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LIBERA UNIVERSITA' INTERNAZIONALE DEGLI STUDI SOCIALI

Faculty of Economics

Bachelor Degree in Economics and Business,

major in Economics and Finance

Dissertation in Introduction to Business

Emerging Markets: China Case
Modes of Entry, Cultural Barriers and Geopolitical Implications

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Academic Year 2010-2011

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ACKNOWLEDGMENTS

It would not have been possible to write this bachelor thesis without the help of the kind people around me that shaped my thinking, that supplied me with data and advices, that enlightened my hardest times especially this last year, and that overall were there when I needed it most. Above all, I would like to thank the following people and organizations for their technical support offered:

My tutor, Prof. Riccardo Tiscini, for team working like any student could only wish. His availability shown in emails, phone calls, texts and meetings was exceptional. Also, his business knowledge was impressive and few minutes in his office would count for a whole hour of lesson and/or seminars, and my work benefited most in terms of content and logic.

Daniel Nivern (CRCC Asia Ltd Director), for providing real knowledge on Chinese culture and offering a view into the challenges faced from a small-medium size firm's perspective. Moreover, thank you for being a true listener when I was working in Beijing and I was experiencing cultural issues myself.

Gino Salica (TwinSide S.p.A. CEO and Founder), for allowing me to gain critical insights into the work of an intermediary helping Italian companies to break into China. The business cases and personal knowledge your presented to my eyes shaped the look and feel of my work.

Irene Corbari (Pirelli Tyre Co., Ltd - Shanghai Branch), for the continuous and comprehensive correspondence via emails (especially emails) and Skype calls over this past year. People were telling me that getting an email reply/interest to my case from multinational companies was something I could only dream of in the back of my mind. But you definitely cleared that up and showed outstanding availability to any singe query of mine. The perspectives you brought to the table expanded the scope of my work and increased my awareness.

Barbara Radaelli, for being what in Finance we call "the lender of last resort". To be clear, money was not exchanged but you entered the whole equation at the right time. If you were not for you my Word processor would have crashed my chances of finishing my thesis after having crashed itself this last week before the deadline.

Other, "non-technical" thanks go to

Dr. Pier Luigi Celli (Managing Director of LUISS Guido Carli University), for always keeping his office doors open to me and hearing me out whist presenting my life plans in order to give me advice. I saw it as a privilege to be able to talk directly with one of the greatest managers and people Italy has ever had. You do add that grade of family-like approach that universities, in my opinion, have long lost along the way of budgeting.

Prof. Marco Scarsini (Mathematics 1 professor during 1° Year), for being my dream professor and a true friend. Your teaching approach managed to bring the best out of me in Maths, something that teachers and professors before you in time failed to achieve due to their "I know it all, you don't" attitude. Universities should have tons of professors like you, because Maths can indeed be taught to everyone and there are not only "chosen ones" deserving attention.

Prof. Giovanna Vallanti (Macroeconomics professor during 1° year), for stimulating my interest in Macroeconomics. It is one of the few modules I enjoyed the most, and it thanks to you if I have grown passionate about it. Your exam was a challenge and required most of my energies to pass, but what I learned still plays a critical role in my understanding of policies and their effects. Also, thank you for supporting my applications, I appreciate it a lot.

Micheal Donadelli (Assistant in Financial Markets and Intermediaries), for being one of the best assistants I could ever ask for. You were professional in and especially out of class; you managed to reconcile theoretical frameworks with life examples that are often left out at this stage of academic studies. Beyond that, you were a friend that offered advices on academic and personal matters. I wish you all the success that you could possibly desire, you deserve it.

My girlfriend, Daniela, for showcasing patience and preparing lovely meals all throughout, almost, my bachelor, especially in these last weeks of hard work before the deadline. I very much appreciate your understanding and support in certain situations; I may have played out at times but be reassured that I cared about you more than you could imagine.

My friends, In particular, I would like to thank **Alessandro,** for the good time spent together....we did have a blast and I wished we had continued in the same class/uni together, I learned a lot from you. **Edoardo** and **Lucia** for winning a smile upon my face when I was down and for the good friendship we maintained after high school....things have changed and distances matter, but we always get along pretty well. **Jacqueline** for becoming a close friend even miles always and sharing professional goals.

Finally, and most importantly, a special note goes to my relatives and parents (my "sponsors"....in all terms):

My uncle Alvaro. You passed away when I was not around, when I was complementing my education in the U.K., and I could not even come back to give you the last goodbye. Knowing you, I am sure you would have loved to have a copy of this work and celebrate this first accomplishment with me. I will always keep you and your optimistic attitude, smile in my heart and thoughts; please be with me as I aim for the stars and help me keep my balance in doing so.

All my relatives and grandparents. Thank you for your support throughout. Thank you grandpa. and grandma. for the love and affect you showed every time I came back home, and the many lunches your lovely prepared for me, understanding that I was super busy. Thank you uncle Gianni and aunt Patrizia for always being close to me, even when it seemed as if I had forgotten about you, which has never been the case. Thank you goes to all other relatives that showed interest and spared thoughts on me.

My family. A page would not be enough whatsoever to express my gratitude for your super support and, simply, for being my parents. I always gave my best in my studies and my development, knowing that you were giving 100 fold more than that.

Thank you **Brother** for always finding a way to play down the many worries and concerns I had during my bachelor and still do at time, for complementing me and, most importantly, for making me laugh like only a great brother can do. This work is also for you, as you showed me what working hard means, what promising to do something entails, I wish you the best and more in your life and I will always be there for you as you have so far been for me.

Thank you **Mom** for being able to read me when others could not. Sometimes, it was hard for me to explain the many workings of my decisions, but you certainly went one step beyond that and always jumped to the core of the problem. We may have got in some fights and not have gone along well at times, but I love you and I know the many sacrifices you made to allow me to study in such a prestigious universities. Thank you so much.

Thank you Dad for being the greatest companion of all my adventures, for being a friend and for being the best dad I could have ever asked for. I loved the many discussions and talks we had about my future goals and the current news, the support you provided me when all I could see was blank is unparalleled. You might say that you just did your job, because you are my father, but in my heart I know you always put me first, even before your own affairs and this really mattered and matters to me. You cannot even imagine how bad I felt when I had to tell you I had performed below my true potential, which you know well. I felt as if I was about to let you down, to zero out all the efforts you made daily, but I am happy that we, as a real team, could get to the end of this first qualification. We know that the way is long and many more efforts will be needed to take on future challenges, but you taught me to work hard, to expand my horizon and to roll up my sleeves when it is time to play seriously. You also taught me to be flexible, adapt to circumstance, you encouraged me to travel, experience the world, open my mind and be respectful. Finally, thank you for teaching me to perseverant with my goals.

I love you dad.

QUOTES

Throughout the journey of my Bachelor Degree, I had choices to make, roads to take and regrets for choices I had not thought over properly. That is part of life I told myself and, looking back on those choices that brought me here to LUISS University, I remembered the important role the following verse and speech played in my development.

" *Even youths grow tired and weary, and young men stumble and fall; but those who hope in the LORD will renew their strength. They will soar on wings like eagles; they will run and not grow weary, they will walk and not be faint*".

Isaiah 40:30-31

"*...You got to find what you love...Your time is limited, so don't waste it living someone else's life. Don't be trapped by dogma — which is living with the results of other people's thinking. Don't let the noise of others' opinions drown out your own inner voice. And most important, have the courage to follow your heart and intuition. They somehow already know what you truly want to become. Everything else is secondary*".

Steve Job's Commencement Speech at Stanford University, 2005

ABSTRACT

Why do emerging markets matter? Brazil, India, Russia or China and why? How to approach it? What is a great concern for the future?

The aim of this paper is to find appropriate answers to these questions and deal with an extraordinary member of emerging countries' "group": China. A number of factors and tables from relevant studies will be presented that will help settle down the first mark. Macroeconomic indicators, charts retrieved from institutional databases, interviews and questionnaires with CEOs of small and big companies will be used to guide the choice that many firms face when they decide to expand. Moreover, modes of entry into the chosen market will be discussed. Finally, an analysis enrichment will allow to appreciate the steps taken up until then. All of it will be accompanied by academic papers, former theses on respective topics and publications on renowned journals.

The results combined will define a journey into market fundamentals that will allow the reader to gain a solid view of main matters to be accounted for when firms expand in emerging nations.

All of this is of the utmost importance for firms, especially small and medium size enterprises, that set their steps into emerging markets for the first time or that already have a stake in one but want to expand further.

Finally, the reviews and topics discussed that follow play a significant role today, in a scenario in which the developed economies recovery fails to take off and sales in main markets, such as the US and Europe, seem to have been set on roller coaster mode.

INTRODUCTION

This work is the outcome of many events and personal experiences that shaped my intellectual development in the past few years. The current financial crisis was the first of such events. Having undertaken my undergraduate studies whilst the global economy was coping with the worst crisis it had ever faced made an impact on my learning. I pondered on the material and concepts I was given a little longer than probably a student does in "normal times". Prior to my enrolment, I had questions I wanted to be answered, I had and still do have a quest for knowledge of workings governing the world of Economics. Fundamentally, I wanted to understand why certain happenings occurred, what caused them to emerge in the first place and, eventually, be economically competent. While I could not attain some of these goals, as great experts still do not have a complete picture of the whole financial turmoil, I certainly enhanced my understanding of key workings in Finance, Economics and Management and expanded my knowledge beyond my initial boundaries.

Influential were also my academic experience at one of the U.K. top universities and my internship in China that I managed to secure whilst I was studying there. Particularly, it is during the latter of these experiences that I started to envision the possibility of focusing my thesis interest on China, its social structure, the pending issues it has and, most importantly, the strategic modes foreign companies adopted over time to enter its vast and potentially auspicious.

In fact, the company I was working for, Corporation China, part of the Rage Media Group, is specialized in offering entry modes services to foreign clients interested in obtaining a stake in the Chinese market. During my time there, I myself had the opportunity to welcome, talk, exchange valuable information and insights into the procedure for setting up WFOEs, as well as to serve and manage clients.

Simultaneously, working alongside and socializing with Chinese colleagues, who would then become good friends of mine, allowed me to dive into their culture and the more I learned about how business was conducted in China, the more I realized the importance of Chinese culture in the successes of many firms.

This work deals with China, and attempts to marry the business knowledge I acquired at work with the cultural enrichment I had. But before doing so, it equips the reader(s) with enough tools and reasons to answer compelling questions as to the choice of firms to expand in emerging markets, and the reason(s) why China is a "better" option among major growing nations, such as Brazil, Russia and India. This analysis will be strengthened by findings of a study conducted in 2011 by Deloitte Consulting, by charts created ad hoc on The World Bank's online database and by pertinent academic literature, such as the works of Prahalad C.K. (2005), Radjou Navi (2008) and Roach Stephen (2003) for example.

Interviews and a questionnaire were also conducted and prepared, with the purpose to bring all of the above to a more practical and realistic level, and appreciate the many different perspectives that CEO's and employees of those companies supporting this paper were offering on the table.

Once this crucial part is exhausted, a further step is taken by providing a clear view and description of the major modes of entry with their respective pros and cons, supporting it all with material obtained on websites of consulting companies and legal advisors such as Starmass International, JLJ Group, Corporation China, Coudert Brothers, Baker and McKenzie, and Kaizen Certified Public Accountants.

Supplementary data on the matter was also retrieved from articles of global newspapers and local Chinese companies such as China Business News, The China Perspective Online Journal, China Briefing News Service and The Economist. Finally, agencies and Ministries’ websites such as the U.S. Government's export service, the Chinese Ministry of Commerce, the U.S.

Commercial service and department of state, as well as famous conference papers, such as the one presented by Wayne M. Morrison in 2011, were consulted.

The paper then goes on examining the cultural aspects of Chinese business and supplies a detailed account of the Chinese culture, paying comprehensive attention to one of the key dynamics in Chinese social networks (Guanxi) and benefits to those within its circle. Academic papers about it abound and have been referred to throughout when necessary to provide a solid base to move on. In particular, the works of Luo Y. (1997), Chu G.C. and Ju Y. (1993), Fan Y. (2002), Hwang (1987), Vanhonacker W.R. (2004), Yumei H.Y. (2009), Katrine V. M. (2009), to mention some but a few, were important sources to draw from.

An additional section is introduced and another question is then raised, which encompasses much of the fear about China's outstanding growth: will it be sustained? In attaining an answer to this pressing question, an historical review of China's geopolitical issues will be carried out. This is crucial to really understand the actual condition of the Chinese market as a whole, and to see further into China's economic standing and its reasons to increase the demand for natural resources. In fact, one will acknowledge the existing link between China's growth and its increasingly aggressive attitude towards regional disputes regarding resources claims. In short, China's performance cannot be summarised by mere macroeconomic parameters only: there is more to the case than meets the eyes. It is worth mentioning, however, that a full study of geopolitics in China is out of the scope of this paper and that the results of this section are to be regarded as complementary parts to the paper as whole.

The paper wraps up the whole discussion in the final chapter by putting forward the business case of a small-medium sized company and the technical problems a multinational one has been facing ever since it stepped into China. A brief description of the company examined is first given to better understand who they are and what they do; the aim is to show how previous content actually evolves into practice.

CHAPTER 1: Why doing business in a Large Emerging Market (LEM)?

Introduction

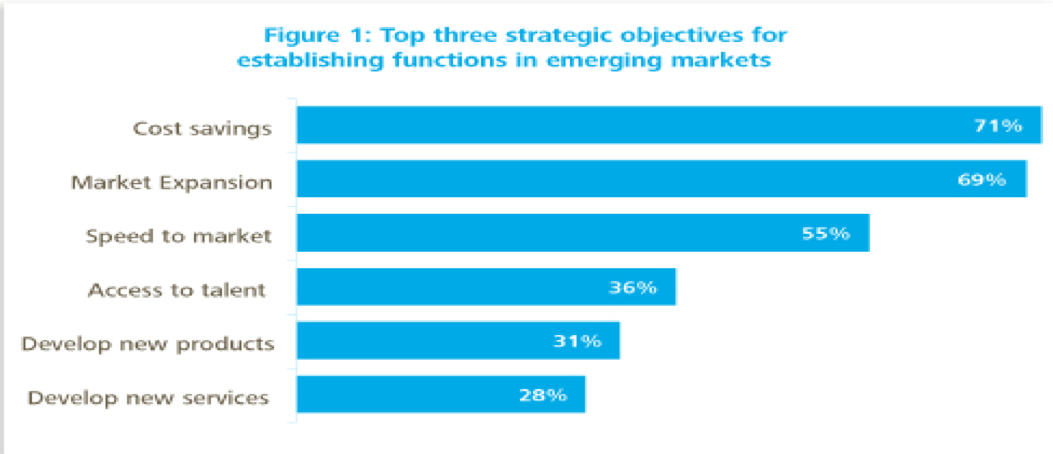
In This chapter it will be laid out the foundation of this work's discussion by seeking out an answer to the issue of why firms should do any business in large emerging markets in the first place. This is done by supplying the reasons that have lead and still leading firms to focus on these geographical areas of the world. A study conducted by Deloitte Consulting will be used as main reference all throughout the chapter

1.1 - Reasons Encouraging Firms to Seek LEM Opportunities

Over the last fifty years the number of international links companies all over the world have built has surged. Some of these players are often on Forbes’ 500 list of most successful companies, while others make up the boutique or small bracket but still hold significant operations. It seems like it has become quite a popular trend among businesses to approach a major emerging market and settle down agreements there. Based on a 2009 study Deloitte performed involving interviews with several executives and a survey of 247 executives from consumer and industrial product companies with presence in emerging markets, companies are increasingly making emerging geographic markets a centrepiece of their global business model. Over the next three years, upwards of 88 percent of companies plan to expand their presence in emerging markets. In fact, nearly half of these organizations expect 20 percent or more of their global revenues to have their origins in emerging markets. Furthermore, a third of these companies plan to place more than 20 percent of their investments in these regions. Moreover, forward thinking companies have not been content to simply increase their presence in low-cost centres. They have become more strategic in their operations by establishing core functions of their value chains in these regions[1].

[1] Vikram Mahidhar, Craig Giffi, Ajit Kambil, Ryan Alvanos (2009). Rethinking Emerging Market Strategies. Deloittereview.

What are the strategic objectives for establishing a presences and functions in emerging markets? Following the study above, it appears as if 71 percent of the companies are driven by cost savings opportunities; 69 percent reported market expansion as a crucial determinant; others instead identified speed to market (55 percent), access to talent (36 percent), new product and services development (31 percent and 28 percent respectively) as key factors for their choices. The top three objectives will be examined promptly below.



Source: Deloitte Study (Last updated on July 17th 2011)[2]

1.1.1 - Lower Costs

Expanding business affairs to new destinations may be driven by mere price/labour arbitrage, which is an economic phenomenon where jobs move to nations in which labour is inexpensive and/or impoverished. International barriers removal or disintegration are the main causes attributable to this shift taking place in the last decade; other factors that keep stimulating such practice include the rising costs of producing in home country, opportunities to benefit from a large pool of workers at a fraction of usual costs, rising competition in home market. As Stephen Roach, senior economist at Morgan Stanley, points out:

[2] Deloitte Study available at: http://www.deloitte.com/view/en_US/us/article/43cc586731101210VgnVCM100000ba42f00aRCRD.htm

"In an era of excess supply, companies lack pricing leverage as never before. As such, businesses must be unrelenting in their search for new efficiencies... offshore outsourcing that extracts product from relatively low-wage workers in the developing world has become an increasingly urgent survival tactic for companies in the developed economies" (*Roach 2003*)[3].

1.1.2 - Market Expansion

Major emerging markets are driving the world's economy; China is prime choice for many products, such as mobile phones, and in 2005 has become the world's second market for new automobiles, with sales of almost six million (*Peter Enderwick, 2007*). Rapid growth and development lay out great opportunities infrastructure specialists, service companies and establishment of public-private partnerships. However, such spur in economic activities usually goes one way in emerging markets due to severe income disparities and widening gap between social classes. A the same time, such differences in purchasing power create further opportunities for a business willing to adopt low pricing policies. In fact, lower-income groups in markets like China are numerically important segments allowing economies of scale to be achieved and are consumers who offer the most interesting challenges (*Prahalad 2005*)[4].

1.1.3 - Speed to Market

As illustrated in the bar chat, 55 percent of the company in the study reported that establishing their position and affairs in large emerging markets is propelled by the speed improvement they gained to the market into question. Working home to sell in a target area is not ideal; the amount of time wasted increases, ranging from weeks to months, and the tailoring to actual needs of local customers decreases,

[3] Roach, Stephen (2003). Outsourcing, Protectionism, and the Global Labor Arbitrage. Morgan Stanley Special Economic Study – November 11.
[4] Prahalad, C. K. (2005). The Fortune at the Bottom of the Pyramid. Uppers Saddle River, NJ: Wharton School/Pearson Education.

causing product failure to happen more frequently. Nokia make a powerful example of what “speed to market” means. Nokia has been in India since 1995, and it conquered 50 percent of the mobile phone market. D. Shivakumar, managing director of Nokia India, attributes this success to the company’s completely localized value chain. Indian operations for everything from R&D to manufacturing, marketing and sales give Nokia the power to launch new phones in a matter of weeks, rather than months, with designs that cater directly to the needs of its local customers[5].

1.1.4 - Hedging

A parallel benefit of serving such markets and, in particular, the vast number of low-income consumers materializes in hedging. In finance, this refers to an investment position meant to offset potential losses deriving from price movements in an asset. The logic behind internationalization hedging coincides with that of financial one except, the aim is to offset potential decreases in consumers’ demand in other regions of the world. This is becoming more and more a tipping factor in the current financial uncertainties main markets are facing. With Europe’s demand for key products following a rollercoaster trend and U.S.’ heading for a W-shaped recession, companies have long realized that lacking a back-up source of revenue from other markets may linger on their ability to be competitive in the long term.

Having the possibility to draw out of other “boxes” makes the difference between staying alive with the few and succumbing with the many. This is, indeed, the case of China, which is acting as the locomotive for consumers’ demand for goods and services. In general terms, the countries making up the BRIC group tend to be target due to their size and relative influence on the global stage, as well as for the amount of natural resources they host within their lands. Other countries, though, are being analysed more and more often by companies

[5] Radjou, Navi (2008). “ How Smart Multinationals Use India to Reinvent Themselves Globally.” Harvard Business Review

producing/offering an array of different goods and services globally. These range from Eastern Europe's countries, North/South Africa's nations to Latin American ones. Some of them "offer" strictly defined markets that function as double-edged swords, while others retain a bag of possibilities to benefit from lower production and labour costs.

These countries have substantial natural resources deposits, human capital, greater catch-up work to do, potential demand growth and, in particular, BRIC countries are a good match " for hedging purposes because their potential internal demand, that is the demand and purchasing power enjoyed by their citizens, is increasing year by year by a far greater percentage than in other countries. BRIC members, therefore, can be viewed as sparkling stars and can be compared, to certain extents, with post-war European countries. Out of the BRIC countries, however, China is the locomotive training the others as it is gaining a dominant position and enjoying more foreign capital injections, thanks to the many reforms it set out to put in place in order to open its doors to the world. Furthermore, companies have noticed that Chinese demand is gradually outweighing European counterpart and is thus helping to offset gloomy prospects in Europe/U.S., which pushes them to invest more in such market.

1.2 - Chapter Summary

There are multiple and diverse reasons why firms decide to expand in LEMs; usually, inexpensive labour cost is a key one. Others include the willingness to expand their influence, desire to offset demand imbalances and speed to market. The next chapter will be complementary in that it will offer insights and tools needed to make the choice of target country among LEMs.

CHAPTER 2: Which is the "cash cow" among LEMs?

Introduction

Emerging markets have so far behaved as the key drivers of a global development and growth, attracting financial investors and firms that were, in turn, lured in by plentiful opportunities offered. In this chapter a closer look at these markets will be given in order to find the optimal one. In doing so, a broader approach is taken that emphasizes the drivers currently in place to identify a target country. The scope will then be narrowed and enhanced via the inclusion of macroeconomic parameters. In the end China will be selected, which will bring this work to its core

2.1 - A Word of Caution on Going Global

Going global always sounds so intriguing and exciting when associated with firms and growth opportunities. However, it is never a smooth road and Thoughtful steps ought to be taken if one wants to grasp the matter into question. That is, a comprehensive process has to be carried out in order to lay out the amount of effort that will be required before further delving deeper into the real practicalities.

First of all, we should clearly identify what that means and actually entails. Specifically, we should ask ourselves the following: What is internationalization? Does simply selling a few amounts of certain goods abroad make a firm international? Too often is the case that SMEs (small and medium size enterprises) misunderstand the meaning of such process and try to define themselves international, when, in fact, they are not. Internationalization is the process by which a firm expands its line of operations and influence in other countries, other than its own, via the set-up of new locations/offices and presenting the respective markets with their offerings after having truly acknowledged the amount of resources it will require to deal with risks, uncertainties and challenges that may arise (Eugenio Cibruscola, 2011).

Such definition is based on key assumptions, which may guide SMEs growth choices:

I) The firm holds offices in the countries where it wishes to operate;

II) The products it sells are aimed at the greater market, as opposed to a handful of potential clients, and are exposed to likely different preferences from the usual ones.

However, it ought to be noted that SMEs do not enjoy a vast amount of resources, especially financial ones and each decision has to be pondered on carefully and accurately. Since their resources are limited, the choice of targeting one country, China for instance, over another, such as Romania or Ukraine, represents a true commitment on the management's side. In fact, management is centralized in small enterprises and the manager is often the owner as well, who brings in capital and has to cover losses with his own resources if they occur.

2.2 - First Set of Drivers for Country Identification

Given the above scenario and circumstances, what leads SMEs to choose one country over another? Certainly whether or not a country is emerging constitutes a relevant factor. But, what may be the drivers, therefore, of a company's strategy in deciding to invest in China, as opposed to other highly "qualified" emerging nations? Empirical evidence suggests the following:

1) Links with someone present in the country of interest

As a manager of a SME, you may wonder whether going international is worth your firm's commitment, especially if you are experiencing it for the first time. The risk and uncertainties are as high as your expectations, whilst certainties are as volatile as the degree of cultural differences between the two countries.

However, knowing someone who has long been working in the country you wish to enter, such as an intermediary, may provide that guarantee you need to start off. Moreover, you will be reassured that the intermediary has tested the process over time and can make a significant impact on your plans.

2) Exhibitions

Exhibitions may also present good opportunities for a firm to understand whether a certain country is worth the effort and commitment required. In fact, there are many insights a firm could gain while attending an event, such as:

- The quality of clients and investors interested in holding a position in the target country/market
- The quality of competitors that devote their own resources to that market
- Whether new products or projects are sold in that country first. That is, a firm might gain a significant competitive advantage by selling there first rather than covering all markets
- Whether, of course, local and foreign clients show interest in your offerings
- The possibility to sign deals, which may evolve into future long-lasting business links, provided that adequate follow-up is carried out

3) Inbox Requests/Orders

There are also cases where a firm may consider an expansion on the basis of requests it receives from consumers, factories or other firms abroad. In an era of digital change and online shopping, it has become common to visit companies' websites, view their offerings, estimate their reliability and, finally, decide to contact them in order to request orders and, perhaps, establish a business relationship. Clearly, this is a driver with a minor influence, but is still worth being mentioned, as one needs not to underestimate the power of the Web.

4) National “missions

A firm also may be tempted to face an international challenge after being invited to partake in “business trips-missions” organized periodically by the respective Chambers of Commerce they are registered to. Certainly, such trips represent a first contact with new markets but they are generally overrated and often lead to disillusionment due to over expectations firms form before leaving. Although promoted by high institutions, the time at disposal, 3-4 days on average, is in many instances not enough to establish and maintain relevant business contacts;

> “….*These missions eventually boil down to mere fieldtrips missing the real purpose: getting contacts with foreign clients and investors*”[6].

5) Long-standing focus on target country/geographic area

Finally, a firm’s management may have had their eye set on a particular country or geographic area for quite a long time and carried out such an extensive research that they now feel ready to proceed with their plans. The drawback of this driver is the amount of time, which doubles normally, but the degree of reliability it conveys is unparalleled. First of all, there is no real commitment until management has a deeper understanding of the market in question, such as a more informed view of the regulatory and competitive landscape, factors driving local demand, the country’s economics and social stability, currency risk, labour costs, as well as the cultural challenges. Second, the greater amount of time spent studying and researching the country may provide useful information to forecast future trends, iron out potential kinks and build an effective database. Last, but not least, it will allow the company to test whether or not social barriers have been correctly estimated.

[6] Gino Salica, CEO and Founder of TwinSide Consulting.

2.3 - The golden driver: Is The First Set of Drivers Enough?

It would now be appropriate to question which of the aforementioned driver is the best and can yield better results. Would it be more effective to rely in "national missions" only? Would it be wiser to wait and see how things turn out in the long run? Would holding a presence in exhibitions secure future success? Would a handful of inbox requests represent the spark to light the terrific fire of business?

The equilibrium rests in the middle; that is, the golden driver is a combination of all drivers previously detailed, rather one or the other. However, this still does not fully answer out the original question of why a firm should choose China over many others. Those drivers supply evidence of actual forces leading management to enter such market, but they need to be complemented with an in-depth understanding of the workings behind them. Why China, then? Why not Brazil or Russia or India? One should analyse the subject from more diversified perspectives to be able to make an informed and well-educated choice with regards to where resources will have to be spent on.

2.4 - Relevant Parameters to Complement The First Set of Drivers: Sifting Through LEMs Systematically

This section will present various parameters, both macroeconomic and non, as to complement the previous analyses and allow to answer the second of our questions: why China is a "better" mattress to land on now.

2.4.1 - Gross Domestic Product (GDP)

The GDP is the most followed measure of the state of an economy; it is an aggregate measure of total production for a country, representing the market value of all the goods and services produced by the entire economy during a quarter, including personal consumption, government purchases, private inventories, paid-in construction costs and the foreign trade balance[7]. What it conveys to investor is the size of an economy, when looking at it as a whole, and its relative health, when viewed from real GDP figures, which account for changes in the price level and provide a more accurate estimate.

Not only can GDP be use to evaluate an economy, but it can also be employed to compare different economies. To this extent, China is one of the world's most relevant markets, with a population of 3 billion people[8], and the most promising one, given its GDP of $5,878,629,246,677[9,] which is greater than any of its counterparts (i.e. Brazil, Russia or India)[10]. This implies that a presence in such market, be it major or minor, may yield huge profit opportunities than in other areas of the world.

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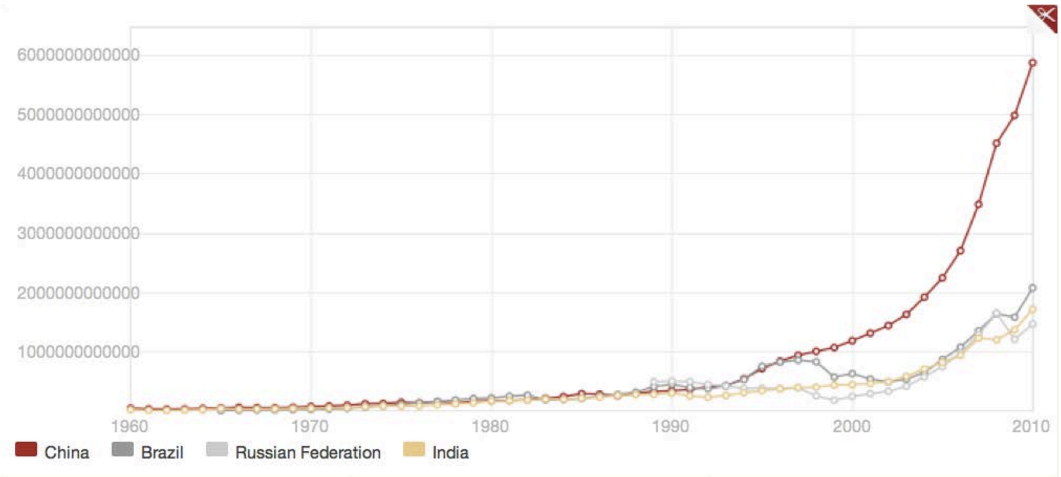
[7] Investopedia Library and Tutorials at :
http://www.investopedia.com/university/releases/gdp.asp#axzz1bXJ0qoEl
[8] San Francisco Business Times
[9] Wolrd Bank's Data Repository and Statistics:
http://data.worldbank.org/indicator/NY.GDP.MKTP.CD
[10] $ 2,087,889,553,822 (B), $ 1,479,819,314,058 (R); $ 1,729,010,242,154 (I); Source: Wolrd Bank



Source: Personally Created on World Bank's Website – World Development Indicators[11]

Note: GPDs above are calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates.

GPD figures do provide interesting and useful insights regarding a country's market scenario without even stepping there. In fact, by mere comparison of crude numbers, China is to be chosen over the other BRIC members. However, GDP alone can only provide so much of useful information a firm needs as it fails to measure or express changes in a nation's quality of life, unpaid labour, real savings, standard of living, transactions on the black market and/or uneven inflationary price changes (e.g. housing bubble).

GDP data ought to be paired up with further relevant data, such as time required to set up a business activity, opportunities for business expansions, difficulties in the environment, performance forecasts by thirds parties on the target country, legal and regulatory environments and, most importantly, analysis on the political and legal systems.

[11] Wolrd Bank's Comparison Chart available at: http://data.worldbank.org/indicator/NY.GDP.MKTP.CD/countries/CN-BR-RU-IN?display=graph

2.4.2 - GDP Annual Growth (Average)

While a crude shot of GDP at a certain point in time provides one side of the coin, glancing at how the figures “fluctuated” on average also enriches the analysis and allows for in-depth reasoning. Since the introduction of economic reforms, China’s economy trotted faster than during the pre-reform period. From 1960 to 1978, in fact, real annual GDP growth was evaluated at 5.3 percent, while from 1979 to current days, time span of reforms, it surged by nearly 10 percent. This essentially has meant that China doubled in real terms the size of its economy in real terms every eight years. The only stain in such an extraordinary growth lies in the interval of time between 2007 and 2009, when the growth slowed down from 13 percent to 9,2 percent. That coincides with the turmoil shaking financial markets; however, the Chinese government was able to roll up its sleeves and implemented a significant stimulus package and a monetary expansion policy, which allowed for the achievement of 10,3 percent threshold in 2010.

Table 1. China’s Average Annual Real GDP Growth: 1960-2010 and 2011 Estimate

Time Period	Average Annual Growth (%)
1960-1978 (pre-reform)	5.3
1979-2010 (post-reform)	9.8
1980	7.9
1985	12.8
1990	3.8
1991	9.3
1992	14.2
1993	14.0
1994	13.1
1995	10.9
1996	10.0
1997	9.3
1998	7.8
1999	7.6
2000	8.4
2001	8.3
2002	9.1
2003	10.0
2004	10.1
2005	9.9
2006	11.1
2007	14.2
2008	9.6
2009	9.2
2010	10.3
2011 IMF Projection	9.6

Source: Official Chinese government data, the Economist Intelligence Unit, and the IMF. (Wayne M.Morrison 2011)[12]

12 U.S Congressional Research Service Paper available at: http://www.fas.org/sgp/crs/row/RL33534.pdf

2.4.3 - Actual Size of a Country’s Economy

Although GDP and GDP average annual growth figures are systematic indicators of economic activity and describe the amount of such activity, need to be married with extra data to offer a comprehensive, thought still limited to certain extents, view of the actual size of an economy. The Chinese one has been under considerable debate as it changes depending on the type of economic viewpoints it is looked at from.

By choosing to adopt nominal exchanges rates as our point of observation, which simply reflect the prices of foreign currencies vis-à-vis a benchmark currency (usually the dollar) and exclude differences in the prices for goods and services across countries, China’s GDP in 2010 was estimated by the Economist Intelligence Unit (EIU) at $5.8 trillion, slightly higher than that of Japan’s and about 40% the size of the U.S. economy (*Wayne M.Morrison, 2011*).

If PPP (Purchasing Power Parity) basis is selected, which basically estimates the amount of adjustment needed on the exchange rate between countries so that exchange is equivalent to each currency’s purchasing power, we obtain a slightly different scenario. The PPP exchange rate increases the measurement of China’s economy and in 2010 it was 69.6 percent the size of the U.S. economy and its per capita GDP was 16.4 percent that of the United States.

These two standpoints do convey some important results as to why China should be preferred over other “contenders”. As we have scratched the top part of the iceberg, we are now ready to consider further indicators to take into account when analysing the option to choose among countries, such as the number of tax payments and people traffic and stability, which will come in handy in our study.

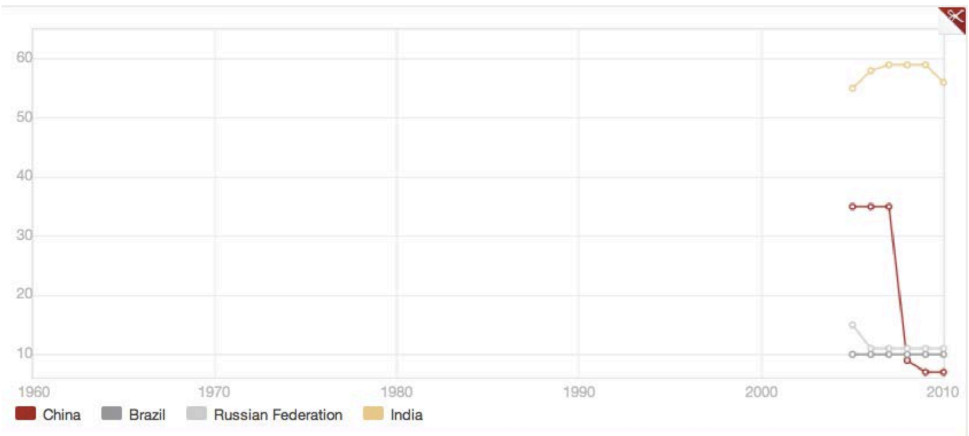
Table 2. Comparisons of Chinese, Japanese, and U.S. GDP and Per Capita GDP in Nominal U.S. Dollars and PPP: 2010

	China	Japan	United States
Nominal GDP ($ billions)	5,824	5,461	14,660
GDP in PPP ($ billions)	10,203	4,299	14,660
Nominal Per Capita GDP ($)	4,440	43,060	47,260
Per Capita GDP in PPP ($)	7,770	33,900	47,260

Source: Economist Intelligence Unit estimates. (Wayne M.Morrison 2011)[13]

2.4.4 - Tax Payments

Knowing how many tax payments a business has to make over time is also very crucial in choosing among large emerging countries. GDP figures may lead wrongly to enter an area where, eventually, losses exceed profits, which are given up to the government. This has been, so far, a plague for certain European economies that chased off an array of investors due to the heavy burden of taxes, although they are economically attractive countries. The logic behind aiming for a large emerging country within the BRIC group lies in the expectation that long-term profits will justify the costs incurred and challenges faced and, most importantly, that taxes there will be of less amount that those paid in the homeland.



Source: Personally Created on World Bank's Website – World Development Indicators[14]

Note: Tax payments by businesses are the total number of taxes paid by businesses, including electronic filing. The tax is counted as paid once a year even if payments are more frequent.

13 Paper available at: http://www.fas.org/sgp/crs/row/RL33534.pdf

14 Wolrd Bank's Comparison Chart available at: http://data.worldbank.org/indicator/IC.TAX.PAYM/countries/CN-IN-BR-RU?display=graph

As it is evident from an observation of the graph above, China requires fewer tax payments than its BRIC counterparts and is thus a better option to go at. Russian Federation and Brazil position themselves close to the level achieved by China; however, if we couple this information with that of GDP the reader can still conclude that China is the optimal path to embark on.

2.4.5 - Country's Economic and Social Stability

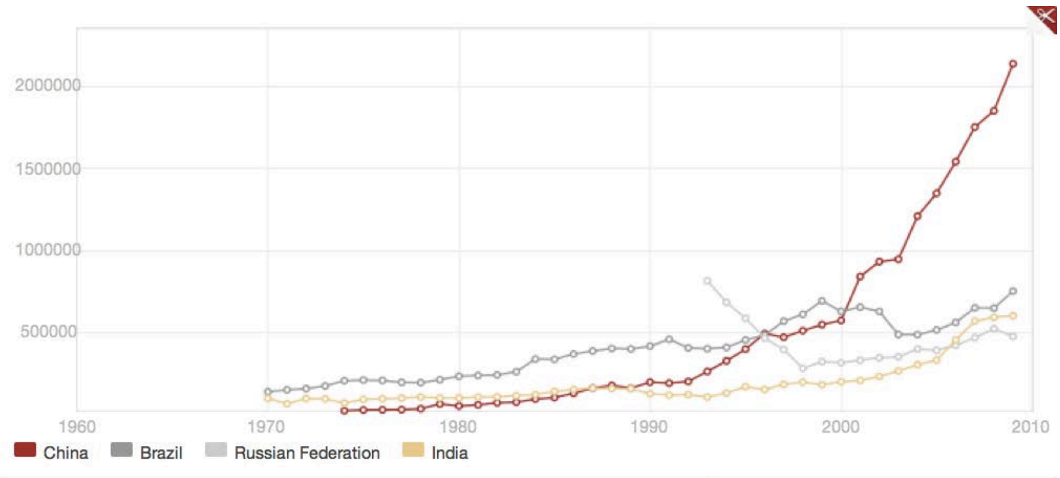
It would be advisable for a firm to investigate systematically into a country's activities with the rest of the world, thus researching whether or not a particular country is financially stable. Firstly, this means frequently checking credit rating agencies' reports on countries' performance; this is critical as firms' operations will be dependent on the economic prospects the country can have in store for them. An example of it is Greece today. Due to the economic and social instability of the country, which was aggravated by slow political and economic response to its weak financial standing, the actual condition of the market is problematic for those firms having physical business affairs there.

Secondly, it calls for a skim through figures and see how much debt the country holds, both its and that of other countries. In October 2010, the China was again recorded as being the world's biggest investor in US debt with sound sum of $906.8 billion, a 32.6% increase compared to the same period in 2008[15]. What this position entail is far more relevant than the increasing economic trend it experienced over the last decade. Financing the world's biggest economy means financing the world's economy and its operations, now and in the future. An interested investor, as well as a firm, should then feel reassured about China's stability from such standpoints.

[15] Guardian UK Newspaper Article – "US federal deficit: how much does China own of America's debt?" available at: http://www.guardian.co.uk/news/datablog/2011/jan/18/us-federal-deficit-china-america-debt

2.4.6 - Air Transport

Large volumes of air traffic into and within a country are one major indicator of several trends: increasing globalization in politics and the economy, non-stop business opportunities, leisure travel, and urbanization. Moreover, the growth in air travel, both inwards and outwards, lures foreign air carriers to court local firms for partnerships or M&A/Joint Ventures transactions. Therefore, financial activity may be spurred by "simply" increasing air traffic, hence increasing the number of passengers hovering over the country (*James K. Yuann, Jason Inch, 2008*)[16].



Source: Personally Created on World Bank's Website – World Development Indicators[17]

Note: Registered carrier departures worldwide are domestic takeoffs and takeoffs abroad of air carriers registered in the country.

The sequence in the rectangle above provides an insightful shot of the current air traffic among emerging nations and undoubtedly shows the domination of China in expanding its air traffic in less than 30 years. The real jump is indentified from year 1990, which coincides with the set of economics and development reforms the government set out to lay out for the future. Another spike can be found between 2001 and 2008; it might be pure coincidence but that interval actually

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[16] James K. Yuann, Jason Inch (2008). Supertrends of Future China: *Billion Dollar Business Opportunities for China's Olympic Decade*. New Jersey; London; Singapore; Hong Kong; Taipei; Chennai; Beijing; Shanghai: World Scientific Publishing Co. Pte. Ltd. p3-150.

[17] World Bank's Comparison Chart available at: http://data.worldbank.org/indicator/IS.AIR.DPRT/countries/CN-BR-RU-IN?display=graph

matches with the bid process for the Olympics, which saw China winning over Canada, France, Turkey and Japan, and the necessary construction works started from Beijing and then expanded to other areas of the country.

Moreover, in October 2007, six new direct flights from the US to China were announced, and under a May 2007 agreement, the total number of direct flights via US carriers alone will increased to 23 a week by 2012. Even more importantly, Boeing estimates that China will require to augment its fleet to 4,460 by 2026 (*James K. Yuann, Jason Inch, 2008)*[18]. China's Civil Aviation Authority also reported that the country would build 97 new airports throughout the whole national soil, yielding a total of 244 airports by 2020[19]. China will, therefore, continue to welcome more passengers in the next years and this, in turn, will indulge other carriers and businesses from abroad to turn their eyes to this market and sought any opportunity to make the year's deal. Where do all the passengers come from? Why do they go to China in the first place? Why is it important to have this piece of information anyway?

To begin with the first question, it is obvious that nowadays' flights to China are loaded with people coming from virtually all over the world, even though back in the 1980s the majority of travellers to China were Hong Kongese, Taiwanese or simply Asian. This change is justified, as discussed earlier, by the various works undertaken from 2001 onwards and also by the entrance of China into the WTO in 2011. WTO membership opened up China's market for more international trade and investments, and allowed the world economy to enjoy China's exports (*Gregory C. Chow, 2001*)[20].

Over the years, several individuals have invested money into spending time at Chinese universities in order to familiarize themselves with the culture and learn

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[18] James K. Yuann, Jason Inch (2008). Supertrends of Future China: *Billion Dollar Business Opportunities for China's Olympic Decade*. New Jersey; London; Singapore; Hong Kong; Taipei; Chennai; Beijing; Shanghai: World Scientific Publishing Co. Pte. Ltd. p3-150.

[19] General Administration of Civil Aviation of China at: http://www.caac.gov.cn/English/

[20] Gregory, G. C. (2011). The Impact Of Joining WTO On China's Economic, Legal and Political Institutions p2-10.

mandarin. According to the Chinese Ministry of Education, 195,000 foreigners attended Chinese universities in 2007, which signals an increase of 20 percent. Some others come for short-term travel, but increasingly is the case that they choose to live and work permanently there. The same holds for senior or executives that are transferred to China and eventually decide to make it their own home. What these groups have in common or the common reason why they go to China, learn the language, travel or work is that job opportunities are superior to those back home. For younger talents, Chine offers positions in management and social status that they could only dream of in their home countries and, at the same time, lower cost of living compared to places like U.K., U.S. or other developed countries. Relocating in China is also valuable for executives looking to advance their career up the corporate ladder and enjoy extraordinary perks, such as chauffeured cars, gardeners, private cooks and full-time house keepers (*James K. Yuann, Jason Inch, 2008).*

It is important to at least have a basic awareness of these trends as it may help debunk myths about the kind of quality a firm can find in the labour force in a large emerging market. As will be overviewed later on this work, the steps China took and progresses it made combining education reforms and economic growth explain much of its outstanding performance in recent years. Success does not only depend on the amount of products you produce and sell; it is also a function of the efforts to bring quality to the system.

2.4.7 - Quality Human Capital and R&D Opportunities

What distinguishes a promising market from a simply interesting one to the eye of an expanding firm is the quality of labour force, hence human capital, it could hire once it has settled in. Having the possibility to recruit talented and, most importantly, educated individuals is definitely a key factor for long-term success, as Macroeconomics literature has always suggested. In an extremely competitive scenario, such as the international market nowadays, it is of the utmost important for a firm to retain quality employees and be able to innovate in order to bring in something unique and differentiate itself from its competitors. It is that firm willing to run the extra email that will secure a dominant position and future success. To do so, it is vital that the target country can provide highly performing graduates and qualified individuals as resources for firms. It is commonly accepted that India has been educating top graduates, however this does not directly imply educated minds can only be outsourced there. In fact, there are two trends that have been shaping China's education and basin of human capital resources the country can provide to the job market: education expansion through reforms and increase in R&D by the government and local authorities with the main aim to boost economic activity and development. What these means is that the government does care for what the possible fruits R&D and education can help reap; if we compare this with what is going in countries, such as Italy, where funds are cut away from research, we can get a better view of why this is a vital factor to be considered.

The implications of all the aforementioned actions were and will be tangible for the firms operating in China; they will be able to conduct research activities at a fraction of the cost incurred in their home countries and with greater availability of talented human capital. Moreover, they will enjoy knowledge infusion from returning brain drain, Haigui (Sear Turtle) students, who will also be of help in connecting Western and Asian cultures within working environment conditions.

2.4.7.1 - China's Education: Reforming for Economic Development

China has been working up significantly skilled labour force in the last decade and this has manifested itself in growing numbers of educated Chinese students and the size of investments in R&D relative to GDP figures. When China opened its doors towards the end of the "70s", it realized that it was lagging behind the most developed countries in the world and that a series of reforms was necessary to speed up its blooming and opening processes, as well as its economy. The very first step in doing so was to reform the education system and adapt it to the American model, which was deemed to be the prime one. In the winter of 1977, a year after the end of the Cultural Revolution, with the strong support of Deng

Xiaoping (the late master planner of China's reform), university entrance examinations were held for the very first time after a 10-year suspension. 11.6 million Chinese took the entrance examination, which set a historical record. A major change, however, occurred from the "90s"; since the 1990s, in fact, when China made higher education a priority, the number of universities accessible to students increased and the share of graduates from secondary schools who continued on in higher education has risen significantly.

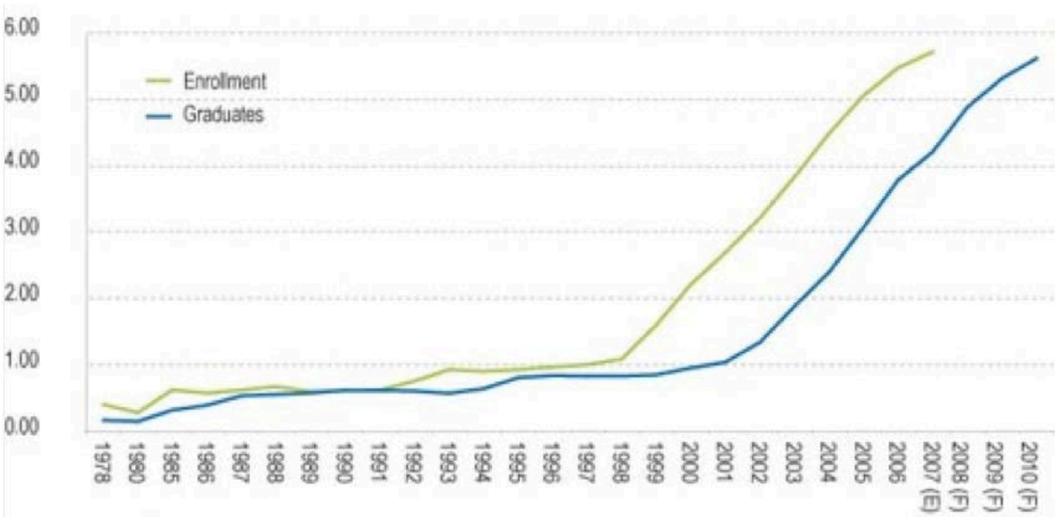
Province	Number of universities
Beijing	30
Jiangsu	9
Shanghai	8
Hubei	7
Shaanxi	6
Sichuan	4
Liaoning	3
Heilongjiang	3
Guangdong	3
Hebei	2
Tianjin	2
Jilin	2
Anhui	2
Fujian	2
Shandong	2
Hunan	2
Chongqing	2
Guansu	1
Zhejiang	1

Source: China Knowledge Group[21]

What can be observed by looking at this table is a list of China's key universities (the ones displaying strong faculty and greater researches in the respective fields) and their location. A great number of universities nests within the provinces of Beijing, Jiangsu, Shanghai, Shaanxi and Hubei. While Beijing and Shanghai tend to top the list due to their influence, the former being the capital of the People's Republic of China as well as the head of the national government and the former being the commercial and financial centre of mainland China, the others do hold a significant role in China's economy and education prospectus.

21 China Knowledge Group – "China Overview" available at: http://www.chinaknowledge.com/Business/CBGdetails.aspx?subchap=1&content=8

Jiangsu, for example, has coal, petroleum and natural gas deposits; moreover, heavy industries, such as chemical industry and construction materials, have been developed. They include machinery, electronic, chemicals, and automobile. Recently, the government has worked hard to promote the solar industry and hoping it will be worth 100 Billion RMB by 2012[22]. All of this creates unparalleled learning opportunities for students interested in heavy industry and chemistry. It also worth taking into account that Jiangsu is a very wealthy province with the second highest GDP, thus being able to attract top students and researches to its institutions.



Source: China Knowledge Group[23]

In this other figure, instead, we can gain a better understanding of the education growth in China from as early as in 1978 to 2010. The graph shows a continuing spike from 1997 onwards, which precisely coincide with the type of reform mentioned above. Such trend is likely to go on for years to come, as China carries on its economic development and its GDP increases more and more, thus yielding more funds for education and R&D. In fact, this latter factor is what boosted China's economy in the last years. What has always distinguished the American system from many others in the rest of the world is the large availability of funds

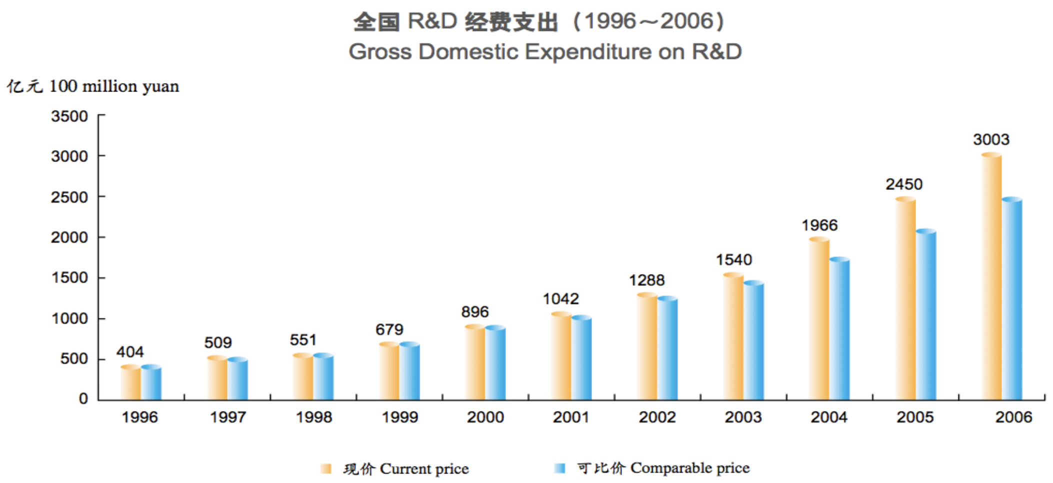
[22] The China Perspective Online Journal Article available at:
http://www.thechinaperspective.com/topics/province/jiangsu-province/

[23] Figure Available at:
http://www.chinaknowledge.com/Business/CBGdetails.aspx?subchap=1&content=8

channelled for researches/researchers and the universities themselves. The idea behind this line of thinking lies in the meaning Americans attach to education and the benefits R&D can bring to society, economics development and business in plain terms. Education, R&D and success are, thus, key concept and almost synonyms; China is a living testimonial of what happens when more funds are channelled to R&D as a share of GDP[24].

	2001	2002	2003	2004	2005	2006
R&D经费支出（亿元） GERD（100 million yuan）	1042.5	1287.6	1539.6	1966.3	2450.0	3003.1
R&D经费支出/国内生产总值（%） GERD/GDP （%）	0.95	1.07	1.13	1.23	1.33	1.42

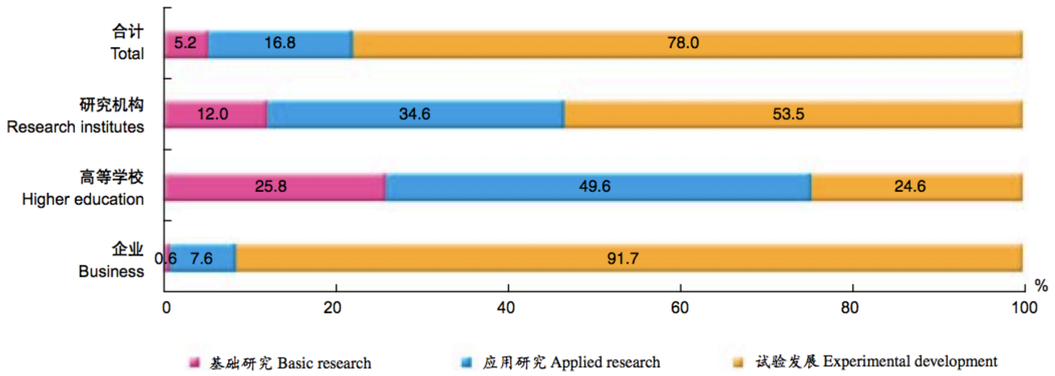
Source: Ministry of Science and Technology of the People's Republic of China



Source: Ministry of Science and Technology of the People's Republic of China

[24] China Science and Technology Statistics (2007) Data Book – Ministry of Science and Technology of The People's Republic of China available at: http://www.most.gov.cn/eng/statistics/2007/index.htm

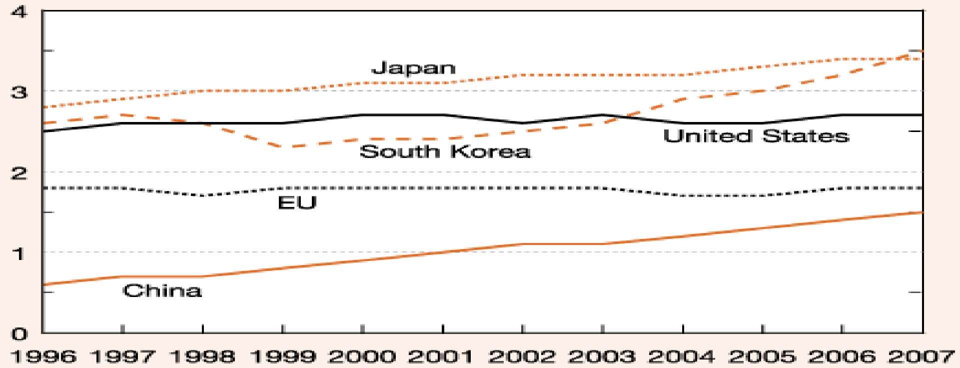
1-3 全国 R&D 经费支出按活动类型分（2006）
GERD by type of activity



Source: Ministry of Science and Technology of the People's Republic of China 2006

R&D expenditures as share of economic output of selected countries: 1996–2007

Percent of GDP



Source: The National Science Board (NSB) – 2010 Science and Engineering Indicators

Table 4-13

Gross expenditures on R&D by performing sector, for selected countries: Most recent year

(Percent)

Country	Business	Government	Higher education	Private nonprofit
United States (2007)	71.9	10.7	13.3	4.2
Japan (2007)	77.9	7.8	12.6	1.7
China (2007)	72.3	19.2	8.5	0.0
Germany (2007)	69.9	13.9	16.2	0.0
France (2007)	63.2	16.5	19.2	1.1
South Korea (2007)	76.2	11.7	10.7	1.4
United Kingdom (2007)	64.1	9.2	24.5	2.1
Russian Federation (2007)	64.2	29.1	6.3	0.3
Canada (2008)	56.1	9.6	33.8	0.5
Italy (2006)	48.8	17.2	30.3	3.7

NOTE: Top 10 R&D performing countries.

Source: The National Science Board (NSB) – 2010 Science and Engineering Indicators

2.4.7.2- Haigui: The Sea Turtle Students

Chinese refer to students returning from overseas as Hai Gui, or Sea Turtles. The pronunciation of turtle in Chinese is similar to the words that mean ‘coming back from overseas’; these are students that obtained their education abroad in countries like the U.K., the U.S, France, Germany and so on. The phenomenon began after the dot-com burst, when two trends combined to make China more attractive to its people abroad: the lack of jobs, especially in technology areas in the United States; and the growing number of opportunities in China as the economy ramped up its pace of development in high-tech (*James K. Yuan, Jason Inch, 2008*). Clearly, not all students that leave for universities abroad will eventually return home; for every one person that comes back, there is a handful of others who never return. China, however, is doing its best to continually increase the share of educated-abroad Chinese students returning home by luring them with preferential polices such as niche spots at top universities, extraordinary job opportunities or supporting their businesses.

The success and development of China, as previously suggested, have also been and will be determined by the continuous infusion of knowledge among locals, expatriates and returning Chinese, by the opportunity for foreign businesses to draw resources out of this basin of high-calibre human capital and by the reassurance that government will fund R&D activities that will bring tangible benefits for its economy and development.

2.4.8 - Competition Evaluation

As a further matter, an analysis of legal and competitive factors needs to be carried out as well in order to place down the right base upon which to see the overall challenge. In particular, one should assess how hard it is to enter the Chinese market; if so, what makes it so hard? Is it the legal framework to complicated to work within? Are competitors too harsh on new entrants? What are such competitors? How did they gain such leading role in that country?

In fact, a firm might be tempted to approach China because of its outstanding performances and endless opportunities for foreigners, but it might not have updated its legal system to ease business requests and operations. This tends to be frustrating for foreign investors, who may use up a great deal of resources for their plans and reap significantly less than expected. Furthermore, not having modern institutions suited to the task at hand can represent another major obstacle, often connected to the legal one. Such was the case of Eastern European countries in the aftermaths of WWII and of Brazil and Russia today, the latter growing at an impressive rate but having a dated institutional framework that has concerned investors about their capability to meet innovation, which has more and more been propelled by financial evolution in IT. Under this standpoint, the Chinese government has been making progresses to ease bureaucracy for foreign enterprises, and seems to be opening more and more as it develops economically and socially.

Although cultural differences do influence the final short-listing, it is wise to recognize that such barrier is also an invaluable opportunity. A market characterized by great cultural differences is certainly a tough one to enter, but it will also discourage other potential firms interested in gaining a stake in it. That said, resisting through initial difficulties with local languages may yield outstanding benefits in the long term. Competition, as anticipated, will also need to be accounted for properly by the management of a firm

Paragraph Summary: In 2.4. an array of parameters were illustrated that allowed to restrict the target market of interest to China. GDP and tax figures were compared, past and future trends detailed and explanation of such trends given. All of this sets the ground for a closer look at "who" China actually is.

2.5 - Where to Locate in China: Tier 1 and Tier 2 Cities

Through an analysis of certain indicators to look at and research actions to undertake, the previous sections helped us answered the original question: why China? Now it is the time to examine how China's market is fragmented; just as occurs in developed nations too, China has its own strategic economic poles and key cities.

China's economy is divided into different categories, or tiers, of cities, which define the status of a particular geographical location with respect to its population size, economic activity (past, current and prospective) and relevance within the country. Tier 1 cities are major metropolitan areas and are considered to be the prime choice for investment and expansion opportunities as they were the first to be opened to competitive economic forces. In China they are: Shanghai with GDP of USD 228 billion[25] (1US$=6.6RMB) and population of 14 million; Beijing with GDP of USD 184 billion and population of 12.46 million; Guangzhou with GDP USD 138 billion and population of 10.26 million in 2009 respectively. Tier 2 cities are, instead, smaller in economic size and population and in China they round up to 15. Normally, they host most of the manufacturing facilities and industrial complexes in the whole country and, thus, are ideal for relocating production and diverting costs. Differences exist between the two categories and they affect investors' choice based upon the kind business they wish to operate.

Tier 1 cities tend to express higher operating costs, sophisticated consumers and may be saturated in long term, but they also offer a larger pool of talents to draw human resources from. On the other hand, Tier 2 cities have lower operating costs, which attracts large manufacturing companies to relocate there, lower rent expenses and a more standardized pool of talents. The following is a list of the categories discussed with detailed information on their size and potential:

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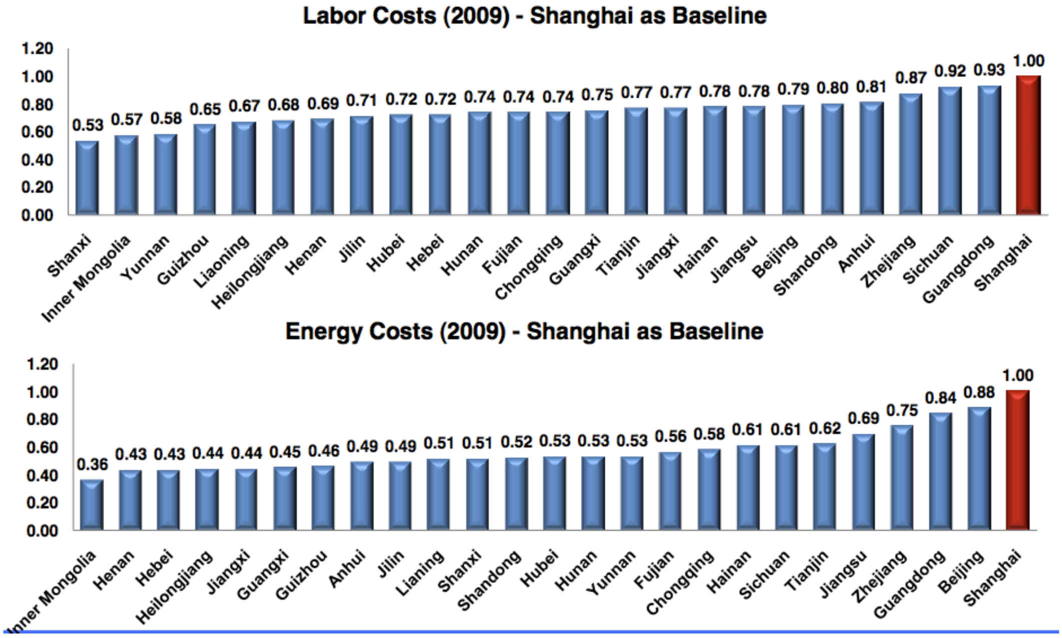
[25] Starmass International Consulting – "Overview of China Major Cities" available at: http://www.starmass.com/china_review/city_overview/china_cities.htm

Category	City	Population (Millions)	GDP (US$ B)	GDP/capita (US$)	FDI (US$ B)
China Total		1,335	4,985	3,734	90.0
Tier 1	Shanghai	19.2	220	11,466	10.5
	Beijing	17.6	178	10,110	6.1
	Guangzhou	10.3	134	12,990	3.8
Tier 2	Tianjin	12.2	110	9,027	9.0
	Dalian	5.9	64	10,794	6.0
	Qingdao	8.5	71	8,361	2.2
	Nanjing	7.7	62	8,030	2.4
	Suzhou	9.4	113	12,095	8.1
	Hangzhou	8.1	75	9,216	4.0
	Ningbo	7.2	62	8,570	2.2
	Xiamen	2.5	24	9,389	1.7
	Shenzhen	8.9	120	13,473	4.2
	Zhuhai	1.5	15	10,198	1.2
	Wuhan	9.1	68	7,434	2.9
	Chongqing	32.8	96	2,919	4.0
	Xi'an	8.4	40	4,729	1.2
	Chengdu	12.9	66	5,124	2.8
	Kunming	6.2	26	4,245	0.6

Source: JLJ Analysis[26]



Source: JLJ Analysis

26 JLJ Group – "Chin's Tier 2 Cities: Understanding Opportunities & Challenges" available at: http://www.mitc.com/PDFs/JLJTier2Cities2011.pdf

Source: JLJ Analysis

2.5.1 - Tier 1 vs. Tier 2 Entry Strategies

Entry via Tier 1 cities has been the dominant strategy for the majority of foreign companies since these cities have the largest and most open markets. It is most common for franchisors to establish a Joint Venture or a WOFE in Tier 1 cities to set up supply chain networks, and establish brand image through a few direct-owned stores. Further store expansion is done either through direct-owned stores, partnerships, or franchising. With Tier 1 cities becoming increasingly expensive and competitive (e.g. many foreign brands present, difficult to find good locations, etc), many companies are considering entering via Tier 2 cities.

Entry via Tier 2 cities has not yet been done by many companies, but Dunhill, for example, entered via Tier 2 markets and later expanded into Tier 1 cities. There are several barriers for entry via Tier 2 cities. Purchasing power is rapidly growing, but still limited; Tier 2 markets are also fragmented, characterized by a large number of potential cities that can each accommodate only a few numbers of stores. For example, KFC, a relatively mature brand in China, has less than 20 outlets in Chongqing compared to more than 150 in Shanghai. The implications include release of products in smaller volumes and at reduced prices[27].

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[27] US Commercial Service - "China- Franchising Industry: Access Dynamics and Emerging Markets" available at:
http://export.gov/china/build/groups/public/@eg_cn/documents/webcontent/eg_cn_027119.pdf

2.6 - Chapter Summary

The following question opened up our investigation: which is the "cash cow" among large emerging markets? In answering this question, a section was first spared to better understand what going global means and entails. A list of modern drivers were then supplied and discussed, which sparked a doubt as to whether those drivers could alone be enough to decide on a specific large emerging market. To address this issues, macroeconomic data and charts were used to offer the right benchmark needed to choose one particular country. This analysis, complemented with previous drivers, highlighted China as preferable candidate and an initial review was started to see "who" China really is by looking closer at development policies, inner potential and its market segmentation, namely tier 1 and tier 2 cities and the strategies of entry into their markets. What will follow in the next Chapter will delve into it; precisely, some major modes to step in China will be presented, examined and compared in the end.

CHAPTER 3: Major Modes of Entry in China

Introduction

The end of the previous chapter outlined China's tier 1 and tier 2 cities and the strategies to enter them. In this chapter a more comprehensive study of the major strategies or, as will be referred throughout, modes of entry into China as a whole. A list of these actions will be given that draws the path followed from the beginning to the end of this chapter. Special attention is paid to foreign direct investment modes, whose pros and cons will be defined, and the importance of lobbying manoeuvres that will emerge from Kodak's business case. The issue of which strategy is best will, then, be dealt with in the final part of the chapter.

3.1 - Overview of Modes

It is possible to analyse the following main modes of entrance; as is evident, exporting has not been included. The reason for such choice lies in the fact that the increase of trade barriers, such as tariffs, quotas and lack of infrastructures has discouraged exports. Moreover, SMEs on their first international expansion may need to grow accustomed to such barriers and relevant issues and exporting directly may just fireback in the long run.

- Licensing
- Franchising
- FDI (Foreign Direct Investment)
    - Joint Ventures
    - WFOE
    - RO (Representative Office)
    - Off-Shore Company
- Lobbying

3.1.1 - Licensing

It is a scenario where one company, which owns intangible property, grants a foreign company the right to use that property over a specific period of time. Such licensed property may consist of copyrights, patents and formulas as well as trademarks (designs and brand names). It is common in the manufacturing industry in which certain process technologies can be "allowed for" in exchange for royalties (e.g. beer breweries, soda manufacturers). Licensing in China yields great potential of earnings, due to the country's economic power and continuing evolution towards what resembles an open market more and more. It certainly is an effective way of approaching China without previous experience on international markets. However, it is of the utmost importance to point out that risks and problems may emerge indeed. Generally, "trade secrets" or know-how is hard to protect and lawsuit cases very often involve leak from employees.

3.1.2 - Franchising

Franchising is similar to licensing, but the franchiser moves a step further by providing a whole set of resources and services that mere licensing agreements do not include, such as a well-recognized brand name, raw materials, advertising, employee training and production. It functions as a "protective" umbrella for the franchisee members seeking to gain experience but, at the same time, without lacking the administrative and strategic support a large corporation may subsidize. Examples of such entry technique abound in practice; McDonald's was one of the pioneers of this method that allowed it to unfold and stretch its influence over other markets with great accuracy. In fact, the franchisee ought to abide by the franchisor's rules and cannot retain all the revenues it manages to generate. This, in turn, confers the franchiser a great control over the operations.

Clearly, franchising is not a viable option for SMEs that, more often than not, can attain to limited resources and experience, which are tippy factors in a success on such type of markets. Nonetheless, it worth exploring the evolution of this entry mode in China over time as to gain a clearer picture of its market.

Franchising in China[28] coincided with the beginning of its economic, political and social renaissance. In fact, up until 1978, ideology ruled to a much greater extent than it does today, and conceiving of a "free" open market was not an option on the agenda. However, as China reformed[29] and opened its economy to the rest of world, following a more practical approach by its leadership, market players turned their eyes to the Chinese market. But first franchising experiences may not have turned out well as the legal and business environments required a great amount of reforms to be put in place. Because franchising typically does not involve investing in equities, the Chinese Government used to put less focus on such business. After two decades, the Chinese government settled down most ideological arguments and realized the benefits the country could get from franchising: it is one method that allows the assembly and concentration of capital from a wide capital base through investment in franchises; it makes up for the commercial inexperience of the Chinese franchisers by linking their investments to completed training within a well-tested operating system; it enables the creation of job positions across the nation.

In 2004 all this was formalized by the Ministry of Commerce in the new Regulation on Commerce Franchise, which stimulated business, in terms of its scale and standardization, and defined more clearly the way foreign brands operate franchise businesses in China[30]. The results were tangible and helped the country foster so much of a thriving environments for foreign firms o be in that, as of 2007, there were approximately 2,600 brands with some 200,000 franchised retail stores in over 80 sectors. Moreover, Franchising experienced significant

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[28] International Franchising Association article available at: http://www.franchise.org/uploadedFiles/Franchise_Industry/International_Development/franchising%20in%20China.pdf

[29] US Department of State - "Background Note: China" available at: http://www.state.gov/p/eap/ci/ch/

[30]http://www.franchise.org/uploadedFiles/Franchise_Industry/International_Development/franchising%20in%20China.pdf

growth in the last few years due to rising disposable incomes and an increasing number of Chinese entrepreneurs willing to adopt franchising models[31]. The key franchising sectors in China are Food & Beverage, Apparel, Education and Fitness, and there exists relevant difference between domestics (Chinese) franchisers and foreign ones, which is depicted in the following table:

	Foreign	Domestic
Overall	- Stronger presence in Tier 1 than 2 - Small proportion of the total franchise market - Generally good consistency across stores	- Larger percentage of competition in Tier 2 - Dominate in terms of number of franchise chains - Usually less brand consistency across stores
F&B	- Many foreign brands, but often not franchised, thus low share of foreign brands among F&B franchises - Strong presence in Tier 1, fast expansion in Tier 2 - Int'l brands common in fast food/casual dining - US chains prevalent among foreign ones	- Large presence in Tier 1 and Tier 2 - A few major brands franchise on a large scale (with hundreds of stores) - Mainly Chinese/East Asian cuisine - Some companies moving away from franchising due quality concerns (e.g. *Chongqing Dezhuang*)
Apparel	- Franchising increasingly popular in *casual wear, sportswear, children's wear* and *underwear* - Large brands, e.g. *Li-Ning* and *Esprit*, are already found in Tier 3.	
	- Good presence of foreign franchisors - Tier 1 often direct-run/JV. Tier 2 has relatively higher degree of franchises - European brands are prevalent (e.g. *Vero Moda, Etam*)	- Franchising very common; mainly in Tier 1 and 2 - Strong in low-end of market due to low prices, largely absent from the high-end market - Quality of management rapidly improving among larger brands (e.g. *Metersbonwe*)
Education	- Presence in Tier 1 and Tier 2 - Few foreign franchisors but the existing ones have relatively high market share (e.g. *Aptech)* - In franchised language education only one US company (WEB International English, via JV)	- Presence in Tier 1 and Tier 2 - Only a few large brand names - The largest player does not franchise (*New Oriental)*
Fitness	- High share of foreign franchisors - Large presence in Tier 1, expanding via mid-end clubs in Tier 2 - US chains prevalent among foreign gyms	- Apart from the larger brands, the market is served by a plethora of local ones - Same high-quality equipment as foreign chains - Generally less management/training expertise

Source:JLJ Analysis[32]

The difference stems mainly from the experience with this type of business methodology, as domestic franchise brands outnumber foreign counterparts but their outlets suffer from poor standardization and consistency, and the leverage at one's own disposal. Major foreign companies, like Kodak or Burger King, retain a stronger appeal among consumers and, thus, a higher chance to leverage their brand against competitors, both other foreign or domestic ones.

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31 US Commercial Service - "China- Franchising Industry: Access Dynamics and Emerging Markets" available at:
http://export.gov/china/build/groups/public/@eg_cn/documents/webcontent/eg_cn_027119.pdf

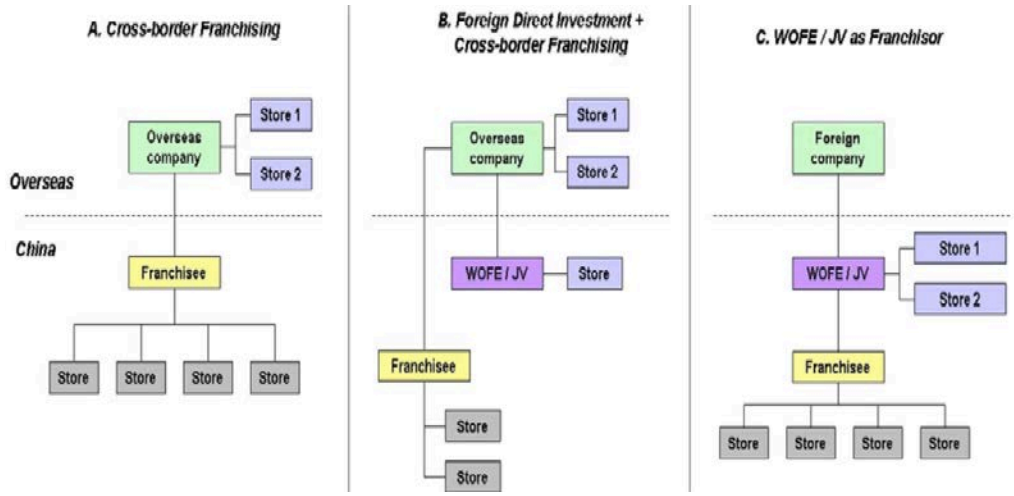
32 Table available at:
(http://export.gov/china/build/groups/public/@eg_cn/documents/webcontent/eg_cn_027119.pdf)

3.1.2.1 - Cross-border franchising (Franchising set-up)

A franchise contract can be signed between a foreign franchisor (which does not have a local presence in china) and a master franchisee. This method has opened up opportunities for mid-sized international franchisors that do not have the resources or do not want to set up a legal presence in China. While cross-franchising is the simplest and cheapest way to franchise in China, it can result in a loss of control and supervision over the franchise.

3.1.2.2- Foreign Direct Investment (FDI) & Franchising

This involves establishing either a Joint Venture (JV) or WOFE and later expanding it into franchising. If the WOFE or JV is to be a franchisor, then it is required to have owned and operated at least two successful stores for at least one year, before it can use franchising (Example C). While this information is based on interviews with the Ministry of Commerce (MOFCOM), it must be noted that this law is still relatively new, and how it is implemented in practice is still unclear; implementation may also vary by region. More time is needed to observe which structures are approved (or rejected) in practice.



Source: JLJ Analysis[33]

[33] Available at http://export.gov/china/build/groups/public/@eg_cn/documents/webcontent/eg_cn_027119.pdf

Although this method requires a larger amount of capital investment than cross-border franchising alone, it allows the foreign franchisor to first set up supply chain networks and establish brand awareness before later expanding.

3.1.3 - Foreign Direct Investment

Foreign direct investment is defined as a company from one country making a physical investment into another country, i.e., building a factory or plant. However, in recent years, given rapid growth and change in global investment patterns, the definition has been broadened to include the acquisition of a lasting management interest in a company or enterprise outside the investing firm's home country. As such, it may take many forms, such as a direct acquisition of a foreign firm, construction of a facility, or investment in a joint venture or strategic alliance with a local firm with attendant input of technology, licensing of intellectual property[34].

Over the last decade, China has experienced an increase of interest from foreign investors in dedicating their financial resources to business activities, partially due to its economics size and because of the open-market measures implemented by the Chinese government aimed at relaxing most of the previous restrictions imposed on foreign firms. As usually happens, high number of projects, thus of inflows of capital, were spotted at the very beginning of the opening process, when investors fundamentally started to inject their capital into the Chinese economy, decreased slightly as the excitement cooled off and eventually picked up again. The following table precisely captures this trend and provides a clear snapshot of such flow of capital from the biggest economy in the world, the United States:

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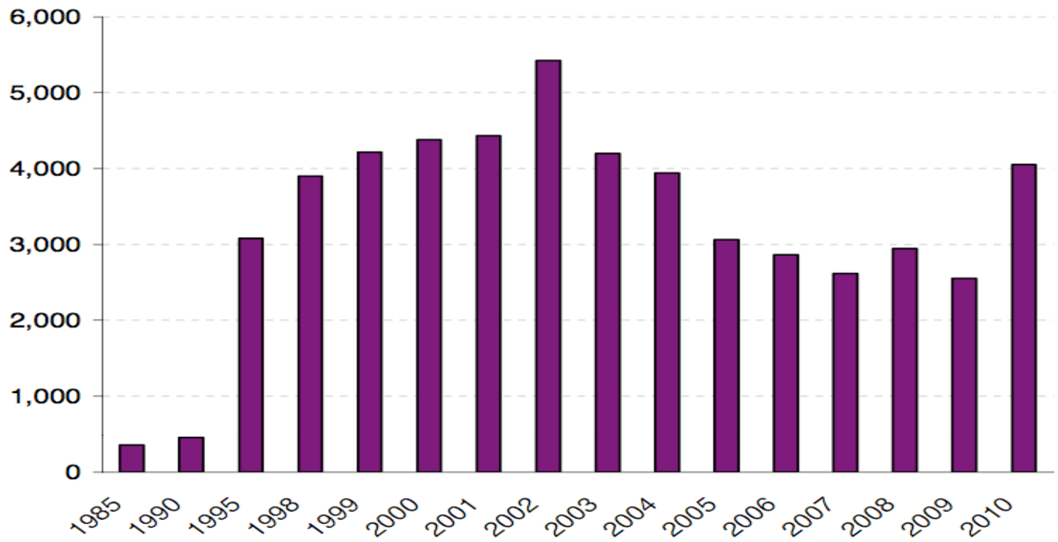
[34] P. Graham and R. Barry Spaulding (2005). "Going Global" available at: http://www.going-global.com/articles/understanding_foreign_direct_investment.htm

Figure 3. Annual U.S. FDI Flows to China: 1985-2010
($ Millions)



Source: Congressional Research Service Paper . (Wayne M.Morrison 2011)[35]

In terms of cumulative FDI in China for 1979-2010, the Chinese government reports that 42.9% came from Hong Kong, 9.4% from the British Virgin Islands, 6.8% from Japan, and 6.2% from the U.S. In terms of annual data, Hong Kong was reported as the largest source of FDI flows to China in the year 2010 (63.9% of total), while the United States ranked 5th.

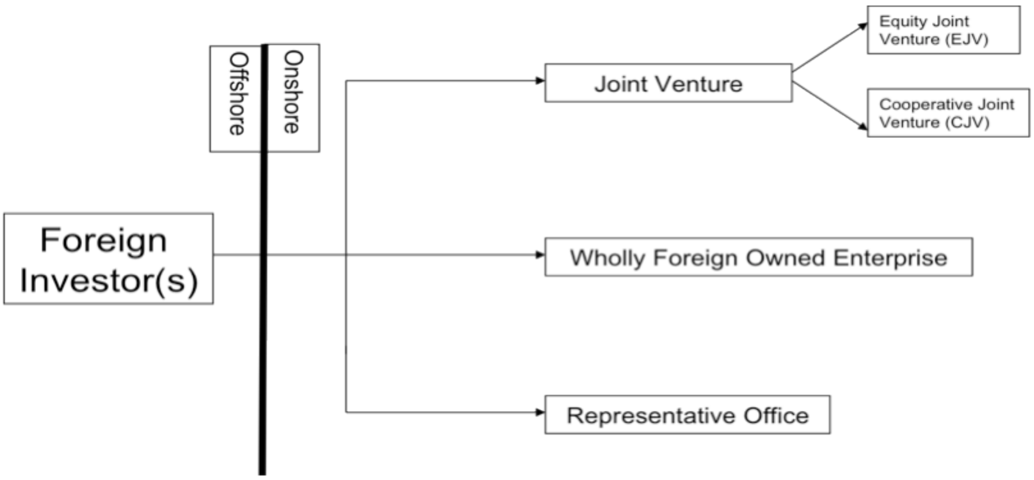
Table 3. Major Sources of Non-Finance FDI in China: 1979-2010
($ billions and % of total)

Country	Estimated Cumulative Utilized FDI: 1979-2010		Utilized FDI in 2010	
	Amount	% of Total	Amount	% of Total
Total	1,078.8	100.0	105.7	100.0
Hong Kong	463.2	42.9	67.5	63.9
British Virgin Islands*	101.4*	9.4*	NA*	NA*
Japan	73.7	6.8	4.2	4.0
United States	66.4	6.2	4.1	3.9
Taiwan	56.3	5.2	6.7	6.3
South Korea	47.3	4.4	2.7	2.6
Singapore	47.1	4.4	5.7	5.4

Source: Chinese Ministry of Commerce and Chinese Yearbook, various year. (Wayne M.Morrison 2011)

35 Wayne M. Morrison (2011). "China's Economic Conditions" available at: http://www.fas.org/sgp/crs/row/RL33534.pdf

The principal forms of foreign investment in China are portrayed in the following graph:



Source: Coudert Brothers Global Legal Advisors[36]

3.1.3.1 - Joint Venture

A Joint Venture is a business arrangement in which the participants create a new business entity or official contractual relationship and share investment and operation expenses, management responsibilities, and profits and losses. The Chinese authorities encourage foreign investors to use this form of company as sometimes they are the only way to register in China if a certain business activity is still controlled by the government, such as restaurants, bars, building and construction, car production or cosmetics. There are to types of Joint Ventures:

1) Equity Joint Ventures (EJV)
2) Cooperative Joint Venture (CJV)

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[36] The figure was part of a Power Point presentation. A copy can be retrieved at: http://www.google.com/url?sa=t&rct=j&q=coudert%20brothers%20global%20legal%20advisors%20foreign%20investment%20firms%20china&source=web&cd=1&ved=0CBkQFjAA&url=http%3A%2F%2Fwww.kemarra.com%2Fdocuments%2Fjoint_venture_wfoe_fie_in_china_Coudert.ppt&ei=MCusTpb1K5CQ4gSq2dXqCQ&usg=AFQjCNH5IilaSMAuz0sFjhTUAwyCHuVC6Q&sig2=kv4Kn_NzX6rNVY8ZZQONJQ&cad=rjt

3.1.3.1.1 - Equity Joint Ventures

Equity joint ventures are an increasingly common manner in which foreign companies enter the China market and the preferred way to connect with the Chinese government[37]. Although China has opened quite significantly to international markets, the government's presence in day-to-day affairs is strong and is highlighted in the very key features o fan equity joint venture.

Overseas parties, in fact, are only allowed to invest at most 25 per cent of the entire registered capital in the form of cash or trade property rights[38], letting the Chinese counterpart manage most of it. However, giving up some participation is not always a hinder to performance in the case of China; in fact, it can be extremely difficult for foreigners to obtain PRC government approval in the industries mentioned above, and local partners may help to navigate the process. Moreover, the Chinese partner may help break effectively into the market by means of personal and business network.

Parties' Contribution

Whilst dealing with the capitalization of an equity joint venture, "registered capital" and "total investment" are crucial concepts foreign investors have to truly understand. According to the legal definitions, registered capital (share capital) refers to the total capital contribution registered with the relevant government agency. Total investment, instead, refers to the amount (including registered capital and funds borrowed by the company) that is required for the planned project as stipulated in the joint venture contract and the articles of association of the company. The two parties can contribute to the capitalization via different means, such as cash, buildings, equipment, technology, materials and the right to use land. Clearly, if contributions take any form other than pure cash, there must

[37] Pathtochina Consulting at: http://www.pathtochina.com/reg_jv.htm
[38] Starmass Consulting – "China Market Entry: Investment" at: http://www.starmass.com/en/investment_in_china.htm

be an agreement on the value of the other contributions upon criteria of fairness. The capital of joint ventures must also meet strict debt to equity ratios[39]:

Current PRC Ratio Requirements for Equity Joint Ventures (EJVs)

Total Investment in the EJV	Registered capital
$3 million or less	At least 70 percent of total EJV investment
More than $3 million and up to and including $10 million	At least 50 percent of total EJV investment or $2.1 million (whichever is greater)
More than $10 million and up to and including $30 million	At least 40 percent of total EJV investment or $5 million (whichever is greater)
More than $30 million	At least 33.3 percent of total EJV investment or $12 million (whichever is greater)

Source: PRC State Administration for Industry and Commerce (SAIC)[40]

Between the two capitals, registered one is subject to more stringent regulation and supervision of the Ministry of Foreign Trade and Economic Cooperation *(MOFTEC)*, which also provides both contribution methods and mandatory time limits for it:

Contribution Method	Registered Capital	Time Limit
Lump-Sum Contribution	No Limitations	within 6 months after the Business License is issued
Contribution in Installments	The first 15% to be contributed within 3 months after the issuance of the Business License; and the remaining 85% is subject to the following schedule:	
	US$500,000 or below	within 1 year after the Business License is issued
	US$500,000 - US$1 million	within 1.5 years after the Business License is issued
	US$1 million – US$3 million	within 2 years after the Business License is issued
	US$3 million – US$10 million	within 3 years after the Business License is issued
	Over US$10 million	determined by the relevant approval authority

Source: Coudert Brothers Global Legal Advisors

39 Kaizen Certified Public Accountants Limited at: http://www.bycpa.com/html/news/20076/570.html

40 Table available on The U.S.-China Business Council's Fact Sheet: https://www.uschina.org/public/documents/2011/02/equity-joint-venture-fact-sheet-2011.pdf

3.1.3.1.2 - Cooperative Joint Ventures

This joint venture is based on a cooperative contract in which matters like the terms of cooperation, the division of earnings, the ownership of property upon the termination of the contract term of the CJV, the sharing of risks and losses laid down in black[41]. Cooperative joint ventures take one of two different forms:

- A "pure" cooperative joint venture in which no legal entity separate from the contracting parties is established and the parties make their contributions to the project and bear the risk of profit and loss directly;

- A "hybrid" cooperative joint venture in which a separate business entity is established and registered and the parties' liabilities are generally limited to their capital contributions to the entity.

Although the Cooperative Joint Venture Law does not explicitly distinguish between these two types of ventures, it provides that cooperative joint ventures that meet the relevant legal requirements may qualify as "legal persons" under Chinese law. The Cooperative Joint Venture Regulations make further distinctions concerning the treatment of cooperative joint ventures with legal person status and those without. A hybrid form cooperative joint venture would generally qualify as a legal person, while a pure form cooperative joint venture would not[42].

[41] China Business News: "Sino-Foreign Cooperative Joint Venture" article available at: http://cnbusinessnews.com/sino-foreign-cooperative-joint-venture/
[42] Baker and McKenzie – " 2005 Doing Business in China Guide" can be found at the following link of the Cornell University ILR School: http://www.ilr.cornell.edu/search/

3.1.3.1.3 - Differences between EJV and CJV

For an EJV

- The distribution of profits has to take place equivalent to the ratio of the capital contributions made by the parties.
- It is always considered as a legal person, and thus a limited liability company
- Each party must make cash or permitted contributions in proportion to its subscribed percentage of registered capital
- Upon dissolution, the net assets are to be distributed to each party in accordance with its respective shareholding of registered capital.

For a CJV:

- A CJV can be a legal as well as a non-legal person, although the latter option is not very common because it would mean that the partners of the joint venture would be personally liable for any losses the company might make in the future.
- A party may contribute non-cash intangibles in the form of "cooperative conditions". Such "cooperative conditions" may consist of market access rights, rights to use buildings or office space owned or leased by the party that are not subject to clear valuation.
- The distribution can take place according to the parties' wishes. A CJV is thus a lot more flexible than an EJV[43].
- Upon dissolution, the net assets may be transferred to the Chinese party without compensation so long as the foreign party has been able to recoup its capital contribution during the term of the CJV.

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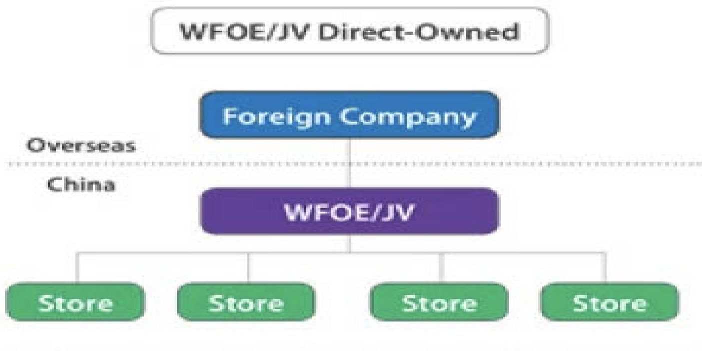
[43] China Business News: "Sino-Foreign Cooperative Joint Venture" article available at: http://cnbusinessnews.com/sino-foreign-cooperative-joint-venture/

3.1.3.2 - WFOE

The Wholly Foreign Owned Enterprise (WFOE) is a limited liability company wholly capitalized and owned by foreign investors and it was originally conceived for encouraged manufacturing activities, which were export-oriented or introduced advanced technology. However, with China's entry into the WTO, the WFOE has gradually become a common investment vehicle for mainland China-based business and is increasingly being used for service providers such as a variety of consulting and management services, software development and trading as well. A WFOE does not include branches established in China by foreign enterprises and other foreign economic organizations. Although the Chinese laws on WFOE does not provide a clear definition of branches, the term should include both the branch companies engaged in operational activities and representative offices, which are generally not engaged in direct business. Therefore, branches and representative offices set up by foreign enterprises are not considered to be a form of WFOE.

The main characteristic of such entry mode is that it does not require involvement of Chinese investors; greater control is then enjoyed and the likely amount of problems experienced may be avoided dramatically. Such problems often include: profit not being maximised, leakage of the foreign firm's intellectual property and the potential for partners to spark competition against the foreign firm[44]



Source: China Briefing[45]

[44] Corporation China; Entry Services into China

[45] China Briefing Magazine and Daily News Service – "FICE Franchising in China: A Flourishing Business Mode" available at: http://www.china-briefing.com/news/2011/07/15/fice-franchising-a-flourishing-business-model.html

3.1.3.2.1 - Business Scope

When setting up a WFOE in China, one of the most important issues is business scope, which needs to be clearly defined. It is written as a list of business activities that the WFOE will conduct in China, and the first business activity will define the overall nature of the WFOE for classification purposes. The classification will further state the minimum required capital, type of invoices and applicable taxes, According to regulations, "foreign investors are permitted to setting up a 100% foreign owned enterprise in industries that are conducive to the development of China’s economic benefits, and not prohibited or restricted by China’s government. “The 2007 Catalogue of Guidance to Foreign Investment"[46] categorises fields of potential investment as "prohibited," "restricted" and "encouraged". It is advisable to fully comprehend the interpretation of these categories[47].

Any amendments to the business scope require further documentation and, most importantly, approval. Inevitably, negotiation takes place with the authorities to approve as broad a business scope as is permitted. In general terms, business scope includes investment consulting, international economic consulting, trade information consulting, marketing and promotion consulting, corporate management consulting, technology consulting, and manufacturing.

3.1.3.2.2 - Registered capital and total investment

The total investment amount may also have tax exemption implications. According to relevant laws and regulations: (i) FIEs belonging to encouraged or restricted under the Foreign Investment Industrial Guidance Catalogue may have import duty exemption for equipment imported under its total investment for self-use, if the equipment is not listed in the Catalogue of Imported Goods Without

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[46] The catalogue is available at: http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/MinisterialRulings/P020071121358108121219.pdf

[47] Corporation China Consulting; WFOE Service

Tax Exemption for Foreign-invested Projects; (ii) where FIEs purchase domestic equipment using funds in its total investment, and such kind of equipment belongs to the Customs department's tax exemption category, the full value-added tax on the purchased equipment should be reimbursed to the FIE, and furthermore, the FIE may set off their business income tax with the purchase price; and (iii) for foreign-invested research and development institutions, the equipment imported for self-use and within its total investment can enjoy exemption from import duties[48].

The minimum registered capital for a WFOE is based on the nature of the industry. The following table provides a concrete insight into how much such contribution may amount to in Beijing, Guangzhou, Shanghai, Shenzhen, Hangzhou, Dalian, Ningbo:

Type of WFOE	Registered Capital
Consulting WFOE*	RMB 100,000 ~ RMB 500,000
Service WFOE	RMB 100,000 ~ RMB 500,000
Hi-Tech WFOE	RMB 100,000 ~ RMB 500,000
Trading WFOE / FICE	RMB 500,000 ~ RMB 1 million
Food & Beverage WFOE	RMB 500,000 ~ RMB 1 million
Manufacturing WFOE	RMB 1 million or USD 140,000

Source: Kaizen Certified Public Accountants Limited

In accordance with Chinese Company Law, at least 20 percent of the registered capital should be paid within three months from the date of registration. Immediately after the remittance of registered capital, the WFOE should arrange a local accounting firm (public accounting registered for practicing in China) to verify whether the registered capital has been contributed and paid in accordance with the regulations of the China Company Laws and/or the WFOE's Articles of Association (a process known as Capital Verification). The WFOE could use the registered capital for daily operation after the issuing of Capital Verification Report.

[48] Kaizen Certified Public Accountants Limited at: http://www.by-cpa.com

3.1.3.3 - Representative Office

The third most sought-after method of entry in China is mainly a branch office of a foreign company set up in China. The Chinese distinguish between a "representative office" (RO) and a fully-fledged "branch office" of a foreign company. An RO must be in place before the company can have a branch in China. Permission to "up-grade" an office is at the discretion of the Chinese authorities[49]. The goals of such office are to engage in market research and carry out the liaison activities with Chinese government and commercial organs, which are essential to successful business in China. This is due to the fact that are not allowed to transact business directly in China and, therefore, to generate revenues and all of their expenses have to be fully funded by the company headquarters.

The most popular sites where to locate a RO have so far been Beijing, Shanghai, Guangzhou and Shenzhen. Since business relations are the core of business success in China, it is advisable to initiate the entry process in Beijing. The advantages are that it gives access to Government departments, Embassies and other foreign businesses, and therefore provides a lot of opportunities to build links and obtain useful contacts, which may be crucial in the long run.

Pros and Cons of RO/JV/WFOE

Major Option	Description/Activities	Pros	Cons
Rep. Office (RO)	• Manage distributors • Develop business network • Able to conduct marketing activities	• Simplest way of establishing direct presence • Low investment • Allows company to learn local market knowledge • May develop business/ client network first	• Results are not certain • Have limited authority to make decisions
Joint Venture (JV)	• Joint venture with a local company; cooperative or equity JV • Manufacture and sell domestically and internationally	• May have cost advantage from manufacturing locally • Faster time-to-market • Leverage network of local partner • Lower initial investment than WFOE	• Generally considered risky • Need to manage relationship with JV partner - conflicts with JV partner are not uncommon, may be difficult to maintain control • Possible IPR [1)] issues
Wholly Foreign Owned Enterprise (WFOE)	• Different types depending on business scope – manufacturing, service, international trading, import & sell domestically	• Full control and ownership of the company • Highest return and most sustainable in the long run • Most popular for foreign entrants	• Higher investment and commitment required • Higher risk

Source: JLJ Analysis

[49] Export Gov. (U.S. Companies Export Support) – "Exporting to China: Representative Office" at: http://export.gov/china/exporting_to_china/RepOffice.pdf

3.1.3.4 - Off-Shore Company

Another method to approach the largest market in the world would be to start off in Hong Kong via the set-up of an off-shore company. This refers to a company that is formed in what is considered to be an offshore jurisdiction relative to the jurisdiction you are located in. The reasons to choose Hong Kong are many and diverse:

- Hong Kong economy system is opened and market oriented with a little government intervention. Investors can choose what businesses they do.
- The capital flows of money between Hong Kong and other countries are freedom, and without controls or restrictions. All currencies such as US$, GBP, Japanese yen, etc are remitted freely between Hong Kong and other countries[50].
- Low tax rate.
- No capital investment is required. The shareholder is only required to sign up the M & A to declare that he will contribute capital to the company, and he doesn't require to pay monetary amounts to the company.

3.1.4 - Lobbying

At the time of Chinese emperors a lobbyist would have been sentenced to death as he/she would have been perceived to dare suggesting course of actions to the Chosen One. Hundreds of years later, the approach to lobbying in China has quite changed but in a relatively ambiguous manner. In fact, although no longer seen as a national offence and illegal practice, it is a publicly known and, at the same time, covert affair; foreign companies still find it tricky whilst lying our their strategies for a position in China. The idea of lobbying is entrenched into the concept of Guanxi and the importance Chinese place on long-lasting relationships.

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[50] Corporation China Consulting; Off-Shore Company Service

Each and every deal is feasible, provided that adequate care is shown to the respective authorities. In 2000, Foreign high-tech companies discovered that the Chinese authorities had passed a law banning the sale of products that made us of encryption, among them were Motorola's mobile telephones, Intel's microprocessors, and Microsoft's Outlook e-mail program. However, American, Japanese and European companies, whose products would have been under fire, resorted to heavy lobbying strategy with ministries of trade and economics. The core of their reasoning relied on the fact that such law would have limited foreign investments in China by a greater amount, something that deeply touched China's agenda and plan to grow further in the years ahead. The Chinese authorities, therefore, weighed things up and took a considerate account of all trade talks pending in the respective Countries and decided that it would be best to relax the lax, applying solely to those products with the main purpose to generate encryption *(The Economist, Feb 15th 2001)*[51].

Not only does lobbying help consolidate a position in the Chinese market by modifying a previously passed law, as shown above, but it may also provide an opportunity to turn a negative performance around and sweep away long-established competitors, as suggested by Kodak's experience. In 1997 it faced growing competition in its domestic US market and was loosing a long-running battle with regulatory authorities in Japan, challenging what it was an anti-competitive practices that protected its key rival Fuji's hold on its own domestic market. At this time it had a limited presence of 600 people in China, importing, distributing and selling film worth $250 million.

It was competing head-to-head with Fuji and local manufacturers, but falling behind. Furthermore, investment options in China then were limited; all major M&A or majority foreign-owned joint ventures were not allowed. Kodak needed a real turn-around, a change in the local "rules of the game" to its own advantage. Kodak wanted to shut out rivals by gaining exclusive rights to produce and sell

[51] The Economist Journal. (February 15th 2001). The gentle art of lobbying in China, available at: http://www.economist.com/node/505497

locally; establish distribution, retailing, and marketing operations in China; establish production facilities for China and the South-East Asian region; and use a combination of M&A and joint venture to tap into local film business knowledge and resources. Surprisingly, it achieved all of these goals.

The key was an agreement with the Chinese government orchestrated from the very top, between Kodak's CEO and the prime minister. This resulted in a moratorium on other foreign investment in the industry (blocking Fuji and Agfa) and forcing all but one of the existing Chinese competitors to close or be acquired. Kodak was then allowed to purchase majority control of three local film companies, two of which had supplier relationships with Fuji, which was left relying on a Hong Kong company to distribute its products on the mainland. Kodak was also allowed to form two companies under Chinese company law and gain 70 percent share in one and 80 percent share in the other. The corporate structure adopted (a limited-liability share company) represented a radical departure from traditional equity joint-venture structures allowed previously allowed by the Chinese authorities. The overall investment has paid off for Kodak. It now controls most of the indigenous Chinese photo film industry and has a market share of around 60 percent, from 40 percent in 1998[52].

These events prove that lobbying can be done in China, but a word of warning comes from Brenda Chow, of British American Tobacco, who was born in the Chinese province of Guangdong, "You don't start lobbying them the first time you meet them, or you'd just run into a brick wall; I have to show them my best Chinese self."

It is expected that you get to know officials and their families, have dinner at each other's homes, and remember their birthdays. Lobbying, moreover, is usually not confined to the pure business nature and is very likely to extend onto a more personal and indirect level. Another lobbyist, in fact, tells of taking the wives and children of Chinese officials to private swimming clubs or embarking on

[52] Alan M. Rugman and Simon Collinson (2009). International Business (Soft Copy)

cumbersome processes before eventually entering real negotiations. This is due to the fact that not all firms are willing to open themselves to lobbying practices with foreigners and actually ban such contacts. Doing personal favours for officials is a “slippery slope”; being a “good corporate citizen” can gain a sympathetic ear with officials. For instance, by contributing to an educational foundation or flood relief one may win bonus points over competing organisations. Most ministries also have research centres run for profit and hiring their researchers can make it easier to get a meeting with officials.

Protocol is vital. The perceived rank a lobbyist will have when dealing with the Chinese government will have to be equivalent to the one of the official he talks to. For example, most American business lobbyists are considered senior enough to meet a deputy minister. On the other hand, a minister would probably expect to meet with a chief executive. When the meetings happen, they usually take place after quite a few months of negotiations beforehand between lower-level officials and lobbyists themselves *(The Economist, Feb 15th 2001).*

However, this is only the tip of the iceberg. In fact, regardless of whether you are a big firm deciding to “add” one more country to the ones you already serve or you are SME pondering on devoting part of your capital for brighter performance prospects, you are very likely to encounter difficulties. The rate at which you manage to tackle your problems depends on your size, experience, resources at your disposal and contacts you can build; the bigger you are, the more resources you will have and get to obtain and the more likely you are to successfully overcome difficulties. In the case of Kodak, in fact, its achievement is largely attributable to its size and quality of lobbying it managed by sending out a delegation of top managers and executives. Numerous challenges might be overcome in that way, a medium-sized enterprise could have never reached out to the prime minister of country like China easily and directly negotiate market structures to its advantage so that its business course would follow a more “common” path.

3.2 - Which Is The Best Entry Mode?

The choice of an entry mode over another depends heavily on managerial skills, needs of individual companies and, clearly, the specific industry. In general terms, for companies with limited amount of resources, as it is case with small and medium size enterprises, or without much experience on the ground, an effective strategy would involve working with a reliable local partner.

Things are different in the case of companies with strong brand names and niche offerings, in fact, they may consider setting up a WFOE. However, this must be combined with strong market knowledge and good networks on the ground[53], which are acquired after some time in China, which will be clear in the final part of this work where real cases of firms shifting from one mode to the other will be presented.

Lobbying is considered very powerful and Kodak's case showed the critical role it can play in the success of a business, even when all odds are against it. Clearly, thought, lobbying alone can only do so much to the cause and has to be complemented with one of the strategies above.

[53] IE Business School article at:
http://www.iesingapore.gov.sg/wps/portal/!ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gDf4PQMFMD_1A3g2BDI0MPVx8DKADKR5rFO7s7epiYgwQtLN0MPL0dHY39XY2N_F0NidFtYGHk6xvoF-jhaBDq4eLnbGoMl8ev288jPzdVvyA3NKLcUVERAEm5Kx4!/dl3/d3/L2dJQSEvUUt3QS9ZQnZ3LzZfMDgyTU1RTlFIQTBVSEROQzJGMTAwMDAwMDA!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/ie/My+Portal/Market+Guide/Market+Information/North+Asia/China/News/Focus+on+Central+China

3.3 - The Step After The Choice of An Entry Mode: Siding With An Intermediary and Period of Additional Research ("Incubation Period")

At this stage, it is advisable to approach an intermediary. In fact, when financial resources are limited and the margin of error is great, it is wise to take gradual moves and learn about the new market from who knows best. First of all, an intermediary, such as a consulting firm, may conduct the necessary analyses to determine whether a certain SME has the capacity and means to undertake an endeavour of this magnitude by studying the market segment it wants to enter, its competitors, as well as the human and financial resources at client's disposal; it basically allows over expectations and overconfidence to realign with actual feasibility.

Secondly, once "this test" is passed, the intermediary and the research conducted up until this point will provide a dramatic help in understanding relevant factors, such as currency stability, exchange rates or level of domestic consumption, which will shed a first ray of light on market's entry costs. Moreover, the intermediary will be able to establish the right price at which the SME's products can sell, find appropriate means of communication with end consumers and determine how its goods need to be adapted to local preferences in the first place.

Last, but not least, the intermediary supports the management of business relationships and provides accurate and reliable updates over time. However, it can be the case that a small firm wants or needs more time before carrying out with the whole process; such time is herein referred to as incubation period. In this time frame, the firm interacts with its intermediary and further researches the market, follows its evolution and investigates shifts in demands over time in order to be well-equipped for when it decides to become fully operative.

3.4 - Chapter Summary

The size of China and the different types of cities (as described in chapter 2) prompt the question of how to enter the market effectively. Different strategies are currently used; the major ones involve settling licensing/franchising agreements, choosing one of the foreign direct investment types, such as representative office, wfoe, joint venture and off-shore company, working on lobbying action with local and national authorities. A best stand-alone mode does not exist, managerial skills, individual companies' needs and the industry they want to be in are all factors that influence the success of a mode over the other. It may be better for small firms to work a reliable local partner, while others may directly choose the wfoe option. It could even be the case to choose one mode and gradually move to another as adjustments are made. Finally, having an intermediary is recommended to reduce the chance of failure.

CHAPTER 4: Introducing a Major Challenge For Firms: Chinese Culture and Guanxi

Introduction

Choosing and operating an entry strategy may not be enough to boost the chances of success in China. Culture in general, but especially in China, represents the one cut-off[54] determinant. This chapter aims to shed some light on the differences of Chinese culture, on Guanxi dynamic and its crucial role in private and business relationships, and on the benefits this could bring to its members.

4.1 - Differences Between Western and Chinese Cultures

The culture of a country is the first and, quite often, the greatest barrier to deal with and overcome. In some countries, like the US, it might not pose major concerns, but as we approach the East, particularly China, a misstep and all of your efforts and reputation fade away. Below are framed the main differences between Western and Chinese cultures:

Stereotypical West	Stereotypical China
Clearly defined individual responsibilities	Group responsibilities
Creativity and innovation	Respect of rituals and tradition
Equality	Hierarchy
Task orientation	Relationship orientation
Individualism	Collectivism
Direct communication	Indirect communication
Address conflict directly	Maintain face and avoid conflict
Lean-management	Over-staffing

Source: Courtesy of CRCC Asia[55]

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54 By cut-off determinant one means the one scrimmage factor among firms seeking success in China

55 The table above was illustrated on a Power Point presentation during the welcome session in Beijing in July 2010

Misunderstanding these differences can place your future success at stake. To begin with, in fact, the relationships you build with your employees and manner in which you treat them live off the idea of strict hierarchy and collectivism. This is quite crucial; since you will have to employ Chinese staff as well, you ought to recognize the hierarchical structure they are used to. Collectivistic cultures, like the Chinese one, have a great emphasize on groups and think more in terms of "we". Harmony and loyalty within a company is very important and should always be maintained and confrontation should be avoided.

A Chinese employee will never question his/her employer in public and will do that in a more private and personal atmosphere to protect a person from the "loss of face". Particularly, the concepts of loosing face (*Mianzi*) and indirect communication are pervasive in the daily life of a Chine; David Yaou-Fai Ho, a Hong Kong social scientist defines "Loosing face as follows: "Face is lost when the individual, either through his action or that people closely related to him, fails to meet essential requirements placed upon him by virtue of the social position he occupies." (Hofstede, 1976)[56] This can be compared with "self-respect" in individualistic cultures. There is understanding and help for employees who have poor performance[57].

If someone has "good face", it implies he/she has a good reputation in front his/her peers. If someone has good enough face, in some cases they can even walk into a lending institution (such as smaller, privately operated banks), and take out a loan on their word only. People with good face are generally dependable, reliable, and safe to do business with[58]. Complementary is the idea of "never saying no" in public. Expressions or phrases are instead used that describe a disagreement or negative statement instead of saying no. Saying no would mean to destroy the harmony in the group and, likely, to make someone loose face. The relationship between employer and employee or business partners is based on

56 Article available at: http://www.via-web.de/individualism-versus-collectivism/

57 Hofstede, Geert (1994). Cultures and Organizations – Intercultural Cooperation and its importance for survival". McGraw-Hill, London

58 Associated Content: John Melendez - The Concept of "Face" in Chinese Culture

trust and harmony and a deep understanding of moral values. The wealth of the company and the groups inside are more important than the individual one's.

The group, as opposed to the single individuals, is therefore a constant that needs to be taken into account when deciding to locate to the East. Western firms may be used to allocating certain amount of work to single employee and placing the responsibility for the outcome on them, but doing so in China may result in poor performance, as studies suggest. In this regard, it is relevant what Christopher Earley[59], an American management researcher, found out.

He gave 48 management trainees from southern China and a matched group of 48 management trainees from the USA an 'in-basket-task' consisting of 40 separate items requiring between two and five minutes each (*Earley, 1989*). The task involved such activities as writing memos evaluating plans and rating job candidates' application forms. Half of the participants from each country were given an individual goal of 20 items; the other half were given a group goal of 200 items to be completed in one hour by 10 people. In addition, half of the participants from either country, both from the group and from the individual goal subsets, were asked to mark each item with their name; the other half turned them in anonymously.

The Chinese, collectivist, participants performed best when operating with a group goal and anonymously. They performed worst when operating with individually and with their name marked on their work. The individualist American participants performed best when operating individually and with their work attributed to them personally, and performed very poorly when operating as a group and anonymously (*Lisa Hoecklin, 1995*)[60].

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59 Earley, Christopher. (1989). "Social Loafing and Collectivism: A Comparison of the United States and the People's Republic of China". Administrative Science Quarterly (Published by: Johnson Graduate School of Management, Cornell University). 34 (4), p565–58.

60 Hoecklin, Lisa (1995). Difference in work ethos between an individualist and a collectivist society, "Managing Cultural Differences: Strategies for Competitive Advantage", p37.

4.1.1 – Impact of Cultural Differences on Everyday Business: Contract in China vs Contract in The "West"

A signed contract in the "West" is typically well-defined in nature: the parties know their roles, tasks and the agreed-upon deadline and they agree to do everything they can to fulfil their contractual obligations. The contract, therefore, represents the point where divergent interests meet and the end of negotiations. However, things are slightly more complicated in China and it is likely that the contractual promises mentioned above are not fulfilled. In fact, a contract only signifies the beginning of negotiations; by signing it, the parties agree to do business with one another, to view the goals of the contract as desirables and the terms as reasonable. However, life is known to be unpredictable, therefore planned activities may not always happen as planned. This belief is a constant in Chinese culture and every citizen lives by according to a principle of "get the most out of today as no one knows about tomorrow".

Moreover, such unpredictability and instability is increased by the very same characteristics of China; in a country where regulations differ across the entire nation's regions and are applied on a case-by-case basis, foreign firms hoping to rely on courts to settle down their disputes may take a great chance.

To complicate matters even more, Chinese never say "no" directly but rather, they imply it in their manners and behaviours. This generates increasing misunderstanding among foreign firms, which believe a deal is settled only to find out in the end that the Chinese party really did not mean to and actually agreed fully to enter negotiations.

Therefore, signing a contract in China and walking away to wait for the desired result is the best thing to for the worst blunder. For as odd as it may sound to Western companies, assuming that the contract is just the beginning of negotiations and that the terms may vary is just the way business is done in that country. Not only do Western firms need to form realistic expectations, but they also show a willingness to adapt to the many cultural differences the challenge may provide.

4.1.2 - 4 Guidelines to Iron Out Cultural Kins in Every-Day Business Affairs

Despite clear issues that may come up out of cultural differences, Nonetheless, the following four guidelines[61] may prove beneficial in conducting business affairs with Chinese counterparts:

1) Constant Communication

Successful business contracts in China revolve around frequent communication; this reduces the probability of a party not fulfilling agreed-upon obligations and/or changing requirements in due course.

2) Engaging Conversation

Conversations ought to be structured in a two-way process: resorting to “yes, no” questions will not generate useful information. This is explained by the cultural need to to “save face” and to preserve harmony in China, which will be dealt with later in this work. Instead, it will be much more informative to take a qualitative approach and ask indirect questions; instead of asking your Chinese contact if the production deadline will be met, request, for example, that recent activities of members of its team are described to you

3) Meet Face-to-Face

While some conversations can take place over the Internet, by fax, or via phone, they will only be successful if they are complemented by follow-up conversations to face-to-face meetings. Chinese relationship culture requires one-to-one commitment and this does not happen overnight, it develops by working together and interacting in person; verbal communication maintains harmony and, most importantly, saves face. Indirect communication is enhanced if it is combined

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[61] Dr. Camille Schuster, (2004). “How to manage a contract in China" available at: http://www.connectionsmagazine.com/papers/4/19.pdf

with live observation of facilities, systems, and business processes and this can only be done in person. It is highly recommended to plan frequent business trips and, of course, empower them with the presence of an intermediary, as previously discussed.

4) Represent All Levels

Finally, several members of your team who are at different levels of the hierarchy must enter the equation. The Chinese culture is extremely hierarchical and problems are not freely discussed with superiors. For instance, a front line worker will not discuss problems with the company Vice President. By having members of your team at different levels one increases the chances to fit within the Chinese corporate structure: quality control managers will talk with other quality control managers, vice presidents talk with other vice presidents, and managers talk with other managers. Moreover, it will be a clear sign that seriousness of intents is present and there is interest in proceeding further along the line of business affairs and relationships.

4.2- GUANXI: The Lifeblood of Chinese Community and A Determinant of Firms' Success or Failure

Guanxi is the Chinese equivalent of "relationship" or "connection" in English. In the Chinese language, Guanxi is a phrase which consists of two Chinese characters. The first word (guan) means "gate". The second word (xi) is a verb, which means to "connect" or "link"; but it means more than connection. Guanxi is considered as friendship with implications of reciprocal exchange of favours.

The deeper significance of Guanxi was revealed in a comprehensive study by Chu and Ju (1993)[62] conducted in Mainland China in 1988. Its research target was the local Chinese in Shanghai and Qingpu (a rural county outside Shanghai). Both urbanities and rural dwellers were invited to participate in the research. Of the 2000 respondents, an overwhelming majority (92.4 percent) confirmed the importance of social connections in daily living. Only 7.5 percent negated its significance. It was found that younger people placed greater emphasis on Guanxi than older folks, 46 percent of young people believed in the importance of Guanxi, as compared to only 35.1 percent of the latter group. Guanxi is so prominent in China that it leads scholars to term the arts of establishing and managing Guanxi as "Guanxixue", (relationology), or the "Chinese gift economy" (*Yang 1994*)[63].

To fully understand the role Guanxi networks play in the Chinese society, and in business, it is necessary to understand where Guanxi finds its roots. They are embedded in the Chinese belief of Confucianism, which is a set of rules and values as defined by Confucius. Confucianism is based on the belief that a person is not a separate entity, but socially interactive (*Luo*, *1997*)[64], and the central element of is maintaining peace and harmony with the group.

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62 Chu, G.C., and Ju, Y. (1993).The Great Wall In Ruins. Albany State University Press.
63 Yang, M (1994). Gifts. Favors and Banauets. New York: Cornell University Press.
64 Luo, Y. (1997). Guanxi and Performance of Foreign-Invested Enterprises in China: An Empirical Inquiry. Management International Review, 37(1): p51-71.

The Confucian belief of maintaining harmony creates "a social hierarchy strong enough to harmonize a large and complex society of contentious human beings" (*Luo, 1997*). Furthermore, years of hardship experienced by the Chinese, due to social and economic factors, stressed the importance of ensuring the wellbeing of the group and the individuals connected to networks (*Luo, 2007*)[65]. Consequently, these networks are found in both the social context, for example family, as well as in the business context, and it is through a shared context that the networks are created (*Katrine Vanggaard Madsen, 2009*)[66].

Who you know is more important than what you know." "Who you known" highlights personal connections among persons. "What you know" could refer to business details, including the price and quality of the product or service[67]. As mentioned before, Guanxi implies a moral obligation of exchanging favours (**renqing**) and could be divided into intangible and tangible assistance (*Fan Y, 2002*)[68] as the source of resources. Reciprocal favours represent the "link to link" and the key ingredient to maintain the Quanxi in the long run. As Hwang (1987) addresses it[69], the development of renqing is the basis of the establishment or use of Guanxi. Luo and Chen (*1996*) add[70] that favour (renqing) as a form of social asset could serve as leverage during the interpersonal communications.

What this entails is that there ought to be **reciprocity** within the relationship of the two parties; favours should not be seen as a forced attempt, they should be carried out consciously and with the intent to "do good". The goal would be to gain a **degree of trust**, which is another important factor to focus on when

65 Luo Y(2007). GUANXI and BUSINESS. 2nd ed. London: World Scientific Publishing Co. Pte. Ltd.. All.

66 Katrine Vanggaard Madsen (2009). The Convergence of Knowledge Management and a Guanxi Network. Bachelor of Arts. Denmark: Aarhus School of business.

67Yumei, H.Y, (2009). The Stakeholder View with Guanxi: A Case Study of Managers in Chinese Aquatic Product Industry. Master's. Tromso-Norway/Nha Trang-Vietnam: The Norwegian College of Fishery Science University of Tromso-Nha Trang University.

68 Fan, Y. (2002). Questioning Guanxi: Definition, Classification and Implications. International Business Review. 11: p543-561.

69 Hwang, E. R. (1987). Face and favour: The Chinese power game. American Journal of Sociology, 92(4), p35-41.

70 Luo, Y. & Chen, M. (1996). Managerial Implications of Guanxi-Based Business Strategies. Journal of International Management.

analysing Guanxi and its effects on our performance. In the same way as it is crucial in Western business relationship, trust plays a key role in Chinese business affairs. According to Ch'en (*Ch'en, C. 1986*)[71], five basic virtues from the teaching of Confucius have been extracted including humanity, righteousness, propriety, wisdom and faithfulness. Among them, the characters of righteousness and faithfulness form a match with the definitions of trust. As shown, again, teachings from Confucianism play a significant role in how Chinese society act on a daily basis; Guanxi is a "dominating card" to hold to capture numerous opportunities but the trust (xinren) you can build will determine the evolution and success of your Guanxi. As we have seen, trust, Mianzi, reciprocity, renqing are salient principles related to building successful relationship in China. However, there are two more that are worth exploring to have an enhanced view of what it takes to effectively do Guanxi, namely: ganqing and ethics.

Ganqing is the degree of closeness between the parties involved. The higher it is, the greater the possibility to build trust, hence attaining better Guanxi, as confirmed by Tsang (1998)[72], who believed that ganqing between persons can be built up by the experience of sharing and interaction through the process of living, working or studying together. The cultivation and nourishment of ganqing is a way to maintain and consolidate Guanxi between two parties.

Ethics, instead, can be seen as the rule governing Chinese in their life. In fact, Chinese say that it is impossible to achieve anything without norms and standards to follow; such approach to life is easily spotted in every Chinese, both at university and work level. The reason to abide by the principles and follow the rules is, again, the goal of harmonious society. Although it might not be easy to observe the relationship between Guanxi and ethics, there actually is and it is also quite strong. As Vanhonacker (2004)[73] in fact points out, Guanxi served as a

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71 Ch'en, C. (1986). Neo-Confucian Terms Explained. New York: Columbia University Press.

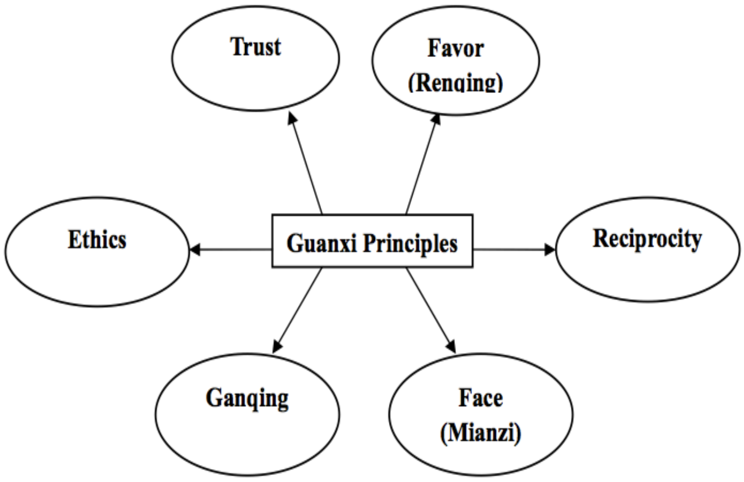
72 Tsang, E. W. K. (1998). Can Guanxi be a Source of Sustained Competitive Advantage for Doing Business in China? The Academy of Management Executive, 12: p64-73.

73 Vanhonacker, W. R. (2004). Guanxi Networks in China. The China Business Review, 31: p48-53

necessary social function complies by its own **ethical norms and codes**. Westerners might consider Guanxi as a shortcut by which Chinese seek favours from others, which is immoral according to western ethics. But, in China, once one uses Guanxi to obtain something, he/she will have an obligation to repay something in the future time (*Han Yumei*, *2009*)[74]. But one should be aware of the scale of returning the favour; in fact, if a person receives favour from another, he/she ought to repay much more than what was given out at the outset.

However, we should refrain from relating the value of Guanxi to any money-based commodities or transaction, as an American or European may think. This implies that it is impossible to make Guanxi balance, that is to return a favour, by using materials or money but according to the heart, conscience or morality. The bottom line is that in usual conditions, "you can't buy your Guanxi out" as if you were in a market; this would be considered corruption and make you loose **face** as well as trust before everyone else's eyes.

To sum up our first analysis of Guanxi, below you can find a structured scheme depicting all principles we defined and delved into up until now.



Source: Han Yumei (2009)

[74] Yumei, H.Y, (2009). The Stakeholder View with Guanxi: A Case Study of Managers in Chinese Aquatic Product Industry. Master's. Tromso-Norway/Nha Trang-Vietnam: The Norwegian College of Fishery Science University of Tromso-Nha Trang University.

4.2.1 - Evolution of Guanxi Through History

The above structure still holds nowadays, but it has undergone significant changes over time. Prior to the 1940s, social relations in China were characterized by friendship and personal commitment. Both characteristics arose from continuous interaction amongst individuals. However, this harmonious status was vigorously impaired when the Chinese Communist Party commenced the terrifying Cultural Revolution. The Revolution had a profound impact on the nature of social relations because it forced social relations to undergo a transformation from trustful friendship to skeptical comradeship. From then onwards, social relations among individuals were deeply coloured by instrumentalism and distrust (*Gold 1985*[75], *Vogel 1965*[76], *Yang 1994*[77]). After the party had established control over the country in 1949, they launched a series of campaigns aimed at achieving control over people's life. They promoted the ideal of creating a new socialist man for the new society. They selected particularistic social relations as the target of attack because it ran against their advocated comradeship.

Friendship is sacred in China and requires individuals to have specific relations with each other. The relationship is nourished by a bond of personal commitment and trust between the parties involved. Yet, it is against the ideology of comradeship. Comradeship is a universalistic morality that puts absolute emphasis on equality among individuals. There are no in-group and out-group identifications because all individuals are supposed to be equal and have universal standing in status or in the degree of closeness (*Gold 1985, Vogel 1965, Yang 1994*). Comradeship is characterized by helpfulness, civility and concern for others. However, helping is given a special meaning. It is a fulfilment of the obligation of being a comrade in Communist China (*Vogel, 1965*). The value transformation of relationships in the Cultural Revolution was accomplished

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75 Gold, T.B (1985). "After Comradeship: Personal Relations in China Since the Cultural Revolution", Vol. 104: p657-675.

76 Vogel, E.F. (1965). "From Friendship to Comradeship: The Change in Persona1 Relations in Communist China."China quarterly, No.27: p46-60.

77 Yang, M (1994). Gifts. Favors and Banauets. New York: Cornell University Press.

through fear. Fear arose because people were unsure when their sharing in private conversations with friends would be subject to sanction by the Communist authority. Friendship as a relation of confidence and affection declined. Not only were the trustful relationships between friends weakened, the bond among family members was questioned as well. Children were taught how to be dutiful comrades and gave "little reports" on family affairs to their teachers. Hence, the risk was omnipresent and there was a prevailing mood of scepticism among people. This had profound impact on social relationships because individuals were reluctant to share information, which might provide undesirable evidence for criticism in future campaigns.

Consequently, cynicism became pervasive in social relations that were then viewed only as a tool to advance personal interests, rather than relations of mutual trust and intimacy. (*Gold 1985, Yang, 1994*) An extreme form of instrumentalism started to emerge in Guanxi relations after the Cultural Revolution, and it persists in China today. At present, the pragmatic impulse of individuals is to seek personal gain replaces some of the affective elements in Guanxi relations. Individuals are related to one mother through cash exchanges rather than through affective connections (*Gold, 1985*).

In addition to the stress on instrumentalism, the value transformation has also heightened the importance of in-group and out-group identity (*Gold 1985, Vogel, 1965*). As opposed to the goal of comradeship, which accentuated universality, the great sense of insecurity induced by political pressure drove people, for self-protection, to be very cautious in confiding information. Whether individuals would be perceived as in-group members depended on their trustworthiness.

Generally, such credibility was found more in family members or relatives than in outside strangers. Hence, the Revolution imposed a dual effect on social. relations in China. On one hand, it unwittingly strengthened the solidarity of familial members; but on the other hand, it widened the gap between in-group and out-group members (*Redding, 1990*)[78].

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[78] Redding, S.G. (1990). The spirit of Chinese Capitalism.

The mentality of the Chinese was demonstrated in a study on Chinese students in America, who were found to have great family loyalty but displayed a higher level of distrust towards strangers (*Sue & Kirk, 1972*)[79]. Respondents admitted that they would not trust strangers until they knew them better. This suggests the existence of great suspicion in social interaction with out-group members.

In short, the Cultural Revolution had a profound impact on the nature of social relations in China. Not only did it break down the traditional social order, but it put the domain of social relations on a platform of comradeship and dressed it in a thick coat of instrumentalism and in-group solidarity. The two elements, compounded by the dominance of personal power, economic /social disarray and political dictatorship, fuelled the widespread dissemination of Guanxi that has penetrated into every single aspect of life in China.

4.2.2 - How To Maintain One's Guanxi and Alleviate Cultural Misunderstandings in Relationships

The connection alone is not a guarantee of success. It has to be constantly reinforced and maintained through continuous social interaction, which can be in form of exchanges of gifts and favours. When a gift has been received or a request for a favour has been granted, different mechanisms immediately occur in the relationship (*Yang, 1989*). Each is designed to deepen the commitment of both parties to the Guanxi connection.

The first mechanism is called incorporation. This is a "symbolic breaking down of boundaries between persons" (*Yang 1989*). The favour or the request granted is identified with the donor, and thereby embodies a personal substance of the donor. Hence, when it is accepted, the personal identity of the donor symbolically enters the personal space of the recipient. This will reduce the barrier between the donor and recipient, thereby breaking down the boundaries. The mechanisms triggers the process of moral subordination. The power struggle manifests itself in

[79] Sue, D.W., and Kirk, B.A. (1972). "Psychological Characteristics of Chinese-American Students."

the contest for face and in the struggle for moral superiority between the two individuals. Face is cardinal to the personal identity of a Chinese because the personhood is attained by approval of his/her significant others. Face can thus be defined as "the individual's assessment of how others close to him see him."[80]

There is a direct relationship between face and power. The greater the face an individual has, the more prestige and power he/she is supposed to possess. When a gift is accepted or a request is granted, the face of donor is enhanced, thereby increasing his/her prestige and power as well. This leads to an imbalance of power in the relationship. The donor assumes moral superiority over the recipient. The imbalance of moral status and face in relations leads to the third process: appropriation.

After accepting the gift or the favour, the recipient is indebted to the opposing party. The recipient will then try to restore the balance of power by repaying the gift received and giving out another gift, or by helping the resource allocator in other ways. The balance of power is restored by means of reciprocity. These mechanisms of power depict the operating cycle of Guanxi relations.

The second cycle of power struggle begins when the recipient repays the social debt, and there is a change in identity. The individual who was formerly the recipient becomes the donor and viceversa, and all of this it leads to repeating cycles of reciprocity, which will never end unless there is a break-up in the relationship.

It is this repeating reciprocity that deepens the commitment of each party to the relation, thereby strengthening the Guanxi connection. In addition to the continuous exchanges of gifts or favours, Guanxi connections can also be promoted through multiplex relationships. This is to cultivate more commonalities or more Guanxi bases when a single-stranded relation has been developed. It can be achieved easily by sending children to the same school or by marriage.

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80 Yeung, Irene Y.M. (1986). THE DYNAMISM OF GUANXI IN COMPANY PERFORMANCE IN CHINA. B.A. thesis, University of Windsor.

The objective is to strengthen the base of familiarity between two parties and to provide a more consolidated support for future Guanxi development. In this way, multiplex Guanxi is more resistant to deterioration than single-stranded relations. For Guanxi maintenance, the mutual satisfaction of the personal interests of both parties is essential. Relations can be easily broken if either side disappoints the other party in the social exchange processes by excessive demands or by a blunt rejection. Excessive demands will overstrain the delicate relationship and create a tendency of avoidance by the opposing party. A rejection will destroy the sense of dependability and cast distrust in the relation.

4.2.2.1 - Dependability

<u>Dependability</u> is essential in Guanxi maintenance because it <u>denotes the trustworthiness of individuals in the Guanxi network</u>. As discussed in the previous sections, trust exists only among in-group members who are supposed to fulfil the obligation of responding to the requests of other members in the same network.
If individuals abide by the rules of the exchange game and fulfil the role requirements, they are considered as reliable and trustworthy and are entitled to the benefits of Guanxi. On the contrary, rejections to other members' requests for no valid reason will be judged as unwilling to take up role obligations. Individuals will then be criticized as undependable and will be labelled as outsiders. They will be excluded from the Guanxi network and lose all Guanxi benefits.

4.2.3- Categories of Benefits Deriving From Respectful Guanxi Maintenance

On top of the knowledge supplied on the importance and establishment of Guanxi via a direct analysis of its origins, ethics and workings, this paper aims to expand such knowledge by examining the various categories of benefits Guanxi encompasses.

To do so, we examined a study that was already conducted by Howard Davies, Thomas K.P. Leung, Sherriff T.K. Luk and Yiun-hing Wong back in 1995[81] conducted. It involved Hong Kong Chinese Executives experiencing business with the Chinese. The study was in the form a questionnaire, which overlooked an array of factors, beginning with how important those executives thought Guanxi could be, and listed benefits categories arising from Chinese networking. The executives had to assign a grading to each of these categories

The first category was concerned with information and its sources. A clear example of it is market intelligence; while in a Western society market intelligence sources are, generally, widely available, in China these are limited due to the way its society was shaped over centuries. Therefore, a Guanxi member may bring a wealth of information resources that would be almost impossible to access in a regular setting. In addition to this, knowing someone in a Guanxi of interest may help in gathering insights into future government policies and restrictions.

The second category highlighted concerned sources of sources. Under the traditional state distribution system of China, the Communist party retained control over the means of production and allocation of resources in the country. To counteract the unbalanced state distribution, the people used Guanxi to secure restricted resources. Therefore, the more Guanxi network individuals had established, the greater relations they had at their command, thus the more advantageous positions they could be in to mobilize restricted resources for personal interests.

Finally, the third category of benefits suggested that Guanxi could yield other tangible assets, such as securing access to land, labour, rights, import licenses, local and central government approvals, smoothing transport arrangements, directly smoothing collection of payments and company's build-up of image and reputation and, last but not least, smoothing the routine running.

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81 Howard Davies, Thomas K.P. Leung, Sherriff T.K. Luk and Yiun-hing Wong (1995). "The Benefits of Guanxi: The Value of Relationships in Developing the Chinese Market".

A more recent article that was posted on the Journal of Business Ethics in July 2002 reinforces the results obtained in the aforementioned study and adds a few more “profits”. Ying Fan[82], in fact, reported that Guanxi gives the opportunity to acquire:

- Business/ import/ export license
- Land, property, shares, personnel hiring, key supplies
- Cheap bank loans or foreign exchange
- Inside confidential information
- Secure a market o distribution channel
- Official endorsement for a poor product

A final advantage enjoyed by the members of such a network that Fan discussed was protection. This encompasses just about any form of protection an individual, a company, a corporation could dream of. More often than not, protection is sought after from threats and troubles, such as fines, tax increases, legal battles, bankruptcy and consumer compensation in case of faulty/harmful products. In short, Guanxi offers immunity from the law.

Fan, however, then continues to use the same benefits he presented to show the dark side of Guanxi. Although, this paper recognizes the truth in his conclusions, an analysis of negative impact of Guanxi on Chinese society is out of scope. The idea behind the omission of detrimental effects of it lies in the reasoning that a firm, at the stage that we have brought it to, should refrain from considering a problem before having actually entered and played in the market.

[82] Fan, Y.(2002). Guanxi's Consequences: Personal Gains at Social Costa. Journal of Business Ethics. 38 (4), p371-380.

4.3 - Chapter Summary

Cultural differences impair the ability of people, hence business too, to interact with each other easily, they create barriers that take time to be overcome. Chinese culture is, in fact, a major obstacle especially to Western firms and adequate understanding of what makes it different is key in smoothing business relationships. Once the key differences between Western and Chinese cultures are clear, a further step requires to fully comprehend the dynamics of Guanxi that are so pervasive in both business and personal lives. Understanding Guanxi and being able to do it become crucial in business success in the long run, as a series of benefits may stem from respectful maintenance of it.

CHAPTER 5: How Long Will China's Growth Last?

Introduction

The previous analyses and discussions generated the conclusion that China is an optimal market to invest resources and energies in, given its outstanding growth and lingering potential to be exploited, that entry opportunities as well as cultural challenges and dynamics do exist for businesses. However, doubts about China's ability to maintain its current growth rate legitimately arise and the question of whether China's growth will last in the next few years erupts This chapter will attempt to find an answer to this question by presenting a series of economic, social and geopolitical issues China is facing that have recently been reported on renowned newspapers and academic papers, and will explain why these are important to the case at hand.

5.1 – Adjustments Issues or Early Signs of Economic Slowdown?

Albeit all major tassels of information about China have been supplied and the relevant “feasiblity-market” questions answered, now comes the big question mark that is keeping most analysts in the field awake at night and hyper during the day: how longer can China sustain its booming economy before it blows up itself?

We have already concluded that China possesses the potential to continue growing the future, but worries are present about what its boom sustainability. Talks and words are being spared on the topic by all major journalists and newspapers, which bring up a wealth of different standpoints that do allow to enrich one's view with quality information.

On The Economist article issued on October 22nd 2011, the dreary performance of Chinese stocks listed in Hong Kong, the rising price of insurance against a Chinese sovereign default, and rare, downward pressure on its currency feed the mouth of fear of China[83]. The article, moreover, adds that such fear is nothing but a mere reflection of problems that run far beyond China's own border or its government's rigid influence[84]. For instance, sales to the EU, displayed a downward trend by registering a 7,5 percent in September, thus alarming relevant authorities as it was an event that had not occurred since 1995.

Nearly at the same time, China became a net exporter of a fear-related product, namely anxiety. Inflation may be falling, but it flew at high altitude for longer than expected. To make things a slightly more worrying than they could already seem, Chinese property market is facing an adjustment period and seem to be showcasing a slowdown, as developers/builders await a demand pick-up in order to avoid selling at a discount.

The wait becomes all the more painful when one realizes what it needs to be done to cool inflationary forces: tightening the taps of credit. The logic is simple, less money available, less money is spent, thus all the other mechanisms that enter the equation once one is on a spending spree are quenched. The result of this measure is high kerbside rates and indebted businessmen performing a runner from their homes. This unfortunately makes sense if we recall our analysis of Guanxi; admitting public failure may be seen a loss of face to the public's eyes, so it may be a better option to leave and never come back to a specific place.

The Chinese government, however, seems reluctant to ease its grip on measures of this at a time of high inflation. This will prove to be a great challenge for the government in the next years. On one hand, growth is stimulated by continues increases in demand, which is in turn propelled by greater availability of money at hand; on the other hand, too high increases in demand push prices, expectations and wages up and skyrocketing inflation is certainly not what an economy needs to attract foreign firms interested in, for example, relocating their production in China.

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83 The Full article is available at: http://www.economist.com/node/21533405?fsrc=scn/fb/wl/ar/afraidofabump

84 According to government officals, control is needed to maintain unity and peace

For the time being, it appears as if the government is a match for the challenge and can keep a lid on the financial system. In other countries, alleviating the symptoms without tackling the fundamental causes could not go of for ever without a painful wake-up, but in a closed system, as it it is that of China, it actually can.

5.2 - Other Side of The Coin: China's Geopolitical Issues

Besides the economics worries that people have about China, it is worth noting that an economy's stability is dependent on its geopolitical stability. To this extent, a great deal of research has been devoted to analysing the development of Chinese territorial issues over time and how these could interfere with China's economic growth and stability. Territorial disputes are in the South China Sea and East China Sea are of remarkable geopolitical significance because they represent an intersection of history, territory sovereignty, geostrategy, and energy security.

A recent article published by China Briefing[85] helps in shedding spotlight on three major disputes. It does so by dividing issues into territorial and maritime sovereignty, it then goes on describing each of the three disputes that have been afflicting China and its people. Due to academic scope matters, this paper will only discuss two of the three disputes and will start precisely with territorial disputes. These stem from claims of ownership of land itself and usually refer to historical presence in determining rightful control. Maritime boundary ones, instead, relate to the territorial delimitations defined by the 1982 United Nations Convention on the Law of the Sea (UNCLOS III)[86].

85 China Briefing is published by Asia Briefing Ltd, and was founded by Chris Devonshire-Ellis, the Principal of Dezan Shira & Associates in 1999.

86 The full text can be found at:
http://www.un.org/depts/los/convention_agreements/texts/unclos/unclos_e.pdf

5.2.1 - Spratly Islands

The South China Sea, an area of 800,000 square kilometres, is for the most part rimmed by land. Many of Asia’s most influential states are its littoral countries: Malaysia, Brunei, Indonesia, the Philippines, Thailand, and Singapore; the Indochinese countries of Cambodia and Vietnam; and the People's Republic of China and Taiwan[87].

The South China Sea’s significance has been recently highlighted much for its abundance of natural resources such as oil and natural gas. The international Energy Agency reported in September 2010 that "total Chinese oil demand is expected to average 9.5 mb/d in 2011"[88]. As a consequence, over the past two decades competing claims to island territories, cast governments, especially Chinese one, into a tangled nexus of regional jurisdictional conflicts and rivalries[89]. Securing enough energy to sustain its economic growth is "just too" important for China.

South Chinese Sea is composed of various islands scattered throughout the region, among which are the Spratly Islands and Paracel Islands. The islands are vital to China for various reasons. To begin with, they are the world’s most productive areas for commercial fishing and the region itself is also one of the busiest shipping lanes. Secondly, and most importantly, they are rich in natural resources that vital for China's economic growth, as mentioned above. Last, but not least, their location is strategically crucial; they lie between Vietnam and Philippines, which means they offer a critical staging location for blocking ships traversing the South China Sea[90]. A first fire of tensions flared up in 1992, when China passed a

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87 Heinemann World Atlas (1995), 78–81; J. R. Morgan and M. J. Valencia eds., Atlas for Marine Policy in South-East Asian Seas (Berkeley: University of California Press, 1983), p3–4.

88 International Energy Agency: http://www.iea.org/

89 Christopher C. Joyner. "The Spratly Islands Dispute in the South China Sea: Problems, Policies, and Prospects for Diplomatic Accommodation"

90 Joyner, Christoper (1999). "The Spratly Islands Dispute in the South China Sea: Problems, Policies, and Prospects for Diplomatic Accommodation." Investigating Confidence Building

special territorial sea and contiguous zone act to legalize its claims to the Spratlys. Article 2 of this legislation specifically identifies Spratly archipelago as Chinese territory[91].

Claims by Taiwan today resemble those of China; the bases for Taiwan's claims are its historic ties to the area into question[92]. However, claiming legal title to sovereignty simply upon alleged links between their discovery and Taiwan is not enough to rule out other contenders in the dispute.

Vietnam, instead, forwarded its claims basing its argument on historic activities during the Nguyen dynasty (17th–19th centuries) and the right of cession that was apparently bestowed by the French in 1933. However, doubts emerged with regard to the authenticity of the historical record Vietnam supplied[93] and to legal title that France possessed before giving it all to Vietnam. Nonetheless, Vietnam moved in 1975 and occupied thirteen islands of the group. Moreover, in 1989 it acquired presence in three more islets; by 1999, the number of troops it had sent there surged and reached a remarkable number of 600[94].

The Philippines also entered the arena of claims and justified its on the "discovery" of specific islands by Thomas Cloma[95] back in1947. To defend this position, they sent hundreds of on eight islands[96].

Measures in the Asia Pacific Region. Ed. Ranjeet Singh. Washington DC: Henry L. Stimson Centre.

91 The Law of the People's Republic of China on the Territorial Sea and Contiguous Zone became effective on 25 February 1992. See People's Daily Beijing, 26 February 1992, 4, reprinted in United Nations, Law of the Sea Bulletin No. 21 (August 1992), 24–27.

92 Kien-hong Yu, "Reasons for Not Negotiating on the Spratlys: A Chinese View from Taiwan," in Hill et al., Fishing in Troubled Waters, p139–149.

93 Valero, Gerardo M. C. (1994). "Spratly archipelago dispute: Is the question of sovereignty still relevant?". Marine Policy. 18 (4), p320–22.

94 Joyner, Christopher (1999). "The Spratly Islands Dispute in the South China Sea: Problems, Policies, and Prospects for Diplomatic Accommodation." Investigating Confidence Building Measures in the Asia Pacific Region. Ed. Ranjeet Singh. Washington DC: Henry L. Stimson Centre.

95 Thomas Cloma, an enterprising Filipino businessman and owner of a fishing fleet and private maritime training institute, aspired to open a cannery and develop guano deposits in the Spratlys

Finally, even Malaysia and Brunei have recently brought up claims to certain islands and reefs in the Spratlys, mainly relying on certain continental shelf provisions in the 1982 LOS Convention[97].

In short, the geopolitical situation remains complicated and the possibility of military clashes increases, albeit the time being there is good reason to believe that large-scale military will be avoided from all parties involved. Nonetheless, it is evident that South Chinese Sea is a patchwork of different wants and needs over key natural resources, which will be in short supply in the future as China requires more and more of them to keep its growth at constantly high levels.

5.2.2 - Senkaku/Diaoyu Islands

The Diaoyu islands, also known as the Senkaku Islands in Japanese, are located to East of China, in the NorthEast of Taiwan and SouthWest of Japan and are disputed among Taiwan, Japan and China. While the Diaoyu Islands are not so strategically important as the Spralty Islands are, they are also rich in natural resources. Unlike the Spratly Islands, the Diaoyu Islands have been controlled by Japan since 1895[98].

Chinese and Japanese claims were put forward in the later "90s", with China exposing a quite aggressive behaviour in more recent times. That should not be a surprise if we consider the increasing need of China to tap into more natural resources and the availability of them in that region. Besides the notable conflicts and developments from the "70s", a more recent incident worth being mentioned

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[96] Baker et al, (1992). “Cooperative Monitoring for South China Sea Disputes,” Cf. Lin, “Taiwan’s South China Sea Policy,” p324; Central Daily News Taiwan.

[97] The full paper can be found at: http://www.un.org/depts/los/convention_agreements/convention_overview_fish_stocks.htm

[98] Kentaro Uzuki (2010). " China's Territorial Disputes: The Diaoyu and Spratly Islands"

happened in 2010, when a Chinese fishing trawler collided with two Japanese Coast Guard patrol boats.

Tension broke out between the two parties the days following the incidents, as Japan detained the captain of the trawler and China, in turn, enforced am embargo on rare earth elements. This was eventually lifted once Japan released the Chinese captain, but unyielding attitude persisted on both sides after the event and Chinese even demanded an official apology of Japan, which rejected, thus flaming up the relationship between them.

The following table gives an overview of the Diaoyu islands disputes and yields a deeper understanding of the relationship between China and Japan by highlighting dated events:

	Senkaku/Diaoyu Islands
Claimants	PRC, Taiwan, Japan
Chinese Name	Diaoyu Islands (钓鱼岛)
Geopolitical Significance	Oil, natural gas, fisheries, shipping links
Ownership and Claims (from 20th century)	**1942-1972:** U.S. Administration **1971:** China, Taiwan claimed sovereignty **1972:** U.S. returned islands to Japan under Okinawa Reversion Treaty
Current Administration	Japan
Notable Conflicts and Developments	**1978:** Japanese right-wing group built lighthouse on an island; China and Japan shelve issue **1990:** Anti-Japanese demonstrations in Taiwan and Hong Kong over lighthouse recognition; incident shelved **1996:** Japanese right-wing group built new lighthouse on an island **2010:** Collision incident between Chinese fishing boat and Japanese Coast Guard, Chinese fishing captain detained

Source: China Briefing News at: http://www.china-briefing.com/news/2011/05/31/chinas-territorial-disputes-in-the-south-china-sea-and-east-china-sea.html

5.2.3 - Future of These Disputes

It would be understandable at this point to enquiry about the future of these disputes, to wonder whether there is going to be any massive military actions in those regions, to question if these actions could have an effect on China's economy and, most importantly, on the world's economy as a whole.

For the foreseeable future, China will retain predominance in the Spratlys and keep its eye peeled to seize any opportunities available within the Diaoyu Islands matter, as well as throughout the South China Sea. The investments on R&D showed in our path create benefits for firms, but have dark side in them; through investments, China has developed its technology and military capabilities that it is now using as motives and means to execute conquering policies. These will most likely be driven by the pressure of its internal demands and growing population consisting of locals, foreigners and Haiguis.

New resources are needed, which will require extensive exploitation of offshore petroleum reserves. The Spratlys emerge as a key consideration precisely for their key basin of natural resources, and China has demonstrated its willingness to implement operations at aimed at bolstering its interests in that area. In this regard, China is acts no differently from its opponent, the United States, which went a long way in acquiring resources via military troops, something that was described as "acting in the best interest of national security" from 2001's Bush Administration's Energy Task Force.

5.2.4 - Other Remarkable Tensions

Clearly, South and East Chinese Seas disputes are not the only tensions that have been afflicting China. A quick look at China's geographic map identifies more areas where it is involved in diplomatic and/or military actions. Tibet protests for independence, for instance, that still run nowadays, made the news of all major and non newspapers across the entire globe (*BBC, 18th October 2011*) [99].

Likewise, tensions exist and persist with North Korea, especially after it attacked China in 2010 (*BBC, 24th November 2010*)[100] causing their relationship to strain even more. Luckily, Beijing did not counterattack and kept muted even when Western leaders and editorials had condemned North Korea's artillery barrage and expected a response from its southern neighbour.

China's northern border witnessed a flood of protests and tensions. Large-scale mining has brought growth and wealth, but not everyone is benefiting, and tensions are rising between indigenous Mongols and Han Chinese who have poured into the region (*Los Angeles Times, June 02nd 2011*)[101].

Finally, China experienced difficult times in its relation with Hong Kong back in 2004, when Hong Kong democracy's lobbying efforts to allow great political freedom irritated Beijing officials, who returned the pressure by asserting even greater control over Hong Kong's political system, thus straining its ties to the great financial even further (*Council on Foreign Relations, July 1st 2004*)[102].

[99] http://www.bbc.co.uk/news/world-asia-pacific-15347106
[100] http://www.bbc.co.uk/news/world-asia-pacific-11828846
[101] http://articles.latimes.com/2011/jun/02/business/la-fi-china-coal-20110602
[102] Council on Foreign Relations article at: http://www.cfr.org/china/china-beijing-hong-kong-tensions/p7726

5.3 - Why It is Important to Be Aware of These Disputes and Tensions in China

The importance of studying these disputes, as well as other disputes, lies in the potential side effects they could bring to China and the world's economy. Should a military conflict take place and evolve into a war, then China would have to convert its civil economy into war mode. This would, in part, increase the GDP to certain extents but it would also depress the activities of many current firms and suggest refraining from any expansionary plans to others. The amount of money available to people and businesses might decrease as more financial resources would be directed to the military cause, banks could decrease its money outflows as businesses would not enjoy the same demand and be unable to repay big loans, to mention but a few results. An analysis of likely incidents, should this scenario ever materialize, is out of the scope of this work. But it is worth having worked this up on a basic level, as it reinforces the impact of existing conflicts among nations on overall expansionary plans and choices of firms.

5.4 - Chapter Summary

Dismal performance of Chinese stocks, high inflation for longer than expected, credit tightening, and geographical disputes, to mention some but a few kinks in the future path of China, have stimulated talks and concerns about its ability to secure future economic growth. On the one hand, increases in internal demand are needed to prop up the economy in the long run, on the other hand these also push up prices, which in turn bolster high wages expectations. A scenario that is unlikely to be welcome by China's policy makers, as high wages are in contrast to the major reasons why foreign firms choose China in the first place. Finally, pending geopolitical issues represent a drain on the nation's purse in terms of monetary and military resources, and a threat to the world's economic stability, as military conflicts usually shape the look of an economy. Nonetheless, China seems capable of juggling its issues management with national economic imperatives.

CHAPTER 6: Putting All Previous Tassels Together: Business Case

Introduction

In this last chapter some of the main material presented in the previous chapters is offered through the account of CRCC Asia experience in China. A questionnaire was sent to its director in Shanghai and it can be found in the appendix section of this work. It included a set of questions aimed at better understanding what it takes to select China and do effective business there as well as the challenges encountered. This report will be enhanced by problems experienced by a global market player such as Pirelli.

6.1 - Background

In August 2006, Daniel Nivern and Edward Holroyd Pearce founded China Consulting Ltd and China Recruitment Ltd in London, UK. China Consulting Ltd offered strategic assistance to SMEs looking to enter the Chinese market and initially focused on projects in education and insurance.

In November 2007 the companies expanded operations by opening an office in Beijing. In December 2008, CRCC Asia Ltd was formed, acquiring a full holding stake in both China Consulting Ltd and China Recruitment Ltd. Mr. Thomas Kirkwood became the third director of the company, extending CRCC Asia's areas of expertise to the energy sector, real estate and investment banking.

In October 2009, CRCC Asia was incorporated in the United States and opened an office on the East Coast and in January 2011, the company's newest offices were established in Shanghai, China and San Francisco, USA.

Today, it specializes in connecting China with the global community through consulting, intensive courses and internships. Its consulting services link international and Chinese companies by offering strategy recommendations, due diligence support and practical advice. Through their courses they introduce young professionals to the legal and financial sectors in China, allowing them to gain insight into many aspects of Chinese business, meet industry leaders and build valuable business networks. As the leading provider of internships in China, they offer students and graduates the opportunity to further their personal and professional development in a dynamic international setting[103].

6.2 – Case

As it is evident, gradual steps were taken in the development of CRCC Asia and in its choice of industry target. This was partially due to its very nature and business ambitions to grow healthily and solidly.

The decision of which country to focus energies and resources on is not only embedded in its original name, it retains a logic behind. Upon asking why they eventually selected China among other BRIC countries, the director argued that China's thriving economy, its safety and economic stability particularly led him and his team to head east. He also added that the gradient of difficulty in entering the Chinese market was key. In choosing their first location, Beijing, major drivers were represented by the size of the city itself, its vibrant environment, its constant growth of number of firms setting offices and operations there, which in their case was a golden factor as more internship opportunities could be available, its historical and economic importance in the country, and the fact that more and more foreigners started identifying it as an ideal point of entry into China.

A competition evaluation was carried out as well to assess the potential of their expansion. Luckily, the internship sector was a free field to run on at the time, which implied that they (CRCC Asia) enjoyed a first mover advantage and could gain more market shares. Since then, the sector has changed much and they reported an surge in the number of companies offering similar internship

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[103] http://crccasia.com/about-us

opportunities, language courses and consulting services. However, the Guanxi network they managed to foster during their first years in Beijing helped them to continue expanding both in the city and throughout China. As he puts it "*Guanxi is 100% vital to build an effective network of trusted allies: it is used every minute of everyday and many things can be done through Guanxi rather than through the law; make sure you invest your time and energy into the right people*".

Their entry process was characterized by trials and errors or, as has been pointed out once in this work, by adjustments from one mode to the other. In fact, the company initially started out as a representative office (RO), which was ideal to get them up and running and allowed them to operate without having a local partner and without having to invest registered capital. However, a RO is deeply affected by the Chinese tax system so they went about to form a WFOE once they gained a better understanding of their industry and market as a whole.

The ride, however, was not always smooth. Problems and barriers appeared as they spent time in China and gained more experience with regard to the Chinese way of doing business. To begin with, they confirmed that a country's size and historical/cultural heritage do matter. In his own words, the director affirms " *China is more difficult, challenging and complex than business owners and companies often realize. The country is not homogeneous, there are different peoples, dialects and strategic considerations to be taken into account in each province*".

Chinese language, therefore, constitutes a source of problems for foreign firms, not only for its difficulty, but also for the many forms it takes in each province. Along with language issues, they also found that Chinese business culture creates barriers in efficient tasks execution and successful business outcomes. The director clearly specified this: "*knowing when the Chinese are saying Yes and No and predicting what they will do is hard......the Chinese will say 'ok' to your price but then one week later, when you have written up the documentation and put everything into your business plan,* *they will change the price and say that they cannot possibly agree to it or they will lose money*".

Other practical challenges they pointed out include little regulation in intellectual property, underdeveloped legal framework protecting firms, complicated and confusing bureaucracy constant worry that the government could change the regulations and/or blacklist companies at its will.

Finally, CRCC Asia's director underlined that finding a good Chinese member of staff is challenging. However, whereas he did not specifically question the quality of Chinese graduate and their studies within the working environment, he suggested that top Chinese employees often perform at the same level as, or even better than, Western ones. He also praised the loyalty, efficiency and hardworking attitude they showcase at work, adding that they can more effectively understand the complexities of the market and be better trusted by Chinese clients. This matched the evidence and results presented whilst studying Chinese education and Haigui students.

Slightly different is the experience of Pirelli with Chinese staff. In their account high turnover was regarded as a main concern for the company. The drivers they identified that led Chinese employees to "abandon" a firm, especially an foreign one, were diverse. Monetary compensation often top the list of reasons why a Chinese employee leave a firm. Current market opportunities also allowed for a "loose" behaviour with respect to jobs, and as China continues growing and job opportunities emerge it is likely that this trend will persist. A further motive was found in "risk taking"; Pirelli's HR department in fact realized that Chinese tended to follow rigid mental schemes and would be unwilling to do anything not falling within the job requirements.

Lack of direct communication between employees and bosses was considered to be another relevant concern. Cultural differences played a key role as Chinese avoid direct talks and discussions in public so as to preserve harmony and not to lose face. Habits and trainings also stirred up issues in staff management; during years of operations in China, Pirelli encountered difficulties in getting its local labour force to attain an adaptive working attitude and be more receptive to changes passed down on them from above. Trying to impose such behaviour would only cause more harm than good as the foreign management would lose trust and face.

Additionally, Chinese habitual behaviour clashed with their constant request for constant training. According to Pirelli's experience, Chinese constantly demanded further training, but at the same time they failed to link the training received to its role in their development. In short, they sought training just to pile up their qualifications.

Finally, the degree of control over the office's operations and expenditure was seen as an increasingly problematic matter. More often than not, foreign management was found to be unaware of all that went on behind the scenes and how money was being spent. This is a crucial piece of information. It shows that even big companies with greater amount of resources face similar challenges to SMEs.

Regardless of all these issues and challenges faced by both companies, the director of CRCC Asia provides an mindful reading of how to do business china, overcome its cultural obstacles and institutional barriers: " *Be brave. The opportunities are enormous in China. But persevere. It won't happen in a few months - it takes time, courage, energy, perseverance and persistence. You also need to respect the Chinese and show good manners and etiquette throughout. Be respectful and well mannered at all times. You don't need to understand everything about Chinese culture - you never will and it would almost be weird to do so - but show interest, listen, be respectful and make an effort. This will be appreciated*".

6.3 - Chapter Summary

CRCC Asia's plan to expand in China was arranged in advance and thought over carefully by its management team. A series of parameters were looked attentively at, such as China's thriving economy, the gradient of difficulty in entering it, and the existence of high or low competition in their chosen industry/sector. After making their way in and doing business for some time, a clearer picture of Chinese society, culture and problems/challenges was drawing their attention. In this painting, the ability to read Chinese "Yes" and "No" and build an effective Guanxi network were widespread and keys to secure a niche spot in the market. Their account provided insights into the HR issues that emerged whilst trying to recruit staffs. Whereas the director CRCC Asia depicted a regular scenario and, in some instance, even praised Chinese hardworking and loyal attitude at work, Pirelli's experience shows that retaining talent and avoiding high turnover is difficulty. Misunderstanding between cultures is often the reason for Chinese employees to abandon a firm, coupled with abundant job opportunities generated by the economy, lack of direct communication and requests for extra working hours/tasks outside job requirements. Nonetheless, a word of optimism comes from CRCC Asia' director, which advices firms interested in China to be brave, perseverant, respectful of the culture and to make an effort, as this will all be appreciated and help smooth the path to success.

CONCLUSIONS AND FUTURE DIRECTIONS

In this dissertation, I have attempted to provide an answer to the question of why a firm should do business in a large emerging market (LEM) in the first place, why it should choose China anyway and how it could enter it through one of the major (not the only) strategies available.

I regard all of this as a vital topic to be discussed, especially in the current troubles times, for multiple reasons.

Firstly, heading east can no longer be thought of as an option, but it must rather be an imperative. With demand for goods and services roller-coasting in Europe and the U.S., offsetting losing positions in these markets with a prosperous prospects in emerging ones may be a viable alternative.

Secondly, size and demand development do matter. In a country of approximately 1.3 billion people, such is China, where consumers' needs are changing, adapting and catching up with Western ones, there is a great scope for products/services expansion. Even more if we consider a relevant trend stemming indirectly from the one-child policy; in fact, allowing families to bear one child created a generation of Chinese used to getting everything they want as they are the only representatives of their families.

Thirdly, I am convinced that China is playing and will continue to play a dominate role in the world's economy recovery. Gaining a foot and stake in it now, even a small one, is as important as flocking to the United States was at the time of its extraordinary economic boom.

Furthermore, a position within the Chinese market does not imply confining business interest to China. Not only is it a big enough platform in itself, but it is also a gateway to other Asian countries.

Finally, equally important is a tour of penetrations strategies in China in order to gain a real sense of what it means to approach its market in terms of business endeavours. To this extent, I have strived to showcase some of the key entry modes available that have proved to be effective over time.

Much attention was especially paid to foreign direct investment (FDI), which was analyzed in more depth than licensing and franchising due to the popularity it won among foreign firms in recent years. Influential in my choice was having experienced first hand some of FDIs whilst working in Beijing. Among the many modes, the exposure that Joint Ventures and WFOEs allow for make them optimal for firms eager to get their feet wet.

In a continuously evolving economy, knowing what options are to be selected in certain circumstances can make the difference. In trying to highlight this fact, I proposed the history of CRCC Asia, which operated in a Joint Venture agreement at first and eventually converted to WFOE.

In my work, I wanted to devote a full chapter to Chinese culture and Guanxi network because all other analyses would have been incomplete otherwise. I firmly believe that tuning to culture in China is, perhaps, more effective than any strategic measure one could possible take to do business there. My experience in Beijing, combined with academic literature and interviews/questionnaires, demonstrated the unique role of understanding local culture in business affairs and success.

Hence, I do support the results obtained that firms cannot thrive in Chinese markets unless they make a genuine effort to understand its culture, build and manage a proper Guanxi network.

Finally, I wished to briefly examine China's geopolitical standing as I am of the opinion that a question into its outstanding growth is legitimate and an evaluation of its issues does provide a clearer view of what China is. It enriches the overall study and opens up one's own mind to forces that could impact business affairs in future times.

In conclusion, choosing a target country is not an easy task and can actually become a cumbersome process. Many parameters have to be accounted for, a comprehensive macroeconomic analysis has to be carried out that includes a clear evaluation of current competitive forces and energies must be devoted to understanding culture and all of its dynamics. Additionally, a firm, and in particular small-medium sized one, is advised to move ahead of time and work alongside an intermediary, which can ease the whole process and iron out possible cultural kinks, as well as, provide an invaluable support in maintaining business contacts. This is all most relevant to China, which represents the market of golden opportunities and of great challenges. A misstep and the chances of success plummet, a right move and a firm can capture unparalleled profits.

For as detailed as I strived to make this work, it is recommended that further research be undertaken in the following areas: country macroeconomic parameters, Chinese regulation and economic stability. More information on global indicators would help to gain a deeper economic understanding of the countries taken into account. It would give us more data to compare them now and in the future. Also, studying changes in Chinese regulation would assist us in assessing the effectiveness of certain entry modes over the other, as well as providing insights into the social and economic development of the country. Finally, future research should include a complete examination of challenges China is and will be facing, such as inner geopolitical tensions, shortage of natural resources, the balance between its authoritarian and capitalistic models, growing population and increasing need for oil, that might affect its economic stability.

APPENDIX

QUESTIONNAIRE

- What made you choose China? Do you think it is more strategic of a target than other BRIC countries? If so, why?

- Did your decision pay off?

- What were your expectations before and what are they now?

- How relevant was it for you to see other competitors had already started or were already planning an expansion there?

- What mode of entry did you first adopt? Joint venture, WFOE, representative office or others? Why?

- Would you be able to outline the main challenges one could face whilst entering China?

- Do you think carrying out business deals in China is harder? If so, how?

- What are the main features of entrepreneurship in China?

- How did you find the Chinese legal and competitive framework in compared to other emerging markets?

- How vital do you think it is in China to build an effective network of trusted allies, or as they call it "Guanxi"?

- What are, in your view, the main threats to an expansion one may have to deal with in China?

- What are the main issues to sort out when dealing with local labour force? In short, how is the Chinese labour forced different from the Western one?

- Did you find a shortage of talent? If so, how did you go about the problem?

- How did you overcome institutional and, most importantly, cultural barriers?

- How did you find the concept of Guanxi/Mianzi?

- How did you overcome overreliance on Western practices?

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