
Ex-Factory China: Distribution, Marketing, and Services

Invigoration of the domestic economy also means opening the domestic economy. There are, in fact, two open policies: open to the outside and open to the inside.

Deng Xiaoping, 1984 (cited in Wedeman 1995, 1)

[I]f the underdeveloped nature of [China's] distribution system causes a further gap in living standards among regions, we have no guarantee that what we fear most will not occur. . . . Material affluence must be enjoyed, not only in one part of the country but by all citizens. . . . This goal cannot be accomplished without modernization of the distribution system. . . . Chinese distribution systems represent not just a "Dark Continent" but a potential quagmire. Yet I feel that it is my duty as an entrepreneur to help modernize distribution in China, for the sake of peace in China, in Asia, and in the world.

Isao Nakauchi, 7 December 1994
(Drucker and Nakauchi 1997, 20–22)

Distribution Rules: A Domestic Trade Policy

Encountering the almost religious fervor of Isao Nakauchi, a Japanese executive, as he talks about China's distribution systems with his friend and business consultant Peter Drucker, many Americans—in Congress or commerce—might be perplexed. More trucks are needed so that ice cream does not melt en route to Hangzhou from Shanghai, and this threatens world peace? Surely such a claim appears hyperbolic. Yet in the opinion of many of his fellow expatriates at work in China, his remarks are not, in fact, off the mark. The state of the systems of distribution within the Chinese economy is probably the single best predictor of the sustainabil-

ity and stability of the experiment in economic reform taking place in the People's Republic of China.

For 50 years, the international trade policy regime has been developed and refined, in order to bring freer trade and the accompanying economic benefits to nations. Its embodiment is the World Trade Organization (WTO), whose focus has been border barriers to trade, such as tariffs, quotas, and arbitrary trade bans (e.g., those couched as spurious health concerns). The regime has been fairly successful at dealing with these impediments. Partly because tariffs are lower as a result of the General Agreement on Tariffs and Trade and WTO, and partly because trade with less economically developed countries such as China has increased, attention is turning to the domestic analogue of the open international trade regime: domestic distribution rules, or *competition policy*. Ironically, although the belief that openness in international rules of trade produces rich rewards for everyone involved is almost universal, openness in rules has barely taken hold *domestically* in many countries.

In exploring foreign participation in the marketization of the production process at the plant level in China, the previous chapter provided an essentially microeconomic analysis. But its implications go beyond the enterprise: the market model of economic efficiency also affects the design of commercial policies governing the interaction *among* economic actors, whether the sellers and buyers be firms or individuals. While market forces are reshaping production processes in China, the actual “markets” where goods and services are bought and sold exist *outside* the firm. This may seem obvious; yet even today, many state-owned enterprises (SOEs) in China are loaded with so many functions and tasks that employees could go a lifetime transacting almost all business within their firm—including housing, groceries, education, medical care, entertainment, and burial.

Such concentration of functions resulted from an excessive concern with equity, which led government planners to provide for economic needs entirely by fostering cooperation (the hallmark of activities within a firm). Competition policy, while recognizing the importance of equity objectives, seeks to achieve efficiency goals as well.¹ There is no single proper balance between cooperation and competition as tools to generate economic outcomes, and no society would want to rely on either exclusively.

China is no exception. The 20-year reform period has been, in effect, a time of experimentation during which different implicit competition policies have been applied to different segments of the Chinese economy. Early on, foreign-invested enterprises (FIEs) were introduced to China largely to cooperate with Chinese firms in the domestic economy (by sharing skills, technologies, finance, and work tasks) and to compete in

1. The introductory section of this chapter is heavily indebted to the work of Graham and Richardson (1997b) in making competition policy clear and understandable to policymakers and noneconomists.

the international economy (through their exports). Over time this demarcation has eroded; today, FIEs both compete in the domestic economy to a significant extent and cooperate with Chinese firms and regulators in a manner that sometimes fails to serve the best interests of the nation.² The ad hoc competition policy regime implicit in China appears to have outgrown its usefulness: the present Chinese marketplace requires a more considered, explicit set of rules for domestic trade. At stake are the fortunes not just of foreign firms but of domestic firms as well—indeed, the aggregate welfare of the Chinese economy is in question.

Before suggesting what the shape of an updated and formalized competition policy regime for China might look like, this chapter picks up the story of the emerging business environment in China where chapter 4 leaves off: it explores the *ex-factory* business functions. Our concern here is everything that happens after the “product”—say, a toaster—is wheeled out of the factory door (see also box 5.1). It must be marketed, advertised, and moved to a point of sale through a set of distribution channels. It must be checked for damage suffered in transit and presented for sale, and perhaps credit terms must be provided to the wholesaler, retailer, or final buyer. The sale must be facilitated and supported through warranty and service. The measure of a market’s *contestability* lies in the firms’ ability to undertake (to whatever extent needed) these functions—in a word, to sell.

A broad set of factors can block ostensibly productive enterprises within a country from serving demand efficiently, thus denying buyers lower prices and a full selection. These obstacles to market-oriented distribution contribute to losses in potential GDP, per capita income, and productivity growth for the nation. Over the longer term, the lack of feedback and signaling among investors, producers, sellers, and buyers—hallmarks of open domestic distribution—has a deleterious *dynamic* effect; that is, economic development will (at a minimum) proceed more slowly. It becomes impossible to divide labor according to comparative advantage, firms cannot decide what to focus on and what to outsource, and cooperation among producers becomes less certain and therefore less productive. These are efficiency arguments in favor of domestic distribution rules.

As Graham and Richardson (for example) stress, competition policy is also properly informed by equity considerations, or “fairness”—a far tougher standard to measure and one subject almost inherently to different interpretations (1997a, 7–9). Nevertheless, it is clear that FIEs walled off from distribution solely due to their foreignness have an equity bone to pick in terms of Chinese competition policy as well; just as important, so too do the great majority of Chinese firms excluded from domestic mar-

2. FIEs, like domestic firms, are forced by the present regulatory environment to engage in collusive arrangements that underperform more competitive models of industrial organization.

Box 5.1 Distribution feedback leading to efficient production

Consider the sophistication of a modern distribution system such as exists in the United States. A small-town retailer notices he is low on a brand of shampoo. Restocking his shelves is a process with many elements, each of which reduces economic waste:

- An inventory management system, typically computer run, tracks the retailer's stock and changes in demand.
- A local distributor can supply the store with product in small quantities, often less than a case, in a matter of days (so that low inventories can be maintained, reducing costs).
- A higher-tier regional distributor is capable of meeting the needs of the numerous local distributors on a timely basis.
- Physical infrastructure—including dependable roads, communication systems, trucks, and smaller vans—exists to move product to the retail level; bottlenecks along these arteries are instantly identified and circumvented; and increasingly, whole fleets of delivery vehicles are tracked via satellite.
- The human resources needed to manage the flow of goods and information through each channel down to the buyer are in place, keeping track of stock, making deliveries, and resolving problems, all with a minimum of graft.
- Financial infrastructure facilitates payment, credit, and allowances among retailers, wholesalers, and manufacturers.
- Demand (national, regional, or even local) is coordinated with marketing and advertising campaigns that affect product flow.
- As signals of demand flow up the supply chain from the retail level to manufacturers, quick production and pricing decisions are made in short order, the product mix is adjusted in the medium term, and new products are developed over the long term.
- Quality assurance and other services, including repair, are available to support the sale—especially for more expensive purchases.

ket opportunities because they are Sichuanese companies in Shanghai or Henan firms in Harbin. It is hardly surprising to find Chinese firms fighting against foreign entry into the domestic market when they themselves are boxed out of the bidding as soon as they leave their hometowns.

The impediments to domestic trade in China fit well into the four categories applied throughout this study. Purely physical problems such as a lack of roads represent daunting transitional impediments to distribution, which will take time to remedy. Unfamiliar with China's many such deficiencies, foreign firms sometimes create problems for themselves by failing to plan ahead for these challenges. Chinese policy plays an explicit and major role in this area. Finally, the market structure emerging in the absence of a formal competition policy is inviting serious collusion in restraint of trade, segmentation of markets, and other problems. National

commitments to permit foreign market entry in order to satisfy external pressures are probably the easy part of the solution; uprooting anticompetitive behavior *within* China's many disparate marketplaces will be the real challenge.

Distribution in China

Pre-1949

Debate continues on the extent to which China saw dynamic growth in the prewar period (1890–1930). There is little question, however, that the commercial infrastructure in China before that time was relatively primitive. By the 1930s China's transportation system was comparable to that in the United States prior to the Civil War (Rawski 1989, 223). Its people were more poorly connected than those of any other major economy of the day, a situation rooted in China's expansive geography, overwhelmingly agrarian economy, and low rates of capital formation. As Rawski explains,

The shortage of financial capital tightly constrained the expansion of production and trade in all sectors of the Ch'ing [1644–1912] economy. . . . The lack of funds restricted the size and scope of mercantile activity. During the imperial era, China's economy spawned a variety of institutions that alleviated the effects of the shortage of capital. Farmers formed revolving credit societies. Merchants employed brokers who performed a variety of services, but whose essential function was to hasten the rate at which commodity stocks could be turned over, thus expanding the volume of trade that could be conducted with a fixed financial base. The urgency of saving time allowed men with no financial assets to begin brokerage careers on the strength of their personal integrity and willingness to spend long hours in search of potential trading partners for merchants who willingly paid fees for successful introductions. (1989, 155)

Two important points can be gleaned from Rawski's observations. First, the lack of mercantile foundations at the start of the twentieth century, though remedied to an extent, continued to shackle the economy. Second, distribution networks and other market-clearing mechanisms would spring up to fill the need, in the absence of pressures otherwise. Unfortunately, violent civil war and the Communist agenda provided just such pressures.

Communist Era

After 1949, the victorious Communists perpetuated the neglect of policies that would support the market. Mao emphasized the precept of "self-reliance" (*zili gengsheng*) above all else (except perhaps national defense). Spurning the notion of comparative advantage that would argue for economic specialization internally (and externally), he prodded the Chinese economy toward local self-sufficiency from the early 1950s onward (see,

e.g., Naughton 1996b, 51, 62).³ In refuting Soviet admonitions to divide labor among socialist nations, Mao declared:

[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[.] (quoted in Riskin 1987, 206)

Whole industries were transplanted out of developed areas and dropped into the interior, in order to create a reserve “third front” in the event of foreign invasion. The emphasis on self-sufficiency suffocated the tendency for the supporting components of a market economy (such as marketing) to develop alongside production. Connections with international markets were at best severely limited; in most cases they were entirely severed. Incentives to expedite domestic trade were squelched. The physical infrastructure necessary for the efficient flow of goods was neglected, reducing even the potential for interprovincial trade. There is little reason to connect towns and regions and to facilitate trade among them if everyone is supposed to be producing everything for themselves.

Post-1979

The manic commitment to local self-sufficiency largely halted when reform began in the late 1970s. The marketization of the Chinese economy has proceeded apace since then; businesses increasingly grapple with the problems of a working rather than a moribund economy. Yet reform initially had a good number of complications, both residual and new, and many of them remain today.

Prior to reform, state-owned entities, or “state trading companies” (STCs), monopolized the distribution process. STCs tended to be hierarchically organized vertical monopolies, usually with four or five levels of distribution (national, regional, provincial, local, and/or county), and in some cases they controlled retail sales as well. Distributors simply moved preallotted quantities of goods from factories run according to state plan to the selling or consumption points. They had little incentive to improve their efficiency: if goods sat on shelves, no signal to slow production

3. Wedeman (1995, 23) notes that during the Mao period, in compliance with the Great Helmsman’s penchant for regional and local self-sufficiency, one microeconomy’s local roadblocks and trade barriers against the products of its neighbor represented *adherence* to policy, not *violation* of it. Echoes of such behavior still ring through China’s economy today, as they have in one form or another since at least the Warring States period (475–221 BCE). Wedeman traces the evolution of the term *guanqia*—roughly, illegal customs posts—back to that ancient time (17).

reached back to the factory; if they sold out, there was nothing to do except wait for the next cycle's allotment. Lacking incentives for higher levels of output, manufacturers had no interest in the odd distributor who might take the initiative to move more product (that would only get them saddled with higher quotas in the next planning cycle).⁴ Retailers similarly had little incentive to increase inventory turnover. Moreover, each product generally had its own distribution bureaucracy, precluding any opportunity to bundle complementary products (bagels and cream cheese, dumplings and soy sauce). Few mechanisms were available to signal changes in tastes or demand, distinguish between innovative and obsolescent production, or differentiate between high- and poor-quality output; the distribution infrastructure, which serves these purposes in a market economy, existed almost solely to move products through a linear progression of steps.

One reform permitted manufacturers to distribute their wares directly to customers, thus ending the monopolies of the designated STCs (their fiefdoms had been enshrined in policy; there were no applicable laws). As a result, the various layers of distributor in the old system began competing with one another for business.⁵ Soon, entrepreneurs were trying to make a profit by moving goods, as pent-up demand for such services showed the way. Today, state-run distributors compete with small, non-state upstarts in many sectors; between 1990 and 1994, goods handled in the old manner fell from 85 percent to 40 percent of the total. Sectors monopolized by large STCs are now the exceptions instead of the rule.

As producers were learning to discriminate among distributors, central authorities were promoting greater macroeconomic level competition as well. The designation of special economic zones (SEZs) nourished pockets of prosperity and generated a virtuous scramble among jealous localities to take advantage of the new conditions, either by lobbying for similar status (which would help a jurisdiction to court foreign direct investment [FDI]) or by establishing an office or agent in the SEZs.⁶ Yang (1997, 48) traces the internal linkages, or *neilian*, that formed like ant-pheromone trails between SEZs and interior provinces in the early and mid-1980s. These pronounced enhancements of distribution architecture were a (perhaps unanticipated) consequence of coastal experimentation.

But the competition could be fierce and frightening, too. The central authorities were simultaneously forcing localities to innovate through "fiscal starvation" as they cut back budget resources unilaterally. Early re-

4. There are cases of SOEs passing out huge bonuses in order to avoid showing a profit that would cause the state to increase their profit requirements the following year (EIU 1996a, 9.5).

5. The Economist Intelligence Unit's *China Hand* (1996b) dates this change to 1986.

6. In 1991 there were 111 SEZs; in 1993, 8,700 (Yang 1997, 56).

forms invigorated value-adding industries on the coast that relied on cheap, undervalued raw materials and basic heavy-industry inputs from the interior. As provinces were thus split between the more and less favored, those in the disadvantaged regions sought remedial steps such as barriers against the onslaught of products from coastal growth centers. These early advantages, even if redressed by subsequent policy, may have given coastal centers a head start that entitled those in the interior (by their way of thinking) to distort distribution channels in compensation (Wedeman 1995, 29). Local governments were inclined to protect their local resource bases. Many set up interprovincial trade barriers by blocking channels of distribution.

In *Bamboo Walls and Brick Ramparts*, Wedeman (1995) describes China's interprovincial trade wars of the 1980s. In province after province, governments directed investment into the same sectors.⁷ The resulting overcapacity was predictable (in hindsight), and it largely caused the rush to local protectionism that followed in the late 1980s. As Wedeman (1995, 197) put it:

“blind introduction of [manufacturing technology] and redundant construction” in defiance of local comparative advantage worked at cross purposes to increased local specialization and weakened structural incentives to expand trade as local governments in less developed regions sought to expand local manufacturing and localize the production of key industrial productions.

Local protectionism to guard local markets against dumping from next door emerged and spread as provinces reciprocated. As specialization and efficiency were undermined, these severely segmented markets made economies of scale unattainable. Only in sectors without local champions (such as high-technology industries) did modern distribution on a national level develop unimpeded.

Wedeman's study also relates the central government's battle against provincial mercantilism, whose importance the quote from Deng Xiaoping that serves as an epigraph to this chapter makes clear. “Opening to the inside” has in many ways been a more difficult task than opening to the outside.⁸

7. The sectors on which Wedeman focused were appliances, beverages, chemical fibers, chemicals, coal, construction materials (extraction), cotton wares, electronics, ferrous metals (extraction), food processing, garments, light machine building, metal products, nonferrous metals (extraction), plastics, steel and iron, textiles, tobacco processing, and transport vehicles and automobiles (1995, 195 n. 11).

8. However, imports still go through a more layered distribution system than do domestically manufactured goods. In many cases the product starts with a Hong Kong transshipper; it next goes to a Chinese trading company and then into the layers of provincial/regional/local wholesaling en route to consumers at the retail level. Avoiding the vagaries of those layers was a powerful motive for setting up FIEs inside China. Nonetheless, for many FIEs and Chinese firms, shipping among Chinese cities produces more headaches than does importing.

Simply rescinding the STC monopolies has not made the distribution system efficient. Central policy still prevents FIEs from distributing any products they do not manufacture in China proper, and the selection of local distributors remains poor even when distribution markets are not heavily concentrated. Where entry is permitted, an oligopolistic market structure often still predominates, owing either to the short time since reforms began or to nontransparent barriers to entry.

The perils of these present distribution problems are fivefold: they aggravate local income inequality, they augment regional disparities, they make administering the Chinese economy more difficult, they are economically costly in the aggregate, and they present an objectionable barrier to foreign firms while failing to offer real protection in return. Reform to remove these undesirable effects is clearly in the central government's interest.

Peter Drucker argues that only "distribution-led economic development can create the *human resources* which China needs more than anything else" (Drucker and Nakauchi 1997, 22). Indeed, the level of business savvy of the average newspaper-stand owner in Beijing or Guangzhou seems to exceed that of the typical SOE manager. It seems likely that the Chinese now rushing into the vacuum left by years of bias against ex-factory commerce will power the country forward in the years to come.

Foreign Investors and Distribution

A "dual economy" has characterized China during the reform period, as Naughton (1996a) has pointed out. Foreign investors, it was hoped, would provide export-oriented growth. Of course, foreign investors more often than not had the domestic market in mind, as had been the case for centuries. As the attentions of FIEs increasingly focus on the local market, the machinery of domestic business operations becomes important. "Distribution" is the most immediate of a group of concerns that arise once the time comes to get manufactured products to market, promote them, and sell them; others include wholesaling and retailing, trade financing, advertising and marketing, service (repair and maintenance), and management of transaction problems. Deng Xiaoping was acutely aware at the start of reforms that long-standing distribution inadequacies were robbing China of efficiency. While that realization set him ahead of preceding policymakers, remedial action is still far from complete.

It is impossible to generalize about foreign investors in China with regard to distribution (such generalizations are equally impossible from the perspective of domestic companies, explored by Wedeman 1995). Foreign enterprises differ markedly in their target customers (many still only

export), product, size, and location of operations within China. Even enterprises with similar profiles can face vastly different distribution challenges. Furthermore, it is unclear whether the distribution strategies presently evolving should be considered success stories or evolutionary culs-de-sac, as the central government may yet clamp down on them. Many other practices are not even known yet; by the time the government endorses a practice (or researchers get wind of it), it has usually been in illegal use for three to five years.

This section will describe the regulatory framework that foreign firms confront as they establish operations in China. Central concerns raised by expatriate managers are then examined. While not an exhaustive survey of the stratagems used to control the ex-factory fate of the product, it does focus on recurrent points made by foreign managers, including what they see as sources of problems. It provides a broad sense not just of the distribution challenges but also of the way these shape market development in general and of the considerable progress achieved in this area.

The Regulatory Environment

No law in China governs the activities of FIEs in the area of distribution per se. Rather, the rights of foreign investors to participate in distribution of their products are mentioned in passing in a number of laws. Chinese regulations generally treat distribution as a distinct sector, not an inherent element of a manufacturing business.

The Catalogue for the Guidance of Foreign Investment Industries (see appendix A) categorizes distribution activities among “restricted foreign investment industries,” in subsection “B.” This means that central-level approval is needed for any foreign participation in distribution as a line of business. The Guidelines make clear that wholly owned foreign enterprises (WOFEs) are not permitted in domestic commerce or foreign trade, reiterating the restriction also found in Article 4 of the 1990 Detailed Implementing Rules for the Law of the People’s Republic of China on Wholly Foreign-Owned Enterprises. In joint ventures (JVs) involved in distribution, to the extent they are centrally approved despite their restricted category status, the Chinese side “must be the holding party or play a leading role,” meaning it must have a majority standing in the ownership of the venture.

The WOFE Rules (Articles 45 and 46) stipulate that WOFEs are prohibited from domestic or foreign trading generally but can sell in China their own products (Chinese-made, not goods produced by sister units of the firm or parent companies outside China), either directly or through a local agent. However, the Rules limit such sales to product in excess of an agreed on “sales ratio” that specifies what share of WOFE production

must be exported (the “export ratio”);⁹ all other domestic sales must be approved by the overseeing authorities. Joint ventures are generally permitted to distribute their Chinese-made goods as they see fit, without a statutory export ratio, but they similarly may not engage in domestic trading of any product that they do not manufacture. Despite the prohibition on distributing goods in China manufactured outside the country by their own companies, they find more or less legal ways to do so quite often (further discussed below). Firms that are not established in China may not distribute products directly in the Chinese market; instead, they must first sell the goods to a Chinese foreign trading company—the only agents authorized to receive invoices from the sellers.¹⁰ Foreign investors, unable to control businesses engaged in distribution services, can now provide only for their own distribution needs.¹¹

The point about invoicing is important, for the illegality of collecting bills without proper standing to ship and sell their products is precisely what makes life so difficult for most FIEs. But, as is the case with every other realm of business law and regulation in China, actual practice is far more complex than national law would suggest. Complexities arise because:

- The regulations are drafted with considerable ambiguity, leading to both legitimate differences in interpretation and considerable legal efforts to find loopholes.
- Central authorities use this ambiguity to privilege favored firms or industries, and to withhold normal rights from firms or industries as a form of protectionism.
- Administrative guidance (from various and sometimes competing sources) can override the basic laws and regulations, either explicitly or unofficially.
- Provincial or local authorities may interfere with the national limits on distribution, being either more generous (to lure investment or meet other local goals) or more restrictive (to protect local interests).

9. Although Japanese companies are beginning to focus on the domestic markets, they remain more dependent on exports. Domestic sales made up about 40 percent of their total sales in 1995. This ratio is rising slowly but it remains considerably lower than that of US companies, whose domestic sales were 80 percent of their total in 1994. The Japanese companies rely on exports because they are more profitable; indeed, Japanese foreign affiliates play a similar role in many Asian countries.

10. As described below, many imports are sent through an intermediate channel: Hong Kong trading companies and “converters” are able to get goods into the Chinese market at significantly lower rates of tax, duty, and sometimes theft.

11. However, there already exist a number of foreign-invested distribution consultancies that contribute strategies to—without directly managing—FIE distribution (interviewee #1 operates such a system).

- WOFEs, whose sales in the domestic market are limited by the negotiable and unequally enforced export ratios, may be saddled with high ratios that foreclose domestic trading opportunities.
- Central or local indifference toward enforcement (or impotence) can mean viable opportunities for FIEs to distribute in spite of the law (as has been the case in the retail sector).

New legal structures may soon permit greater FIE participation in distribution. First, a few “joint venture trading companies” have been approved, though with significant qualifications (see footnote 10 in chapter 2).¹² Second, FIE trading companies set up in Waigaoqiao, a section of the Pudong new development area in Shanghai, may purchase products, “export” them into the trade zone from anywhere in China, and then sell directly anywhere in the world. This may be interpreted to mean the companies can sell back directly into China to anyone they want, *after* paying import duties (#1).¹³ Furthermore, these firms may be able to purchase worldwide and distribute goods into the rest of China from Waigaoqiao. The firms can invoice in renminbi directly, the trade zone authorities handle the import/export documentation (for a fee), and the renminbi can be swapped for foreign exchange to transact further business. At the moment, this practice seems to be legal.

FIE and Distribution in Practice

While the regulatory regime is being loosened incrementally to allow wider FIE participation in distribution, many foreign firms are already more deeply involved than the law would suggest is possible. Acting in the belief that law follows practice in China, not the other way around as in the West, they have good reason for their bold behavior. First, involvement in the distribution process is key to knowing who a firm’s customers are, critical information for marketing purposes. It is also important for ensuring payment, as many local businesses routinely ignore obligations until administrative pressure is brought to bear on them. Second, involve-

12. Interestingly, the Shanghai representative of a large American conglomerate (#6) reported that her firm chose to decline an invitation to receive one of the few licenses to establish such an entity. The reasons: a suspicion that profits from the venture would disappear, and a certainty that some of the firm’s strategic business units would refuse to let others elsewhere in the firm take the lead on distributing their wares. This internal fighting was a source of tremendous frustration to the interviewee, a Chinese citizen, who found it difficult to explain to her local government contacts why her Fortune 100 company rejected a much-sought license.

13. Some may interpret (and are interpreting) the Waigaoqiao regulations to permit them to trade and distribute directly, without having to pay duties as though the goods were reimported, but that reading is more questionable.

ment is essential in order to teach (and provide incentives for) shippers and sellers to operate more efficiently and thus to move more product. Third, in the absence of an overarching procompetitive stance on the part of central authorities, many FIEs are worried that firms that fail to seize a distribution channel for themselves now will be closed out later. And fourth, there is an out-of-control aspect to the distribution picture in China that leaves some firms little choice: they must do it themselves or it will not get done. As the Economist Intelligence Unit noted, “The downside of this evolutionary process [of breaking up state distribution monopolies] is that distribution in China has progressed from a tightly organized—if rigid—system to a chaotic system with few rules and little means of enforcing the rules that do exist” (1996b, 9.8). The chaos remains, although the rigidity imposed by limited channels to market may be returning in some sectors as well.

For clarity, the laundry list of concerns raised by expatriates about marketplace conditions will be grouped into four sets of government imperatives:

- *Let go of the bad:* Legal restrictions on scope of business and the ambiguous legality of distribution operations in practice must be redressed.
- *Grab the good:* Domestic firms and FIEs alike are eager to develop more extensive operations addressing specific functions, such as marketing and services; they should be encouraged through the development of good regulations. The physical infrastructure required for efficient distribution also requires attention.
- *Principles, not just policies:* Unless authorities take direct action (beyond mere rule making) to control the behavior of local authorities, ministries allocating market shares, and private and quasi-private companies employing anticompetitive practices to block other firms’ access to the market, the benefits of a contestable marketplace cannot be enjoyed. Corruption problems plaguing the marketplace also require executive action.
- *Include the foreigners:* Because of their own choices and their forced adaptation to the Chinese regulatory environment so that they might participate in the marketplace, foreign parties are still distinguished from domestic in the Chinese view. Complex corporate structures and resulting internal organizational problems, failure to plan well, and a predilection to delegate direct involvement in Chinese markets all separate the foreign-invested sector from the domestic. But in reality the distinctions are quickly eroding, in part because external waves of pressure are reshaping Chinese distribution patterns. Authorities must transcend the “who is ‘us’” debate (in which all globalizing nations engage) and secure commercial activity, domestic *and* foreign.

This could just as well be called “include the outsiders,” as nonlocal Chinese firms are as prone as foreigners to be excluded locally.

Let Go of the Bad

Regulatory Regime

Removing impediments in the existing regulatory structure is the first, most explicit, and probably most important step that FIEs call for to improve the ex-factory marketplace environment in China. The regulations have already been discussed in detail. While they are implemented to serve parochial needs at the local level, they essentially reflect national policy, as local distribution positions derive from top-level directives. If such policies were left to localities or even provinces, sufficient competition would be generated to counteract most anticompetitive barriers. As it is, FIEs are finding back doors into domestic commerce that circumvent the limits set out in law, thereby eroding the utility of the existing regime. In the long term, competition will cut through efforts to base local gains on antilocal policies.

Ambiguity

FIEs complain that central policy is designed to keep them guessing. “The strategy for finding distribution channels,” bemoans the government affairs manager for an American firm, “is to explore what you can get away with” (#15). The more fastidious a firm is about adhering to the letter and spirit of the murky law, the more disadvantaged it will be in dealing with distribution issues in China. US firms in particular—bound by the Foreign Corrupt Practices Act—are hindered more than others.

Ambiguity provides room for a government inexperienced at managing a market economy to experiment. As one interviewee put it, the center remains aloof until it can no longer avoid decisive action; then it moves slowly and deliberately. But while this wiggle room on policy makes life more comfortable for Beijing, it frustrates many FIEs. It is hard to be certain what is legal and what is not, and that by itself is a source of frustration to firms concerned about legality. Most FIEs settle for keeping their distribution activities from clear illegality, which is quite different from keeping them legal. Yet other firms distinctly *prefer* legal murkiness to the glacial pace of opening implied by a strict interpretation of national law. So even as many complain about the current state of distribution, many are quietly building extensive networks. Inchcape Pacific, for example, has bundled a variety of licenses together to offer broad logistical services. Proctor and Gamble is envied for the success of its approach, evident in its shampoo being sold on most of the street corners in China.

The general manager of the Beijing-based holding company of an American chemical multinational spoke frankly about how ambiguity on

the highest level affected his distribution function. The first task, he explained, is to find out what the existing laws mean, which requires trusted local hires who are politically well connected. The next, more difficult task is to obtain an “interpretation” of the “provisional implementation” of a law or regulation. To Western sensibilities, the process is duplicitous:

Even a vice premier said China would not open its trading regime for at least five years. If this is the case then fighting to open it will not be wise for the firm. To exist, you must move product. You must find a way, find someone, to help you send an invoice, and then to get paid for it. So you team up with a local company. They can bring in the [imported] product, and resell it. [Our firm] has an agreement with them to pay a certain commission. [Our firm] is doing all the marketing, all the real management of the Chinese company. It's just a front providing the service of shipping. Then that agent has the responsibility to collect payment. The agent often has influence, intimidation, they can use that to extract payment. (#15)

China is more unpredictable than most emerging markets because Beijing has enough leverage over investors to change the rules of the game if it sees fit. And because of the particular hurdles facing central authorities who seek to shape an efficient market structure, the government may see fit to do quite a range of things.

Grab the Good

Collecting

Expatriates stress that distributing product is the key to numerous attendant business functions, ex-factory issues that are essential to tailoring operations to customers, assessing creditworthiness, and developing an ongoing service relationship with customers to secure buyer loyalty and satisfaction. The most critical of these functions are collection/finance, marketing, and service provision. They are not all walled off from FIEs explicitly (FIEs may gather marketing data for their own use), but restrictions on distribution stymie these efforts in practice. In other areas, notably services, FIEs are more directly prohibited from developing a business presence.

Because FIEs need to finance the inventories being expanded by the retailers and wholesalers, they need better control over their property as it moves through the economy. Conversely, a key reason why the existing state-owned distribution channels are folding is their inability to provide and manage the credit needed to make distribution run smoothly (EIU 1996b, 9.6).

The heart of the collection issue is accounts receivable. The interviewees had diverse responses on this topic, agreeing only that dealing with it was a large drain on managers' time. Happy FIEs claimed accounts receivable averages of around 30 days or less, and pointed to deposit or advance payment requirements as essential. Less sanguine finance directors (and less senior officers more generally) reported waiting up to 120 days or

more to get paid. Many interviewees saw their receivable periods lengthening, but this could have been a cyclical event.

This state of affairs is complicated, though many firms are driven to offer long terms by cutthroat competition. More important, however, is the point that knowing the customer is absolutely essential to getting paid anywhere in China today—and that knowledge requires intimate participation in distribution. If FIEs must move their wares through state-dominated channels, then they will fare no better than the indigenous dinosaur enterprises to which they are connected through interlocking debt.

One finance director put it like this:

If you don't get paid, you need to make noise at the brother, father, grandpa companies [referring to the interlocking holding arrangements common among new Chinese firms]. Especially it's useful to say, "If your son [subsidiary] can't pay, maybe you can pay me 95 percent [of their debt]." The more you know, the more quickly you can act. (#15)

Scrambling to build market share, FIEs will find such relationships powerful aids to their balance sheets. But these ties cannot be developed unless the foreigner is allowed to face buyers directly and assess their purchasing power.

Marketing

To the extent that restrictions on distribution insulate FIEs from their customers, they lose the ability to carry out marketing research directly, having to rely on less-sophisticated local surrogates instead. For General Motors interns in the Beijing office, this has meant being sent into the streets of the capital to find out who is buying their cars after the middlemen get them, so that GM can set up a relationship with those buyers.

Service Provision

Like the products they distribute, the products that FIEs may service must be from their local manufacturers and not unaffiliated goods. They technically cannot even service products made by their firms elsewhere and imported into China. However, there appear to be exceptions to these rules. First, several expatriates suggested that a handful of firms had secured superregulatory service rights by cozying up to regulators. Second, many FIEs "manage" local companies providing service to their products in parallel to their local manufacturing. As with sales, the implication with service is that the "localness" of these Chinese partners is a ruse; their operations are managed by the FIEs. Third, the products that many FIEs are most concerned about servicing are indeed their local manufactures, and they are expanding their service networks quickly to do that (recall table 4.7).

But for many FIEs that strategy is not yet feasible. High-technology firms must be able to service complicated products that they are not yet

able to manufacture in developing China (imagine the complexity of a CAT scanner or a jet aircraft engine). Other firms are simply uncomfortable doing service in China in a “gray” manner and are insisting on clear legal approval. And in a highly competitive environment, many FIEs will be able to differentiate themselves from local and foreign rivals only on the basis of their superior service. Unless subtle (and less subtle) firewalls are removed, they will be unfairly locked out of the market—a market, therefore, that will be dominated by service providers of inferior quality.

Physical Infrastructure

Expatriates talk a great deal about the state of China’s physical distribution infrastructure. Despite tremendous growth in recent years, the country still lags far behind in the stock of roads, railways, and other arteries needed for transport and distribution. Delayed infrastructure development is likely the greatest impediment to productivity growth for FIEs and Chinese firms alike. Tables 5.1 and 5.2 summarize basic indicators for physical distribution infrastructure. Table 5.3 shows the retail infrastructure in China, while Table 5.4 compares it to that of more mature markets.

Joe O’Leary of the Polaroid Corporation states his concerns this way: “Polaroid doesn’t have a market access problem in China. We’re satisfied with the duty rate. It’s physical distribution that’s the problem. Distribution in China is one of the biggest challenges that Western companies face.” In O’Leary’s case, the problem is a largely state-owned trucking industry that is subsidized and thus insulated from the market pressures that might force it to be more efficient (quoted in “6-Year-Old Polaroid Venture Gives China Its Best Shot,” *Journal of Commerce*, 1 October 1997, 7D).

A large logistics company included in this study (#21) can provide the most basic infrastructure item: a fleet of vehicles owned through its China joint venture. McCormick China gets its product to the Shanghai market through a fleet of small vans that provide marketing materials to retailers as well (Spicing Up the Chinese Market, Catherine Gelb, *China Business Review*, July/August 1997, 25). But outside local markets, roads are rarely developed sufficiently to permit distribution by truck. The few exceptions include the Guangzhou-Shenzhen-Hong Kong corridor; hence the statement by several interviewees that infrastructure was decisive in their decision to locate in Guangdong (##8, 19).

Cross-country distribution mostly relies on the rail system, the only truly national connector. But those using it face serious delays, pilferage, bribery, and other problems (##18, 40). The Chinese and foreign managers of a Sino-American manufacturing venture interviewed together in northern China (#23) decried with one voice the tendency of railroad shipments simply to stop during holiday seasons—or for no reason at all. “International shipment is no problem,” they said; “shipping to south China by rail or boat” is the tough job.

Table 5.1 Distribution infrastructure growth: structure of freight volume by transportation type, 1978-96

Year	Railways (percentages)	Highways (percentages)	Waterways (percentages)	Total freight traffic (thousands of tons)	Railway freight traffic (thousands of tons)	Highway freight traffic (thousands of tons)	Inland waterway freight traffic (thousands of tons)	Civil aviation freight traffic (thousands of tons)	Principal seaports freight traffic (thousands of tons)
1978	44.2	34.2	17.4	2,489,460	1,101,190	851,820	432,920	64	198,340
1980	20.4	69.9	7.8	5,465,370	1,112,790	3,820,480	426,760	89	217,310
1985	17.5	72.1	8.5	7,457,630	1,307,090	5,380,620	633,220	195	311,540
1990	15.5	74.6	8.3	9,706,020	1,506,810	7,240,400	800,940	370	483,210
1991	15.5	74.4	8.5	9,857,930	1,528,930	7,339,070	833,700	452	532,200
1992	15.1	74.7	8.8	10,458,990	1,576,270	7,809,410	924,900	575	603,800
1993	14.6	75.3	8.8	11,157,710	1,626,630	8,402,560	979,380	694	678,350
1994	13.8	75.8	9.1	11,802,730	1,630,930	8,949,140	1,070,910	829	743,700
1995	13.4	76.2	9.2	12,348,100	1,658,550	9,403,870	1,131,940	1,011	801,660
1996	13.0	75.9	9.8	12,962,000	1,688,030	9,838,600	1,274,300	1,150	851,520

Source: State Statistical Yearbook, 1997, China State Statistical Bureau.

Table 5.2 Infrastructure development under the Ninth Five-Year Plan, 1996-2000

Sector	Capacity to be added, 1996-2000	Total capacity^a	Capacity growth, based on 1995 level (percentage)	Total investment (billions of dollars)^a
Aviation				
Passenger traffic (million)	55	100	122	na
Air freight traffic (million tons)	0.9	1.8	100	19.7 ^b
Ports and waterways				
Shipping traffic (billions ton-km)	595	2,300	35	8
Roads (km)	130,000	1,230,000	12	37
Telecommunication				
Exchange lines (million)	70	140	100	60
Power				
Total installed capacity (gw)	90	300	43	64.3 ^c
Nuclear power (gw)	18	20	852	na
Coal				
Production (million tons)	230	1,500	18	24
Oil				
Production (million tons)	36	185	24	48.9 ^d
Oil refining (million bpd)	0.9	4.6	24	na
Gas				
Production (billion cubic meters)	2.6	20	15	na
Total capital investment	na	na	na	303

na = not available.

a. Estimated.

b. Includes \$16.3 billion for aircraft and \$3.4 billion for airports.

c. Half of this capital budget is to go to transmission lines.

d. Includes \$38.5 billion for oil and gas exploration and \$10.4 for oil refining.

Source: Australia Department of Foreign Affairs and Trade (1997a, 237).

Principles, Not Just Policies

Distribution and Local Authority

Authorities at the provincial and local levels of government control the typical FIE's market access to an even greater degree than central rules do.

Table 5.3 China's retail structure, 1980-96

	Retail stores (thousands)	Population (millions)	Retail stores per 1,000 persons	Persons per retail store
1980	1,463	987	1.5	675
1985	7,783	1,058	7.4	136
1989	8,412	1,127	7.5	134
1990	8,710	1,143	7.6	131
1991	9,240	1,158	8.0	125
1992	10,063	1,171	8.6	116
1993	11,570	1,185	9.8	102
1994	12,260	1,199	10.2	98
1995	13,287	1,211	11.0	91
1996	13,963	1,224	11.4	88

Sources: *State Statistical Yearbook*, China State Statistical Bureau; *International Marketing Data and Statistics*, 1996, Euromonitor, quoted in Arie Goldman (1996a).

Table 5.4 Retail structures in five selected markets

		Number of retail stores (thousands)	Population (millions)	Retail stores per 1,000 persons	Persons per retail store
China	1996	13,963	1,224	11.4	88
Japan	1992	1,591	126	12.6	79
United States	1994	1,513	258	5.9	170
Hong Kong	1993	57	6	9.5	105
Singapore	1993	20	2.7	7.4	137

Sources: *China Statistical Yearbook*, China State Statistical Bureau; *International Marketing Data and Statistics*, 1996, Euromonitor, quoted in Arie Goldman (1996a).

As discussed in chapter 2, gaining the local license to operate is generally the most important hurdle that foreign investors need to clear,¹⁴ and doing so requires making compromises. Local authorities know how important distribution is, and they can use their influence over it to allocate and manage market share, protect favored industries from competition, and shape investment patterns. Their power ranges from influencing the export ratio for WOFEs, to approving a labor contract for a JV that seeks

14. Recall that as a rule of thumb, projects under \$30 million in value can sidestep the need for central-level approval (provided they meet other requirements in the Guidelines—see appendix A). The great majority of FIEs are established under that ceiling.

to shed preexisting distribution staff, to designating what will be considered a “local manufacture” and thus qualify for local distribution rights.¹⁵

Central authorities increasingly are pushing social obligations (e.g., pensions and other elements of the workers’ safety net) down to the localities. Local authorities are heavily invested in local enterprises, and their base of political power is often dependent on their industries as well. Looming SOE and banking-sector reforms (including a bankruptcy mechanism) will bring additional pressure at the local level. Thus, local authorities have potent reasons for using influence over distribution as a tool to deal with the costs that they are responsible for, especially in the absence of any strong procompetitive policy promulgated from above.

Local parochialism is not necessarily bad news for FIEs; some individual firms are enjoying privileged positions. For example, foreign oil companies are eager to get into retail distribution through ownership of fuel-service stations. However, the national Guidelines for foreign investment explicitly state the central government’s disapproval of foreign participation in retail service stations (see appendix A, “Restricted Industries,” category A).¹⁶ Yet industry representatives interviewed for this study reported:

Small foreign [gasoline] firms will go directly into distribution, especially in southern China, and not worry about the Ministry of Internal Trade [MIT] cracking down on them; larger firms stand back and use a middleman. The middleman comes to us and says, “I have approval for 200 gas stations.” We check it out, and someone at the MIT will confirm to us that this agent does in fact have the right to invite us into business—he somehow got past MIT or whatever ministry. If we trust the guy enough, we will let him use our name; if not, [we will supply the gas and he will] use a local name. (#12)

Once firms crack open the market they become less concerned about, or perhaps even antagonistic toward, further opening for competitors. The FIEs that are first into the market often intend to dominate local distribution. The petrobusiness manager quoted above continued:

[There are] limited means of distribution in China, and it’s a crowded ballroom. People are looking for partners. There is a limited amount of time to partner up. Once these partnerships are formed, it will be an oligopolistic marketplace: a few competitors will split up the retail market—including services—and control it. China is a chaotic, anarchic market trying to find a template, a pattern—a collusive one. Barriers to entry will increase, and the first firms in will make the money. This is not a matter of policy for China, it’s just the way it will play out.

To date, his company has far fewer than 200 gas stations around Guangdong; it appears to have about the same number as Mobil, Shell, Caltex,

15. “Manufacture” can be used very loosely; rolls of imported plastic were approved for local distribution by a JV simply because they were cut in half in Shanghai.

16. The exception is along “superhighways,” where the Guidelines invite foreign participation—a distinction that echoes the separation of advanced enclaves from the main economy.

and Hong Kong-based Fortune appear to have. These firms and others are getting a taste of the distribution process in gas retail, and they are doing so through the permissiveness of local authorities in Guangdong Province. Their local partners, the middlemen with special dispensations to enter into distribution/retail arrangements, are often associated with local governments, or perhaps the People's Liberation Army. Local quasi-governmental entities may collect fees or a share of profits from the stations. Most important, the number of such stations now appears to be capped. Costing only \$10,000 or so a station to open up, these venues are cheap; instead of opening markets, these partnerships with local government may now serve to ensure that capacity does not drive down margins for established ventures. Under the guise of better enforcing national law, local officials can thus protect existing players from new competition.

Direct influence at the license/start-up phase of the business (when distribution rights are defined) is just one way in which the behavior of local governments affects FIE distribution. As noted above, local trade wars raged between jurisdictions in China in the 1980s. Tactics included setting up local customs posts (*guanqia*, which are gates across the road) where trade is fined or taxed, attempting to corner resource markets or otherwise prevent raw material from reaching other producers (*ziyuan dazhan*), and engaging in predatory pricing and other anticompetitive practices (*jiage dazhan*) (Wedeman 1995). These aggressive measures attracted considerable criticism from Beijing, and central policymakers have waged campaigns to stop them. Though progress has been made, local distribution barriers orchestrated by subnational governments continue to distort commerce and investment. This occasions much complaint—but many FIEs use the parochialism to their strategic advantage too. An auto-sector specialist in Beijing noted:

SAIC [Shanghai Automotive Industries Corporation] and, just as importantly, its JV partners—GM and VW—are looking to distribute products nationally. Ultimately, this will be the only way to compete profitably in the market. This does not preclude JVs' using local protection to suit their own purposes at various points in time. Protectionism at the local level in the auto industry is rampant throughout China and will likely remain so for some time. (#46)

An interviewee with a competing auto consortium described a typical tactic:

Shanghai auto industry authorities had a regulation on their books requiring that all cabs had to have 1.6-liter engines, which happened to be the specification of Shanghai-built VW-model cabs.¹⁷ This effectively was a ban on TJs [a Chinese-built car made in Tianjin] and Citroen [a Chinese JV model made under the Dongfang name in Guangzhou and Wuhan]. The central authorities came out and said Shanghai couldn't do that—but Shanghai continued to do it anyway. The center [Beijing] couldn't stop them from favoring VW in this way. (#26)

17. Cab fleets still constitute a major portion of the passenger car market in Chinese cities.

The Beijing-based consultant corroborates:

The municipal Shanghai government put forth a regulation stating that only cars with engines having a displacement of 1.6 liters or above may be used as taxis. They further stated that cars without trunks (i.e., hatchbacks) could not be used as taxis—these were aimed at the Tianjin Xiali mainly, but also affected the other small cars (the Changan Airto and the Wuhan/Citroen Fu Kang). These cars were making inroads into the Shanghai taxi market as they have done elsewhere. As usual the loser is the consumer. I can't comment on exactly what passed between the central government and Shanghai. Regulations are not always followed. What is clear is that there are fewer and fewer non-Santana [i.e., non-VW] taxis on the road. (#46)

This interviewee also observed that the city of Wuhan retaliated with a carefully tailored set of cab restrictions of its own. The result of such policies, as so often seen, is markets more segmented and collusive than they need to be. Unable to distribute vehicles nationally, auto firms will not attain economies of scale in production. Efficient scale would permit firms to produce more cars with fewer resources, thereby better serving the Chinese market and—ultimately—competing head-to-head with efficient producers worldwide. In an extreme example already noted, there are still many state-owned vehicle factories in China producing a few thousand or even fewer vehicles a year (see table 4.6). Because these facilities need subsidies and their poor-quality product must be absorbed, more efficient producers lose opportunities to distribute better-made products and to lower unit prices by increasing the volume shipped.

Local impediments to efficient distribution take myriad forms, and only a few examples have been presented here. Several qualifications should be added as well, however. First, these issues can affect domestic companies as well as foreign enterprises. One cannot assume that FIEs are singled out at the local level for discriminatory treatment just because central regulations make such treatment possible. Second, these concerns are not unique to China, though they may affect China to a greater degree than elsewhere because of the legacy of Mao's self-sufficiency campaign. Third, the amount of local interference in distribution varies widely across firms, sectors, and regions. And finally, it is worth recalling that the central government has exerted pressure against local protectionism in recent years, though with mixed success.

Allocated Market Share

Some interviewees argued that their total available market was "allocated" by industry authorities whose plan was to nurture not competition or marketplace efficiency but local champions. This protective action seems most likely when a limited number of buyers have budgets directly influenced by central economic authorities: for example, in the area of telecommunications switching equipment. In this sector, a limited num-

ber of provincial telecom entities operating under the guidance of the national Ministry of Post and Telecommunications (MPT, in the process of merging with several other ministries) are the buyers and operators (and regulators).¹⁸ Seven Sino-foreign joint ventures, which together control about 60 to 65 percent of the market, offer equipment in this sector, while the remainder is shared among domestic suppliers (five with greater than 1 percent share, dozens smaller than that). The general manager of one of these joint ventures observed:

The central government has tremendous impact on your [sales] volumes. It's tough for us from North America to understand this. Access to knowing where the jobs will be, and who the customers [with authorization to make purchases] are, is essential. Your "allocated volume"—never in writing—is the key. We were so enamored of the Chinese market, we totally lost perspective that it was a controlled market. We thought we could outmarket the Chinese. We were wrong. It is a market *planned* economy. (#20)

Having learned to pay ubiquitous "rep fees" of perhaps 3 percent of sales price back to the customer (after the sale, never before—*that* would be a bribe!), this manager still cannot get his bids taken seriously in other provinces. Such restriction is this chapter's closest approach to an industrial policy *per se*. Allocating market share is a way for government either to keep more players in a market than the market would bear or to keep new players from coming in and eroding the margins of existing players. In a system in which Asian values such as the sanctity of doing business based on cozy relationships are held dear, it is easy to imagine that in volatile markets the urge to allocate would be strong, at least in some industries. It is conceivable, however, that the financial difficulties East Asia has experienced since 1997 might alter Chinese attitudes toward industrial policy. Time will tell.

Market Foreclosure

Several interviewees expressed concern that distribution channels would be "locked up" in China by private or quasi-private actors. The expatriates fear not so much constraint by central design, as in allocated market share, but old-fashioned private-sector monopolization, accomplished through control over distribution. They have observed that in some sectors there exist a limited number of distributors, that sometimes the

18. Some have questioned whether the national MPT really can control the powerful southern provincial telecom companies that are already half spun-off from their regulatory mothers. However, the ministry has unilaterally announced that Guangdong Telecom and Zhejiang Telecom would be bundled into a China Telecom Company to be offered as an "H-Share" offering to foreign investors on the Hong Kong market (Leah Nathans Spiro, "Goldman: Wired to a Wireless Bonanza?" *Business Week*, 13 October 1997, 94). This may signal a reassertion of national prerogative over cocky provincial authorities.

number is fixed or declining, and that barriers to entry (such as restrictions on foreign participation in domestic trading and retail) prevent new competitors from entering the market. Under such conditions, distributors could employ exclusive dealing arrangements, impose contracts requiring buyers to purchase exclusively from them, and stipulate tying and bundling that would foreclose market opportunities to other producers.¹⁹

These concerns mostly arise in sectors in which the state retains control of the distribution channels: for example, aerospace, coal, tobacco, and some agricultural goods, such as wheat. To be sure, this list is shrinking as traditional state distribution companies break up and enterprises expand their use of new channels. Nonetheless, limitations on entry into the distribution process are likely to persist, as industrial ministries fight to dampen competitive pressure within their fiefdoms.

But more important than these remaining pockets of statism is the tendency toward greater private concentration of market power when central authorities fail to promote and protect competition. Collusive arrangements involving formal and informal partnerships among local regulators, producers, and distributors permit a few firms to manipulate markets and thus achieve monopolistic profits. One interviewee stressed that such arrangements need not be a function of central government policy (indeed, they may even be seen as undesirable); rather, they will occur naturally (#12)—if there is no counterbalancing antitrust policy. These policies are critical to economic development in a globalizing economy, in fact, though they are only beginning to be discussed multilaterally (Graham and Richardson 1997a, 1997b).

One cannot help noting that private barriers to trade rising from the ashes of public barriers is precisely what has most worried foreign analysts of Japan's marketplace in recent years. The huge Kodak-Fuji case regarding photographic film that went before the WTO concerned private practices that had the effect of closing Kodak out of market opportunities.²⁰ The Dispute Settlement Body at the WTO declined to find on behalf of the US plaintiff, on the grounds that private restraints are outside of the organization's charter, but the issues raised in the case are certain to return soon. Japan has demonstrated how difficult such practices can be to deal with, once they are ingrained. Of course, the Chinese market differs from the Japanese in important ways, and little indicates that Chinese firms could act so concertedly on a national basis. At the local level, however, they will be increasingly disruptive to competition.

19. Analysis of such practices and their implications can be found in Scherer and Ross (1990, 562–69).

20. See Graham and Richardson (1997a, 1997b) for thorough explorations of this case and its larger context of competition policy.

Corruption and Distribution

Expatriates point to another factor complicating the distribution picture: corruption. Firms in many sectors confront “shrinkage”; that is, a portion of a given shipment of product disappearing between the factory door and the point of sale. One interviewee suggested that a 1 to 5 percent theft rate was acceptable to him (#1). Moreover, the quality of remaining product can diminish as a result of pilferage, as opened shipments are exposed to the elements. Similar shrinkage can also occur at the other end of the production process: arriving shipments of intermediate goods or raw materials may be tampered with in transit. Again, these are problems in all developing (and many developed) markets as well; but in China the limits placed on the ability of foreign investors to manage the problem by closely controlling distribution creates more tension than usually occurs elsewhere.

Corruption can also lead to FIE complacency about restrictions on distribution that insulate the firm from the sleazier aspects of the Chinese marketplace. Several managers thought it was just as well that their local Chinese agents handled distribution, as they would be uneasy engaging directly in the practices necessary to make sales, such as bribes, kickbacks, payments through “black accounts,” and so on (#19). Almost all interviewees agreed that it was next to impossible in China to both keep one’s hands completely clean and prosper at the same time. By situating distribution outside its control, the FIE gains some comfort in uncomfortable circumstances.

The China country manager for a large petrochemicals firm hints at a strategy for dealing with company positions that might be attacked as illegal or unethical: “In the US, what is not explicitly legal to us we worry is illegal; in the Chinese perspective it is the opposite. So our approach is the ‘return of the compradors’ ” (#12). Compradors, as explained in chapter 3, have a long history in China, and the term retains a pejorative connotation of Western imperialism. These intermediaries have always served as a sort of shock absorber between the ethical sensibilities of Western and Chinese businesspeople. Such partnerships are widely used today to skirt charges of corrupt practices, qualify a business for legal status, and otherwise deflect liability. Compradors themselves—even those with foreign citizenship—are not, of course, protected from prosecution if they break Chinese law. Nonetheless, the enterprising Chinese keen to profit from the gap between FIEs’ official practice and the compromises required for success in the Chinese market are evident everywhere.

Include the Foreigners

Organizing to Distribute

The original means by which foreigners entered the Chinese market was to buy an existing set of channels through a joint venture arrangement.

The commercial counselor at the US Consulate in Guangzhou remarked: “Yes, you can find a tactical way in, but only if you get in bed with a Chinese partner in order to distribute. . . . Is that what WTO means?” Indeed, this model has been less than satisfying to many FIEs. Chinese partners oversold the capacities of their channels and failed to update them to accommodate productivity improvements on the manufacturing side. In general, they were fearful of change, avoiding confrontation with vested interests that enjoy government patronage and resisting the release to foreign partners of authority to manage distribution assets; they worried that the result would be layoffs, cost cutting, and a loss of their own relevance as firms got to know clients for themselves.

Increasingly, therefore, FIEs have sought greater control over distribution, through partnership with Chinese investors who are more passive, or through more determined negotiation or pressure on Beijing to change the law. They must be able to choose efficient channels. In the words of one manager: “Relationships are important; if you are lacking market share, then you ought to get a better distributor” (#17). Getting a Chinese partner to break ties with a long-standing distribution partner can be very hard indeed if the FIE is confined to traditional organization structures.

The American petrochemical firm mentioned above produces a variety of agricultural chemicals at one joint venture in China, and hence—according to statute—it has the right to distribute those products through the distribution channels of its choosing. The JV’s parent firm also produces chemicals outside China purchased by the same Chinese customers. While it is logical to sell the two complementary chemicals together through the same channels—like tablecloths and dinner napkins—doing so is not permitted; an ostensibly Chinese importing company handles the item not produced in China. But the FIE effectively directs the sales, shipment, and marketing of the imported product, too. At the retail level one can hardly tell that the sister products arrive through separate channels. The middlemen receive an “agent fee” (*daili fei*) of 3 to 5 percent of retail price but add practically no value to the chain of commercial processes by which the product reaches the customer. These local “partners” are learning little about how to manage distribution, because the FIE makes all the decisions. Essentially, the Chinese are paid to be a shell.²¹

The firm has had to develop a complicated organization, creating a China holding company, which coordinates with the local JV and a Hong Kong company; “the Hong Kong agents have better control over billing and payment” (#17). While the local JV has a sales force to promote distribution of the locally manufactured products, sales into China of related products manufactured elsewhere must be made (and the invoice sent

21. One finance director described a common tactic: “Taiwan firms form a local shell JV, which is local from a legal perspective. As locals they can invoice, they can buy directly and sell locally. There are many of them” (#17).

from) the Hong Kong company (a subsidiary of the US parent). The China holding company—based in Beijing—is not permitted to engage in any sales, only to “coordinate” them by referring customers and otherwise representing the firm.

This arrangement generally has not worked well. At the time the holding company was created, the foreign investors knew that selling through such a structure was not explicitly legal. However, their negotiators were given to believe that in short order such activity would be permitted. In fact, the new regulations clearly barred holding companies from coordinating sales. Thus, the firm is left with an organizational structure that is bulky and not legally useful; moreover, it continues to face the same distribution problems, with retailers being invoiced separately—from local JVs, Hong Kong, and even the home country. However, the firm still hopes to use the promise of future investments as leverage in resolving these problems.

By contrast, the German chemical firm BASF has trumpeted a very similar organizational structure, designed to meet the same challenges, and it claims to have had a better experience. It too is most concerned with integrating its relationship with customers, as its slogan suggests: “one face to the customer.” Like the American firm, BASF established a China holding company, which owns 10 percent of each of the firm’s ten JVs. Acting as agent for the JVs, the holding company sells for them. Again, however, it is not allowed to issue invoices or collect the bills directly. But BASF uses a computer system to automatically invoice the appropriate JV for each “sale” the holding company makes. Managers at BASF claim this works well and have not expressed anxiety that the legitimacy of their organizational structure will be challenged.²²

Such markedly different experiences may be explained in part by different relationships with partners and within the firms. Complicated stratagems do not work without a good deal of complicity and cooperation within the organizational family. In order for the holding company to be effective, the JVs must fully consent to the arrangements. If they wish to retain control over customer relations and distribution, they may balk. It is also clear that such arrangements cannot succeed without the acquiescence of central authorities (especially when the firm touts its strategy publicly).

Organizational tangles can become even worse. The general counsel for another major American conglomerate (#7) described no fewer than seven overlapping distribution structures, each one built on top of the last and all still functioning. Thus the firm now has

- three separate joint venture companies (“to spread our dances around”),

22. This description of BASF’s operations is based on reporting by the Economist Intelligence Unit in *Business China*, 13 October 1997, 4–5.

- an import/logistics wholly owned company in Shanghai,
- a wholly owned China holding company that they had hoped could do distribution and service,
- 23 rep offices of the Hong Kong branch of their US-based international operations company, which provide service (technically illegal) on the firm's products, and
- 16 liaison offices set up under the holding company in the mistaken belief that they would be legally permitted to handle service and distribution.

Tasked with ensuring that the firm meets its worldwide commitment to full compliance with local laws and regulations, this general counsel is amply challenged by the China operations structure. He summarized, "The idea is to shut down the Hong Kong-parented branch offices. But in the meantime we have huge overhead here with these multiple layers. We are stuck with multiple distribution channels, none of which is clearly legal."

Firms seek other effective ways—short of achieving integrated distribution like BASF's—to serve the Chinese market. A common approach is to combine direct selling where it is legal and the use of local agents where it is not (or where the market is too small for the FIE). The director of the American chemical company cited above (#16) was realistic: "I am ready to go 100 percent to customers directly. For now, I would be happy with a combination of distributors [for smaller sales] and direct contact with big customers."

The manager of the Shanghai sales office of a high-technology company (a joint venture with the Shanghai Ministry of Post and Telecommunications, though the parent company's China operations are wholly foreign-owned) is trying to enlist the aid of independent distributors while he focuses on the bigger customers. These "independents" are useful because the nearby markets both are too small for the firm to look after and require more "specialized knowledge" (#24).²³ But the parent company in Tianjin, the JV sales office in Shanghai, and the Chinese partner to the Shanghai JV are all distributing products in parallel (#33).²⁴ The result is a good deal of conflict before a new distribution channel can be put to use by any of the three, but especially by the joint venture in the middle; the

23. This particular "specialized knowledge" apparently was in the application of bribes.

24. To further complicate the situation, Shanghai MPT has been instrumental in helping the firm gain entry to far-off Kunming (Yunnan Province) where collusive deals had previously locked them out. So the parent firm in this case has felt obliged to restrain its JV and let the Chinese distributors take the lead in Shanghai. The JV manager sighed, "[This is a good relationship, but] it takes a lot of energy to use relationships this way. In the bottom of our hearts, we'd like to see China a totally opened market."

partners get together regularly to review their distribution patterns and how they affect pricing, but that does not prevent confusion.

Another alternative emerging in China today is assistance from distribution consultancies or logistics companies with global experience. For example, UK-based logistics company Inchcape Pacific now has 2,000 employees in China, only 18 of whom are non-Chinese (and only 2 of those 18 are non-Asian). Inchcape has acquired a variety of trading licenses, which they exploit to the maximum. They have a JV transportation fleet, a JV freight-forwarding license, and a customs brokers license (also JV) that, bundled together, make possible one-stop distribution service to some customers. Focusing especially on fast-moving consumer goods, Inchcape has developed a strong presence in China. As a distribution firm with a foreign face, Inchcape offers other foreign firms a degree of comfort—at a price, no doubt. Other logistics companies are far smaller than this 70-country player; some ply the waters of a single city such as Shanghai (#1), or a single industry. While logistics companies provide a solution within the law (if loosely interpreted) for the distribution needs of some foreign businesses, “converters” operate in a grayer legal area. Converters take title to goods in Hong Kong, get them across the border, and resell them (often back to the same firm that brought them to Hong Kong, or an entity associated with it) with a lower markup than the statutory tax and duty regulations specify, including the fee for this service. The trick is to understate either the volume or the value of the goods being brought in. Any import must have a value-added tax (VAT) receipt with it when purchased, and the legal responsibility for its accuracy lies with the purchaser. Regardless of the particular arrangement with a converter, in the end the buyer is burdened with the taxes due on the import.

Some foreign firms believe that they must get a toehold in China but find the statutory duty rates prohibitive. By using converters, they are entering and gaining market share, albeit at risk of “channel shutdown.” A logistics firm director interviewed (#21) judged the central government content with the current level of these abuses (or not bothered enough to try to stop them in faraway Guangdong, anyway) and believes that Beijing probably has accurately estimated the costs. He pointed out that as tariff rates fall further, whether unilaterally or as a condition of WTO entrance, converters will become less and less relevant. Even now, they represent only a very small share of total imports into China, being mainly used for high-value, high-duty goods in Guangdong Province. Of course, as long as tariff rates remain high, then ways of circumventing them through shady distribution are likely to persist.²⁵

Only a small sample of distribution practices in China has been examined.²⁶ Especially in southern China, the reality is that a distribution

25. In 1998, another in a long line of antimuggling campaigns was announced.

26. See USCBC 1998 for more insight on distribution and the tactics of foreign firms.

regime far more liberal than the official standard is already in place. Business licenses have been approved permitting distribution centers to be set up in local jurisdictions such as Panyu, a wealthy Guangdong municipality in which freewheeling Chinese customers will find foreign firms merchandising almost anything, more or less directly to the public. Such centers, characterized by high-end imported goods, have been joined by distribution powerhouses such as Wal-Mart, which today operates in Guangdong as Sam's Club. These arrangements are generally made possible through a business partnership with a powerful local entity. They are tolerated either because Beijing is interested in seeing whether they work or because there is nothing the center can do to reel them in; indeed, there is truth to both explanations.

Failing to Plan for Distribution

Michael McCune is a young American who has been involved in distribution activities in Shanghai for some years, including the design of distribution strategies for FIEs. He had a clear sense of the weakness of most foreign investors: "China reps typically come to Shanghai with three folders: a negotiating plan, a production plan, and a marketing plan. But since they are coming from mature markets, they do not come with a distribution plan." A Beijing-based expatriate made a similar observation:

A [foreign] firm took a 95 percent equity position in a pharmaceutical JV, but agreed to give exclusive, open-ended distribution rights to the minority [Chinese] partner. What company would do that in New Jersey, or France, or Chile? The company is now hostage to the minority partner. (#46)

Foreign investors fail to plan for distribution for a number of reasons.²⁷ First, as McCune stressed, accustomed to mature markets, they simply take for granted the draw of the market in general, ignoring the infrastructure, services, and regulatory framework that undergird it. Such incompetence is a plausible defense only for smaller FIEs without much experience abroad, at least in an emerging market. Furthermore, this naïveté is unlikely in the operations of Hong Kong or other overseas Chinese investors, who are the most numerous of those contributing to FDI.

Second, foreign investors may be ignorant of prevailing conditions in China; for example, they may be overly credulous of the capacity promises of Chinese partners. Consider the subsidiary of a major American auto parts manufacturer included in this study, which operates in interior China supplying components to a major automotive JV. The firm's prospects are tied to the ability of the auto company to sell passenger

27. Obviously, this issue is less important for firms interested only in exporting from China and not in participating in the domestic market. However, to the extent that these firms still rely on the distribution system to obtain their raw materials and inputs, it also is a concern for them.

cars, and therefore it suffered when the plan of the venture's Chinese partner to use its access to truck distributorships proved infeasible. Up to speed and ready to supply more than 2,000 units monthly, this American parts supplier is shipping only hundreds while waiting for the auto JV to create a network of dealerships from scratch (#26).²⁸ Here, too, incompetence is a thin excuse, though perhaps even larger multinationals can be somewhat forgiven for not fully comprehending the specifics of the Chinese market.

Third, investors may intend to adjust or amend their distribution function after setting up their venture, only to discover the difficulty of reconfiguring this aspect of the business once it is running. With distribution rights, like other areas, a well-negotiated contract will not guarantee an FIE a trouble-free existence in the China market; but too many careless assumptions during establishment will almost surely lead to frustration down the line.

A final possibility is that the Chinese economy is changing so quickly that what seem to be assets can obsolesce between the time a venture is negotiated and the time goods are shipped.²⁹ For example, one American agribusiness firm constructed an expensive food-processing plant in northern China only to have its source of inputs—the region's soybean crop—wiped out by drought. As its existing distribution and supply plans became useless, the firm has had to start over, creating a new use for the plant (#2). This problem is not primarily attributable to a poor distribution system: such larger forces can knock a business plan off track anywhere. Recovering from this change of fortune, however, is tougher in China due to the limited distribution networks, which complicate the task of finding a secondary application for the plant.

Whatever the reason(s) for poor planning about distribution, the results can be paralyzing. Local partners may be content to rely on sluggish statist channels to move product, and reliable providers of distribution services are reportedly hard to find. These problems often damage the product and market development. As their market share stagnates, many FIEs are unable to understand why or to adjust distribution to break the logjam. Intelligence on the activities of competitors, innovations in retailing, changes in demand, and the like fails to flow back to the manufacturer.

28. More disappointing still to the foreign investors was the belated discovery that the auto JV is essentially locked out of major markets such as Shanghai by the anticompetitive practices of local governments that favor local producers; in the case of Shanghai the beneficiary is Volkswagen, although the aggressive entry into Shanghai of GM (which, making Buicks, will theoretically be producing for a more upscale market) may bring VW's local dominance to an end.

29. Note that the FIE itself may change between the times of negotiating and shipping, deciding to switch from a focus on exporting to a focus on the domestic market and thereby creating for itself a new set of distribution needs.

Willingness to Participate Directly

The messages from FIE managers are contradictory. Many stressed how essential it is that foreign firms be themselves involved in the distribution process. There is no other way, they insisted, for expatriates to appraise accurately how much product the system can move, where to best allocate resources to spur sales, what competitors are doing (including piracy), what customers want, and how brands and marketing are evolving. The more intermediaries (be they partners or independent distributors) between firm and customer, the more distorted the signals from the market.

Other managers, conversely, emphasized that even if they were totally unfettered by restrictions they would still leave distribution to partners or subcontractors, because there is no way for them—as foreigners—to know enough about the market to do the job effectively. Also, as already mentioned, some intimated that they were happy not to be sullied by the corrupt practices rife at the street level.

How is this paradox to be resolved? The present era is transitional, and most FIEs will employ a variety of strategies to learn as much as they can about this marketplace. At a minimum, laws requiring that aspects of distribution be left outside the FIE must be treated with some respect. FIEs may not be able to operate as far afield as they like, because they have failed to obtain the necessary licenses from the Chinese or because they cannot justify the expense to their parent organization, given all the uncertainties about still-growing markets. Human resource constraints (see chapter 2) hamper far-flung distribution systems. While many poor-quality, old-line distributors remain, competition is generating service providers that FIEs should not ignore (especially as the best among them may be able to move quickly in the current environment to *dominate* channels). At the same time, unless the firm intends solely to export, direct involvement in the marketplace is critical; China is changing so rapidly and business practices there are so idiosyncratic that isolated firms will not have a clue about how to operate effectively.

Many FIEs both run their own distribution and farm it out. In this way they test alternative methods of getting goods to market. At least until the market structure matures, hybrid strategies will likely make the most sense. Other hybrid aspects of the successful FIE are the high proportion of overseas Chinese in management and the push to localize leadership of the Chinese operations.

Internal FIE Problems

Firms with multiple business units commonly establish separate joint ventures with numerous Chinese partners, in order to achieve as much access as possible in each business niche. Because they seek market opportunities in different sectors, they must find existing players who can bring the required influence to bear. This practice also spreads out the risk of be-

coming entangled with a local partner that turns out to have problems. There are costs to such a complex organizational structure, however, including difficulty in coordinating tasks such as distribution that should be consolidated for efficiency. Interviewees at several conglomerates discussed their frustrations at getting disparate units to agree on common ex-factory distribution and service strategies. Units may guard jealously their own distribution channels, especially when they rely on painstakingly crafted personal relationships.

Even within the same business line, clashes occur over distribution. One example involves a firm with facilities in different cities. In each municipality the firm had associated itself with a local partner to enter the market, and rivalries between the different partners subsequently erupted over cross-penetration of markets. Similarly, a large American conglomerate that has formed a trading company to handle distribution cannot convince one of its most important units to cede management of sales to the trading company (#6). The holdouts prefer to manage their own distribution channels. The multiple couplings designed to broaden distribution in the face of the FIE restrictions make such squabbles common in China.

External Pressures, Regional Disparities

Managers interviewed for this study observed that quantitative and qualitative changes in distribution networks inside and outside China were shaping Chinese development. For example, FIEs that decided to locate in southern China cite proximity to shipping facilities and reliable delivery to overseas markets as critical determinants of their choice. The lack of reliable distribution infrastructure elsewhere dissuades these labor-intensive industries from moving inland to take advantage of cheaper labor. Developments in international shipping and the falling cost of air freight will further alter the comparative advantage of Chinese production, shaping regional economic development in China just as in other countries.

In industries in which time to market is most important, aspects of physical distribution related neither to policy nor to inadequacies of infrastructure can influence the operations of FIEs. Segments of the apparel industry, a sector in which distribution speed is key, provide an example. From the 1960s through the mid-1980s price was of relatively little concern to apparel producers in the Hong Kong-southern China corridor; labor and materials made up an insignificant portion of costs. In the low-to mid-price niche for which these firms produced, delivery times were not a pressing issue either. Attaining basic quality was the factory's main objective.

Today, designs prepared in New York are instantly transmitted to production sites around the world, and getting the new line to stores ahead of rivals is a first-order challenge. From southern China, delivery times to

New York for finished garments today stand at 21 to 24 days, thanks to trucking from the factory, proximity to frequent fast ships, and extremely efficient port services. The fastest freighters, if timed right, can get product to the New York market in 15 days. This distribution access is both a determining and limiting factor in locating factories today. Hence expanding inland to find cheaper labor is out of the question unless a vastly improved distribution system is installed. From competing production sites in Latin America, product can reach New York in only three to four days.

The textile manufacturers interviewed for this study have managed to keep US-oriented facilities in southern China from relocating to Western Hemisphere sites with liberal tariff arrangements by focusing on productivity and quality and by taking no chances on weak, undependable distribution channels. Nevertheless, several managers are all but resigned to shifting a portion of their company's manufacturing to Latin America from Hong Kong-Guangdong (#8).³⁰ As of this writing, it is not clear how the Asian financial turmoil of 1997–98—particularly the devaluations in almost all the regional currencies except China's renminbi—will affect microeconomic behavior, and hence the distribution channels that grow up in its wake, in the long term. Undoubtedly the effects will be significant.

Analysis

As with the other business functions, distribution issues can be sorted into four categories of cause: transitional, self-imposed, policy, and market structure. Table 5.5 summarizes the issues discussed in this chapter according to that framework.

Transitional Factors

Transitional factors stand behind a number of the concerns expatriates raised about managing distribution and other ex-factory business operations. It is important to recognize that legal ambiguities in the regulatory realm are not all the fault of legislators. The pace of policy formation has in fact been quick over the reform period, especially in light of the virtual absence of earlier laws and regulations. As authorities strive to develop the frameworks needed by the market, clarity of law does not keep pace. There is a policy element as well, addressed separately below, but one can expect uncertainty to subside in the future with or without external pressure on Chinese leaders.

30. In April 1996 Mexico surpassed China as the top exporter of textile and apparel goods to the United States, owing partly to shifts in manufacturing sites ("Apparel Sales to US Still High Despite Moves to Other Sources," *Journal of Commerce*, 1 October 1997, 3D).

Table 5.5 Roundup of ex-factory issues

Issue	Category	If policy . . .	
		Level	Priority
Regulatory restrictions	Policy	Central	High
Legal ambiguity	Policy, transitional	Central	Medium
Marketing	Policy	Central	Medium-low
Collection, finance	Policy	Central	Medium-high
Service provision	Policy	Central	Medium-high
Physical infrastructure	Transitional		
Local authorities	Policy, self-imposed	Local	Medium
Allocated market shares	Policy	Central	High
Market foreclosure	Market structure, policy	Central	High
Corruption	Transitional		
Organization complexity	Self-imposed, transitional		
Failing to plan	Self-imposed		
Willing to get directly involved	Self-imposed, transitional		
Internal organizational problems	Self-imposed		
External pressures on distribution	Transitional		

A similar logic holds for the deficiencies in physical infrastructure. Pervasive and profound, these will take some time to be fully remedied whether or not the most effective and expeditious strategies for financing are pursued. Economic growth will outpace even rapid infrastructure construction for some time, and it is far from clear that the best choices will be made. To the extent that FIEs tend to be concentrated in the more advanced segments of the economy and not scattered through the hinterlands, they may enjoy some advantages (on average) over domestic companies spread across the country. These gaps affect all firms in China, of course, not just FIEs.

Insofar as corruption is involved in distribution, it is largely a transitional matter: graft and other private corrupt practices by distributors now threaten FIEs. A broader array of distribution options in the future should permit selection of the less corrupt, hence diminishing the importance of this issue over time.

Three of the four “foreigner-specific” topics include transitional elements. Problems of organizational complexity resulting from attempts to circumvent restrictions, foreign willingness to participate directly in markets instead of leaving ex-factory tasks to compradors, and exogenous (overseas) economic pressures on shipment times and product cycles all stand to change naturally over time. Some of this change is a function of learning (how better to work with Chinese partners); some, capacity (avail-

ability of qualified local staff to expand service operations); and some, the natural disequilibrium of changing economic patterns and tastes.

Self-Imposed Problems

Not surprisingly, self-imposed problems are predominant in the foreign-specific cluster as well. The failure to plan for distribution in China, the organizational contortions, and the internal squabbling documented in this study make clear that FIEs are responsible for a significant share of these problems. It can be hoped that these, like transitional factors, will recede over the coming years: firms (successful ones anyway) are self-correcting. In addition, the complications that can arise in dealing with local authorities in China to secure control over distribution can be laid in part to the FIEs. Investors have choices to make about the collusive (or privileged) arrangements they enjoy in exchange for the dollars and jobs they bring. While it may be reasonable to argue that such arrangements are a minimal compensation for other disadvantages that FIEs attempting to compete domestically face, they nevertheless are pernicious from the perspective of the next FIE that tries to enter the market—or, for that matter, of the next Chinese firm from a different locality.

Policy-Related Issues

Foremost among policy-related distribution issues are the formal regulatory restrictions on FIEs, along with the ambiguity of the central legal framework (and ambiguous administrative guidance issued from competing camps in Beijing). Conflicting local-level policymaking, tolerated by Beijing, is an additional policy problem facing FIEs, particularly for firms that desire clear adherence to the law. Allocation of market share, in those sectors in which it takes place, directly blocks access to distribution opportunities and markets. Because so many large enterprises in China either remain state-owned or retain a quasi-state status to some degree, the tendency of firms to foreclose markets and restrain trade is not just a “private” problem, as was argued on behalf of Fuji of Japan in an important WTO case in 1997, but a matter of policy.

Market Structure

The market foreclosure problem possesses a policy aspect because so many firms are technically still state owned; nonetheless, it is the case that many are acting privately in their attempts to foreclose markets—and, of course, many Chinese firms acting similarly are truly private (as are FIEs themselves, some of which act anticompetitively). In the absence of an

explicit competition policy supported by central authorities, vertical restraints on trade will crop up in markets wherever only a few distributors are able to move products between production points and markets.

Considerably more evidence is needed to measure whether the trend in China is in this direction, and how widespread it might be. Market structures set slowly. Central authorities (and local ones, in a few cases such as Shanghai's) are exploring the utility of a competition policy in guiding China's nascent markets, but it is unlikely that such a framework can be put in place and enforced before significant concentration has occurred in broad swaths of the Chinese economy.