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China: A New Force in the Global Marketplace

by Murray Weidenbaum

This is a time of fundamental change in the global marketplace. It's like the middle of the 19th century when European nations dominated the world economy — and then the United States elbowed its way into the club of industrialized nations.

Again, in the middle of the 20th century, when Western nations dominated the world economy, Japan elbowed its way into the club. In both cases, the world economy continued to grow, if not to accelerate, although the monopoly of the “club” was broken. In absolute terms, each nation experienced growth in its production and exports, although their relative shares of the world market declined.

Today, China stands at the threshold of a similar breakthrough. By some widely used measures, it already is a larger economy than Germany. China, in effect, is in a race with Japan for second place — just behind the United States. A word about the changes in China is in order. There has been no dramatic equivalent of the Berlin wall coming down. But, since 1979, China has been moving toward capitalism and economic expansion — only a step at a time and only partially.

The Transition from Communism

Deng Xiaoping was the driving force. He made that decision on practical rather than philosophical grounds. The economic superiority of capitalism became obvious. While China had difficulty feeding itself, Taiwan and Hong Kong — both with the same

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kind of people as the mainland — were booming. He substituted economic incentive and technology for Mao's ideology, unity for class struggle, and experts for "red" loyalists.

It is fascinating to recall that private agriculture — rather than private industry — was the entering wedge. After selling the required amount to the government, a farmer could sell the rest in the market. That's the incentive of capitalism — produce more and earn more. And it worked! To save face, they called it "market socialism."

The results were impressive. By 1990, pork consumption doubled. The number of fresh eggs eaten tripled. Luxury fruits and vegetables became commonplace.

The reform of industry followed agriculture, but more slowly. Special Economic Zones were set up to promote exports. Coincidentally, all four were near Hong Kong or Taiwan. Tax breaks and other capitalistic incentives lured foreign business. Deng eliminated the three socialist "irons" that had inhibited economic growth in China: The "iron rice bowl" that had guaranteed jobs; "iron chains" that had guaranteed management tenure; and the "iron wages" which had guaranteed that pay never would be cut.

Most of those foreign businesses were not from the obvious places — Japan, United States, or Western Europe. Rather, they were overseas Chinese who were investing in their traditional homeland. I'll have more to say about that bamboo network in a moment. The special economic zones were a smashing success. Foreign investment in the zones expanded very rapidly and now accounts for large shares of China's exports. Guangdong province, adjacent to Hong Kong, became the wealthiest part of China. Guangdong is almost an extension of Hong Kong and the recent exit of the British is unlikely to change this relationship. Xiamen near Taiwan has also boomed, although not to the same extent as Hong Kong.

Other parts of China want to copy the success in the Southeast. They haven't yet done as well. Some of the more urban areas are tied down by socialist approaches to production. The rural areas lack transport and other infrastructure. Nevertheless, substantial amounts of new industry are expanding into the interior, especially along the Yangtze.

Even before the Hong Kong takeover, Beijing began to hedge its bets. The national government is promoting the economic rebirth of Shanghai, which before World War II was China's commercial capital. Foreign business in Shanghai now has more leeway than in Guangdong. They can sell to the local population, while most foreign ventures in China are limited primarily to exporting or to providing items not available from domestic producers.

Economic progress in China is uneven. In some areas, Coca-Cola is available — but it is delivered by mule. China has no personal checks and few credit cards, no 800 numbers, and no overnight shipments. If you've been to a major Chinese city recently, you will recognize that it is a bicycle society moving up to motor scooters.

Business Opportunities for Americans

To state the obvious, business opportunities in China for Americans are numerous. Nevertheless, cynics abound among Western business executives living in China. They love to quote an imaginary P. T. Wang: "There's a foreigner born every minute." They will also tell you of a T-shirt on sale in Beijing: "If you're too honest, you'll always lose out."

But signs of U.S. companies are frequent: Marlboro Man billboards, KFC restaurants, Motorola cellular phones, Elizabeth Arden cosmetics, and Nike sneakers.

McDonald's in Guangdong set a world record — 14,000 customers in one day. When the local 7-11 opened, riot police were called in to control crowds.

Guangdong is Procter & Gamble's largest overseas market for shampoo. Coca-Cola dominates the soft drink market with bottlers at 16 locations — seven more are on the way. Hainan Coconut Juice is just not a very strong competitor. Other U.S. firms that have invested at least \$100 million in China include ARCO, Amoco, United Technologies, Pepsico, Lucent Technologies, General Electric, General Motors, Hewlett-Packard, and IBM.

To be sure, there is often a need to adapt foreign products to China's culture. Hasbro sells its GI Joe doll as an "international hero." It changed the colors to the People's Liberation Army's camouflage green and the Communist Party red. Maxwell House sells instant coffee — complete with premixed packets of cream and sugar for a market not very familiar with the product.

Those of us who take the freedoms of our private enterprise economy for granted should not forget that government is still pulling many of the strings in China's economy. Companies that try to compete against domestic firms for the Chinese market may not find the path as easy as those that generate the high-tech products and exports that Chinese leaders are so eager to see expand.

The Chinese are the original Yankee traders. They know the great business potential that will be generated as a country with 1.2 billion people industrializes, and they are trying their best to take advantage of it. They love foreign investment when it creates new jobs, pays taxes, and generates foreign exchange. But, from our point of view, sometimes those exports compete against the products of the same company's factories located in other countries.

Thus, Motorola is encouraged to sell cellular telephones *and* to produce them in China. McDonnell Douglas and Boeing sell jet airplanes in China *but* they involve local subcontractors and train local maintenance people. These companies are also showing more sophistication than some of the early entrants, such as Schwinn. That U.S. bicycle manufacturer lost its business in China by transferring its technology to local manufacturers without adequate protections.

Typically, a U.S. company faces the challenge of developing a presence in the China market in a manner which is very different from our experience at home or even in Western Europe. In China, there are few 100 percent American-owned companies but mostly joint ventures and often with Chinese middlemen either from the mainland or elsewhere in Southeast Asia.

Guanxi, or personal connections, can help in dealing with the many layers of bureaucracy in China and the “bamboo network” of ethnic Chinese business families in Southeast Asia can be a big help in serving as a transition. Their emphasis on personal relations can clash, however, with the U.S. practice of using lawyers as intermediaries. The head of the Charoen Pokphand (CP) Group, the Bangkok-based former joint-venture partner of Wal-Mart in Hong Kong and China, laments that U.S. lawyers can destroy the chemistry needed between partners to make a deal work. We have to wonder whether that’s why that prominent constituent of the bamboo network is a *former* joint partner of Wal-Mart — or whether the U.S. firm just did not want to cut too many corners. In any event, Wal-Mart is reportedly off to a good, albeit belated, start in China with both a Supercenter and a Sam’s Club in Shenzhen.

Another difficulty that Americans encounter in China and the Orient generally is the Asian model for promoting human rights. In that part of the world, economic

freedom comes before political liberty. To put it in perspective though, here's an important quote, "I firmly believe that business is the ultimate force for democratic change in China."

Who said that? An NAM official? An export promoter? No. Li Lu, an exiled Tiananmen Square student leader who has been studying in the United States.

Many U.S. firms enter China via joint ventures with a Chinese company that is part of what I have called the bamboo network. The tales of the work ethic of the overseas Chinese are legendary. The leading Hong Kong billionaire started work at the age of 12 to support his family. The grandfather of a former student of mine generated the original nest egg to finance the family multinational enterprises by ironing shirts in the back room of a Chinese hand laundry. He used his savings to buy a \$50,000 rice concession in Hong Kong, which is the basis of the family fortune. Think of hundreds — or thousands — of Horatio Algiers repeating these experiences.

A good example is the CP Group of Thailand. It started as a very small seed company in China and then moved to Bangkok. CP is now the largest agri-business investor in China and perhaps the largest "foreign" investor in China. It was a partner to KFC, 7-11, and Heineken, to get them started in the region.

The bamboo network firms are family-oriented. They shy from publicity and take a low profile in the commercial world. They do not produce and distribute consumer products with their own brand names. Instead, they make components, manufacture for others, do sub-assembly work.

These overseas Chinese business firms rely on centralized family control and informal transactions. That minimizes bureaucracy and paperwork. Key information is obtained in conversation and retained in the heads of senior managers. That certainly

eliminates the need for a lot of formal reporting. Just compare that with the massive flow of studies, reports, and memos in a typical U.S. business.

In the ethnic Chinese firm, transactions are often dealt with by a note jotted in a diary. Money is borrowed from family and friends on trust. Clearly, management styles are far more informal and intuitive than Americans are accustomed to. The Chinese approach to business allows opportunities to be seized as they arise with little need for elaborate consultant reports. Due diligence is not an expensive, legal-oriented process. On the other hand, this management model works better in low-tech than in high-tech businesses, in industrial markets rather than in consumer markets, in areas with rudimentary legal systems rather than in countries with sophisticated jurisprudence.

The information network of the overseas Chinese business family leaders is unrivaled. They know each other personally, often coming from a common birthplace. They cooperate across borders. For example, the key ethnic Chinese banking family of Thailand — they control the Bank of Bangkok — provided the initial financing for what is now the largest Chinese business family in Indonesia. That family, in turn, provided the beginning funding for a major Chinese business family in Malaysia.

The typical bamboo network firm operates through an intricate network of enterprises rather than a unitary family company. There is no equivalent of a Ford or Walton family focusing on one very large firm. Rather, the typical family groups own percentage interests in a galaxy of medium-sized firms. Family members are inserted into key management positions. Cross-holdings are common with other family-controlled firms. This provides both secrecy and diversification in a region where discrimination and threat of expropriation are pervasive. A common saying is, “Keep your bags packed at all times.”

A word of warning is always in order. Doing business in China can be very difficult. Don't expect to find a consistent, easily understood, universally enforced judicial system. There are only rudimentary and limited legal protections that foreign ventures can draw on. This can dampen the enthusiasm for making large investments in what is fundamentally a very attractive market. Consider the irony: in the United States, we are concerned about the *excessive* degree of litigation. Perhaps, we should reduce our trade deficit with China by exporting to them some of our surplus lawyers.

Economists are notoriously wet blankets. So, true to form, let me report that business in China is not always profitable. Foreign companies doing business there usually talk about current sales successes and future profit performance. To some extent, that is to be expected with new investments, but perhaps not as universally as seems to be the case in China. Take Volkswagen's five-year-old joint venture with China's First Auto Works. VW has not yet reported a profit. But sales are high — up 6 percent in 1996. That is better than Peugeot's experience — a \$100 million loss.

Even fellow ethnic Chinese have difficulty breaking even. Less than 40 percent of Taiwanese investments in China are now profitable. Also, Chinese labor may not always be as productive as we expect, although the unit cost is low. They may require more managers than other developing countries. Often companies doing business in China have to import overseas ethnic Chinese managers.

Even experienced Asian investors can get burned. Recall the Hong Kongers who opened a restaurant for tourists near Tiananmen Square just a week before the shooting. No amount of due diligence would have prevented that fiasco.

China's Role in History

It is helpful to have some historical perspective about China's role in the world. In the broad sweep of world history, China has not been a backward nation. For most of recorded history, China was No. 1 — more developed than the West, more prosperous, more sophisticated, and more civilized. That is why they called themselves the “Middle Kingdom.” Only in the past 500 years has the West been ahead. Of course, that's a long time for us. But the Zhou Dynasty in the first millennium BC lasted that long. Naturally, most of us never heard about it.

China is now on a road that could restore its earlier greatness. By some economic measures, China is just behind Japan. If current trends continue, it could become No. 2 early in the 21st century, just behind the United States in terms of economic output. Some optimists (or rather pessimists) think it will be No. 1 later in the 21st century. But here we can take considerable satisfaction with a standard caveat: trends rarely move in a straight line, especially in China. There is no shortage of serious problems facing the Chinese people and their leadership — energy shortages, environmental degradation, infrastructure, inadequacies, and corruption and crime. Then again, there is the famous forecast which is attributed to Napoleon: “China is a sleeping giant. When it wakes, it will shake the world.”

It is vital for Americans to better understand events in that exotic part of the world and not be on the outside trying to look in. China is the prime example of my standard forecast: In change, there is both threat and opportunity. My final point: in *feng shui* (Chinese numerology), eight is a lucky number. Thus, I leave you with my favorite eight letters: Good luck!