

# I Introduction

## *Who Lost China?*

In February, 2018, a picture was posted by Mercedes-Benz on Instagram showing a white Mercedes car on a beach, with an inspirational quote from the Dalai Lama: “Look at the situations from all angles, and you will become more open.” Little did Mercedes know that this well-meaning quote could cause such a national fury that might wreak havoc on Mercedes’ market in China.<sup>1</sup>

It would be an understatement to say that the fate of Mercedes-Benz in China has undergone drastic changes over the past fifty years. In Mao’s China in the 1970s, Mercedes cars were a rarity, and only the very top government officials rode in them. During that period, my family and I lived in a government-military compound in the capital city of Hebei Province, Shijiazhuang. The compound also housed some ten villas for provincial heads and generals. Of the ten top officials, only one general had a Mercedes sedan, which was given to him as a used car. Back then most Mercedes cars in China were brought from Chinese embassies in foreign countries after the ambassadors used them first. The chauffeur of the general in the compound was generous in blowing the car’s distinctive horn. Hearing the horn and seeing the car was a big privilege for me to brag about with my friends who did not get to live in the compound.

Today, China is the largest market for Mercedes-Benz in the world, buying 204,684 Mercedes cars in 2020, surpassing Mercedes’ home market, Germany (95,265), and the United States (78,078) (Automotive World, 2021). It is small wonder that Mercedes is extremely attentive to what China thinks of its brand. But how

<sup>1</sup> P. Li and A. Jourdan, 2018. Mercedes-Benz Apologizes to Chinese for Quoting Dalai Lama. *Reuters*, February 6 ([www.reuters.com/article/us-mercedes-benz-china-gaffe/mercedes-benz-apologizes-to-chinese-for-quoting-dalai-lama-idUSKBN1FQ1FJ](http://www.reuters.com/article/us-mercedes-benz-china-gaffe/mercedes-benz-apologizes-to-chinese-for-quoting-dalai-lama-idUSKBN1FQ1FJ)): Accessed December 13, 2020.

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Mercedes has achieved its success and why such success is so fragile not only requires far more explanation but is also merely a small drop in the ocean of China's evolution and its relationship with the world, which I will examine in this book.

### I.1 ENGAGING CHINA

The year 1976 was a watershed year in Chinese history: Mao Zedong died. Mao, the founder and chairman of the Chinese Communist Party (CCP), ruled the People's Republic of China with absolute power and a revolutionary policy from its founding in 1949 until his death (see Figure 1.1). Under Mao's reign, the society experienced ceaseless political purges, and the economy was so severely damaged that even obtaining life's bare necessities was a constant daily struggle. It is safe to say that no one in China cared about how Mercedes promoted its



FIGURE 1.1 Members of the People's Liberation Army paying respects to the remains of Mao Zedong (September 12, 1976).

Source: Getty Images

cars: Needless to say, the people had no access to such information even if they cared.

Therefore, his death presented a historic opportunity for the country to change course. In order to save the near-bankrupt economy, the CCP under the leadership of Deng Xiaoping adopted a pragmatic approach to downplay communist ideology and introduce capitalism to China, albeit in a limited fashion. Deng and his associates, who had neither the experience nor the capital necessary for the development of markets, realized that they needed help from rich capitalist countries.

That required China to improve its international standing, which had been badly damaged by Mao's revolution. So, Deng and his associates reversed Mao's confrontational stance against the United States, which Mao accused of "American imperialism," and its allies, or "imperialist running dogs,"<sup>2</sup> according to Mao's phraseology. They eagerly sought trade and investment from these countries. This strategic shift would allow China to acquire much-needed foreign currencies, technologies, and management know-how (see Chapter 2 for more discussion on this topic).

The democracies welcomed China's move with great enthusiasm. They began to trade with and invest in China as early as the late 1970s, even though China was still a communist state with a protected economy. In addition to the economic benefit for them from engaging with China, their enthusiasm was also built on the hope that with China's economic development, a middle class would emerge, and they would demand democracy. Such a conviction – known as the "engagement approach" (Dobbins & Wyne, 2018) – was based on the experience of democratization in Europe several hundred years ago, especially in England, where the newly formed middle class, in order to protect their personal and property rights, demanded the rule of law and representation in politics (Chen, 2013; Moore, 1966).

<sup>2</sup> "Running dog" is a literal translation of the Chinese pejorative 走狗 (*zou gou*), meaning someone who follows the orders of those more powerful and often evil. Mao Zedong used "imperialist running dogs" to refer to the allies of the United States.

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The engagement approach reached a high point when China applied for membership to the World Trade Organization (WTO) in the late 1990s and early 2000s. Against concerns about China's political repression and economic protectionism, engagement advocates in the democracies, especially in the United States, successfully persuaded other countries to admit China to the WTO. Then US president Bill Clinton, an ardent supporter of China's WTO bid, explained his rationale and hope as follows:

By joining the W.T.O., China is not simply agreeing to import more of our products; it is agreeing to import one of democracy's most cherished values: economic freedom. The more China liberalizes its economy, the more fully it will liberate the potential of its people – their initiative, their imagination, their remarkable spirit of enterprise. And when individuals have the power, not just to dream but to realize their dreams, they will demand a greater say.

*(Clinton, 2000)*

Multinational corporations eagerly followed this call. Jerry Yang, the founder CEO of Yahoo!, recalled in 2007,

As our young company grew quickly in the late 1990s, the U.S. government, including Congress, made the decision to normalize trade relations with China. Since then, and across Democratic and Republican administrations, the U.S. government has encouraged American businesses – including technology companies – to engage with China, an enormous market and one focused on modernization. With this backdrop, Yahoo! made the choice like many other companies across many other industries to engage in the Chinese market by establishing local operations and providing services to Chinese citizens.

*(Yang, 2007)*

When doing business in China, Yang met a little-known entrepreneur by the name of Jack Ma (Ma Yun in Chinese) and invested in his

startup. As Yang put it, “Yahoo! became a shareholder in a Chinese company called Alibaba” (Yang, 2007).

After four decades of rapid economic growth, China’s economy has reached US\$23 trillion (based on purchasing power parity), larger than that of the United States (US\$21 trillion), with a per capita income of US\$16,700 and a huge middle class (estimated to be 400 million people). Jack Ma’s Alibaba has grown into a US\$668 billion global behemoth, while Yahoo!’s core business was sold for less than US\$5 billion in 2017.

Despite its extraordinary economic achievement, China has yet to become a responsible member of the international community. Domestically, the CCP has failed to open many sectors of China’s economy as promised on entering the WTO. And to the great disappointment of engagement supporters, democracy and the rule of law have not followed the emergence of the middle class in China. Internationally, the CCP imposes its ideology and practices on other countries and firms. As shown in the opening paragraph of this chapter, a well-intentioned inspirational quote from the Dalai Lama, a highly respected global figure and Nobel Peace Prize laureate, could cause one of the best-known brands in the world to be shunned in China.

## I.2 TIMES HAVE CHANGED

In the spring of 1989, the death of the reform-minded Chinese leader Hu Yaobang triggered a large-scale pro-democracy demonstration in Beijing’s Tiananmen Square. On June 4, 1989, the CCP ordered the military to open fire on the demonstrators, resulting in the Tiananmen Massacre (see Chapter 2). The world focused on China, and the major democracies were debating how to react to the brutal crackdown. The question that I heard most from policy-makers in the democracies was, “How can we democratize China?”

Back then, the question did not seem unrealistic at all. The Chinese economy was small, the Chinese army was not known to have much capability other than killing its own people, and most

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important of all, the Chinese people seemed ready for a change. So, for the mature democracies, ending the dictatorship in China appeared to be within reach.

Fast-forwarding thirty years, China is now a global superpower economically, militarily, and in international affairs. Instead of converging with the rule of law and democracy, it challenges existing international law and order and undermines the political and economic systems of the democracies. And now the question regarding China asked by leaders of the democracies has become, “How can we protect our democracy from China?”

### 1.3 “WHO LOST CHINA?”

What went wrong? Why did the emergence of the middle class in China fail to lead to democratization? Why does China’s “peaceful” rise (as the CCP claims) fail to give peace of mind to the democracies? What should the democracies do to protect their way of life from the CCP’s expansion? In the global marketplace, how should firms from other countries compete with Chinese firms, which are often intricately intertwined with the Chinese state?

In the above-quoted speech supporting China’s accession to the WTO, President Clinton criticized the United States’ wavering stance on China in the past and joked, “Who lost China?,” implying he had found the right policy on China – engagement. Now we know that was an overstatement. The question of “Who lost China?” not only remains but more than ever needs to be addressed.

Indeed, numerous scholars have been trying to explain China’s economic success. One of the main genres in this effort is to identify the major institutional forces behind China’s economic success, namely, how its political and economic systems affect China’s economic performance. There are two opposing views in this debate. One emphasizes the role of the state, and the other the market. The first view, which has been termed “the China model view” or the “Beijing consensus,” believes that China’s rapid economic growth is the result of the unique model that China has been following, characterized by

one-party rule, state intervention in economic activities, dominance of state-owned enterprises (SOEs), and well-designed industrial policies (Lin, 2012). The second perspective, or “the universal model view,” argues that the way in which China achieved its economic development is just the same as the method used by Western democracies earlier – relying on “the power of the market” (Zhang, 2019). They further argue that China has benefited from what they call “the latecomer’s advantage,” namely, that “China could avoid many detours and directly share the technological achievements that others have already obtained” (Zhang, 2019).

Both views have merits, and it is not my focus in this book to discuss which one has more merit. What I want to emphasize here is that they are not intended to (and are therefore unable to) address the questions I raised earlier, because these scholars study China’s economic performance from a *China-centric* perspective. More specifically, their concern is what political and economic policies are best for the development of the Chinese economy. For example, the China model view attributes China’s economic success to well-designed industrial policies. We need to ask how those policies affect *other countries*. The universal model view believes that China’s rise is no different from the rise of other developed countries. This comparison may not be appropriate as most of the other developed countries were small and democratic, and were less interdependent. The universal model view admits that China’s rise benefited from taking technologies from other countries, which I agree with. But the question is, did China do it truly through free market exchanges, or by some other means, against the technology-holders’ interests?

As China has become the world’s largest economy, intentionally or not, its mere existence causes great anxiety among and affects all the countries in the world. And scholars in China have begun to realize it too. They believe that given China’s important position in a highly globalized world, all countries are stakeholders in what China does, and they therefore have the right to comment on and influence China. Qin Hui, a well-known scholar in China, commented that

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“due to globalization, the China factor is becoming bigger and bigger. If you don’t understand China, you can’t even talk about the United States . . . China’s problem does not only affect China ” (Qin, 2020).

In this sense, we need to examine China’s rise *from the perspective of other countries*, and this is what I attempt to achieve in this book. I will examine how certain institutional factors in the past four decades have shaped today’s China, how China exerts its powerful impact on the world, and how the world has responded and should respond to it. In developing the themes of my book, I was motivated by two observations. The first is that in contrast to the engagement view (i.e., that economic development ushers in liberalization), the CCP has been steadfastly increasing its power over the past four decades along with the rise of the standard of living in China. The second is the growing integration of the CCP with the Chinese people and businesses. These two trends have enabled the CCP to run the entire country like a giant corporation. And, as I will elaborate on in the book, such a new form of organization, with unprecedented resources and flexibility, will have enormous and far-reaching effects on the world in both state affairs and business operations.

### I.4 A GLANCE AT MY BOOK

This book has three parts. In Part I, “The Advantage of Low Human Rights,” I explain the political, economic, legal, and cultural factors that paved the path for China’s economic development and global expansion.

In Chapter 2, I start with an explanation about the CCP, the most important force in shaping China, with its features that are often overlooked but deserve our attention. For example, unlike political parties in democratic countries, in which citizens are free to participate or leave, the CCP is a Leninist party, which closely resembles a secret society with select and exclusive membership. I build my case concerning how the low human rights environment was created by the CCP, and how it has lowered the costs for the party to push



through its policies. I show why the middle class in China today, unlike its counterpart in European history, has failed to push for democracy.

In Chapter 3's analysis of the development of China's legal system, I introduce a framework of two contrasting governance systems – rule-based (relying on public laws) and relation-based (relying on *guanxi* [personal connections]) – and show that people and firms in China rely on the latter to protect their socioeconomic exchanges and interest. An important reason that Chinese people rely on relation-based governance is not because they love the traditional *guanxi* culture but rather because the law is not impartially enforced. However, relation-based governance is not always inferior to rule-based governance: When markets are small and local, the former can be more efficient.

Chapter 4 sheds light on an important factor that has greatly contributed to China's economic performance, and yet is often overlooked: culture. The essence of this chapter is that recent history and the current political economic system of China have created a culture that is strongly materialistic and conducive to productivity growth in China. The combination of Mao Zedong's law-defying spirit and Deng Xiaoping's call to get rich has provided a business culture of poor quality and safety standards.

In a rare historical moment from the last quarter of the twentieth century and the early twenty-first century, these unique political, economic, legal, and cultural factors all coexisted in China. The outcome of the interaction among these factors is the emergence of what I call China, Inc.

In Part II, "The Rise of China, Inc.," I build my case on how the CCP runs the entire country like a giant corporation, the competitive advantages of such an arrangement, and how China, Inc., achieved dominance in key industries.

Chapter 5 presents evidence on the emergence of China, Inc. Since the late 1970s when the CCP embarked on reforms, it has tried to loosen or tighten its control to varying degrees. Eventually, the CCP realized that for its own benefit, it had to increase its control as

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much as possible. Following this conviction, the CCP has been building what it calls *juguo tizhi* (举国体制), “the system of mobilizing the entire country as a whole.” In China, living, working, and doing business are not rights but privileges granted by the party-state. To a great degree, state-owned firms are business units, state-related firms are subsidiaries, Chinese-owned private firms are joint ventures, and foreign firms are franchisees of the party, with the party leader being the CEO of China, Inc. This perspective identifies a key and unique feature of the Chinese political economy: The government and firms are highly integrated to allow China, Inc., to have a firm’s agility and a state’s resources and power.

Building on the theme that the CCP runs China as a corporation, Chapter 6 shows how the Chinese government formulates and executes its industrial policy like a corporate strategy. The general pattern of China’s industrial policy is that first, the CCP identifies certain industries and determines them to be high priorities. Once an industry is designated as strategically important, the party-state will mobilize all necessary resources from across the country to develop this industry. The party-state will also pick some domestic firms as national champions, and at the same time erect barriers against foreign firms entering the industry. With a large, protected domestic market, designated firms will be able to quickly realize scale economies and lower unit production costs. Once a designated domestic firm becomes efficient, the party-state will support it as it goes out and dominates the world market. Three cases are used to show how China’s industrial policy has worked. They are electric vehicle batteries, solar panels, and high-speed rail.

Part III, “China, Inc.’s Achilles’ Heel and the World’s Response,” covers the following related topics: the built-in structural weakness of China, Inc., that requires it to have an expansionary global strategy, the effects of the strategy and how other countries have reacted to it, and my policy and strategic suggestions for democratic countries and multinational corporations.

In Chapter 7, I first present a fundamental issue that China, Inc., faces: On the one hand, to maintain the low rights environment in