Brazil and 5,194 in the United States. Moreover, 44 Chinese cities populated by more than a million people still have no mass-transit system other than buses.⁷

Resources China's well-educated population creates an immense pool of productive labor. Wage rates for unskilled labor are less than those in many other countries—perhaps 5 percent of comparable costs in the United States, Japan, and Europe and a third of those in Mexico and Turkey.⁸ Besides efficient factory workers, China boasts a large and growing number of productive, lower-cost brainworkers. In 2013, it added another \$250 billion to its university infrastructure, and after doubling its number of universities over the previous decade, it plans to produce 195 million college graduates by 2020. China's current five-year economic plan directs millions to study alternative energy, energy efficiency, environmental protection, biotechnology, advanced information technologies, and high-end equipment manufacturing.⁹

Strategic Positioning China represents the biggest growth opportunity in the history of capitalism. The country is experiencing roughly ten times the economic acceleration, on more

MAP 3.1 China: The Inscrutable Market

With more than 1.3 billion consumers and a labor force of just over 800 million workers, China is attractive to foreign investors. One of every five people in the world lives in China, but the population is unevenly distributed. Approximately 50 percent of Chinese citizens live on just 8.2 percent of the country's total land. Even so, maintaining centralized control over the nation's political and legal affairs has traditionally been difficult. The vast distances between seats of authority helps local officials evade the watchful eye of faraway bosses.



than 100 times the scale, resulting in an economic transformation that carries over 1,300 times the force of change than seen during the Industrial Revolution. MNEs are responding in kind: Ford plans to double its production capacity in China to 1.2 million vehicles by 2015, its most rapid expansion anywhere in 50 years; GE relocated its 115-year-old X-ray division from Wisconsin to Beijing; Yum! now looks to China for half its global sales and 40 percent of its operating profits. Bluntly put, “You are not a global player unless you are in China.”¹⁰

THE COMPLICATION OF REALITY

Notwithstanding the hype and its hyperactive performance, complications tarnish China’s appeal. Its political and legal systems make business operations a nebulous, frustrating process. In a nutshell, China practices “State Capitalism” whereby the government manipulates market activities to achieve political goals. Consequently, MNEs doing business in China often find themselves at a disadvantage. Ambitious Western firms such as Exxon Mobil, ABB, Caterpillar, and Vodafone purchased big stakes in Chinese companies. Political problems and legal difficulties short-circuited their plans. Eventually, like many others, they sold their stakes and reset their strategies.¹¹

China’s rapid emergence aggravates long-running idiosyncrasies. The resulting mix of ancient and contemporary outlooks creates many grey areas. Some observers argue that, when it comes to doing business in China, the number one rule is to throw away the rulebook. Sage foreign investors abandon the notion that Western ideas automatically work in China. The principle of forming a corporation “for any valid business purpose” does not exist there. Incorporating in China requires telling the government—in

excruciating detail—who you are, what you want to do, how you plan to do it, how much you intend to invest, and how many jobs you will create. MNEs endure protracted negotiations in obtaining permission to open local operations. At each stop of the long march, national, provincial, and local officials ask how the investment encourages capital formation, promotes exports, creates jobs, and transfers technology. If you hit the right targets, only then does the government green-light your project.

DRAGONS AND SNAKES

As in China, centralized governments worldwide determine the path and pace of local economic development. China, however, poses a particularly tough case given that its political and legal systems impose many time-consuming tasks. Moreover, China tends to stack the odds against foreigners who are bold enough to forge ahead in the face of an elaborate government bureaucracy and a fledgling legal system.¹² “If the great invention of European civilization was a legal system,” quipped an observer, “then China’s was bureaucracy.”¹³

Exasperated investors blame China’s treacherous terrain on a bureaucratic system that regulates activity based more on arbitrary agendas than objective standards. Connections, not competencies, often matter more. Those who believe that economics should determine the efficient means of generating prosperity see this as illogical. Still, it is utterly logical to Chinese leaders who regard state control of business activity as the most reliable path toward harmonious prosperity—and, one mustn’t forget, staying in charge of the show.

Foreign investors navigate often-mysterious political channels. The long-running conflict between central and local Chinese authorities further confuses issues. The vastness of the country means that local officials, whether headquartered in the smallest village or the largest city, are often left alone by their comrades in Beijing. Certainly, there are national laws, but how they move from Beijing to the provinces is a different story. “The center,” notes one observer, often “has no control over the provinces. When it sends people to investigate illegal pirating of CDs, local governors block access to the factories.”¹⁴ As Chinese folklore warns, “The mightiest dragon cannot crush the local snake.” This proverb captures the spirit of the enduring power struggle within China. Essentially, even though the central authorities in Beijing may appear to be all-powerful, the politics of powerful local fiefdoms often subvert their authority.

PRECISE LAWS OR AMBIGUOUS GUIDELINES?

China had no formal legal system in 1978 when it launched one of the greatest campaigns of legal reform in history. Ongoing developments have stabilized what had been an unpredictable, periodically chaotic legal environment. Still, China faces such ongoing challenges as legislative gaps, hazy interpretation, lax enforcement, and philosophical disagreements. Legislation is chock-full of ambiguities, says one Beijing-based lawyer, who thinks it will take 10 to 15 years to iron out many wrinkles.¹⁵ Some are less optimistic, comparing the state of the Chinese legal system with that of the United States in the 1920s—then an antiquated composite of statutes and codes that took several decades to modernize.

Others note that, in the case of the Chinese system, even bigger problems reflect a difference in the concept of legality in that society. Western legal systems rest on the rule of law and its doctrine of legitimate regulations transparently administered by public officials who are held accountable for their just enforcement. In contrast, China practices the philosophy of the rule of man, seeing the right of the “man” (once in the person of the Emperor, today in the form of the CCP) to act free of checks and balances. Besides being the law, the CCP is seen as above the law and given the legitimacy bestowed upon it by its ostensible “mandate from heaven.”¹⁶ Rarely does the Chinese criminal court end with anything other than a guilty verdict. Rather, explained an FBI Special Agent and legal attaché at the U.S. Embassy in Beijing, “there is really no rule of law here . . . they (CCP) make a decision ahead of time to make a point.”¹⁷

THE LEGALITY OF ILLEGALITY

China’s legal practices combined with the growing pains of its novel legal institutions and evolving political norms challenges MNEs. A sensitive tripwire is the theft of intellectual property—patents, trademarks, copyrights, and so on. MNEs complain that relentless, widespread, and sophisticated robbery of their

intellectual property fuels China's economic surge. Aggressive estimates link nearly a third of the Chinese economy to piracy.¹⁸

The FBI estimates that American companies lose hundreds of billions annually to counterfeiting. China continues to be the number one source country for counterfeit and pirated goods seized; in just the U.S., Chinese counterfeits accounted for 62 percent or \$124.7 million of the total domestic value of seizure.¹⁹ U.S. authorities, noting the rarity of legal punishment, charge Chinese officials with tolerating, if not encouraging, pirates.²⁰ Still, countries wage battle. The United States, for instance, has frequently appealed to various transnational institutions about China's "inadequate enforcement" of intellectual property regulations.²¹

What accounts for China's status as the world's premier counterfeiter? Analysts point to a mix of its quest to catch the West, collectivist orientation, rule-of-man legacy, and dubious enforcement of ambiguous laws—conditions that create a political and legal morass. Noted an observer, "We have never seen a problem of this size and magnitude in world history. . . . There's more counterfeiting going on in China now than we've ever seen anywhere."²² Problems threaten to escalate. Government policies have "left a deep impression on companies that intellectual property is there for anyone to use it." Local and provincial authorities rely heavily on pirates to power local economic growth. Moreover, China excels in making high-quality knockoffs. As some say in Shanghai, "We can copy everything except your mother."²³

WHERE TO NOW?

Inevitably, investors question how an opaque single-party political system bolstered by a murky legal environment can protect their rights. Some believe that external institutions will improve transparency. China's 2001 ascension to the WTO, for example, required it to accept rules on all sorts of business matters, including tariffs, subsidies, and intellectual property. And, granted, China has steadily amended its legal codes to comply with WTO standards. However, the struggle is not a shortage of regulations. Rather, China's sluggish enforcement, even in cases of outright violation, is the primary problem.

Despite intimidating political difficulties and confusing legal questions, legions of foreign investors fall sway to the siren call of China. Whether driven by bright forecasts, confidence in continued progress, or desperation to ride this megatrend, companies leave the sanctuary of predictable markets for the distinctive ways of the Middle Kingdom. Then, once they clear immigration and cross the modern-day Rubicon, they face the daunting task of interpreting China's political and legal systems. ■



QUESTIONS

- ★ 3-1. Identify three compelling economic reasons to invest in China. Then identify three compelling political reasons to avoid doing so. Recommend a criterion one could use to trade off the opportunities of operating in China versus the risks of doing so.
- ★ 3-2. What sort of operational safeguards would you advise a company to adopt in order to better manage the risks of China's legal environment?

INTRODUCTION

Chapter 2 showed that the cultural issues facing international businesses differ from those facing domestic firms. This chapter carries the analysis forward, emphasizing that once a company leaves its home country it operates in markets with different political and legal systems. Some countries are similar; Australian companies would not find many surprises in New Zealand, for instance. In other cases, the differences are profound; an ill-prepared U.S. company would encounter shocks in Russia. Navigating among countries requires that MNEs study how political and legal circumstances overlap and differ. Determining where, when, and how to adjust business practices without undermining the basis for success is an enduring challenge.