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What Should a China Manager Know about China's Economy, Politics and Society?

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1.1. Is China's economy more reliable or only bigger than other economies?

One of the most important preconditions for successful business in China is a reliable evaluation of the political, economic and social situation of this complex country. Managers need a number of parameters that allow them to get a relatively clear picture without too much research. They have to foresee coming developments at an early stage, allowing them to change their strategy and inform their head office before it has to find out itself. Furthermore, these parameters help to support a long-term market entry strategy. The last two economic crises (Asian crisis, global recession) have proved the parameters China's stability is built on.

The Asian financial crisis in 1997 and the world recession in 2001 heavily upset Asian people's dreams of a pacific century. Not only Japan, but also the four little tigers, South Korea, Taiwan, Singapore and Thailand still have serious economic problems that can only be solved by an upswing of the global economy. Of all Asian countries, the only one that could live up to its economic promises until now is communist China. Western companies reward the right mix of stability and growth in this big market with high investment. In most other countries foreign direct investment (FDI) has been sinking significantly. However, China's contracted FDI grew 10.4 per cent to 69.2 billion US dollars (6 per cent of GDP) in 2001. In times of crisis it has become even more obvious how much the international business community trusts China. Today, China is second only to the US as the world's biggest receiver of FDI and gets 80 per cent of FDI that flows into Asia. By comparison, India only receives 10 percent. China's WTO membership, officially starting on 11 December 2001, has given China euphoria an extra boost.

China's transformation economy can only be understood if one keeps in mind that constant policy changes are inevitable to keep the country stable.

For example, the Chinese government might sometimes offer preferential treatment to foreign companies in a particular business sector in order to attract more FDI, only to scrap these bonuses if it gets the impression that foreign businesses are getting too strong and threaten to push out local industry. While frustrating to foreign businesses this policy might in the long run turn out to be a well-advised one, because, other than the Russian economic shock therapy of the early nineties, it stabilises the country. Maintaining social and economic stability being the government's most daunting task, there are three main areas of conflict that have to be kept in balance: firstly, the overstaffed, unprofitable and poorly run state owned enterprises (SOEs) have to be made competitive with the emerging and rapidly growing private sector. Secondly, two thirds of Chinese people live in the mostly poor countryside with its uncompetitive agriculture; many try to make their way to the cities to seek better jobs and income perspectives. Thirdly, China's growth currently mainly benefits the boom cities on the east coast, while the vast inland and western regions lag far behind and their poor inhabitants find it hard to benefit from the country's development.

The most important questions

- How long can China keep up its strong growth?
- How stable is China?
- Is China playing games with western companies' dreams of a giant market with 1.3 billion consumers?
- Which parameters allow an evaluation of the country's internal strengths?
- What role does WTO membership play?

Even after the 2001 global recession, during which risk evaluation became extremely rigid, it very much looks like the trust in the Middle Kingdom's stability is still justified. The assessment, that China is not only a big market, but also a strong and seminal one, is based on the following requirements:

- Stable growth, low inflation/deflation rate; supported by useful, moderate government spending;
- Conservative, protective fiscal, monetary policy;
- Down-to-earth reform management, which puts stability as first priority;
- Balanced mix of high tech and low cost;
- Patient people willing to carry the burden of reforms;
- WTO membership forcing China to apply international business standards.

Naturally, the factors are very interdependent. If in case of an inflation the government stopped controlling it, the people would lose confidence in their Chinese money, withdraw their savings from the banks and spend them on durable goods. Demand would rise faster than the necessary supplies could follow, further driving up inflation and pushing the black market for local currency. Consequently, people's real earnings would drop dramatically until they'd finally lose patience with the government. This is what happened in Argentina in the first half of 2002, and the government had to close the banks. Therefore it's useful to take a closer look at the factors that stabilise China's economy.

High, stable growth

Emerging from a very low level of economic development China's high growth is no luxury, but a basic necessity to guarantee the country's stability. In the short-run, it serves the stability of the labour market. Every year, about 10 million workers lose their jobs in SOEs and seek new employment. Every year, China has to create 14 million jobs to provide for them and the young people who enter the job market. Analysts see the root of the countrywide protest movement of 1989 in the low growth rate and high inflation of the late 1980s. This served as a warning to politicians, who in the early 1990s subsequently moved to a policy that accelerated growth at any rate. The overheated economy again led to galloping inflation. Therefore, the main goal of People's Bank of China president and later Premier Zhu Rongji's economic policies in the mid-1990s was a soft landing for China's boom. Since then, the official growth rate was between 7.1 and 8.8 per cent and inflation was later.

Since the Asian financial crisis in 1997, the government has had to make sure that growth is not slowing down too much. In times of falling exports, which are one of the main engines for China's growth, state planners used infrastructure projects to keep the economy busy. Mainly used as a means of fiscal policy, government domestic spending rose 80 per cent between 1998 and 2001. This sounds alarming at first, but is actually quite reasonable. There are two reasons: first, if compared to other countries, China's government spending is still quite acceptable. Only 20–30 per cent of tax income is used to pay interest for mostly long-performing loans, a rate comparable to that of Germany. In 2000 infrastructure development made up for about 1.5 per cent of GDP growth. Second, these projects are not merely employment projects; they are mostly reasonable investments that will make the country more competitive in future and also benefit international corporations. After all, in contrast to Japan, China still needs a lot of infrastructure if it wants to meet the needs of a modern economy. Many of today's problems are burdens from Mao Zedong's regime. He promoted the self-reliance of all regions, leaving the country with a miserable infrastructure. Connecting underdeveloped, poor western China with the booming coastal area is especially important if the whole country is to prosper. However, China's authorities sometimes have odd priorities, even in the coastal areas: Beijing's *hutongs*, the traditional courtyard houses, have been provided with broad-band Internet access, but are still waiting for private toilets and running water.

One of the biggest projects, the highly controversial Three Gorges Dam, is hoped to produce an annual 18,000 megawatts of power as well as controlling the devastating floods that regularly hit the Yangtse River. The dam, to be completed sometime in the second decade of the twenty-first century, will cost an estimated 90 billion US dollars; 1.3 million people have to be resettled.

Another power supply project that is currently under construction is a 2,500-kilometre gas pipeline. The 20 billion US dollar project will connect Xinjiang, which is rich in oil, gas and other natural resources, with Shanghai and the adjoining boom-area on the east coast. A 1,200-kilometre channel is going to provide China's dry northeast with water from the subtropical south.

A nationwide highway network is also very important. The basic skeleton, soon to be finished, is a system of two north-south and two east-west highways; smaller roads will then connect to every corner of the country. At the beginning of the decade, the total length of highways was 16,000 kilometres. By 2010 China hopes to have a network of 12 main highways. And China's construction projects follow a long-term strategy: the new highways are in no way inferior to the ones in developed countries. With regard to railways, a German state-of-the-art magnetic levitation (maglev) train, Transrapid, is under construction in Shanghai. Starting in 2003, the train will connect Pudong, Shanghai's Manhattan, with the new airport 37 kilometres away. Should the first-ever commercial maglev connection stand the test, this system is likely to be used for a 1,200-kilometre high-speed connection between Shanghai and Beijing.

China is like a huge high potential company that has to invest in all fields of core business in order to become more successful. Today, the country with 20 per cent of the world's population produces only about 3 per cent of the world's general inland product (GIP). In comparison, the US produces 30 per cent of global GIP with only 4.5 per cent of the world's population.

But Table 1 shows that global trends seem to be working for China. China is the only country with long-term rising nominal GDP.

Table 1 Nominal GDP increase in US dollars (per cent)

	1980–90	*1990–2000*	*2000–2010 (estimation)*
China	28	178	200
Tigers	265	95	60
US	108	70	55
Japan	185	56	20

Source: Morgan Stanley Research.

Over the coming decades, the Chinese government will still be able to rely on infrastructure spending without running into dangerous overspending, especially if it can stimulate private consumption at the same time.

Conservative fiscal and monetary policy

The Chinese government handles its money reserves carefully, always ensuring it has enough in reserve to be independent from others. Foreign reserves exceed 210 billion US dollars (2001). According to Moody's Investors Service, this is four times more than China needs to cover 12 months of imports. On Moody's rating list, China reaches a good A3. At 30 per cent of GDP, national debt is still relatively moderate.

For the time being, the Chinese leadership has also made sure that big international finance players cannot put China under pressure.

- Trading on international stock markets cannot influence China's interests because access to local markets is still mostly restricted for foreigners (see question 1.8).
- The Renminbi (RMB), China's currency, is not freely convertible; just like the Hong Kong dollar, it is tied to the US dollar by a peg. As the government chooses a realistic exchange rate, there is no significant black market.
- China does not take high-risk short-term credits ('hot cash'–borrowing huge amounts at high interest rates) from international capital markets. Therefore China, although its banks are technically bankrupt, does not risk bankruptcy in times of crisis, when most foreign creditors suddenly call in their loans and debtors cannot pay back. Thailand chose this risky strategy in the 1990s and triggered the Asian financial crisis in 1997.

Down-to-earth reform management

Not a democratic mandate from the voters but robust economic success determines the Chinese government's legitimacy. Beijing's communist leaders are well aware that they have the best chances of staying in power if China succeeds in becoming a competitive player in the global economy. Therefore, the more successful cadres in the leadership leave behind ideological limitations and mostly base their decisions on down-to-earth economic considerations, which put stability as the first priority. In this respect, China does not reject the help of acclaimed international consultants. The economic reform policy, triggered in the early 1980s by paramount leader Deng Xiaoping and revived in the early 1990s by the party's reformer wing around Premier Zhu Rongji and President Jiang Zemin, has become the broad party line. If the reform process is occasionally slowed down, it is mainly because the government has to protect weak state owned enterprises to guarantee social stability.

But even then, the losers of the reform process, such as party hardliners headed by former premier Li Peng, are unable to stop it (see question 1.2).

Balanced mix of high tech and low cost

China has a unique position in the economic world because it is attractive for both low cost as well as high tech production. Therefore, China is not dependent on one sector only. In comparison, countries such as Indonesia or Bangladesh rely mainly on low cost products, while Taiwan, South Korea and Japan are almost fully dependent on the IT sector and have a population that is no longer willing to work for low salaries.

There are no signs that China is likely to grow out of or give up its dual approach in the near future. China is increasingly able to produce sophisticated IT products, and China's west provides an inexhaustible pool of cheap labour. The only drawback is the high cost of transportation to the east coast.

During the Asian crisis, China insisted on the peg of the Renminbi to the US dollar, making the country a more expensive production base than other Asian economies. The Asian Crisis has shown how stable China's position is. Lasting only a little more than one year, the crisis was too short for western companies to move to other cheap labour countries. Considering that it takes quite some time to teach factory staff to produce output of reliable, consistent quality.

Also, China has rising numbers of well-educated young people, making it attractive for foreign companies to not only move their production sites to China, but also their research and development centres. Especially in research-intensive sectors like biotechnology or life sciences, China is emerging as a very competitive player.

Patient society

Currently there are no signs of a general country wide opposition to the central government. It seems like the government and its people have reached some kind of 'society agreement': as long as the Beijing leadership sets the country on the track to prosperity, the people will not directly interfere with the central government. On the side of the people, this is surely more an act of toleration than acceptance. Still, the people show a certain willingness to carry the heavy burdens of the reforms. After all, the hard times of the Cultural Revolution (1966–76) are still fresh in the memory of those who are now in their mid-30s. Even the poor peasants have experienced a slow rise in living standards.

Although there are frequent demonstrations in China, they still mainly attack regional problems and usually end when the dispute is solved locally. This balance, however, is unstable. It would be a very alarming sign if demonstrations increased and started attacking the system as a whole (see question 1.11).

WTO membership

WTO membership not only makes it easier for foreign enterprises to enter the Chinese market. This will boost the reform development of the Middle Kingdom in two possible ways.

Firstly, the reform wing of the government gets more leverage to speed up the restructuring of state owned enterprises. The message is simple: companies have to become competitive by international standards or face the consequences of being shut down. This pressure has already led to impressive modernisation in sectors such as banking, airlines, telecommunications and extractive industry.

Secondly, foreign corporations that invest in China call for international standards. They not only demand open markets, but also a reliable legal system, less corruption, greater transparency of Chinese enterprises and, last but not least, well-educated, experienced Chinese employees. This will put pressure on politicians and the public sector to speed up reforms, as long as stability is not in danger.

Nevertheless, the current strength of the Chinese economy should not lead western investors to drop their guard and underestimate the fact that the country's most complicated transition period since the death of Mao Zedong in 1976 is still ahead. For the last 20 years, China's economy was based on turnover. The only goal was growth at any rate, which led to corruption (see chapter 1.6) and businesses run by poorly educated but very charismatic leaders that resembled the so called 'robber barons' (Rockefeller, Vanderbilt) of the United States at the turn of the nineteenth to the twentieth century.

Now, the economy has to produce sustainable growth. That includes a functioning social system, efficient banks and a reliable legal system. The fairly closed financial sector, which is protecting China's economy now, becomes a growing disadvantage as the economy gets more sophisticated: the lack of transparency raises doubts about the stability behind the walls. Using these parameters the only thing one can be sure of now is that external pressure (Asian crises, global recession) has so far not been high enough to fundamentally destabilise China. But apart from that, we have to rely on estimates.

At least there is no doubt about the general direction: the government will have to give up its tight grip and strive to strike the right balance between *laissez faire* and control. This will definitely lead to less control. Should the government lose this balance, foreign enterprises will feel a painful slow-down of the boom. Nobody knows how deep China could fall again, but experiences of the past allow us to be cautiously hopeful. Even the last big crisis, the bloody crackdown of student protests on Beijing's Tiananmen Square in 1989, threw the country's economy off track for little more than a year.

Summary/Recommendations

On the basis of the above-mentioned six parameters, China's economy currently seems to be stable and prospering on the turning point from a turnover economy to a sustainable economy. By keeping these six factors in mind, it should be possible to make relatively reliable evaluations and forecasts about the country's development. However, if one or two parameters take a major turn for the worse, it is advisable to be careful and reconsider the long-term strategy.

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1.2. How stable are the Communist Party and the government?

In everyday business, one often has to deal with Communist Party cadres. They draw up the nation's economic policies and decide which sectors will get how much government support and how fast China opens its doors for international investors. Every company, including western-Chinese joint ventures, has its own party committee, and the party secretary wields considerable influence. Even though the party's influence seems to be slowly fading, it is and will remain a major factor for China's economic success.

The most important questions

- What are the Communist Party's power instruments?
- What are the party's main weaknesses?
- What are the party's strengths?
- Is the party flexible enough?
- What forces the party to act according to modern economic developments?

During the 1990s, China was Asia's pillar of stability, not only economically, but also politically. While the region's big players (Japan, Indonesia, Philippines etc.) were paralysed by interior turbulences and power struggles, China has been able to take a stable course for over a decade. The main reason for this is the strong position of the Communist Party. It defends its unrivalled power using the following instruments:

- top-down decision-making;
- occupation of all leading positions;

- control over career opportunities;
- control over media;
- ban on political competition;
- ban on separation of powers.

All influential government positions and decision-making processes are in the hands of the party, making it impossible to distinguish where affairs of the party end and affairs of the state begin. For example, all provinces and cities have a head of government and a party secretary, with the latter being the more powerful body.

The most influential positions, currently all held by Jiang Zemin, are the following: Party Secretary General, State President and Head of the Central Military Commission. The innermost power circle is the standing committee of party's politburo, formed by the country's seven most high-ranking politicians.

Formally the highest state organ is the approximately 3,000-strong National People's Congress (NPC), which comes together in Beijing's Great Hall of the People every spring. It is at these meetings the premier in a comprehensive political declamation, carefully drafted by all government sectors, announces the new guidelines for the government's work, including economic policies. The following discussion is of great importance to the leaders, giving them an overview over their parlamentarians' opinions and worries throughout the country. Sometimes delegates will even show their discontent. In one case in 1992, one-third voted against the construction of the Three Gorges Dam. Having its annual meeting at the same time is the Chinese People's Political Consultative Conference (CPPCC), a body made up of representatives from all fields of society, which acts in an advisory capacity, and includes businessmen like Jing Shuping, Chairman of Minsheng Bank, China's only privately owned bank listed on the local stock market, and Henry Fok Ying-Tung, one of the richest and, politically, most influential businessmen in Hong Kong.

However, the main legislative work of the NPC is done by its 150-strong standing committee, which meets every two months. Parallel, the Central Committee of the Communist Party of China (CCCPC) meets to discuss state and party affairs and make the necessary decisions. Although the party does its best to speak with only one voice, behind the Scenes there are several factions struggling for influence.

There has been much speculation about a coming collapse of China's Communist Party. Most analysts that predict an imminent end to communist rule point out that the party's weaknesses are becoming more and more of a hindrance for the development of the country. The following are the main weaknesses mentioned:

- avoidance of political competition;
- phase-out model: ideology and the cult of leadership do not work any more;

- complex economy cannot be centrally planned;
- too big (60 million members);
- cannot be controlled (corruption);
- clinging to power is more important than economic reasoning;
- too much emphasis on uncertain leadership personalities.

Until now, much to the surprise of many China watchers, a collapse has not happened, and there are strong arguments that suggest that there will be few changes in the near future. On the one hand, government and party try their best to go with changing times and adapt to the market economy. On the other hand, there is no general opposition or underground movement that could challenge the party's position. The question is why?

The main reason is that the party has a number of structural strengths that are quite helpful for the modernisation of the huge country:

- ability to make long-term plans for modernisation;
- successful balancing of different currents within the party;
- ability to implement and balance reforms nationwide.

Still, the strongest advantage of the Chinese Communist Party is definitely its pragmatic flexibility in the economic field, necessary to cope with huge national and international interests and pressure.

Flexibility

Compared to other communist systems, China's Communist Party has shown a great amount of economic flexibility over the last 20 years. Taking a very pragmatic approach, the party has managed to fend off massive pressure from two directions.

One is the people's desire for higher living standards but also for personal freedom and the pursuit of happiness. The other is the competition of the global economy. This at least makes the government aware of the huge problems that urgently have to be solved, as Premier Zhu Rongji's speech to the National Peoples' Congress in spring 2002 shows:

> *However, we are clearly aware that there are still many problems demanding prompt solution in our economic and social life.*
>
> *The principal problems are as follows: farmers' incomes are growing slowly; incomes for farmers in some major grain producing areas and disaster-afflicted areas are decreasing; in some places, wage areas are now a serious problem; some enterprises are still having difficulties in production and the life of some workers remains hard; and employment pressures are increasing. Industrial structure remains irrational and deep-seated problems in our economic system have not been solved.*

Problems of the ecological environment are outstanding.

Local Protectionism remains a problem despite repeated orders to ban it, and the order of the market economy is yet to be fully rectified.

In some localities and government departments and among some leading cadres, formalism and bureaucracy are rife, deception, extravagance and waste are serious problems, and some forms of corruption are relatively conspicuous.

There are cases of work units misappropriating budgetary funds or special funds in disregard of the relevant rules and regulations. Failure to abide by the law in handling affairs and laxity in law enforcement are common occurrences. Grave worksite accidents frequently occur. Public security order is poor in some places. Some of these problems have remained unsolved for many years, and there are also some that are caused by shortcomings and errors in our work. We must attach great importance to these problems and take effective measures to solve them.

When it comes to major decisions, pragmatism usually wins over ideology. However, this does not necessarily mean that these decisions are what foreign investors hope for. For example, even though China has entered the WTO, the banking sector will only open up to foreign competition very slowly. This is not caused by the ignorance of communist ideology, but by the simple fact that China's state banks still need time to overcome weaknesses and deficiencies and prepare for foreign competition. The Government's first priority is always to maintain social and economic stability.

National pressure

Apparently, China's communists thoroughly analysed the fall of Eastern Europe's communist systems. They came to the conclusion that there is only one thing that can save them from being swept away by uprisings and rebelling masses: economic prosperity. They reckon that as long as Chinese people are mainly concerned with raising their own salary and consumer power and as long as the majority can afford more today than it could yesterday, nobody will challenge the central government. In that respect the people controls the party.

The party, however, has all the instruments it needs to influence the people. Whoever wants to be successful in his career has to act in harmony with the party because it controls all state run business up to the top positions. In a way this even applies for private entrepreneurs. Without close ties to local cadres, no enterprise will be able to establish a successful business. Lawmaking, judging, law enforcement and administration are all controlled by one organisation – the party's politburo (see chart below). Therefore, rules can be enforced easily and propagated through the media. This has advantages and disadvantages. The politburo can reach decisions, for example on long-term development plans, quickly and efficiently. Also, only a few groups are involved in the decision-making process. There is little competition when it comes to fighting over the best ideas, but this power monopoly leads to a huge problem with corruption.

Within the party, different directions struggle for power. During recent years, party secretary general and state president Jiang Zemin succeeded in balancing the fighting fractions. The losers were those cadres whose know-how or connections were not strong enough to compete in the new market economy environment. They therefore try to slow down the reforms. What is obvious is that development cannot be turned back: ideology and the cult of leadership might still work to control peasants, but the educated city dwellers will not fall for it. Party leaders increasingly have to develop pragmatic project manager qualities.

Global pressure

The party's economic policy not only depends on its own people, but also on the international community. It has learned from mistakes it made in the 1960s and 70s. Efforts to build up a new, independent third way economic system have been abandoned; the party now follows the mainstream of global developments. Under pressure to survive in the global economy, China has to implement international business standards. In this respect, WTO membership is a very important step in the right direction.

Promising foreigners a huge market of 1.3 billion consumers bought time for the party because international companies, not wanting to miss out, were willing to set up businesses under unstable conditions. However, this will not be enough to make China competitive in the long run. International support,

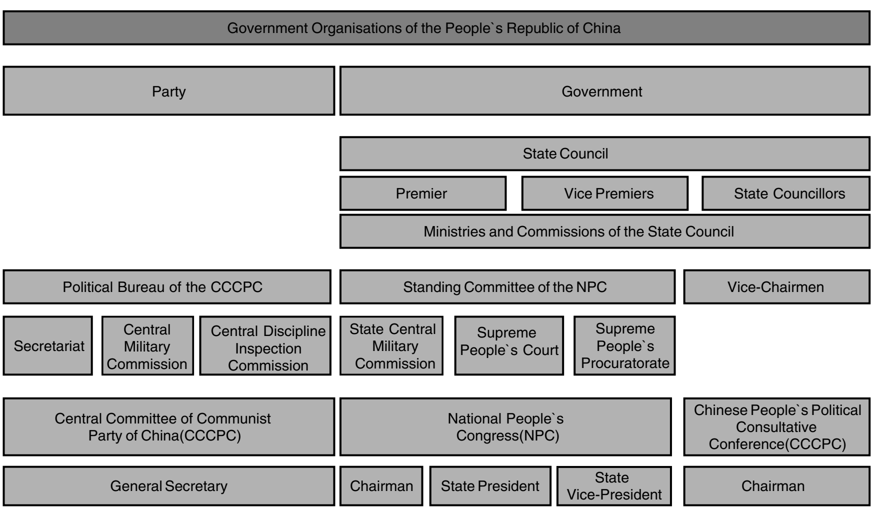

Chart 1 Government organisations of the People's Republic of China

acceptance and stability depend on consequent, reliable and fast implementation of international standards. Should party managers wield too much power, this might be harmful to the party's long-term control. Government and Party can only maintain their credibility with its own people and the international community if they succeed in checking corruption in their own ranks (see question 1.5). The government tries its best, but for outsiders it is hard to judge if the efforts are successful. The economic sector is particularly difficult, because central planning of all details of the economy has become virtually impossible. The most important task for government party in the coming years is letting the economy have its fling without losing control. The conflict lies between clinging to power and giving in to economic necessities. As long as leaders do not try to ignore national and international pressure and move ahead with reforms, party and government may hope to remain stable for quite a while.

Summary/Recommendations

The party's stability depends on its success in coping with the above-mentioned weaknesses. For the time being, there seems to be no alternative, as no other organisation is as well structured as the party.

In recent years, the reform-oriented government has had a lot of support from its own people and also from abroad. Even if China officially remains communist, in reality it has long launched pragmatic economic reforms towards market economy and international standards. Opposition movements that knocked over the socialist systems in Eastern Europe do not yet exist; mass protests only occur locally. The country's stable growth supports the trust of the international community in the government's stability.

Still, the system is too dependant on leadership qualities and personalities. For the time being, the leadership seems to fully back the reforms, being aware that internal quarrels could be harmful.

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1.3. When making business, what is important to know about China's history?

The Middle Kingdom had its time of greatest prosperity between the third century BC and the seventh century AD. During that time, China came up with groundbreaking inventions such as the plough, paper, pasta and porcelain. But these times, when China was a world power, have long passed.

By the fifteenth century, development of this empire stagnated when conservative officials barred the great discoverer Zheng He from seafaring and increasingly isolated China from the outside world. Since then, inventions and discoveries that drove global development have come from Europe, North America (a little later) and, in the second half of the twentieth century, from Japan as well. China lagged behind, becoming for several hundred years a second-rate, if not third-rate country. The emperors tried to live off the shine and glamour of older times and keep the huge middle Kingdom together. Opposed to progress and reform, the imperial court rejected all impulses for change necessary to cope with the requirements of a modern world. By the beginning of the twentieth century, the empire fell apart under international pressure and different forces, mainly provincial warlords, struggled for power. Japan, trying to dominate Southeast Asia, benefited from internal chaos and ongoing fights between the nationalist forces of the *Guomindang* and the Chinese Communist Party, occupying a big part of the country in the late 1930 and early 1940s.

The new leader (1934–49)

It was under these chaotic conditions that Mao Zedong, a charismatic revolutionary and strategist, came to power. Trying to escape nationalist *Guomindang* troops, he led China's communists through a 10,000-kilometre hike later known as the Long March (1934–5) to Yan'an in northwestern China. After the Japanese lost World War II, the United States forced communists and the *Guomindang* to form a coalition, which didn't last long and led to continued civil war. In 1949, the communists succeeded in forcing the *Guomindang* off the mainland to Taiwan. Most of China's successful entrepreneurs fled with them or made their way to the British colony of Hong Kong; some of them even disassembled whole production lines and carried them off. On 1 October 1949, Mao Zedong, the leader of the Communist Party, proclaimed the People's Republic of China, triggering a few years of euphoria. An economic boom fuelled this optimism. In these promising times, many people willingly followed the party leadership. Unfortunately, it soon turned out that Mao, an outstanding political strategist, was less skillful and knowledgeable when it came to economic reforms.

The most important questions

- Which are the main phases that influenced the People's Republic?
- What were the goals of the different leaders?
- How did they implement their goals?
- How successful were they?
- How did these developments affect the Chinese people?
- Which historical experiences and events can still be felt today in everyday business?

China's dark ages didn't end with Mao's rise to power and proclamation of the People's Republic. Centuries of lethargy in imperial times and chaos during the republican transition period were now followed by a time of unbalanced, precipitate reforms.

Short-lived hopes (1949–56)

Mao was not hesitant; he knew he had to move swiftly to restructure China. And his analysis of the situation was correct: after centuries of immobility under the emperors, China had fallen far behind the west. In order to become competitive, China had to make enormous efforts to catch up. But Mao's conclusion tragically had a small, but momentous error. Mao was convinced that a well-organised mass movement that selflessly laboured for the good of the community would be much better at building up the country than a system of competition that offered material incentives and social promotion to the individual. His strategy was the setting up of collectives in the countryside, nationalising privately-owned property and decentralising the economy. He wanted to win over workers and peasants by offering them lifetime employment and social security, the so-called 'iron rice bowl' including housing, medical care, schooling, pensions, in return for low wages. Unfortunately, this system did not have a very motivating effect. Shanghai, the booming coastal metropolis of the early twentieth century should have taught him better. Unfortunately, he was charismatic enough to press ahead with any idea he had. Without any sign of comprehension, Mao forced China's economy to follow this course for over 20 years, further ruining the country. He was obsessed with having found a revolutionary shortcut to economic modernity. Tragically for millions, this bypass never worked out.

'Let a hundred flowers blossom ...' (1956–7)

Mao, born into a family of farmers, always sympathised with peasants and workers, but had ambivalent feelings towards intellectuals including engineers, managers, doctors and lawyers. While at the same time feeling inferior to them, he had to rely on their co-operation in order to succeed. They constituted up to 14 per cent of his 20 million plus party comrades. About the same number of party members had a working-class background, while the majority was made up of farmers.

In 1956 he ventured to improve the intellectuals' situation and asked them for helpful criticism and new ideas. The criticism soon turned against him. The results were devastating for Mao. He called off the campaign after only five weeks and turned it into a witch-hunt against all his critics. Between 300,000 and 700,000 intellectuals were detained or sent to the countryside to be 're-educated' by the farmers. For decades, this sent out a warning to the leadership elite of the country that Mao's ideas were not negotiable.

The 'Great Leap Forward' (1958–60)

After unsuccessfully lobbying the intellectuals, Mao was afraid that the peasants and workers would lose their enthusiasm and motivation. In order to stop the country he had 'liberated' (as the official Chinese vocabulary puts it) breaking apart again, Mao tried to keep the people busy with new mass campaigns. The 'Great Leap Forward' was a massive effort to push the borders of growth and catch up with the West within a few years. Unrealistic as it was, the campaign ruined most that was left of the country's economy. Instead of counting on automation and division of labour, millions had to use the most primitive of tools or even their own hands to till the land and build bridges, streets or channels. Everybody was supposed to do everything. Villagers were forced to produce their own steel in tiny little steel mills, live off their own agricultural products and build their own roads. The results were disastrous. The newly set up industry broke down. Western scholars estimate that between 20 and 30 million people starved to death because of famines partly caused by this economic insanity.

At the same time, Mao, still fully convinced of the success of his campaigns, broke with the Soviet Union that had until then been like China's older brother. Choosing to do things his way, he expelled 1,300 Soviet experts. They took with them the blueprints for 600 major projects, thus causing immense damage. This move finally isolated China from the rest of the world after the West had already installed a strict embargo against China after the Korean War (1951–3)

Not until 1960 did Mao gave in and call off the campaign in order to avoid losing all political influence. Struggles within the Communist Party had reduced the great helmsman to the leader of a minority fraction. Economic specialists took over, amongst them Deng Xiaoping who would become China's paramount leader from the late 1970s till to his death in 1997.

The Cultural Revolution (1966–76)

Mao, weakened by his failure, tried to regain absolute power with all his might. Having lost all influence with intellectuals, peasants and workers, he now set his hopes on the young generation. He developed a marketing campaign for himself: in order to show off his still youthful strength and revive his charisma, he went for a historic swim in the strong currents of Yangtse River in 1966. The photographs, spread by mass media, had the desired effect. Mao proclaimed an unlimited school-free period making himself the admired leader of a 110 million-strong youth movement that formed the Red Guards. With the support of the military, still Mao's stronghold in the party, the students once again unhinged the country. Their goal was to eliminate the four old things: old ideology, old thinking, old culture and old habits. In reality, it was the country's culture and its economic know-how that was swept away.

During the 'Great Proletarian Cultural Revolution', many middle–aged people were sent to the country side or to factories for 're-education by the proletarian masses'. This, it was hoped, would lead to an economic boom. Instead, anarchic chaos spread across the country. Zhu Rongji, the later premier and top economic reformer of the 1990s, spent years herding pigs and doing other odd jobs, as did most members of the elite. Even Deng Xiaoping, who served his country by working in a tractor plant. His son, trying to escape from Red Guards, jumped out of a window and was paralysed for life. Mao himself, ageing quickly, spent these years speeding around the country in his luxury train and celebrating the heyday of his personality cult.

With all experienced experts being sidelined, another collapse of the country was inevitable and came in the early 1970s. Mao, trying to ignore the chaos, turned towards foreign policy. In 1972 he established diplomatic ties with the United States; in February of that year, US President Richard Nixon visited China.

Still, it was not until Mao's death in 1976 that the country could be brought back under control and the cleaning up of the 'Ten Dark Years' began. The state of the country after the Cultural Revolution was disastrous. China had basically suffered an economic standstill; the living standard of most people had remarkably decreased. However, the Chinese still hold Mao in high esteem today. He is credited with liberating, unifying and holding together the country. But most of all, it was Mao who gave the Chinese a new feeling of national pride. Even today, Mao's picture dangles off the mirror in many Chinese cars.

Social market economy with Chinese characteristics (1978–88)

After a short power struggle and an interregnum, Deng Xiaoping eventually became Mao's successor and put the country on a new track. Although the great helmsman had left behind economic chaos, between 40 and 90 million unemployed workers and a GDP that was a sixth of Taiwan's (which only has a population of 20 million), Deng was wise enough to carry on Mao's personality cult to keep the country together.

Politically and economically, Deng Xiaoping had a completely different approach. Starting in 1979 the pragmatic communist radically modernised the economy by turning towards the western mainstream of development. Deng followed a double strategy: on the one hand he kept the central planning system, on the other hand he introduced market economy mechanisms. Thus prices were controlled and free at the same time, even for the same kind of product. His major changes were:

- Small private business was allowed. The industrial sector was opened for new market players.
- He sent students to study abroad, even though he knew not all of them would come back.
- He established special economic development zones near the former Portuguese colony of Macao (Zhuhai), Hong Kong (Shenzhen) and Taiwan

(Xiamen). Foreign experts were invited to come to China to co-ordinate the new start.
- In order to collect foreign investment, special finance institutions were founded, such as China International Trade and Investment Corporation (CITIC), which is still a powerful bank today.
- State-owned companies were given more leverage. If they produced more than the required quotas, they could sell the overproduction – even on the global markets.
- Peasants were given their own fields and were free to decide what to do with at least part of their harvest.

This 'social market economy with Chinese characteristics' could soon show off remarkable success. By 1983, China's trade surplus had grown from virtually nothing to 5.2 billion US dollars. Direct foreign investment rose to 910 million US dollars. Between 1978 and 1985, the percentage of people living in poverty dropped from 30 to 10 percent. 'Don't be afraid of prosperity!' was the message party secretary general Hu Yaobang spread on his tours through the provinces. After a couple of months of scepticism about the seriousness of the movement, the Chinese people were happy to follow, and ironically replaced Mao's 'four must-haves' (bicycle, radio, watch and sewing machine) with the 'three high things': high income, high education and high body build.

The Tiananmen crackdown (1989–91)

The euphoria and cry for more personal independence resounding in this saying were soon to become a huge problem for Deng. Having been voted *Time* magazine's 'Man of the Year 1986', Deng saw his boom running out of control: everybody wanted to make a quick buck instead of relying on long-term investment; some products were over produced and others not produced at all. Corruption surged in this chaos economy. In the late 1980s, GDP growth slumped to less than 6 per cent. And even those who didn't produce anything demanded more freedom, including students. Deng had underestimated the complexity of this transition economy and its liberating effects on the people.

In the mid-1980s, more and more students and other people staged joint demonstrations, publicly airing their discontent. In 1989, after weeks of mass protests on Beijing's Tiananmen Square, Deng finally decided to send in the army, leading to the so-called Tiananmen massacre on 4 June. This, along with Deng's harsh rhetoric calling the student protesters 'social scum', cost not only him, but also China the trust it had just started to regain in the world. Foreign companies pulled out of the Chinese market and western foreign investment totally went down. Ageing Deng lost power to the conservative forces within the party. Whoever could afford it went abroad to study, mostly to the US. Many students never came back, leading to a brain drain that China still suffers from today. Even those who had retained same socialist ideals gave them up after the crackdown, joining the big group of pragmatists who would pursue freedom in their own business ventures.

The trip to the south (1992)

Ironically, the same man who had ordered the crackdown on the movement for more social and economic freedom fought against his successors, that he had elevated to their positions, for more economic openness three years later. Conservatives in government and party were lacking strategies and Deng himself was unable to regain power in Beijing's leadership circles.

In this hopeless situation, 88-year-old Deng made a clever move: in January and February 1992, he travelled to China's southern provinces and criticised State President Jiang Zemin and Premier Li Peng in front of economically minded cadres for being to slow in opening the country to foreign economic influence, ideas and investment. International trends and progress should no longer be ignored, Deng demanded: 'That includes progressive working and management methods developed by other countries, including capitalist ones.' For weeks, the Beijing leaders tried to hush up the trip, but after it became obvious that substantial parts of the population and military supported Deng, the central government had to give up its resistance.

The wise old strategist was able to rally the people behind him for the last time by giving a public voice to their dreams of a better life. Deng was able to live up to his promise by triggering an unprecedented boom. He forced President Jiang Zemin in the right direction of market-oriented reforms. Deng appeared for the last time in public in 1994 and died in 1997.

The golden 1990s (1992–9)

While the Chinese were busy earning money, the collective memory in the West would not forget the Mao times of 'little blue ants' and the tanks on Tiananmen Square. Even today, China's rise to a major political and economic world power is being much underestimated. China's economic statistics underline this impression. In 1978, China was listed as the number 32 of international trade. Now, more than 20 years later, China has reached rank nine. Since 1993, China has been second only to the United States in receiving direct foreign investment. After Japan, China has saved up the largest amount for foreign exchange reserves – more than 200 billion US dollars. This gives Chinese economy planners a lot of leverage, as does the 40 per cent saving rate of Chinese people.

When Premier Zhu Rongji came to power in 1996, he successfully fought inflation (as he had as a central bank governor) and opened the country towards more international know-how and advice. Many global players started investing and set up huge joint ventures on China's mainland, and FDI surged.

In 1997 China regained control over the British crown colony of Hong Kong. The party decided to keep it as one of the freest market economies in the world.

Beijing is only partly to blame for the big problems Hong Kong faces in the first decade of this century. On the one hand it is simply losing its position as the gate to China, as foreign companies not longer depend on Hong Kong's help as much as they used to. On the other hand, the communist leaders want to show the world that they don't need British colonial help to build up a modern city by trying to make Shanghai the new gate to China.

Also in 1997, the government decided to further boost the reform of state owned enterprises (SOEs). SOEs had to become profitable instead of only fulfilling plans.

During the Asian crisis (1997–9), which started just after the Hong Kong handover, the government had to protect its economy against unexpected outside pressure. It refused to devaluate the Chinese currency and eventually emerged from the crisis with a strengthened position.

In October 1998, the government closed down the Guangdong International Trust and Investment Corp (GITIC) investment arm of Guangdong Province, that had accumulated 5.4 billion US dollars in liabilities many of them to foreign banks. These had, until then, expected the central government to stand up for liabilities even of provincial finance institutions, although the central government had repeatedly denied this. The closing down of GITIC came as a rude awakening to many foreign banks. The biggest bankruptcy in Chinese history shows that Beijing will not bail out just any provincial institution. Instead, they will have to learn to play by the rules. In late 1999, after 15 years of negations, China achieved a breakthrough in the negotiations with the US and the European Union to join the World Trade Organisation (WTO).

The rough new century (since 2000)

The start of the century was marked by a big success: the first big public offering of a Chinese company on the New York stock exchange, Petro China (fourth largest petrochemical enterprise in the world) raised 3.9 billion US dollars for 10 per cent of the shares. However, it has to be added that the buyers where mostly foreign competitors who believed that this was a good way to get access to the Chinese market.

The euphoria did not last long. In autumn 2000 the worldwide boom was over and the government had to protect its country against stormy weather. At the same time, under the pressure of its coming WTO membership, it had to further accelerate reforms of state owned enterprises, build up a stable social system and fight corruption (see question 1.5).

The most important event of national pride since the establishment of the People's Republic in 1949 occurred in July 2001, when Beijing won the right to stage the Olympic games in 2008. A spontaneous all-night party swept the country for the first time, with people using Mao's famous 1949 quote: 'China has stood up.'

How does Chinese history influence everyday business? How it can be useful to a China manager?

These questions are often posed by expats who only spend a limited time in China and don't want to read huge numbers of books. The answer is obvious: Chinese habits that seem strange to a foreigner relate to the individual, but also the cultural background. Behavioural patterns have their roots in collective experiences as well as in traditions passed on by older generations. People usually try to learn from mistakes and make these experiences available to others. Knowledge about China's collective background makes it easier to successfully deal with Chinese counterparts and be on friendly terms with them.

That there are many differing attitudes and changing ratios lies in the nature of a large country with a huge population. Nevertheless the economic development of a country is reflected in its common behaviour and the performance of its people. Some characteristics and habits that western managers are often confronted with are explained below.

Having suffered under Mao's obsession with mass movements and collectives, Chinese today tend to be quite selfish and individualistic. After 30 years of campaigns, this is not surprising, especially since those were usually short lived and quickly replaced by other movements that called for the exact opposite.

What Chinese care most about is the pursuit of their *personal material wealth*. For the system as a whole, this leads to the problem that people care less and less for their relatives who are not yet protected by a social system. Eventually today's people seek to be spiritually and economically *self-sufficient*. For companies this implies that, in contrast to Japan, for example, it is hard to build up a corporate identity and make young people fully committed to their employer. Job-hopping is quite common. Although some people keep looking for salvation in movements like the pseudo-Buddhist religion Fa Lun Gong, most have developed immunity towards dictatorial prophets.

Mao's social experiments have taught the Chinese that too much individuality can be dangerous. Playing with the band was the most important principle. *Creativity means trouble*, fighting openly for the best idea has no tradition in China and is not taught in schools. Mao's harsh reactions to the 'Let a hundred flowers blossom . . . ' movement as well as Deng's Tiananmen crackdown made it clear that free brainstorming could lead to punishment.

Egoism is one of the strongest engines of the economic boom. Having lived through difficult times, today's Chinese are *pragmatic* and willing to make compromises. Although they are *tough negotiators* and start out with high expectations, they usually *prefer a small solution to no solution*. Big solutions were not available in the troubled past; slipping through narrow gaps was the usual way to reach one's goal.

When it comes to business, they mostly *think in the short term*. Setting up a stable company step by step that will promise solid, long-term profits sounds far less attractive to them than making a quick buck. Collective experience has taught them that policies can change suddenly and opportunities be wasted forever.

Because it is hard to win the support of Chinese people for new social experiments, they tend to be quite *open towards successful western developments* and products. Whatever seems to work or is successful in the West will quickly earn the trust of Chinese people. That does not keep them from sometimes showing *exaggerated national pride*. For centuries, they had nothing to be proud of. The lethargy of the old emperors, the colonial influence, including the Japanese invasion and Mao's vain efforts to modernise the country have deeply hurt Chinese national feelings. But for the past 20 years, things have been looking up. A feeling of 'now its our turn' sometimes leads to ultra-elation. This occasionally goes along with a lack of self-criticism and arrogance towards other countries, which the government often uses for its own purposes. Still, nationalism is also a growth engine. The Chinese are desperate to impress their competitors such as the US, Japan, Europe or India. This makes them *very impatient*.

However, the Chinese have shown impressive *patience regarding painful reforms*, such as mass lay-offs in state owned enterprises, because they still believe that it will eventually make the country strong (see question 1.11). Those born by the middle of the 1960s still remember the deprivations of the Cultural Revolution and know that painful reforms are inevitable. But they also know that standing up and talking politics can be dangerous. In companies, this behaviour can eventually lead to severe grievances, with problems swelling for a long time before breaking out with great force.

That institutions and their rules are not functioning or unreliable is a key experience of all people living in the People's Republic of China. Therefore, it will probably take a long time before the Chinese people accept the rule of law and stop showing a deep *mistrust for institutions* (see question 1.5). The Chinese proper to provide for themselves or seek help from relatives and friends rather than relying on support from state or company institutions.

This short excursion into Chinese habits, which could be easily prolonged, shows that the Chinese and their history are much less mysterious than one might expect.

Summary

- By the fifteenth century, the development of the huge kingdom stagnated.
- At the beginning of the twentieth century, the empire fell apart and was crippled by several wars until the new leader, Mao Zedong, took over and established the People's Republic of China (1949).

- After a short period of economic prosperity (1950–56), it soon turned out that Mao was an unskilful and incapable economic reformer, pressing ahead with idealistic, compelled reforms.
- Calling for 'a hundred flowers to blossom', Mao asked the country's elite for advice, but violently hit out against them when their criticism turned out to be too harsh (1956–7).
- During the 'Great Leap Forward' (1958–60), Mao ruined the economy even more by dividing the country into many small, self-sufficient units, the so-called People's Communes.
- In the 'Great Proletarian Cultural Revolution' (late 1965–76), Mao swept away what was left of economic know-how by sending the middle-aged to the countryside for re-education and giving all power to the young people's Red Guards.
- After Mao's death in 1976, Deng Xaioping took over and opened the country to 'social market economy with Chinese characteristics' (1976–88).
- In 1989 the economy was about to collapse after wildly booming years; Deng violently cracked down against mass demonstrations by students on Beijing's Tiananmen Square.
- Deng, sidelined by the party's conservative wing, regained power in 1992. With his 'trip to the south' he successfully fought for further economic liberalisation.
- In the golden 1990s (1992–9), the government of President Jiang and Premier Zhu prevented the booming economy from over heating and then successfully protected the country against the Asian financial crisis (1997–8).
- At the beginning of this decade, China has to fend off the global recession. Having joined the WTO in 2001, the country is under pressure to accelerate its internal reforms; the biggest steps are still ahead.

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1.4. Why do the Chinese negotiate the way they do?

Negotiating with the Chinese is widely feared by western managers: big delegations, people that are hard to tell apart for the western eye, expressionless faces, beating about the bush, demanding the impossible and results agreed upon in the evening being questioned again the next morning.

Still, these extreme cases have become as rare as Chinese bikers wearing Mao suits. After 20 years of political opening, the way the Chinese – in particular the ones living on the developed east coast – negotiate, has become much more transparent and factual.

However, this does not mean that centuries-old strategies passed on from generation to generation have suddenly vanished under western influence. In order to adapt one needs to know why the Chinese behave the way they do.

The most important questions

- What cultural traditions do Chinese negotiators follow?
- What institutional weaknesses influence the Chinese?
- How does this show in negotiations?
- What are powerful tools to achieve one's goals?
- What are the chances for western managers?

Chinese people's approach to negotiations is different from westerners' for two reasons. One lies in their rich cultural heritage: Chinese managers are under the influence of China's centuries-old impressive tradition of strategic thinking. The acquirements of this tradition, however, are complemented by a social shortfall that is just as important: they negotiate differently because they cannot rely on functioning institutions such as a legal system.

Cultural tradition

The cultural differences can well be illustrated by the board games that are most popular in the respective cultures. While westerners play chess, East Asians play 'Go', a game that is said to have been invented in the third millennium BC by the legendary Chinese emperor Yao.

While chess' aim is to incapacitate the enemy and ending the game with 'checkmate' (*shah mata* – the king is dead), Go aims at winning as much territory on the board as possible, encircling the opponent. At the end of a good game of chess, the board will be almost empty, while two good Go players will have filled almost all of the board's 361 reticule points with black and white stones. Put simply, one could say that chess is a game of destruction, while Go is a game of construction.

These different games call for different strategies. The chess player pursues an outright attack on the very heart of his opponents' power – the king. The Go strategist will choose an indirect approach to encircle his enemy. Thus, the Asian game promotes integration, the western game confrontation.

The games and their strategies became popular mostly because they are closely related to the different kinds of war fought in Europe and China. China was always a large country and therefore mainly concerned with protecting its empire from interior uprisings and from central and northern Asian nomads like Tschingis Khan. In contrast, Europe's smaller nations' wars were mainly of expansionist nature, as were those of the young United States.

A Chinese philosopher and war strategist held in high esteem by managers is Sunzi, who in 350 BC, after 1,500 years of Chinese history, summed up Chinese strategic thinking:

> *The art of manoeuvring is difficult. The task is to make a detour into a direct way and a disadvantage into an advantage. For this reason, use the indirect way and detract your enemy by giving him some bait. If he reacts to that, follow him and get there before him (Sunzi Bingfa, Chapter VII).*

The prevalent western strategy has been laid down by his colleague Carl Gottfried von Clausewitz (1780–1831), a German general also well known by management strategists who probably knew Sunzi's theories: 'The best strategy is to always be quite strong. At first generally, and soon in the decisive spot.' (For Clausewitz, this, 'spot' is very physical: 'Just like the centre of gravity is where most mass is found, and just like a strike against a load's centre of gravity is the most efficient, and like the strongest strike is inflicted in the centre of gravity, it is also in war' (Carl Von Clausewitz, 1990, Vom Kriege, Augsburg, p. 531.)

The different strategies can also be observed in martial arts. The western boxer tries to serve a well-directed blow to the weakest spot he is allowed to aim at, that is the chin or the temples, in order to knock his opponent out. Most Asian martial arts, such as Chinese Gongfu, try to make use of the opponent's strength and turn it against him, unbalancing him in order to disable him.

Dysfunctional institutions

Probably more important than Chinese tactical traditions are the country's often incompetent, unreliable institutions, which force managers to use negotiations to emphasise points that are different from a westerner's concern.

From the very beginning of reform economy, Chinese managers have experienced that they cannot rely on state institutions to guarantee the establishment and implementation of certain rules (see chapter 1.6). Even today, China's businesses have to survive without a functioning legal system. Therefore connections and networks are much more important than in the West (where they are nevertheless known to be very important too). To solve a problem, good contacts to the partner's network can be used to get advice or to put on pressure. A written contract plays a much less important role than good personal relationships. Insisting on a contract in case of conflict is not a smart approach in China, where it is almost impossible to agree on a verbatim implementation of an agreement. Instead of discussing the meaning of an old paragraph that is not appropriate to solve a new problem, Chinese have a more pragmatic approach: if harmony between the business partners is disturbed, they have to find a new balance of harmony. Therefore the order should be: stable, reliable relationship first, a well-founded contract later.

The different cultural traditions and social conditions in negotiation habits can be summarised in opposite word pairs as illustrated below:

West	**China**
Direct	Indirect
Confrontation	Integration
Based on facts	Based on trust
Reassurance through contract	Reassurance through connections
Fixed, comprehensive set of rules	Flexible, complicated set of rules
Negotiations to be closed	Negotiations everlasting

Although both sides insist on the superiority of their method, neither the western nor the Chinese approach can be said to be better or more successful *per se*.

Still, the Chinese undoubtedly have a home advantage. As negotiations are usually about business deals for the Chinese market, the Chinese partners have more clout to determine the style of discussion. They often even force ignorant foreign counterparts to accept their rules by implied argument. The Chinese partner, with the support of powerful state institutions, has a huge market to offer, with western companies queuing up, begging to be let in. If one can convince the Chinese that the opposite is true, that China urgently needs your product that only you can provide, success is within sight.

An even bigger possibility for western companies to succeed lies in the fact that a lot of Chinese enterprises in the transition from state owned enterprise to market economy company sometimes have goals that are less based on economic reasoning. Under certain circumstances, political aims will be even more important than economic ones. Negotiating with that in mind can suddenly open the doors and enable both sides to find a stable, long-term win-win relationship.

However great the pressure may be, or however one might be impressed with Chinese people's negotiation skills, one should not leave one's own tradition further behind than common sense allows. The frequently discussed topic of losing face is a pertinant example regarding the fundamental approach towards Chinese managers. Whether in China or in the West, if possible the counterpart should be spared a 'loss of face'. But if someone repeatedly behaves inappropriately, embarrassing him in front of others can work wonders, especially with Chinese, who tend not to be very sensitive when amongst people they do not know well. In fact, in Chinese tradition one can only lose face in front of friends, not in front of foreigners.

Clever Chinese negotiators have therefore started using the 'losing face' myth to trap their foreign business partners. One Chinese negotiation team left a delegation of European board members flabbergasted when they got up in the middle of a banquet and left the restaurant without further explanation. The westerners racked their brains trying to find out which Chinese custom they had neglected and how they made them lose face. At the next round of talks two days later the Chinese behaved as normal, while the westerners where highly nervous and unsure of themselves. That was exactly what the Chinese had wanted to achieve. In fact, the Europeans had done nothing wrong at all – indeed, a very modern way of putting the Chinese managers at an advantage. This new Chinese negotiations strategy is to make use of the foreigner's perception of Chinese negotiation tradition.

Summary/Recommendations

- Chinese negotiation strategies are becoming more modern, but are still influenced by cultural traditions and dysfunctional institutions.
- Their cultural background teaches Chinese negotiators a more indirect approach in negations.
- Dysfunctional institutions (no rule of law) make the Chinese rely on stable, balanced networks rather then on contracts.
- Western and Chinese strategies are equally strong, but Chinese have a home advantage.
- One should serve the political needs of a Chinese business partner to realise one's own business interest and create a win-win situation.

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1.5. To what extent is corruption undermining the economy?

With China rapidly changing from a state owned economy to a modern market-oriented one, corruption could hardly be avoided. All companies in China were originally run and controlled by cadres and military officials. At the beginning of the reforms, they were the only people who had assets and licences, and naturally they had no intention of giving up their privileges. Therefore, many of them would only support new business if they could expect to make some personal profit, too. The officials would demand anything from bribes to shares, or keep the business inside the family. For businessmen who were faced with having to bribe officials, it was a simple and rational choice: the one who is the first to pay an influential cadre will have the best contacts and first mover advantage. Even nowadays where there are many private entrepreneurs, foreign business is still dependent on cadres when it comes to applying for permission or licences.

The most important questions

- How did corruption support China's growth?
- Why does corruption not support growth any more?
- Why is the government fighting corruption?
- How is the government fighting corruption?
- What kind of corruption are foreign managers faced with?
- How should they deal with this phenomenon?

Corruption supported China's growth

In the first 15 years of market economy reforms since the early 1980s, the government largely ignored the corruption problem. The focus was on setting up market economy operations and boosting the economy in every way possible. Economic planners reckoned that, in the short run, economic growth caused by corruption would succeed economic loss. China had no functioning tax system and the money involved would stay within the Chinese economy anyway. This strategy guaranteed prosperity for cadres and managers of state owned companies who were thus willing to support reforms. High growth fuelled by corruption was better than little, honest growth.

Corruption slows down growth

This strategy only worked for little more than a decade. Then corruption started to strangle the economic boom. Old networks that manoeuvred business around the state and market forces did immense damage to the economy. The government started to worry for the following reasons:

- Chinese money disappeared to foreign accounts and was thus lost for the Chinese economy;
- although a tax system had been set up and the companies were wealthy enough to pay, there was large-scale tax evasion;
- corruption scares away foreign investors who demand a reliable and fair business environment;
- corruption scandals involving high-ranking government officials did a lot of harm to the public image of the Communist Party.

The last two reasons in particular forced the government to react strongly.

Internal pressure

The Chinese public puts a lot of pressure on the government. According to surveys, the Chinese believe that corruption is the country's most urgent problem. The refore, the Beijing central government feels it has to demonstrate that it is serious about fighting what President Jiang Zemin calls the 'cancer of corruption' on all levels. The leadership is well aware that in order to maintain the Communist Party's credibility it has to do more than just proclaim a general crackdown. The Chinese people demand equality of all citizens in front of the law, including cadres. With stability of the country depending on the party's credibility, security advisers tell the politburo that it would be too risky to ignore the sentiments of the people. President Jiang said with unusual openness: 'If corruption is not controlled, it will soon threaten the government.'

External pressure

With competition for foreign investment on the world market heating up (in the last years China has reaped in 40 billion US dollars per year), the government needs to provide foreigners with a stable environment that encourages them to embrace long-term projects. Looking at China World Bank President James Wolfensohn emphasised: 'An effective legal and judical system is not a luxury, but a central component of a well functioning state.' China promises that as a WTO member it will administer its laws in a 'uniform, impartial and reasonable' and transparent manner. And it will be judged by the international business community on those acknowledgements.

Government measures

For these reasons, the party and the government have started a countrywide crackdown on corruption with a particular focus on its own members and comrades.

- In the 1980s, almost all foreign luxury cars were smuggled into the country. Today, this number has dropped to under 2 percent.
- In 2000, 77-year-old Cheng Kejie, vice-chairman of the National People's Congress, was charged with corruption for embezzling 5 million US dollars and eventually executed. Only State President Jiang Zemin and National People's Congress Chairman Li Peng were senior to him, making Cheng the highest-ranking Chinese official ever to be charged and executed for corruption in the history of the People's Republic.
- Also in 2000, Li Jizhou, vice-minister of the Ministry of State Security was surprisingly charged for accepting millions in bribes. The case against Li is obviously part of a huge smuggling scandal in the coast town of Xiamen in southern China. Cars, oil, mobile phones and computers worth 10 billion US

dollars were brought into the country; at a certain point the smugglers supplied one-fifth of Chinese oil demand. Smuggling kingpin Lai Changxing managed to escape to Canada, where he is currently under house arrest fighting extradition. The most senior administration elite of the city are among the 200 officials who have been charged. The case was widely reported all over the country and several members of the smuggling ring have since been executed.
- Former Bank of China President Wang Xuebing, one of the country's top bankers and a close ally of Premier Zhu Rongji, apparently obstructed an investigation into mismanagement of his bank. The National Audit Office, suspicious of Wang but lacking evidence, managed to have him moved to another post as president of the China Construction Bank in February 2000. In January 2002, with enough evidence collected, Wang was finally dumped and charged. During his term 800 million US dollars disappeared.

Better anti-corruption institutions

As a strong tool in fighting corruption, the National Audit Office was reorganised and made into a powerful institution. It has turned out to be something like an anti-corruption ministry. Premier Zhu Rongji vested it with strong authority, allowing it to implement a security system that makes corruption much harder for managers and politicians. Up to the level of ministers or bank presidents, officials are being checked and their institutions audited as soon as they change their post or retire.

But the corruption police not only target high-profile cases. It has also been successful in the middle ranks. In 2000, more than 130,000 corrupt cadres were charged, 17 of whom were ministers. Around 20,000 illegal or even criminal companies belonging to the military or police were closed down. In smuggling cases alone, customs officers in 2000 uncovered more than 1,000 cases involving goods worth over 600 million US dollars. That year, the National Audit Office audited 55 government institutions, 18 of which turned out to have embezzled a total of 250 million US dollars, while 36 institutions had misused 300 million US dollars. The most corrupt ministry was the Ministry of Water Resources. Instead of using 72 million US dollars for flood-fighting and prevention, former minister Niu Maosheng, an ally to party headliner and former Premier Li Peng, took the funds to build a luxury hotel and office complex. The ministry was just preparing an auction to sell the hotel when the case was discovered.

Only a drop in the ocean?

It is hard to say whether all these cases brought to justice are more than just a drop in the ocean. The rankings of international corruption fighters also say little about the real extent of corruption in China: Transparency International ranks China at 58 out of 99 countries. And even National Audit Office Minister Li Jinhua admits that the most difficult problem is to change the attitude of the people: cadres 'still think that they were very clever, acted smartly and were only caught because they had bad luck. This attitude stems from their experience that public institutions were sometimes not audited for years. They were corrupt without even knowing.' Corruption increases with greater distance from the central government.

Naturally the controllers cannot be everywhere at the same time. 'We execute one to scare a hundred others,' Premier Zhu sums up the strategy. This naturally leads to drastic exaggerations: the vice-mayor of Ningbo in east China was given the death penalty for accepting bribes worth 50,000 US dollars. He was granted a delay of his execution for two years. In a similar case, the general manager of the International Trust and Investment Corporation in Hunan province was sentenced to death for accepting 25,000 US dollars over three years.

The reformers still have to shake off the suspicion of using the anti-corruption campaign for their own political purposes. The National Audit Office's corruption busters, who are under liberal Premier Zhu's direct command, have repeatedly targeted party hardliner and reform opponent Li Peng: executed congress vice-chairman Cheng Kejie, for example, was a close ally to Li. Such cases not only strengthen the reform wing, they are also good publicity. Li is not very popular amongst the Chinese, who not only regarded him as incompetent, but also accuse him of being responsible for the massacre in Tiananmen Square in 1989.

Western business and corruption

Foreign investors claim that the anti-corruption campaign has not yet taken effect and that levels of corruption have not decreased. Paying local authorities for permission and licences is common practice and part of the budget. No case of high bribes involving foreign companies and local officials has been unveiled. Particularly annoying for foreign enterprises are corrupt approval procedures.

- Manufacturers of machines are forced to work with suppliers that deliver bad-quality parts that make the whole product hard to sell.
- Successful telecom companies suddenly had their licences withdrawn because their Chinese partner was allegedly not allowed to sign the co-operation agreement.
- The whole car import business relies on licences that have to be bought on the black market.
- Pharmaceutical companies have to reveal the chemical composition of their products to Chinese authorities. A Chinese copy of the product will often hit the market before the foreign company has received its licence.

Still, corruption in China is a relatively calculable risk, at least when compared to other regions of the world. Western managers in China normally have to make their own arrangements with the phenomenon, as reporting cases to the authorities will usually lead to even bigger trouble. Ripping off foreign companies is seen as a petty crime in China. Western managers therefore have to find a way to make corruption calculable, reasonable and predictable.

How to deal with corruption?

Here are three basic rules China managers count on when having to deal with corruption:

- bribes are only paid for specific services;
- the sum must have an appropriate relation to the service;
- every 'service' is only paid for once and to one person.

Note that bribery is also common practice amongst foreign businesses in China, graft crimes committed in foreign countries can be prosecuted in many western countries. To find out which kind corruption is common in which field of business, it is advisable to confer with colleagues from the same sector and work out some basic standards. Sometimes it is possible to use the press to curb the most serious abuses. Still, it is difficult to keep control over the process.

At least the Chinese have one advantage. They are too keen to make business to let corruption get in their way. If a manager budgets some time and money for such cases, it is a problem that one can live with, especially as the government promises that its anti-corruption campaigns will show results soon.

Summary/Recommendations

The government has finally declared war on corruption, mainly using the tool of deterrence. The policies are enforced with spectacular arrests and executions. Furthermore, it tries to implement powerful auditing institutions and control tools to curb nepotism and abuse of position. No quick results should be expected. Still, the pressure on the government is rising because the people are now less willing to tolerate the dealings of corrupt cadres.

Foreign investors demand reliable rules. In every day business, western managers have made their arrangements with corruption, trying to make it calculable and predictable.

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1.6. How to do business in a country with a weak rule of law?

'How can you tell an honest judge?'
'He will pay back the bribe to the losing party.'

Unfortunately, this Chinese lawyers' joke is not far from reality. Lacking an established legal system to support social life or the economy, party cadres are free to make highhanded decisions. Adapting to these conditions, western managers and lawyers can still find ways to get their rights and solve conflicts.

The most important questions

- Why does China lack a stable legal system?
- What difference will the WTO make?
- What is the Chinese perception of law?
- How should western managers change their attitude?
- Who can you team up with to get your rights?
- What alternative ways are there to protect your rights?

Lack of law enforcement

The lack of legal security and transparent, impartial and independent courts is currently the main deficiency of the Chinese social system. It is corrupt, unpredictable and incalculable; getting involved in legal conflicts is one of the main fears of Chinese people. Only ten per cent of all judges actually have legal training. Equally, the absence of a functioning legal system is the biggest concern of foreign managers in China. If delivered materials are not being paid for, if the Chinese partner thievishly copies machines, if the joint venture's money trickles away into delinquent accounts, if decisions by the joint venture's western management are not followed, taking the offenders to court usually won't help much. Although China certainly still lacks many of the laws that support social life and economy in the West, the main problem is not the laws themselves, but their implementation. Since the beginning of the decade, there have been an increasing number of cases in which foreign companies get their rights through lawsuits, but these cases are still exceptions. And even if a case is won in court, that does not necessarily imply that the losing party will accept the verdict and act accordingly. The police are not always willing to enforce a verdict.

Increasing pressure

The government has recognised this problem and is trying to solve it in order to make China internationally competitive. In his annual government speech in 2002. Premier Zhu Rongji told the country what he wants to change about the business environment:

> *The financial order needs to be thoroughly rectified. We need to earnestly investigate and deal with business activities that violate laws and regulations concerning banks, securities and insurance companies, and other financial institutions. We need to resolutely ban illegal financial institutions and illegal financial activities. Financial swindling, illegal fund-raising, manipulation of the securities market, insider trading, and malicious evasion and cancellation of the debts should be investigated and dealt with according to law.*

During the WTO negotiations China agreed not to allow provincial governments to pass local laws that do not comply with WTO obligations. Decisions favouring particular parties or interest groups and undermining competition will be illegal. Laws have to be reasonable. Obviously, China can't adopt measures that don't comply with basic principles of fairness. Although WTO membership will increase the pressure, there is no quick solution. China's lawmakers know that they have to synchronise the legal system to keep up with the rapidly changing social reality and the pressure of globalisation.

No legal tradition

Today, Chinese lawmakers try to adapt the European and American legal system because there is no time to develop their own. The country has no legal tradition comparable to that of the West. For decades, cadres' words were law and verdict in one. An independent legal system only existed in theory. Judges were appointed without having studied law. Most of them came from the military – and still do today. While odd in westerners' eyes, Chinese people have been used to this not only since the times of Mao Zedong, but for thousands of years of imperial China.

For 'higher' political reasons, the government still keeps up this tradition. Before the Olympic Council's evaluation committee visited Beijing in early 2001 to gather information about the city's Olympic bid, the government quickly got rid of some eyesores. These included thousands of old houses considered too unrepresentative for the world to see. Residents and shop owners had to leave within days and were moved to the suburbs. Compensations paid by the city government could not buy them a comparable flat. Expecting protests from angry residents, the city warned lawyers and courts not to take on or allow any related cases. Still, more than 100 residents went to local courts. All cases were turned down.

The official position sounds cynical to western ears, but is not altogether unreasonable: a big country like China needs a different balance between individual rights and public interests to western societies. For the time being there is no balance at all; it is the government that makes all decisions.

Adaptation of the western legal system

While China's long-term goal is a system modelled on European abstract norms, the transition period is dominated by American case law.

The last thing China wants is to scare away investors, so it appeases them by granting special treatment to foreign companies who do not have to follow Chinese company law in all cases. While lawmakers try to do their homework and set up a modern legal system (working together with several western countries), law enforcement is much more difficult. It will take decades before law enforcement officers, lawyers and judges all have law school education. Whether they will ever work in an independent legal system is impossible to predict.

Problems of implementation

Chinese judges' everyday work has little to do with interpretation of the law. A western lawyer, who was invited by the Chinese government to give seminars for high-ranking judges, was amazed to find out about their working methods: when given a model case to solve, all of them came up with different verdicts. Asked about the reasons for their decisions, 'experience' was the common answer. Further questions revealed that none of the judges knew the relevant law or had bothered to consult legal texts. 'Experience' in this respect means that judges know what superiors want to hear. If no politically sensitive matters are concerned, right and wrong is often decided on instinct. Sometimes, Chinese judges tend to have a social instead of 'legal' adjudication. A foreign manager involved in a traffic accident with his company car was found innocent in a court hearing. Still he was asked to pay damages to the other party. The argument: the western company has much more money than a Chinese individual. As the amount was moderate, the manager's foreign lawyers advised him to accept the verdict.

But even before courts are approached, the different perceptions of law can be felt. A joint venture contract in China is rather a communicative tool for both sides to sketch out their ideas about the co-operation than a binding document. Therefore contracts between Chinese and western companies should be longer rather than shorter, allowing both sides to use the negotiations to get to know each other. The differences are obvious: western managers want to be prepared for all possible conflicts, while Chinese businessmen insist that it is impossible to predict the future, making it unnecessary to include all eventualities in the contract. Problems should be solved when they occur.

Not being able to rely on contracts and courts, foreign lawyers have found unconventional, creative ways to deal with conflicts. They try to turn the tables on their Chinese partners and use alternative methods to fight for their client's rights. Therefore, when choosing a law firm in China, one should check whether the company is willing and able to look beyond ordinary western legal patterns. Basically, the trick is to find influential groups that can put pressure on the other party.

Pressure through banks

Recently, the state banks have turned out to be good coalition partners. After decades of central planning, they are now forced to work in a competitive market and take more responsibility for the credits they grant. Therefore, it is in their best interests to ensure that their creditors' companies work properly. A well-worded tip-off to the right person can do wonders.

In some particularly serious cases, banks have started to impound the Chinese partner's shares, an option the Chinese law has provided for a long time and that the high court has just recently encouraged banks to make more use of. In that case, the foreign investor might get the chance to buy his Chinese partners' shares. Usually it will be the bank that negotiates the deal.

Political pressure

When trying to use political channels to take influence, the arguments one has to use have changed significantly over the last couple of years. Until recently, the state machinery took pride in the fact that a little turn on the party's disciplinary screws could solve any problem. Today foreign lawyers in the Middle Kingdom use competitiveness as a key argument. In polite letters they write to political institutions, warning them that there might be trouble in store for them if their superiors find out that the respective political body does not implement market reforms as smoothly as demanded. In other cases they threaten that the foreign company might move its operations to another city or province if the situation does not improve. With competition for foreign investment rising, this can be quite a scare for authorities. In any case, it is important to launch one's complaint on the appropriate political level.

Pressure through media

Some lawyers make use of the Chinese press. Media are much more willing to report on economics, business and corruption than on delicate political topics. However, this does not imply that Chinese journalists have the same work ethics as their western counterparts. One has to make sure that the information is used in the intended way and has the desired effect.

Ambition

The young heroes of China's market economy have a weakness that foreign lawyers like to use against them – their ambition. If they repeatedly find stumbling blocks slowing them down, they will soon be willing to negotiate.

This is much more useful than direct confrontation, which can sometimes bring immediate results, but cannot solve the basic problems of a joint venture. The general manager of a British company, for example, reacted to a long-lasting conflict by taking away his Chinese partner's company stamp, which in China is more important than a signature. The Chinese partner was blocked, but without his co-operation the joint venture was unable to go on working as a whole, too. If the situation is unresolvable, lawyers sometimes advise investors to end the co-operation and rebuild the operation from scratch, this time as a wholly owned enterprise or joint venture with a larger foreign share. This might be easier and even cheaper then treading the path of legal battle. In many cases, the Chinese side will not be able to lead the company on its own and might soon be forced to give up.

Image

Sometimes clients are surprised to see their lawyers win cases that wouldn't have a chance if the relevant laws were applied. A foreign company's lawyer complained, in legal terms, to the Bank of China that his client had been ripped off. The bank promptly replied in English, saying there was no breach of Chinese law. Two weeks later, however, the money was transferred to the client's bank account without further comment. In the hard competition of market economy, Chinese companies cannot afford a bad image any more.

Ethics

The Chinese are known to be tough negotiators. Still, ethics can be helpful where law is of no avail. The Chinese have a good feeling for right and wrong. That does not stop them from giving their partners bad deals, but at least there is something like a bad conscience that can be used to get one's rights. If you tell a Chinese entrepreneur that his actions are illegal, that will hardly bother him, as manoeuvring around the law is seen as clever. But if you tell him that his methods are unfair and a disgrace for serious businessmen, you might be successful.

Summary/Recommendations

China, lacking a legal tradition of its own, has the long-term plan to build up a system modelled on European law. But even after the country's WTO entry, it will be a long time before judges and lawyers have received proper education and developed a modern sense of justice.

For the time being, it is important to know the peculiarities of China's legal system. At the same time, one has to form interest coalitions with influential institutions to get one's rights: Chinese banks want to know the behaviour of their debtors; regional politicians want foreign investment, and young Chinese entrepreneurs do not want to be slowed down.

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1.7. How important is the WTO for the Chinese economy and western business?

No doubt, China's accession to the World Trade Organisation (WTO) that officially started on 11 December 2001 after 15 years of negotiations is good news for the global economy. This date stands for the international community's hope that China will, in future, follow the rules of international market economy. China has proudly celebrated the accession, seeing it as proof that the world accepts China as a strong, respected country.

The most important questions

- Can the government implement the reforms demanded by the WTO?
- How will WTO membership change China's economy?
- What are the new possibilities for foreign investors?
- What will change for the different industry sectors?

More reform pressure

For China's leaders, the WTO means more than rising exports. In that field, China was on the right track anyway: in January 1992 Korea and Taiwan together exported three times as much as China did; in 2001 China exported goods worth 266 billion US dollars (up 6.8 per cent) more than the two countries combined.

As far as the leaders are concerned, the most important reason for China to join the organisation is to get more power to press ahead with domestic reforms. Finally they have a strong tool to push state enterprises towards modernisation and restructuring, putting them under pressure by pointing at rising foreign competition. Thus, they have the possibility to speed up the reforms when social stability allows for it.

In recent years, the government could only appeal to its managers' understanding. Still, they often avoided to take the necessary steps, either because they lacked know-how, or because of insuperable resistance within the enterprise's staff. Some managers opted for a corrupt quick buck, giving away the company's assets to some close followers and then making off. With controlling and accounting still primitive, they could also get away with forged numbers, weak excuses and playing for time.

The problems that have to be solved urgently were mentioned by Premier Zhu Rongji in front of the 2002 meeting of the National Peoples' Congress (see Chapter 1.2):

> *This year we need to concentrate on increasing our international competitiveness and fulfilling the following tasks on the basis of what has been achieved.*
>
> *First, following the principles of the uniformity of law, nondiscrimination, and openness and transparency, we need to quickly improve the system of foreign-related economic laws and statutes so that they are suitable to domestic conditions and the WTO rules and able to guarantee fair and efficient law enforcement.*
>
> *Second, according to China's commitments in its entry into the WTO, we need to gradually expand the spheres of activity open to foreign businesses. In addition, we need to promptly formulate and revise market access standards for quality, sanitation, epidemic prevention, environmental protection and safety.*
>
> *Third, we need to study, master and fully exercise all the rights that China enjoys as a member of the WTO, and promote and participate in regional economic co-operation.*
>
> *Fourth, we need to study and publicize information about the WTO and its rules, and we need to provide training to public servants, especially leading cadres at and above county and division level and managerial staff in large and medium-sized enterprises by stages and in groups. We need to bring forth, through training, a contingent of people who are well acquainted with the WTO rules and international economic co-operation and trade.*

Since WTO membership the performance of foreign companies pushing into the market has easily brought to light the shortcomings of the local Chinese companies, leaving them with no more excuses. Most of the companies have no stable management structure and, at best, are held together by a charismatic leader.

Only companies that adhere to international profitability criteria will survive. Latecomers stand no chance.

Balancing act

The all-important question for the coming years is: will the government be able to uncompromisingly stay on the reform course? Surely, it cannot let local industry be forced into bankruptcy by foreign players. Mass lay-offs and social instability threaten to push the country to the brink of being governable. Whatever the contracts say, China's WTO policies will be a balancing act. The government has to put as much pressure as necessary on its local enterprises, while at the same time protecting them in order to keep the country competitive. This balancing act will be influenced by two further factors: consumer behaviour and attractiveness for international investors.

The consumers

As the sale of imported goods shows clearly, China's consumers simply hope that WTO membership will lead to falling prices. In the last quarter before the WTO entry, sales dropped sharply. Right afterwards they picked up just as strongly. Should the government not meet the expectations of its people, it risks a slow-down of consumption or even social unrest. This mainly concerns goods that are much more expensive in China than they are in the rest of the world, e.g. computers.

Still, the government is optimistic and expects a rise of 50 billion US dollars in private consumption. International trade is also likely to increase. A research institute of the State Council has estimated that imports and exports will both rise by 1.5 per cent. However, the government won't be able to ignore WTO rules and artificially protect local industries with their high product costs. The political costs would be too high if consumers refused to accept higher prices.

Foreign investors

China has fuelled foreign investors' hope that WTO membership will considerably improve investment conditions. A State Council research institute estimates that WTO membership will raise China's growth by 1 per cent. That means that by 2010, China's GDP should be 34 per cent higher than without the WTO. Foreign investment should double in the next couple of years, reaching 100 billion US dollars. These expectations are impossible to verify because nobody can know-how China would have developed without the WTO. Still, one thing is obvious: expectations are high and the Chinese government will have to work hard to avoid disappointing many foreign investors, because it depends on them to carry through its reforms.

While the Chinese government's scope is limited by these four factors (reform pressure, protection of local industry, consumer behaviour and foreign investors), governments in the US, Europe and Japan have other criteria to measure China's performance as a member of the global business community:

- scope for foreign companies will increase;
- protective taxes on imports will gradually be lowered until they reach international standard;
- rapid elimination of over 300 non-tariff barriers like quotas, licences and local content requirements;
- set-up of a legal system that will guarantee compliance with the rules;
- growing competition between foreign and Chinese companies.

Table 2 WTO influence on different business sectors

	Market focus	
	China	*Rest of world*
Value added in China low	**To China** (Companies which export to China) WTO impact: **MEDIUM**	**From China** (Companies which import form China) WTO impact: **LOW**
Value added in China high	**In China** (Companies that conduct business in China for the Chinese market) WTO impact: **HIGH**	**To China for the world** (Companies that use Chinese cheap resources for export) WTO impact: **MEDIUM**

In order to analyse the impact on the respective business sectors, it is useful to divide the companies according to their business scope. Depending on where the produce goes, WTO entry will have different strategic consequences. Companies that manufacture their products in China and have to import parts for that reason will benefit much more from WTO entry than companies that produce in China for the world market, as illustrated in Table 2.

Western managers are well advised to be careful when analysing the impact of the WTO on their respective businesses. Japan's WTO entry has shown that membership itself is not enough to bring a country under the control of international regulations. For years Japan refused to give foreign businesses the contractually agreed access to the local market. China has already made it clear that it has no intention of letting go of any decision-making power. After having reached agreements with the US in November 1994 and the European Union, China suddenly slowed down the speed of negotiations over the last details. Thus the government won time to implement further reforms.

Influence of WTO entry on specific industry sectors

Paper

Over 2,000 years ago, the Chinese invented paper. Back then it was a valuable material, available to the rich and powerful only. Today, every Chinese uses an average 25 kilos a year. Although that is only half the worldwide average, consumption is rising rapidly. By 2010, China will be the world's biggest paper consumer. Many products need high-quality paper, be it for newspapers printed for a billion readers or for China's 350 million smokers. Currently, China is unable to feed its own demand. On the one hand, China lacks technology: many factories are small and work with old machines that cause serious environmental pollution. On the other hand, China lacks natural reserves: with only 3.9 percent of China is covered with forests, wood for better-quality paper has to be imported. More than half of China's paper is produced using straw or reed. Most of the paper imports come from international paper heavyweights such as Scandinavia, Indonesia, Japan or Korea. Although the government offers favourable conditions to foreign investors, industry sources do not regard the impact of WTO as very strong.

Clothing/Shoes

Western managers in the clothing industry are sceptical: 'If the WTO forces the Chinese government to get rid of import or export quotas, it will come up with a new tax on needles to make up for it.' China has good reasons to make life difficult for foreign clothing companies. The efficiency of state owned enterprises that produce around 60 per cent of export textiles, still lags behind their western competitors. In 2001 1.2 million workers were laid off. But more and more Chinese companies have discovered that they can earn more with quality garments than with cheap, low-quality produce. The WTO will accelerate this trend: in the next five years, production is expected to double, and by 2003 growth will have reached 20 per cent.

China is the world's biggest producer of shoes, and that is not only because 1.3 billion pairs of feet walk around the country. Having produced 1.6 billion pairs in 2001, China has a world market share of 40 per cent. WTO entry means more work for China's shoemakers. As soon as prices for the expensive imported raw materials fall, production cost will also fall and increase China's competitiveness. Big international shoe companies, who currently have their shoes sewn in several different countries, eyeing China, will plan to move all production to one country.

Plastics/Chemicals

Chinese construction sites currently need 2 million tons of plastics each year. However, only 0.5 per cent of that is locally produced. Although demand for China's huge infrastructure projects grows by 25 per cent each year, local production can only come up with a growth rate of 10 per cent. Therefore, China's plastics industry heavily depends on foreign companies. More than 50 per cent of plastic products are imported, mainly from neighbouring Asian countries. Western global players such as Bayer or BASF are currently making billion US dollar investments.

China's chemical industry faces the same problem. Still, the industry is developing quickly. Foreign business insiders expect hard competition from Chinese companies. Many life science products can already be produced by Chinese enterprises; the niche for foreign companies again lies in up-market products.

China has used a clever import substitution policy to attract foreign companies, who come up with 35 per cent of the sector's investment. Although foreign-produced goods are far superior in quality, they cannot match the Chinese for price. Tax benefits for foreign companies will slowly be phased out. Foreign businessmen see the WTO as a means to make the sector more transparent. Still, the government will have ways and means to interfere.

Cars

If people in the West want to drive an Audi A6 limousine, it will cost them 50,000 US dollars. The Chinese have to come up with 100,000 US dollars for an imported Audi. If that is too much, they can settle for a locally produced A6, which comes for 70,000 US dollars and is inferior in quality.

High tariffs, quotas and a bad environment for car production give foreign car producers a hard time. Production costs are high for two reasons: western carmakers only produce relatively small numbers and they have to buy a certain percentage of parts from local suppliers at horrendous prices. Quality is below and costs above world market standards.

Despite several ambitious tries, China has not succeeded in producing its own quality cars. China has an annual production capacity of 2 million cars, but only 1 million were produced in 2002. However, 10 million potential buyers are in the queue. Therefore, China depends on foreign imports and know-how.

The WTO is forcing China to lift tariff barriers and reduce tax, which will be of benefit to foreign companies. Still, tough competition is to be expected. Several international carmakers are fighting for the market for small and family cars. It is possible that China will produce these cars itself.

Toys

China is the world's biggest producer of toys: 30,000 different kinds are available, covering a quarter of the world market and generating an export turnover of 5.1 billion US dollars a year. Currently, 97 per cent of exports are soft-toys and dolls of low quality. Because the low-price market is more or less saturated and labour cost in other Southeast Asian countries is lower than in China, the country has to start technical modernisation of its toy industry. By 2004 China hopes to have 6,000 companies, half of them foreign-owned, that have reached international standard. The WTO will be of help: tariffs will disappear and access to international markets will become easier; imports of raw materials will get cheaper and more foreign companies will be able to invest.

China will also open its doors to import of foreign toys, which are seen as much more educational. Chinese families invest 30 per cent of their income in the education of their 'little emperors', as they call their indulged single children. With China's 300 million kids, this adds up to a market potential of 6 billion US dollars. Currently, Chinese toys only make up 1 billion US dollars.

Household goods

Gone are times when a bicycle, a radio, a watch and a sewing machine were the four symbols of wealth. Rising living standards have lead to an increase in the purchase of household goods, many of which are imported. While imports of finished products are on the decline, demand for components such as compressors for refrigerators is rising, allowing China to produce high-quality products. Ten big companies, the most prominent being Haier, control the local market and are now targeting the rest of the world. Every second fan and one in five air-conditioners comes from China. Therefore, Chinese companies welcome the WTO. Although imports will rise and many old state enterprises will not be able to withstand the pressure, consumers can look forward to falling prices as components get cheaper and more investment flows into China.

Agriculture

The WTO agreements for the agricultural sector were the last to be reached, showing how strongly the accession to the world trade body is going to affect China's farming industry. Today, prices for domestic wheat, soya beans, corn and oil are 20–50 per cent above international market prices. With Chinese production costs still rising, imports can be expected to increase substantially. Tariffs, quotas, licence requirements and state trading still protect China's farmers. But all quotas will eventually be turned into tariffs that will gradually be reduced until they reach an average 14.5 per cent by 2005, down from 31.5 per cent today.

The Chinese government will try to give its 600 million farmers maximum protection because of the huge potential of social instability. Fifty million farmers live below the poverty line (income 60 US dollars per year), and not all of them will be able to shift to more profitable, labour-intensive products such as flowers, plants, fruits and vegetables. This is where China has a huge, mostly untapped, export potential.

Distribution, retail, wholesale, trading, after-sales services

Today, there are harsh restrictions on foreign investment in wholesale, retail and after-sales service. Only a small number of big cities are open to foreign distributors, but even here, business scope is limited. The application process is time consuming and unpredictable. The reason for this discrimination is obvious: China's logistical sector is highly inefficient; damage rate is high and payment unreliable. WTO regulations will force the government to liberalise the sector, putting local companies under extreme pressure. For most products, restriction on distribution services will be phased out by 2004. But although they might have superior know-how and technology, foreign enterprises will have a hard time competing with Chinese connections and networks.

Telecommunication

China is the biggest telecommunication market in the world. Currently, it has 180 million fixed lines and 140 million mobile phone users. In 2001, the industry turned over 32 billion US dollars; double digit growth is predicted for the next couple of years. These numbers cannot disguise the fact that China's telecom system is far from compliant with the WTO agreement. The four big players (China Telecom, China Mobile, China Unicom, China Netcom) are all state owned. The government tries to stimulate competition between them, but this has nothing to do with fair competition.

The WTO will play an important role in opening up the sector, which has long been seeking foreign management know-how, technology and capital. Within a few years, foreign companies can take 49 percent stakes in telecom companies. Global players are already queuing up: Siemens has teamed up with a Chinese partner to develop its own third-generation telecom standard TD-SCDMA. Corporations like Telstra, AT & T and Vodafone have formed strategic alliances with Chinese partners.

Banking and leasing

More than 500 international banks have set up offices in China. For the time being, their business scope is reduced to representation, risk management and foreign exchange services for foreign companies and other small businesses, with their assets making up only 3 percent of China's total bank assets. But they are preparing for the moment when regulations allow them to start 'real business' in Chinese currency. For this they will have to wait until 2006, and even then, foreign banks do not expect to get a market share bigger than 1.5 per cent in the near future. The reason for China's reluctance to speed up the opening of the sector is obvious: the country first wants to modernise its own state banks. These still drag along about 30–50 per cent of bad loans from the times of central planning and the speculative property project throughout the mid-and early 1990s. The state has set up asset management companies to relieve the banks from the non-performing loans. The General Audit estimates that two of the country's big four banks, the Industrial and Commercial Bank of China and the China Construction Bank have each lost 1.2 billion US dollars through illegal activities. Most of the banks are technically insolvent. But as long as they are state owned banks and the government is able to take care of the debts there is no existential harm for the whole economy.

Securities

The securities market has so far been the most heavily guarded sanctum of modern Chinese economy (see chapter 1.8). Although B-shares, traded in US dollars, are available to foreigners, China will make sure that it stays invulnerable to international speculators. Though growing quickly, the stock market is still small in size. But most important of all, neither the companies nor the trading comply with international transparency standards. Although an independent China Securities Regulatory Commission has been set up, government influence is still strong and law enforcement lax. Therefore, China seeks to first restructure its own weak system before it can allow foreign financial institutions full entry. For the time being, foreign enterprises are restricted to minority joint ventures that engage in fund management, debt restructuring, asset management and financial advising.

Insurance

Formerly, a single state owned company monopolised the whole insurance sector. In the meantime, more than 200 international insurers have set up offices in China, which has an insurance market of an estimated 15 billion US dollars, with several European and American insurers already holding licences. By 2003, all customers will be available to foreign insurers, and according to the WTO agreement, licences will be awarded solely on the basis of prudential criteria, with no quantitative limits on the number of licences issued. Being under extreme pressure to set up a working social system, the government has a special interest in life insurances and has been trying to attract the know-how and financial strength of foreign insurers. Ownership for life insurance will be permitted to 50 per cent, while reinsurance has been fully opened to 100 per cent ownership. This shows that the government follows a very aggressive strategy towards local companies: they enjoy less protection from foreign competition than banks. But insurers are still sceptical, remembering that in Japan, a long-time WTO member, they haven't reached more than 7 per cent market share.

Summary

The WTO will make it easier for foreign enterprises to enter the Chinese market. However, the speed of the opening-up depends on four factors that the Chinese government has to consider:

- useful reform pressure through a rising number of foreign enterprises;
- protection of local industry;
- healthy consumer behaviour through falling prices;
- international competitiveness for foreign investors.

Examples such as Japan and South Korea suggest that the contract will hardly be followed in every detail – generally at a disadvantage to foreign companies.

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1.8. What role does the stock market play in China's economic development?

Many analysts underestimate the trade volume of China's stock markets and the role it plays in the country's economy. In the 1920s and 30s, Shanghai already had the world's third largest stock exchange after New York and London. And it is well on the way to regaining that position. If you add up the market capitalisation of the partner marketplaces of Shanghai and Shenzhen, China is already the number three in Asia with a market capitalisation of 580 billion US dollars in 2001. Only Japan's Nikkei Index and Hong Kong's Hang Seng are stronger. But it has to be taken into consideration that about 30 per cent of the stocks traded in Hong Kong are Chinese and will in future probably be traded in China as well.

The most important questions

- What are the problems of China's stock market?
- How strong is the reform pressure on the government?
- How is the government cleaning up the stock market?
- Why is a modern stock market important for foreign companies?

China's stock market has a huge potential. Although at about 40 per cent China has one of the highest saving rates in the world (in 2000), only 4 per cent of Chinese citizens own shares. At the moment, the stock market has an annual growth of 12 per cent, accelerating quickly.

Present problems

But there are several good reasons why the Chinese stock market is only slowly winning the attention of investors.

- Of all listed companies 90 per cent are state owned enterprises; 62 per cent of all stocks belong to the government. Even, the English language party mouthpiece *China Daily* complains: 'The management of listed companies is bad because the state holds the majority.'
- Foreign company's stocks are still not being traded in China. Only a very small amount of shares, so-called B-shares, are available to foreigners and traded in US dollars.
- The daily B-share turnover of 20–60 million US dollars is relatively small.

- Few stocks compete for a lot of capital. In such a so-called liquidity-managed market, single stocks are not too closely analysed, because high turnover has to be achieved anyway.
- Reliable rules, such as the ban of insider trading, are still not the standard for Chinese traders. Dealers arrange prices; funds trade stocks back and forth to raise the trade volume and details of major sales are agreed on in bathhouses.
- Although some progress has been made, most companies still lack modern management.
- Transparency is insufficient. The accounting standards do not give a realistic picture of the companies. The reason: most of today's managers grew up to meet the demands of the central planning commission.

A short overview of the last rallies shows even better, what is still going wrong on the Chinese market:

Red-chip rally (1997)

The first impressive rally of Chinese stocks happened on the Hong Kong stock market. Shares of mainland Chinese companies traded in Hong Kong are called 'red-chips'. They even have their own index, the so-called Red-Chip Index. The listed companies are usually subsidiary companies of big state owned enterprises. They had their first boom in 1997, shortly before the crown colony was handed back to the People's Republic. High hopes for the companies' good political connections sent share prices soaring. Conglomerate China Enterprise's IPO, for example, was oversubscribed 1,300 times; however, the company was not a big success, showing a poor performance and proving that government relations alone do not make a successful company.

WTO rally (1999)

The mainland's stock market had its first big rally at the change of the millennium, shortly after dramatic negotiations led to agreements with the United States that finally put China on track for WTO membership. The general expectation that this would benefit the economy was enough to start the rally, which gained an extra momentum through the New York Nasdaq rally. But it was like betting on a horse you don't know just because the climate is good for fast running.

Market liberalisation rally

In February 2001, China's stock market experienced another big upturn when the government allowed Chinese citizens to buy B-shares (traded in US dollars) that were previously only available to foreigners. Thus the government successfully raised the trade volume because Chinese people rushed to invest their savings on the stock market. In March of that year, the 35 billion US dollar-strong B-share market had already by far exceeded the A-shares, although ten times as many companies are listed there. While the rest of the world was falling head on into a recession, China's boom just wouldn't stop. The Chinese, who still have few investment options, didn't worry when P/E rates of 15 to 20 suddenly rose to 50, although 90 per cent of listed companies belong to traditional industries that usually don't perform exciting growth leaps. While inexperienced investors had already spent an estimated 1 billion US dollars on the stock market, many foreign investors – mostly professionals – found it too risky. Before China opened the B-share market for locals, 30 per cent of these stocks were in the hands of foreigners. This rate has dropped to 10 per cent. Where the Chinese are ready to burn themselves, foreigners leave the casinos.

WTO rally (2001)

In May 2001, another tide of success rolled over the country, after China and the European Union had solved the final issues for China's WTO accession. About 20 local insurance companies, which had been promised months ago they would be allowed to set up China stock funds, got more space through new regulations, which further fuelled the rally. Until now, only 3.5 per cent of insurance companies' assets were invested in stocks, making up for around 1 per cent of stock market capitalisation. Social security and pension funds were also set up.

Reform pressure

What kind of pressure forces the government to quickly reform the stock market? There are three reasons:

- The government needs a booming stock market to finance China's social and economic reforms. A reliable growth in the stock market stabilises China.
- The degree of the stock market transparency and profitability will be an important indicator for foreign analysts to evaluate the development of the Chinese economy in the coming years.
- Chinese people save about 40 per cent of their income, adding up to total savings of 850 billion US dollars. The government wants to see this capital invested on the stock market.

Importance for foreign investors

The stock market will be of growing importance for foreign enterprises: share offerings will provide them with a new alternative to raise local currency capital. Currently, they can only do so through joint ventures. Stock offerings will make them less dependent on underdeveloped Chinese state banks or western banks with subsidiaries in China, who can only offer Renminbi loans with less favourable conditions. But what is even more interesting is that western enterprises will be able to buy their way into profitable state owned enterprises, or they can buy out their Chinese joint venture partners. Such Chinese companies under new western leadership will be the snips for western investors. These options, however, will only become relevant when the IPO market is liberalised.

Cleaning up

In 2001, after four years of successive losses, Shanghai Narcissus Electric Appliances had the dubious honour of being the first company to be banned from the stock market by the China Security Regulatory Commission (SRC). This was seen as a warning that showed the central government's determination to put an end to messy stock trading.

The reform pressure on entrepreneurs should not be underestimated. Those who are too slow to comply with international standards of transparency will not stand the pressure of competition. Multinationals are all ready to list their Chinese subsidiaries and will steal the show from local corporations.

Companies that are too slow in reforming themselves are the shelf-warmers of old times and the government can only sell them at bargain prices. Sooner or later, Chinese investors will see that a well-managed company might be slower developing at the beginning, but will soon be far superior to the alleged snips. The China Securities Regulatory Commission has already been restructured under the guidance of Hong Kong experts. Progressive opening of the market is hoped to get China's stock market used to international standards. Certain amounts of A-shares, which are currently reserved for local investors, will be made available to so-called 'qualified foreign investors', which are common for example on the Taiwanese or Indian stock exchanges. Foreign brokerages will soon be allowed to trade in Shanghai and Shenzhen. Both markets will be unified to form one big trading place.

Under such pressure, the China Securities Regulatory Commission has set itself the goal to push government-owned shares under 12 per cent. Some government shares will probably be used to set up a social security fund. The most important sign, however, is the government's determination to crack down on corruption. Market manipulation is often exposed in state media. Courts have started correcting the government's licensing procedures. Foreign brokerages and investment banks are all set to enter the Chinese market. In Shanghai in 2001, 30 of them were working out strategies for the time when China opens up its markets. It will take until the middle of this decade for the market to be at international level.

Summary/Recommendations

The Chinese stock market is not far away from reaching international standard and is therefore becoming more and more interesting for investors. Still, the government urgently needs a modern stock market to finance the reforms. Recently, quite a number of regulations and control organs were established to get the stock market on the right track. Foreign enterprises will then have new possibilities to buy themselves into Chinese companies or use the stock market to get local currency capital.

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1.9. How will the Internet change China?

'Chinese will be the No 1 language on the World Wide Web by 2007' is the slogan of a leading international consulting agency's worldwide advertising campaign. The ad probably overestimates the expansion of the Chinese language. At the beginning of the decade, 8.8 per cent of all Internet users spoke Chinese, compared to 57 per cent of native English speakers (2001).

But this does not mean that the potential of China's cyber-world is small. At the end of 2001, the United States had more than three times as many users as China (119 million and 33.7 million respectively). But with 46 per cent of Americans already online, US growth is slow, while China at 2.8 per cent is still at the beginning of its boom. Furthermore, the Internet's impact on social development is much stronger in China than in western countries.

The most important questions

- Why could the Internet have a stronger impact on China than on western countries?
- How does this impact show?
- What possibilities does the Internet offer for western companies?
- How does the government regulate the Internet?

Even during the 2001 global cyber slump, China's Internet usage grew by 50 per cent. Traditional infrastructure is still underdeveloped: Therefore, be it for the modernisation of state owned enterprises, cross-linking companies (B2B) or knowledge transfer, the Internet is a relatively easy way to build up new systems, skipping traditional technologies used in developed countries.

Modernisation of state owned enterprises

The Internet offers astonishing solutions for the reforms of state owned enterprises (SOE). While latest technology is only slowly being implemented in western countries because many companies are used to working with older, expensive systems like SAP, new Internet solutions are without competition in China. The catchword is EDI-Web – electronic data interchange.

EDI-Web needs nothing but a computer and Internet access to connect a company with all its suppliers, distributors and different departments. For example suppliers can handle the whole business process from order to settlement through a website instead of having to use an expensive direct line or a special software. Joint venture partners can synchronise their accounting without sitting in the same office.

At the centre of the system is a main server that all users can access via Internet. With most of China's hinterland having stable Internet connections, this poses no problem. The advantage: the software does not need laborious installation in every single company, and the computers do not break down because of misuse or lack of service. Little training is needed, with software and hardware centrally maintained; costs for every single company are low. For China's state owned enterprises this technology could mean a breakthrough because it only takes a relatively small investment to catch up with international IT standards, making them more competitive.

B2B

Chinese business to business benefits from the country's huge demand for the exchange of goods. In order to get political backing and easy market access, most B2B forums have forged alliances with influential state institutions. For example, Guangzhou-based Hong Kong Internet company Chinaproducts.com has teamed up with the powerful China Council for the Promotion of International Trade (CCPIT), and Meet.China.com has an alliance with the Ministry of Information Industry. However, the web is useful for making first contact, maintaining established business ties, and to a certain degree for finding new clients. Getting to know each other well on the web is impossible, though, as nobody will order 200,000 drilling machines without knowing the factory and its manager.

B2C

Although China's potential for the business to consumer sector is huge, there are too many problems that still have to be solved. Credit card payment is difficult. Fearing that someone else might hack into their bank account, many users refuse to reveal their card number. And after decades of inferior products of unreliable quality, Chinese customers are still not used to buying something they haven't seen and checked. Before B2C really takes off in China, consumer habits will have to change.

Learning

The Chinese are eager to acquire international know-how and are willing to invest a lot of time and money. As many regions of the country still lack facilities for advanced or professional training, the Internet is a good option. According to a 2001 survey conducted by Hong Kong-based Internet Network Information Center, 25 per cent of Chinese users claim that they mainly use the Internet for educational reasons. Already there are more than 200 online schools, including numerous business schools. Fifty per cent of users believe that online schools are the greatest opportunity the Internet has to offer. People use spare time in the office to get an extra degree or qualification, with some employers even willing to pay for it. Furthermore, the Internet is a very useful tool for acquiring traditional knowledge sources: 46 per cent of users say they want to use the web to purchase books or magazines online. At 50 per cent, only computer products get a higher rating.

Political regulations

In 1994, the Chinese leadership realised it had run into a dilemma with the fast-growing Internet: it wanted to make the best economic use of efficient mass communication systems, while at the same time not relinguishing the information monopoly. China's politicians were aware of this conflict of interests, but did not want to sacrifice one for the other. Eventually the state council passed control regulations in 1996 that it was hoped would guarantee a 'healthy development' in the information age.

- All networks and their 20,000 users had to register again.
- Choosing a wording that countries without a strong legal system like to use as an all-purpose weapon for interference, the regulations made it clear that the government would not tolerate any activities that 'endanger state security or state secrets'.

Six months later sites containing 'critical content' were blocked: US media, Chinese language information on Taiwan, China-critical news sites from Hong Kong, dissidents' sites and pornography. Never before has a state tried practising such all-round control of the Net. But such tight control was hard to keep up for any length of time. The Net grows at such a speed that, in the long run, only random checks will be practicable. Today, almost every village has a telephone line and Internet access.

Thus, a big Internet crackdown in 2001 was of limited success. User information has to be saved for 60 days. Systematic surveillance of China's 33.7 million users and all e-mails is impossible. The government still blocks websites, but its firewalls are not able to fend off the avalanche of new pages. Internet cafés that lack an official registration are shut down but soon reopen somewhere else. Chat-rooms have become the country's main forum for occasional criticism of the government, discussing corruption cases. Popular Internet portals sometimes even publish foreign news, which is almost impossible for newspapers.

The Internet industry regards these crackdowns as warnings rather than a real constraint on personal freedom. Total control of the Internet is impossible, and powerful institutions such as China's official news agency Xinhua have an interest in liberalising information policies. They want to make money out of knowledge and information transfer, which is only possible if they can quickly and independently report on business developments.

Three factors suggest that China could be the country that will be most influenced and changed by the Internet. In many areas, China lacks traditional infrastructure, making it easier to implement modern technology; China is so big, that the Internet is probably the only way of effectively organising data transfer; and, most importantly, China not only has high demand, but the market is booming and direct foreign investment is high, allowing China to implement and develop new solutions.

Summary/Recommendations

The Internet could have a stronger impact on China's society and economy than on western countries because the country lacks traditional infrastructure. For outdated companies, EDI-web solutions are a cheap and effective way to reach modern standards. Because of a general lack of educational institutions, the Internet is used by many Chinese to get professional training. B2B is a useful way to manage established business relations. The B2C sector is troubled by underdeveloped payment methods and the Chinese habit of not buying things one has not seen.

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1.10. Will tensions between Taiwan and the People's Republic increase?

China has been divided since 1949. During the civil war following the end of Japanese occupation during World War II, the communists managed to drive Jiang Jieshi's (Chiang Kai-shek) republican forces off the mainland. The *Guomindang* army was accompanied by most of China's business elite. Other's fled to the British crown colony of Hong Kong. While mainland China suffered under Mao's collectivisation experiments and was economically crippled until the 1980s, medium-sized industries brought Taiwan an unprecedented boom.

Today, Taiwan's computer and semiconductor industry has made the island an important player in the global economy. With only 2 per cent of the mainland's population, it generates a GDP of 309 billion US dollars – one-third of the People's Republic's. Taiwan has foreign reserves of 80 billion US dollars, 40 per cent of what China has in its treasure trove.

Most countries followed the example of the United States, who severed their diplomatic ties with Taiwan in 1972 in favour of China with its huge market and strong political standing. Regarded as a break-away and rebel province by China, Taiwan has been fighting for its political survival and independence ever since. There are almost no direct connections between the island and the mainland.

The most important features

- Why is the possibility of a war not very high?
- Which factors keep the two partners at bay?
- Under what conditions will the situation relax?
- What role does economic development play?

The relationship between Taiwan and China is determined by two factors that point in opposite directions and are getting ever harder to harmonise. The young generation of the 23 million Taiwanese show little interest in their ancestors and relatives on the mainland. They feel independent and have a Taiwanese identity. But the economies on both sides of the Taiwan Strait are growing together and have developed a strong dependency on one another. Despite the dividing aspects it is likely that the relationship could be stable for the next couple of years. There are several reasons.

The role of the United States

The United States plays the major role in maintaining this stability. The superpower wants to underpin its influence in the region and follows a simple strategy. In the official, diplomatic arena they stand by China with its huge economic potential, but backstage they grant Taiwan military assistance.

The US and Japan have no interest in any kind of reunification between Taiwan and China, which would give China a much stronger political and economic position not only in Asia Pacific. On the other hand, the US does not support a Taiwanese declaration of independence, which would lead to regional destabilisation and a restructuring of power. When former Taiwanese president Lee Teng-hui caused strong protests from Beijing in the late 1990s by talking about a *de facto* state-to-state relationship between Taiwan and the mainland, Washington refused him the hoped for support. Obviously the US wants to avoid China having its back up against the walls. US President diplomatically Clinton and Bush Jr even supported the 'three nos': no support for Taiwan's entry into the UN; no independence; and no entry into international organisations that demand national status.

But as long as the present power constellation is stable, strategic analysts see no reason for concern that the aggressive rhetoric and ritualised provocations from both sides could lead to a war. In February 2002, exactly 30 years after Richard Nixon's historic China visit, US President George W. Bush called on both sides to deepen their dialogue.

Possible loss of face for China

The more China is integrated into the global community, the higher the political and economic price China would have to pay for a sudden military attack on Taiwan. Acceptance of China as a reliable trade partner would suffer for years and western countries would impose heavy sanctions. Unless China is threatened by internal collapse and a war against a foreign enemy is the government's last chance to stabilise the country, the risks and costs of an attack on Taiwan already seem too high.

Economic approach

Meanwhile, the Taiwan boom seems to have reached its limit. The high-tech island has become too small and too expensive, so that Taiwanese companies now move their investment to the mainland. With Taiwan having modern technology and know-how, and the mainland having a huge market and cheap labour, the two parts of China complement one another well. The exodus to the mainland has reached quite a respectable size. In 2000, Taiwanese investment in China doubled to 2.6 billion US dollars. Consequently the growth of Taiwanese enterprises, in particular the big ones, lies in China. WTO membership of both China and Taiwan will invigorate this trend. Already, 300,000 Taiwanese live in Shanghai. The heir to Formosa Plastics, the biggest Taiwanese company, runs a joint venture with a company run by the son of China's President Jiang Zemin. With the help of Taiwanese companies, China has already outrun Taiwan as the world's biggest producer of IT products and will soon overtake Japan. Then only the US is bigger.

And it is not only production that moves to China for the sake of cheap labour. Boasting many qualified scientists that work for salaries far below that of their Taiwanese or western colleagues, China has also become an attractive base for the research and development departments of Taiwan's industries. With a population of only 23 million, Taiwan has a lack of young people. Schools and universities are not well known for promoting creativity and innovation. And compared to Shanghai, Taiwan's infrastructure is quite old fashioned. In this light, political confrontation seems to be a secondary problem. The latest economic crisis has accelerated the inevitable: Taiwan and China have moved closer together. However, there are still foreign enterprises that size up their investment in Taiwan and in return are punished by the Chinese by being barred from entering the Chinese market.

Most probably there will be a gradual change over the next few years. Politically Taiwan will neither be independent nor part of the People's Republic. Economically, the two Chinas will grow together. Taiwan's economic planners are already developing concepts to deal with this new situation.

Centre for regional headquarters

With its geographical location between Shanghai, Hong Kong, Seoul, Manila and Tokyo and its high living standard, Taibei is the ideal city for multinational companies' regional headquarters. However, western managers agree that it would only be practicable to move to Taibei if there was a direct connection to the mainland. Currently, flights between Taibei and Beijing are one-day trips, stopping over in Hong Kong where one has to change plane. Taibei's tough stance (no direct links) is starting to waver. Direct ship connections could run through one of Taiwan's off-shore ports. Taiwanese travellers have repeatedly succeeded in making their way from the small island of Matzu to the Chinese port of Xiamen. Airlines are getting ready for the next step. Taiwan's China Airlines has bought a 25 per cent stake in the cargo daughter of Shanghai's China Eastern Airlines.

Centre of innovation

China and Taiwan will probably see less and less sense in economic competition. Taiwan will have to act like a company that tries to stay first class in some selected technological fields. Thus, Taiwan will not be competing with China any more, a fight the small island would have no chance of winning anyway.

Summary/Recommendations

For western companies, the troubled relationship between Taiwan and China will gradually cease to be a problem. Political tension will ease off and economic co-operation will grow. The taboo of direct connections won't hold very long. Taiwan and China will grow together and form one big economic zone. Politically, the status quo is likely to be held.

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1.11. Is the gap between rich and poor getting wider?

In the past 20 years, China has experienced incredible growth. While per capita income was only 120 US dollars in 1980, it increased to 840 US dollars by the turn of the millennium. According to government statistics, 3 per cent of Chinese live in poverty today, down from 30 per cent in 1980. The growth has mainly been generated by Deng Xiaoping's opening policy of the early 1980. After the disasters of the Maoist era and the Cultural Revolution, his main goal was to stabilise the country politically and economically.

Pragmatic politics took over from ideological social experiments. Deng opened the country towards the western way of modernisation by gradually introducing a market economy and inviting foreign investors. The Chinese had to learn to fight for their own prosperity instead of relying on the state to provide them with everything. 'Who cares whether the cat is black or white, as long as it catches mice it's a good cat,' was Deng's credo that shocked communist hardliners. After two decades of Maoism, this sentence sounded quite sensational to Chinese ears. Critics warned of social injustice and saw Deng's policies as a betrayal of the communist ideal of equality, but Deng wouldn't listen to them. Still, he knew very well that a market economy and competition would not result in better conditions for everyone at the same time. Social injustice was inevitable, but convinced that it was the only way to revive the economy Deng, the pragmatic communist, coined the liberal phrase: 'Let some get rich first.'

The most important questions

- Is the gap between rich and poor increasing despite constant high growth?
- Why is the country still stable?
- How predictable are future social tensions?
- Which are the groups that most depend on social stability?
- What measures does the government take?
- Which role do the young urban elite play?

Less poverty

Deng's economic policies brought to an end a turbulent century and gave China two decades of social stability and economic growth. Today, China's economic situation is better than ever before. At 840 US dollars, average per capita income is still modest by international standards, but only few regions still suffer real poverty. The Human Development Index has reached 70.1 per cent and GINI currently stands at 40.30. The social situation still is mostly stable.

Wider gap

Nevertheless the gap between rich and poor is getting wider and wider. While the urban elite enjoy living standards quite similar to that of their western counterparts, many of China's 800 million peasants are still poor, even if they are now better off than they used to be. In 2000, peasants' per capita income grew by 2.1 per cent, reaching an average 270 US dollars. Ordinary city dwellers earned an average 760 US dollars, up 6.4 per cent, while Shanghai people go home with 4,200 US dollars. Tensions are obviously growing. Criticism voiced by Deng's opponents at the beginning of the opening policy is more justified today than ever before. Is China heading towards social upheavals because the gap between rich and poor is increasing?

No immediate danger

For the time being, there seems to be no immediate danger. Some China analysts have been warning for years that China is heading for serious instability, but until now everything seems to be under control. It is therefore interesting to analyse why the country has stayed relatively stable, even though the opposite has been predicted so many times.

Several reasons have to be mentioned:

- The fast growth of the coastal regions does not imply that the West has no growth at all. There are exceptions, but usually stagnation is as bad as it gets. Most people have felt some improvement over the last couple of years. For the time being, this is obviously enough to keep the people more or less quiet and peaceful.
- The Chinese are much more willing to resignedly accept their fate than modern westerners. Many people still keep telling themselves: 'I myself can't change much, anyway. Today my life is better than it used to be, and with a little bit of luck there will be some improvement in the future.'
- The success of boom-towns like Shanghai does not necessarily lead to jealousy. Just like the 2008 Olympics in Beijing, success is also seen as a symbol of national pride country-wide.
- The Chinese are very flexible. They are willing to accept a small solution rather than waiting for a big coup or other people's help.

The Chinese government has shown violence and arbitrariness towards the student movement in 1989 and the Falun Gong sect since 1999. It is prepared to do anything in order to suppress mass movements that could destabilise the country. All potential movements are suffocated at once – and everybody in the whole country knows that. Therefore, people think twice before publicly voicing their criticism and organising demonstrations.

- Those who stage mass demonstrations are modest and avoid major provocations. They protest against local problems without holding the central government or the system as a whole responsible. Alternatives to the current system do not play a prominent role in the life of average Chinese.

Summing up, the relationship between party leadership and the people can be characterised using a football related metaphor. There is only one team playing in the premiership, but the fans still support it even if it occasionally loses by scoring own goals. Fans hope the team will be more successful in future; after all there is only one team they can pin their hopes on.

Nevertheless, China seems to be more stable than other Southeast Asian countries such as Indonesia or the Philippines.

Near future

Nobody, not even the government, can know when the people's flexibility will come to an end and the current united-front breaks apart. It is also difficult to predict how the situation will change when more state owned enterprises are shut down or when Chinese peasants lose the basis of their income after WTO entry (China's agricultural products are one-third above world market prices).

Which groups does social stability mainly depend on?

The most problematic group is the floating population of more than 100 million, mainly peasants. Even though they are not very well respected, they are more successful than the state wants them to be, more multifaceted than government propaganda proclaims, and more capable than the police admit. They are not only mobile and flexible; they are clever enough to take their lives into their own hands. Having opted against badly paid fieldwork, they are a very heterogeneous lot: migrant worker statistics include students and flower girls, accountants and actors, garbage collectors and restaurant owners. By the beginning of this decade, an estimated 2.5 million of the 12 million people living in China's capital Beijing, were migrants: 80 per cent are under 40 years of age and most of them can read and write. Those who are successful will stay; more than half of them spend more than a year in Beijing, with one-third staying for more than three years. In Beijing, many of them already belong to the 'small healthy one's', as the well-off middle class is called. Although they are officially registered as living in the country, they have even opened their own schools, because migrant-worker children from outside the city are not permitted to attend the regular local schools. The losers amongst the migrant workers are those that do not manage to set up a network of relationships. Many come to the cities through agents that tell them tall tales. Some don't succeed in getting a grip anywhere and are doomed to travel from one construction site to the next.

It will become harder to belong to the winners because competition with city dwellers is increasing rapidly. A study by the European Union suggests that WTO membership will cause at least 13 million peasants to lose their jobs because their small fields will not be able to compete with big farms in Europe or the US. Some experts predict that privatisation of state owned enterprises might lead to as many as 50–60 million additional migrants heading for the big cities. Women and children staying in the villages will be left with the hard fieldwork. By 2010, 520 million Chinese, or 40 per cent of the population, are expected to live in cities. Currently, the quota stands at only 20 per cent.

City governments' strategy

The city governments try to solve the problem with three short-term strategies:

- in order to get an overview, all migrants have to register;
- migrant workers will be legalised, but they will have to apply for work permits. The goal is to make successful workers official, tax-paying city citizens;
- deterrence through crackdowns: the city governments want to spread the message that it has become very difficult to be successful in the city.

This approach has many problems, but one big advantage: China's mega-cities have so far avoided slums, which are part of many big Southeast Asian metropolises, such as Manila in the Philippines or many big cities in India. Also, Chinese cities are relatively safe.

Central government's strategy

The central government tries to develop China's west in order to make it less attractive for people to migrate to the coastal boom-cities. This includes large-scale infrastructure programmes as well as tax privileges and special economic zones. Some foreign companies that try to enter the Chinese market will only get the necessary license if they are willing to set up their production plants in the west or at least the country proper. Some big companies such as airlines attempt to relocate 'back office' work that is labour-intensive but requires no high qualifications. As long as the necessary information technology is available, this approach is quite practicable.

After having been neglected for the last 20 reform years, the development of the west is now proving to be extremely difficult. Infrastructure is underdeveloped, enterprises are outdated, social values are old fashioned and purchasing power is low. Many clever young people head for the big cities, leaving behind the less qualified, non-flexible ones.

Urban elite

The emergence of a new urban elite makes the gap between rich and poor even bigger. Having prospered only recently, they don't want to have anything to do with their poor compatriots. They earn an average monthly salary of 1,500 US dollars or more, speak English, drive their own car and invest money into education or trips to Hong Kong, Thailand and Singapore. While widely accepted in the US and Southeast Asia, they still fight the image of being mere assembly-line workers or blind followers of communist propaganda in Europe. Before, strong family ties used to guarantee that successful city dwellers would support a whole clan of relatives living in the country. But now, these traditions are breaking up. Young successful urbanites will only provide for their immediate family, while at the same time trying to preserve their personal flexibility and improve their economic situation. According to one survey at the beginning of the decade, 80 per cent of employees in Chinese enterprises and 75 per cent of employees of joint ventures dream of one day having their own company.

Summary

Although China has shown incredible growth in the last 20 years, the gap between rich and poor is getting wider. The life of the poor has improved to some extent but problems are likely to increase. The growing tensions are best seen in the plight of the migrant workers. How long the peasants will be willing to accept the growing injustice is hard to predict. However, a mix of pressure, lack of alternatives and identification with the central government have led to a resilience of the population that is higher than many analysts expected.

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1.12. What are China's future problems?

China has experienced the most unique growth in world economic history. But there is no doubt that China has a long way to go before it can count as a modern, international, competitive economic power. The aftermaths of Mao's painful social experiments are still much more evident than the jolly surface of today's new China would suggest. The most important and fundamental reforms, such as privatization of state owned enterprises, a social security network, modern financial institutions and a reliable, stable legal system are still in their infancy. While the turnover of China Inc. looks promising, its structure is still alarming.

The most important questions

- How far have China's reforms come so far?
- What kind of reform pressure is on China's leadership?
- Which reforms have not yet been completed?
- Which will be China's main problems in the future?
- What is the leadership's key dilemma?
- What weakens the fundament of future reforms?
- Which are the impacts on China business?

For most of the last 20 years, China's leadership liberalised the country's economy but was hesitant to take the above-mentioned reforms and tasks head on. With foreign investment pouring into the economic low-density zones of China, the pressure for those reforms was not very high; especially since foreign investors met a leadership and a people with a good feeling for basic business. In the 1980s and 90s, Chinese and foreigners teamed up to create a huge boom that even the Tiananmen crackdown could only interrupt for little more than a year. As long as it made sure the economy didn't boil over, the leadership was on the safe side.

The Asian financial crisis in 1997 and the global recession in 2001 were the government's wake up call. Weakened by external slumps beyond its influence, it suddenly feared it would lose control over the country and again face *luan* (chaos), a nightmare which has been the leitmotiv of modern Chinese history. Since China's entry into WTO, structural weaknesses have become even more visible and the fear rising. However, this fear has its favourable side as it forces the Chinese government to increase its reform efforts. Concern for the stability of the country, declining economic power and loss of face have always been factors that spurred Chinese leaders' ambition.

More than ever before, State President Jiang Zemin and Premier Zhu Rongji feel the pressure to quickly change this turnover economy into a sustainable one. At the same time they have to avoid that growing social problems that might endanger or destroy the country's stability.

Controlling this increasingly difficult constellation will also be the main task that their successors will have to tackle. The first decade of the twenty-first century will not be a decade of boom for China but of fundamental social and economic reforms, which will make business easier. After the Olympic games have been successfully held in 2008, an event of the utmost importance for the Chinese people's and leaders' national pride, that should pass without social disturbances, these will become the most challenging tasks ahead. It is likely that these problems can be technically solved: for most modernisation tasks, western blueprints are available, such as Germany's civil code, the US Federal Bank system, Hong Kong's stock exchange or Britain's social legislation. With international support, it should be possible to adapt these to China's specific needs. The most important question is whether the government can keep social stability during the time of implementation.

Even if these hurdles are successfully overcome, China is still not on the safe side. For the first time, China will have to solve problems that are without examples or ready-made solutions in modern civilisation. Questions like the following will be have to be answered:

- Does modern China have enough work for all its people?
- What kind of economy can prevent China and the rest of the world from sailing straight into ecological disaster? Where will enough water come from? What about energy?
- How can the exploding population be handled without interfering too much with modern Chinese people's wish for individual freedom.
- How will other countries deal with a Chinese economy that is becoming very powerful?
- How could a democracy for 1.5 to 2 billion people work?

An additional problem will make the life of the Chinese government harder: where challenges become more and more comprehensive, the scope of its political action is diminishing. The possibility of making long-term plans and taking immediate action, that dictatorships in booming countries have and that some western politicians envy, will shrink further and with it the means to make corrections.

This will be unavoidable for two reasons: on the one hand, with rising economic power the Chinese people will eventually ask for more independence from government restrictions. On the other hand globalisation is progressing, further impairing the sovereignty of national states and forcing them to follow common rules. This trend will be particularly strong in a country like China, whose ups and downs are of rising importance for the world economy. It will no doubt be tough for China's leaders to accept that their young, proud, national autonomy and power will have to be shared with others even before coming to full blossom. The greater China's economic success and the bigger its affect on the world, the more the Chinese government will have to share its power. Even in the best case, China's leaders will never be able to achieve the same amount of power as their colleagues in the US. Much rather China will be one of several big industrial powers competing with one another, while goes along with the Chinese government, concept of a multiples world circle .

But this could lead to new global conflicts: The fight for natural resources and its sensible use could take the place of the fading struggle between capitalism and communism or religious fundamentalism and liberal civil societies. The Afghanistan conflict might develop into a fierce battle between China and the US for oil and gas. Even if some problems can possibly be solved through technological innovation, such as hydrogen-powered cars, the Chinese population strives to achieve western living standards and will eventually demand its share of the world's natural resources, at least according to the size of its population. However, the Chinese government, already buying big oil and gas fields as well as forests in other countries, will meet no support from foreign governments because only a cutback in western living standards could give China the space it needs. Naturally, this is hardly acceptable to the West. This new global castellation is huge interest for business people because internationally operating companies and their businesses may get caught between the two sides.

Still, these future power plays should not shift the focus from China's currently most harmful weakness: its lack of what economists call 'social capital'. A lack of responsibility of Chinese individuals towards their country's economy is visible almost anywhere, mainly in spreading corruption, which is still the country's dominating problem. China's boom is built on one great weakness that puts all successes on an unstable foundation: the rapid development overstrains the people's ability to take responsibility for their actions. China's boom is built on a gold rush mentality.

While the hardware of technical modernisation is relatively easy to update, the software of modern mindsets, the social capital, takes much longer to develop. The dilemma: people are asking for more freedom, which means less control by the government. Less institutional control needs more sense of responsibility, but this develops too slowly in comparison with the impatience of the people and the speed of the boom.

It took western countries a long time to establish the standards for a modern society and economy, with mixed success and a constant danger of falling back. Unfortunately, China does not have the same timeframe. But it is not possible to modernise an economy without having responsible market players who act reasonably even without immediate control. In the first 40 years of the history of the People's Republic, the leadership tended to underestimate this problem: Mao Zedong failed several times with his mass education campaigns which relied too much on social reliability within a totally idealistic economy. But even in the second half of the 1980s, Deng Xiaoping had to witness how a wildly sprawling economy gets out of control if everybody does what he wants. Premier Zhu Rongji and State President Jiang Zemin also had to learn the bitter lesson that not only the losers of the reforms were against them in their goal to establish a clean, sustainable economy, but also the winners, who had made a fortune through corruption.

The lack of responsibility that China's leaders have to cope with is a challenge for China's managers as well. They have to deal with this problem in their daily work. Many joint ventures in China are in trouble because certain rules, which where taken for granted by westerners, were not at all common for their Chinese partners. Establishing a functioning corporate communication is therefore one of the most important preconditions for success in a Chinese business environment. Convincing your Chinese partners of voluntarily sticking to some common rules in order to keep their own position comfortable in the long run is one of the most difficult tasks. Neither China's leadership, nor western managers should hope for quick success. As long as human beings are concerned, there is simply no shortcut to modernity.

Summary

For most modernisation tasks western blueprints are available and they are relatively easy to implement. But there are other questions which are much more difficult to solve, being without examples or ready-made solutions in modern civilization. These questions are particularly serious as they not only affect China but also the whole world. The process of China's development is hindered by one great weakness which puts all successes on an unstable foundation: as massive corruption shows, the rapid development overstrains the sense of responsibility of the people. China's future development relies on progress in these critical matters.

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