# 7

# Conclusions and Policy Recommendations

*[I]n the semireformed system both the major cities and the small townships are developing more a negotiated economy than a competitive market-driven system. Over the long run, this situation is reducing competition and restricting the size of real markets for many goods and services. This system is also creating powerful vested interests at local levels in which local officials and enterprises collude to take resources out of the larger system to serve their own interests. This starves both the central government and the agricultural sector for necessary funds and amounts to a major change in the PRC's overall political economy. Wrestling with this problem without reimposing centralized administrative controls over the economy will be one of the difficult issues confronting Beijing during the coming years.*

Kenneth Lieberthal (1995, 265)

For the United States, managing commercial relations with China is likely to become a more complicated affair in the coming years. In the 1990s US policy toward postreform China has revolved around well-recognized modules: Taiwan relations, intellectual property piracy, human and labor rights, missile proliferation, and Congress's annual debate over renewal of most favored nation (MFN) status. A growing bilateral trade imbalance has begun to capture our attention and prompt calls for "market access," but conclusions about causes and implications have relied more on analogies with Japan than on a meaningful examination of the forces shaping the Chinese marketplace.

The analysis in this study explores the experiences of foreign firms in China in order to demonstrate that our commercial concern with China



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cannot stop at the border. In fact, analysis must go beyond central Chinese domestic policy. Impediments to China's ability to absorb goods have more fundamental causes: the transition from statism to market, industrial market structure problems related to underregulated capitalism, and the behavior of foreign enterprises themselves as they wrestle to secure a position in what may someday be the world's largest marketplace. These factors have been at work at each stage of the value chain within the foreign-invested enterprises (FIEs) in the chapters of this study.

Despite this multiplicity of factors, US policy has generally treated China as a market to be pried open through policy pressure. Perhaps that is unsurprising: China's foreign policy authorities cultivate an image of being gatekeepers to a monolithic entity that would jump if the mandarins so demanded. While negotiations over China's World Trade Organization (WTO) accession approach their 12th year with a focus on, for example, domestic trading rights for foreign enterprises, many (if not most) of those foreign ventures already dabble in such activities. Central announcements of a smaller bureaucracy, fiscal stimuli, enhanced tax collection, and antismuggling and corruption campaigns are diluted by foot-dragging at the local level. Policy analysts in Washington admonish trade negotiators to make negotiations over performance requirements their first priority, but again the expatriate managers themselves confide that such requirements are underenforced and of less concern than issues pertaining to scope of operations and partnering.

This study suggests that Beijing officials prefer at this point to face foreign pressure for concessions on some of these issues rather than admit that some local authorities are already making these changes, ahead of Beijing. Furthermore, the fiction that the old restraints on domestic competition still apply fully provides Beijing with a convenient negotiating chip. Many incumbent foreign and domestic enterprises benefit, insofar as it discourages new entrants and they want no more competition in Chinese markets than they already face. And it is useful for US and other negotiators who have a solid objective to target in bilateral meetings—a target that is already half achieved. However, it is dangerous to ignore or forget the ramifications of the central authorities' inability to enforce trading limits on FIEs partnering with local authorities and their unwillingness to acknowledge these practices for fear of losing internal control.

Not all the problems that foreign enterprises encounter in China can be addressed by new policy set forth from Beijing, even if those authorities are willing to meet foreign demands. Throughout this study nonpolicy factors influencing FIEs have been considered alongside policy concerns. Table 7.1, which summarizes the results, demonstrates that there is much more at work in the Chinese marketplace than policy matters alone.



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**Table 7.1 Roundup of FIE issues**

| Stage | Transitional | Self | Policy | Market |
|---|---|---|---|---|
| Negotiation and establishment | 6 | 9 | 12 | 3 |
| Human resources and staffing | 9 | 5 | 9 | 0 |
| Productivity and running the plant | 9 | 6 | 10 | 4 |
| Ex-factory issues, selling and service | 6 | 5 | 8 | 1 |
| Legal issues | 6 | 9 | 10 | 1 |
| **Total** | **36** | **34** | **49** | **9** |

## Conclusions

Chapter 1 argued that the United States needed a new China policy, one capable of addressing the changing profile of the Chinese state and economy and thus US interests. The observations of our set of expatriate interviewees have now been exhaustively laid out in chapters 2 through 6. The interviews were not focused on the ten general questions proposed in chapter 1 but on microlevel commercial concerns and topics. For example, rather than being asked directly "How compatible is China's investment environment with international expectations?" the interviewees discussed their individual experiences and assessments (see appendix B for a simplified version of the questionnaire). Taken together, however, the collected observations of the foreign firms and managers provide much useful information for approaching those larger questions, considered in detail below.

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

There is no one answer to the question of what level of Chinese economic openness is acceptable to the major trading nations today, whether the context is preconditions for WTO accession (the target event on which discussions of China's openness have focused) or bilateral policy. The United States, Japan, and the European Union have all expressed different opinions.[1]

Investment conditions are not fully covered by the WTO, it should be stressed; while the Trade-Related Investment Measures (TRIMs) move in this direction, they are not sufficient. Talks on the Multilateral Agreement

1. See articles in *Inside US Trade:* e.g., EU-China WTO Principles Include New Understanding on Tariff Cuts, 17 October 1997, 3–4; EU, China Target Late 1999 for Conclusion of WTO Entry Negotiations, 19 June 1998, 8–9; and Japan, China Announce Preliminary Market Access Deal in WTO Talks, 5 September 1997, 4–5.



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on Investment (MAI) within the Organization for Economic Cooperation and Development (OECD) have stalled. The international institutions' slow progress on this front belies its importance: a local presence in China is a critical prelude to selling many goods and services of concern to the United States.[2] Failure to establish may be tantamount to a ban on market access. As chronicled particularly in chapter 5, a local presence used to be crucial because restrictions on foreign distribution left an offshore seller without distributors to get their goods to Chinese customers and because of inter- and intraprovincial trade barriers to selling within China. While today this market fragmentation is less acute, and many new distributors are popping up, the quality of their services remains very poor. As competition grows, it is becoming increasingly important that firms manage the quality of their local distribution functions in China. Otherwise, product does not arrive, or is pilfered, or turns up damaged, or else accounts receivable lag because no personal relationship has been established with the consumer. These real problems described by the expatriates underscore the need to permit foreign establishment. They will likely remain even once "state trading" is fully reformed (i.e., when any foreign exporter can sell directly to any Chinese buyer who might want those goods). This study therefore argues that the domestic trading experiences of FIEs is a better gauge of the long-term prospects for trade with China than an assessment of border barriers, and, thus, there must be concern with investment issues beyond those covered by the WTO.

On paper the establishment process in China retains exclusive aspects, but the large volume of utilized FDI demonstrates the country's openness in practice to foreign establishment. Chapter 2 reported expatriates' views on the tendency of local authorities and other partners to undermine the gatekeeping intentions of central authorities. These phenomena led many interviewees to characterize the establishment regime in China as more open than that in Japan or South Korea, where central bureaucrats wield more control over local behavior, even today. This is quite consistent with data on the trade openness of China and its two neighboring countries (see Zhang, Zhang, and Wan forthcoming), where central impotence also results in virtuous outcomes ("virtuous" from a perspective of liberal economics, that is).

Once operating in China, FIEs are exposed to a host of noncommercial forces ranging from partnering pressures to corruption; these certainly would not be considered hallmarks of an open investment environment. Nor would residual restrictions on scope of operation, a critical impediment to efficient plant productivity and ex-factory operations. The magnitude of these problems for foreign firms was examined in chapters 4 and

2. The United States hopes that China will absorb its own goods, of course; but there is also concern that China absorb the region's specialty offerings, thus avoiding Japan's failure to consume its share of the region's product.



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5, which presented a picture of various experiences and outcomes depending on sector, region, and the firm's approach to dealing with China. Overall the trend appears positive if still not progressing nearly fast enough to satisfy either impatient foreign managers or the needs of a country dependent on regular and dramatic marginal growth from its reform efforts. Chapter 6 added the many legal (and superlegal) privileges enjoyed by FIEs to the balance sheet of complaints more often talked about.

Performance requirements, an important topic in assessing developing-country investment conditions today, are often at issue in China. The analysis in chapter 2 suggests that these are less onerous than generally thought for foreign firms in China; in addition, they are shaped considerably by the choices of the firms themselves as they make trade-offs to achieve goals such as superregulatory levels of management control.

Moreover, in assessing China's investment practices, recall that no one can insist on China's matching, say, Hong Kong's standards of compatibility with international expectation. It is accepted that absolute levels of openness differ among nations, reflecting valid cultural choices and differences in level of development. What matters most is whether the domestic environment for investment by foreign firms passes muster in terms of national treatment and most favored nation status.

China illustrates a problem with the national treatment standard required of WTO members: there is no standard of treatment for domestic firms. Indeed, conforming to regulations can be even more onerous for domestic entities than for foreign firms, which as often as not negotiate privileged treatment by using their power to bring money and technology and jobs into the country. The interviews make clear that foreign firms can enjoy a level of independence from state intervention greater than the typical Chinese state-owned enterprise (SOE) can (per the viewpoint of western commercial norms anyway). Foreign managers are generally less concerned about state-controlled firms, which lack independence;[3] instead, they are focusing on the smaller set of private domestic firms with which the FIEs will increasingly compete in China and which may benefit both from managerial flexibility and from favoritism written into the regulations.

Investment treatment for firms no less favorable than that enjoyed by firms from other countries—that is, the MFN principle—is also hard to assess. Particular firms often receive superior treatment, both on a sectoral basis and within sectors. The policy dimensions of these preferences are legitimate concerns in light of some WTO regulations (such as the Subsidies Code), especially as they seek to support particular industries or favor domestic over foreign firms. However, it would be difficult to find a pattern of specifically *country*-oriented investment privilege. Even US

3. Foreign firms do not have *competitive* concerns regarding SOEs; however, to the extent that they are given market shares to keep them barely afloat, they displace production by efficient firms (such as FIEs) that would permit economies of scale.



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firms reported little discrimination based on their "Americanness," despite threats and tensions over bilateral political flare-ups. To be sure, there do appear to be advantages along ethnic lines, particularly for enterprises of the overseas Chinese. But these can be explained by referring not to government policy but rather to better knowledge of how to work the system. In sum:

- Expatriates report that the ostensible barriers to investment are negotiable and that establishing is generally easier than in other WTO countries—mostly because local authorities undermine central rules.
- An analysis of the national treatment and MFN principle profile of the Chinese investment environment is not in clear contradiction with expectations; but in any case, no multilateral investment agreement yet exists to cover these issues.
- The enforcement of performance requirements in China, one area that is partly (but only partly) addressed by the WTO, is less pernicious than usually thought.
- China has achieved its present, not-too-shabby level of investment openness very quickly and has committed to continue its rapid progress.

Based on these facts—gathered from the study of expatriate perspectives on the ground and from broader data sources—this study would assign China an acceptable grade for its openness to investment.

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

The analysis of commercial issues presented in this study has been focused on foreign firms and managers, and geared toward those in the United States (and other Western countries) who make decisions about business and policy. But the government of China should and must be concerned about the problems of foreign firms, and thus should heed this study, for the five reasons given below. That Beijing most definitely does care about what FIEs have to say also (and significantly) suggests that the interests of FIEs and of home and host governments are interdependent.

First, the flow of foreign direct investment to China is a primary concern; so far these flows have been as much despite central policy as because of it,[4] but the Beijing authorities must now show greater understanding of

4. Consider the extent, described in chapters 2, 4, and 5, to which local authorities have made life easier for FIEs, often in contravention of the spirit—if not the letter—of the central authorities' pronouncements on investment policy.



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foreign investors' needs. The early frenzy to secure market share as first entrants has given way to more caution, as investors pay more attention to the difficulties of doing business in China. Furthermore, the Asian financial crisis has both made firms more reluctant to invest in developing Asia generally and diminished China's particular utility (i.e., as a base from which to serve high growth in the broader region). This study will aid Chinese officials eager to understand the priorities of foreign investors.

Second, the distinction between Chinese and foreign firms is quickly eroding. As the clear separations between domestic and foreign interests disappear, Chinese authorities must ask a question heard in the West a decade ago: "Who is 'us'?" Increasingly FIEs and Chinese firms are the same; at least, it is increasingly beyond the ability of the Ministry of Foreign Trade and Economic Cooperation to see any difference in microeconomic behavior (and data). With so many of the most admirable and competitive firms active in China either in the foreign-invested sector or inextricably joined in value-chain relationships with FIEs, it is essential that Chinese regulators take cognizance of the problems they face.

Third, Chinese authorities should pay attention to this study because purely domestic Chinese firms are increasingly calling for many of the same reforms that FIEs desire, feeling the same pressures from the market. As privatization and independent management of Chinese firms continue to spread, these calls will only become louder. If Chinese companies are to compete effectively with FIEs either domestically or abroad, they will need a home marketplace that encourages competitiveness through sound regulation. Chapter 4 documented the difficulties of well-trained foreign managers in creating an environment conducive to productivity growth in China; imagine how much harder the task is for those running indigenous enterprises. Chinese authorities can learn much about what they are doing right and wrong for their home firms by listening to the expatriates.

Fourth, China can no longer depend passively on a "propitious external setting" (see Oksenberg, Swaine, and Lynch 1997, 16); it now needs to contribute to the stability of that setting. Neglecting the interests of foreign firms established in China will set home governments in conflict with China and will ultimately call international rules into play. At the least, China must nurture its foreign market access, and that means attending to the concerns of trading partners' firms.

Fifth, and finally, Beijing's technocrats realize that they must deal with these problems because China's economy must become competitive. Enhancing the rule of law, improving distribution efficiency, expanding human resource training programs: these and other requirements that FIEs seek are the reasonable objectives of China's leadership and are essential for a strong, independent China.

That the authorities are indeed paying attention to FIEs' concerns is clear; expatriates stressed that it is much easier to deal with officials today



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than it was in the past. Furthermore, the FIEs are contributing to building capacity in the bureaucracy to address their own needs (see chapter 6), demonstrating that Chinese authorities both care about those needs and are in fact learning from their foreign investors.

### Has China Really Turned a Corner, and What Should Be the Reaction to Its New Leadership?

The expatriate managers supply considerable evidence that China has broken with past economic and political policies in important ways. In 1997 China restored important import duty abatements,[5] agreed to negotiate trading rights and state trading in the context of WTO accession talks, resisted devaluing the renminbi, and accepted a dramatic increase in the number of wholly owned foreign ventures (WOFEs). Cohesive pressures to overstaff have abated to a degree, and performance requirements appear to be stressed less (see chapter 2). Beijing has committed to a crackdown on smuggling and petty corruption even when the army is involved (see chapters 4, 5, and 6 for the productivity, distribution, and legal problems arising from such smuggling).[6] Western firms are being bombarded with resumes from government officials, who are facing a 50 percent reduction in the total size of the Chinese bureaucracy over the coming years. In follow-up discussions, interviewees expressed strong confidence in Zhu Rongji's leadership—a remarkable endorsement in light of their feelings about former prime ministers. Some of the interviewees involved in finance predicted a major change in the terms required for wholesale foreign buyout of major state industries.

Tangible political and economic developments inside and outside China—not least the Asian financial crisis itself—precipitated these new trends. China's closed capital account provided time to strengthen the economy against the causes of the crisis, but the rigidity needed to micromanage capital flows is costly. Leaders must press ahead with bank refinancing, enterprise reform and recapitalization, and liberalization of the financial services sector (which must be opened to foreign participation) even in a time of external instability. Complaints of FIEs reported in chapters 2, 4, and 5 concerning restrictions on firms' financial practices are

5. To the extent that these create a disadvantage for domestic firms (and therefore an incentive to "roundtrip" investment), such abatements are not necessarily advisable. However, they do demonstrate a sympathy with the needs of foreign investors and an awareness that standard import duties can be prohibitively high. The next step is to recognize the disproportionate harm they may do to purely domestic firms.

6. From *China News Daily*'s 20 July 1998 edition (citing Agence France-Presse): "In a frank editorial on Thursday, the People's Daily assessed the involvement of party, government and army organizations, as well as judicial and law-enforcement departments, in rampant smuggling and urged 'relentless punishment' (Agence France-Presse, 07/16)."



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mounting, and they will only worsen so long as central authorities try to maintain their capital account controls. Foreign direct investment has peaked (for the moment), and some of China's best customers (Japan, Hong Kong) are stymied by their own economic malaise. If China continues to rely on its precarious ability to stave off external financial pressure without structural and regulatory adjustment, new FDI flows will fall significantly.

Chinese leaders are grappling with novel choices; the new China seen during President Clinton's 1998 summit meeting appears to be more than just a stunt for the cameras. Many expatriate managers perceive major changes in policy, practice, and business culture in a variety of commercial settings. This break with the past can be for the good (more open and fair competition) or for the bad (more private collusion and asset stripping). The sea changes that have taken place in China must be recognized to encourage developments in the right direction.

For Chinese leaders, the Asian financial crisis provided a rare glimpse into their own possible future, a moment before they were to jump full swing into the *chaebol*-making business. The lessons have been burned deeply into Chinese thinking: unlike its neighbors, China has a chance to avoid building shiny skyscrapers on a foundation of shaky industrial policy choices. The changes in Chinese intention and perspective must be reflected in US policy to encourage further reform and to best support US firms competing in China's markets.

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

China's economy is strained by rapid growth, rising unemployment, near-critical environmental degradation, and widening gaps in income distribution along regional and urban-rural lines. Many elements of these largely transitional problems (and their policy aspects too) are discussed in chapters 2 to 6 as they relate to FIEs. As best documented in Nick Lardy's *China's Unfinished Economic Revolution* (1998), financial-sector reform is looming as well, after years of deferral. Interlocking nets of nonperforming loans, inadequately funded pension and social welfare pools, increasingly fragile capital markets, and poor domestic banking habits must be dealt with if China is to unlock further productivity growth and resolve its state enterprise paradox (i.e., a growing share of fixed investment is needed to keep increasingly unproductive and obsolete industrial behemoths afloat). Rightsizing a portion of the bureaucracy alone will release perhaps 5 million workers into sluggish labor markets. As evidenced by the difficulties that expatriate managers are encountering in reengineering plant productivity (analyzed in chapter 4), coping with these challenges is an enormous task. In this environment, can China be expected to be a more open marketplace for foreign firms? The answer is yes—and no.



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Consider two characteristics of the marketplace: cooperation and competition. Under the communist experiment, all was cooperation; self-contained corporate entities encompassed all the competition and supporting firms that in a capitalist economy would lie outside a manufacturing company. Housing, restaurants, even crematoria and undertakers were controlled by the state. When foreign firms were reintroduced to China in the early 1980s, their role was to cooperate in the domestic marketplace. Internationally, they competed as usual, exporting aggressively to earn hard currency as they would elsewhere. But within China they were instead expected to bring skills, investment, and technology; they were pressed into the family. While the special economic zones were islands of incentive, they were also holding pens to reduce foreign involvement in the domestic economy. This "dual economy" characterized the experiences of most foreign enterprises (see Naughton 1996a, 1996b).

As foreign firms press ahead inside the economy, external barriers continue to fall. Trade negotiators haggle over a simple average tariff that has fallen to 15 from 40 percent in four years, but leaks and loopholes bring the revealed average tariff rate below 4 percent. But while policy impediments have receded, the nonpolicy problems identified in this study have increased. For example, the shortage of local human resources severely hampers firms in major markets such as Shanghai. Self-created hindrances that once seemed like innovations (e.g., getting a jump on a major regional market by strategically partnering with a local champion company) are coming to the surface (as the firms find it difficult to convince Chinese partners to expand to other regions). And market structure problems are escalating as the healthier SOEs change ownership categories and suddenly command local markets, not surprisingly with a friendly wink from government regulators (their erstwhile owners). Private constraints to commerce will become more common in China in the absence of a procompetitive regulatory policy. FIEs continue to be pressured—with varying effectiveness—to transfer commercial power over scope, technology, and management to Chinese partners, who play an important role in finding opportunities to sell (see chapters 2 and 5). Taken together, these forces could create high barriers to entry and a collusive and segmented market structure. While incumbent FIEs may be beneficiaries of these concentrations of market power (which may create a greater opening for them), those *aspiring* to establish businesses are closed out not by policy but by dominant rivals.

An important contribution of this study has been to demonstrate (particularly in examining distribution in chapter 5) that private and semiprivate restraints to trade are indeed among the greatest threats to economic openness today. Some argue that the large scale of the Chinese economy will spawn sufficient competition even without a strong central policy supporting it. Interviewees' comments—on exclusive distribution arrangements, limited opportunities to partner with local firms that heavily influ-



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ence local distribution, and informal pressure from allied authorities to sell within a province instead of more efficiently on a national basis—suggest that the question of whether liberal outcomes can be achieved without a concerted policy on competition must be considered sector by sector. Localism could lead to significant market segmentation within regions for some time, even after the most obvious roadblocks to intraprovincial trade are removed. "Openness" to foreign firms, once achieved, can vary considerably in quality. Official openness without the proactive steps to ensure low barriers to entry (and to remove barriers to exit), an outcome that looks ever more likely, would be of reduced value.

Therefore, this study can only highlight this important question, without providing an answer. China's future openness to foreign firms, like the openness of regions within China to firms from other regions, will likely depend on the central authorities' active role in competition policy. If the large scale of operation in China does, as some predict, ameliorate tendencies toward regionalism and localism, then the need for such activism may be reduced. But the trends described in the distribution sector suggest that the ancient local focus is changing only very slowly and that Beijing's willingness to step up to this challenge is the best indicator of whether China will continue its rapid progress in this regard.

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

When FIEs in China were mainly assembly operations or subcontracting sweatshops, the level of added value that they sought to achieve was low. Necessarily, the typical foreign manager had little opportunity to engage his 20-cent-a-day worker in conversation. In any case, the manager did not speak Chinese and the worker knew no English. Throughout this study (especially in chapter 3), an alternative picture of foreign business culture has been offered.

Some might argue that the terms of the comparison are unfair. The more benign view of FIEs in China, characterized by heavy emphasis on productive growth through training, monetary and nonmonetary incentives (e.g., facilitating home mortgages), and career development, is based on interviews at larger Western manufacturing ventures, not Guangdong textile factories. But the shift in FIE establishments from low-value-added contractual joint ventures to more sophisticated equity joint ventures and wholly foreign-owned enterprises reflects a broad trend across the country. A mix of low-value and more sophisticated manufactures (electronics, power generation, and medical equipment on the one hand, textiles and toys on the other) now dominates US imports from China.[7] Service-sector activities are also expanding, bringing a whole new wave of training as

7. See http://www.uschina.org/press/trade7–8.html#trade8 (9 June 1998).



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well as much more sophisticated jobs than the exploitative work stereotyped as "Chinese."

Such changes will necessarily lead FIEs to focus even more on investing in human resources; and "China's new business elite," as Pearson (1997) describes the emerging middle classes of coastal cities, is growing quickly. Foreign firms are not solely responsible for creating the wealth that fuels this enormous socioeconomic leap, but they play a crucial role in setting expectations and providing a template for workplace reform. The number of Chinese employees of FIEs rose from 660,000 in 1990 to 5.4 million in 1996. If only a million of those employees attain at least a lower-level managerial position, they will form the nucleus of the entrepreneurial class of tomorrow.

In addition to jobs (increasingly producing higher-value-added goods and services), FIEs bring to China skills, training, and wage and nonwage benefits (again, see chapter 3). But perhaps most of all, FIEs influence Chinese society by bringing a different workplace culture—one characterized by initiative taking, career development, and quality control.

Yet for a number of reasons, these efforts have received remarkably little recognition outside China. Firms in China are inclined to develop their company cultures quietly so as to avoid drawing the attention of nervous overseeing authorities. In urban centers, tensions about foreign firms simmer just beneath the surface, as indigenous enterprises compete with FIEs for choice employees and struggle with the new, higher expectations the foreign firms have introduced.

Similarly, those FIEs with a greater scope of operations than simply manufacturing have the most positive workplace environments but function on somewhat ambiguous terms; they rely on such techniques as bundling business licenses from unrelated municipalities, interpreting regulations more liberally than officials would (publicly) allow, or getting key officials (unofficially) to turn a blind eye to practices that take place outside the spotlight. Under these circumstances, FIEs can carry out a range of sophisticated sales, marketing, and support functions, with the help of significant numbers of self-motivated, well-trained local employees. To trumpet all their activities in human resource development, however, would jeopardize their positions.

An FIE may also hesitate to call more attention to the virtuous impact of its operations because at even the most hands-on ventures, aspects of the business are unclear to senior management. Nobody wants to make what one manager called the "Gary Hart blunder": that is, to invite inspection of one's actions only to have numerous flaws discovered. While many foreign firms expend considerable energy to improve the conditions under their roofs, few would be willing to claim that they control or even know of all the related activities around them in the larger Chinese marketplace. Subcontracting relationships, as well as gray sales and supply practices, are often somewhat nontransparent to foreign venture managers.



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But it is becoming more important for FIEs to communicate their social impact. Support for commercial policies conducive to foreign investment weakened worldwide in the late 1990s as concern grew about the implications of economic globalization. For example, in the United States in 1997 and 1998, charges leveled against overseas labor practices figured prominently in campaigns against fast-track trade legislation, renewed funding for the International Monetary Fund (IMF), and the planned Multilateral Agreement on Investment. In order to turn these debates back toward engagement and away from protectionism, firms operating in emerging markets such as China must publicize their efforts and encourage attention to their foreign operations. Increased scrutiny is inevitable; better to invite it than be taken by surprise.

### Will WTO Accession Address the Commercial Priorities of China's Trading Partners?

The WTO has broader competence to manage international trade today than had its predecessor, the General Agreement on Tariffs and Trade (GATT), prior to 1995. In addition to traditional work fostering the liberalization of goods trade (aimed at border barriers such as tariffs and nontariff measures), the organization has new or stepped-up authority on trade rules (antidumping, subsidies), services (the General Agreement on Trade in Services), investment (TRIMs) and intellectual property protection (Trade-Related Intellectual Property, or TRIPs). An invigorated dispute settlement mechanism (DSM) now has power to enforce findings on members; under the GATT, procedures required defendant concurrence. The WTO has approved working groups on trade and competition policy, and on trade and the environment. A "built-in agenda" is already turning to additional business, having successfully negotiated plurilateral agreements on basic telecommunications and financial services.

Clearly the WTO's coverage has broad implications for the Chinese economy, especially as membership entails a "single undertaking": China must join all at once, not in stages. Furthermore, during accession China must negotiate market access concessions that will cover a very substantial portion of its marketplace immediately, phase in access for other sectors quickly, and leave only very narrow areas unopened to foreign trade and establishment. While in many sectors wide gaps remain between China and her trading partners as of this writing, the magnitude of Chinese liberalization that has resulted from this process is not in debate.

But the WTO cannot be expected to solve all of the world's commercial problems with China. First, though much was accomplished in designing the WTO, certain of its regimes are not fully capable of addressing their targets. TRIMs, which open the door to arbitration over performance re-



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quirements on FIEs (see chapter 2), cannot prohibit them and only includes a partial illustrative list of what is not permitted. Neither the government procurement agreement nor certain important sectoral agreements are required of China. Notwithstanding these shortcomings, concessions can still be pressed on China in bilateral accession negotiations; indeed, there is no single template for accession. Second and more important, the WTO does not yet squarely address the area of domestic competition policy. Essentially, any US exporter whose opportunity to sell into China was precluded by Chinese policy could bring a case before the WTO (were China a member) on the grounds of nullification and impairment of an expected benefit. However, no such argument can be made when the sales opportunity is foreclosed not by public policy but by private actions (Graham and Richardson 1997a, 48).

As shown, especially in chapter 5's discussion of distribution, as reforms move forward in China more firms are removed from state ownership, and their commercial problems also become less closely bound to the state. These are not wholly private matters, given the residual involvement of lower-level governments in local enterprises and state policy lending among the SOEs (perhaps 100,000 still remain). But the "corporatization" formula for shedding state ownership exists, though in its earliest stages.

In the absence of procompetitive policies from central authorities, many sectors in China are likely to reflect—on a local basis—the sort of nationwide private closing of markets that foreign firms have complained about in Japan, notably in the auto parts and photographic film sectors. Some have suggested that China's large scale will make such a trend to monopoly impossible; but as long as regional or provincial markets remain physically segmented, the problem will remain. Indeed, this will concern not just FIEs but nonlocal Chinese firms as well, some of which already complain bitterly about being locked out (of the Shanghai auto market, for example). Conversely, it is quite possible that titularly foreign firms able to solidify relationships in China may enjoy the status of forecloser instead of foreclosee. But such privileges will create more difficulties for foreign governments trying to devise a commercial policy toward China, as firms from their home country eager to do business in China will be divided into incumbents and aspirants. This phenomenon is common in developing economies, but China's sheer size makes it necessary to find solutions uniquely suited to the Chinese context, because there is less leverage against such a superpower.

Therefore, the study argues that rather than concentrating solely on the WTO, commercial remedies should be crafted in partnership with progressive Chinese leaders. This recommendation is bolstered by the growing evidence that China is resigned to deferring WTO accession until the dust of the Asian financial crisis is well settled—perhaps after the millennium.



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

Canada and the United States have had as many bilateral trade disputes as any pair of nations; but it should not be concluded that their commercial relationship is not healthy. The natural growth in transactional disputes as commerce increases explains the focus in chapter 6 on legal regimes for resolving disputes as they arise. Times of transition and adjustment bring even more conflicts than usual. For example, the Asian financial crisis will likely lead to trade maneuvers that will generate a surge in antidumping suits between the United States and Asian nations, including China.[8] But while an increase in disputes between private parties is inevitable, conflict between sovereign overseers over these cases is not. Chinese and foreign authorities have a common interest in creating more stable, efficient, and equitable market conditions in China, and therefore they are joining in a considerable effort to build capacity for dispute resolution. The WTO will provide an important multilateral venue for such cooperation, while its rules will help to forestall the unilateral actions that can themselves be a source of conflict.

The WTO can play these roles only after China's accession, which will be largely motivated by China's own self-interest. Chinese authorities are concerned with maintaining the flow of FDI into their domestic economy, keeping the capital stock from eroding, and lowering the high transactions costs associated with an unpredictable investment climate. Commercial problems have long been remedied by administrative intervention, whose replacement by standard, internationally accepted procedures progressive elements within China are eagerly anticipating. They recognize that the change will not just promote foreign investment but nurture competitive domestic companies as well, better preparing them for the international market. Chapter 6 provided evidence of China's legal maturation, with the views of the interviewees on China's progress toward these goals.

Chinese leaders must be concerned with not only the microeconomic but also the macroeconomic effects of failing to resolve commercial conflicts with reasonable fairness. Recall that the most problematic restraint of trade suffered by FIEs in China may increasingly involve private actions rather than policy (see especially chapter 5), actions that may harm Chinese firms even more than FIEs. By stifling competition, these actions reduce innovation, block structural adjustment, and stall the reabsorption of displaced labor, serving neither equity nor efficiency objectives for China. Such market foreclosure does not even serve nationalistic ends: incumbent foreign firms ensconced in collusive arrangements by virtue of being early

8. Just as important, such suits can be expected *among* Asian economies as well. See Noland et al. (1998).



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contributors of technology and capital may benefit disproportionately, as compared to nonlocal Chinese firms from excluded jurisdictions.

In some sectors—for example, many consumer electronics and durables—market domination is already creating problems.[9] The evidence in this study suggests that these conflicts are a primary concern of FIEs, as seen in their focus on dominating partners (chapter 2), the productivity challenges arising from restrained market growth (chapter 4), and difficulties in expanding operating scope (chapter 5).

The United States and China share an interest in avoiding further development along these lines. The costs to China are high: exacerbated regionalism and urban-rural division. And such a marketplace—dependent, like Japan's, on exporting because of a multitude of domestic trade impediments—would undoubtedly draw much political fire from the United States, especially from the Congress. This animosity would diminish the ability of China to assume a regional or global leadership position, as the United States and other Group of Seven (G-7) nations are now hoping it can. Therefore, there is strong logic on both sides in favor of Sino-US cooperation, both to build capacity to support each other's procompetitive regulatory functions and to defuse bilateral confrontations. Having a more efficient legal system to serve business, as an interviewee quoted in chapter 6 put it, "is a practical matter, not an ideological one" (#51). The trend since 1997, influenced largely by the desperation with which Asian host governments are seeking more FDI, points unambiguously toward better conflict resolution, not only for firms but between governments; political stability, after all, is an important dimension of economic stability.

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

Much has been written in recent years about the devolution of power from the central to provincial and local authorities in China. The boldness of southern provinces such as Guangdong, which had integrated deeply with freewheeling Hong Kong even before the latter's reversion to China, has raised the specter of renegade regionalism typical of China's past. FIEs (and many Americans at home) initially viewed this phenomenon positively, since local autonomy allowed greater freedom from bureau-

9. See, e.g., Yang 1998, whose work shows market shares in China of 40 percent and above for the dominant firms selling refrigerators, videocassette recorders, and microwave ovens, and concentrations almost as high (25–35 percent) for the market leaders in air conditioners, washing machines, and televisions; the number two firm is also often in an extremely strong position.



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cratic constraint. However, the survey of operational problems in this study shows that an impotent Beijing is not in the FIEs' interest. Many interviewees have recently come to this realization, as they have sought to move beyond their compliant local partnerships to take up a more national position—only to find that there is little national framework within which to operate and that unchecked tensions between provinces can interfere with economic opportunity without a strong center.

There are strong tensions between Beijing and the provinces as well. But while localism stands to stifle openness, even in a worst-case scenario the provinces wishing to be strong have to draw on linkages with nonlocal economies. Interviewees described mounting interdependence both among provinces and between provinces and foreign markets; and those foreign links in particular *do* depend on central management and acquiescence. Such interdependence is evident in labor specialization between coast and inland (chapter 3),[10] productivity considerations favoring multiprovince production plans (chapter 4), and the eagerness of FIEs to develop national distribution operations (chapter 5). Coastal China depends on cheap raw material inputs from Southeast Asia; coal, oil and other energy supplies from northern and interior China; and more sophisticated intermediate inputs from Japan, Europe, and the United States (which later make up a large share by value of Chinese exports—i.e., reexports—by value). Dynamic coastal China will be a net consumer of foreign capital for decades to come. In previous eras, a rich province might aspire to be self-contained; but in the new China these provinces will depend on smooth interprovince commerce, and hence on the specialized services of the national government, as never before.

Many expatriates pointed out that the wealthier provinces are sure to respond to the social unrest likely to accompany structural adjustment of the economy over the coming decade by imploring Beijing to maintain a strong position of authority in order to prevent chaos. Poorer provinces, meanwhile, will continue for the foreseeable future to depend on the center for fiscal transfers from the wealthier regions. It cannot be concluded that in important economic sectors regional markets will not be segmented, or that Beijing will find it easy to impose a liberal commercial template on 10 dynamic provinces and 20 more static ones. But Beijing has a strong role to play that cannot be delegated. It is also clearly in the US national interest to bolster Beijing's regulatory power, as bilaterally negotiated agreements are worthless without the command and control necessary for implementation at the local level.

10. Because of rising wage pressures, low-value-added industries are already departing the coast for points inland, leaving the port cities to businesses higher up the ladder (i.e., finishing work and services).



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

This study has catalogued the range of difficulties that FIEs encounter at each phase of establishment and operations. It has presented evidence and opinions from expatriate managers on which of these concerns are becoming more pressing and which less, which are more important and which relatively trivial. By definition, the removal of impediments will permit the FIEs to perform better; and because their very survival in a complex market such as China's demonstrates strength and determination to expand, they should be expected to perform well, all other things being equal. So in large part their future performance depends on how intractable the complications in the Chinese market are.

Beyond question, a great many of the problems examined here are lessening—including information gaps and ignorance of local culture (chapter 2), constraints to efficient human resource deployment and management (chapter 3), resistance to change on the factory floor (chapter 4), inadequacies in the physical distribution system (chapter 5), and failure of the court system to address transactional disputes (chapter 6). To be sure, the time and effort still required before these problems are resolved are sobering, but they clearly are distracting FIEs from improving performance less now than in the past. Ceteris paribus, as the economists say, these trends augur well for FIE success, just as they are positive for domestic Chinese firms.

Nevertheless, fundamental problems remain. The foremost of these are partnering issues. Many foreign managers remain proud of cozy relationships with regulators and Chinese partner firms, believing that these links provide an inside track to success. In early phases of operating in China, these relationships can indeed make life easier (e.g., in facilitating the approval process). But in subsequent phases the tables turn. Disagreement within the joint organization about how best to measure the firm's performance impedes human resource development, plant productivity, and broader distribution of firm operations. Chinese partners (government and company) continue to emphasize local social objectives that Western firms delegate to national social safety nets that have been in place in advanced economies for many years. The Chinese perspective will not change until the structural economic transition—with its potential for civil unrest—is over, some years (perhaps decades) in the future.

In the long term, forced partnering will not help the Chinese to address these social pressures: FIEs have a different set of performance metrics—namely, those of profitability—and will simply cease to invest in China if they cannot operate profitably. Thus, there has been a dramatic shift away from joint venture arrangements and toward wholly owned foreign enterprise structures in recent years, a trend that is likely to continue. But as this study has repeatedly stressed, partnering decisions are only partly



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policy driven; many FIEs have tied themselves to Chinese firms hoping to leapfrog competitors or thinking partnership a shortcut to achieving market dominance. The majority of existing FIEs are JVs, and many new entrants continue to join with local partners either by choice or by coercion.

This study has examined FIEs that had moved beyond establishment to the later stages of expanding and toward acceptance as a local entity.[11] These firms are finding it exceedingly difficult to shed the constraints and obligations of partnering that they had accepted during earlier stages of operation; retaining flexibility has become much more important in their negotiations with local powers. For the longer term, expatriates emphasize the need for a "divorce law" (i.e., a bankruptcy mechanism) to make resolution of partnership problems less difficult. As greater exogenous threats to FIE performance appear, such as financial turbulence outside China, Chinese authorities have had to take these concerns more seriously or risk scaring away investors.[12] The second critical encumbrance on FIE performance identified in this study is limitations on scope of operation (see chapter 5); firms are particularly hampered by their inability to distribute or sell directly products not manufactured in China and to manage the financial functions of Chinese operations on a consolidated, countrywide basis. For many, limitations on entry in service-sector activities that support the main business are a problem as well. Progress is being made in these areas, but not enough.

These two factors—partnering dynamics and scope of operation—are, according to this research, the best indicators of future FIE performance. Of course, other factors will have a significant impact. During a time of massive layoffs and adjustment in the state sector, overall social instability could diminish everyone's performance. The slow recovery of the Asian economies from their financial collapse will reduce performance for FIEs in China as well, as the crisis both makes China less attractive to investors as a regional export platform and makes Beijing hesitant to press ahead more quickly with economic reform. However, such variables are beyond the scope of this study.

FIEs already tied up in undesirable partner arrangements have an uncertain future, while firms able to retain more independence, including the next generation of FIEs starting up without such partners, are better posi-

11. The proportion of foreign firms that have reached the final phase is still small: most FIEs arrived in China in the first half of the 1990s (see table 2.1).

12. This conclusion rests on the analysis of interviews that preceded the Asian financial crisis. China's own ability to withstand volatility has much to do with the willingness of foreign investors to continue coming to China; Fernald, Edison, and Loungani (1998), Rosen, Liu, and Dwight (1998), and others have analyzed the implications of the crisis for China. Here, note that the crisis will amplify the trends in FIE performance already under way rather than create new problems. Hence meaningful separation of commercial and political interests is all the more urgent if frazzled investors are to stay excited about China. This trend toward separation is in evidence already, particularly in the context of incentives (see chapter 2).



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tioned to succeed. For most firms tied up in JVs, their scope of operation depends on their partner. For WOFEs and JVs with significant control, scope is dependent more directly on China's government. Many firms are already creeping quietly into restricted areas. If Beijing either formally countenances this trend or else abstains from cracking down on the pioneers, then performance is likely to improve. Should a crackdown come, then diminished performance can be expected. The United States should clearly focus considerable attention on policies that affect these two variables.

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

A major debate in the United States revolves around fear of a "global glut" of supply that would undermine American jobs and wages. According to this thesis, capacity is being added to global production at an unprecedented rate, outstripping demand worldwide. Much of this capacity, the argument goes, is added by multinational firms from advanced economies creating more production facilities than needed (as a result of an imperative to expand), combined with pressure from emerging markets to shift production. Prominent proponents of this view, who argue that host governments like China's turn production back out toward advanced economies through export performance requirements, include William Greider and Jeremy Rifkin. As economic development in China is a leading source of the anxieties fueling this debate, the American policy debate over engagement with China must concern itself with these views. It has even been suggested that the new Chinese capacity, combined with a supposedly cheap renminbi policy after 1994, precipitated the Asian financial crisis in 1997. But these views are incorrect, and the situation within China is misunderstood.

Overall, the theory of global glut does not hold up today any better than it did one hundred years ago when it was first proposed. In the specific case of China, the surge in Chinese exports and share of the US external deficit in the early 1990s that came seemingly at the expense of other economies in the regions such as Hong Kong, Taiwan, South Korea, and Japan should not be seen as taking something from those neighbors. The change marked not so much an addition to capacity as a transfer of capacity along the lines of comparative advantage.[13] Those nations had some years earlier induced many of those industries away from countries such as the United States, and now as they developed they too were forced to move up value chains. Within China, however, the problem of overcapacity has taken on real salience in less traded sectors, as noted with regard to economies of scale (see especially chapter 4).

13. See, e.g., Noland (1996, 36) and accompanying text.



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Two policy phenomena have contributed to this overcrowding. First, financing was provided without sufficient consideration of the venture's commercial viability. If financial intermediation were competitive and efficient in China, then strenuous due diligence would ensure that serious misallocation of resources into already crowded sectors did not occur. Unfortunately, just the opposite has taken place. Local investments were controlled largely at the provincial or local level, where decisions were made without benefit of a broader perspective on demand and supply. As a result, many provincial decision makers reached similar conclusions about what investments were attractive and acted as if they were members of a herd.[14] Second, weak firms are deterred from selling out or going out of business in China. For fear of the social consequences of increased unemployment, struggling state firms in crowded sectors have been subsidized into hobbling along when their resources should have been redeployed to more promising opportunities. Barriers to exit are a major challenge to the condition of contestability that is necessary for a healthy market structure, although they are often forgotten in the shadow of barriers to entry.

Therefore, there is a problem that is more a Chinese "sectoral glut" than a global one, but the sectors affected happen to draw international attention—automobiles, for example. The FIEs that participated in this study argued that they would survive when competition was finally allowed in China; they believed it was only a matter of time before Chinese authorities would be forced to stop the current practice of supporting all firms indefinitely and allow the unproductive ones to exit the market. Chinese authorities clearly will make such a change not all at once but in phases—which sector will be first? Will the most "important" sectors—say, computer electronics—be the last ones receiving subsidies, by virtue of the power that Chinese special industrial interests wield? Such "luck" would be ironic: the longer real reform is delayed, the further sheltered firms fall behind independent ones. The answer is of acute interest to FIEs, because as long as Beijing or provincial officials support given sectors, the fit FIEs in those industries will continue to suffer unnecessarily, waiting for the day when competition and market exit are the norm.

To date, Chinese policymakers have tried to remedy their sectoral overcapacity by limiting entry to and exit from overcrowded markets. This practice is neither consistent with WTO principles nor an efficient use of scarce resources within the Chinese economy. How quickly Beijing permits the invisible hand to cull the markets of uncompetitive firms depends entirely on the readiness of central authorities for the marginal social strife that these adjustments will cause.

14. Chapter 4 considers the present results of such behavior in some of the markets the interviewees compete in; see further extensive background in Wedeman (1995).



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## Implications

The conclusions above lead to the following four policy recommendations.

### Recommendation 1: Refine US Policy Priorities toward Pragmatic Goals

Using a screening device such as that employed in this study to separate problems amenable to foreign pressure from those that are not, the United States must recognize the present limits of Chinese authority and adjust *expectations* accordingly. Consider table 7.2, which lists only those issues from chapters 2 to 6 with both a policy-related aspect and a high-priority rating: its considerable scope suggests that more narrowing down needs to be done. (While understanding issue areas that have been filtered out is also critical to an analysis of Chinese economic behavior, those issues should not be the primary objects of scarce negotiating leverage.) Of the issues in table 7.2, the present analysis (which is clearly subject to debate) finds only seven to be solely policy oriented.

It is worth focusing on these seven priorities, because policy pressure alone will be ineffectual in the many cases in which transitional, self-imposed, or market structure variables are significant. Five of them involve the scope of FIE operations: regulatory restrictions on distribution, financing within the organization, economies of scope, collection, and service provision. Therefore, continued focus on these areas in WTO talks, where distribution, customer services, and financial services are all on the table, is essential; these are basic business functions that must be permitted to foreign enterprises.

The two remaining top priority issues—Chinese efforts to steer FIEs toward specified partners and to allocate market shares—are the most important and intrusive vestiges of state planning and control of industrial policy. They stand to distort an efficient market structure, defeat competitive impulses, and foster habits of collusion and circumvention. Especially in light of the financial crisis of 1997–98, US policy should concentrate on dissuading China from emulating Japanese or Korean orchestration of industrial policy, as the leadership until recently had explicitly intended. It will take years to fully quantify the costs that a now outmoded market structure has imposed on the Japanese people; other developing countries are still in danger of using the same flawed model.

### Recommendation 2: Consider the Limits of the WTO

As observed, the WTO is currently limited in its ability to redress the full slate of FIE concerns raised in the course of this study. The future will see the rise of private competition policy problems, as noted especially in



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**Table 7.2 High priority, policy-related issues**

| Issue | Category | Level |
|---|---|---|
| **Negotiation and establishment** | | |
| Locating strategically | Policy, market structure, transitional, self-imposed | Central, lower also |
| Government industrial policy, steering investors | Policy | Central, lower also |
| Partner issues | Market structure, policy, transitional, self-imposed | Central, lower also |
| Labor structure | Policy, self-imposed, transitional | Central |
| Scope of business | Policy, self-imposed | Central |
| **Human resources** | | |
| Securing managerial control | Self-imposed, policy | Central |
| Comprador employment | Transitional, policy | Local |
| **Productivity at the plant** | | |
| Capital: Financing the organization | Policy | Central |
| Institutional: Discordant organizations | Self-imposed, market structure, policy | Provincial, central |
| Institutional: Economies of scope | Policy | Central |
| **Ex-factory issues** | | |
| Regulatory restrictions | Policy | Central |
| Collection, finance | Policy | Central |
| Service provision | Policy | Central |
| Allocated market shares | Policy | Central |
| Market foreclosure | Market structure, policy | Central |
| **Law and privilege** | | |
| Interpreting the law to advantage | Transitional, policy, self-imposed | Central, provincial, local |
| Securing superlegal privileges | Policy, self-imposed, market structure | Central, provincial, local |

chapters 2 and 5—problems that will affect nonlocal Chinese firms as much as FIEs and that thus should be of broad interest to the Chinese government. Ultimately, such market power concentration poses as great a risk to aggregate Chinese welfare as to FIE prospects, given the ability of many dynamic FIEs to benefit rather than suffer from collusion. Therefore, the United States should immediately consider going beyond the current WTO-accession negotiations to address concerns about competition policy, exploring Chinese willingness to pursue such steps in a cooperative partnership. An appropriate venue may be a bilateral, regional (i.e., Asia Pacific Economic Cooperation), or multilateral forum other than the WTO.



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Alternatively, the United States and China could agree prior to China's WTO accession to push for a "Shanghai Round" of WTO talks to finally bring competition policy explicitly into serious negotiations; these talks could be agreed on prior to China's WTO accession, either to stand alone or to feed into "Millennium Round" plans (which would bundle a number of multilateral issues). Such a joint statement of preparedness to address this topic would reduce the burden placed on the WTO. If, as at present, the United States tries to negotiate a Chinese accession package that will accomplish more than the WTO is able to handle, it should not be surprising that a "commercially viable" formula has not yet been mutually agreed to. By putting the imperative of competition policy discussions on the table, the worries of "hawks" anxious about China's accession—that domestic competition practices will erode the spirit of China's concessions on international trade—can be assuaged. Equally important, such discussions begun outside the WTO could facilitate, instead of creating a new requirement for, Chinese membership.[15] They would give both US and Chinese proponents of a quicker accession track a major boost.

Certain conditions would have to be present in order to implement this strategy. First and foremost, senior Chinese leaders would have to be convinced both that competition policy is important and that China is ready to aid in constructing a new international regime to address it. These points are far from obvious to many Chinese officials, but Beijing has for its own reasons already started thinking quite seriously about competition policy, with some support from groups such as the OECD and the International Republican Institute of the United States: draft laws are already under consideration nationally and in Shanghai. Policymakers recognize that competition policies embraced by the United States at an intermediate stage of American economic development—from the 1890s onward—were critical to US success. And they also recognize the key role of collusive commercial practices and lack of competition in precipitating the Asian financial crisis.

Making the jump from accepting the need for a domestic competition policy to embracing competition standards at the multilateral level is not easy, but globalization has undeniably changed the rules: policy must change as well. Still, just as a matter of good politics, it is important that this not be construed as raising the bar for Chinese accession. Rather, China here has a chance to address proactively an agenda that is in its own interest, to help neutralize the objections of opponents of its WTO accession, and to demonstrate leadership on an issue whose time has come.

15. As with the Information Technology Agreement catapulted from the APEC forum to the WTO in 1996–97, however, these discussions ideally would be moved inside the WTO once progress was made.



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A second condition necessary to advance this strategy is that advanced economies, especially the United States, accept that the time is right to develop competition policies for the global economy, as argued by Graham and Richardson (1997a, 1997b). This will not be easy: such nations can be fearful that mature competition regimes will be watered down at the multilateral level. Though these concerns are legitimate, they cannot be allowed to obstruct progress toward a global regime that can prevent unevenness and volatility in the process of international economic integration. Enthusiasm—and pressure—from Chinese authorities may be just the thing needed to break through the misgivings and resistance in Washington and elsewhere of experts on competition policy.

Third, while this study is proposing that a special US-China initiative set out the terms of a "Shanghai Round" of discussions on competition policy, such an effort would of course include other major players as well. One would not expect resistance to this proposal from the European Union or Japan, as they are already more comfortable with China's WTO accession than the United States appears to be (see note 1, above). However, given that Japan was the battleground for some of the most intense skirmishes over competition policy to date (in the now famous Kodak-Fuji case heard by the WTO),[16] it might be wise to secure Japanese participation in a Group of Three arrangement to lead this effort. Should these three markets make significant progress on the international competition policy agenda, it would be far easier then to draw other parties into the discussion. Like China, Japan has strong reasons of self-interest for coordinating domestic economic reforms with an external discussion of competition policy, provided that leaders are prescient enough to attack these issues proactively instead of again waiting for an economic meltdown.

Finally, such a parallel conversation on competition that would ultimately feed into the WTO process would have to be coordinated with the organization's ongoing formal work. Its unfinished business may be addressed in a proposed "Millennium Round," WTO 2000, or a program of less intimidating "roundups" (see Schott 1996a, 1996b, 1998). The formal agenda might range from sector-specific negotiations (driven by the organization's built-in agenda) to the all-encompassing rounds that are the GATT/WTO norm. The former would offer little chance to draw the understandings fashioned among the United States, China, and Japan into the multilateral discussion of competition policy, except in implementing rules for specific sectors.[17] The latter, however, might very well seek to

16. See Edward M. Graham, Kodak Reveals WTO Limits, *Journal of Commerce,* 11 December 1997, 6A.

17. The value of such a contribution is not to be underestimated, however. The most useful result of the Negotiating Group on Basic Telecommunications, which undertook to deal with a single crucial sector, was the appendix of Procompetitive Regulatory Principles that emerged (see Petrazzini 1996, 85–89).



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"tee up" competition policy, especially if the time were not right to commence multilateral negotiations.[18]

### Recommendation 3: Accommodate Impending Political Reform

In every area examined, marketization and the presence of foreign firms create pressure for new reforms in China that go beyond economics: political reform will *necessarily* occur in the wake of economic trends. Such reform is required in order to keep China's economic revolution on track—for example, by strengthening ownership rights (see Steinfeld 1998) and sharing risk more equitably across Chinese society. Furthermore, political liberalization has been shown to correlate well with rising income levels, at thresholds that per capita income in China's major urban centers is already nearing.

These sentiments are pervasive in the expatriate community, though opinions vary greatly on whether the leadership can successfully manage the coming changes. There is a good deal of evidence supporting this picture of China on the verge of political loosening. Democratic elections have already been introduced broadly at the village level, with surprising success (IRI 1997a, 1997b). Chinese intellectuals are already talking about a "soft political landing," and the senior leadership is beginning a program of serious "democracy research" in the aftermath of President Clinton's 1998 summit meeting in Beijing.[19] American observers, convinced of democracy's relationship to stable development, are keenly interested in Chinese political liberalization. Both US and Chinese officials must pay more attention to sustainable economic regulation as the process of political reform unfolds. Only the central authorities in China can shepherd overall commercial development and implement the changes necessary to reinforce the country's economic underpinnings without which political reforms cannot possibly occur.

It is essential that the United States accommodate political reform and political strengthening simultaneously. To date, the common view has been that strong leadership by Beijing and political liberalization are antithetical; but that is mistaken. A model that stresses the responsibilities of the center is critical to the country's continued well-being. The evidence from FIEs in this study underscores this point, though (ironically) by revealing that some foreign firms support devolution of power away from Beijing and toward more pliant local authorities. The United States must

18. Schott (1996b, 19) noted, "Clearly, much more work needs to be done in this area before WTO negotiations could be contemplated." The agenda proposed above is precisely the kind of "work" that is needed.

19. See Kathy Chen, "Jiang Zemin Orders Research on Democracy," *China News Digest—Global News*, 23 July 1998 (http://www.cnd.org).



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resist the temptation to support these firms' short-term interest in profit at the cost of the nation's interest in a strong and stable China. To accommodate reform in China, the broader American foreign policy establishment must acknowledge that political restrictions are being relaxed, that reform must occur under the existing regime, and that the regime's authority needs to be strengthened temporarily to implement economic reforms (especially those stressed in the discussion of the prognosis for FIE performance, above).

## Recommendation 4: Hold Out a Helping Hand

The analysis in this study illuminates several practical ways in which the United States should help cement reform, bolster bilateral relations, and accelerate resolution of the nonpolicy problems with which its firms grapple in China.

First, as chapter 3 described in detail, the resource China most lacks today is human. After years of denigrating market imperatives, China has a relatively small pool of entrepreneurs and businesspeople with experience running enterprises small or large. In order for China's reforms to succeed, a larger share of the population must be involved in marketization and distribution-led growth (discussed in chapter 5). The United States can help transfer employees more quickly from outmoded deployment to new economic activity by making larger contributions of one of its greatest comparative advantages: educational and training expertise.

The European Union cosponsors a major joint venture business school at Jiaotong University in Shanghai, and Japan contributes significantly to scholarships and teaching for young Chinese. While individual American universities are involved in China, and a large pool of Chinese students study in the United States, a concerted government-to-government effort by the United States to support the banner of higher and technical education in China, perhaps along the lines of the EU flagship MBA program, would concentrate resources and public attention where it is needed most. This focus on human capital can generate additional investment in training in China and can also serve to direct Western human and labor rights activism into constructive channels. As much as anything else, this would help to remind us that China's ability to reach toward developed-country standards is determined by the education and experience of its vast multitudes of people.

Second, in many governance areas in which this study advocates building capacity to meet the needs of foreign firms in China, the United States already has regimes in place. A good example is antitrust policy, which falls under the larger umbrella of competition policy. Through government-to-government exchange the US executive branch, Congress, and judiciary can transfer the soft technology of good governance—that is,



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know-how—to their Chinese counterparts. While many US agencies are already striving to increase interaction with their Chinese equivalents, they must do so ad hoc, without the benefit of a general US budgetary commitment to programs to build capacity in China. To be sure, international organizations—including the World Bank, IMF, United Nations Development Program, and Asian Development Bank—have long been engaged in such activities, and channels exist between the US Treasury Department and Ministry of Finance as well as many other agencies. Yet the reciprocal state visits of 1997 and 1998 made clear (as bureaucrats scrambled to get involved in the action) that many counterpart organizations between these two superpowers had few ongoing, working-level connections and that the gains from such exchanges could be tremendous. Given the effort and money expended on such dialogue with Russia, the relative paucity of US-China institutional dialogue is inexplicable—all the more so in light of significant Japanese and European bilateral programs in China, which many US interviewees considered marginally advantageous to their competitors from those markets.

Finally, the US-China commercial relationship does not take place in a vacuum. Increasingly, the exogenous factors affecting US firms are not whether Taiwan policy will disrupt the relationship or geopolitics push China into a position hostile to the United States, but what China and the United States can do together to better manage the international economic and political currents that affect both.[20] For these two countries, the silver lining to the Asian financial crisis was the discovery of mutual interests, mutual responsibilities, and mutual willingness to take hard positions to nurture stability and growth even as other would-be leaders vacillated. The United States should continue to explore the capacity of China to bear the burden of international economic leadership, with an eye toward China's taking on a new, institutionalized management role in the G-7 or elsewhere. FIEs are the major bridge across which news of this new Chinese role will be transmitted.

20. On the opportunities for such cooperation, see "The New Agenda with China," by Fred Bergsten, at http://www.iie.com/news98-2.htm.



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