# 1 Introduction

> Let China sleep, for when she wakes she will shake the world.
> *Napoleon Bonaparte*

Some 200 years after Napoleon Bonaparte, the brilliant general who became emperor of France, made the above statement, China has indeed begun to wake up and shake the world. In the past thirty-five years China has been the fastest-growing economy in the world, with an average annual gross domestic product (GDP) growth rate of 9 per cent. The rapid economic growth in a country with a population of 1.3 billion implies, among other things, enormous business opportunities, which attract millions of business people to China from all over the world. Doing business with China has now become a fashion, or, rather, a necessity for survival.

In this opening chapter we first discuss China's rise in the world economy in recent decades from a historical perspective, the driving forces behind the rise, and the significance of China's rise to international businesses. We then move on to illustrate the rapid pace of development of international businesses in China, with a focus on the massive inflows of foreign direct investment (FDI). Finally, we analyse the prime challenge faced by transnational corporations (TNCs) operating in China, and set out the structure of the book.

## The rise of China in the world economy

When Napoleon made the above statement about two centuries ago China was a great economic power in the world, as shown in figure 1.1, accounting for just over 30 per cent of world GDP. Afterwards, however, China – as described by Napoleon – 'fell asleep', and the Chinese economy weakened significantly. Up to the middle of the twentieth century China accounted for just 5 per cent of world GDP, only one-sixth of what it had been about one and a half centuries earlier.

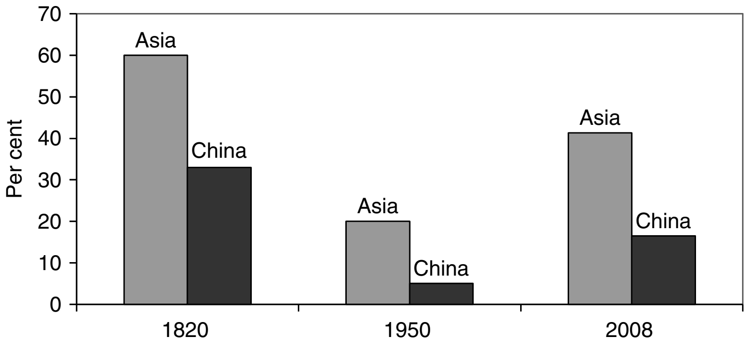


**Figure 1.1** Share of China in world GDP (1820–2008)
Source: Maddison website at http://www.eco.rug.nl/~Maddison.

Backward and outdated political, economic and social systems were the main cause of China's decline. While Western countries had done away with the long-standing feudal system and begun to move towards free markets, democracy and industrialization, Chinese rulers still cherished their outdated social system and resisted reforms and innovations. Their closed minds allowed China to fall prey to foreign commercial and political powers, which, armed as they were with up-to-date knowledge and technology, found that China was too weak to offer any resistance. From the 1840s onwards China was repeatedly defeated by expansionist foreign powers in wars of aggression, including the Opium War (1839–1842) and the War against the Allied Forces (1900). The invasions of foreign powers further weakened the country, accelerating the decline of the Chinese economy.

These wretched experiences taught the Chinese a lesson: the backward come under attack. After the Opium War generations of Chinese undertook the long, hard struggle for a resurgent, modern China. Under the leadership of Dr Sun Yat-sen the Chinese people overthrew the country's last feudal dynasty, the Qing dynasty, and established the Republic of China in 1911. Soon afterwards, however, China suffered a series of calamitous events: large-scale fighting between warlords, invasion and brutal occupation by imperial Japan, and then civil war between the Nationalists and the Communists. Headed by Mao Zedong, the Communist Party defeated the Nationalist Party and established the People's Republic of China (PRC) in 1949.

Following the establishment of the PRC China enjoyed a relatively long period of peace (except for short-lived involvement in the Korean War, 1950–1953), and managed to rebuild the economy from the ruins left by the protracted wars and political turmoil. Not for long, however, as fierce political conflicts soon broke out among the top leaders of the Communist Party, and resulted in a series of nationwide mass campaigns, including the Hundred Flowers movement (1956), the Anti-Rightist campaign (1957), the Great Leap Forward (1958) and the Great Proletarian Cultural Revolution (1966–1976). The Communist idealists, headed by Mao Zedong (the Party chairman), gained the upper hand in these struggles, and led China in the direction of an orthodox Marxist–Leninist ideology and a rigid economic planning system aimed at delinking from the global market system (Tian 1996; 1998). Realistic Party leaders, such as Liu Shaoqi (the chairman of the PRC) and Deng Xiaoping (the Party general secretary), were purged during the Cultural Revolution, and the economy again suffered tremendously. By the 1970s China was lagging far behind not only the advanced market economies of the West but also the four emerging 'Asian Dragons' of East Asia: South Korea, Taiwan, Hong Kong and Singapore.

After the death of Mao Zedong in 1976 Deng Xiaoping began to emerge as the paramount Party leader, and he initiated policy changes in 1978 that have fundamentally transformed China ever since. Deng's slogan, 'White or black, it is a good cat so long as it catches mice', has served as a justification for introducing Western-style market systems to China. The core of Deng's policy initiatives was to make full use of market mechanisms, or, in other words, to relink with the global market system domestically as well as internationally (Tian 1996). To relink with the global market system, China is trying to move from a plan-based economy to a market-based economy, and open up to capital, goods and services from the advanced market economies. The relinking strategy is proving to be a success, and it has been the main driving force behind China's rapid economic growth for the last few decades. As shown in figure 1.2, the Chinese economy has taken off like a rocket since 1978. Even though the outcome of the rapid economic growth has not been distributed evenly among social groups, the living standard of all Chinese people has undeniably improved enormously. Very few, if any, Chinese would like to go back to the old days of orthodox socialism, and the momentum for reform and opening up remains strong and irresistible. It is expected that China will move further in the direction of relinking with the global market system, and the Chinese economic boom is far from over.

The rise of China in the global economy has far-reaching implications for the world as a whole, because it generates growth momentum for other countries by increasing demand for their goods, services and capital. By common consent, China has been the powerhouse of the world economy

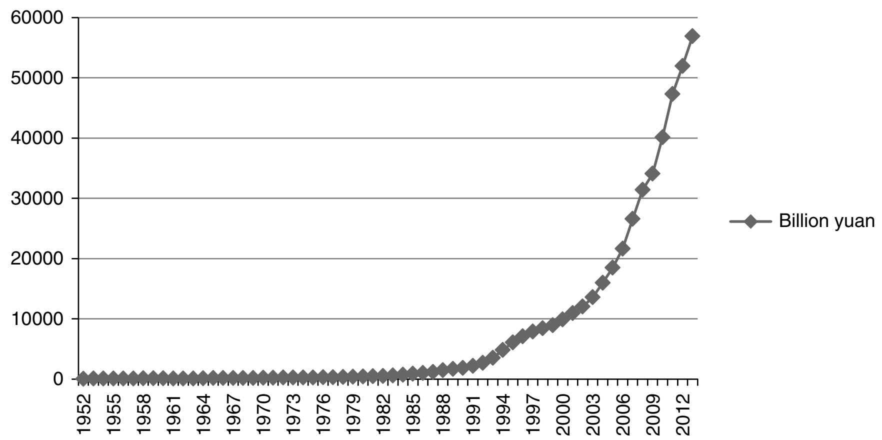


**Figure 1.2** GDP growth in China (1952–2013)
Source: *China Statistical Yearbook 2014*.

for the last three decades. In particular, China's rise carries enormous significance for the international business community. China accounts for nearly one-fifth of the world's population, and the majority of Chinese are in poor rural areas. The size of the market, the low cost and skills of labour, and the growth potential together offer unprecedented business opportunities for foreign investors, with the result that the landscape of international business will be transformed in the decades to come.

## Development of international business in China

In the pre-reform period China maintained only minimal economic contacts with the outside world, primarily in the area of foreign trade. After the reforms China became increasingly integrated with other parts of the world, and opened up to a whole range of cross-border economic activities. International businesses have developed very rapidly in China since then.

As shown in figure 1.3, China's foreign trade grew rapidly after 1978. The total value of China's foreign trade reached $4,158 billion in 2013, and China has now surpassed the United States to become the largest trading nation in the world. Moreover, there was a noticeable change in the composition of foreign trade during this period, with a significant rise in the share of manufactured goods in exports. From 1980 to 2013, as shown in figure 1.4,

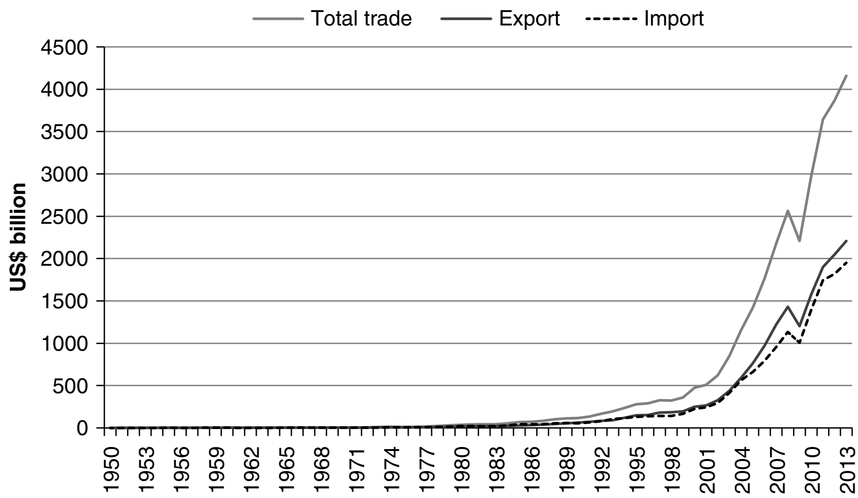


**Figure 1.3** Foreign trade in China (1950–2013)
Source: *China Statistical Yearbook 2014*.

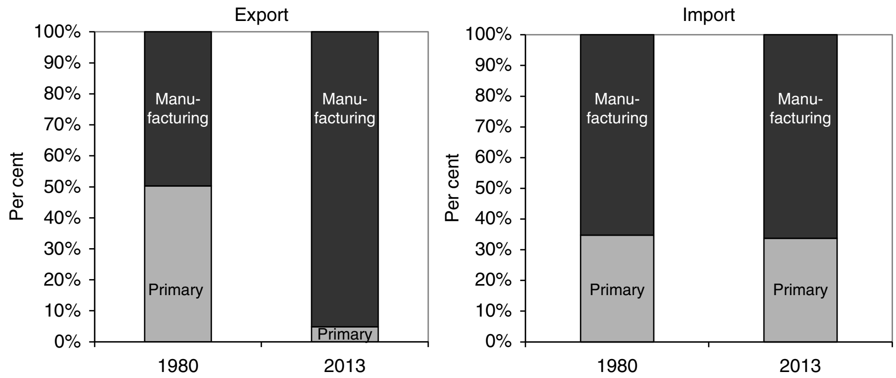


**Figure 1.4** Composition of foreign trade in China (1980–2013)
Source: *China Statistical Yearbook 2014*.

the share of manufactures in exports increased from around 50 per cent to 96 per cent, and the share of manufactures in imports remained virtually unchanged. This change in the composition of exports is a reflection of the progress that China has made in industrialization over this period. China now has trading relations with almost all countries and regions in the world, with Asian countries being the largest trading partners, followed immediately by Europe and North America (figure 1.5).

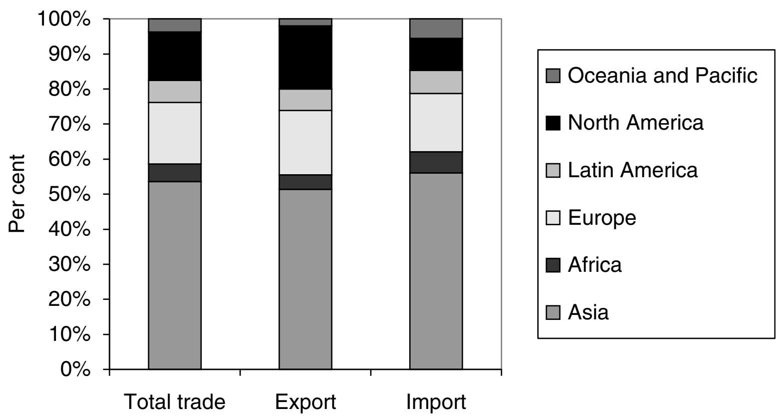


**Figure 1.5** Foreign trading partners of China (2013)
Source: *China Statistical Yearbook 2014*.

The most distinctive feature of the development of international business with China in recent years, however, has been the massive influx of transnational corporations and the boom in foreign direct investment. A clear definition of 'foreign direct investment' and 'transnational corporation' can be found in management focus 1.1, but suffice it to say that the two terms are used interchangeably in this book to indicate the bulk of international businesses in China today, as they involve direct investment made by a foreign entity in enterprises operating within China in order to acquire a lasting interest. This kind of international business is the focus of analysis for this book, so it warrants closer attention here.

**Management focus 1.1**
Definitions of transnational corporations and foreign direct investment

### 1. Transnational corporations

TNCs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered the threshold for the control of assets. A foreign affiliate is an incorporated or unincorporated enterprise in which an investor, who is a resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of 10 per cent for an incorporated enterprise, or its equivalent for an unincorporated enterprise). In the *World Investment Report*, subsidiary enterprises, associate enterprises and branches – defined below – are all referred to as foreign affiliates or affiliates.

- A subsidiary is an incorporated enterprise in the host country in which another entity directly owns more than a half of the shareholders' voting power, and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body.
- An associate is an incorporated enterprise in the host country in which an investor owns a total of at least 10 per cent, but not more than half, of the shareholders' voting power.
- A branch is a wholly or jointly owned unincorporated enterprise in the host country which is one of the following: (i) a permanent establishment or office of the foreign investor; (ii) an unincorporated partnership or joint venture between the foreign direct investor and one or more third parties; (iii) land, structures (except structures owned by government entities) and/or immovable equipment and objects directly owned by a foreign resident; or (iv) mobile equipment (such as ships, aircraft, gas- or oil-drilling rigs) operating within a country, other than that of the foreign investor, for at least one year.

### 2. Foreign direct investment

FDI is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate). FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as business entities. Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. FDI has three components: equity capital, reinvested earnings and intra-company loans.

- Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own.
- Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested.
- Intra-company loans or intra-company debt transactions refer to the short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

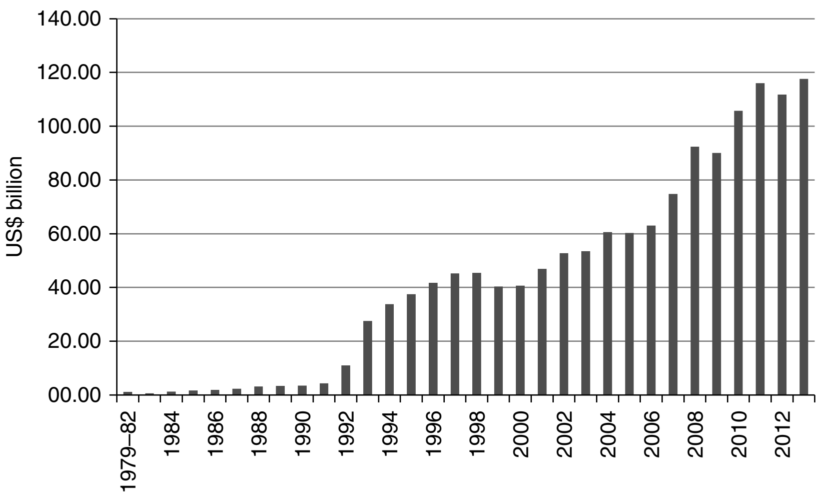


**Figure 1.6** Foreign direct investment in China (1979–2013)
Source: *China Statistical Yearbook 2014*.

Foreign direct investment started to move into China in 1979, when the Equity Joint Venture Law was issued. In the 1980s, as shown in figure 1.6, FDI grew gradually in China, with an annual inflow of about $1.6 billion. FDI inflows began to slow down again in the immediate aftermath of the Tiananmen Incident in 1989, but soared after Deng Xiaoping called for accelerating economic reforms and further opening up in his much-publicized tour of China's southern provinces in early 1992. Consequently, most of the inflows of FDI in China have occurred after 1992. In 2013 China received $117 billion worth of FDI, accounting for nearly half of total FDI inflows in developing countries and about 20 per cent of FDI inflows worldwide. China has been the largest FDI recipient in the developing world and has consistently been among the top FDI recipients in the world since the mid-1990s.

Today there are nearly a million foreign investment enterprises in China, with parent companies from more than 170 countries. The foreign investors come mainly from the industrialized or newly industrialized economies in the Asia-Pacific region. As indicated in figure 1.7, companies from Asia (particularly from Hong Kong) are the largest investors, accounting for 81 per cent of the total FDI in China, followed by companies from Latin America, Europe and North America. Most of the foreign investors are, to varying degrees, more advanced than their Chinese counterparts in terms of production technology and management know-how. Western investors are,

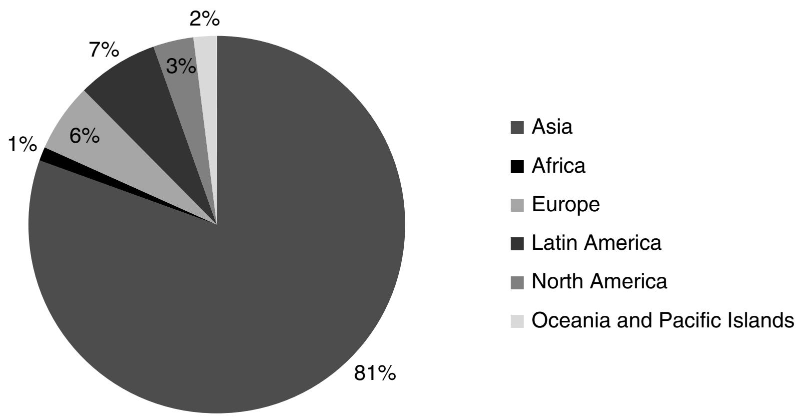


**Figure 1.7** Country of origin of FDI in China in 2013
Source: *China Statistical Yearbook 2014*.

for instance, more advanced in high-tech areas, whereas East Asian investors are more advanced in labour-intensive technology. Arguably, China's greatest benefit has been from the technology transfer associated with the massive inflow of FDI (see, for instance, Li, Liu and Parker 2001; Liu et al. 2001; Buckley, Clegg and Wang 2002; Tian, Lin and Lo 2004; Tian 2007; 2010).

As discussed in chapter 4, foreign direct investments take different forms or entry modes in China. There are three main entry modes of foreign direct investments in China: equity joint ventures (EJVs), co-operative joint ventures (CJVs) and wholly foreign-owned enterprises (WFOEs). In order to maintain control over the pillar industries and to benefit from FDI technology transfer, the Chinese government encourages foreign investors to take the form of joint ventures. In the early period after China opened up, the majority of FDI was made in the form of equity and co-operative joint ventures. In 1992, for instance, equity and co-operative joint ventures accounted for 73 per cent of total FDI. Nonetheless, in recent years, with the removal of policy restrictions, FDI in the form of wholly foreign-owned enterprises has increased steadily, while FDI in the form of equity and co-operative joint ventures has declined. In 2013, as shown in figure 1.8, wholly foreign-owned enterprises accounted for 76 per cent of total FDI. In addition, as shown in chapter 4, some new entry modes of FDI are emerging.

In terms of industry distribution, FDI was first permitted only in oil exploration projects and in a small number of industries. After 1986, particularly after China entered the WTO in 2001, foreign investors began to gain access to a wide range of industries, including manufacturing, retail, real estate,

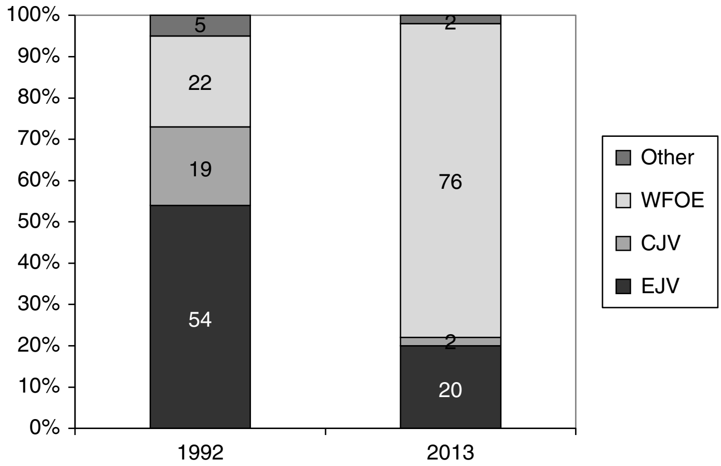


**Figure 1.8** Change in entry modes of FDI in China (1992–2013)
Source: *China Statistical Yearbook 2014*.

transport and banking. Up to 2013, as shown in table 1.1, the manufacturing sector attracted most of FDI (46 per cent), followed by the real-estate sector (16 per cent), leasing and business services (8.8 per cent), and the wholesale and retail sector (6 per cent). Banking and other pillar service sectors attracted little FDI. There are two reasons for this pattern of industry distribution of FDI. First, China has been very cautious about opening up such service industries as banking, telecommunications and transport to foreign direct investments, and has set strict restrictions on FDI in these sectors. Second, foreign investors are particularly keen to move into the manufacturing industry so as to take full advantage of the low labour costs in China.

The geographical distribution of FDI in China has been quite uneven. It is customary to divide China into three regions: eastern, central and western. The eastern region, as shown in map 1.1, consists of twelve provinces located along the coast, and therefore it is also known as the coastal region. The central region consists of nine provinces and the western region consists of ten; together they are called the interior region. FDI has been primarily concentrated in the coastal region, particularly in Guangdong Province. The coastal region enjoys geographical advantages over the interior in terms of the infrastructure, particularly transportation infrastructure. In addition, the Chinese government encouraged FDI to locate in the coastal region from the very beginning of China's opening up. In consideration of the widening gap between the coast and the interior, the Chinese government is now trying to