
Gauging the New Chinese Marketplace

[Specialization] is not a good idea. We do not suggest this even with respect to our own provinces. We advocate all-round development and do not think that each province need not produce goods which other provinces could supply. We want the various provinces to develop a variety of production to the fullest extent. . . . The correct method is each doing the utmost for itself as a means toward self-reliance for new growth, working independently to the greatest possible extent, making a principle of not relying on others[.]

Mao Zedong (quoted in Riskin 1987, 206)

[We must] sail with borrowed boats, exit through other's borders, sing on rented stages, and make money on foreign land.

Qinghai provincial official (quoted in Yang 1997, 57)

Introduction

In the final years of the twentieth century, the United States has little choice but to formulate more practical and effective foreign and commercial policies toward the People's Republic of China. This imperative is made necessary by great economic, political, and social changes taking place in China in recent years. To succeed, the architects of this new strategy will need an accurate and nuanced understanding of the characteristics of today's China and of the directions in which China is most likely to evolve. Making those judgments from outside China is notoriously difficult, and it is not possible to do so unerringly. In the long-dominant strategic formula, China was seen as a transitional economy useful for its geopolitical weight but less critical from the perspective of US global eco-

conomic security; this view has become a poor guide for US policy as China has recast itself in the past two decades from totalitarian quagmire to looming capitalist (but still authoritarian) aspirant. Such transition has created contradictions, both within China and in the configuration of international economic and political power, leaving policymakers divided on how best to proceed. As a result, the evolution of US policy toward China largely stalled in the 1990s.

In order to help in crafting the commercial aspects of a dynamic policy toward China,¹ this study gets “inside” China in a novel way: by using the growing pool of expatriate professionals in China to uncover the country’s development patterns. The time for exploring this group’s insights is right. The Clinton administration has exhausted the utility of lambasting Beijing and moved toward a new strategic partnership. At the invitation of Jim Sasser, a former colleague turned ambassador, many members of Congress have visited China personally, and with the benefit of firsthand knowledge many have begun to tone down their annual indictments of China’s trading status. At the same time, the need for US-China cooperation to address regional economic problems (especially the Asian financial crisis) and security problems (especially South Asian nuclear proliferation) provides a major impetus to find a new approach.

President Clinton’s summit trip to Beijing in June 1998 marked a turning point in US-China relations. Though the visit achieved little in concrete terms, it worked to change perceptions of China in the United States and was used by Chinese leaders to demonstrate a new level of public openness in political debate. The results of the visit will require years to tally, but it is already clear that both countries have become much more open to compromise, negotiation, and cooperation.

A window for shaping a more constructive relationship has thus cracked open, but the strategic partnership remains a long way off. As the Chinese neglect public relations and US policy remains incoherent, popular misunderstandings continue to fester on both sides of the Pacific. In the United States, best-selling books such as *The Coming Conflict with China* (Bernstein and Munro 1997) are laden with alarmist predictions reminiscent of past red (and yellow) scares. In China, *Zhongguo Keyi Shou Bu* (China Can Say No), which apes a similarly titled Japanese book, illustrates how paranoid even younger Chinese writers can be about foreign interference in Chinese events.

In short, a new, better-informed strategy for dealing with emerging China must be devised to transcend these mutual misgivings and begin

1. Traditionally, it was maintained that foreign policy required little attention to commercial matters; however, US concerns about China, from human rights to nuclear proliferation, cannot be understood apart from international commercial realities. So whether one admits a commercial policy imperative or merely seeks greater economic understanding in the “realist” vein of traditional foreign policy, the relationship between commerce and policy must be studied.

to reconcile the outdated view of China common in the West with the reality of the surprising new China now taking shape. In the larger bilateral picture, the economic relationship between China and the United States is critical; it is the part on which the political and security demands of the region increasingly depend. Drawing on insights into the economic forces shaping the Chinese marketplace today, this study addresses pressing questions in US-China commercial relations (which requires a discussion of social and political topics as well).

Why Study the Expatriates?

For a number of reasons, China has long been poorly understood in the United States. First, China remains remote from the West linguistically, culturally, and geographically, with the hinterlands beyond the few largest cities more remote still. The difficulties of penetrating the complexities of Chinese society are heightened during this period of rapid change.

Second, Chinese officials often intentionally portray their governing regimes as more monolithic, orchestrated, and disciplined than they actually are, reflecting a long-held belief in the importance of presenting a unified front to foreigners. Too many Americans take this portrayal at face value—and thus mistake China for a bigger, badder Japan of “Rising Sun” vintage (never mind how quickly that bogeyman has fallen away in recent years). Third, even Western enterprises established in China sometimes misrepresent reality in order to curry favor, to talk up the markets or, conversely, to discourage potential rivals from following them into the market. The result is a distorted understanding of Chinese conditions, which can only lead to faulty US policy.

Because of these impediments to comprehending China by analyzing its formal economic regimes from the outside and by relying on normal government channels of interaction, this study brings non-Chinese eyewitness perspectives on present developments to the attention of Westerners. The eyewitnesses are primarily managers of foreign-invested enterprises (FIEs) in China, a growing group of dedicated observers as yet little surveyed for the purpose of policy analysis.² Their views will assist US policymakers in crafting more effective policies toward China, as well as helping analysts to review whether current policy adequately supports the endeavors of US firms in China.³

2. Although this cohort contributes to a literature on doing business in China, the foreign and commercial policy implications of their views are rarely explored.

3. That US outward foreign direct investment is beneficial for both the host country and the United States has been well established (see, e.g., Dunning 1958 for early work; Bergsten, Horst, and Moran 1978; Graham and Krugman 1995 on the reverse case of FDI in the United States; Graham 1996; and Rodrik 1997b for a discussion of the broader effects of globalization).

There are already many thousands of Americans (in addition to Europeans, Japanese, etc.) at work in China, managing as many as 250,000 Chinese employees on their payrolls.⁴ By learning from the expatriates, many of the obstacles to a clear conception of China's position and direction can be avoided. It is not that the opportunity to draw on these experts was overlooked until now. Only recently has the pool of expatriate managers swelled to considerable numbers, and it is now time to exploit this new community of China expertise.

This study aims to reach a number of audiences. The policymaking community in the United States and developed-country capitals will find it useful to examine views from the private sector. Commonly, such views are filtered through so many parties that they have lost much substance by the time they get to policymakers; this study cuts out the filters. Corporate planners and other business professionals view aggressive policies from the US government as a key variable in their China operations, which is one reason why they too will find this analysis important.⁵ Another is that despite their detailed knowledge of their own factories, they sometimes lose track of broader market trends addressed in this book. Academic readers with either general or business-related interests in China will find plenty of new questions worth pursuing, in addition to useful information in the interviews. Finally, Chinese government authorities will find here an honest appraisal of how well (or how poorly) their efforts to provide an attractive investment environment for foreign businesses are faring. The several reasons why Chinese authorities will read this study closely are the subject of one of the conclusions previewed in the executive summary and treated in depth in chapter 7.

A Methodology for Drawing upon Expatriates' Insights

The strategy of learning from the expatriates involved recruiting a set of firms willing to offer access to their managers in China and their frank opinions in return for anonymity. A core group of 13 firms participated; 48 managers from these firms were interviewed, while an additional 40 interviewees outside the core group were added ad hoc. Following their interviews, all reviewed the progress of the study.

4. American Chamber of Commerce in Beijing, "In China, the Twain Meet Almost Everywhere; Public's Association with US Industry, Culture, and Education Grows Daily," *Washington Post*, 24 June 1998, A26.

5. In interviews, several such planners identified US policy swings as the single greatest threat to their commercial success in the Chinese market.

These firms and individuals have unique insights, and the experiences on which they draw are extremely valuable. As the Beijing office director for one US conglomerate remarked in a 1997 speech to a US congressional delegation:

The 17 people in the representative office of my company are in and out of more government offices, in and out of more state-owned enterprises, in and out of more private Chinese companies, and meet with more Chinese officials, managers, intellectuals, and workers in a month than the US embassy political and economic officers see in a year. I make that observation as a former military attaché (personal communication).

As useful as this methodology is, qualifications must be kept in mind. The views presented are oriented toward commerce, without pretense of disinterest. They can be expected to differ from the observations of political scientists, activists, or anthropologists. Moreover, expatriate investors in China and exporters on the other side of Chinese tariff barriers might disagree. For example, a German investor inside China may take comfort in the same external tariffs that are anathema to his exporting rivals in Bavaria.

The number of enterprises that can be involved in such a study is limited. Over 120 interviews were conducted, of which 88 were systematically explored for substance (the rest were culled for material as well, though somewhat less thoroughly). The sample was biased toward US manufacturing firms, but significant discussions with Europeans, Japanese, and overseas Chinese in Hong Kong and elsewhere were also included. A size bias is present, that is, most were large firms. While an effort was made to canvass as broad a selection of industries as possible, not all sectors were examined.⁶

Questionnaires and wide-ranging interviews were used to draw out information from interviewees. Though the study employs academic literature, press reports, and business analyses to flesh out and fill in parts of the story, these interviews were the primary source and determined all the “specific issues” identified. The participants, ranging from directors of China operations to plant managers to lobbyists, were asked to describe both the experiences of their firms in general and the focus of their daily work in particular.⁷ Once the interviews were complete, remarks were grouped together by topic: for example, “comments about firm motivations,” “importance of management control,” “distribution,” “legal issues,” or “the role of relationships and connections.” After related groups of comments and company documents were put together with

6. See further appendix B, on methodology, which also includes a descriptive list of interviewees.

7. Local Chinese employees also provided background information, but the study intentionally focuses on the expatriate perspective.

published and unpublished materials, principal business functions were assessed. These functions are

- negotiation and establishment (chapter 2),
- human resources and staffing (chapter 3),
- productivity and production management (chapter 4),
- ex-factory distribution and marketing (chapter 5), and
- legal obligations and privileges of ventures (chapter 6).

Though it was rare to find perfect consensus across industries and locations, the comments of expatriates revealed clear patterns and trends.

In addition to discussing broad themes, respondents described specific challenges. These groups of issues are listed in the concluding table to each chapter. The analytic section of each chapter examines the implications of these themes. How should these many topics be thought about, and which of them deserve the most prompt attention from readers concerned with policy? To answer this, four “drivers” of business problems are postulated: transitional problems, self-imposed problems, policy problems, and market structure problems. Distinguishing among these causes helps us to focus on those commercial concerns that foreign policy activism can affect and set aside those beyond the reach of policy intervention. Far too often, all issues regarding China have been seen as policy issues, and if this study does no more than uproot that tendency, then it will have succeeded.

Transitional problems reflect the adjustment of China’s rapidly evolving economy from statism to the market. While Chinese authorities can marginally soften the impact of such problems, they are to a great extent inevitable and must be weathered.⁸ For example, shortages of skilled labor will plague China for some time as a result of high growth rates and inadequate capacity for training key types of professionals. The solution is to develop greater training capacity and the market incentives to pull people into school and then match them with employers. It is important to recognize these transitional adjustments as such, because misdirected intervention on the assumption that they are policy problems could hinder efficient outcomes or make things worse.

One of the least-noted dimensions of the foreign commercial experience in China is the second category: *self-imposed problems*. For many reasons, foreign investors sometimes have entered the Chinese market hastily,

8. Though present (as opposed to past) policy cannot be blamed for transitional problems, it can play an important role in facilitating the process of transition.

sometimes recklessly. Often they have relied on data, partners, and assumptions that would never pass muster at home. The relative dearth of home-country analysts capable of second-guessing managers in China has contributed to these lapses.

But by arguing that they simply use the best information available and that the Chinese market is just too large to ignore, firms hardly answer these criticisms. Once established, foreign investors have often declined to scale the cultural walls that separate the expatriates in the special economic enclaves from the real expanse of the Chinese market. New “compradors”⁹ often make this too easy for them. Therefore, many of the priority themes identified in interviews with foreign professionals in part originate with the firms themselves.

There is no question that many of the phenomena treated in this study involve *policy problems*. Government intervention, only partially lessened by the press of market forces, still pervades China’s economy. New policy activity—some of it virtuous, some misdirected, and some simply bad—issues forth from the seat of power at Zhongnanhai (China’s executive leadership compound in Beijing), as well as from lowly town rat-control boards.

Last come *market structure problems*. These problems are due not to policies in place but to the *absence* of procompetitive policies on the part (primarily) of central authorities. The preventive measures needed to support an open market include antitrust rules and a host of others as the Chinese economy becomes more sophisticated. The policies must address concentration of market power, public and private collusion in restraint of competition, and anticompetitive practices. In their absence, barriers to market entry naturally arise (as do similarly unhealthy efforts to bar *exit* from the market), harming consumers—especially the poorest—and foreclosing opportunities for new entrants both foreign and domestic (that is, other Chinese firms). While these problems are not specifically caused by policy, they cannot be remedied without policy reform.

Beyond identifying the proper drivers behind each business concern that the expatriates identified, this analysis indicates—where policy problems are involved (i.e., policy and market structure problems)—whether the policy problem is central, provincial, or local in nature, and whether the issue is considered high priority by foreign investors. This additional information will help Western policymakers separate policy issues that deserve focused pressure on central Chinese authorities from less immediate concerns.

9. Compradors (a mildly derogatory term from the pre-Communist era) are local Chinese agents of foreign merchants, used as a buffer between local markets and foreign business (see chapter 2).

Questions Needing Answers

This study provides busy policymakers with a comprehensive description of the real China experienced by expatriates living and working there today. Because policymakers do not have time to spend in the field (and, when they are in China, rarely have ample time for these business professionals), chapters 2 through 6 of this study bring the expatriate insights to them instead.

Building on its descriptive analysis, this study also seeks to provide answers to a set of China-related questions more relevant than those that have preoccupied the United States in recent years. Policymakers in Washington have fixed their attention on human rights, intellectual property rights, and the bilateral trade balance. More recently, concerns about inadvertent technology transfer to the Chinese military as a result of deeper engagement has become a hot topic, as have allegations of Chinese interference in US political campaigns.

These are all more or less valid areas of inquiry; but are they the most important questions bearing upon the long-term interests of developed economies, especially the United States? Many China specialists are frustrated that this narrow agenda crowds out a host of other questions that deserve serious attention. The answers to these questions will suggest no less rich an agenda for US policy toward China than have the recurrent politicized debates.

This section briefly lays out 10 questions that will be dealt with more completely in chapter 7. The reader should keep them in mind throughout the upcoming chapters on specific business functions.

How Compatible Is China's Present Investment Environment with International Expectations?

There is no one answer to the question of what level of Chinese economic openness is acceptable to the major trading nations today. The United States, Japan, and the European Union have expressed different opinions. The openness of the investment environment is clearly significant, though, because a local presence is often a prelude to selling goods and services in China.

The establishment process remains a tool to exclude foreign ventures deemed counterproductive to development in China, though the large volume of utilized foreign direct investment (FDI) does demonstrate extensive openness. The remaining impediments—and reasons why money continues to flow despite them—are explored in depth in chapter 2, while inequalities in the subsequent operating environment are explored in chapters 3 to 6. The process for many sectors is often more open than it first appears, and foreign investors can sometimes enjoy as

many privileges as restrictions once their enterprise is set up. Moreover, in gauging the compatibility of the Chinese marketplace with international expectations, no one can insist that China come up to Hong Kong standards. Absolute levels of openness differ among nations, reflecting, in part, legitimate social choices.

What matters most is whether China passes the tests of national treatment and most favored nation status in the context of its investment environment. FIEs in China face noncommercial burdens ranging from partnering pressures to corruption to residual restrictions on scope of operation. But there is no one standard of treatment even for domestic firms; indeed, foreign firms can enjoy a level of independence from state intervention greater than does the typical Chinese *state-owned* firm, tempering the national treatment concern. The most favored nation principle is also hard to assess. It is difficult to find a pattern of specifically *country-oriented* investment privilege. Even US firms reported little discrimination based on their “Americanness,” despite threats and tensions over bilateral political flare-ups. These key indicators suggest that the “openness” of the Chinese market in an investment context is minimally acceptable.

Why, Given Its Domestic Worries, Should China Care about the Concerns of Foreign Enterprises?

There are five reasons for Chinese authorities to attend to FIE concerns. First, they want FDI to keep coming, which necessitates a profound understanding of the needs of FIEs today (mere tax holidays are no longer sufficient). Second, the distinction between Chinese and foreign firms is disappearing. Third, a growing number of purely domestic firms are calling for many of the same reforms as do FIEs, in order to compete on a more even footing with them. Fourth, China needs to play by international rules in order to nurture its access to foreign markets, and that means attention to the concerns of trading partners. Fifth, the technocrats in Beijing know that they must deal with these problems if China’s economy is to be competitive.

Has China Really Turned a Corner, and Should Foreigners React Differently to Its New Leadership?

There is considerable evidence that China has broken with past trends. Changes include a more open market, less emphasis on performance requirements (see chapter 2), more attention to smuggling and petty corruption (see especially chapters 4, 5, and 6), and an expected reduction in the size of the Chinese bureaucracy. Moreover, interviewees expressed strong confidence in Zhu Rongji’s leadership. These developments coin-

cide with the passing of Deng Xiaoping, return of Hong Kong, and ascension of Zhu Rongji to the premiership, all seminal political watersheds.

The tangible political and economic developments inside and outside China suggest that the “new” China seen during President Clinton’s 1998 summit meeting is genuine. This break with the past can be for the good (more open and fair competition) or for the bad (more private collusion and asset stripping), but it must be understood before any policy actions are taken. A Chinese leadership serious about deep domestic liberalization and structural adjustment deserves more robust consideration from the United States than does leadership committed to an inadequate status quo, and such leadership is in evidence.

Will the Chinese Economy Be More Open to Foreign Participation in the Future?

This is among the most difficult of questions to answer; the verdict thus far is mixed. The comments of expatriate managers today, especially those recorded in chapter 5, make clear that traditional policies restricting FIEs from competition have eroded.¹⁰ Some Chinese authorities saw the inevitability of this long ago, while others continue to resist domestic competition from foreign firms even today. Foreign firms have made alliances permitting them to penetrate the Chinese firewalls. They are, to varying degrees, actively involved in distribution, service, and even retail sales. In their eagerness to grow, in many sectors they are shaping the first nationwide markets. While the number of FIEs grows, the most important indicator of openness to foreign firms is expanded scope of operation. And as documented in the following chapters, such expansion is taking place in many places and in many ways, though mostly still informally (i.e., without unambiguous legal encouragement to do so).

As firms find their way forward inside the economy, external barriers continue to fall. Trade negotiators haggle over a simple average tariff that has fallen to less than 15 percent in 1998 from over 40 percent in 1994 (though tariff peaks in key sectors remain a problem). Moreover, the revealed average tariff rate is below 4 percent, owing to myriad leaks and loopholes in China’s customs system.

But despite these encouraging signs, problems remain. First, informal central policy still plays a major role in distributing economic opportunities in China, no matter how low the external tariff may be. Until firms establish a presence in China and learn to do business effectively, the marketplace can seem quite impenetrable taken sector by sector. Chapter 2 provides a good look at the role of partners in finding opportunities to sell. Second, even as policy barriers fall, other difficulties worsen—for exam-

10. See also the section of chapter 2 titled “Keeping Up with the Joneses and the Yamamotos.”

ple, the (ironic) scarcity of qualified local workers, hindrances created by the firm themselves (particularly by misjudgments during establishment), and market structure problems.

Are Foreign Corporations in China Influencing Social Trends in a Positive Way?

Chapter 3 of this study, on human resources, documents the array of mechanisms by which FIEs in China are transferring skills, opportunities, and benefits to workers. As Chinese authorities disassemble the remaining elements of a command economy, such as subsidized housing and free burial services, the superior model of employment at foreign-run facilities and their positive impact on China are increasingly apparent—to *Chinese* policymakers, who seek to emulate not only their mechanistic efficiency but their cultures of opportunity and social mobility. However, Washington policymakers seldom acknowledge the social benefits of foreign involvement in China. Those who know of such effects often predict virtuous results from commercial activity alone, irrespective of social agendas; those who are ignorant of them tend to condemn the economists as myopic. Policymakers have elected not to disrupt the ability of US firms to do business in China not *in light of* foreign enterprise's social impacts, but *in spite of* them—often arguing incorrectly that these effects are negative.¹¹ Isolated negative incidents have shaped opinion, dissuading policymakers from championing the presence of US firms in China.

Will World Trade Organization Accession Address the Commercial Priorities of China's Trading Partners?

Despite the broad competence of the World Trade Organization (WTO) to manage international trade, important Chinese policy problems remain outside its purview. The organization's agreement on investment (Trade-Related Investment Measures) opens the door to arbitration over performance requirements imposed on FIEs (discussed in chapter 2) but cannot prohibit several important types. The government procurement agreement is not required of China, nor are certain important sectoral agreements that are of keen interest to WTO members, including the United

11. For example, Rep. Chris Smith (R-NJ), in a 1996 missive, argues that the Clinton administration policy of "engagement" through "stronger economic and diplomatic ties" has led to worse human rights abuses (Smith 1996). Some members of Congress have taken the position, as did Sen. Craig Thomas (R-WY) on 12 September 1996, that "contact with the West through trade has let a genie out of the bottle that the regime in Beijing will never be able to put back" ("The Annual MFN Debate," Congressional Record 1996 (104th), page 510, 404). But even in those cases, the virtues of foreign business are depicted as abstract; the direct effects of employer-employee contact are not examined.

States. More important, the WTO does not yet squarely address the area of domestic competition—the problem of sales opportunities foreclosed not by public policy but by private actions.

I argue (especially in chapter 5) that as firms are transferred away from national ownership, local internal trade blockages will increase. These are not wholly private matters, given the involvement of lower-level governments in local enterprises and state policy lending among the remaining state-owned enterprises (SOEs). But the “corporatization” formula for shedding state ownership is afoot. This will create the sort of nationwide *private* foreclosure that foreign firms have complained about in Japan and have unsuccessfully tried to address through the WTO.¹² Therefore, rather than concentrate solely on the WTO, there should also be a discussion of commercial remedies in partnership with progressive Chinese leaders. This recommendation is bolstered by evidence that China is resigned to defer WTO accession until the dust of the Asian financial crisis is settled. The venue could range from the Asia Pacific Economic Cooperation (APEC) forum, to a bilateral competition discussion, and to a plurilateral “Competition Round” (or “Shanghai Round”) initiated at Chinese suggestion.

Do Economic Trends Augur for Cooperation between US and Chinese Authorities, or Confrontation?

More trade between China and the United States will inevitably bring more commercial disputes but not necessarily more conflict. Canada and the United States have had as many trade disputes with one another as any other couplet of nations. That does not mean that their commercial relationship is not healthy. The rapid growth of new commerce portends transactional disputes, as explored in chapter 6. In fact, this analysis suggests a very significant role for cooperation between US and Chinese economic authorities.

The most problematic foreclosures of markets will increasingly involve private actions, not policy, actions that will probably harm Chinese firms even more than FIEs. Indeed, they are already producing harmful outcomes, and the United States and China share an interest in avoiding further development along these lines. The costs to China are high: exacerbated regionalism and urban-rural division. And the United States does not wish to face another marketplace that, like Japan’s, is dependent on exporting because of rigid domestic trade impediments. That dependence would hamper China’s ability to assume a regional or global external pol-

12. Importantly, this will be a concern not just for FIEs but for nonlocal Chinese firms as well, some of which already complain bitterly about being locked out (of the Shanghai auto market, for example).

icy, as the United States and other G-7 nations desire. Therefore, there is strong logic on both sides in favor of Sino-US cooperation to build capacity and a common agenda to support each other's procompetitive regulatory functions (see the "Competition Round" suggestion in the previous point). The blind eye turned toward Japan's domestic practices during the Cold War is not an option for China, and Chinese leaders understand that.

Will China's Central Government Remain the Conductor of Chinese Reforms?

Throughout this study (but especially in chapter 2), expatriates describe the tensions between central and local authorities and limits on Beijing's ability to compel local behavior. While FIEs initially welcomed local autonomy as allowing greater freedom from bureaucratic constraint, many interviewees have recently come to realize how the lack of national preeminence frustrates their desire to expand beyond compliant local partnerships. The US national interest is clearly in bolstering Beijing's regulatory power as well, as bilaterally negotiated agreements of all stripes are worthless without the ability to implement them locally.

This microeconomic study does not clearly predict how this tension will be resolved. Several interviewees judged the strong center and significant devolution of control scenarios to be equally likely. Central authorities are using FIEs to help train policymakers to deal with modern commercial regulatory tasks such as legal authorization, rescinding some licenses granted by localities that exceeded national guidelines, and providing more rational compliance mechanisms; these are essential for the strong center scenario. Moreover, both wealthier provinces (fearful of potential social unrest in a time of transition) and poorer provinces (still dependent on fiscal transfers from the wealthier regions) will continue to look to the center for help. Given the convergence of domestic, FIE, and foreign government interests in a robust central regulatory and security authority, the study concludes that the center will bear responsibility for China's reforms for some time, perhaps to an even greater degree in the future than today.

What Is the Prognosis for Foreign Firm Performance in China in the Coming Years?

In 1996 the Council on Foreign Relations' James Shinn edited *Weaving the Net*, a study on engaging with China. If this were concerned solely with the prospects for FIEs in China over the next five years, it might be titled *Leaving the Net*, a study in disengaging from Chinese partners. It is extraordinary how many expatriate managers in China still privately brag about their cozy relationships with local government entities, regulators,

established firms, or other power brokers who made them adopted children and brothers in the fiercely contested Chinese market. But as the family grows, so do quarrels, which impede productivity (discussed in chapter 4). Will anyone be bragging about cozy relationships in five years?

Management analysts have observed “phases” of FIE development in the Chinese market.¹³ In the first phase, businesses explore the Chinese market and make initial investments to get established and learn how things work. The second phase involves efforts to optimize productivity, to market brand names, and to identify distribution channels. The third phase brings acceptance as a local entity committed to China for the long term and, presumably, the right to compete aggressively within the Chinese market.

The number of foreign firms that have reached phase three is still small compared to those at earlier points. Most FIEs arrived in China in the first half of the 1990s, and many of them are experiencing difficulties dealing with sometimes intractable partners. The prognosis for future FIE performance is of course affected by market conditions, the resolution of the financial crisis across Asia, and a host of other factors. All other things being equal, however, many expatriate managers point to the relations between foreign firms and their Chinese partners as the most telling determinant of FIE performance for the coming years.

The dynamics of these relationships are discussed in chapter 2, particularly as regards venture format, and in chapters 4 and 5, regarding productivity and ex-factory issues respectively. Pertinent evidence includes a shift toward wholly owned foreign enterprises (WOFEs) and away from joint ventures (JVs), buyout or reduction of some Chinese partner shares in existing JVs, and increasing acceptance of Sino-foreign partnerships that limit foreign control only on paper. It appears that foreign firms increasingly will rise or fall on the basis of their own business plans, unhelpt and unimpeded by shotgun marriages. Incumbents already stuck with indissoluble arrangements are likely to fare marginally worse, while the new wave of establishers will have a better chance of succeeding in the Chinese market. To genuinely separate commercial and political interests, and to deliver improved prospects for foreign and domestic firms alike, Beijing must ensure that public, centrally directed cronyism is not merely replaced with private or locally directed cronyism. As such wholesale privatization of business and government is a new phenome-

13. Several interviewees expressly rejected this three-stage model of business development in China, claiming that it offers a false trajectory and creates low expectations. They insisted instead that a firm should have its eyes clearly fixed on a path to profitability before ever signing a contract in China, denying the need to “bleed for some years” en route to success. Surveys by the EIU suggest that many successful firms turn profits in under three years, less time than the three-stage model would suggest is necessary. To many of the managers interviewed, however, the stage model did seem valid.

non on such a large scale and with so little market-oriented heritage, the outcome is naturally difficult to predict.

Is China a Source of Endless Excess Capacity That Will Threaten Other Economies?

China plays a leading role in the debate over the existence of a global capacity glut. It has even been suggested that new Chinese capacity, combined with a supposedly cheap renminbi policy after 1994, precipitated the Asian financial crisis in 1997.¹⁴ Such misapprehensions arise because the situation within China is not understood.

Internationally, the shift of production to China reflects not so much an addition to capacity as a transfer of capacity along lines of comparative advantage. Economies that had some years ago lured lower-value-added industries away from nations such as the United States and France now were being forced to move up the value chain themselves (see Noland 1996, 14–19). Unwise capital allocation and insulation from the market, which blocked signals that capacity had to be shifted, led to problems.

But *within* China, overcapacity is a salient concern in competition to serve domestic markets, mostly because of naive local investment strategies and barriers to market exit. The result is more a Chinese “sectoral glut” than a global one, but the sectors affected are of particular interest to trade negotiators. Expatriates typically argue that their firms would survive were constraints on competition and bankruptcy in China lifted. So far, Chinese policymakers have tried to address their sectoral overcapacity problems with an approach less consistent with the WTO spirit, limiting entry to and exit from overcrowded markets. This is not an efficient way to use the scarce resources within the Chinese economy.

Results

The analysis presented here challenges assumptions about the scope of policy orchestration in China. It suggests that the frustrations of foreign firms can be self-generated, can reflect issues of transition, or can result from market structure problems—and thus may not be easily remedied by decree from Beijing. Once it is recognized that Beijing is incapable of delivering some of the policy concessions sought, finite negotiating energies can be redeployed. This point underscores the need to provide some

14. See Fernald, Edison, and Loungani (1998), Rosen, Liu, and Dwight (1998), and Noland et al. (1998) for arguments countering these incorrect views. China’s renminbi actually appreciated in real terms following consolidation of the exchange rates at the end of 1994.

support for China's central authority, or at least to temper enthusiasm for the rapid devolution of authority away from Beijing.

By categorizing the obstacles to FIE operation, this study supports more accurate analyses than those focused on Chinese border barriers or negotiating positions alone. Formal positions lag behind developments in China—because policy takes time to formulate, as elsewhere, but also because China's central bureaucracy lacks capacity, is removed from the marketplace, and refuses to acknowledge some practices for ideological reasons (or out of embarrassment). By the time authorities liberalize distribution, for example, one can be assured that foreign participation will have had been taking place for some time: indeed, it already is.

The US government should not disregard Chinese official positions in setting its negotiating objectives: that is not how government-to-government negotiations work. But national strategy and negotiating objectives are not the same thing either; strategy should fully account for the realities on the ground, no matter how far removed from those realities Chinese negotiators insist on staying in the short term.

This study concludes by examining the implications of China's WTO membership, especially regarding aspects of market access that the organization cannot promise to address in its current form, and hence draws out an alternative strategy for progress. Efforts should focus on securing full scope of operation for FIEs in China up and down the value chain, a goal closely tied to dissuading China from relying on a Japanese or South Korean model of industrial policy for growth. The views of foreign managers regarding social trends and conditions suggest that political change in China is closer than widely believed. In light of these perspectives, how can US firms and the US government join efforts to influence this process positively when it comes? That is, how can they help China to achieve the most efficient economic governance possible, sacrificing the least liberty and entrepreneurialism for the greatest welfare gains to China's people: that is the question.