

1 Reflections on China at the End of the Second Millennium

China has given much to the West. Paper, pasta, porcelain, gunpowder, azaleas, and mandarin oranges are a few of the contributions from a civilization that has lasted for over 5000 years.

Despite the flow of trade that gave rise to this transfer of everything from technology to plant species, China's borders have remained closed to foreigners for much of this time. At the end of the eighteenth century, George III of England sent an ambassador to the "Middle Kingdom" (the meaning of the Chinese words for "China") to explore the opening up of trade routes. Emperor Qianlong rebuffed him, and the encounter demonstrated a lack of willingness to accept the other's point of view or his customs. Chinese perceptions of their own historical achievements and cultural superiority were powerful forces against the need for further contact with outsiders.

In the nineteenth century, the expansionist British and French governments used force where diplomacy had failed. The Opium Wars, the sacking of the Summer Palace in Beijing, and the treaties that legalized the handing over of Hong Kong to Great Britain were, and still are, regarded with great shame by the Chinese people. As the Qing dynasty neared its end, China experienced hard times.

The foreign domination of Shanghai in the 1920s and 1930s, the Japanese invasion of China that began in 1931, and the massacre of Chinese citizens at Nanjing in 1937 increased the suspicion and fear. In the 1940s, backing of Chiang Kai-shek's Nationalist Army by the U.S. government and its allies encouraged a negative attitude toward foreigners among the victorious Communists who seized power in 1949. Borders were again closed and were to remain so for 30 years.

After three decades of social advancement amid mixed economic results, China's leaders decided in 1978 that, to develop the economy, it was necessary to reopen the country's borders. Foreign trade and investment would bring much-needed modern technology and capital. This "Opening Up," as it became known, progressed slowly but steadily during the 1980s, and halted temporarily in 1989 after the Tiananmen Incident, when many foreign companies fled the country. It resumed again in earnest after Deng Xiaoping's historic visit in March 1992 to Guangdong Province in the south of the country, neighboring Hong Kong. Although retired from office, the former paramount leader urged the Chinese people to be bolder about making reforms, and he reassured foreign investors.

The overseas Chinese from Hong Kong, Taiwan, and Singapore were the first to appreciate the significance of this visit. It confirmed in their minds that China wanted to become part of the world economy, and they seized the business opportunity presented by the Chinese government's new policies. Capital poured in to construct new offices, expatriate residential accommodation, and factories, particularly in 1992 and 1993.

Then the world's major corporations began to recognize the potential offered by China's huge market and large pool of low-

Reflections on China at the End of the Second Millennium 3

cost labor. A gold rush mentality gripped many global corporate headquarters. Head office management believed that it was important to secure a presence, a foothold in this evolving economy, before the competition gained an advantage. Morgan Stanley's analyst, Barton Biggs, famously said that he was "maximum bullish" about China. Foreign bankers were eager to lend. Time was of the essence. This fever was accompanied by huge increases in GDP in China, which topped 14 percent in 1992, and which in turn led to consumer price inflation of 24 percent in 1994.

From 1995, the PRC government began to reduce the rate of inflation by slowing growth and redirected investment into productive ventures. Capital flows into property began to tail off, while the huge injection of money, management, and know-how by multinational corporations into business ventures increased. Even when the East Asian economic crisis occurred in 1997, inward investment into China continued. China had become, after the United States, the second-largest recipient of foreign direct investment in the world. Meanwhile, China's exports increased and its trade surplus grew to US\$40 billion annually. The standard of living increased each year, as the Chinese people enjoyed the newfound prosperity created by economic liberalization. The new Socialist Market Economy was bringing economic benefits that the previous generation had not imagined, much less experienced.

During the second half of the 1990s, the initial enthusiasm and euphoria on the part of global companies gave way to greater realism. It became clear that this was not an easy country in which to do business. The regulatory environment was tough. Laws and regulations kept changing and were interpreted in various ways in different parts of the country. In the early years, foreign companies had chosen or had been directed by ministries or local governments toward Chinese joint venture partners; many of these turned out to be less than satisfactory as business associates. Their dissimilar objectives and their shortcomings had not been so obvious at the time agreements were negotiated. This was especially so where joint venture contracts were negotiated quickly and the resulting partnership was later to fall far short of the "contracted" expecta-

tions of both parties. There had been the pressure to catch the market—or perhaps to enhance the global chairman's first visit to China for an audience with a minister at the Diaoyutai State Guest House in Beijing.

Now the cracks were beginning to appear. Distribution systems in China were worse than anticipated, while government regulations prevented foreigners from establishing their own distribution capabilities. Quality components and raw materials proved more difficult to source than joint venture partners had represented. Chinese partners entrusted with core functions such as sales and marketing, human resource development, even government relations, fell short of the foreign investors' expectations of performance. The list of problems and complaints was endless. As a result, the start-up period for joint ventures took longer than budgeted in business plans. Projected profits were taking longer to materialize. Many companies found they had invested resources far ahead of the actual market opportunity. The rate of investment outpaced the rate of return.

It was not that these problems were absent in 1993, 1994, and 1995, and then suddenly emerged in 1996. "It was," in the words of Jack Perkowski of Asimco, "more the case that if a company had a problem in the early days, when the press was bullish about China, management was unlikely to talk about it, since this would point to something wrong with your company, or your strategy, or the way you were doing business." By the late 1990s, negative investment sentiment, fueled by the nagging persistence of both trade and non-trade issues separating China from the more mature economies, coincided with a new frugality imposed by many global headquarters on their China operations.

Then, in early 1999, the PRC government permitted the state-sponsored Guangdong International Trust and Investment Corporation (GITIC) to go into liquidation. Perceived to be backed by the state, the failure of this enterprise, which had received huge foreign loans, marked a watershed in the confidence of foreign bankers. The collapse, in the late 1990s, in equity prices of PRC enterprises whose shares were owned by foreign institutions also caused foreign

Reflections on China at the End of the Second Millennium 5

fund managers to shy away from the market. The flow of initial public offerings (IPOs) of PRC corporate shares all but dried up, with little immediate prospect of recovery.

Global companies began investing on a large scale in China in 1993. Senior executives have therefore had six or seven years' experience of operating seriously in the country. The views of the 11 chairmen interviewed for this book collectively reflect more than 120 man-years of hands-on experience of managing businesses in Asia. These individuals are collectively responsible for over 160 legal entities doing business in China.

Based on their views and on the experience of PricewaterhouseCoopers in China, what issues have foreign companies faced during the 1990s, and what lessons have been learned?

Lessons Learned

The Market

China is not one uniform, integrated market, but many. In many respects, China resembles Europe. Geographically, linguistically, culturally, and economically, it is very diverse. Because communications in the country have been so poor for so long, it made sense for each province to have its own supplies of almost all products and services. Given the size and complexity of China, the provinces were often left to marshal their own resources as best they could. The arrangements for governing the country also created different markets. Major cities such as Beijing, Chongqing, Shanghai, and Tianjin were created as administrative regions, including large areas of neighboring agricultural land. The thinking was that this would at least give the city control over the food supply for its urban population.

China today is not a market of 1.3 billion people. This misconception misled some foreign investors, at least initially. Living standards and consumer purchasing power on the east coast of China (Guangdong Province, Fujien Province, Zhejiang Province, Jiangsu

Province, and around Shanghai) are more than 5 to 10 times the level of the poorer west and south of the country and of the north. In the latter areas, export-focused activities are fewer, and restructuring of state-owned enterprises is a priority. The market for lower-priced consumer goods may be large, but for some higher-priced products such as automobiles the market is in many respects similar in size to that of one of the smaller European countries.

The Chinese market is fast-changing and difficult to read. It is also being constrained, in ways that have not previously been fully appreciated, by space, energy and environmental considerations.

In the words of Brian Anderson of Shell, "The biggest problem I have is getting a handle on the marketplace. Matching our investment in China to the growth in the market is a tricky game. Normally, in a new market, we would import our products and test the market out first. If the circumstances and the financial projections looked right, we would then invest and build capacity. Here in China, that's not possible. You have to invest up front—and that's a killer."

In most industries in China, the shape of the market is changing. Timing is crucial. For example, consider cellular phones. Ten years ago they hardly existed in China, while at the beginning of 1999, there were over 25 million cell phones, and the cellular market is growing exponentially. Every three years the number of fixed-line phones is doubling. Household appliances and entertainment electronics, virtually unknown a decade ago, are now found in 70 to 80 percent of China's homes.

By contrast, development of the automotive market has been slower than expected. In 1995, passenger car sales were projected to be 1 million units by 2001. Recent projections have been downgraded to less than 500,000. Existing capacity in China to manufacture passenger cars is more than twice the market demand.

In the health care sector, traditional Chinese medicines (known as TCMs for short) have a tremendous following, especially for the cost-effective treatment of chronic illnesses. Where Western medicines have gained a foothold (for example in the treatment of acute infectious diseases), foreign pharmaceutical companies find them-

Reflections on China at the End of the Second Millennium 7

selves competing with state-owned enterprises and struggling to protect their intellectual property. And it remains unclear how medicines that have stood the test of 1000 years will blend in with or be replaced by Western medicines, which are becoming increasingly fashionable in China. Conversely, it should of course be mentioned that TCMs are becoming increasingly popular and fashionable in the West as a means of providing a softer treatment for chronic ailments.

Competition

The Chinese, like the Japanese before them, excel at copying Western products and adapting them where necessary for the local environment. Similar but typically lower-quality products are offered at lower prices by lower-cost domestic producers. Many foreign companies, particularly in consumer products, have large legal departments in China devoted to searching out counterfeit goods and to protecting their intellectual property rights. However, legal judgments against infringements can take longer than in other countries and enforcement, especially at a local level, has been extremely uneven.

If the local competition is fierce, that from other foreign companies is even fiercer. As Bruno Lemagne of Unilever puts it, "Today, in Europe, you have European, some American, and a few Japanese competitors. In Japan, you have Japanese, some American, and a few European competitors. In the United States, you have American, some European, and a few Japanese competitors. But in China, everyone is here. The competitive pressure will not go away. Competition will stay. It does not frighten us. However, it doesn't make life easy."

At the time of writing, the problem is that in many industries in China there is massive overcapacity. Whether it be automotive, consumer products, electricity generation, electronics, or new technology, too much was invested in the 1990s. Many foreign investors were so focused on overcoming the regulatory hurdles to gain market entry that, in hindsight, projects did not always meet normal

commercial criteria. Coupled with this, the growth in GDP slowed in 1997 and 1998, partly as a deliberate strategy to contain inflation and partly as a result of the East Asian economic crisis. A new level of uncertainty began to influence consumer behavior in the PRC. Savings rates continued at high levels, while willingness to spend on consumer products declined abruptly. Consumer surveys showed a shift toward longer-term savings goals—housing, old-age health care, and higher education for children and grandchildren.

As a consequence, consumer demand within China faltered in 1998 and 1999 and, except for a few industries, competition proved to be so fierce that prices actually fell. Despite this, a study in April 1999 by *China Economic News* showed that of the top 500 foreign-invested enterprises, only 47 were loss-making. This statistic, which surprised many China watchers, was borne out by the experience of PricewaterhouseCoopers clients in the PRC. Perhaps things were not so bad after all for the foreign investor.

The Regulatory Environment

Control is a dominant feature of Chinese society. Scholars of Chinese history have characterized this as a feature of a “hydraulic society,” where large-scale public works coupled with efficient coordination of individual activity are required for basic survival. For example, in a village, ensuring the right quantity and flow of water to each field at successive levels on a hillside is a prerequisite for growing rice productively. Thus, control of the water supply is in the interest of the entire community. In such a situation, it is natural for the village council (or at a national level, the central planners) to provide guidance, incentives, and controls.

Approvals and licenses are required for anything and everything. For the Chinese, to secure employment in a different part of the country may be difficult because approval is required. Obtaining a passport to travel abroad, particularly to Hong Kong Special Administrative Region (SAR), takes a long time. To marry or have children requires permission from the work unit. This is a Chinese phenomenon, developed over centuries by successive generations

Reflections on China at the End of the Second Millennium 9

of mandarins anxious to ensure that the Emperor's decrees and the wishes of the court in Beijing were obeyed by subjects many thousands of miles away.

Hard experience over the last 50 years, including the famines of the Great Leap Forward in the 1950s and the trauma of the Cultural Revolution in the late 1960s and 1970s, has made the Chinese leadership extremely concerned about consensus and stability. Even with the introduction of greater rights of private ownership, the Party and the Government will still wish to support the socially and economically deprived.

The Chinese leaders have witnessed what can happen when change is allowed to occur too quickly and with inadequate control. They will not permit the horrors experienced in Russia in recent years to be repeated in the PRC. With 1.3 billion people to care for, the risks are too great. Control is essential to stability. As Hank Greenberg of AIG explains, "The thing that China cannot tolerate is chaos. Chaos would destroy China. To create political instability in a country with that mass of population, until there is further progress and maturity in a political and social sense, would be quite wrong. Change will come. But it will come in China's time, not on or of a timetable of external forces." Control permits gradual change, a value that is both Asian and Chinese. For Western companies used to getting things done quickly in a less regulated environment, these strictures seem burdensome and are certainly time-consuming. They are also contrary to the invisible hand of market forces venerated by foreign investors for whom Adam Smith is a more familiar sage than Confucius.

A further aggravation is caused by the fact that the rules seem to be forever changing and are capable of being variously interpreted by different officials in different provinces. As the country's economy evolves from one that is centrally planned and state-owned to one where market forces operate and diverse means of ownership are permitted, the laws and regulations need to be changed. There is no precise model to follow. Thus, if a policy and its accompanying regulations do not appear to work, the law is changed.

Such changes occur frequently. Further, Chinese regulations have for centuries been interpreted by local officials on the basis of loosely worded legislation. Scholars of Chinese law point out that in China rules and regulations are administrative rather than judicial in nature. Most significant developments in economic law and regulation are preceded by years of experimentation. Written legal guidance is codified only after contending views have been reconciled and senior officials are satisfied that they are favorable to the State's interests.

The vagaries of the process and the uncertainty of regulations are aggravated by the complex and incomplete reforms of the judiciary itself. In the first three decades of the PRC's existence, the courts were, in the opinion of many commentators, instruments of the political leadership. Few serious economic cases were ever adjudicated according to any explicit commercial law. The existing contract law was developed in the mid-1980s, although the courts had little experience in enforcing it before the early 1990s. Contract law is, therefore, in its early stages of development. Having said this, I should also make clear that efforts are being made by the State Council and the People's Congress to invoke rule by law rather than rule by man, although this requires a radical change in generations of habitual practice.

The gradual "Opening Up" of China's market has not been as speedy in certain industries, such as financial services, as it has in others, such as consumer products. This has caused frustration to foreign companies and delays in licenses being granted to undertake business. It took AIG 17 years of patient relationship building and contributions to China to obtain the first license to be issued to a foreign insurer, in 1992.

The numerous licenses and approvals required from different authorities when the door has been opened can prove exasperating. In a recent review by a newly appointed PRC official, no fewer than 27 licenses were found to be necessary to operate a multidisciplinary accountancy and consultancy practice; in the UK, a maximum of just three would have sufficed. These burdensome

Reflections on China at the End of the Second Millennium 11

requirements are not only numerous, they are also fragmentary and poorly coordinated. Ministers and senior officials do not oversee a coordinated system of licensing and regulation. Rather, they manage numerous bureaucracies that struggle for revenue and power through licenses, fees, and taxes that they individually create and promote.

Apart from being overlicensed, China is also overregulated. But these are inescapable features of doing business in China, where the simplest of tasks can take three times as long as elsewhere. Happily, looking forward, these deterrents to effective business have not escaped the notice of the more reform-minded ministers and officials, who are determined to make China's economy more efficient. But this will take time, and China needs time—a theme that commentators have repeated over the centuries.

The Importance of Government

In China, where the environment is heavily regulated and where public ownership has been the basis of production for so long, government has a far greater impact on business activities than in many other countries. Of course, in agrochemicals, energy, pharmaceuticals, and telecommunications, central government is never far away in any country because of the importance of these industries to the welfare of society. In China, the historical influence of ideology is mixed with concerns over security and control.

As Terry Barnett of Novartis explains, with its horrendous famines in the 1930s and, after the Revolution, during the Great Leap Forward, China's leaders are obsessed with the objective of self-sufficiency in food. China wants the security of having all its agricultural products and inputs grown or made in China. This has led to the encouragement in agrochemicals of synthesis plants, to make the basic substance that is then formulated into the final product.

The commitment to self-sufficiency was not limited to the agricultural sector. Much of the collectivization and communiza-

tion of all productive units in the Maoist era was focused on creating micro self-sufficient economies. As one of the basic ideologies of that era, this created movements that promoted everything from family pig farming to family pig-iron furnaces. At the other extreme from this pervasive subscale inefficiency was the superscale inefficiency of the massive state-run industrial plants. Neither group was subjected to any measure of market discipline. These protected twin monuments of China's Maoist past became the twin targets of Deng Xiaoping's economic reforms.

The importance of government in China is something that all successful foreign investors must recognize and accommodate. For U.S. companies, as Randy Yeh of Lucent advises, "a sound, stable and good relationship between the United States and the PRC is key to business success in China." Given the growing trade imbalance with the United States and the views of Congress on such subjects as human rights, Taiwan, and Tibet, the going is unlikely to be smooth. The impact of politics on the business prospects of American companies can be significant. Some British companies believed they were disadvantaged in securing contracts in China as a result of the "Cold War" climate that prevailed prior to the handing back of Hong Kong in 1997. To counter these political influences, the senior executives of global companies in China spend a significant part of their time nurturing relations with government ministers and regulatory agencies, both in Beijing and at the provincial and municipal levels.

For Shell, China is no different in this respect from other countries. As Brian Anderson puts it, "If we can develop the right relationship, then we can have frank and open dialogue." The importance of good relations with government in China cannot be overemphasized. When Zhu Rongji was the Mayor of Shanghai, Hank Greenberg helped him establish Shanghai's first international business advisory council, a prestigious annual gathering that the chairmen of many global companies aspire to join. This and other expressions of goodwill are necessary in order to build the relationship and demonstrate that your company is a true

Reflections on China at the End of the Second Millennium 13

“friend of China.” Such favors tend to be repaid in the form of licenses and contracts.

The Importance of Relationships

In China, one of the first words a foreigner learns is *guanxi*, which means *connections* or *relationships*. This is the process by which each side seeks to establish who the other is, whom the other knows, and whether they are respectively able to deliver what each promises.

Anywhere in the world, networking and building relationships are important to business success. As Richard Latham of United Technologies reflects, “People come to China and think that they have stumbled across something that is so entirely unique that only the Chinese are concerned with it. What is different about China is the sort of intensive preoccupation with relationship building that goes on—the whole time. It’s an almost consuming aspect of Chinese life. Foreign managers fail to realize how pervasive it is and that, at every meeting, social or business, the other partner is working on some aspect of the relationship.” While the process of relationship building is not peculiar to China, it does take longer than elsewhere because of the lack of information about people and organizations and because of the complexities of the society. The weak legal environment and the lack of transparency mean that many objectives can only be achieved through *guanxi*.

All too often in China, one hears that a foreign company has a poor relationship with its joint venture partner, or that another multinational corporation has been able to obtain a license because of its excellent relationships with ministers and officials.

The concept of mutual back-scratching (but certainly not bribery) is essential to success. While it is not necessary or at all desirable to present lavish gifts or to transfer funds to numbered bank accounts, to achieve one’s objectives it is important to be helpful. Many foreign companies spend huge sums on training programs and overseas educational visits for PRC officials and leaders of state

enterprises in order to demonstrate commitment and to build relationships with regulators and potential joint venture partners.

It is sometimes difficult for management back home to appreciate that its on-site managers must spend what appears to be an inordinate amount of time in building and maintaining such relationships.

Closely linked to relationships is the issue of “face.” In a society that has a weak legal system, consensus is important. Frequently, a problem can only be solved if one party backs down. Those who back down today may be those who see others back down tomorrow. Face needs to be preserved. If not, relationships can break down and will be difficult, if not impossible, to reestablish.

The Shortage of Qualified Management

It should come as no surprise that in China there is not a large pool of managerial talent trained to international standards. For 30 years, the economic system was based on central planning; state ownership of the means of production; absence of a market; and directives given to production units concerning what to make, when to make it, where to send it, and at what price to sell it. Time was definitely not money. There was no local competition and foreign companies were not permitted to trade. The managers of business enterprises were administrators carrying out orders, who had little or no experience operating in a competitive market environment. Yet subsequent to the Opening Up in 1978, Deng Xiaoping encouraged the Chinese to be more entrepreneurial, and many rose to the occasion with great success.

In this environment, there are twin problems: managers whose behavior is entirely bureaucratic, shaped by decades of compliance; and managers who are wildly entrepreneurial, fueled by decades of frustration and evasion. As Jack Perkowski graphically points out, “If the management you have in China is too bureaucratic, you can’t get anything done. On the other hand, if it is at the other end of the spectrum, you can’t sleep at night because these cowboy entrepre-

Reflections on China at the End of the Second Millennium 15

neers practice a brand of management that no multinational company would feel comfortable with. You might be in the components business today and find that you are in the hotel business tomorrow.”

When global companies began to establish businesses in China during the 1980s, and to a greater extent in the 1990s, there was no available managerial talent trained in Western methods. Senior executives had to be shipped in from abroad, together with their personal effects, which often included the fridge, the lawn mower, and the family pet. The cost of expatriate housing was kept artificially high by a shortage of supply. The “hardship” premiums, together with allowances for children’s education and medical care, added to mounting payroll costs. It was an expensive business.

A further problem was the steep learning curve for those expatriates who did not have previous experience of Asia and who did not speak Mandarin. It takes time to understand China. The culture is very strong. The civilization is perhaps the oldest remaining in the world. Language and literature, idioms and nuances of meaning are as complex as you will find in any country. Failure to take the time to understand can result in costly mistakes by well-meaning but ill-informed expatriate executives.

The Problem with Joint Venture Partners

A joint venture will survive for as long as the objectives of the parties to the joint venture remain compatible. All too often, the Chinese partner has different objectives from the foreign partner, and these are not always identified when the joint venture is formed. Kent Watson considers that the difference in expectations is often the biggest barrier to success. He comments, “Foreign investors in China hope for a financial return on the investments they make. They seek a return, perhaps over a long time frame, from access to the large market and from the lower cost of labor. On the other hand, Chinese joint venture partners want technology and know-how, together with capital and modern equipment, and they invariably expect dividends immediately.”

Any gap in initial expectations is exacerbated by changing expectations in the early years of a joint venture. Once technology is successfully assimilated into a joint venture, Chinese partners resent having to pay for it in perpetuity either through a technical service fee or through the equity presence of the foreign partner. On the other hand, once the initial regulatory and licensing processes are complete, foreign partners soon resent how little the Chinese partner is able to contribute to the basic business needs of the venture—for example, marketing, distribution, and management development.

The relationships between Chinese and foreign partners are not helped by the baggage of history, which tends to create barriers between the two parties. The Chinese people's underlying mistrust of foreigners, coupled with the sense of cultural superiority and the desire no longer to be treated as the underdog, results in tensions that are sometimes hard to defuse. And the prosperity that foreigners display in China makes many Chinese feel that they have a right to a slice of that wealth.

A further problem is that the expatriate assigned to make the joint venture work often is not the same expatriate who negotiated the deal. The Chinese place great value on personal relationships built up during the course of negotiations. Trust and confidence are developed through a frank exchange of views. However, views expressed and verbal promises made when the joint venture is being constructed may not always be reflected in the legal contracts and are all too often forgotten later, especially if foreign management changes continually. The failure to agree on objectives and to understand the other side's point of view is amusingly captured in the Chinese expression "to share the same bed but to have different dreams."

Problems have also been created by the PRC government's desire to transfer technology and know-how to state-owned enterprises selected as potential partners based on political objectives or cronyism rather than on sound economic reasons. Chinese partners who purport to have access to distribution systems or reliable sources of raw materials or components have too often been found, in practice, to be sadly lacking. The disappointment experienced by international companies is reflected in the increasing desire to

Reflections on China at the End of the Second Millennium 17

liquidate joint ventures and change them into wholly foreign-owned enterprises (“WFOEs,” or “wooffies,” as they are known).

In practice in the longer term, a joint venture has been rarely found, anywhere in the world, to be an ideal vehicle for business success. In China, it is used as a method of transferring foreign technology and know-how while retaining an element of Chinese control. It is hardly surprising, then, that so many joint ventures are considered to have failed. But there are some highly successful ones and these are, of course, much publicized.

Communication with the Head Office

The incidence of failure among expatriate senior executives in China is very high. According to some studies, the failure rate is twice the world average. How is it that highfliers with 20 years of experience in a company can so often fail when they are sent to China? The problems of harmonizing the expectations imposed by two contrasting business cultures cannot be overemphasized. As Kent Watson explains, “On the one hand you have the demands of the home office corporate management, who probably negotiated an agreement that they were sure would succeed. On the other hand, you have the Chinese manager and the people who negotiated the agreement for the Chinese side, who are also looking to you to make the venture successful. Then you have the poor expatriate manager who has been seconded to China to make the whole thing work. He is in a lose/lose scenario.”

Too often, the board member responsible for China back home changes. Each time there is a change, there is a chance that corporate strategy might change, and there is typically an interval of time before the new senior executive gets up to speed in understanding China. The burden of educating head office management usually falls on the top managers in China, who are then often cast in an advocacy role for projects they did not create. When profits take longer to materialize and the forecasts in the business plan are not met, it is easy to forget the peculiarities of the Chinese operating environment. Criticism can come too swiftly.

Michael Portoff of Bayer has a view on this: “The picture is very complex in this country. Therefore, you have to paint a realistic picture to your board of management. You must not conceal or withhold the difficulties, the problems, and the challenges. This is not a champagne-drinking country. It is still a place for the pioneer. You have to roll your sleeves up. In our presentations at Bayer’s head office, we have referred to China as a ‘giant with certain weaknesses.’ It is not an Eldorado, nor is it a country with no hope. If this is how you describe it, then people will not have unrealistic expectations. In addition, you absolutely need the backing of your board of management at home and of the executives at headquarters. Otherwise you cannot work in these difficult and complex surroundings.”

Solutions

Much has been written recently about the difficulties of doing business in China and on the disillusionment developing in global boardrooms. Toward the end of 1998, the PRC authorities became concerned about declining levels of foreign direct investment and sought to reverse the trend. Mayors and foreign investment commissioners from a number of cities met with intermediary organizations, requesting assistance to encourage further inbound investment. It has been suggested that the drive for WTO accession by the premier, Zhu Rongji, was partly influenced by China’s desire to maintain the interest of global companies.

While foreign technology and capital poured into China during the 1990s and stimulated the protected domestic economy, US\$300 billion of inbound investment is not enough. China is a big country, and its appetite for capital is bigger still. A great deal of the investment to date emanated from overseas Chinese who ploughed it into small-scale businesses and real estate. In the last 10 years, over 85 percent of China’s fixed asset and infrastructure investment has been funded from domestic capital sources. However, strains in the state banking system and the lessons of the East Asian crisis have influ-

Reflections on China at the End of the Second Millennium 19

enced China's leaders to seek more foreign capital in the form of direct investment. The Opening Up to foreign companies must continue in order to maintain the growth in GDP that the country needs to transform its economy.

While the issues facing multinational companies will become easier to handle with the passage of time, the lessons learned over the last 10 years will continue to be relevant for executives in the first decade of the new millennium. It is both tempting and dangerous to try to draw a road map of how to succeed in China. Every industry, every company, and every situation is different and requires individual attention. With change taking place in China at a dizzying pace, in the time it takes to publish this book much of the terrain will have shifted. However, some of the essential features of success can be described.

Research and Due Diligence

It seems almost too obvious to mention, but too little time is spent by corporate executives on researching the market in China and analyzing business opportunities. As Richard Latham observes, "When I listen to managers from all sorts of companies, I'm often surprised at how nebulous their goals and objectives are before they come to China. They form partnerships and they can't figure out why they did it. Probably the truth of the matter is they didn't give much thought to it in the beginning. They didn't do their homework. You know, it's amazing that many times companies don't know what questions to ask. The Chinese will answer precisely the questions they are asked. But they usually won't volunteer answers to fill in the gaps and they won't think about the questions the foreigner didn't ask. They take the view that the foreigner must know what he is doing."

Richard Latham's comments suggest that there is a certain irony in the way that improved knowledge about doing business in China derails a reasonable entry process. Executives know that negotiating projects can take an inordinately long time. This

prompts them to measure success more by how quickly they can get through the negotiation process and less by how skillfully they conduct the negotiations and how good a foundation they create for the business. Executives know that a labyrinth of regulatory problems lies ahead of them in the entry process. This prompts them to focus resources more on navigating through that labyrinth than on developing a reliable market model and investment plan. Executives know that their Chinese partners are masters of *guanxi* and that the more important they are, the better their *guanxi*. This prompts them to overestimate the impact of the Chinese partners' relationships on the ultimate success of the business and to rely excessively on their partners to resolve problems of compliance that should have been identified and avoided in the first place.

Based on our experience in helping multinational corporations establish operations, enter into joint ventures, and acquire businesses in China, we know that certain common issues recur. The range of problems identified during strategic planning, negotiations, and due diligence assignments is best illustrated by a long list:

- Misunderstanding of the market
- Quality of the management
- Bureaucratic hurdles
- Distribution difficulties
- Quality of production
- Supply of components
- Unwanted employees and social liabilities
- Title to property
- Reliability of accounting records
- Misstatement of inventory and receivables
- Misstatement of liabilities
- Valuation of fixed assets
- Quality of systems
- Quality of finance staff

If you establish operations in China but don't encounter and address most of these issues at the beginning, before the commit-

Reflections on China at the End of the Second Millennium 21

ment is made, then it is probable that at a later date you will be in for a rude shock.

Choice of Partner

With further relaxation encouraged by WTO negotiations—even accession—and the growing confidence of the Chinese authorities, in many industries a joint venture will still remain the only available route to market entry for many years to come. On the positive side, the PRC government is gradually taking a less prescriptive approach to the choice of joint venture partner. In the early stages of the Opening Up, there was greater governmental direction. Except in sensitive industries, the foreigner is increasingly being allowed more freedom to choose, based on business rather than political or macroeconomic considerations. With increased choice comes the need for greater care to identify precisely what might be expected of a joint venture partner and to confirm that what is expected can be delivered.

“Don’t rush,” is the advice given by foreign executives who have negotiated and operated joint ventures. Jim Conybeare of John Swire & Sons has established no fewer than 21 joint ventures in China involving some of the world’s leading companies. One of his most successful joint ventures is the Coca-Cola franchise in Guangdong Province. “That took three years to negotiate,” he notes, “and, after all that time, we got to know each other pretty well. As a result, we have an excellent relationship at board level.”

Another common piece of advice is the need for alternatives when negotiating a joint venture. The Chinese side understands the concept of competition and may seek to play one foreign company off against another. It is not out of order for the foreigner to adopt the same tactic. After all, it is in the interest of both parties to ensure that, going forward, they have the right partner.

“Don’t put all your eggs in one basket,” is another maxim offered by a number of chairmen. For example, granting a national pan-China franchise to one joint venture could prove to be a costly mistake if the partnership does not work out. Sometimes, it is

preferable to limit the joint venture's geographical scope to a single city or province. Retaining flexibility is crucial.

The Right Approach to the Market

"It's not one market but many," is the observation made repeatedly by the chairmen interviewed for this book. "It's changing so fast," is another. There is little doubt that with personal incomes in China increasing annually at a rate of over 10 percent, the market for goods and services of all types is expanding. What makes China more complicated than other markets is the continued interaction of government and business.

Bruno Lemagne believes that China differs from other countries with regard to the specifics of consumer products, but that the strategic issues are the same. In his view, the key to business success is adaptation. "Wall's ice cream is well-known in many countries, but its flavors vary region by region, based on local taste and local culinary history. In the West, for example, people like their ice cream to contain a lot of dairy and a lot of sugar. Not so in China, where neither features in the Chinese diet. Tastes are different. It is more likely then that the next ice cream flavor in China will not be mint chocolate chip or tiramisu, but red bean."

Similar considerations apply to communicating with customers. The content and style of advertisements vary within Europe from one country to another. In China, the messages and the way they are communicated have to be tailored to the specific audience being targeted. For Terry Barnett, the answer to these uncertainties is to get closer to the market—not just in the big cities but in the rural areas as well. As he stresses, "It is necessary to understand the customer mentality and the way it is changing."

Expatriate Management

There is an emerging view that the chances of success are greatly enhanced if senior executives sent to China have knowledge and experience of Asia and also have Chinese language capabilities. In

Reflections on China at the End of the Second Millennium 23

Asia, “relationships” and “face” assume added importance. “Look at ‘loss of face,’ ” reflects Bruno Lemagne. “Are there many people who would like to lose face? This is not particularly a Chinese issue. However, the way it is dealt with, the way it is interpreted, is very Chinese.” These matters take time to understand, as do the different methods of communicating. Richard Latham explains, “To begin to understand how to operate in China, it helps you to understand the differences between Chinese society and its people and the society and people you know back home. There is a Chinese way of looking at things and a Chinese way of doing things.” On the question of language, he advises that “you can get by using English, but you may be missing 60 percent of what is going on.”

In an environment where everything can seem hostile—culture, regulators, joint venture partners—alienation can set in quite easily, particularly if head office support begins to wane. Multinational corporations need to consider carefully the qualities that are necessary in executives they select for secondment to China. Character defects and skill deficiencies can be magnified when managers are put under pressure in these unfamiliar surroundings.

Successful expatriates must be persistent, patient, and flexible. As Jack Perkowski puts it, the ideal candidate is “someone who does not take no for an answer, someone who is willing to roll up his sleeves, someone with the relevant experience who will do things he probably hasn’t done for 10 or 15 years.” Kent Watson goes further, adding that “people who have an interest in the language, people who are sensitive to cultural differences, people who get beyond their expatriate world, are far more effective in accomplishing what needs to be done.”

The reality is that China has much to teach the foreigner. It is not just a one-way transfer of technology and know-how. The foreigner who listens, learns, and adapts is more likely to be successful.

Localization

Localization has been described as “the coin of the realm” or “like motherhood and apple pie.” Certainly, everyone is doing it. The

PRC government encourages localization, in part based on a deeply held view that the Chinese do not want the foreigner to control, ever again, their economy and businesses. Xenophobia is a phenomenon found in most countries, but in China there is perhaps more historical justification for such an attitude. There is also a natural desire that the Chinese people rather than others be the first to enjoy the benefits of economic progress in their own country. These are understandable sentiments.

Regardless of the governmental objective, localization is a key priority for every multinational corporation operating in the country. This is important not only because it reduces the significant cost of expatriates, but because it provides a career progression for Chinese employees. Randy Yeh of Lucent, for example, notes that “We have established training and career development plans for all employees to demonstrate to our people that we are serious and that we have their long-term interest at heart.”

Jim Conybeare had no fewer than 1200 indigenous salesmen attending the Swire Group’s sales training program in the first quarter of 1999. “One of the pieces of advice I would give a potential successor,” he says, “is the importance of training.” Hank Greenberg ascribes an important feature in AIG’s success in China to the relentless program of training, so that the business is run by Chinese and not by foreigners.

One of the most professional training programs in China has been put together by Johnson & Johnson, renowned globally for the group’s focus on people development. “Outward bound” style, off-site courses seek to identify those recruits who have the potential to adapt to the international culture of a foreign company. The architect of the program, Jerry Norskog of Johnson & Johnson, explains: “When I interview a new recruit, I ask him what advice his father and mother gave him about being successful in life. The answer is usually: ‘Keep your head down, keep your mouth shut, ensure you have a good relationship with your boss, be obedient, and work hard.’ Now I am going to ask him to stand up, to speak out heretical ideas, to fight intellectually, to challenge his boss. I am going to tell him that risk taking is rewarded, not punished. I am lit-

Reflections on China at the End of the Second Millennium 25

erally going to turn the tables on him. He is going to have to make a 180-degree turn if he is to meet my expectations.”

During the last five years, PricewaterhouseCoopers China has recruited more than 1500 PRC nationals from universities and trained them in China to become qualified accountants or consultants. It has also seconded abroad over 100 people for periods exceeding one year. Kent Watson comments, “This program is working well, but you can’t rush it. You know, in any country, it takes a minimum of 10 years to take a new graduate and develop him or her into a partner. We haven’t been at it that long in China.”

Developing a Culture of Change

Creating and sustaining a culture of change in global companies is considered essential to corporate success. Chairmen of technology companies, such as Jorma Ollila of Nokia, put this high on their list of objectives. In China, the challenge is greater because of the country’s history. If Chinese managers come from a state enterprise, there is tremendous loyalty to the old ways of doing things.

The formal training course is one way to crack the problem. Jerry Norskog points out that “the talented youngsters who are the fine products of these fine universities are also the sons and daughters of the Communist past. They have grown up in work units. Their reference point is the ‘iron rice bowl.’ They learn by rote, they write it all down and memorize it, and then regurgitate what they have learned when asked a question. They are very good at memorizing data and at assimilating facts and ideas, but they have not been trained to be free thinkers.”

What is taught in the training course needs to be repeated and emphasized in the operating environment. Jack Perkowski explains one of the problems: “Most people, including the Chinese, don’t like change. The response from a PRC general manager sometimes goes like this. ‘Yes, those techniques and those practices may work in Europe and the United States. But this is China. And China is different.’ They may actually believe that. Years of unfortunate contact

with the foreigner have taught the Chinese that they are special. We agree that the Chinese are special. Everyone is special. But, we don't subscribe to the notion that because it works elsewhere it won't work in China. We think that, when you boil everything down, China actually operates in the same way as other places. The laws of economics apply here as they do in every part of the world. However, the fact that Chinese managers are able to argue in this way gives them an immediate excuse for not changing."

It is difficult for foreigners to change the Chinese way of doing things. There is, on occasion, a genuine and understandable mistrust of foreigners. The Chinese partners to a Sino-foreign joint venture want to control the workforce, which is the traditional manner in which Chinese organizations are controlled. There is often a fear that the foreign company will seek to cut the large workforce, and the Chinese managers do not want to abrogate their responsibility. This can lead to the retention of old-fashioned work practices.

Further, as Richard Latham notes, "We can bring into a joint venture factory a technology model of how to produce something. Our Chinese partners will try very carefully to copy the model exactly. But it will be an analogue copy, because they will have looked at it with eyes that are accustomed to seeing the analogue nature of the technology. They will miss the detail and may not understand why things are done in a certain way." In his view, the key is successfully integrating Chinese culture and Western technology. "The message is the medium," he remarks. "In our joint ventures, where we've taken the external message and wrapped it in Chinese paper, we've succeeded very well in changing ideas and work habits." You have to do it in a Chinese way, but without for one moment forgetting the objective you are striving to achieve.

Building Trust

There is general agreement that, after a history of 150 to 200 years of unfortunate contact with the foreigner, the Chinese have some reservations. The foreigner has a wall to climb if he or she is to develop trust. This task is often not helped by the very different

Reflections on China at the End of the Second Millennium 27

objectives and perceptions of the two parties. Most multinational companies think and operate globally, whereas the Chinese are more nationalistic.

In the view of Michael Portoff, "Regardless of our ownership percentage, we have tried to treat our joint venture partners as equals. Trust has to be built up over a period of time. You can only achieve this if you do it in an open, honest, and frank way. During joint venture negotiations, potential problems have to be discussed at the outset rather than being left until the joint venture is founded and then the trouble begins. When you form and operate a joint venture, the emphasis has to be on the word 'joint.' You have to understand that there are different points of view. But this doesn't mean that you have to give in. To succeed, you have to get the balance right."

These sentiments are repeated by Brian Anderson: "When you are dealing with people, you can be very frank and very direct. But for it to work, they have to believe that you are sincere, and to achieve this you have to develop a good, but simple, relationship." You have to explain, very frankly, that attendance at a week-long training course will not automatically transform someone from being a state enterprise manager into an international executive. There is a tendency among some Chinese managers and officials to underestimate how long it takes and how much work is involved to reach international standards.

Problems are invariably caused by expectations not being met. For example, foreign companies sometimes find that feasibility studies, often carried out five years ago on the basis of limited experience of the country, predicted positive performance that has taken longer in practice to materialize. When the Chinese partner discovers this, mutual trust can break down because it is typically the foreigner who prepared the business plan in the first instance.

Sometimes it is too easy to gloss over problems or to sweep them under the carpet. In China, this will rarely work, since if a problem emerges and the Chinese partner believes that it should have been anticipated or that it seems to have been hidden by the foreigner, then mistrust can be created. Actions can be misunder-

stood. Suspicions can be easily aroused. Motives can be frequently misinterpreted.

You also have to show the benefits of investment and of retaining rather than distributing profits. The latter is the natural inclination of the Chinese partner, who is looking for a rapid return. Jim Conybears advises, "Of course, you must not promise a level of dividend income and then suddenly try to switch it off because you need to invest more capital."

Kent Watson focuses on what needs to be done to bridge the gap. He advises, "In my view, the gap can only be bridged when the two parties are able to build a relationship of trust. The difference in objectives needs to be understood and discussed, so that mistrust is not created when doing business." He emphasizes training and career development: "Training is not just for the purpose of increasing efficiency and production. It will also create equals. We want to develop people who will become true partners. In this way we hope to develop a relationship of trust."

Randy Yeh was born in Qingdao, on China's east coast. As he was educated both in Taiwan and in the United States, where he worked for many years, he understands equally well the Western and the Chinese approaches to these issues. He is able to offer advice from a unique position: "You will always have differences, but if you act fairly, frankly, and honestly, you can make a joint venture succeed. When there is fairness on both sides, frank discussion can happen and a relationship can be built. Understanding can be established and trust will develop. Once you have trust, many things can work in China."

Managing Costs in a Volatile but Regulated Environment

Building and sustaining a business in China requires aggressive management of a range of costs—some familiar and some not. Many businesses find themselves in a margin squeeze that becomes the main issue in business planning and execution. The squeeze is between unforeseen pressure on costs, some commercial and some

Reflections on China at the End of the Second Millennium 29

regulatory, and unforeseen pressure on prices, some commercial but many regulatory. Regulatory costs include items found in other countries, such as duties and taxes, which are subject to sudden change. They also include items that are particular to China, such as forced partnering costs; inflated real estate prices in designated investment zones; extra margins paid to state-licensed importers, distributors, and retailers; and so on. Price pressures are brought about by the mandatory involvement of local pricing bureaus, forced distribution channels, and unconstrained and subsidized state-enterprise competition.

To address these issues successfully requires the senior China executive to manage the interface with the regulatory environment actively rather than treating it purely as a compliance process. Through good relationships with regulatory officials, it is possible to influence the development of regulations as well as their interpretation, to the benefit of the business. For example, a process of tax planning to enhance one's tax position needs to be supported by a process of relationship management with the taxing authorities. A business that relies on significant imported inputs needs to be supported by a function that not only monitors compliance with customs and excise regulations but aggressively manages relationships with the appropriate agencies.

Making the Long-Term Commitment

In a survey carried out in the first half of 1999 among the chairmen of the top 50 PricewaterhouseCoopers clients in China, most expressed caution and commented that the operating environment in China was more complex than had been imagined a few years ago. The focus of companies was on reducing losses and on improving profitability through consolidation of legally separate joint ventures and through operational efficiencies, including a reduction in the number of expatriates. In the short term, there was a desire to generate a better return for shareholders from investments already made before committing further funds. However, there were some global companies that had not yet invested signif-

icant sums in China and had committed to doing so in the near future. The overall picture indicated a reduced level of foreign direct investment from global companies, when compared to the heady days of 1994 to 1997.

But all of the 50 chairmen surveyed were optimistic about the future and stressed the importance of multinational corporations' having a long-term vision and long-term commitment when it comes to investing in China. These views have been encouraged by the belief that the Chinese leaders know what they are doing, and, although there are many serious issues to be faced, there is confidence that they are up to the job. The zeal with which the program of market reform is being pursued has given grounds for comfort, as has the desire to restructure the loss-making state enterprises and the nonperforming loans of the state banks. The decision made in early 1999 by Premier Zhu Rongji to make every effort to join the WTO encouraged MNC chairmen who recognized the opportunities that would be generated by the further Opening Up.

In March 1999, the People's Congress changed the constitution to provide a constitutional basis for the private sector. It was announced that contract law would be improved and that legal protections would be introduced for the private investor. By mid-1999, a comprehensive revision of contract law was in its final stages. At all levels, advocates of competition are emerging as major influencers, reminding one of the early 1980s when Margaret Thatcher championed the free market in the UK and rolled back the frontiers of socialism. This phenomenon, which spilled over to many countries and led to worldwide privatization on a massive scale, has even influenced the Chinese leadership. Of course, it is being introduced in China in a Chinese way, with a strong focus on caring for the people and on maintaining the achievements of socialism. For example, it is not called privatization but, euphemistically, "introducing diverse forms of ownership." The train has left the station, and China's desire to join the world's international organizations and become a truly global player implies a direction from which there will be no turning back. There will of course be false starts and hiccups along the way, but the direction is clear.

Reflections on China at the End of the Second Millennium 31

As Michael Portoff comments, "If you go to Beijing or Shanghai, you will not meet Mr. Marx or Mr. Engels or Mr. Hegel on the streets. This is a capitalistic country, more like what you would have seen in Manchester at the end of the nineteenth century."

Questions are often posed by journalists and commentators about the future political stability of the country. To address this issue effectively requires a separate political treatise. However, chairmen of multinational corporations seem to have confidence in the ability of the country's leaders to transform the economy within the present political framework. The control that the Party maintains over the people and over the changes taking place appears strong. Predictions of another Russia are not given much credence.

The often-turbulent relationship between China and other countries, particularly the United States and the UK, gives foreign businessmen cause for concern. Trade negotiations, commercial contracts, and the granting of licences can all be influenced by a sudden deterioration in relations. For example, a meeting between a foreign prime minister and the Dalai Lama can be used by China as a lever against a company from that country if the meeting occurs in the middle of negotiating a joint venture. Alternatively, it might provide an excuse to the Chinese authorities to delay the granting of a license. The dimension of international politics makes life difficult for foreign businessmen in China. But this phenomenon also exists in other countries.

Economically, China has witnessed something of a miracle in the last decade. Economic statistics may be highly suspect, even "cooked," in the view of some observers, but real economic progress is highly visible. A visit to the Shanghai Pudong area or to an electronics factory in Guangdong evidences the success. Most foreign businessmen are confident that this will continue, albeit not at the rate experienced in the early 1990s.

The regulatory environment is seen as the greatest uncertainty for multinational corporations, and as the area of highest risk. China's accession to the WTO may start to reduce this, but compliance with commitments made will be a fearfully difficult chal-

lenge. The vagaries of the administrative environment will remain for many years, despite the political will for change.

In summary, the prospect of political stability, the scale and growth of the economy, and the professional manner in which it is being transformed give the chairmen of the world's top companies optimism and confidence in the longer term about the market in China. The regulatory environment continues to give concern and headaches. The need for flexibility on the part of multinational corporations doing business in China is paramount.

The dichotomy between long-term optimism and short-term caution, even despair, has interested writers and commentators on China for the last two centuries. Success in China depends on the industry you are in, the timing of market entry, and the many other issues referred to in this book.

I shall leave the last word to Hank Greenberg: "If you want to do business in China, you need to take the long-term view. You have to be patient. China is, after all, a 5000-year-old civilization. They don't measure time in the same way that we do in the West. You can't rush China. You have to take it step-by-step. That's the secret of success."