Investing in China: Tackle the uncertainties

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INVESTING IN CHINA:
TACKLE THE UNCERTAINTIES

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CHAPTER I

INTRODUCTION: INVESTMENT ENVIRONMENT

AND MARKET DEVELOPMENT IN CHINA

'To give the Readers a general Idea of this charming country, we cannot
do better than quote the Words of a late Author, who, in his Account of
China, writes as followeth:

"China is justly reckoned the finest Country in the World. It is
exceedingly fruitful; the Mountains themselves being cultivated to the Top.
It produces, in many Parts, two Crops of Rice, and other Grain, with a
Variety of uncommon Trees, Fruit, Plants, and Birds. It abounds with
Cattle, Sheep, Horses and Game. It is full of large navigable Rivers, and
Lakes, stored with Fish. Its Mountains yield Mines of Gold, Silver,
Copper, brown and white, etc. with Plenty of Coals everywhere. Pe-che-li,
Kyang-nan, and Shangtong, are mostly plain, and cut into infinite Canals,
like Holland. Being of great Extent in Latitude, the Northern Provinces are
cold, the Southern hot; but the Air generally good. In short, China far
exceeds all other countries for Number of People, Cities, and Towns; the
Morality, Civility, and Industry of its Inhabitants; the Excellency of its
Laws and Government."

A Short way to know the World, quoted in Thomas Astley, A New
General Collection of Voyages and Travels (London, 1747)

INTRODUCTION

China is the world's largest and oldest society. It has about 5,000 years of
history, and a current population of 1.18 billion. It is also one of the largest countries
in the world, with land territories of about 9,600,000 square kilometers, close to the area
of the U.S. Before the industrial revolution, Chinese economy was well developed in
the world, as quoted above.
For several thousand years, China had evolved along its own path, in a unique self-containing, self-sufficient, and self-satisfied way, emphasizing stability rather than growth. Largely due to this inward-looking orientation, China missed the industrialization movement in the early nineteenth century, and experienced more than a hundred years of weakness, humiliation and isolation, along with constant domestic chaos.

Ever since China's recent economic reform began in 1978, the country has witnessed a period of rapid economic growth, and is now the world's fastest growing economy. Ironically, the International Monetary Fund recently reported that, adjusted by the purchasing power parity system, China came in an astonishing third in the world ($1.7 trillion), after the U.S. ($5.6 trillion) and Japan ($2.4 trillion), in 1991.

Although most people believe this is an overestimation of the Chinese economy, it clearly shows China's growing importance in world economic development. It is also obvious that the United States, which is by far the world's largest economy, and China will inevitably have to establish a close, strong economic relationship. In fact, Sino-US bilateral trade has grown from none in 1970 to over $36 billion in 1993. The same economic dynamics indicate that foreign investment, especially American investment in China, will certainly play an increasingly important roll in this relationship. However, due to the drastic differences between the two countries, there are many difficulties and confusions experienced by Americans doing business in China.

The purpose of this paper, accordingly, is to seek out a strategy for American investors to succeed in China. This paper is non-experimental, using secondary data as well as the author's personal knowledge and judgement. More attention will be focused
on selected macro-environmental issues such as inflation, politics and trade policies.

In this chapter, China’s evolving path regarding international business activities and various aspects of current investment environment and market development will be discussed. An outline of existing American investment in China and its current trend will be given in Chapter II. Chapter III will be focused on China’s high inflation in the last few years and its implications for American investors, as well as the depreciation of China’s currency -- Renminbi (RBM), which has resulted from inflation. In Chapter IV, the issues of China’s the "most favored nation" (MFN) status and US trade deficit with China will be examined. Conclusions and recommendations will be provided in Chapter V.

**CHINA -- BEFORE 1949**

An ancient Chinese philosophy goes that less desire is the only way leading to true happiness. In old Chinese tradition, a peasant family, which represented the majority of the Chinese people, was to process its own food, spin its own yarn, and weave its own cloth. It helps to explain the way Chinese people always tend to save instead of spend. The old Chinese market system was "quite complex, inefficient and highly fragmented."1

Until some 200 years ago, the Chinese had little knowledge about Western countries. Aside from some missionaries whose activities and influence were very restricted in China, virtually the only contact between the two sides was between Chinese and western merchants trading in Canton. Merchants were regarded as disreputable,
having only limited influences through corruption with government officials. Trade in Canton consisted largely of Chinese export of tea, silk, etc. There was no foreign investment other than some trade outlets in Canton.

The Opium War (1840-1842) opened more Chinese coastal cities for international trade. Trade regulations were also eased by the Ch’ing court. But demand for foreign goods was still very small. By the end of the nineteenth century, all major western powers (except the U.S.) had secured their spheres of interest in China under various unequal treaties resulting from various wars. China was brought to the brink of partition.

In 1895, China and Japan signed the Shimonoseki Treaty to permit Japanese-owned manufacturers to operate in China. This right was soon extended to other countries. This treaty could be considered as the official beginning of foreign direct investment in China.

The early foreign investments were heavily concentrated in the so-called "treaty cities" in Northeast China (Manchuria) and areas around Shanghai, where foreigners created a mini environment for themselves and stayed out of the Chinese government’s touch. The major players included Great Britain, Japan, Russia, and the U.S. They made good fortune in China, but not as good as what they had hoped, as China in general was so poor.

The 1911 revolution brought down the Ch’ing dynasty, giving birth to the Republic of China (ROC). The ROC was confronted by continued domestic chaos between local warlords, the governing Nationalist Party and the Communist Party, in
addition to an eight-year war against Japanese invaders. Severe government corruption did not help. The economy finally collapsed in the late 1940s, leaving behind "over 500 million people who were poorly fed, clothed, and housed and ... a per capita GNP that was less than 50 U.S. Dollars." At that time, industry still accounted for only a very small fraction of the total economy. The country saw little fundamental social or economic change.

From 1840 to 1949, numerous war indemnities drained China's financial resources, leaving the government incapable of investing to support economic growth. The old Chinese tradition prevailed, especially in the vast inland countryside. Finally, the fact that modern industry forced its way into China and was dominated by foreign powers caught the Chinese in a dilemma between patriotism and economic development.

COMMUNIST CHINA -- 1949 TO 1978

The Chinese Communist Party (CCP), when emerging in the early 1910s in the wake of the Russian Bolshevik Revolution, mostly recruited support from intellectuals who were aware of the social illnesses and looking for alternative solutions. After the 1927 crackdown by the Nationalists, CCP turned to peasants and began to pursue armed struggle in the countryside. It successfully drew vast support from peasants and factory workers by advocating land-ownership reform and labor rights, and generally attacking the wealthy and supporting the poor.

The Communist Party strengthened its position during the resistance against Japan. It took full advantage of the economic collapse and the Nationalists' lack of
leadership, eventually driving the ROC government to Taiwan. On October 1st, 1949, Mao Zedong, chairman of the CCP, announced the foundation of the People's Republic of China (PRC).

As the communists came into power, Western investors fled the country and never came back. China later broke away from the Soviet block over ideological and regional interests disputes. Despite its domestic difficulties, China had to pay-off all Soviet credits before the scheduled time. The Chinese leaders vowed that China would never use foreign debt again. On its own, China established a relatively complete, independent but inefficient industry system, through consistently high capital formation rates and centralized, large scale mobilization of resources.

In this period, the Chinese domestic market was undermined by the command economy of central planning, price fixing, and rations for virtually all commodities. Several pragmatic reforms took place but all have short-lived, due to intensive internal political struggles, including the most damaging Cultural Revolution from 1966 to 1976. In announcing the termination of the Cultural Revolution in 1976 after Mao Zedong's death and the fall of the ultra-leftists, the party leaders admitted that the economy was at the brink of total collapse.

It should be noted, however, that some features of the command economy did fit well with the old Chinese tradition. For instance, the profit and expense control policy, which required all work units to hand over all of the differences between revenues and expenses to the government and only spend whatever the government permitted them to spend, has been justly accused of suppressing economic dynamics. Yet it was consistent
with the traditional common practice of consolidating an entire family’s income under the control of the family head. Given the large size of a traditional Chinese family, it was essentially a mini sample of the profit and expense control system. The Chinese effortlessly applied many family management terminologies, such as "mother in-law and daughter in-law relations," to the national system and found most of them valid in substance. It was too convenient a way for the peasant-turned bureaucrats to resist.

On the other hand, even before the reform, the Chinese economy differed from the typical command economy. There was much initiative from "below." Eckstein reported his observations in late 1972 of the burgeoning of small and medium scale industries in rural areas, relating this to the development of small scale industry in Japan. This phenomenon was actually a very localized practice. There was also more formal or informal interaction between those outside and within the bureaucracy. Accordingly, problem solving was often accomplished through consultation and negotiation rather than through a set pattern of rules and procedures. Communist ideology applied in power struggles, but more often than not in practical matters. Therefore, there was more room for local autonomy, making it possible for the reform to succeed, but also creating confusions for foreigners.

**IMPLICATIONS OF THE HERITAGE**

The above discussion suggests that, firstly, although a command economy is obviously inefficient and bound to fail, it has deep roots in the Chinese tradition. Thus it will be very difficult to transform China into a market economy. It has to be done
under pressure, and it will take time.

Secondly, while the Chinese have recognized the need for advanced technology and economic growth, thus the need for foreign investment, there is deep-rooted and widely shared suspicion about foreigners, their motives, and their activities because of history. And Chinese people are very good at remembering their history. The only way to overcome this suspicion is for both sides to work together closely, respect each other, and try sincerely to understand each other.

CHINA AFTER 1978

In late 1978, the sweeping economic reform began. Unlike any earlier pragmatic efforts, this reform has been decisive on at least two fronts.

Firstly, it has recognized material incentives as an important drive of economic performance. The Production Responsibility Program, the Production Contract Program, and then the Profit Detention Policy have evolved based on such philosophy, allowing differentiated compensations based on work performance as well as for enterprises to retain a certain portion of profits. As profits became the concern, in 1984, the State Council issued provisional regulations to expand the autonomy of enterprises. From there began the campaign of transformation from the command economy to a market economy.

Secondly, it opened China's door to the outside world again. As soon as the reform began, China found itself in need of foreign capital as well as technology. 1979 witnessed the introduction of China's first Joint Venture Law. In practice, Sino-foreign
joint ventures with foreign stakes less than 50% were allowed. Later, foreign stakes over 50% were approved. In 1986, the Chinese government published the Provisional Regulations on Foreign Ventures to allow sole foreign ownership of enterprises in so-called "open areas."

Along another line, the creation of special economic zones (SEZs) beginning in 1980 also had very significant effects on the forthcoming social and economic changes in China. Among them Shenzhen is the most famous one. The SEZs were created to attract foreign investment, and they did. It was also in SEZs where the free market took the initiative, demonstrating the benefits of having an open, market-oriented economic system in place, as well as the importance of having foreign capital and technology available. In 1993, Shenzhen became China's No. 1 exporter, exporting goods worth $8.3 billion. Aside from the economic success, the SEZ experiment also paved the road for the opening of fourteen coastal cities in 1984. In 1985, the open policy was extended to the entire Yangtze Delta, Zhujiang Delta, and the "Golden Triangle" (Xiamen, Zhangzhou, and Quanzhou) in southern Fujian Province. These "open areas" represented approximately 49% of the total labor force in the light industry sector, 51% of total fixed assets, and 55% of total GNP in China.6

In the early years of the open policy, a major part of foreign capital made available to China was passive, such as government loans (dominated by Japan), loans from international institutions like the World Bank, and various commercial credits.7 The early direct investments were mostly made by overseas Chinese. Emphasis was mostly placed on using China's cheap labor, land, and natural resources. The Chinese
government granted tax and tariff relief, and some other incentives such as market protection to foreign investors in the "open areas." However, foreign access to the domestic market was strictly limited. Balanced foreign currency budget was mandated. An investor had to export enough products to bring in foreign hard currencies to pay for imported equipment, material, and foreign personnel's salaries. At this stage, the norm for investing in China can be described as "to be close to the resources."

These early foreign investments successfully boosted China's export and brought in hard currencies. In the mid 1980s, the government regained confidence in using foreign capital. China called for greater and faster utilization of offshore capital, and promised to open its domestic market to attract more investors. Inspired by the great success in SEZs, and realizing that the long-told myth of the huge Chinese market might finally come true, foreign investment began to flood in. This movement greatly helped push the reform all across the coastal areas, and then in hinter-land areas.

Even the 1989 Tiananmen crackdown put only a temporary halt on the capital inflow. In 1992, nearly $60 billion-worth of foreign direct investment (FDI) was contracted for and more than $11 billion-worth actually delivered. In 1993, contracted overseas capital reached $1.23 trillion (a 76.7% increase over 1992), actual inflow was $36.8% billion, up 91.5%. New FDI contracts worth $1.11 trillion, and actual inflow reached $25.8 billion, up 90.7% and 130%, respectively. By the end of 1993, the number of foreign-funded enterprises exceeded 167,500. Foreign investors now consider investing in China as to be close to the market, and to follow the competition.

Understandably, the investment environment in China is still far from satisfactory.
Many foreign investors are quite frustrated. Even Taiwanese, who are considered to be the closest in nature with the mainland Chinese and thus should have fewer problems, are complaining.

In 1991, Su-Wei Hu reported the obstacles experienced by Taiwanese investors on the mainland as: lack of infrastructure and raw materials supply; government control; inadequate legal system; fluctuating political situation; hidden operating costs; poor labor quality; and monetary and banking problems.\textsuperscript{10} The author of this paper agrees with this observation, and suggests that many of these obstacles still remain as major threats to foreign investors, while the overall environment has greatly improved.

As far as American businesses are concerned, issues regarding the investment environment in China falls into three categories. The first is political, such as policy stability, gaps between the two legal systems, and China's "Most Favored Nation" (MFN) trade status with the U.S. The second is economic, such as monetary issues, infrastructure, labor, etc. The third is about communication and understanding, such as language, social and cultural differences. While the last factor is not the least important, and will be referred to frequently, this paper is to focus on the first two factors.

\textbf{POLITICAL STABILITY}

The greatest concern about China has always been its political stability because of the country's past history. So far, the reform has survived setbacks as severe as the 1989 Tiananmen Crack-down. But as China's paramount leader Deng Xiaoping is aging, many people worry about the future of the reform. It will be unrealistic to expect no
difficulties, even setbacks, down the road as China has yet to be integrated into the international society, but from a long-term point of view, China has already passed the point of no return.

However, this author does see widening gaps between the newly rich and the poor as well as between coastal and hinterland areas as major threats to China's domestic stability. Western observers and Chinese leaders all agree that the solution to this problem can only be further reform. The difference is that the West insists on immediate political reform and the Chinese government does not agree. As the economic reform continues to produce a larger and stronger middle class, political reform is inevitable. This has happened in the Republic of Korea and Taiwan. On the other hand, referring to Russia's recent experiences, "shock therapy" could mean a disaster. This author believes that a smooth transition is essential to the benefit of both China and the whole world.

LEGAL AND REGULATORY UNCERTAINTIES

In a common law country like the United States, contracts tend to be very detailed, spelling out all contingencies. The Chinese legal system is closer to the civil law system, in which contracts tend to be shorter and less specific as many of the issues covered in a common law contract are actually included in the civil code.

However, although the government is pulling out laws and regulations at a full speed, business activities in China are not well regulated. This situation makes a loophole between the two legal systems that foreign investors have to keep in mind. In
addition, although China has a long history of established legal system, law enforcement records are not as good. Chin-Ning Chu, author of *Thick Face, Black Heart* which is the best-selling book on strategy in Asia, pointed out that "Chinese culture is based on an agricultural society. It is a economy of favors running back and forth. If your counterpart in a business deal won’t do something he’s supposed to do by agreement, you don’t sue. It’s too hard to get justice. You find someone who owes you a favor -- who is himself owed a favor by your counterpart in the deal. Your debtor gets your counterpart to perform for you."  

To make things more complicated, an old Chinese saying goes "the sky is high, the Emperor is far away." The local authorities always have a tendency of playing games with the central government to look after their own benefits while they are getting more and more autonomies as reform goes on. Local regulations and provisions, which may differ from area to area and often do not agree with the central government, can be expected to be enforced more strictly. For instance, SeaLand, a U.S. shipping company, was blocked from providing trucking services from Hong Kong to Guangzhou by the Guangdong provincial authority, against an agreement between U.S. and Chinese governments.  

This kind of uncertainty is an especially great disadvantage to small, passive foreign investors who do not have the "right connections" or do not have resources to acquire sophisticated knowledge about Chinese socioeconomic background. On the other hand, the fact that many foreign businesses are doing well suggests that this difficulty can be overcome with greater precautionary measures and efforts.
It will take a long time before this obstacle can finally be removed, as it is a problem deeply rooted in China’s social and cultural heritage. But things are moving in the right direction. On the other hand, opportunities come together with risks. It would be too late for an investor to wait until the problems are all solved.

BANKING, ACCOUNTING, AND TAXATION SYSTEM

A major implication of the legal and regulatory uncertainties in China is its inadequate banking, accounting, and taxation systems. While China’s existing accounting system has created difficulties and confusions in integrating the Chinese economy with the international system, its lame-ducked banking and taxation system has been a major factor of the high inflation problem.

In late 1992, the government launched a campaign to reform its financial and accounting system. In March 1993, following the example of Shenzhen, unification of the taxation system began. It has also been decided that the specialty banks be commercialized. On Jan. 1, 1994, China adopted the single market foreign exchange rate system, abandoning the long existing government mandated exchange rate system. Although there is still a long way to go, these are all moves in the right direction and have received praises from the international community.

INFRASTRUCTURE

China lacks basic infrastructure facilities, especially power supply and transportation. Recently, this situation has in fact become one of the greatest
opportunities for foreign investors. Recently, China has gradually opened its infrastructure industries to foreign investment. In fact, highway construction, power plants and telecommunications facilities all became the focus of foreign investment in 1993.

In highway construction programs, over $1.7 billion foreign loans have been used for more than 7,000 kilo-meters of highways, along with $500 million for several first-grade highways. Another 1,000 km of highways are planned for 1991-1995. In recent years, World Bank loans have become one of the most important financial sources for funding highway construction in China.

American companies have also taken a major position in China's infrastructure development. Some details will be provided in the next chapter. However, the long-term perspective of foreign direct investment in this sector will largely hang on the future development of domestic infrastructure regulations.

HUMAN RESOURCES

The common wisdom is that China has a cheap and abundant labor force. It is true that Chinese workers receive lower pay. But Chinese employers usually provide employees with various benefits such as free health care, free child day care, pension, and very cheap housing. So foreign companies not providing these benefits has to pay much higher wages to attract and keep skilled workers. In the end, savings in labor costs might not be so significant, especially in coastal areas, as some foreign investors have discovered. This is a good example of the "hidden costs".
Yet Chinese labor is indeed not expensive, especially when it comes to well educated, highly skilled labor. China has a huge number of scientists and engineers. This is a great advantage which has not been fully taken by the industry. According to Theron Fok, general manager of IBM’s International Software Development joint venture in Shenzhen, Chinese programmers can do the job at one quarter to one third the cost of programmers in North America. At Legend Group, a Hong Kong computer maker, all but five of its about 30 engineers are from China. Those who deal with Legend are very impressed. "If they have a new motherboard, they can make five prototypes and decide at the last minute which one to produce," says Stacy Fender of software house Phoenix Technologies of the U.S. "That’s the type of manpower resources they have."15

In the meantime, it is common now even in Chinese factories to hire labors from the hinterland areas at substantially lower costs. This is also an indication of the growing wealth and the emergence of a middle class in coastal areas.

MARKET CONDITION

Since the reform began, China has been steadily moving toward a market economy. Now 90% of prices in goods markets are set by supply and demand. Market pricing is also to be extended to labor, property, and financial markets. Since 1992, most capital goods have been no longer subject to state allocation and fixed prices. More than 60,000 markets of various kinds of capital goods have mushroomed nationwide.16 The government is to exercise control through macroeconomic instruments instead of administrative orders. This is a remarkable progress in merely fifteen years from a
totally centralized, planned economy, and shows Chinese reformers’ determination. This is also a major improvement of China’s investment environment concerning both the supply end and demand end.

The reform is improving the living standard of the whole population and making many people rich. As a result, people are showing up at the market place and buying. Since 1979, retail sales in China have grown at a compound annual rate of 15%, to just over RMB one trillion yuan (roughly $114 billion at current exchange rate). In the first half of 1993, sales surged 24% to RMB 572 billion. The growth is strong even after the high inflation in recent years. This is a market full of opportunities.
CHAPTER II

AMERICAN INVESTMENT IN CHINA

HISTORICAL TIES

The first American ship was sent to China as early as 1784, and the first American business was set up in Canton in 1802. By the time of the Opium War, the U.S. had already become one of China's major trading partners. The first Sino-U.S. agreement, the Treaty of Wanghia, was signed in 1844 to grant the most favored nation treatment to the U.S.

However, at the end of the nineteenth century, America's position in China began to decline due to the aggressive actions taken by other major countries and the mistreatment of Chinese immigrants in the U.S. "When in 1894 ... it became apparent to the United States that if it did not take measures to check the movement its trade would be wiped out, its religious and educational interests restricted, and its influence and prestige with the Chinese reduced to naught." Trade with China then was about two percent of total U.S. foreign trade.

President Taft responded with the Dollar Diplomacy toward China in an effort to increase the U.S. political influence in the area by expanding its economic stake there. But most American companies, while happy to trade with China, were shy of investment ventures in a mysterious country that was the prey of fierce foreign rivalries. The dollar diplomacy came to an end as Taft left the office. Even before this, Wall Street had
already quietly eased itself out."

During the years of the Republic of China (ROC) under the Nationalist Party in the 1920s through 1940s, American businesses had a fairly good presence in China. They fled the country when the Communist Party came into power. In 1971, the Nixon administration began to dismantle the embargo that had blocked all economic transactions between the U.S. and China since 1949. The establishment of formal Sino-U.S. diplomatic relations and the beginning of China’s economic reform in 1978 brought a big jump in bilateral trade to reach $1.7 billion in 1979. But it still accounted for less than one percent of total U.S. international trade.

Things have changed greatly since then. Now China is the third largest trading partner of the U.S., after Canada and Japan, with a total trade of over $36 billion in 1993. As bilateral trade booms, American investment in China is also gaining momentum.

THE U.S. CAME BACK

American companies resumed investing in China in 1978, after the two governments signed the investment protection agreement. The very first US-Chinese joint venture, Foxboro, was set up in Shanghai. In 1979, American Automobile Corp. set a joint-venture in Beijing to make its Jeep Cherokee, which later became a rather famous case of early American investment in China. Others quickly followed suit. According to a Chinese source, as of October 1992, there were about 2,800 American-invested enterprises involved in food, textile, medicines, machinery, telecommunication,
instruments and building materials industries in China, with total investments of $6.3 billion. This was the third largest volume after that of Hong Kong and Japan for direct investment in China. The U.S. actual investment reached about $1 billion.

In 1993, American FDI in China gained more momentum as a number of leading U.S. companies announced some mega deals. Among them, Arco signed a contract to invest $1.2 billion in a natural gas project in Southern China. On March 10, Wing-Merrill announced a $2 billion contract for power plants in Henan Province, letting the Aspen (Colo.)-based company own 70% of the equity. In the preceding weeks, AT&T and Coca-Cola Co. also announced major deals in China. AT&T declined to reveal the money figure of its telecommunications, semiconductors, mobile phones, and R&D projects in China, but it has been estimated at $1 billion-plus. Unlike the fate of the Dollar Diplomacy, now it is the Wall Street taking the initiative, and asking the government not to get in the way. A review of selected cases would provide some insights into current American investments in China.

**Coca-Cola vs. Pepsi in China**

Coca-Cola Co. and PepsiCo, Inc. are having a head-on competition in China. Both companies have made China a priority in their global expansion. In the past decade, the Chinese soft drinks market has increased tenfold, and some industry executives expect it to emerge in the next century as the world’s biggest beverage market.

Like many other old American companies, Coca-cola Co. first entered China in
the 1920s, but quit the country in 1949 as the communists took power. It returned in 1979 by exporting to China from Hong Kong. In 1981, Coke opened its first bottling plant in Beijing. It now has 13 more, as well as two plants making concentrate, along the Chinese coast.

At first, to introduce the foreign drink, Coke had to give away coolers to retailers, and advertise heavily on television. That helped it race to an early lead over Pepsi, which also began to open plants in China in 1982 but at a much slower pace. In 1992, Coca-Cola Co. said it had 12% of China’s soft-drink market, compared with 5% for Pepsi. Coca-Cola has received the kind of brand recognition as the "soft drink" itself. In 1993, Coke sold 100 million cases, about twice as many as Pepsi sold. According to the company, it took Coke almost ten years to turn its first profit in China, but since then profit has been increasing at an average annual rate of about 20%.

Coca-Cola Co. likes the formula that if the Chinese drank the same amount of Coke per head as Australians do, it would be some 10 billion cases annually. Chinese consumption of soft drinks is still merely 13 drinks per person a year, compared with 750 in America. The current Chinese consumption is heavily concentrated in big coastal cities like Shenzhen, Shanghai, Guangzhou, Tianjing, as well as in Beijing. In February 1993, Coke announced a $150 million plan to open ten more bottling plants in inland cities such as Xian, Shengyang, Chongqing, and Wuhan, which Coke said were not ready for their products until now. By 1996 the total investment by Coca-Cola and its joint-venture partners will be about $500 million.

But Coke’s position as China's leading soft drink brand is challenged by Pepsi.
Pepsi now has 12 joint-venture bottlers and concentrate-producers in China. On January 25, 1994, it announced a $350 million expansion plan, in addition to the existing $100 million Chinese operations. Pepsi predicted that within 12 years China would be its biggest market outside the U.S. "By 2000, we aim to be the leading soft drinks producer in China," boasted James Lawrence, president of Pepsi's Asia division. Pepsi reckoned that each bottling plant in China should produce a return on investment of about 20% a year. But "we have not taken a nickel out of China and won't for the next ten years," said Mr. Lawrence. "Our return will come in the next century."

Two factors will decide which company wins this competition: the location of bottling plants and the quality of the partners they choose. China's rickety transport system and lack of national wholesale network make nationally or even regionally distributing a low value, large volume consumer commodity like soft drinks an expensive and time-consuming proposition. This makes the location of new plants critical to either company's success. And such a degree of localization only makes choosing the right partner more difficult yet more important.

Over the past two years, the Chinese government has given foreign investors far more flexibility to pick local partners and investment locations, but the control over which cities Coke and Pepsi are allowed to enter is still considerable. In many cities (except Shanghai, Guangzhou and Beijing), particularly the inland areas which are now the focus of both companies, only one of the giants has been allowed in at a time. Coke has no operations in Fuzhou, Nanchang, Guilin and Chengdu, where Pepsi has recently been given permission to open bottling plants. And the opposite has happened in
Both companies have to tailor their marketing to different local markets as consumption habits in China vary greatly from city to city and between urban and rural areas. For instance, lemon-lime flavored soft drinks outsell colas by nearly three to one in Shanghai, while cola has long been the most popular flavor in Guangzhou. In poorer rural areas, orange flavored drinks remain the top sellers.

To boost their market share and meet Chinese requests that they help develop local industry, Coke and Pepsi have both aligned themselves with local producers. In 1989 Coke launched a local brand called Jinmeile in conjunction with the commercial arms of several government agencies. In 1993, Pepsi joined forces with two local beverage companies to help them develop the Tianfu and Asia brands.

Coke and Pepsi have followed different strategies regarding other foreign partners. Malaysian-Chinese tycoon Robert Kuok, who enjoys close ties to the Chinese government, joined Coke in July 1993 as a key investor in Coke’s new bottling operations. Coke’s other key foreign partners in China are Hong Kong-based Swire Pacific Ltd., which also bottles Coke in Taiwan, Hong Kong and the U.S., and China’s state-owned China International Trust & Investment Corp. However, Pepsi has so far declined taking on foreign partners. Mr. James Lawrence insisted that the company was going it alone in China because it would rather not share what one day should be a very big pie. "It’s our goal," he said, "to be the No. 1 beverage company in China."
AT&T's experience provides another perspective about American investment in China. With a formal announcement on February 23, 1993, AT&T became the fourth foreign company to join in a major way in the vast task of modernizing China's old and inadequate telecommunications systems. The other three are several European divisions of Alcatel (particularly Alcatel of Belgium), Japan's NEC and Germany's Siemens.

When Bell Telephone of Belgium (now Alcatel) staff arrived in Shanghai in 1983 to set up a joint-venture factory to make digital telephone switch gear, they found the electro-mechanical rotary switches supplied by Bell of the U.S. 51 years ago still in use. This was where China started as the world's fastest growing telecommunications market. The country's telephone exchange capacity ballooned to 52 million lines by the end of 1993, and is expected to have 100 million lines by the year 2000, making it one of the world's largest telephone networks. China plans to invest $6.16 billion in its telephone network in 1994 alone.

AT&T had three joint-ventures in China (AT&T of Shanghai, AT&T of China and AT&T of Beijing Fibre Optic), but not on the same scale or technical level as the other three companies' projects. AT&T was asked by China in 1979, while it was still a monopoly in domestic and international telecommunications in the U.S., to build a joint-venture factory to produce switches. This would have been the first such plant in China. But AT&T was, for some reason, unwilling to provide the level of technology China required, and turned down the offer.

The company changed its mind to some extent later on, and in 1985 established its fibre-optic joint-venture in China. But its competitors took the plunge into making
high-tech switches before AT&T had completely swung around. Suddenly it was too late for AT&T. As a result of the 1989 Tiananmen crackdown, the U.S. imposed trade sanctions against China which, among other things, restricted transfers of technology in telecommunications. In retaliation, in August 1989 China's State Council issued Article 56 which limited sources of switches to Siemens, NEC and Alcatel, thereby eliminating AT&T from the market.

The Bush administration initiated an investigation of China's trade practices in 1991, in response to a rapidly growing Chinese trade surplus and complaints from US companies about lack of access to the Chinese market. AT&T was able to use the political situation to overcome its earlier mistake. In October 1992, China eventually agreed to remove the blockage imposed by Article 56. AT&T won a commitment from China's State Planning Commission in February, just three months before the scheduled Northern Telecom Ltd. of Canada agreement.

But AT&T had already paid a high price. According to Alcatel's estimate, it now has 40% of the digital switching market in China, followed by Ericsson's 16%, NEC 13%, Fujitsu 11%, Northern Telecom 9%, Siemens 4%, leaving AT&T with only 3%. Alcatel's 1991 after-tax profit of its Chinese joint-venture was $18 million, on sales of $128 million. Its 1992 sales reached $228 million. For sure, Alcatel has overcome many difficulties, including that its Chinese joint-venture had a negative value in 1987, to achieve this result.

AT&T is now determined to beat its competitors in China. It has undertaken to cooperate with China in 10 main areas. These include making digital switches,
microelectronics, network management, optical transmission products, cellular systems, training, system integration, and research involving its Bell Labs. The first phase is to set up joint-ventures to make switches. AT&T will transfer the technology related to the design and manufacture of the switches' components. It is still subject to US government approval of export licenses, but it should not be too difficult, as Alcatel is already doing this.

Although experts estimated such a huge project at over $1 billion, AT&T would not put a dollar figure on how much it would end up investing, or how much the package could be worth. But for it to be worth anything at all, a favorable decision is needed from President Clinton and Congress in June on China's most favored nation trading status. In late January, Beijing announced that it wanted to cull its dozen suppliers of network transmission gear to a small number of three or four by early July — right after the June conclusion over the MFN debate.3

MOTOROLA -- "A GREAT LEAP FORWARD"

Motorola did not think its venture in China was a sure bet at the beginning. The company was very cautious about the prospect of investing in China. At a point, it even put a halt to its China deal and looked for an alternative project in India. When the company finally decided in 1992 to put together a plant, Motorola (China) Electronics Ltd., in the northern port city of Tianjin to make paging devices, it thought Chinese demand would be small and that it would have to find export markets to make the investment pay off.
It did not turn out that way. Motorola (China) Ltd. in Tianjin sells its entire weekly output of 10,000 units in China, where a pager with one year of service retails for $200. Annual demand for pagers in China exploded from 1 million in 1991 to 4 million in 1993. Motorola (China) Ltd.'s general manager Lai Chi-sun was more than happy when he said: "We no longer talk of the 'potential' Chinese market. That market has arrived." Already, the company has reported China as its largest cellular phone market outside the U.S. Large expansion plans have been set for a wide range of products from cellular phones, microprocessors, walkie-talkie systems to software. In China, the word "Motorola" becomes a standard substitute for "wireless communications".

The Motorola venture goes beyond setting up factories to take advantage of low-cost labor or getting a foot in China's vast market. The company expects that, over time, Chinese technicians will play a big global role in the design and engineering of products, much as its plants in Singapore and Malaysia do. So far, Motorola is delighted with its Tianjin venture. In terms of both quality and productivity, the Tianjin plant is already close to the company's Singapore plant, where Motorola designs its pagers. "We could be exporting them competitively right now," said Tan Yik Fay, manager of the Tianjin pagers factory. But with China's huge demand, exporting may have to wait for a long while.

Motorola expects to recruit heavily at China's colleges. So it is providing hundreds of scholarships to students and faculty in eight universities. It is also donating computer equipment and staff so schools can set up chip-design labs. It is also planned
to offer working internships to college students and dispatch managers to Chinese high schools to explain uses of technology.

At the same time, Motorola is spending millions on in-house training programs, preparing for the startup of its design centers for integrated circuits and telecommunication products in China. It already is sending engineering recruits to its facilities in the U.S., Singapore, and Hong Kong. For the Chinese executives who will eventually head the Tianjin complex, Motorola has a career management track called "Cadres 2000." Each year, it plans to put up to 20 top recruits into leadership training programs and rotate them through Motorola operations worldwide. The first batch of seven already have visited almost every Motorola chip plant in the world.

IMPLICATIONS

These companies' experiences suggest that those who get into China before the competition quickly put a distance between them-selves and their competitors. It is obvious that the Chinese government intentionally helped this happen by willingly taking a discriminating stance against the late-comers. In fact, this strategy of playing international competitors against one another has proved to be very effective.

On the other hand, Chinese consumers tend to be heavily influenced by what "new luxury item" other people are buying. Chinese people are prudent savers. With large amounts of cash sitting ready in their bank accounts, most people become able to afford a certain product at about the same time. We have witnessed this happening with color Tvs, motorcycles, and now telephone lines, which all became popular in a matter
of less than five years. Chinese now buy more color TVs and motorcycles than people of any other country in the world. In Shanghai, some 30,000 people put about $1,000 apiece in deposit, waiting for their turn to have an in-house phone line installed.

Moreover, Chinese customers usually demonstrate a very strong brand preference. People are expected to compare with each other not only what, but also of which brand, they have. This kind of brand loyalty is as heavily based on status-quo as on the confidence in the product itself. When a certain brand out-sells other brands, people accept it as the best and become very discriminating to other brands. Those other brands would have a very hard time to catch up. Coke has edged Pepsi here.

These factors make the Chinese market more like a choice between have-all or have-none. Under such circumstances, the level of entrance barrier increases significantly as time passes by. It is usually too late to join the game when sales of a certain product have actually boomed. One can not let others develop the market and still expect to claim a decent share of it when the market comes. This is a lesson AT&T learned the hard way.

Investing in China also requires long-term vision. Chinese people are used to measuring things in terms of years even decades. When they measure, they tend to reward those who make long-time commitment and show patience. Pepsi understands this well, and is using it as a competitive advantage to catch up with Coke. Motorola has also prepared itself by taking actions to integrate China into its long-term global strategy.

Operations of American investments in China are generally profitable. American businesses have expressed optimism in investing in China. A survey of 1,067 American
firms, conducted in June 1993 by the American Chamber of Commerce, showed that 63 percent of companies without a current presence in China intended to make an initial investment over the next five years. Of the firms already operating in China, 89 percent planned to make additional investments there over the same period.

OTHER CHOICES

In addition to FDI and loan/credit, China is now also offering portfolio investment opportunities to foreigners as the country has recently established its stock markets. To have a foot in China’s fast growing economy, an investor can buy: 1) Chinese B shares, which are designed for foreign investors only; 2) Chinese A shares through a Chinese agent; (This approach is literally unlawful as A shares are for Chinese residents only.) 3) Shares of companies with strong Chinese background or deeply involved in investing in China, known in Hong Kong as "red chips"; or 4) Shares of listed Chinese funds. But risk could be extremely high in all these investments.

As mentioned in Chapter I, the uncertainties of China’s investment environment put small, passive investors at a great disadvantage. One problem is Chinese companies’ lack of transparency resulting from China’s inadequate accounting and disclosure system, and the highly personalized nature of business. It can be very difficult for small shareholders to understand the operation of the companies and the performances of these companies are often surprising, either for good or for bad.

Another problem is just as obvious: agency theory concerning the listed companies’ management. The existing accounting mechanism is inadequate to check upon
the management. One concern of many fund managers is that the newly raised capital is often used in activities such as property speculation which has little to do with a firm's principal operation. This problem is further complicated by the likelihood of government intervention, either as outside pressure or boardroom frustration.

The third problem is that the Chinese stock market is still tiny. By the year end of 1992, the total capitalization of B shares was less than RMB 21 billion ($3.7 billion) for merely nine issues while the total capitalization of A shares was less than RMB 53 billion ($9.3 billion) for fewer than two dozen stocks. Southeast Asia's two smallest stock exchanges, Jakarta and Manila, are capitalized at $9 billion and $20 billion, respectively. Moreover, trade is also not very active, averaging only a few million dollars daily. It is very difficult for an investor to build a risk-hedged portfolio.

Therefore, market activities in the Chinese stock exchanges are no doubt more speculative. The market is as unpredictable as an infant. The recent wild fluctuation of the market confirms this observation.
CHAPTER III
CHINESE ECONOMY: GROWTH, INFLATION,
TAXATION AND CURRENCY DEPRECIATION

China has witnessed accelerated economic development since the reform began in 1978. In the 1980s, China’s GNP increased at an annual average rate of 9.2%, second only to the Republic of Korea’s 9.7%. According to China’s State Statistical Bureau, GDP grew by 13% in 1992, with industrial output by 21%, agriculture by 4% and fixed capital investment by 38%; in 1993, GDP grew 13.4%, reached 3.14 trillion Renminbi (RMB, China’s currency) about $363 billion. Retail sales reached RMB 1.22 trillion yuan, up 26.1% (11.6% net of inflation) with 31.2% in urban areas and 19.5% in rural areas.

THE CHARACTERISTICS AND PATH OF GROWTH

China’s economic take-off has shown a marked trend of regional inequality. Guangdong and Fujian, both Southern coastal provinces, are the major beneficiaries of the huge sum of overseas Chinese capital investments. Particularly, Fujian received the most Taiwanese investments and Guangdong the most from Southeast Asian countries. Guangdong also benefitted greatly from being next-to-Hong Kong and Macao, becoming the production base for them. Japanese investments are heavily concentrated in Northeast China, their historical interest sphere dating back to 1895. The city of Dalian is
becoming very much a Japanese Town. Shanghai is again becoming an international city, drawing all foreign investors’ attention by its sound industrial, technological and financial status in the national economy.

It is estimated that the coastal areas are about ten years ahead of the inland provinces in terms of economic development. Recently, as economic growth has radiated upwards the Yangtzi River valley and the Pearl River valley, Sichuan Province and Hunan Province, particularly the cities of Chongqin, Wuhan and Changsha, are drawing more and more attention as the gates to reach the back-country areas.

Another significant event is the thriving of the non-state-owned sector in the coastal areas. In Jiangsu Province, one of China’s most developed provinces, state-owned enterprises accounted for 40% of the total provincial production in 1993. An emerging new power is the local township enterprise groups. These township enterprises claimed RMB 1,162 billion yuan, or 30% of the total national industrial output value, in 1991 and 1,650 billion yuan in 1992, which is a 42% increase. In Jiangsu, township enterprises alone produced 300 billion yuan in 1992.

The author visited a few such enterprises and found out that they are by no means "peasant operations." Their managements are competitive, more efficient, more market sensitive and more motivated than their counterparts in the state-owned sector. Many experienced engineers and technicians as well as college graduates are recruited by them. These local enterprise groups have much autonomy, thus are flexible enough to ride out the competition. And they pool together small plants, so they have enough capacity to
mobilize resources.

Also, the rapid economic development has linked China more closely with the rest of the world. When the reform began in 1978, China's participation in international trade was nominal. Between 1979 and 1991, China's total international merchandise trade have been increasing at an average annual rate of about 14%. By 1993, it became the 11th largest trading country in the world, up from 1978's 32nd.

China's economic development can also be characterized as highly cyclical. In 1984-1985 and 1988-1989, the economy was over heated and inflation was high, leading to social panics. Lacking macro fine-tune instruments, the central government abruptly applied administrative measures to cool the inflation down. However, the reform continued and was not undermined by the fluctuations.

An economy which is big yet growing fast is what makes China considered by many economists the powerhouse of the world's economic growth in the years to come. As Robert Allen, CEO of AT&T, said: "China is becoming the largest market in the world for almost any product you can name." All major industrialized countries are taking action to have their share of this market.

PROBLEMS IN MEASURING THE CHINESE ECONOMY

The 1991 World Development Report of the World Bank listed China's GDP in 1989, as measured by the conventional exchange-rate standard, ninth in the world. However, in last year's IMF "World Economic Outlook" which for the first time used
the purchasing power parity (PPP) system, China was ranked third in the world in 1991, and accounted for more than six percent of the world GDP, not the previously estimated two percent. In the same report, the U.S. economy fell to 22.5% of the world economy. The new measure also put China’s per capita income at about $1,600 in 1992, instead of $370 as it was calculated in the exchange-rate standard.

The new method of evaluation draws many arguments, and in another report recently issued by the United Nations Development Program (UNDP) China ranked 101st in human development (which includes life expectancy and educational attainment). However, IMF’s new calculation is supported by the fact that from 1987 to 1992, China’s foreign trade grew from less than 20% of GNP to more than 40% (figures derived from China State Statistical Bureau’s reports). Even 20% would be considered an unusually high figure for a big economy like China’s in terms of real production.

This extremely high level of foreign trade exposure strongly suggests that China’s domestic portion of economy is significantly under-valued. This can be attributed to the severe distortion of the price structure due to thirty years of planned economy as well as the government’s administrative control on foreign exchange which led to the depreciation of RMB and increase of foreign exchange reserve at the same time.

**GROWTH -- AT THE COST OF INFLATION**

A growth rate at 12%-13% is not thought to be sustainable in the long run for any economy. During its recently session, the People’s Congress, China’s supposedly highest authority, has targeted to rein in its annual growth rate to a more comfortable 9% for the
rest of the century. According to Vice Premier Zhu, the 1994 result will most likely exceed this benchmark, but after 1995, things will be in control.38

China's breath-taking growth pace is creating serious problems. The economy is overheated and inflation is running high. In 1993, cost-of-living index rose 14.7% (urban areas 16.1%; big cities 19.6%; rural areas 13.7%), and retail prices rose 13% (among them cereals up 27.7%, cooking oil 16.2%, construction materials 28.8% and fuel 35%). Cash supply increased RMB 1,529 billion while M2 increased 24%.

The inflationary pressure mainly came from the runaway capital investment, which reached 1.18 trillion yuan in 1993, a 50.6% increase over 1992 (22% net of inflation). However, the central government in Beijing is not the one who single handedly caused it.

The reform has already changed the power balance between local authorities and the central government. One major implication of this development is rather negative. Local governments have every intention of keeping money in their hands. They use the unintended loopholes of tax regulations to the limits, dish out tax breaks, even order local businesses to under-report their profits. Beijing has seen its tax revenues vanishing. In the meantime, government spending is increasing rapidly. For Beijing, there is no other way but to face a budget deficit, planting the roots of inflation.

In autumn 1992, local governments grabbed much of the money the central government intended to pay farmers for state crop purchases. It was used for investment in local projects, leaving the farmers with IOUs. With no way to make the local authorities return what they had already spent elsewhere, Beijing had to print money to
avoid the possible farmer riots.

The central government's financial authority has been sapped in a more serious way by the failure of its lame-duck banking system. China's banks, all state-owned and under a triple-matrix management system made of the People's Bank of China, their own structures and local authorities, are run by bureaucrats rather than bankers. As their salaries and benefits are now more directly decided locally, these days they often respond more readily to the demands of local authorities, whose only interest is spending as much as possible locally. This, together with the rescue credits extended to the money-losing state enterprises to stabilize employment, helps explain the 100% overshoot of 1992's bank loan target.

Moreover, a lot of credit in China, especially in Southern coastal areas, is now extended by private institutions (which are legally grey) and private investors. They are not subject to the quantitative credit control which is the only serviceable inflation-fighting weapon at the central government's disposal.

INFLATION: ITS IMPLICATION, AND MEASURES TO CHECK IT

Yet, as George Horwich, an economist from Purdue University, put it: "It's hard to say just what inflation numbers mean when you are moving from controlled to decontrolled prices." China has long been practicing price-fixing and supply rationing. The reform brought up an abrupt (but not radical) change. According to the World Bank, by the end of 1992, China was conducting "more than half (perhaps two-thirds) of all transactions ... at market prices." It was a compelling experience, as the author
has personally encountered, when people for the first time found that the same commodity was sold for different prices at different stores. Rather than matching the lowest price as we are used to in the U.S., Chinese vendors in the domestic market tend to do the opposite by trying to match the higher price. No one wants to be over-sold, as far as the profit is concerned, as long as there are enough customers. But as competition intensifies in the more open market, the supply-demand relations will finally put an end to this kind of structural inflation.

The adjustment of China’s price structure has pushed inflation index up. But it also serves to correct the distorted relations between the domestic and foreign related sectors of the economy. As domestic prices rise while export-import prices and the exchange rates remain relatively stable, China’s foreign trade exposure will certainly decrease to a more reasonable level, and the gap between the evaluations of China’s economy based on the traditional exchange rate standard and the PPP system will narrow. China will therefore be better oriented in the world economic system.

The good news is that people’s incomes are basically keeping up with inflation. Last year, personal income in urban areas increased moderately, net of inflation. In rural areas, purchasing power slipped, but was still tolerable. In addition, rural population is more immune from the inflation on grocery items and rents, which bore the sharpest price hikes.

China’s money supply numbers are equally difficult to interpret. Although the inflation is running high, banks are still able to attract deposits at a 3-year CD rate of
about 10.5%. Total bank deposits reached RMB 2,324.5 trillion by 1993, an increase of 23% over 1992. People are not in a panic this time in spite of the inflation, unlike what happened in the late 1980s, because there is no sign of short-supply of anything. It is just that prices are getting higher, and people are making more money to compensate for the higher cost of living. Rush-buying could be a total waste of money, while by leaving the money in banks one would at least be able to salvage a large portion of it.

To ordinary Chinese people, the economy means cash. There is no such thing as personal checks in China. What they call credit cards are in fact cash cards, as one has to actually deposit enough money in the account before a card can be used, and the account can never be overdrawn. Even when buying a big-ticket item such as a big screen TV, people pay in cash. It is an exotic scene seeing cashiers count piles of cash in any store on any day. On payroll days, people actually receive cash. Banks have to prepare cases of cash every day to meet the payroll needs. It is only very recently that a few companies have begun to hand out savings certificates instead of cash to employees. These common practices heavily increases the demand for cash supply.

Moreover, a huge sum of cash never returns to banks. By 1992 it was estimated that there were about RMB 200 billion "sitting under mattresses and in rice jars." When the author was in China early this year, this figure was said to be between RMB 400 to 500 billion yuan (roughly $56 billion at the current exchange rate).

Some of this "free" cash is used in underground business transactions, which are conducted in cash to avoid taxes, or unauthorized capital raising activities. Some is the resource for corruption, which is condemned as the Number One social disease. But
much of it is just cash — sitting idle, nonproductive. The People’s Bank of China (PBC), China’s central bank, has to print more paper money to compensate for the "lost" cash, knowing that it is only helping worsen the inflation.

Some development may help lighten the inflationary burden cast by the excessive cash in circulation. The newly established stock markets have absorbed some RMB 100 billion yuan and these markets are growing. This movement of money from consumption to investment has double effects against inflation since otherwise the government would have to issue that much debt for the capital investment in those listed companies.

Also, Beijing is pushing a campaign to privatize the massive state-owned housing service. State employees are allowed to buy their apartments at a substantial discount. It converts a money-losing government operation into badly needed cash for investment.

Meanwhile, gold consumption is rising. Western economists see this as a simple action of inflation-hedging, the evidence of low confidence in the economy. However, while this is certainly an important factor, it is far from the whole story. Chinese people in every corner of the world all have a strong traditional passion for gold. They do not see gold as simply a monetary instrument. They see gold as the sign of purity, authority, long-living and high-spirit. They buy rings, necklaces and earrings made of 24K pure gold as soon as they can afford them, largely not as investment but as luxury accessories.

In 1993, mainland China absorbed 223 tons of gold, surpassing the U.S. as the world’s largest gold consumer. And the State makes handsome profits from selling gold. The money people spend on gold items is effectively retired from circulation, as in China there is no ready market for people to liquidate their gold.
China's gold market potential is still very high, comparing with that of Taiwan (population 20 million) and Hong Kong (population 6 million), who purchased 160.6 tons and 36.4 tons of gold in 1993, respectively. That is a total of 420 tons for the three, now often referred to as the "Greater China," accounting for 65% of all gold absorbed by Asia.42

All these may only be temporary measures. In the long run, the solution lies in the fundamental reform of China's banking and taxation system. And Beijing is taking measures in this direction.

TAXATION REFORM -- TO MEND THE BIG LOOPHOLE

According to Jin Xin, director of the State Administration of Taxation, the previous tax structure was not well thought out, and many loopholes existed.43 He was largely referring to the loss of tax revenue to local governments over the complicated tax deduction and calculation process.

China's new tax reform was initiated on January 1, 1994. Some new taxes were levied on certain goods such as tobacco, alcohol, cosmetics, petrol, cars and jewelry, the consumption of which is relatively price inelastic. The major feature of this new taxation package is the restructuring of business taxes. To fight back the local governments' various tax-evasion tactics, Beijing imposed a set rate of value-added tax and product tax, which would be more easily red-tapped to the central government. Also, the tax base was expanded and freed from any reduction. In exchange, the number of industrial and commercial taxes was decreased from 30 to about 20.
As this restructuring is basically intended to assure the central government’s collection of a proper portion of the total tax revenue instead of to increase the total tax revenue, its net effect on businesses is said to be nominal. This move is winning praise from the international financial community. If implemented successfully, it will strengthen Beijing’s control over the economic growth, and makes it possible to rein in the budget deficit and reduce money supply. By restricting money supply and making land appreciation taxable, Beijing can put a break on local property speculation which is blamed to be the spark of the over heated economy.

Under the new system, foreign-funded enterprises will retain their preferential tax status. Those set up before the end of 1993 will receive rebates for any tax increase resulting from the tax reform for five years, while those set up in 1994 and after will follow the new tax system. This treatment is based on the consideration of the impact the tax reform could have on evaluations of investment projects.

However, favorable tax policies for foreign investment would be affected once China rejoins the General Agreement on Tariffs and Trade (GATT). GATT demands the same treatment for domestic and foreign businesses.

In fact, these changes in taxation are rather welcoming for the more rule-biding American businesses operating in China. The new unified tax system would make American businesses more competitive by making everyone play by the same rules.

**BANKING SYSTEM REFORM -- MAKE THE LAME DUCK WORK**

Banking system reform is also under way. On one hand, the state-owned
specialized banks are in the process of commercialization. For instance, the Agriculture Bank of China, which was responsible for the 1992 diversification of the state corp fund, is to be reorganized into two banks: the Agriculture Policy Bank will take custody of the state corp fund and can not lend, and the new Agriculture Bank will be made fully responsible for the credits it extend as well as its profitability. The Industrial & Commerce Bank of China will still take care of loans allocated by the government to state-owned enterprises, but it will also be responsible for its outstanding commercial credits. This is also the general guideline for the reform of the Bank of China, which used to be China's sole foreign exchange bank, and the Construction Bank of China, which takes care of capital investment. It is going to be a long process and not going to be easy at all to transform those bureaucrats into competitive bankers, not to mention the fight to keep the government's political intervention at bay.

On the other hand, People's Bank of China's (PBC) regulatory authority to discipline the banking industry is expected to be enhanced. Since the re-establishment of the Bank of Communications in July 1986, nine commercial banks have appeared in succession. These institutions mainly deal in short-term industrial and commercial loans and other commercial monetary operations. Their total assets have surpassed RMB 210 billion yuan, accounting for one-tenth of the total capital of all banks in China. Moreover, scores of nonbank financial institutions have mushroomed recently, some of them not even approved by PBC. Even the state-owned banks are seeking ways to bypass PBC's supervision by creating related institutions. Without an enhanced discipline system, it would be impossible for PBC to carry out policies like a central
bank should do. This task is said to be accomplished by the People's Congress by a set of laws and regulations.

The most fundamental, thus the most difficult measure to reform China's banking system would be for PBC to become a truly independent central bank, instead of simply being a money printer and the government's cashier. It should make its own decisions on monetary policies like money supply, interest rates, etc., free of political intervenes. Without in-depth political reform, this objective would be almost impossible to achieve.

Beijing is now tackling this problem by having its senior Vice Premier, Mr. Zhu Rongji, assuming the post of the head of the People's Bank, hoping it will make the transformation easier by lifting the bank's stature from the cabinet level up to the State level. However, it would be a wise judgement to expect to wait a long while for the People's Bank of China to become a fully functioning central bank.

Many foreign banks are now allowed to conduct foreign currency business in China, with some major restrictions. There is a rumor that China might soon allow them to take Renminbi (the Chinese currency) business as well. Many American banks have operations in China. Under the current circumstance, it is very difficult to predict what kind of impact it will have if foreign banks get into the Renminbi market, and what kind of consequences these foreign banks will encounter.

**CHINA'S CURRENCY CREDIBILITY**

One major disadvantage for foreign investment is that it is exposed to the risk of depreciation of a host country's currency, which directly cut down the value of its capital
investment and revenues. This is why foreign investors care so much about China's money supply and inflation numbers which are indications of foreign exchange rate changes. And they have good reason to do so.

From November 1992 to March 1993, China's Renminbi (RMB) has seen its value against the dollar plunge more than 20% at the swap centers, where exchange rates are set by market forces. The low point reached RMB 11 yuan to one US dollar. This magnitude of depreciation was not anticipated by either foreign investors or the Chinese government. The people's Bank of China intervened with its large foreign exchange reserve at a point. The mystery of this significant fall of the RMB was that China had a trade surplus of $4 billion in 1992\(^4\) and a healthy foreign exchange reserve ($19.4 billion, year end 1992). No matter what the reasons could be, the damage was done.

Foreign investors in B shares have suffered mightily, with the fall in the currency adding to the price drops already sustained. So did the "red chips" and China funds. Also badly hit were FDIs with most of their revenues in RMB.

In China, foreign investors have few methods to hedge against inflation. There is no currency future market. One way is to raise prices. But this is a difficult path to follow. A Big Mac at McDonald's already costs a day's wage for many Chinese workers. To establish and maintain a foothold in China, prices have to have their limits.

Believing that the currency depreciation was short-term, many foreign businesses in China tried to side-step the pain by limiting imports and pumping profits back into local expansion. In a bid to reduce its imports, McDonald's established a potato project near Beijing that it hopes will eventually provide low-cost French fries for all its Chinese
46 outlets. A company spokesman said: "McDonald's wants to be here long term. The hedging strategy (for us) is localization." As for Pepsi, expansion would sound perfectly good.

Still, some foreign investors are smiling. Exporters benefitted from a depreciating RMB, which made their costs in China fall, their products cheaper and easier to sell overseas.

However, this RMB panic is now over. On January 1, 1994, Beijing took a dramatic step, announcing that it has abandoned the long existing market-decided-not official exchange rate system. The swap market rates, adjusted by over-night interbank foreign exchange rates, are now used as the sole effective rates. This measure actually makes the Renmingbi semi-convertible. Previously, foreign capital investment and imported materials were valued at the meaningless low official rates (about RMB 5.8 to $1 in late 1993), yet often had to convert profits at the much higher swap rates. The recent reform of the foreign exchange system has removed this obstacle and will, therefore, encourage more foreign investment to China.

Since then, and up to early April this year, the exchange rate against the US dollar has been stabilized at between RMB 8.6 to 8.8 yuan for $1, and even showed some small signs of strengthening. This is achieved despite the fact that China had a large trade deficit in 1993, its first time in recent years. It carries a very strong message that the value of the RMB will remain relatively stable in the near future.

Also, Beijing is accepting applications from foreign banks for officially entering the new foreign exchange market. With foreign banks operating in the system, the level
of transparency will increase, and investors will feel more secured.

In spite of all the problems, the future of China's economy is bright. John Greenwood, the chairman of GT Management (Asia), a Hong Kong fund-management company, pointed to the many parallels between the development of Japan's economy in the 1950s and 1960s and that of China at present. Both enjoyed fast productivity increases even while suffering periods of high inflation and severe stop-go economic cycles caused by a closed financial system.
CHAPTER IV
CHINA'S MFN AND U.S. TRADE DEFICIT WITH CHINA

China's fast growing economy and its vast potential market have drawn the attention of many American investors. American investment in China is surging. However, American businesses, which have entered or are about to come into the Chinese market, find themselves fighting on two fronts.

CHINA'S MOST FAVORED NATION (MFN) STATUS

Obviously, it is difficult and risky to invest and operate in China which is very different from the U.S. in political system, economic conditions, as well as social and cultural values. In addition, the recent debate on China's Most Favored Nation (MFN) status with the U.S. is threatening to U.S. corporations doing business with China.

Following the establishment of formal diplomatic relations, the U.S. and China reached a trade agreement in 1980 which contained a provision of reciprocal MFN status. But according to U.S. law, China is a communist country thus its MFN status is subject to annual renewal which comes in June every year. Before 1989, there was no trouble for the yearly renewal. From the standpoint of politics, Chinese communists were seen as moderate at that time. Meanwhile, in geopolitics, China was needed to counterbalance the Soviet Union. China had only a small trade surplus with the U.S. after years of deficit.
In recent years, things have changed dramatically. The Soviet Union has fallen apart, and Russia is not expected to be a great threat, at least by now. After the Tiananmen Square crackdown in 1989, anti-Chinese government feelings became strong among the American public. In addition, China’s trade surplus with the U.S. is running higher every year, reaching $27 billion in 1993. For the last 3 years, China’s trade surplus with the U.S. has run second only to Japan’s. Also, the problem of weapons sales created more political complications.

In these circumstances, the U.S. Congress began its annual attempts to attach conditions to China’s MFN in the renewal. Last year, President Clinton issued an executive order to extend China’s MFN, but demanded China make "overall significant improvements" in human rights for this year’s renewal.

Although it is at the center of America’s China policy, MFN is not supposed to be used for political pursuit. Different from what it sounds like, the expression "Most Favored Nation" is merely a trade status which does not imply political or moral approval. As Senator Max Baucus (D-Mont) stated: "MFN is not a special benefit we extend only to our closest friends, rather it is the minimum treatment we extend to virtually all of our trade partners. ... Though we have taken other measures, we grant MFN to Iran, Libya, South Africa, Syria and even Iraq." MFN treatment is in line with a provision in the General Agreement on Tariffs and Trade (GATT) stating that when a member party applies the most favorable duty rate to a product imported from one GATT member country, it should also apply the same duty rate to like products from other member states.
Therefore, MFN is not a special favor, nor a privileged benefit. The term "most favored" is indeed misleading. The terms of "undiscriminating" or "normal" would be more appropriate, and the "most favored nation treatment" should be rightfully called "nondiscriminatory tariff treatment," or simply "standard tariff treatment." Revoking a country's MFN would be considered the equivalent of declaring war in bilateral trade, as well as an open invitation for retaliation. This is the danger of using MFN as a political weapon.

Thus, while dealing with foreign political issues, such as human rights, the government should not put the interests of domestic and foreign private business sectors in jeopardy. Indeed, a responsible and capable government should be able to deal with political issues to avoid or minimize the possible business loss. Especially, when the government has made a mistake, as many in Congress and the Administration have come to believe, it would be unreasonable to ask private businesses to pay for it rather than to admit the mistake and correct it.

In 1992, while defending China's MFN against adding human rights conditions to it, President Bush argued that "there is no doubt in my mind that if we present China's leaders with an ultimatum on MFN, the result will be weakened ties to the West and further repression. ... We have the policy tools at hand to deal with our concerns effectively and with realistic chances to success." He also believed that "HR 2212 would severely handicap US business in China, penalizing American workers and eliminating jobs in this country. Conditional MFN status would severely damage the Western-oriented, modernizing elements in China, weaken Hong Kong, and strengthen opposition
to democracy and economic reform. Hereby, President Bush made a good judgement about the weakness and danger of regarding MFN as a political instrument.

Loss of MFN status, of course, would cripple Chinese trade, especially if the Chinese, as expected, retaliate. Tariffs would make Chinese products less competitive in U.S. market. For example, tariffs on imports of Chinese-made clothing would quadruple, and those on toys would probably rise from 7.4% to 38%. There will be an estimated loss of 75,000 jobs in Hong Kong and millions of jobs in China.

Moreover, if China's MFN were revoked, China's pragmatic economic reformers and more coastal economic developing areas would be most hard hit. It would be a severe set back of the reform that even Tiananmen crackdown could not accomplish. This is what the U.S. definitely does not want to see.

On the other hand, were China's MFN revoked, the U.S. would also suffer, especially U.S. consumers and multinational corporations operating in China. If China retaliates against U.S. exports, it is estimated that more than $9 billion in sales of American goods and 200,000 jobs would be lost. Future job losses could be worse. Compared to the jobs lost in China, these U.S. jobs are high quality jobs, because the U.S. exports capital and technology-intensive products and imports labor-intensive products.

Moreover, the U.S. is acting along on attacking China's human rights situation with bilateral trade. Other industrialized countries are seeking this opportunity provided by the U.S. to make deals with China, and laughing all the way to the bank. China will
spend the money anyway if the U.S. choose not to make them.

In addition, China's growing economy and vast market potential provide a great opportunity for U.S. industries seeking profits abroad. Revoking China's MFN would obscure the long-term prospects for U.S. multinational corporations owning or developing investments in China. For example, China will soon decide whether to let Chrysler or Mercedes Benz assemble mini vans in China, exclusively.

Since MFN is not a special favorable treatment and revoking it will have damages on both sides, Clinton's decision to attach human rights conditions to renewal must be based on the judgement that China will do everything to keep its MFN status, as its huge trade surplus and millions of jobs are at stake. However, this judgement is problematic for various reasons.

First, the estimation of China's trade surplus with the U.S. itself is rather questionable. This figure hides more than it reveals. Further discussion on this topic will be given later in this chapter. Second, it is still impossible that the U.S. Government would let China keep its surplus, even if China had improved its human rights. Washington already used its Super 301 Action to get a market-access memorandum of understanding from Beijing in October 1992. Thus, it dose not make much sense for Beijing to give up on human rights now and still have to deal with the trade balance problem later. Third, although most American politicians and Chinese dissidents do not believe China would break away from the U.S., they have forgotten that China has done that before, with the Soviets in the 1960s. Ironically, at that time, no one in the West anticipated such a move from China. In the current situation, China might still do this
if the U.S. pushes too hard. China clearly indicated their attitude when Warren
Christopher, the Secretary of State, visited Beijing in March 1994.

However, recent developments on this matter indicate that a compromise for this
year’s renewal is still possible. According to BusinessWeek, the State Department is
prepared to declare victory by claiming that China has met enough of Clinton’s
conditions to merit renewal, if China does not take any further hostile action. China’s
recent release of Wang Juntao, a leading dissident, for medical treatment in the U.S. is
a gesture for the White House to save face.

Senator Max Baucus, Chairman of the Senate International Trade Subcommittee,
is quoted as saying in a recent floor statement that "we should think hard about our goals
in human rights and the means we use to achieve them," and "(The MFN conditions)
have proven no more effective and far more dangerous than the other means at our
disposal. Thus, if we can renew (China’s) MFN status in June, we should not impose
conditions again. Instead, we should find other ways to promote human rights. ... We
should learn our lesson and find a new approach." If a new political consensus could
be built on such a reasoning, Clinton would be able to get out of the corner he has
backed himself into and settle the MFN issue for good. American businesses would have
a much brighter prospect in China.

As a matter of fact, promoting human rights in China should be a long-term and
persistent political effort. It requires not only sweeping political reform, but also
economic improvements and gradual changes of social values. It will take years, even
decades. For sure, many of those fighting for it will probably never be able to see the
results. For the U.S., a logic of this argument should be to be engaged in China, then get a chance to influence it. In fact, during the past few years, the human rights situation in China has been improving gradually. For the real welfare of the people in China, the attempt of seeing China changed completely over night would be immature and unrealistic.

**TRADE DEFICIT FIGURE HIDES MORE THAN IT REVEALS**

Another concern which bears heavy influence on the debate over China’s MFN is the U.S. large trade deficit to China. According to U.S. statistics, the trade between the U.S. and China for the recent ten years is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports from U.S.</th>
<th>Imports from China</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>2.16</td>
<td>2.24</td>
<td>-.08</td>
</tr>
<tr>
<td>1984</td>
<td>2.98</td>
<td>3.06</td>
<td>-.08</td>
</tr>
<tr>
<td>1985</td>
<td>3.79</td>
<td>3.86</td>
<td>-.07</td>
</tr>
<tr>
<td>1986</td>
<td>3.10</td>
<td>4.77</td>
<td>-1.67</td>
</tr>
<tr>
<td>1987</td>
<td>3.48</td>
<td>6.29</td>
<td>-2.81</td>
</tr>
<tr>
<td>1988</td>
<td>5.03</td>
<td>8.51</td>
<td>-3.48</td>
</tr>
<tr>
<td>1989</td>
<td>5.80</td>
<td>11.98</td>
<td>-6.18</td>
</tr>
<tr>
<td>1990</td>
<td>4.80</td>
<td>15.22</td>
<td>-10.42</td>
</tr>
<tr>
<td>1991</td>
<td>6.28</td>
<td>18.97</td>
<td>-12.69</td>
</tr>
<tr>
<td>1992</td>
<td>7.47</td>
<td>25.67</td>
<td>-18.20</td>
</tr>
</tbody>
</table>


Faced with the consistently growing trade deficit in recent years, especially the large figures in the 1990s, the Clinton administration has threaten to get tough on
Beijing, unless the imbalance is reduced. But Chinese Government claims these figures hide more than they reveal.

Fifteen years ago, when the reform began, China had little that the U.S. would buy. The U.S. enjoyed surplus in bilateral trade with China. In the 1980s, as China’s economic reform continued, it began to attract more and more foreign capital and new technology, including U.S. investment. Coupled with China’s cheap but rather efficient labor, China became more productive and its products became more competitive in the global market. Although U.S. exports to China increased rapidly, it could not keep up with the explosion of imports from China. Thus these figures really indicate that China’s economy is developing rapidly, while bilateral trade between China and the U.S. is increasing.

The early foreign investments in China were mainly to take advantage of China’s cheap labor. Most of their products were aimed to be exported. Naturally, the U.S. was the largest market for these labor-intensive products. In fact, by shifting their production to China, the foreign investors exported their trade surplus to China. Indeed this could be another major reason for foreign companies to invest in China. In the U.S. world trade statistics system, the "country of origin" for imports was used in calculating bilateral trade balances. Anything which is "Made in China" and sold in America is certainly China’s export. Thus, China’s large amount of trade surplus with the U.S. included a part of transferred surplus from other regions, especially from Hong Kong, and Taiwan.

Despite many political barriers, China, Hong Kong, and Taiwan have achieved
a remarkable degree of economic integration focused on manufacturing processes since 1980s. The inflow of capital and technology have improved China’s productivity and competitiveness. A large proportion of output has been destined for overseas and most inputs similarly come from abroad. In the Greater China, the exports from Hong Kong and southern Chinese provinces, especially Guangdong, depend on the U.S. market. Taiwan also has a large portion of China-based production to be exported to the U.S.

From 1987 to 1992, Taiwan’s trade surplus with the U.S. was almost cut by half, and Hong Kong’s reduced to a fraction, while mainland China’s increased dramatically. However, if the surpluses from three regions were combined, the total amount of the Greater China’s surplus with the U.S. would remain remarkably the same at about $28 billion. Only the relative export shares of the three have changed. Therefore, regarding China’s $27 billion surplus with the U.S., it is not difficult to understand that Hong Kong and Taiwan have simply exported their surpluses by shifting production to the mainland.

It is reasonable to assume that other countries, including the U.S., have followed this pattern. China has added only a fraction of the total value of these "Made in China" items, yet it would have to take full responsibility for them. Such an artificial nature of the trade balance measurement clearly undermines the reliability of the results.

RELATIONS BETWEEN MFN AND TRADE DEFICIT

From this perspective, revoking China’s MFN status would have serious consequences for all three regions. For instance, it has been estimated that the loss to
Hong Kong could be as much as US$15.7 billion in overall trade and 75,000 jobs; re-exports from China might fall by US$4.6-6.2 billion. Failure to resolve the MFN status and trade issue would undermine the very process of regional economic integration by damaging investors' profits and lessening their involvement in China's economic development.

On the other hand, revoking China's MFN will not reduce America's overall foreign trade deficit. On the contrary, the deficit will increase as more expensive substitutes from other countries will be imported. Or American importers will have to pay for the sharply increased tariffs. American consumers will pick up the tab in the end.

Based on the above discussion, the author argues that MFN is not the source of America's trade deficit with China and thus should not be used to solve the problem. To make this problem clearer, the U.S. should uncover the truth behind the deficit figures, and realize that trade surpluses and deficits are normal and not a sign of underhanded dealings.

Furthermore, China's trade surplus with the U.S. should not be simply attributed to its import restrictions. According to the mutual MFN treatment, these imposed import restrictions should be the same to the U.S. as to other countries. On the other hand, the U.S. Government imposes more strict restriction on exporting high-tech products to China. Much of the money the Chinese have spent on high-tech product purchases went to Japan, Germany and France. AT&T understands this well. Also, if the U.S. revokes China's MFN and turns to protective practices, it will have no leverage to influence
China. Meanwhile, this will entitle China to single out the U.S. to restrict its exports.

**A POSITIVE APPROACH**

To address this problem, the U.S. Government should focus on specific trade barriers and attack them one by one, instead of threatening to break away. Once a barrier is brought down, American companies will have to move quicker than their competitions. This approach will be more complex, but will also be more constructive. The fact is that China is still an infant in market economy. The old legacy of command economy is still vivid. The reformers are just beginning to show confidence in the marketplace but still lack experience. Foreign investors can obtain a chance to harvest their long-term profits only by building a good, constructive relation-ship with the Chinese.

The government of the United States at the first place should be responsible for the national interests of the U.S. Unconditionally renewing China’s MFN status serves America’s interests, such as jobs, and its long-term economic perspective. President Clinton should make a strong case that MFN is not a privilege for China and has nothing to do with moral standards. Stripping MFN away from China will bring nothing good to China, nor to the U.S.

If the MFN issue can be solved this year, there should be no more problems in the years to come. The Clinton Administration has already hinted it wants to change the annual renewal of China’s MFN to multi-year renewal. This is a very positive signal to American businesses, encouraging them to make longer term commitments in China.
CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS TO
U.S. INVESTORS IN CHINA

According to the previous discussion, the risks of investing in China are high. Challenges include potential political instability, inadequate legal system and the overheated economy, as well as cultural differences. In addition, the currently sour relations between the U.S. and China threatens China's Most Favored Nation (MFN) status, which is essential for American investors to succeed in China.

However, opportunities always go hand in hand with risks. China's continuing economic development provides great potential rewards for U.S. investors. Only the rebuilding of Europe and Japan following World War II can be compared with the emerging of China as a world power. China needs U.S. capital and technology, and the U.S. needs China as a huge market as well as a production base. American investment in China is the very instrument to serve the needs of both sides. The success of such investments is of great importance for both countries' economic future.

KEY FACTORS

The author believes that several factors are essential for American investors to succeed in China. First, investors must have long-term vision. Because of the still unsatisfactory investment environment, short-term results could be highly vulnerable.
But in the long-term, China is the country that no major global competitor could afford to ignore. Therefore, investing in China is more a long-term strategy, which must be well designed, well executed, and most importantly, well prepared for in terms of difficulties, uncertainties and changes. American investors are used to looking at quarterly performances. Now they should learn to plan for ten years and 20 years investing horizon, like what Pepsi is doing.

Second, American investors should not wait for a later time to invest in China. As Alcatel has proven to AT&T, those who come into China earlier are more likely to gain competitive advantages over the late comers. American businesses should have a sense of urgency, seeing Japan and European countries moving into China quickly. "Play it safe" could mean "play it into competitors' hands."

Third, along with the long-term strategy, American investors must be prepared to make long-term commitment in China. Long-term commitment involves localization, which includes training local personnel and developing local supplies, and expansion of their Chinese operations. At the center of localization is technology transfer, which has always been a controversial issue in foreign direct investment. Only when put it in a long-term and global perspective, as Motorola did, can an investor have the insight to solve this problem. Expansion requires reinvesting of profits and continued capital investment in light of confidence about the future economic growth and market development.

Localization and expansion are welcomed by host countries as positive signs of the investors' efforts to help the local economy. Those who do so often receive
favorable treatments in return. In China, localization and expansion are also the fundamental means of hedging against inflation and the depreciation of Renminbi, the local currency.

Fourth, American investors should establish close control over the operation of their investments. They must make sure that the capital they brought in be used on the approved projects instead of being diverted to other activities such as property speculation. They must also make sure that the technology they provide is used properly and productively. Moreover, American investors must keep close eyes on the operations to see they do not break neither Chinese laws nor U.S. laws.

Finally, but certainly not the least importantly, American investors must make a strong case to both the public and the government that their presence in China serves the interests of all sides, including promoting human rights in China, and their absence will do the opposite. By doing so, they can earn themselves a chance to compete against other leading Western countries operating in China.

LARGER MAY BE BETTER IN CHINA

Based on the above opinions, the author further suggests that large multinational corporations (MNCs) would stand a better chance to succeed in China than small investors do. First, large MNCs have worldwide operations. They are usually well diversified, and have higher flexibility to mobilize resources worldwide in large scales. Thus they are better positioned to carry out long-term plans, and are more likely to be able to withstand possible fluctuations of their risky Chinese ventures and provide support
when needed.

Second, large MNCs' special status often enables them to deal directly with the Chinese Government. They tend to be able to gain more insight to counteract the possible effects of political instability. They also have the leverage to receive better treatment when involved in legal problems, while a small investor would more possibly be ignored by the bureaucracy.

Third, MNCs have experienced and culturally diversified management talents in not only financing, but also production, marketing and R&D, to exercise close control of their Chinese operations. MNCs have more operational mechanisms at their disposal to hedge against risks, and have their companies' core businesses to rely on.

Therefore, the author proposes that for American investors, the best way to succeed in China might be to establish Chinese subsidiaries. The big multinational corporations could provide venture capital. Their worldwide operation networks could help guide these Chinese ventures to success. Small U.S. investors should not venture into China unless they are fully prepared for initial losses and have the resources to sustain their operations there. Because the Chinese security market is still immature, market index fluctuates wildly. Shares of Chinese Funds are more appropriate for speculation, not for income or growth.

One century ago, the U.S. businesses shied away from investing in China despite the government's efforts to carry out the Dollar Diplomacy, because China was then so weak and instable. Today, China is regarded as the world's greatest growing economy,
while the U.S. remains the world's greatest power. There is surely a wide field for the
two to cooperate with each other. Although they should anticipate difficulties and take
appropriate measures, American investors should seize the opportunity, take on the
challenges to seek business success in China, and claim their rewards for their long-term
vision.
ENDNOTES:


20. Overlach, T.W.,


22. *Dragon by the Tail*. p.94

23. Crow, Carl, *Four Million Customers*.


33. Data quoted from the *Annual Statistical Report on Economic And Social Development*, published by China State Statistical Bureau, for the respective years. Sources are the same for the statistical figures in this Chapter unless otherwise specified.


40. See Note 36.


42. See Note 37.


47. "Yuan A Debased Currency?" The Economist, April 24, 1993, p35.


49. US Department of State Dispatch, March 9, 1992 v3 n10 p189.


