Challenges and Opportunities for Multinationals in China

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Abstract: In this article, I address some of the misperceptions about China's transition from plan to market economy and lay out five challenges and related opportunities for multinational corporations in China. The points to take away from this article are: (1) political knowledge is key, but not in the form of building relationships or watching for corruption, as was the case a decade ago; (2) institutional knowledge is more important than cultural knowledge; (3) uneven geographic development creates niche opportunities, if you know where to look; (4) the real competitive challenges are coming from within the country; and (5) the leadership vacuum means investment in human capital is money well spent.

Introduction

It is no longer controversial to assert that China is an economic juggernaut and an emerging global superpower. However, there are a variety of perspectives on how China reached this status, and there is a good deal of misunderstanding surrounding the issue. The world's most populous nation has resisted the prescriptions of the IMF, the World Bank, and many economists, who asserted that the transition to a market economy must begin with a rapid and full-scale privatization plan. Instead, China has made the transition from planned economy to market economy in its own time and on its own terms. In doing so, it has not only become the most radically successful case of market reform in the world, but it has proved an entire generation of economists and pundits wrong about the process of creating a market economy. It has also shown that its homegrown multinationals are emerging as a force to be reckoned with in the global economy. Finally, after years of losing money in the midst of this complex transition process, multinational corporations from around the world are finding new opportunities in this vibrant economy.

In this short article, I will first argue that China's reform process has been nothing short of radical. This is true on two levels: it is true in terms of the empirical reality of the reforms that have actually occurred in China over the last 28 years; it is also true in terms of the process of change (gradualism instead of rapid privatization). Second, I will spell out the implications of the first part of this argument for the operation of multinationals in China.

Third, I will discuss these issues in terms of the challenges and opportunities multinationals operating in China face.

Misconceptions and the Real State of Things

China is always in the news, the depictions are disproportionately negative, despite the fact that China's transformation has been the most radical and successful transformation of a reforming communist economy the world has seen. Some depictions of China's transformation take the China-threat perspective. In 2001, the much trumpeted Cox Report warned of the country's capacity to reach the United States with a deep and readily deployable ICMB stockpile. More recently, the *Atlantic Monthly* presented a picture of a sinister-looking member of the People's Liberation Army and a jingoistic title, "How We Would Fight China: The Next Cold War." The author, Robert Kaplan, wrote: "The Middle East is just a blip. The American military contest with China in the Pacific will define the twenty-first century. And China will be a more formidable adversary than Russia ever was… If not a big war with China, then a series of Cold War-style standoffs that stretch out over years and decades." And U.S. Secretary of Defense Donald Rumsfeld (citing no evidence) speculated in 2005 that China's military budget is actually much higher than it officially acknowledges, ominously stating, "Since no nation threatens China, one must wonder: why this growing investment?" (It should be noted here that China's investment in its military has remained steady at 8% of the National Budget since 1979. In other words, the economy and national budget have grown, and while the investment in the military has grown in absolute terms, the growth has not been out of step with the economy. It should also be noted that the US's pre-Iraq war investment was at about 16% of GDP.)

These days, the hawkish handwringing over China's military buildup has subsided somewhat, but it has been replaced by an equally loud din of concern over China's impact on the global economy and the corresponding dangers for international business. On July 23, 2007, the cover of BusinessWeek gloomily asked "Can China be Fixed?," and spent many pages in the magazine documenting the looming crisis. The article summoned images of Gordon Chang's 2001 screed *The Coming Collapse of China*, which predicted a collapse that never came. The recent press over lead paint in Mattel toy products, poison in dog food, endemic corruption, and the threat to the global environment has made the issues omnipresent in the public consciousnesses.

However, it is important to place these views in the context of what is actually occurring in China and the misconceptions of how that progress has been represented. To be very clear: rapid privatization (the so-called "shock therapy" approach to the creation of markets) was wrong; the economists who advocated this approach across the board in the 1980s were wrong. This simplistic approach to the creation of markets could not have been more naïve and many economies around the world have paid the price for this foolishness. In China, on the other hand, gradual reform has been the hallmark of the transition process, and it has been a process that began with experimentation and close state engagement in the transition process. A strong state has led to unparalleled growth and a radical reduction in poverty in absolute terms. The fact of a strong state, however, has not meant that the government has avoided radical institutional change. On the contrary, the institutional transformation of China's economy has been both radical and deep. And the lesson that a vibrant and dynamic market economy does not rest primarily on the institutions of private property may be the most radical lesson of all from an economic standpoint. Even with the success of China's transformation, it is still conventional wisdom that state-owned organizations in countries across the globe are less efficient than their private counterparts. China has shown that the issue for all firms is not state- versus private-ownership but rather the *type of incentives* that exist.

The core issue here is that building institutions is hard work, and it takes time. Yet China has been slowly and methodically putting the institutions that govern the marketplace into position over the last two decades. Take, for example, the establishment of the rule of law. The Chinese Communist Party (CCP) gets little credit for this part of the transition, but it is a process that has been systematically underway for the last two decades. These changes, which the CCP set forth ideologically as a package of reforms that were necessary for economic development, have fundamentally altered the role of politics and the role of the Party in Chinese society. The early years of reform not only gave a great deal of autonomy to enterprise managers and small-scale entrepreneurs, but also emphasized the legal reforms that would undergird this process of change. However, creating a body of civil and economic law upon which the transforming economy would be based meant that the Party elites themselves would be held accountable under the new legal standards. Thus, in a number of ways, the rationalization of the economy has led to a decline in the Party's ability to rule over the working population with impunity.

In recent years, the next step in this process has come from global integration and the adoption of the norms of the international community. By championing global integration and the rule of law, Zhu Rongji also brought about broader political and social change in China, just as then-Premier Zhao Ziyang did in the first decade of economic reform in China. Zhu's strategy has been to ignore questions of political reform and concentrate instead on the need for China to adopt economic and legal systems and norms that will allow the country to integrate smoothly with the rest of the international community. This phase of reform has been oriented toward creating the standards of the international investment community, from putting forth the rhetoric of "linking up with the international community," to creating laws such as the Patent Law and institutions such as the State Intellectual Property Office, the Chinese International Economic Trade and Arbitration Commission, and, most importantly, the State-Owned Asset Supervision and Administration Commission (SASAC). Thus, Zhu's objective was to deepen the reforms that were launched in the 1980s, but at the same time to begin to hold these changes up to the standards of the international community.

After two-and-a-half decades of transition, the architects of the reforms have set in place about 800 new national laws and more than 2500 new local laws. These astonishing proliferation of new laws, in addition to thousands of new regulations and experiments with new economic institutions, have driven the process of reform forward. It is important to underscore that these policies have adeptly blended economic transformation with the protection of individual civil liberties. Legislation such as the Labor Law, the Prison Reform Law, and the National Compensation Law, among others, are tied to the protection of individual civil liberties; the Company Law, which is rooted in American and German corporate law, places much more emphasis on employee welfare than the American version. These laws and many others provide the legal infrastructure that allows workers to file grievances against managers and individual citizens to file for compensation for past wrongs committed by the government. Laws such as these are a crucial part of the evolution of the conception of individual rights in China.

The main point here is that institutional economic change (along with the transition to democracy) has been occurring in China for more than two decades. China rarely gets credit for these changes, because (1) we have not seen dramatic and rapid movement toward a democratic system; and (2) it is generally assumed that Chinese officials are corrupt oligarchs willing to use any means to hold on to power. With respect to the first issue, it must be noted that respect for institutions and the building of a rule-of-law system will take time regardless of the government's willingness to cede power. It is not at all clear that the business climate and civil society are any safer in Russia, for example (which followed the Western prescriptions of rapid privatization), than they are in China. With regard to the second point, it is important to keep in mind just how large and complex the CCP is as an organization. I have worked with many Chinese officials—some of whom I have taught in executive education programs—who are open and committed to change but also recognize that they are safer and more effective in their own jobs if they work gradually so as not to inflame the conservative wing of the Party.

Take, for example, the leadership of the Party: in the 1990s, Zhu Rongji avoided discussing democratization publicly. However, by championing global integration and the rule of law, Zhu brought about gradual political change in China, just at Zhao Ziyang did in the first decade of economic reform in China. Zhu's strategy was to ignore questions of political reform and concentrate instead on the need for China to adopt economic and legal systems and norms that will allow the country to integrate smoothly with the rest of the international community. Yet Zhu clearly recognized that the adoption of the norms of the international community would continue to push China down the road of general societal transformation. Many of the laws passed under Zhu Rongji's watch, while purportedly concerned with global integration, had at their core an emphasis on individual civil liberties. Laws like the Prison Reform Law and the National Compensation Law have fundamentally transformed the rights of individuals in Chinese society and have little to do with the institutional infrastructure of a market economy. Zhu avoided marketing this aspect of the reforms, at least in part, because his political career unfolded in the shadow of 1980s leaders Hu Yaobang and Zhao Ziyang's (both of whom were deposed for moving too quickly on political reform). However, it is undeniable that Zhu Rongji, who consistently championed the rule of law, and Jiang Zemin, who incorporated entrepreneurs into the Communist Party, pushed forward reforms that have had an impact on political reform in China. And with his seemingly authoritarian stances on a number of issues, many have worried that Hu Jintao would leave his once-liberal image behind, showing instead his true colors as the leader of "China's new authoritarianism." But under Hu Jintao we have seen a fundamental transformation of private property rights and the right to form independent unions, two issues which have been central to criticism of China's political reform process. As reform-minded elites emphasized the need for a rational system for economic development, they were also altering the politics of the party system.

China's reform has been gradual, and the lack of a sudden break from the past has led many observers to believe that there is not a commitment to real change. This view is simply mistaken. Gradual the process may be, but the result has been nothing short of radical. It has been radical in its success, as the stability created by a gradually-receding state allowed for greater experimentation and actually “getting the institutions right.” The reformers are real champions of radical change, and they have brought this change about under the watch of the more conservative wing of the Party. It has also been radical in its implications. China has taught the world (and an entire generation of economists) that it is more important to get the institutions and incentives right than it is to assume that markets and private property will, of their own accord, reach the most efficient outcome.

Challenges and Opportunities for Multinationals Operating in China

Let me now turn to the opportunities and challenges that multinationals in China face. The opportunities in China are well known. Since the early 1990s, China has been a major recipient of foreign direct investment, which constitutes the major part of total foreign capital invested (along with foreign loans and other investments). In 1993, China received more FDI than any other country, and since then China had been the second largest recipient of FDI in the world, behind only the United States. By early 1999, FDI in joint ventures and wholly foreign-owned companies exceeded US$250 billion, several times larger than cumulative FDI since World War II in Japan, Korea, and Taiwan combined, as economist Nicholas Lardy has pointed out. In 2002, China’s total inflows of FDI reached US$400 billion, making it the world’s largest recipient of FDI, and by 2005, the amount of FDI committed there had topped $600 billion. As these numbers reveal, the wide recognition of China as a market with huge upside potential is beyond question. However, the challenges that multinationals face are also well-known, though some of them are more serious than others. Unfortunately, the popular press is not a very accurate guide in this area. In my view, there are five key areas of challenges that multinational corporations face in doing business in China.

Corruption and Politics: The first of these is the most obvious and most widely-discussed—corruption and the general unevenness of political control at local levels. Official corruption is among the most serious crises with which the Chinese government has had to deal. The massive scale of official corruption in the late 1980s was one of the catalysts of the 1989 Tiananmen student movement, and many commentators explain the initiation of village-level elections as a response to the widespread corruption among local officials in rural areas. In the 1990s, China was rated one of the most corrupt countries in the world by Transparency International. In the past decade, however, the CCP has initiated a number of political campaigns to curb official corruption, and today the central government seems more determined than ever to eliminate the problem. There is strong evidence that China is well on the way to rationalizing its rule by law (as described briefly above), and many high profile officials have been brought to justice for corruption. In Transparency International's 2006 survey, China was ranked 70 out of 163 nations, right alongside Brazil, India, Mexico, and Egypt.

Thus, while corruption still exists in China, especially at local levels, it is the wrong strategy for multinational corporations to expect to find corruption. The bigger mistake that multinationals often make today is in underestimating their political counterparts on the other side of the negotiation. China's new generation of technocratic elites are intelligent, educated, and savvy businesspeople who know all too well how to secure advantages in a negotiation process.

Institutions over Culture: Second, there is the issue of institutions and culture. Many Western firms focus on the cultural differences between themselves and Chinese firms, but this is the wrong approach. It may have been the case that understanding the cultural differences between China and the West was an important tack for entering China in the 1980s, but this issue is hugely overemphasized today. Cultural difference matters in China to the extent that it matters in operating across any cultural boundaries. Today, however, Chinese managers and officials simply find the obsessive focus on Chinese cultural difference as patronizing. Much more important than cultural difference is an understanding of the institutions that are taking shape in Chinese society today. For example, understanding the structure of organizations such as the State-Owned Assets Supervision and Administration Commission (SASAC) and the role it plays in shaping China's domestic publicly-traded firms is absolutely crucial for understanding investment opportunities and the domestic competition. However, in my work with Western multinationals and investment fund managers, I often find a startlingly low level of understanding of this crucial organization. Senior management and fund managers seem much more concerned with figuring out the right cultural cues than they do with understanding an increasingly complex institutional landscape. If you want to gain strategic advantages in China, focus on the country's institutions first and cultural subtleties second.

Localism: Third, the unevenness of opportunity and competition in geographical terms makes investing in China unpredictable and difficult to navigate. Since the beginning of the reform era, policies of economic decentralization have transferred most economic decision-making power from the central government to localities by a series of tax and fiscal reforms. In

1980, the fiscal reforms started with the implementation of a fiscal responsibility system, under which the central government and provincial-level governments signed revenue-sharing contracts. According to this contract, taxes collected by local governments were to be divided into two parts: (1) central fixed revenues, which were to be remitted to the central government; and (2) local revenues, which the central and local governments were to share in terms of various standards across regions. This revenue-sharing system provided local governments both strong incentives and institutional means to increase their revenue base by allowing them to retain more when they collected more revenues and guaranteeing the rights of localities to income from their assets. The increasing responsibilities in the reform era have made local governments actively involved in economic activities and business affairs in the localities. Lower levels of local governments have played significant roles in the development of TVEs, which became the most dynamic sector in China's transitional economy in the 1980s and early 1990s. By the early 1990s, the TVEs were contributing between 40 and 50 percent of tax revenues for local governments. Local governments, in many cases, actually came to behave like "industrial firms" themselves during the rural industrialization process, engineering the development of collective enterprises and forming the corporate structures to govern them. The fiscal reforms of 1994 put more duties on the localities and requested that the lower levels of local governments be responsible for expenses and social welfare. At the same time, the early 1990s liberalization policy of foreign investment and foreign trade increased local government responsibility for managing the foreign sector in localities. These conditions created both fiscal pressure and incentives for local states to be more involved in local-global business activities for capital accumulation. Aside from directly dealing with foreign capital, local governments were given the authority to relax the rules governing foreign exchange balances, power and water fees, land prices for factory buildings, restrictions on hiring non-local workers, and other policies related to foreign investors. Local governments often interpret Beijing's policies flexibly and have frequently implemented them strategically for their own good. As a result, foreign investors have begun to realize that favorable investment policies issued by Beijing are not nearly as advantageous as the "special deals" that can be crafted with local officials. Rather than dealing with the central government, foreign investors often prefer to build up long-term alliances with local officials for more stable and favorable investment conditions and cheaper local resources. In addition to directly developing enterprises and attracting foreign capital, local governments have formed various relationships with local business organizations, including those in non-state sectors. The result of these macro-level policies is that the state has established the conditions under which a variety of organizational types, including those that are still state-owned, have the latitude to behave like business organizations in China today.

Homegrown Competition: Fourth, perhaps *the* key challenge that foreign multinationals operating in China face today is a newly emerging one—the growing strength of China's own multinationals. China was never going to be on the path to becoming a dominant economic power in the world based on the size of its labor pool alone. It was always necessary that China make the transition from an economy built around supplying labor to the world's largest corporations, to one built around the development of great corporations of its own. Fortunately for China, and challenging for the rest of the world's corporations, China's domestic corporations have arrived. Only two of China's corporations have cracked the Global 50 (Sinopec and CNPC at 23 and 39, respectively), but the tremors are being felt more widely than this statistic indicates. A number of companies around the world will readily admit to the competitive pressure they feel from Chinese companies: Lenovo's purchase of IBM's Thinkpad division; Haier's purchase of Maytag; CNOOC's bid to take over Unocal; Huawei's tense competition with Cisco. The competitive pressures are real, and multinational corporations that ignore Chinese domestic firms do so at their own peril.

The Leadership Vacuum: Fifth, one of the key challenges that companies operating in China face—both foreign and domestic—is the leadership vacuum. Labor markets in China, particularly those that relate to the leadership positions in organizations, are extremely inelastic. The demand for Chinese professionals who are fluent in both Chinese and English is so high that it threatens the localization effort that many multinational corporations aspire to make. Indeed, within the companies I work with that are continuing to develop their business in China, the most common concern I hear is the lack of "high potentials" in the leadership pipeline. Demand for high potential leaders is a problem corporations always face, however, the inelasticity of this labor market in China is higher than in other emerging economies because of the Cultural Revolution (CR). The CR had a profound effect on the Chinese economy during the last decade of Mao's life (1966-76), as production very nearly ground to a halt in most sectors of the economy. However, the residual effect that is still felt in China today (and is often underestimated) is that an entire generation of the highest educated sector of society spent a decade in the countryside for "re-education" (the *xiangxia* movement) rather than attending college and entering the workforce as the next professional class. Few of these individuals were able to make up for their lost opportunities, and thus entered the workforce at a much lower level than they otherwise would have.

Intertwined with these challenges are also a series of opportunities. These can be summarized in the following statements:

1. Politics and politicians matter, but not in the ways they did fifteen years ago. The Chinese government is no longer the haven for corrupt officials that it once was. The new generation of technocrats generally plays by the book. They are more likely to out-maneuver counterparts across the negotiating table through preparation, knowledge, and hard bargaining than they are to pursue personal benefit through graft. Understanding the nature of these politics is as crucial as it has ever been precisely because this new generation of politicians is so good at what they do.
2. Institutions matter more than culture does. This point is crucial. Many multinational firms pour resources into securing consultants who can deliver the best set of connections and the best cultural knowledge. This approach is a vestige of the past. Your money is much better spent investing in individuals who know the institutional landscape.
3. Local development means local opportunity. Finding the next Suzhou—a small town outside of Shanghai that became one of the fastest growth areas in all of China due largely to an activist local government—depends upon understanding local development and focusing on the small rather than the large picture. There are many opportunities for this type of niche development as Western China opens up.
4. Homegrown competition is certainly a threat, but it is also an opportunity. Understanding who these firms are and what they can provide in the way of strategic alliances is crucial for multinationals that want to succeed in China.
5. Invest in human capital. The leadership vacuum is a problem for all companies, domestic and foreign alike. But talented Chinese employees that see a firm investing in their future will become key strategic assets for the organization.

Conclusion

There is no doubt that the 21st century will increasingly be China's century. Corporations, and nations, cannot afford to ignore this fact. China may be emerging as a venerable adversary, but the economy it is building is one that can be navigated with the right tools and knowledge. The market economy that is emerging in China is increasingly one that is rational and sensible. The tools and knowledge necessary for success within it are decreasingly about cultural differences and increasingly about the complexity of the institutions that are emerging there. Multinational corporations that focus on the five key principles described herein will enjoy a competitive edge over the competition.