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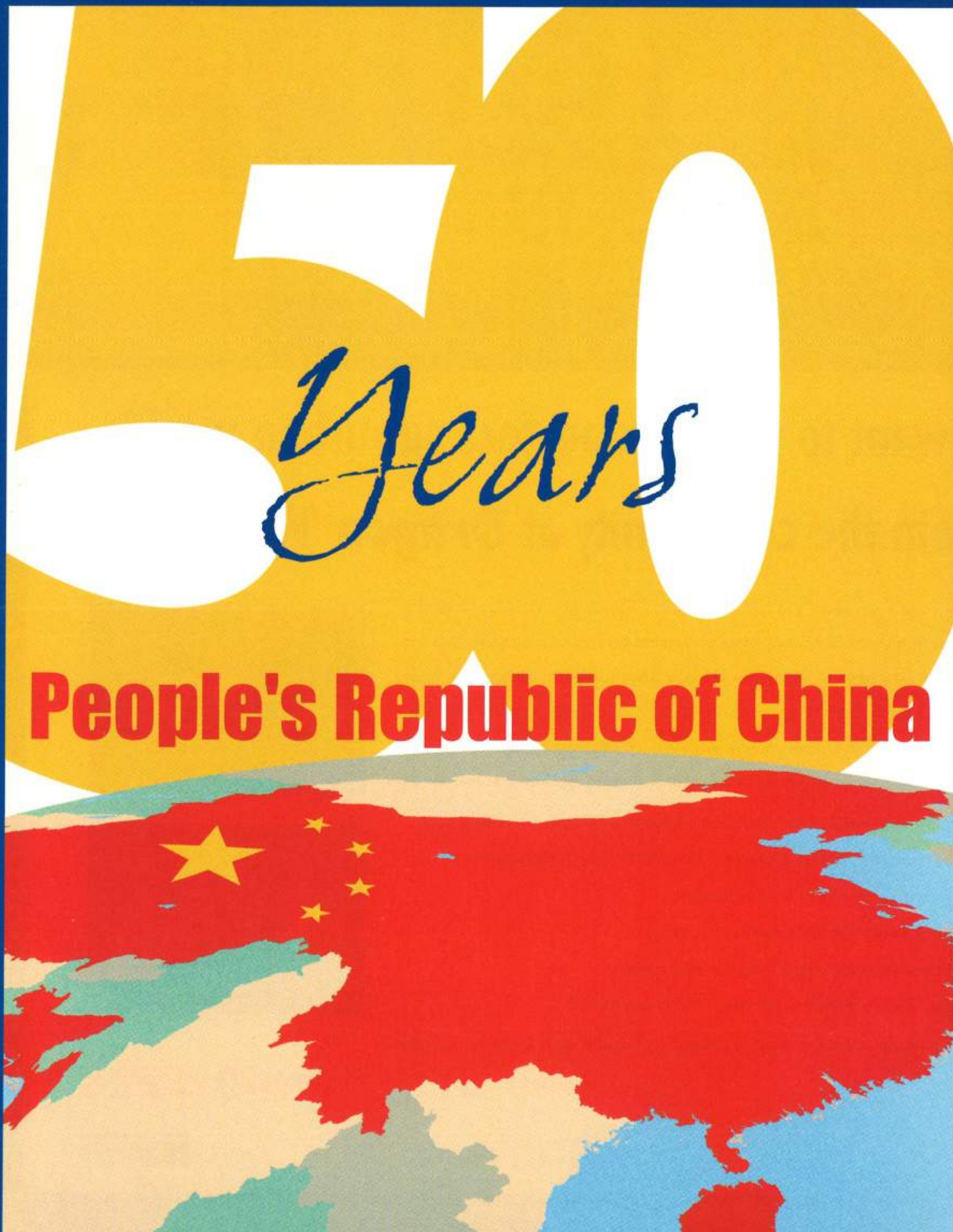
THE CHINA BUSINESS REVIEW

SEPTEMBER–OCTOBER 1999 VOLUME 26 NUMBER 5



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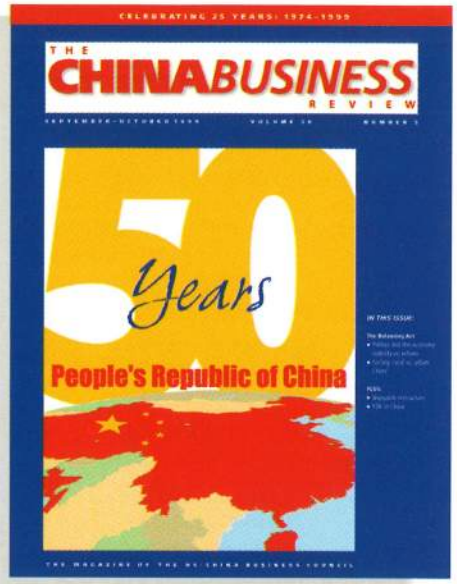

Cover design by Greg Berger

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美中商贸评论

The magazine of the US-China Business Council

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PRINTED IN THE USA

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The China Business Review, ISSN No. 0163-7169, is published bimonthly by the US-China Business Council, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA (Tel: 202/429-0340), a nonprofit organization incorporated under the laws of the District of Columbia. Periodicals postage paid at Washington, DC, and additional mailing offices. Postmaster, please send address changes to *The China Business Review*, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA.

ISSN No. 0163-7169; USPS No. 320-050

Annual Subscription rates: $99 US/Canada; $150 international. Single copy issues: $20, airmail $25; issues over 1 yr: $10, airmail $12.50. DC residents add 5.75% sales tax.

Subscriptions to *The China Business Review* are not deductible as charitable contributions for Federal income tax purposes.

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Short TAKES

Hong Kong Slips a Notch

Hong Kong has dropped from second to third place in the World Economic Forum's Global Competitiveness Report. The drop corresponded with declines in the government savings rate and competitiveness of non-manufacturing wages. Nevertheless, the expatriate business community still rates Hong Kong banks as the best in Asia, according to Political and Economic Risk Consultancy.

Have a (Cheaper) Beer, Save the Industry

The 1999 China Beer Report shows that beer prices across China sank 5-10 percent last year. Intense competition caused domestic beer prices to plummet in Shanghai, Beijing, Wuhan, Chengdu, and Guangzhou. Even with the drop in prices, beer consumption in China rose only 5 percent, from 15.1 to 16 liters per capita. On top of this, China's new standards for beer bottles, which include marking them with a "B" for "beer," took effect on April 1. The more expensive new bottles will significantly increase brewers' production costs, possibly forcing local, low-end breweries out of business.

Why the US Will Go for WTO

According to the Women in International Trade (WIIT) third annual poll, nearly two-thirds of Americans "strongly" or "somewhat" approve of free-trade agreements. Eighty-four percent agreed that the United States cannot expect other countries to open their markets without reciprocation. And while believing that imports may harm some industries, the majority of respondents felt that imports provide US consumers with a broader and cheaper selection of goods. Roughly three-quarters of respondents agreed that imports are good for US businesses, as they force US companies to become more competitive.

Chiang Kai-Shek or Jiang Jieshi?

According to a recent AP report, Taiwan will adopt China's Pinyin romanization system. Officials say its widespread use makes Pinyin the most practical system. Currently, Taiwan uses several romanization systems, some based on local Taiwanese or Hakka pronunciation. Thus, the same street often has several different romanized spellings. Internationally recognized spellings, such as Taipei, Kaohsiung, and Chiang Kai-Shek would remain the same.

Hong Kong Salaries on the Rise

In spite of the Asian economic crisis and a drop in its global competitiveness rating, Hong Kong's workers continue to receive raises. According to Hewitt Associates, the raises are aimed at retaining talented employees.

Wuhan Takes Wing

The *Beijing Evening News* reports that Wuhan Sky Taxi will soon provide mini-helicopter services around the city—at a reasonable cost. The mini-helicopters are owned by Wuhan Airlines. They are half the size of a normal car, which allows them to land and take off from anywhere in the city.

Recycling Education

Pedestrians on Beijing's busy Chang'an Avenue have no idea that the yellow and green garbage cans lining the sidewalk are anything other than decorative, says the *Beijing Youth Daily*. In fact, the cans are part of a recycling plan, and were placed by the Beijing Environmental Protection Bureau. The bureau insists the cans are labeled in accordance with international standards, but others say the labeling is unclear. The newspaper suggests further education in the ways of recycling.

Correction and follow-up

The article "Macao Aims for a Turnaround," which appeared in the July-August 1999 issue, misstated the number of civil servants in Macao. That figure should be 17,000, not 7,000.

Corporate Status and SAIC Inspections: Setting Aside the Blame Game

Edward Lehman and Stan Abrams

In Tianjin, a foreign-invested enterprise is visited by the State Administration for Industry and Commerce (SAIC) and slapped with a ¥200,000 ($24,163) administrative fine. In Guangzhou, a multinational manufacturing company executive is faced with a similar raid. After asking to contact the company's attorney for advice, the executive is forcibly detained until the raid has been completed.

Some executives have declared these raids a shakedown by government authorities concerned with satisfying internal quotas. Most companies have nonetheless paid the fines without question. But paying these fines without addressing their underlying cause is pointless—if indeed the problem is the companies' failure to comply with the law.

The question therefore is whether these SAIC inspections are heavy-handed acts of governmental intrusion or are based on actual violations. An informal survey of several affected multinationals suggests a direct relationship between the legal status of the corporation and the size of the fine levied by AICs. Some foreign enterprises operate either outside the scope of their corporate status or maintain offices with no legal status. For example, though foreign representative offices are only permitted to engage in promotional activities, a number of companies sell products through such offices. In other instances, joint-venture offices have been improperly selling products manufactured abroad.

Unfortunately, these are fairly common practices among foreign multinationals in China. Although large corporations usually start with a single executive legally setting up a representative office or joint venture, some foreign companies then open sales offices in far-flung localities that amount to no more than a *de facto* sales representative with a fax machine and cell phone. Often, executives who join the company's China operations years later assume that their predecessor set up the office according to the letter of the law. Thus, when AIC officials arrive claiming that fines must be paid because of improper corporate status, executives automatically assume that the officials are mistaken—an assumption reinforced by the Western notion that once a business license is obtained, a company is free to sell whatever it chooses out of any office it opens. AICs are challenging these assumptions by staging unannounced visits and uncovering violations.

In addition to the raids themselves, which lead to turmoil, fines, and internal finger-pointing, there is the possibility that AIC officials will share the information they have collected with other government agencies. Because many offices that operate outside the scope of their official corporate status also violate employment, tax, and other laws, a corporate-status offender not only runs the risk of AIC scrutiny, but also the unwanted attention of tax and labor officials.

Multinationals can ensure that all of their offices comply with relevant PRC laws and regulations, beginning with corporate status, by having an internal corporate-compliance plan, with one employee designated as a corporate-compliance officer. Foreign companies wishing to conduct business in China commonly organize themselves as either a representative office, a foreign-invested enterprise (FIE), a branch office of an FIE, or a representative office of an FIE. A brief introduction to the various corporate forms available to foreign businesses reveals some of the common pitfalls of setting up an office in China.

Representative Office

A representative office is the most common form of business organization employed by foreign companies planning to establish a long-term presence in China. However, assumptions of what a representative office may or may not do, based on Western legal principles, are extremely dangerous and often lead to serious exposure to liability. The most common example of these mistaken assumptions involves sales activities. The rule is relatively simple: representative offices may not engage directly in profit-making activities. Foreign representative offices may only engage in promotional activities—office staff are not "sales staff," but "promotional team members."

According to the rules governing representative offices (Implementation Rules of Ministry of Foreign Trade and Economic Cooperation Governing the Examination, Approval and Administration of Resident Representative Offices of Foreign Enterprise in China [Implementation Rules]), a representative office may engage in indirect activities such as business liaison, product recommendation, market research, and technological exchange. All of the representative office's activity must be within its business scope and within China.

Office personnel may not receive fees for services, sign contracts, or directly generate income. Many representative offices in China administer contracts that are signed by their home office, or by executives of a corporation not residing in China, and this is generally acceptable to PRC regulatory authorities. It is also common practice for the executive officer of a representative office to sign contracts, as long as the officer obtains power-of-attorney from the home office. Significantly, a representative office may not use its chop to sign business contracts, with the exception of office leases.

In practice, a foreign company may open multiple representative offices within China. However, only one representative office may be approved and set up per city. To establish a representative office, a firm must apply to and be approved by the relevant PRC government authorities. The local AIC office processes the application and issues the registration certificate upon approval. Without this certificate, a foreign representative office cannot legally order an office chop from the Public Security Bureau; hire Chinese employees; open a bank account; import personal effects duty-free; import office equipment without an import license; secure a long-term multiple-entry visa; or obtain resident and employment permits for expatriate staff. Additionally, many office buildings require a prospective tenant to provide proof of registration before signing a long-term lease.

The Implementation Rules also stipulate that a foreign enterprise is legally responsible for all activities of its repre-

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Letter FROM THE PRESIDENT OF THE US-CHINA BUSINESS COUNCIL

Robert A. Kapp

The PRC at Fifty

Reflections on the United States and China

On October 1, the People's Republic of China celebrates its 50th birthday. Looking back, looking around, and looking ahead, it's hard not to trip over the evidence of how much has changed. But looking at five decades of US-China relations, the staying power of history is astonishingly strong as well.

Looking Back

It may be worth pausing for a moment to consider the condition of China in 1949. Perhaps it's best to start with an anecdote, told by a dear personal friend who grew up in China and later prospered and succeeded brilliantly in the United States.

One lovely evening in 1997, as we strolled down one of Shanghai's busy and prosperous main streets after a nice dinner, my friend—working for a US law firm by then—pointed out to me a small, fluorescent-lit building across the road. It was the hospital where she had been born in 1949.

At the moment of her birth, her father, a Western-trained professional, was at his place of work near the waterfront. Her mother was miles away, in labor in the tiny hospital.

The Communist armies were poised at the edge of town, awaiting the order to enter Shanghai and claim the city. The Nationalist forces, routed, were retreating pell mell. On the streets, my friend told me, fleeing government soldiers were stopping passing cars, shooting the drivers, and commandeering the cars to make their own escape from the city. My friend's mother was desperate: how could she reach her husband at The Bund to warn him not to come to her side, lest he be killed in the chaos?

Amid such chaos my friend—and the PRC—came into the world.

China at the Moment of Transition

In that autumn of 1949, and in the months surrounding it:

- The price index, rated at 100 in 1937, stood at 800,000,000,000, up from 874,000,000 (Nanjing only) at the end of 1948. To have money—local currency—was to be destitute.
- A colossal civil war was nearing its end, with the Communists in control of all China except for remote border areas, and those Nationalist forces that had not surrendered to or been captured by the Communists clinging to their new refuge in Taiwan. Hundreds of millions of dollars in US military equipment provided to the Nationalist government had fallen into the hands of the conquering armies of Mao Zedong.
- The Communists had embarked on their first organized campaign of social revolution, a fitful but violent expropriation of the rural landholding elite that had long dominated agrarian society in collusion with local warlords and armed militias impervious to national government influence. Land reform had provoked firestorms of peasant violence.
- Hyperinflation, epidemic official corruption, and the capricious but brutal repression exercised by the fraying Nationalist government in China's cities took their toll on China's writers, professors, students, and even civil servants. These groups found themselves financially destroyed and subjected to violent secret police reprisal if they spoke out against the misdeeds of the official order.
- Taiwan was reeling under the weight of the national government's evacuation to the island, and from a 1947 massacre by Nationalist forces of tens of thousands of native Taiwanese. These local residents had risen in protest against the chaotic Nationalist military occupation of the island following the Japanese surrender.

The birth of the PRC as seen by the USA

In the United States, Mao's victory in China was the latest in a series of fearsome postwar traumas that had begun even before the world split into lethally threatening communist and non-communist "blocs," as we all came to say.

Only eight days before the establishment of the PRC, on September 23, 1949, the USSR had exploded its first nuclear device, inaugurating four decades of "Balance of Terror" and galvanizing domestic American fears that "Soviet agents" encysted in positions of the highest sensitivity were boring from within, scheming on behalf of a foreign power bent on destroying the United States and all it stood for.

By the fall of 1949, US policy toward China was in ruins. During the war, the United States had worked to elevate China to one of the "Big Four," alongside the USSR and Britain and itself. The Americans believed that despite its internal weaknesses and political fragility China's sheer size and immense potential would make it the critical factor in postwar Asian affairs once Japan's power was broken. But for all the verbal reassurances, the United States had never met the Nationalist government's incessant demand for a place at the top of America's list of strategic priorities. China had remained a backwater theater of war, as the United States devoted its primary resources to victory in Europe and to a maritime island-hopping strategy against Japan in the Pacific.

As the wartime Chinese economy descended into inflation and disorder, no amount of American financial assistance seemed to suffice to stabilize the chaos, and American aid was not unlimited. Symbolically, perhaps the most important US action during the conflict was to abandon "extraterritoriality," that system of exemption from Chinese legal jurisdiction that the United States and the other major industrial powers had forced upon China during the Opium War, and which remained for a century the most galling symbol of Euro-American civilization's contempt for a weak and humiliated China.

Staring Cold War in the face in 1949, most Americans interpreted the communist victory in China as a Soviet victory, in the manner of recent Soviet takeovers in Eastern Europe. Encouraged by a thirsty and partisan political community and a media instinct for the sensational, prominent Americans asked, "Who lost China?" and sought answers in repeated searches for domestic "subversives."

As the Cold War froze into place and Americans faced the reality of merciless global confrontation, China's political upheaval became a crucible for the politics of fear at home. Loyalty Boards scoured the State Department. Special congressional committees set out to expose those who had created the China disaster. Newly risen political stars named Americans as pro-Chinese Communist operatives. Americans were "investigated" for their social contacts. "Guilt by association" became a household term. Political meteors blazed in the darkened skies, lighting the way for the crusade against the domestic treachery that had "lost" China to Mao Zedong and Joe Stalin. *The China Story*, published in 1951, bore the subtitle, "How We Lost 400,000,000 Allies;" inside were chapters entitled "How Communists Captured Diplomats," "...And the Secretary of State," "...And the Public."

To put it simply, the very establishment of the People's Republic of China, a momentous event in China's modern history, was also a towering political trauma for the United States. Even now, with most of the key actors long gone, the scars incurred half a century ago itch and burn from time to time.

A year after the birth of the PRC, the United States and China were at war in Korea. America's wartime allies had become the enemy; the patient, long-suffering recipients of Americans' wartime United China Relief charity were now human-wave attackers, and would soon be Mao's "blue ants." Meanwhile, the new Chinese rulers pressed forward to establish unquestioned control and crush all opposition, mobilizing the populace into one of the first of the great "mass campaigns" of the Mao era: "Aid Korea/Resist America." "Thought Reform," the method of psychological remolding employed by Mao to deal with dissidence within his political movement, was applied to American prisoners of war captured in Korea. Americans called it "brain washing."

Then the two nations went their ways. China turned first to the USSR, trying to transplant the Stalinist economic system onto Chinese soil, and later pursuing a messy disengagement from the Soviet "elder brother." Repeated mass campaigns in the name of political purity and obedience to the supreme leader had, by the time the Cultural Revolution collapsed in 1976, left a legacy of needless death, doctrinal exhaustion, economic disruption, and nearly irreparable political and psychic wounds. More than once through that long period, "US Imperialism" was the political target of choice for Chinese domestic figures intent on the achievement of internal political objectives.

Americans noticed and responded; many did not forget what they saw. America's growing and ultimately unsuccessful intervention in Vietnam was defined, early on, as a life-or-death resistance to China's appetites for territory and ideological conquest, necessary whatever the cost. In spite of Eisenhower's injunction against American involvement in a "land war in Asia," there would be no "appeasing" China, as Britain's Chamberlain had "appeased" Hitler in 1938. Americans went to bed at night fearful not only of Soviet nuclear attack but, as one key American administration figure put it in the 1960s, "A billion Chinese armed to the teeth with nuclear weapons." During the riveting Offshore Islands crisis of 1958 in the Taiwan Strait, the use of US nuclear weapons was quietly on the table in Washington.

Looking around, looking ahead

Now, the PRC is 50 years old. Mao Zedong and Chiang Kai-shek, whose deadly struggle swirled through American politics for three decades, are 25 years dead. The founding generation is almost all gone in China. The current President of the United States was three years old when the PRC came forth. The President of China was a teenager.

Of all the ways the world has changed since 1949, the most salient here is that it is no longer gripped by a single frozen and transcendent rivalry between two militarized ideological systems whose conflict provided a demonic ordering principle to world affairs for four terror-backed decades.

The China that lay exhausted in 1949, its political structures in ruins and its economy prostrated, now lives within secure borders, an increasingly significant force to reckon with in a world still unaccustomed to China's

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Asia's Political Lessons

China has important political lessons to learn from the East Asian economic crisis

Minxin Pei

The two-year-old East Asian financial crisis appears to be over. Many macroeconomic indicators, such as rising growth, falling interest rates, and stabilizing exchange rates suggest a recovery in progress.

Policymakers in China have patted themselves on the back for having avoided the brunt of the financial turmoil that plunged much of the region into recession. Judging from public discussion in the Chinese media, these same leaders have learned several—now familiar—economic lessons from the East Asian crisis, including the importance of a strong financial regulatory regime, well-capitalized banks, and the dangers of full capital-account convertibility. To their credit, Chinese reformers led by Premier Zhu Rongji have taken steps toward addressing these problems.

The same discussion, however, also suggests that many Chinese policymakers may not be sufficiently aware of the political and institutional roots of the Asian crisis and may not have learned its critical political lessons. Ignorance of the political origins and aftermath of the crisis could ultimately prove dangerous to China. Despite its luck and unique circumstances, the Chinese political economy shares the same underlying malaise that debilitated political and economic institutions in Indonesia, Malaysia, South Korea, and Thailand. This malaise raised these countries' systemic vulnerabilities to such high levels that an unanticipated adverse event was able to set off a chain reaction culminating in the collapse of the financial system or, in the case of Indonesia, the fall of the ruling regime.

At the moment, China's leaders are focused on solving the country's short-term economic difficulties: slowing growth, rising unemployment, deflation, weak banks, and poor export performance (*see* p.12). But it is unclear whether, should they overcome these economic difficulties, they will address the deeper institutional problems in China's political and economic spheres. It is, nonetheless, in the leadership's self-interest to recognize several political lessons from the East Asian crisis.

The Necessity of Institutional Reform

Economic growth is not a substitute for institutional reform. If anything, economic growth may make a society's institutional flaws more entrenched and intractable, as growth-induced economic booms mask the severity of problems and minimize pressures for reform.

Although the development strategies adopted by individual East Asian countries may differ in detail, they share one central characteristic: an unshakable faith in the magic of growth. Implicit in the growth-oriented strategy is the hope that two developments will occur to make future reform easier. The first is that the tangible results of growth—particularly rising standards of living—will build up political capital and popular support, both of which are required to

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address deeper problems in their country's political system and economy. The second is that growth's ability to improve the overall welfare of the populace will make for favorable conditions for reform. Under such conditions, it is hoped that some politically powerful groups will make sacrifices so that high rates of growth can translate into the resources needed to buy off unemployed state workers and other losers in the reform process.

In reality, however, these hopes have not panned out in East Asia. Although rapid growth has led to rising standards of living, political leaders throughout the region have found it hard to channel growth into lasting support. Rapid growth may produce more wealth, but it also creates new problems, such as socioeconomic dislocation. In China's case, growth has increased inequality and raised popular expectations. Some members of society find themselves losing out relative to others as the economy shifts, from agriculture to industry and from manufacturing to services, for example. Required institutional changes produce losers as well.

While a growing economy does provide opportunities, chiefly job opportunities in new sectors, governments tend to lack the ability to address new growth-created problems and meet rising expectations. This, in turn, typically reduces rather than increases their political capital. Governments thus have been unable to reform flawed political and economic institutions, from weak courts and corrupt bureaucracies to lax regulatory systems and cozy business-government relations.

Moreover, while structural shifts in the economy normally affect the most vulnerable members of society—such as the peasantry—first, institutional reform aimed at curbing bureaucratic power, increasing judicial independence, and making markets more transparent threatens the powerful—bureaucrats, politicians, and well-connected businesspeople. Unless the government is able to overcome the resistance of these groups, institutional reform cannot proceed even during the best of times.

Since those who lose out in the process cannot imagine that they could possibly be better off after the implementation of reforms, they would view any "buy-out offers"—lump-sum payments for early retirement, managerial positions in semi-private firms, or promises of future favors, for example—as inadequate and resist reform. This analysis helps explain why reform proposals to strengthen the banking systems in Indonesia, South Korea, and Thailand that aimed to prevent party-related lending failed before the crisis, and why suggestions for breaking up large conglomerates in these countries were scorned and resisted.

The Dangers of a Weak Legal System and Corruption

Economic growth is unsustainable if deep institutional problems are left uncorrected. Although businesspeople and scholars often blame bad policies for economic inefficiency and poor performance, bad institutions are equally capable of destroying economic incentives and creating inefficiency and waste.

A typical example is a weak legal system, among the most common institutional deficiencies in emerging markets. Courts that lack autonomy and effectiveness are fundamentally products of the political system. Weak courts can increase the costs of economic activity enormously. Their ineffectiveness—most often exhibited through the failure to enforce contracts and protect property rights—raises uncertainty for investors and entrepreneurs; increases transaction costs as parties are forced to undertake additional hedges against breaches of contracts and unfair courts; and limits the size of the market when investors fear to venture into unfamiliar and unfriendly territories where they lack political ties to the courts.

Another costly product of flawed institutions is corruption. Bribery inevitably increases the costs of doing business and, eventually, the prices of goods and services for consumers. Bribes paid by inefficient and incompetent firms to secure government contracts and licenses create additional hazards by prolonging the lives of uncompetitive entities that produce shoddy and often dangerous goods.

Corruption also discourages private entrepreneurship, as rapacious government officials tend to impose arbitrary taxes and fees on these start-up companies to enrich themselves. Since income from corrupt activities is mostly consumed privately or salted away in offshore bank accounts, large-scale official corruption always results in the reduction of government-provided public goods and services such as education, environmental protection, and research and development. Finally, corruption increases the systemic risks of financial and fiscal systems when it results in falsification of information, financial fraud, capital flight, and poor tax collection.

It is politically difficult to reform weak institutions during boom years because rising growth and investment rates conceal such institutions' negative effects on the economy.

Unfortunately, it is politically difficult to reform weak institutions during boom years because rising growth and investment rates conceal such institutions' negative effects on the economy. The corrosive effects of weak institutions become clear only after an unusually severe economic crisis exposes their underlying frailties. But at that point, the costs of improving poor institutions have already accumulated, and the economy and the government end up paying a steep price. Indonesia's collapse was all too vivid an illustration.

The Superficiality of Political Legitimacy

The emphasis on growth in East Asia had a political origin: authoritarian regimes ruled in all high-performance East Asian economies except Japan when growth began to take off. Several regimes eventually made the transition to democracy. But during the authoritarian phases of these regimes and for the region's remaining authoritarian countries, maintaining high growth rates was and is regarded as essential for building not just industrial economies, but the political legitimacy of the ruling elites.

However, there are two serious problems with economic performance-based political legitimacy. First, it is inherently superficial and unreliable. Although most citizens may accept authoritarian rule while their living standards improve, they do not develop an abiding affection or lasting support for unaccountable government or its leaders. The notion of maintaining legitimacy on the basis of growth becomes even more problematic when the gains from growth are unequally distributed. Disadvantaged groups given short shrift are especially unlikely to hold their governments and leaders in high esteem. Rulers counting on high growth to maintain popular support may also have unwittingly entered an impossible race: economic growth must be kept at an ever-increasing pace to meet people's rising expectations. Leaders risk erosion of political support if growth rates slip even slightly—country leaders from Indonesia to South Korea can testify to this.

The second problem with economic performance-based legitimacy is the difficulty of maintaining high growth rates. Obviously, corruption-related costs are likely to slow growth if the ruling elites fail to control graft. But in an increasingly globally integrated economy, many factors essential to keeping growth rates high are beyond these rulers' control. Capital today is extremely mobile, and can leave a country *en masse* at a moment's notice. Competition is also fierce at the low end of the market, where companies often resort to price wars. Comparative advantages, especially cheap labor, are now much less reliable or enduring than they have been in the past.

The fall of Suharto's regime proved just how unreliable growth-based legitimacy could be. The now-disgraced Indonesian leader spent most of his 31 years in politics transforming an impoverished and unstable society into a quickly modernizing one. Under his watch, the Indonesian economy maintained one of the highest rates of growth in the world in the post-WWII period. The level of poverty was cut dramatically, and the standard of living for almost all Indonesians improved substantially. Indonesians thus hailed Suharto as the "Father of Development."

But Suharto mistook popular recognition of his achievements as unconditional endorsement for a permanent hold on power and for his family to engage, unrestrained, in corrupt activities. The shakiness of his support became clear only when, barely eight months into Indonesia's worst economic crisis in three decades, angry citizens and the country's armed forces—supposedly the mainstay of the Suharto regime—forced the leader out of office.

Democracy lowers risks and uncertainty

Established rules and procedures for resolving both state-society conflict and clashes among the elite can help reduce systemic risks and market uncertainty. Why did some countries in the region handle the crisis more effectively than others? A large number of Western politicians and observers point to the "success stories" of South Korea and Thailand and the "failure" of Indonesia as evidence that regimes with democratic characteristics are more capable of handling economic crisis than authoritarian regimes. But available scholarly research supporting this argument is scant and inconclusive, and the evidence from the recent East Asian financial crisis is mixed. While Indonesia, an authoritarian country, was a basket case, certain semi-democratic governments did not fare as poorly. Hong Kong, Singapore, and Malaysia seemed to have weathered the storm in relatively good shape, even though Malaysia experienced its most serious economic and political crisis since the 1969 race riots.

Democracies may have one notable advantage in handling crises, however. Although democratic countries all over the world differ in administrative capacity, party systems, electoral procedures, and legislative institutions, they all rely on a set of rules and procedures to help resolve conflicts among the political elite and between the state and society. Succession, for instance, rarely inspires uncertainty and anxiety in democratic systems.

Moreover, popular discontent with democratic governments is frequently vented through street demonstrations, strikes, and the ballot box but seldom culminates in massive social unrest. In fact, there is not a single instance in history in which a social revolution overthrew a democracy. Markets, cognizant of the benefits of such rules and procedures for conflict resolution, tend to price political risks accordingly. For democratic states, such political risks are considered relatively low. For nondemocratic states, risks are perceived as relatively high. Investor confidence may thus return sooner in democratic states than in authoritarian ones.

Political playbook

The lessons of the Asian crisis should alert Chinese leaders to the risks of delaying crucial institutional reforms and the rewards of pursuing them. These leaders maintain that the current macroeconomic situation is too severe to contemplate dramatic reform measures. "Stability overrides everything" is the dominant official policy. Although this policy makes intuitive sense, it ignores the crucial fact that any institutional reform is difficult, even under the best of circumstances.

PRC leaders and policy advisors should start thinking more conceptually about the course of institutional reform once current economic difficulties are overcome. Strengthening state institutions and extricating the Communist Party from routine administrative functions of the government; accelerating the pace of legal reform and enhancing the independence and effectiveness of the courts; and encouraging the growth of civic organizations—which can help organize citizens and increase social cohesion in a time of rapid socioeconomic change—should top their agenda. The government should also mobilize the mass media against corruption, as scholarly research has demonstrated that there is an inverse relationship between civil liberties and corruption. Finally, Beijing needs to promote democratic participation at the grassroots level to increase the political accountability of local officials.

These measures may sound radical, but they are necessary both for China's continued modernization and for the survival of the Communist Party as the leading political force in the country. The East Asian crisis—and crises elsewhere in the world—have shown that governments forced to adopt reform measures in a position of weakness are seldom able to control the pace and direction of such measures. Deng Xiaoping, by initiating bold economic reforms in 1979, avoided Gorbachev's mistakes and resulting fall from power. Deng's successors should push political and institutional reform now to avoid Suharto's fate. 完

Growth, Reform, and the Effects of the Asian Crisis on China

Robert Frost once wrote, "Some say the world will end in fire, some say in ice...." While some Asian economies went down in a firestorm two years ago, China's economy seems more likely to freeze over

John Fernald

In the context of the apparent collapse of many of the "Asian miracle" economies in 1997, China's continued strong growth is striking. After all, many of the lessons drawn from the Asian crisis might seem to apply to China. For example, one clear lesson of the crisis is that it is dangerous for a country to have weak, poorly regulated banks making policy loans to inefficient, over-leveraged state enterprises—a reasonable description of China. Some commentators, such as Nicholas Lardy at the Brookings Institution, argue that China's financial system looks at least as bad as, and perhaps far worse than, those of other regional economies.

China's growth rate has certainly slowed from the double-digit rates of the first half of the 1990s. As the growth rate approaches 7 percent, Chinese policymakers have voiced increasing concern about the state of the economy. But this gradual slowdown is nothing like the firestorm that hit Indonesia, Korea, and Thailand. So why has China so far survived the crisis so well? What are the major economic risks it now faces?

Keeping the House Warm

Suppose you want to keep your house warm in winter. If the windows are open and the house is freezing, then the initial step is easy. Simply closing the windows makes a huge difference, even if the walls are uninsulated and the furnace is inefficient. But the later steps—perhaps installing insulation or replacing the furnace—are costly. Replacing the furnace means removing the old one, and you might lack heat for a while. The construction may reveal new problems, such as asbestos lining the pipes. And if you undertake substantial structural repair such as replacing a wall or the roof, you may be temporarily vulnerable to a heavy storm. Nevertheless, it makes sense to accept the risks and pay the costs if you want a warm house.

Even after two decades as the world's fastest-growing economy, China remains a relatively poor country. The World Bank estimates that China's income per capita is roughly one-tenth that of the United States—comparable to Egypt, Macedonia, or El Salvador. Small reforms had a rapid and radical effect on China's very poor, inefficient, centrally planned economy. China's reforms have allowed an active, dynamic non-state sector to grow outside of the centrally planned core. Several years ago, a Western diplomat in Beijing suggested to me that the house analogy helped explain the process: just as shutting the windows rapidly improves conditions inside the house, reforms that allowed for individual initiative—such as the contract responsibility system and the dual-track pricing system—unleashed rapid growth despite substantial structural problems.

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China's approach to reform is often described as a gradual one, in which changes are made around the edges of the centrally planned economy. But as Stanford economist Laurence Lau and his collaborators have argued, China's seemingly small steps were in many ways quite radical. They meant that at the margin, market forces widely determined what goods were produced. Of equal importance, the gains were fairly evenly spread across the country, minimizing political opposition. World Bank Chief Economist Joseph Stiglitz pointed out in a recent speech that if one considers each of China's provinces as a separate economy, then the 20 fastest-growing economies in the world from 1978 to 1995 have all been in China. Also, though income inequality appears to have risen, there have been few outright losers from reform.

Postponing the Inevitable

China has paradoxically achieved this substantial progress while avoiding financial collapse in part because some important financial sector reforms have barely begun. China wants to liberalize its financial system and move from a non-commercial banking system where market incentives do not work to a viable commercial banking system where incentives are appropriate. But China is only just beginning this transition.

In a recent and wide-ranging survey of financial liberalization, John Williamson of the Institute for International Economics argues, along with coauthor Molly Mahar, that there is considerable evidence that financial liberalization fosters a more efficient allocation of investment. Hence, making the transition to a commercially oriented banking system is clearly important to China's ability to sustain high growth. At the same time, however, they point out that the process of liberalization can itself lead to financial crisis. The transitional stage—where controls have been lifted but incentives remain inappropriate—holds clear dangers, as was evident in the Asian crisis economies. In this perilous transition, banks and other financial institutions have an incentive to take too many risks: if the government will bail them out when they run into trouble, then bankers are not fully responsible for any losses they incur. But they keep the profits if these risky loans are repaid. In other words, bankers have little to lose and much to gain from taking too much risk.

In China's case, the real dangers of partial liberalization have been largely, though perhaps not entirely, limited to the fringe of non-bank financial institutions, such as the Guangdong International Trust and Investment Corp. (GITIC) and other ITICs. GITIC's activities were widely reported following its closure in fall 1998 and subsequent bankruptcy in winter 1999 (*see The CBR,* May-June 1999, p.36). These activities exemplify the moral hazard problem. GITIC's investments were far too risky, because the institution could capture gains without bearing responsibility for any losses. Over time, the scope of GITIC's activities widened considerably. Poorly regulated, its relatively legitimate activities included excessively risky real-estate ventures. Its less legitimate ones have led to allegations of fraud and corruption.

Chinese ITICs are important to their creditors, but nevertheless remain small relative to the rest of the financial sector. Lardy and others have emphasized the parlous state of the four major banks, with their substantial overhang of bad loans, low transparency in and accountability for their actions, and little experience or skill in assessing loans on commercial grounds. Though bad for the long-run health of China's economy, the fact that China's financial liberalization is only beginning suggests that these severe problems need not spark a crisis.

That is, Chinese banks remain subject to substantial restrictions on their activities, and not fully subject to market discipline. As a result, they—and China—remain less vulnerable to financial collapse. For example, regardless of their other, often adverse effects, capital controls prevented most Chinese financial institutions from borrowing excessively abroad, and helped keep the country's external fundamentals strong. Domestically, Chinese banks can continue to operate with negative net worth, because the government implicitly guarantees deposits. Berkeley economist Barry Eichengreen notes a more extreme example: "North Korea's financial system is immune from crises because it is subject to such draconian controls." China is no North Korea. But it does remain subject to substantial controls.

Chinese banks can continue to operate with negative net worth, because the government implicitly guarantees deposits.

Of course, just as a tourniquet on a bleeding arm is no substitute for proper medical care, controls—to the extent they did contribute to China's stability—have serious costs. First, controls are often leaky. A tourniquet may slow the flow of blood from a wound, but if it's not tight enough or if the wound is serious enough, you will bleed to death slowly rather than quickly. Similarly, controls may for a time work well enough to prevent financial crisis, but people always have incentives to find ways around the rules. Moreover, this evasion potentially contributes to further problems in the form of corruption and fraud, such as capital flight through under-reporting exports or over-reporting imports. Second, the controls may in some sense work too well. If you twist the tourniquet too tight, to stanch all flow of blood, the arm will eventually die. North Korea, for example, may have survived the Asian crisis—but its harsh controls help explain its extreme poverty.

Fortunately, capital and other controls are not the whole story behind China's resilience. The PRC financial system may be weak, but many of the economy's fundamentals look far stronger than in the front-line crisis economies. In particular, China has relatively low external debt relative to GDP, large foreign-exchange reserves, a current-account surplus, and continuing sizeable inflows of foreign direct investment, though these have been less robust of late. And much of the non-state sector remains vibrant.

What Risks Remain

If an Asian-style financial collapse seems unlikely, what are the major risks facing China? Perhaps the most serious risk is that the economy could continue to slow. Sectors other than

Because of China's low inflation, its real exchange rate has largely reversed its strong appreciation following the Asian financial crisis.

public investment appear weak, in particular consumer demand, reflecting uncertainty associated with reforms; non-government investment, reflecting lack of financing; and the external sector. Only a surge in public investment in the second half of 1998 kept growth from slowing further. Nominal state investment was 22 percent higher in 1998 than a year earlier, with most of that rapid growth coming in the second half of 1998.

On the demand side, the most serious concerns are probably consumption and investment. Precautionary saving appears to be very high, reflecting the need to pay much more—though how much more remains uncertain—for medical care, retirement, and housing, for example. If uncertainty rises further, precautionary saving could continue to rise. In addition, to the extent that consumption is interest-sensitive, then the current high levels of real interest rates also work to depress consumption. Though nominal interest rates are now relatively low, having been cut steadily since 1996, China's deflation implies that in real terms, interest rates are much higher now than they were then.

Private investment is constrained by restrictions on the availability of financing. Despite the fact that the non-state sector has grown much more rapidly than the state sector, a striking aspect of China's financial landscape is how little bank financing goes to this sector. Instead, most intermediated financing goes to the state sector; for example, HSBC economist Chi Lo reports that 86 percent of state-bank lending went to the state sector, as of September 1998 (*see The CBR,* March-April 1999, p.50). The non-state sector relies heavily on retained earnings, foreign direct investment, and leakage—or relending—of funds from the state sector. All three of these sources could continue to slow. A weaker economy, for example, tends to reduce retained earnings. New FDI inflows appear to be falling as well, reflecting both concerns about the desirability of investing in China and the residual effects of the Asian crisis, given that about 80 percent of FDI appears to come from Asia. Improvements in accounting standards and tighter scrutiny of enterprise activity may make the on-lending of funds from the state sector more difficult. Hence, private investment could continue to weaken.

Public investment probably has a limited ability to take up the slack. After all, in order to provide a continuing stimulus to output growth, public investment must not only remain at a high level, but must continue to grow strongly. Given China's relatively low level of tax revenue and undeveloped bond market, financing a further surge in investment is difficult (*see* p.16). Finally, such a surge may be undesirable—even in countries with a high degree of transparency, public investment projects often reflect pork barrel politics rather than sound economics. Press reports suggest some concern about the low quality of some projects, and the potential for corruption.

In assessing China's potential vulnerability, commentators often stress the narrowing trade surplus or continuing deflation. But these are probably not the major sources of concern for the future. Consider the trade balance, which has deteriorated sharply in 1999. Although the deterioration shows some weakness in export growth, it primarily reflects a surge in the recorded level of imports in 1999—after remaining roughly constant since 1995. If the deterioration indicated mainly an overvaluation of China's real exchange rate, concern could be warranted. But because of China's low inflation, its real exchange rate has largely reversed its strong appreciation following the Asian financial crisis.

Instead, this import surge has largely resulted from China's anti-smuggling campaign: previously unrecorded imports are now recorded and taxed. The resulting narrowing in the trade and current account surpluses in 1999 does not, then, appear to indicate a fundamental change in the state of the economy, and thus its economic effects are probably small. As of July 1999, year-over-year export growth remains weak, but that actually is the result of weak exports in the first half of 1998—not this year. Adjusted for seasonal factors, the dollar value of exports actually grew in the first half of 1999 relative to the second half of 1998.

THE DEFLATION BOGEY

What about deflation? In China, consumer prices have been falling since early 1998, a consequence of the slowing economy as well as declines in import prices. In developed economies such as Japan—or the United States during the Great Depression—deflation is a concern because it is not only a symptom of a downturn, but also exacerbates it. First, expected deflation raises real interest rates for any given nominal rate, thereby reducing investment and other interest-sensitive expenditures. Second, falling prices raise the real value of debts. This, in turn, makes debt repayment more difficult, which tends to reduce the investment and consumption of debtors, and worsens the financial condition of bank balance sheets.

These effects are much less important in China than in other countries, since it is unclear that the real value of borrowers' debts has a major effect on bank's activities. State-owned enterprises and other politically connected enterprises, regardless of who technically owns them, do not necessarily repay their debts in any case. For this reason, demand for bank loans is unlikely to be sensitive to the interest rate.

Deflation does, presumably, affect the incentives of households to consume or perhaps invest in ways not intermediated by the banking sector. That is, high real bank interest rates affect households' incentives to save through the banking system versus "direct investment" in non-state enterprises, such as start-up businesses, loans to relatives, or loans through the illegal curb market. This suggests that deposit rates may have some effect on investment decisions, although the quantitative effect is uncertain. To the extent that capital is more productive outside the state sector, deflation is likely to worsen the long-run allocation of capital.

Another risk is that China's reforms may slow. The increase in state investment since the second half of last year appears to have been financed to a large extent by substantially faster lending by the four major banks. Hence, the increase in growth appears to be at the expense of previously announced enterprise and bank reform.

A SLOW FREEZE?

In the long run, a sound banking system is crucial for ensuring that household saving is channeled into worthwhile, productive projects. As long as Chinese banks are forced to undertake quasi-fiscal operations of lending to the state sector, capital will not be allocated appropriately. This continuing misallocation of capital helps explain why China has failed to "grow out of the plan," as has sometimes been hoped. China's reforms have allowed rapid growth outside the state sector. However, as long as the state sector continues to receive preferential access to bank loans—without the necessity of paying them back—it will not simply wither away. State-owned enterprises account for a declining share of industrial output, about a quarter, but nevertheless continue to account for the majority of urban employment and bank credit. Politically, cutting enterprises off from credit is extremely difficult, because it means putting people out of work.

China's approach is to try applying steady reform pressure throughout the system—for example, pushing ahead with sales of small and medium-sized state enterprises where possible, telling banks that they are responsible for any new bad loans, and cleaning up balance sheets. Indeed, China has made steady progress; in 1998, state enterprises reportedly shed about 6 million workers. But each step causes dislocations or problems that need to be addressed, as suggested by the apparent backtracking in some areas in 1998. Moreover, in a system with numerous distortions, economic theory tells us that eliminating any single distortion may not improve the functioning of the system, since one distortion might help offset the effects of some other distortion. Thus, one should not expect any quick panaceas.

Indeed, enterprise restructuring can, in the short term, contribute to a slowdown in China. For industrialized countries, recent macroeconomic literature explores the importance of "sectoral shifts," the idea that reallocating resources across sectors is costly in the short term. The controversy in this literature is not whether reallocations and restructuring are costly, but whether they are important in practice. They might not turn out to be a significant source of shocks to the United States, for instance. So this macroeconomic literature suggests that some further temporary slowdown could occur in China, if the necessary reforms proceed.

China is attempting to balance conflicting concerns—a desire for short-run stability and growth, which tends to slow reforms—versus a need for long-run improvements in the allocation of resources, which requires that reforms move forward. This tension was apparent in 1998. Growth slowed in the first half of the year, and as a result, investment by state firms rose sharply in the second half of the year, financed by lending from state banks.

Elsewhere in Asia, decades of strong growth ended—one hopes only briefly—in metaphorical fire. In China, there remains the serious risk that it could end in ice. Without major structural reforms, China's economy is something like the house with a lousy furnace and uninsulated walls. The economy could then stagnate, and China would remain relatively poor, just as the house would remain cold in winter. Fortunately, Chinese leaders appear to be aware of the risks. Unfortunately, their choices are hard, requiring a trade-off between the political risks of a further short-term contraction and the economic risks of a long-term slowdown in growth. 完

> *China is attempting to balance a desire for short-run stability and growth against a need for long-run improvements in the allocation of resources.*

China's Fiscal Time Bomb

With more debt than it lets on, and low tax revenues, China's budget is weaker than the official statistics show

Chi Lo

Beijing's fiscal deficit is a ticking time bomb. The government's total budget deficit could be up to five times greater than official Ministry of Finance figures indicate, because Beijing counts funds raised by bond issuance as budget revenue rather than as borrowing. An inefficient tax system and the government's increasing reliance on debt financing for its spending needs also make the repayment and servicing of the public debt a mounting concern.

The fiscal bomb may not explode just yet, as ample household savings will sustain the fiscal deficit in the short term. But the ongoing decline in fiscal revenue from 28 percent of GDP in 1979 to 12 percent in 1998 is a serious concern, because it limits the authorities' ability to respond to the inevitable need to spend more on social and structural reform. Thorough fiscal reform is needed sooner rather than later to resolve these long-term budgetary woes.

The True Face of the Fiscal Mess

The culprit for China's worsening fiscal position is the long-term decline in the central government's tax revenues. On the surface, the decline has not led to a widening state budget deficit as a percentage of GDP, because of cuts in government spending. But this official deficit figure is misleading because Beijing inflates its budgetary revenues, mainly by including funds raised by bond issuance as revenue. Such bond issues should be treated as borrowing.

Adjusting for this accounting trick, China's fiscal deficit would have amounted to 5.3 percent of GDP—or ¥423 billion ($51 billion)—in 1998, instead of the official figure of 1.2 percent, or ¥92 billion ($11 billion). This adjusted budgetary gap has been widening, with Beijing financing the deficit by issuing still more bonds to make up for the precipitous fall in tax revenues (*see* Figure 1).

The Eroded Tax Base

According to the International Monetary Fund, the steady decline in China's tax-to-GDP ratio is a result of the combination of a tax policy that gives extensive tax concessions; structural changes that lower the effective tax rate for key economic sectors and erode the tax base; and weak tax administration. Until 1984, Beijing counted all state-owned-enterprise (SOE) profits and depreciation funds as part of central budget revenue, thus imposing an effective 100 percent income-tax rate on SOEs. This public-enterprise revenue was the cornerstone of Beijing's budget in the early 1980s.

But changes to the tax system have cut SOEs' tax obligations substantially over time. Especially damaging to tax collection efforts was the contract responsibility system (CRS), under which taxes were paid according to negotiated tax contracts rather than a standardized tax schedule. The 1994 tax reform replaced the CRS with a much lower, uniform rate of 33 percent for all state and non-state enterprises.

More important, structural changes in the economy have eroded the traditional tax base. The key revenue source—the state sector—has dried up, while the rapidly growing non-state sector has not been sufficiently

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THE CHINA BUSINESS REVIEW

1818 N STREET, NW SUITE 200 WASHINGTON, DC 20078-6587 integrated into the tax net. SOEs contributed only 8 percent of total tax revenue and accounted for less than 30 percent of total industrial output in 1998, compared to 29 percent and 65 percent, respectively, in 1985. Meanwhile, the non-state sector, which includes collectives, township and village enterprises, private enterprises, and foreign-funded enterprises, has been taxed relatively lightly—though this may be changing, at least for foreign enterprises (*see The CBR*, July-August 1999, p.8). The poor finances of the SOEs and the declining share of public-enterprise earnings relative to wages have also contributed to this state-sector revenue loss. About half of SOEs are in the red, and SOE wages have been taxed relatively lightly, further dragging down the overall tax intake.

From a macroeconomic perspective, the declining share of consumption in GDP, from 64 percent in 1979 to 59 percent last year, has also reduced the government's goods and services tax intake. This is another indication that tax revenues are not growing in step with the economy. Further, the rise in the export sector's share in GDP—from about 5 percent in 1979 to 20 percent in recent years—does not help raise tax revenue much, as export production is taxed at lower rates to encourage foreign participation in Chinese export industries. After recent VAT rebate increases, many products are taxed at 5 percent or less.

And then there are collection problems

The 1994 tax reform has failed to arrest the erosion of the central government's fiscal control. Fiscal revenue has declined precipitously, from 28 percent of GDP in 1979 to only 12 percent today, one of the lowest percentages among the major economies in the world. The absence of a nationwide tax system is the main administrative culprit. The State Administration of Taxation and local tax authorities define separate tax laws for their own jurisdictions and grant tax exemptions within their authority.

Local governments collect the bulk of taxes and share the revenues with the central government via complex, contract-based, intra-governmental fiscal arrangements. Local tax authorities work with local financial bureaus to formulate and administer local budgets. But these arrangements, coupled with the fact that many SOEs are locally owned, provide an incentive for some local authorities to maximize local revenues at the expense of tax contributions to the central government. These local authorities grant local SOEs generous exemptions from the taxes that are shared with the central government, but preserve their own portion of tax revenues mostly untouched.

The local authorities also wrung a big compromise out of Beijing in the 1994 reform, in the form of a guarantee that the absolute level of local tax revenues would not fall after the reform. Furthermore, Beijing agreed that the post-reform revenue-sharing scheme would only apply to the net future increase in tax revenues. Hence, the reform has failed to improve Beijing's tax-collection ability, as reflected in the figure for tax revenue as a percentage of GDP.

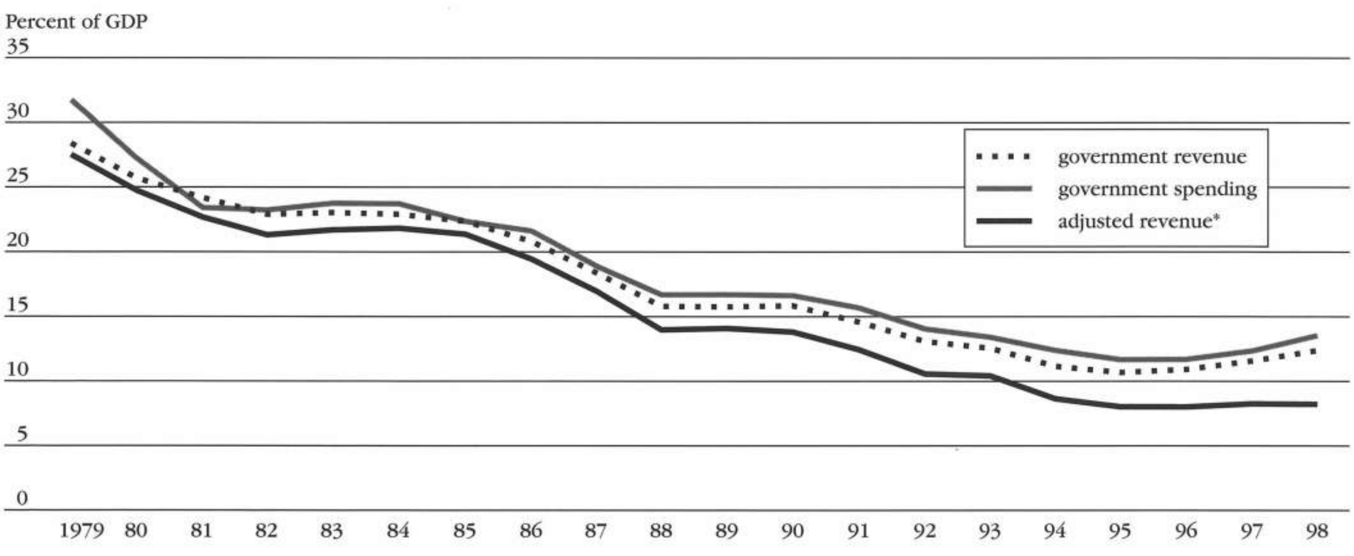
Fiscal revenue has declined precipitously, from 28 percent of GDP in 1979 to only 12 percent today, one of the lowest percentages among the major economies in the world.

How big is the budget hole?

With tax revenues inadequate, Beijing has been relying on debt financing to fund government spending and, more recently, to boost GDP growth. This has led to a sharp rise in the public debt-to-GDP ratio (*see* Table).

But China also has a hidden debt. Using Bank for International Settlements

Figure 1
The True Face of the Fiscal Mess



SOURCES: HSBC Economics, CEIC
*Total revenues less government bonds issued

Local authorities grant local SOEs generous exemptions from the taxes that are shared with the central government, but preserve their own portion of tax revenues mostly untouched.

(BIS) statistics, HSBC estimates that China's short-term (less than one year) borrowing from international banks amounted to $34.5 billion, or 53 percent of total borrowing, at the end of 1998. But official PRC statistics only show $17.3 billion—or 11.9 percent of the total—in short-term foreign debt. Even if one accounts for the possibility that official statistics may be inaccurate, the magnitude of the discrepancy between BIS and official data suggests that there might have been significant unauthorized foreign borrowing by Chinese enterprises last year—as much as $17.2 billion. The increasing size of this hidden debt adds to the true debt burden on the economy.

But the official budget deficit does not reflect this rising strain on central-government finances, largely because of Beijing's inclusion of funds raised by bond issuance in its budgetary revenues, which has effectively deflated the true budget deficit by an average of 2.5 percentage points of GDP in recent years.

Beijing also requires the state banks to increase lending—to a large number of SOEs—by the same amount as the increase in government spending. This has effectively doubled fiscal spending without counting it as expenditure. If bad debts at the state banks, estimated at over $200 billion in total, were included in the budget, the deficit would be significantly bigger.

Debt-Servicing Worries

The government's reliance on debt financing suggests that the rising cost of servicing the public debt could become worrisome. Indeed, the resources going toward servicing existing government debt have been rising steadily. Debt servicing and repayment accounted for over 70 percent of new government bond issues, which totaled ¥331.1 billion ($40 billion) in 1998 (*see* Figure 2). Thus, the share of fiscal revenue spent on debt servicing and repayment rose to 24 percent of total government fiscal revenue last year, from less than 3 percent in 1989.

If economic growth were strong, Beijing could simply cap spending and enjoy the rise in tax revenues to help ease its fiscal strains. But with the economy struggling through structural reforms, such a cyclical bailout is unlikely.

No Imminent Crisis

Nevertheless, China's high domestic savings level, estimated at 40 percent of GDP, should provide ample funds for the government in the short term. By selling bonds to the banks, Beijing can tap into the roughly $630 billion in household savings—61 percent of projected 1999 GDP—in the banking system.

China's rising debt-to-GDP ratio is still low by international standards. Even if the hidden debt is included, China's total debt is still about 30 percent of GDP, far below the internationally acceptable threshold of 60 percent. All this makes China's public-sector dissaving much less problematic. Beijing should have little difficulty financing its fiscal spending needs for at least the next two years.

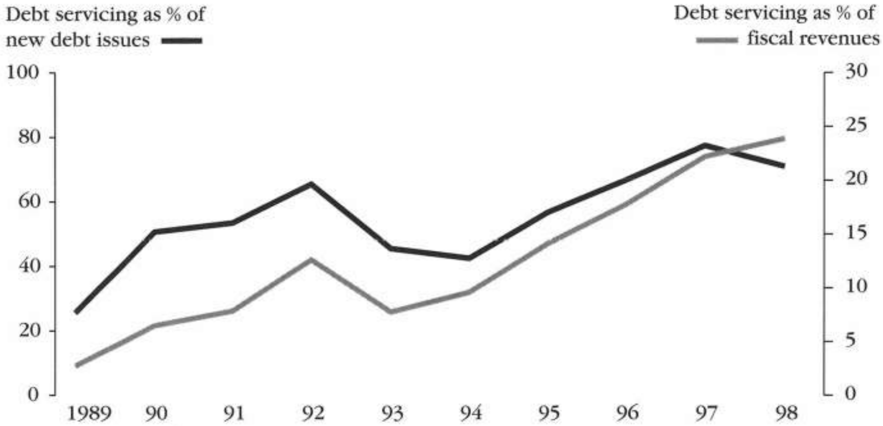
Compared with other countries, China's debt burden does not appear crushing. The public debt of the United States and Britain in 1946, Europe in the early 1990s, and Japan today has exceeded 100 percent of GDP without disaster striking. Indeed, Beijing's effort to generate a cyclical economic rebound, if successful, will help to reduce its financial stress by increasing revenues.

Rising Public Debt

Year	Percent of GDP
1994	21.63
1995	20.46
1996	20.55
1997	21.37
1998	26.98
1999 (forecast)	28.13

SOURCES: HSBC Economics, CEIC

Figure 2
Rising Cost of Debt Servicing



SOURCE: CEIC

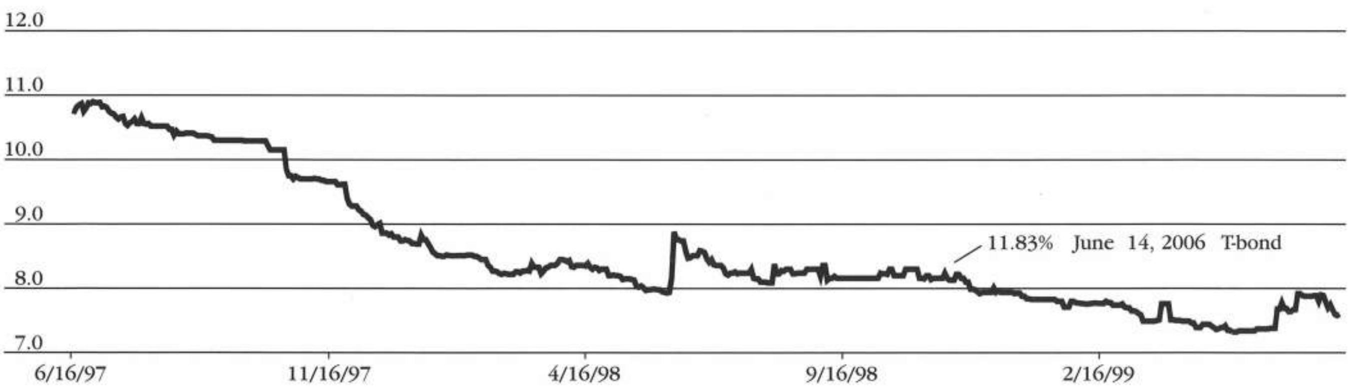
Markets Remain Calm—For Now

In theory, Beijing can live beyond its means as long as it can borrow from the public at reasonable cost. And such an ability to borrow is, in turn, decided by bond investors. If they are worried, they will demand sharply higher interest rates, causing government debt to spiral. But this does not seem likely in China. The yield of the 11.83 percent June 14, 2006 Treasury bond, traded on the Shenzhen Stock Exchange, has continued to fall despite Beijing's rising demand for funds (*see* Figure 3).

Several factors suggest that Beijing faces few fundraising difficulties in the near future. The high savings rate and the lack of investment alternatives have ensured a strong local demand for bonds. The government is also selling bonds to distressed domestic banks to help improve their balance sheets. At the same time, demand for funds from the non-state sector is weak, due to low investment levels—a result of the economic slowdown—and the absence of a consumer credit market. As long as the flow of funds to non-state borrowers is weak, the government should face little competition for funds. Finally, most of the government debt is domestic. Unlike foreign creditors, who would pull out at any sign of fiscal stress, domestic investors are usually loyal. And at 15 percent of GDP, foreign-currency debts—the proximate cause of the recent Asian financial crisis—are small.

Current levels of fiscal spending, however, are unsustainable. Without thorough fiscal reform, the government could lose control of its finances entirely. This steady decline in fiscal revenue also limits Beijing's ability to respond to economic shocks and economic reform's growing funding needs. Thus, however faithful its bond buyers, Beijing must soon undertake thorough fiscal reform: it must redouble its efforts to mend the tax net; reduce reliance on the state sector for revenues; and collect taxes from the growing non-state sector. Though the recent anti-smuggling campaign has led to an increase in import tax revenue, it will not be enough to improve Beijing's finances—total imports account for only 15 percent of GDP. While a fiscal crisis is not imminent, fiscal reform is. 完

FIGURE 3
FALLING CHINESE TREASURY BOND YIELDS



SOURCE: CEIC

Letter from the President
continued from p. 7

ability to do much more than protect its interests by playing off one "barbarian" against another. Originally established on a foundation of iron doctrine instilled through coercion and authoritarian control, the People's Republic at 50 is an entity that neither the modern world nor China itself has known before.

The "mass campaign style" of Maoist politics is nearly (but, apparently, not quite) gone; the Great Leader is no more; the coercive insistence on literal-minded devotion to the Chairman and his Word has been almost totally abandoned. The proletariat, so beloved of Marxist-Leninist ideologues and rulers, goes nearly unmentioned. "Class struggle," the first principle of political life for three decades after 1949, has been officially discarded. Living standards have risen spectacularly, and hundreds of millions of Chinese citizens have escaped the bonds of poverty. High-decibel purges and annihilations of politicians defeated in obscure inner-court struggles are 20 years out of date. China is "younger brother" to no one, least of all the now-defunct Soviet Union. China has joined the world in myriad ways that it once rejected, and the world has accepted China in institutions that for decades had no room for Beijing: the UN, international financial organizations, and hundreds of international agreements and covenants.

The United States, 50 years after the emergence of the PRC, remains the most powerful military force in the world. Its economy continues to grow and thrive. Its leaders and citizens bask in the luxury of not having to bear moment by moment the burden of preventing mankind's destruction. The world at large seems, to many Americans, far away and probably not worth worrying too much about. Vietnam is a receding memory, stopping Chinese Communist expansion a quaint curiosity remembered by only a few.

And yet, continuities and residues remain.

The situation in Korea today, encased in amber in 1953, is as dangerous to the world as it has been in nearly five decades, even though the United States and China are no longer on opposite sides. The Nationalist administration on Taiwan looks urgently to the United States for protection, as its forbears did sixty years before. The United States remains perched on the edge of the razor blade of mainland-Taiwan tension, even though a passing observer might at first have trouble recognizing today's Communists as the heirs to Mao Zedong and today's pluralistic Taiwan politics as the successor to the one-party autocracy of America's onetime Chinese client, Chiang Kai-shek.

Again, in 1999, Beijing's organs of opinion thunder at the United States, or "US-led NATO," or "US hegemonists," recalling the canonical Mao essay on America as a "paper tiger" that was required reading during the Cultural Revolution. Senior figures in the US Congress lash out at China as a nation of "child molesters and torturers." Again, a wave of fear pulses across the United States over the loss of atomic secrets—not, this time, to the rampant Soviet Union of Joe Stalin that confronted the United States on every continent in 1949, but to a China whose "shadowy" operatives and "sleeper" spies are said to be at work deep within the fabric of American life in 1999. Political stump speeches explicitly link the China-focused national security scare of 1999 to the searingly traumatic execution of Americans convicted of nuclear spying for the USSR in 1949. Columnists re-discover for the umpteenth time the well-worn accusation of "appeasement," and apply it this time to US policy toward Beijing.

It is disconcerting to find the legacies of 50 years ago so vivid. It is troubling to note the mixture of overheated anxiety and incurable casualness in American perceptions of a China that focuses our attention only when something terrible happens or a domestic "angle" ignites the media and the political sector. It is frustrating that the United States remains hostage to an only partially visible Chinese ballet across the Taiwan Strait, with each of the adversaries demanding that the United States bestow better treatment, spend more resources, offer better terms, and show more respect lest America embolden the other to greater misconduct.

The message of US-China economic relations

But if the legacies of 50 years ago still occasionally have the power to grip the United States and China by their throats, the economic relationship between America and China is an important indicator that things have changed for the better and can yet move further ahead.

America's business and economic relations with the People's Republic of China are not 50 years old but twenty-five. They embody many of the progressive breaks with the past that have marked China's development and US-China relations since the late 1970s. They are above all the products of China's decision to move from ideological rigidity toward greater practicality, from self-imposed isolation to self-motivated global engagement. They are also a reflection of American technological prowess, agricultural productivity, managerial-entrepreneurial vigor, and from time to time the strength of the American example.

American and world commercial engagement with China has been unintentionally transformative within China. As Professor Doug Guthrie's new study, *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China*, concludes:

> *In other words, political pressure at the state level is not meaningful without the pressure in the marketplace to take these institutional changes seriously. A fundamental component of the pressure for institutional change in China is the pressure of individual economic actors in the markets of China's transforming economic system....The best hope for helping a formal rational-legal system emerge over the course of China's transition is to continue allowing the local-level negotiations between Chinese citizens and foreign companies to occur in China's market.*

Economic engagement between Americans and Chinese has not wafted the United States and China beyond the reach of their darker tendencies. But neither has it entombed America and China in a downward spiral. Instead, economic and commercial engagement is gradually fostering something much more positive. No one listening to the remarkable presentations offered by Premier Zhu Rongji during his April visit to the United States could fail to be struck by this realization.

Deeper economic interactions are not the be-all and end-all of Sino-American relations, but they are today the most promising way forward for two great and proud nations facing each other in a world both transformed over 50 years and sadly chained to its not-so-distant past. 完

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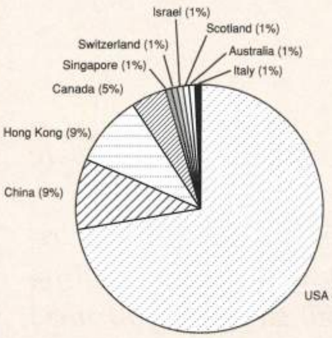

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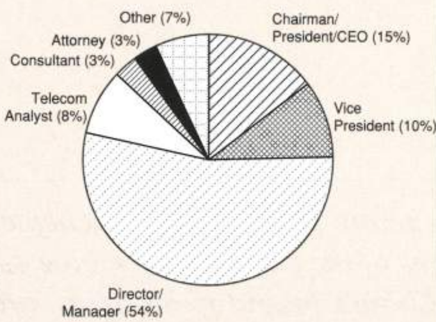
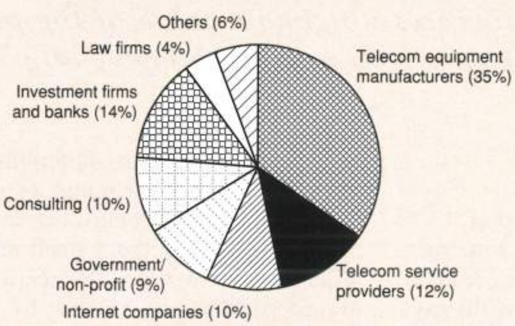


Distribution of Attendees by Industry Sector



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The Other Side of China's Prosperity

Rural laborers have provided the muscle behind China's economic growth

Daniel Wright

W*hile many in China have benefited from the economic reforms of the past 20 years, others, especially those residing in China's inland rural areas, are still struggling to meet their basic needs. The following excerpts from 1997-99* ICWA Letters—*written by ICWA Fellow Daniel Wright from Guizhou, one of China's poorest provinces—highlight some of the problems faced by China's rural residents, who make up roughly 80 percent of China's total population.*

SPLENDID: A TYPICAL VILLAGE

My internal alarm clock sounded at 4:57 am. I drew back the mosquito netting, switched on the light bulb that hung from a wire above the bed, and pulled on my clothes. In a matter of minutes Shui Jianhua, my 26-year-old farmer friend, and I were off to begin the day.

We walked up an uneven stony path, passing quiet wooden village homes in the faint pre-dawn light, and headed toward a series of terraced rice paddies that cut into the mountainside like a staircase. We stepped onto a narrow mud retaining wall that separated Jianhua's two levels of paddies, each the size of small putting greens. Carefully placed rows of tender, green rice seedlings, each row separated by about four inches, poked above the surface through the water-filled plots.

Jianhua's first task of the day was to divert the flow of a spring-fed rivulet that emerged from a rock-faced cliff above his paddies. During the night the stream had been used to water a neighbor's network of paddies; now it was his turn. Before he introduced the flow of fresh water, Jianhua first inspected each paddy's outlet, a six-inch-wide opening that functions either to retain water or release it into a spillway that leads to the paddy below. At some of the outlets he constructed a small mud wall in order to dam the flow of water. In more saturated paddies, he patted the mud wall down a bit, or adjusted several stones to release a trickle of water, revealing the understanding and skill that enabled him to maintain appropriate water levels—with the use of gravity only—in this labyrinth of irrigation channels halfway up the side of a mountain.

Shui Jianhua lives in Splendid (*Guangrong*) Village, a mountain community in southern Guizhou Province. To get to Splendid from Duyun (the provincial capital), one has to travel by bus for several hours, hike for 60 minutes along a crystalline mountain stream, and then climb straight up for 30 minutes. The village sits perched among rock ledges, waterfalls, and pine forests.

Typical of China's rural hinterland, Splendid's 1,000 residents work hard just to maintain a subsistence-level standard of living. Primary crops are rice, maize, potatoes, wheat, and cabbage. All work is done manually. A "man's best friend" is the beast that

see p.24

Daniel Wright is a Guizhou-based Institute of Current World Affairs (ICWA) fellow studying the people and societies of inland China.

Guizhou at a Glance

Landlocked in southwest China, Guizhou Province is the sixteenth-largest of China's 30 provinces. It has a total area of 176,000 square kilometers (68,000 square miles), roughly the size of Washington State, and 36 million residents, equivalent to California's and Oregon's populations combined.

Guizhou has yet to shed its centuries-old description: "Not three feet of flat land, not three days without rain, not a family with three grams of silver." Its per capita gross domestic product is the lowest in China—¥2,215, or roughly $267, in 1998. The province's widespread poverty is in large measure due to its severe physical conditions.

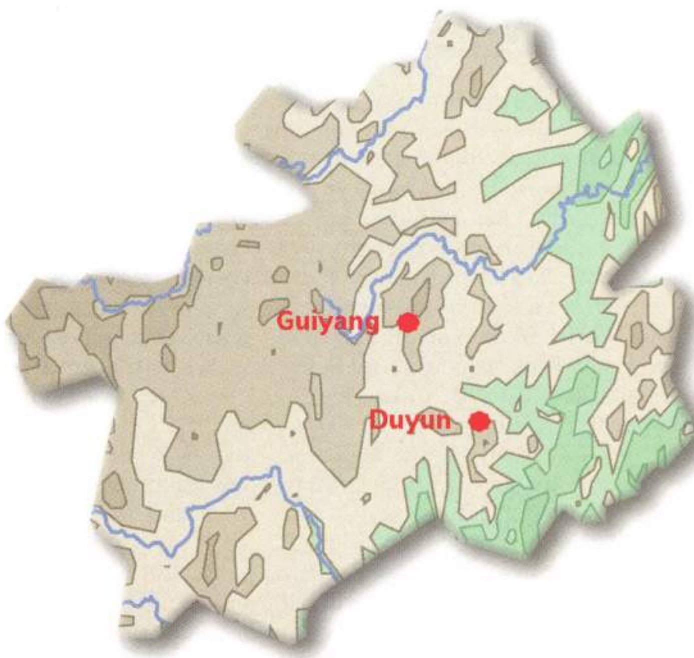
Guizhou is 87 percent mountainous, 10 percent hilly, and 3 percent valley—meaning that arable land is scarce. These conditions create another problem: drought. Though it seems to rain almost continually, the shallow, rocky soil does not hold moisture well; rain seeps quickly down to the rivulets and rivers far below most villagers' homes. Attempts to irrigate are extremely arduous because for many farmers, irrigation technology consists of shouldering buckets on each end of a pole and heading down a steep, treacherous path to the nearest source of water.

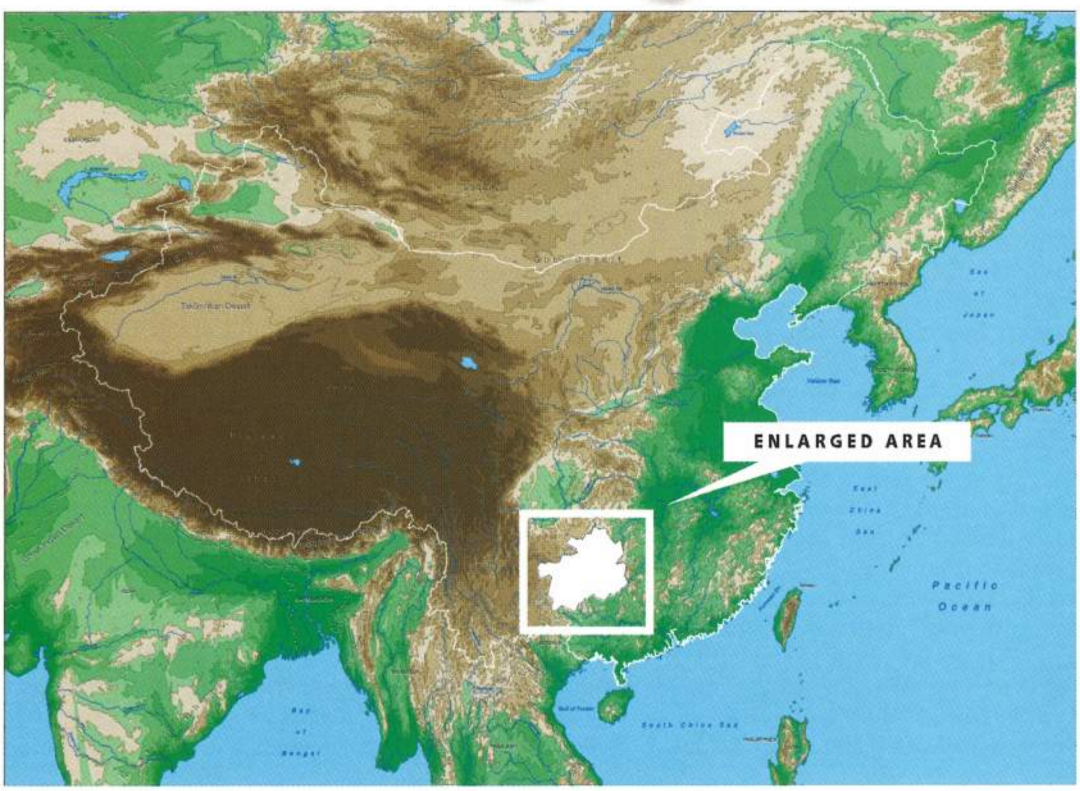
Beneath most of Guizhou's soil, however, lies an abundance of natural resources. Guizhou's coal reserves rank fourth in the nation (70 percent of its counties have coal), and in 14 classifications of minerals Guizhou ranks among the top five provinces. The coexistence of Guizhou's obvious poverty and disguised wealth is startling; one Chinese economist characterized southwest China's backwardness as a "poverty of plenty."

From a cultural perspective, the population is anything but impoverished. Guizhou has the fifth-largest minority population in China. Thirteen major ethnic groups, including Miao, Buyi, Shui, Dong, Yi, and Yao—each distinguished by their headdresses, delicate embroidery, handicrafts, cultures, and languages—constitute 34 percent of Guizhou's population. The wide variety of ethnic peoples and their customs makes for over 1,000 festivals across the province each year.

—*Daniel Wright*

Guizhou Province





The biggest income-producers for Splendid Village are family members who work as migrant laborers.

pulls the plow: water buffalo, ox, or horse.

Agricultural goods for the most part are consumed by the villagers themselves. Other sources of income come from raising pigs or capturing wild animals such as snakes. The biggest income-producers for Splendid Village, however, are family members who have left to work as migrant laborers in either nearby urban areas like Duyun, a city of 200,000 that was developed around state-owned industry, or in faraway coastal cities like Guangzhou and Shenzhen.

Almost everything in Splendid is handmade. Houses and most furniture are built from local pine; roof tiles are baked in local kilns; every part of the plow except the iron blade is made from tree limbs; and baskets are made from local bamboo.

Items that are not made by the villagers (such as pots and pans, rope,

China's War on Poverty

Despite China's economic gains over the last 20 years, many Chinese still lack adequate food and shelter. In the poorest villages, more than one in every 10 infants dies within a year of birth; few children attend school; and infrastructure fails to provide for basic needs such as clean drinking water.

The World Bank estimates that roughly 270 million people in China survive on less than $1 a day—the international standard used by the World Bank and the United Nations to define the poverty line in many developing countries. The PRC government, however, sets the poverty line much lower, at an individual income level of roughly 16 cents a day. And many provincial governments set the poverty line even lower than that. In Gansu Province, for example, the poverty line hovers at 10 cents a day. According to the national standard, 42 million Chinese live in dire poverty, but this figure includes only people at or below the poverty line living in officially designated poor areas. Nevertheless, the official number of people living in poverty has fallen from 250 million in 1978.

PRC leaders, vowing to eliminate poverty by the end of the century, have shifted their strategy from merely providing relief funds to developing infrastructure, educational systems, and the economies of China's poorer regions. This strategy is reflected in the National Seven-Year Plan for Poverty Reduction (1994-2000), which focuses on the poorest areas. Though PRC leaders intend to rely mostly on the efforts of central, provincial, and local governments, as well as private organizations, they are also enlisting assistance from multilateral institutions, foreign governments, and international private organizations.

Funding from home...

As part of the seven-year plan, the PRC government has substantially increased poverty-relief funding. In January 1997, President Jiang Zemin ordered that government spending and lending be increased to roughly $1 billion a year. In June 1999, Vice Premier Wen Jiabao announced that an additional $783 million would be channeled into poverty-alleviation efforts this year, bringing the total for 1999 to $3 billion. During 1994-2000, the State Council is distributing $121 million each year in interest-free loans to governments of poverty-stricken areas such as the Guangxi Zhuang Autonomous Region, and has instituted preferential tax policies for enterprises with a majority of staff below the poverty line.

Poverty alleviation is also a priority for the Ministry of Education, formerly the State Education Commission (SEC). Often in China's poorest areas, half of the boys and nearly all of the girls cannot afford to attend school. In 1995, SEC and the Ministry of Finance launched a six-year compulsory education project targeted at poverty-stricken areas. Central and local governments are investing $3.1 billion in school improvements in these areas.

Since 1986, Beijing has funneled $8.1 billion into microcredit schemes. Such programs provide credit for start-up independent businesses to many families that would otherwise be ineligible for bank loans. A total of $600 million in loans of $150 or less will be made available this year. Small loans have also been issued at the provincial level: Guizhou Province provided roughly 200,000 households with $24.2 million in loans in 1998.

The Work for Food Program, which supplements the government's infrastructure development programs for poorer regions, provides employment to residents in impoverished areas. The roughly $9.7 billion that has been poured into this program between 1984 and 1998 has helped build or renovate 300,000 km of roads, construct irrigation facilities for 5 million hectares, and provide potable water to over 63 million people.

Local, municipal, and provincial governments are active participants in poverty-relief efforts. The Guizhou provincial government, for example, allocated $183 million for poverty-relief projects in 1998. The local committees of the Chinese People's Political Consultative Conference, the administrations of industry and commerce, and civic groups have initiated a program aimed at poor farmers. Over 36,000 experts and technicians have introduced new rice strains and farming techniques to more than 200 townships and villages. The province has also raised $3.6 million to return impoverished students to school. And the national education program known as the "Hope Project" has helped send over 71,500 Guizhou children—who dropped out of school for financial reasons—back to the classroom.

Coastal regions, meanwhile, are not only assisting their own impoverished residents, but also helping their poorer inland neighbors. These regions have donated an estimated $483.7 million since 1997 to 240 poverty alleviation projects. In particular, Dalian, Ningbo, Qingdao, and Shenzhen gave $20.3 million to Guizhou and helped build or remodel 228 primary schools, construct 87 hospitals, and create jobs for 120,000 workers. In 1998, Guangdong Province allocated an estimated $8.5 million to support neighboring Guangxi.

plastic items, rat poison, and fertilizer) are purchased or traded for at the nearest market town, a three-hour hike away. Markets are open on calendar days that end with the numbers 3 and 8. On market days, over 10,000 residents from the surrounding mountains pour into the town to buy and sell.

Though Splendid belongs to one of the poorer townships in the area—average annual per capita income hovers around $80—there have been improvements in recent years. The most exciting was the introduction of electricity in December 1997. The villagers say the most important way electricity has changed their lives is convenience. Instead of having to build a separate fire to cook rice, for example, many homes can now accomplish the same task by flipping the switch on an electric rice cooker. Jianhua even has a used, black-and-white television that receives one channel. The reception is horrible, but it is television—and for the first time in Splendid history.

The nearest market town to Splendid Village is a three-hour hike away.

While electricity has kindled enthusiasm in Splendid, poverty remains a

Nongovernmental organizations (NGOs) are also pitching in. Wind Beneath My Wings, initiated by the Expert Committee of the China National Committee on Care for Children (CNCCC) and the Foundation for Underdeveloped Regions in China (FURC), seeks donations to assist poor children. Founded in 1991, the CNCCC is a 2.4 million-member NGO composed of 400,000 grassroots organizations spread across 30 provinces and municipalities. Established in 1989 to offer assistance to impoverished farmers, FURC has helped create arable land, support animal husbandry, grow fruit trees, and improve water supplies. In 1998, FURC provided $2.4 million in funds for poverty-alleviation projects in Gansu, Guizhou, Shaanxi, and Sichuan provinces.

Last but not least, a number of urban professionals have jointly sponsored a "course of glory" program that involves 100 development projects in minority, remote, and poor areas. Close to 3,000 entrepreneurs, including those from Hong Kong, Macao, and Taiwan, have donated $602 million to China's poor regions since 1994.

...AND FROM ABROAD

Most major international organizations and multilateral institutions, and some foreign governments and firms, have responded to Beijing's call for help with poverty-elimination efforts. The World Bank, a major partner since 1990, has provided $3.8 billion for 31 projects in 23 provinces. In addition to direct poverty-relief grants, the bank has provided the Ministry of Education with funds to develop elementary education in 349 poverty-stricken counties. In 1998 alone, the bank allocated roughly $885 million towards rural development and health projects. In western China, over 100 million residents have benefited from World Bank programs.

One of the bank's major resettlement projects has sparked controversy, however. The China Western Poverty Reduction Project will move 58,000 Qinghai Province residents to Dulan County in Haixi Mongolian and Tibetan Autonomous Prefecture in western Qinghai. Despite protests by some exiled Tibetans and members of the US government who claimed that the resettlement threatened the prefecture's Tibetan cultural heritage, the World Bank approved the project.

The United Nations International Fund for Agricultural Development, meanwhile, has supported 12 poverty-relief projects in China worth $620 million. And the UN World Food Program has donated $720 million to China since 1980. These funds are divided among 56 projects, ranging from the construction of irrigation systems and terraced fields to soil conservation and afforestation projects.

Foreign governments and corporations are also assisting. In 1983, the Japanese government initiated a program to increase grain output. By 1997, it had poured $51.3 million into more than 170 towns and villages in 20 provinces. The program has helped raise grain output by 2.5 billion kg in these areas and increase farmers' incomes twelve-fold. Among other foreign companies, Hoechst Marion Russel has donated $121,000 to poverty-alleviation programs in Guangan and Yilong counties in Guangdong. The funds, to be channeled through the Ministry of Foreign Trade and Economic Cooperation, will be used to improve medical facilities in two hospitals. Hoechst is also sending consultants to the two counties to work with local enterprises and train their staff. And the Kuwait Fund for Arab Economic Development will provide $86 million in loans to irrigate 130,000 hectares of land and improve living and working conditions for 1 million farmers in Ningxia Hui Autonomous Region. To date, two water-pumping stations, a power-control system, a power-transmission line, and a telecommunications network have been completed there.

AN UPHILL BATTLE

Beijing's best efforts may not be enough to eradicate poverty entirely, however. The poorest citizens reside in the country's most remote and resource-deficient regions. Furthermore, in addition to lifting 42 million people above the poverty line, China must ensure that the 200 million people hovering above the line do not fall below it.

Whether China can successfully combat poverty depends to a large extent on provincial and local governments' ability to allocate spending efficiently and effectively. In some provinces, central-government funds are being wasted or pocketed by local officials. At the same time, the number of officials needed to carry out reforms has multiplied. Staffing and funding burdens strain many of the poorest counties financially. Counties in southern Guizhou, for example, cannot meet payrolls and undertake poverty-relief projects at the same time. Thus, to reach the goal of eliminating poverty by 2000, Beijing must not only increase investment, but ensure that such funds are used properly.

—Darlene M. Liao

Darlene M. Liao is assistant editor of The CBR.

Life is difficult in the mountains; but for farmers-turned-migrant laborers in the city, it is bitter, degrading, and dangerous.

chronic reality (*see* p.24). The village's remote location, the difficulty of transportation (everything must be carried by men, women, or animals from the nearest road), and other infrastructure limitations are key reasons for the village's poor living standards.

Education levels reflect the hardship. Of the 300-plus Splendid elementary school-age children, half attend school. Many families cannot afford the $12 annual tuition. When families have to choose which child to send to school, daughters often lose out.

Similar to much of the southern half of Guizhou Province, Splendid is populated by a mix of ethnic groups that intermarry. Splendid Village is 60 percent Shui, 30 percent Miao, and 10 percent Buyi. Because the majority is Shui, and the village is located near a county primarily populated by Shui people, most of the villagers have adopted Shui customs and language. Actually, the men dress like the Han Chinese that make up 97 percent of China's population, sporting blue or gray Mao jackets. The women, however, wear traditional Shui dress. In addition to speaking the Shui language, most villagers speak a local variety of Mandarin Chinese.

Shui Jianhua's family is typical. His father is Buyi and his mother is Shui. Though Jianhua's wife is also Buyi, neither of them can speak Buyi. And because his wife is from another county, she cannot speak Shui either. As a result, Jianhua and his wife speak the local variety of Mandarin with each other.

Though Jianhua's family farms six *mu* of land (a bit more than a half an acre) spread over 21 paddies, and has plenty of grain to eat, the family members realize that they must find income outside the village to maintain a stable life. In Splendid, at least one member of nearly every family has left to find work in urban areas. Three of Jianhua's five immediate family members are part of China's migrant labor force. His parents both work as janitors in Duyun, and his brother has been working in a Guangdong Province factory for three years. Jianhua's sister was married several years ago; she lives in a nearby village. Even Jianhua, who is just 26, worked construction on the coast of Guangxi Province for five years and pedaled a pedicab in Duyun for three years. As long as one family member remains in the village to tend the paddies and animals, Jianhua's family believes that it is best that everyone else work in urban areas.

Local Migrant Labor

In fact, a lack of food and clothing for most residents of this poor community is no longer a serious concern. The villagers say their biggest need is cash: the means to pay their children's school tuition, prepare daughters' dowries, and purchase fertilizer and other needed items like cooking utensils. As a result, 90 percent of the men and many of the women in their 20s and 30s have departed Splendid for the cities—the country's cash centers.

Despite the strong attraction, however, urban areas stir apprehension in the hearts and minds of these rural folk. Life is difficult in the mountains; but for farmers-turned-migrant laborers in the city, it is bitter, degrading, and dangerous.

One of Jianhua's First Uncle's daughters was deceived while looking for a job in Guangdong; she ended up getting sold as someone's bride. She later escaped and found her way home. Jianhua's Second Uncle's sister-in-law lost her husband in a mining blast in neighboring Guangxi last year—yet another migrant-labor casualty. Second Uncle says he would be working in a city somewhere, regardless of the risk, were it not for his wife's frail health. Because neither he nor his wife can earn cash outside the village, one of their three children is facing the grim reality of having to drop out of school. Third Uncle, the youngest of the brothers, works in nearby Duyun, the prefecture capital, pulling a pushcart from dawn to dusk. He speaks to me without raising his eyes, seemingly ashamed. Yet after expenses, he averages ¥500 ($60) a month, almost as much as the average annual per capita income for the township. Good money, yes, but he earns every *fen* (cent) of it through exhausting labor and the disdain of urbanites.

Many observers view China's labor migration as primarily a flow from the country's backward hinterland to the more prosperous eastern seaboard. Indeed, it looks this way from afar. But disparity in China cuts most deeply between city and countryside, not coast and interior. Labor on the move responds accordingly.

China is not a country simply tilted east with all its labor sliding toward the coast. Rather, urban centers across the land—small, medium, and large—attract China's estimated 200 million redundant farmers from fields and mountains. Most farmers in Guizhou say that more of their fellow villagers seek work in southwest China's urban areas than venture toward the better-known coastal destinations of Guangzhou, Shenzhen, and Shanghai. Two-thirds of those who leave Splendid, for example, remain in Guizhou's cities.

Little-heard-of Duyun, the city's 200,000 people squeezed along a river valley in the middle of southern Guizhou's mountains, is one of those points. Just ask some of the 2,000 pushcart operators who run its streets each day. Though the primary ways in which the urban-rural divide was institutionalized in the 1950s—household registration and migration restriction—have been eased or eliminated, they produced a two-caste mindset that remains today. The result has produced perhaps China's greatest wall: little understanding or appreciation between its agricultural and non-agricultural populations.

Even so, as long as cash remains difficult to come by in many rural regions and as long as the wage difference remains so large, millions of rural laborers will continue to migrate to the cities looking for work. How their urban bosses view them is among the least of their concerns. In the longer term, practically inexhaustible flows of redundant labor from the countryside to China's cities—coast or interior—must be viewed as a temporary solution to the shortage of cash in the countryside. Both the numbers and the realities of the rural-urban divide are just too dramatic. Cash centers must be developed that are more numerous and widely dispersed than the urban areas that dot the country.

Prospects for prosperity at home

One obvious need is to promote non-agricultural income-generating alternatives in the countryside. Township and village enterprises (TVEs), for example, have brought means of production and capital to the countryside, and have become important employers of idle farmers, absorbing 27 percent of redundant rural labor. But that's primarily in eastern, more prosperous China where rural areas tend to have better infrastructure, access to markets, and traditions of non-agricultural production. As of 1995, TVEs in western China were producing only 4 percent of the total national value.

There is lots of room for TVEs to grow in western China. Still, it takes money to make money. Financial institutions, even of the most basic sort, that extend credit to rural residents must be normalized and made more accessible. Even in the better-off regions of rural Guizhou, like Splendid Village, the likelihood of gaining access to any meaningful credit seems light-years away. Much-needed infrastructure improvements are also spreading in these areas, but slowly.

As policymakers work to improve conditions in the countryside, the continued development of urban areas must not be overlooked either. Cities and towns will continue to attract rural laborers. As these points across the country become increasingly connected to roads, railways, and telecommunication grids, they have the potential to stimulate complementary growth in the countryside. In this way, urban-rural relations need not be seen as a contradiction, but as mutually dependent. Generations-deep prejudice, however, is difficult to reverse.

In the meantime, China faces declining growth of rural incomes and rising levels of corruption that thwart efforts to institutionalize rural residents' ability to gain access to cash at more local levels, especially in towns and townships. Thus, for the foreseeable future, the welfare and stability of the countryside will in large part depend on the ability of migrant laborers to earn cash in the country's urban areas.

One obvious need is to promote non-agricultural income-generating alternatives in the countryside.

Further from home

"Home" is a powerful notion for most Chinese. Traditionally, they prefer not to leave the beloved soil of their ancestors—that is, absent war or natural disaster. But times are changing. Since the late 1970s, when Deng Xiaoping unleashed economic reform, push and pull factors—created by the economic growth of a nation in which per capita income doubled twice between 1978 and 1996, and by the enormous contradictions of rural/urban and

China faces declining growth of rural incomes and rising levels of corruption that thwart efforts to institutionalize rural residents' ability to gain access to cash at more local levels.

interior/coast disparity—have resulted in increasing numbers of people on the move. The most concentrated sector of China's 115 million-strong "floating population" is migrant labor, some 50 million people who have left their homes to work in other parts of the country.

Despite increased mobility, "home" remains an important part of the Chinese emotional makeup and sense of responsibility. The result is a fascinating phenomenon each year before and after Chinese Spring Festival: millions upon millions of people on the move—crowded into buses, trains, and planes—returning home to celebrate the two-week holiday and then flowing back to the coast to continue or search for work. This unusual population group—growing and on the move—outnumbers the combined populations of Beijing, Shanghai, Nanjing, and Guangzhou.

To form my own opinions on the role and prospects of China's migrant labor, I decided the best place to begin was not in books, newspaper articles, and interviews with government officials, but rather on a piece of hard-fought-for bench in a train carrying thousands of migrant workers from their homes in the interior to work on the coast.

All aboard

I was one of the lucky ones. I had successfully competed with several hundred migrant laborers for a seat on the 31-hour journey of train No.488. My migrant-labor comrades and I stood, squatted, and sat together as the train crawled through the mountains of Guizhou over its 1,600 kilometer route toward the fertile farmland and wealthy cities of Guangdong. It turned out that most of those sitting around me were laid-off (*xiagang*) factory workers headed for the coast to look for a way to support their families.

As the train rumbled down the tracks, I began to realize that, with the slow-motion collapse of much of China's state-owned sector, traditional migrant labor is absorbing a new type of person: urban factory workers from across the country, some skilled and others not, who are joining the search for wealth in Chinese cities and Special Economic Zones (SEZs). One fellow on the train told me that in Duyun at least 30,000 people have been laid off, and 80 percent of these have left Duyun to look for work on the coast. This is just a drop in the bucket of the estimated 30 million across the country who are being forced to find food outside China's rapidly rusting "iron rice bowl."

All the people I met on the train were young (mostly in their 20s), and had a shared need to leave their homes and a common destination—the cities and SEZs of Guangdong. But beyond the general observation that a growing number of laid-off urban factory workers were joining the masses of predominantly rural migrant labor, I found no other common pattern. Each individual had a specific story as unique as his or her life.

Directly across from me sat a quiet, self-confident man, about 30 years old, who was returning to his job in a Shenzhen electronics factory, a job he had already held for a number of years. The annual journey back to Duyun to see his wife and daughter, for him, was no major ordeal. He was used to it. One of the first things he told me, however, was that "people on this train won't tell you, and you can't see it on their faces, but they're scared to death. They fear the unknown that lies ahead of them. Most of them don't know where they are going."

The logic of mobile labor

I have read the literature that evaluates China's migrant labor as a social, economic, and political threat. Since migrants form a group outside the system, it is argued, there is no way to organize or control these people. Whether for family-planning purposes, concern over rising crime, or just the menace of the unemployed sleeping in the streets, migrant labor lives beyond the reach of the state. Others also cite migrant labor's vulnerability to exploitation and the lack of basic social services available to them, especially health care. Needless to say, it doesn't take much imagination to envision a chaotic drama of 50 million jobless migrant laborers swamping China's cities.

But many view migrant labor as a normal consequence of economic reform, which, while loosening control of China's countryside through the breakup of the commune system, encourages some areas and some people of China to prosper first. As a *de facto* component of government policy, therefore, it is only natural that large numbers of people would flow from the less- to the more-developed areas of the country. The contributions the laborers make, however, to both the coastal areas as well as their home regions, outweigh the costs and risks. Much of China's economic growth has been built by the callused hands and sweat of migrant labor. In urban areas, for instance, migrant labor often does the dirty work that locals would never touch. China's powerful export market, as well, has been underwritten by the inexpensive and willing labor of those from the interior.

And while migrant labor can be viewed as a threat to stability, an equally persuasive logic argues that migrant workers are the thread that keeps a rapidly transforming China from ripping apart. Migrant labor has helped to relieve pressure from the country's impoverished regions and to transfer resources and skills back to those areas. Several migrant laborers told me that beyond the funds remitted home, they believe their role is to open the minds of people back home to new ways of doing things and try to keep them from being satisfied with simply having enough clothes to wear and food to eat.

Like the powerful force of overseas Chinese, "Overland Chinese" (my term for the millions of migrant laborers who remit significant amounts of cash to their homes in the interior) play an important financial role in their local economies. A Guizhou official who runs a government-representative office in wealthy Shenzhen told me that in 1997, migrant laborers from Guizhou remitted ¥5 billion ($600 million) to family members back home. That figure equals Guizhou's entire annual local-government revenue! It is also equivalent to 10 percent of the province's gross domestic product. In this regard, one of the most important contributions made by migrant labor is the ability to get resources directly into the hands of individual families in China's poor interior, something government bureaucracies and aid programs seem to have great difficulty doing.

Economic analysts agree that the gap between the coast and the interior will not begin to close for at least the next 30 years. In the meantime, the labor that flows from China's interior to the coast—and from more wealthy areas in the interior to less-wealthy areas—serves as an important mechanism to transfer capital, skills, and knowledge.

My primary concerns over the future prospects of migrant labor revolve around whether the Chinese economy will continue to grow quickly enough to continue to absorb the migrants, particularly in cases of natural disasters or other unexpected events.

Population pressures in the interior and surplus labor, totaling over 200 million people—two-thirds of the US population—almost guarantee that the numbers who desire to work in the country's wealthier urban areas will continue to increase, especially if wage disparities remain.

One of the greatest hopes for the future of migrant labor is that while sufficient country-wide economic growth is sustained (not a given), wealth and economic opportunity will spread to more regions and layers of Chinese society. In this way, those seeking non-agricultural economic opportunity would have more options. Risk for the country as a whole would also be more diffuse. Indeed, this has been happening. But from the perspective of poor, interior provinces like Guizhou, it is not happening fast enough.

No question about it: prospects for migrant labor cut both ways. It should continue to be a major contributor to economic growth, progress among the poor, and social stability. At the same time, however, migrant labor will remain a threat and a challenge, especially if and when there is a serious economic downturn. That's the tightrope China has to walk. 完

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2009: China's Human Resources Odyssey

MNCs must be creative to staff their China operations successfully

Rebecca McComb

The backbone of any multinational operation is an adequate human resources function. From paying salaries to approving interdepartmental moves, from hiring to firing, the human resources function is integral to the smooth and successful workings of any company.

In China, this system has been difficult to establish. The field of human resources as a whole is still developing and focuses heavily on personnel and administration. As such, it consists mainly of paperwork processing, rather than placement strategy. China's inefficient educational system and teaching methodology, moreover, have yet to provide the country's economy with the adequate base of trained professionals it desperately needs to become globally competitive. The dearth of well-educated, trained, and skilled professionals in the recruitment market forces MNCs in China to explore other ways of staffing their growing operations. Companies seeking success in China thus must take the time to understand the characteristics of both the recruitment marketplace and the human resources function.

THE EARLY YEARS

When large numbers of MNCs first entered China in the late 1980s, the human resources function was in its most basic, primarily administrative, form. Because of the Communist cradle-to-grave system of caretaking, human resources was a non-issue. Personnel issues were party-related and heavily dependent upon personal relationships. Though many aspects of the Chinese workplace have changed drastically over the last 20 years, the personnel function in most firms has changed little.

In China, human resources has tended to refer to the execution of essentially two tasks: building a relationship with the relevant government labor bureau, which amends and modifies labor laws as they relate to employees, and administering state-supported benefits—medical, housing, and pension—directly to employees. These often tedious and complicated tasks can range from finding an employee an apartment to doling out baby formula and extra milk powder for pregnant and nursing staff. Strategic concerns that tend to fall by the wayside include decisions on basic hiring; whether to move a talented employee to another department in which he or she would be more effective; career path planning for new employees; or reviews of the company's global

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staffing situation to identify where cuts might be logical and cost effective.

The educational system has, until recently, failed to foster strategic thinking. Traditional Chinese education has relied on rote memorization, valuing technical skills over general business skills, and in many cases discourages creativity and new thought. The Cultural Revolution (1966-76), the most damaging period in China's recent history, brought about a virtual collapse of the educational system by closing schools and universities nationwide.

In 1978, these institutions reopened. But because teachers had also been given a 10-year break, education did not improve significantly until the late 1980s, when international exchanges for both teachers and students became more common. Thus, diplomas and degrees received between 1960 and 1980 represented very little in terms of actual knowledge acquired by the graduate—Chinese over 40 years of age generally lack the necessary English-language and innovative thinking skills to serve an MNC in a managerial capacity.

Since the late 1980s, many young Chinese have gone abroad for post-secondary education, becoming the potentially qualified staff most MNCs would like to recruit. Indeed, most local Chinese managers of foreign-owned operations are aged 25-40, with the vast majority aged 33-36. Applicants over the age of 40—who were in their teens and twenties during the Cultural Revolution—tend to be overlooked for management positions.

Shifting strategies

In the joint ventures of the early 1980s, the MNC partners usually agreed to hire much of the PRC partners' local staff. Because most state-owned enterprises were overstaffed, lay-offs were often the first step for most joint-venture human resources departments. Strategic human resources functions were virtually unknown.

In the late 1980s and early 1990s, MNCs began to recognize that more was required in terms of human resources strategy. The first wave of MNC expatriate staff experienced difficulties because few, if any, of them were trained in the language, culture, or history of China. MNCs thus increasingly looked to local Chinese to fill their staffing needs not only because their salary requirements were less onerous than those of expatriates, but also because their knowledge of the business culture enabled them to expedite matters more quickly (*see* p.34).

But as MNCs turned to the local market, the gap between their staffing requirements and the supply of qualified locals became clear. Between 1990 and 1995, many MNCs began to import human resources managers, usually based at home-country headquarters or in Hong Kong, who consulted with senior expatriates about strategic human resources issues.

These specialists, typically expatriates, managed the demand and supply game every MNC faced in China at this time. However, their work was frustrating and unrewarding, as Chinese ideas of personnel issues did not accord with Western human resources strategies. For instance, Chinese personnel staff were unaccustomed to determining whether someone was qualified for a particular job, since they had been trained to select people based on which university the candidate graduated from or which degree the candidate held. This was partly because qualified applicants were few and far between until 1992. Until then, university graduates were assigned to either government bureaus or local companies for their career. Depending upon the type of enterprise the MNC established in China, MNCs were also assigned staff. Within the last seven years, however, graduates have been allowed to find their own jobs.

In the 1990s, large-scale foreign investment has opened new employment opportunities for the Chinese populace. The demand for qualified local managerial candidates has continued to soar exponentially, while the supply remains small. Recruiting and retaining these valuable employees are daunting tasks that require a precise and informed strategy on the part of the hiring team. Successful strategies might include well-thought-through retention tools such as incentive bonuses, frequent evaluations, pay raises tied to performance, and clear definition of career paths within the company.

Localization at any cost

Currently, MNCs' preferred hiring policy in China is to replace expatriates in management positions with local Chinese. MNCs aggressively pursue such localization policies in part be-

Many expatriate managers would prefer to localize gradually, not only because of the lack of qualified staff, but also because of the damage that unqualified staff can cause a business.

cause their headquarters often insist on increasing the number of local hires. Most headquarters tend to consider localization the culturally appropriate way to proceed, regardless of what they might know about China, its educational system, history, people, and business customs. A second reason for aggressive localization is that the local environment seems to require it—a 1998 A.T. Kearney survey found that overseas firms with higher rates of localization tend to have higher profits. Thus, localization appears to be a logical and effective human resources strategy.

But the headquarters' definition of localization often clashes with what localization means to the expatriates attempting to implement it. They must deal with the shortage of qualified candidates every day, a problem further compounded by staffing challenges such as high turnover, demand for high salaries, and false reference and recommendation letters, degrees, and accreditation.

Many expatriate managers would prefer to localize gradually, not only because of the lack of qualified staff, but also because of the damage that unqualified staff can cause a business. This is especially true for a small or medium-sized business that may not have the resources of a blue-chip company to fall back on. Some expatriates hire what is termed a "local expat" or "local hire," an expatriate with a background of some degree in Chinese language, culture, or history, and who is committed to a professional life in China but who does not have years of professional experience working for a large corporation. These hires tend to be in their twenties—younger than expatriates sent from home. Many companies employ these people on a project or interim basis to help guide the local staff. Without such an interlocutor, senior expatriates and entry- to middle-level local staff often cannot achieve the business goals set by the head office.

In the years 1992-94, companies were essentially expatriate-heavy. But 1995 saw an expansion in hiring both local expats and Chinese. During the boom hiring years of 1996-97, there was a sudden push to localize as companies began to feel financially burdened by the large number of expatriates on their payrolls. However, some companies have come full circle: having pushed too hard on localization, and paid the price in terms of re-

Finding the Best Chinese Staff

MNCs can use several methods to recruit local staff: local newspaper advertisements, networking and referrals, on-campus recruiting, private recruiting firms, and government bureaus assisting with personnel needs, namely Foreign Enterprise Service Co. (FESCO). The selection of a recruitment method depends largely on the type of candidate the MNC requires.

FESCO was created in the early 1980s to deal with foreign companies entering China. It assists with the hiring of basic staff, and has recently moved into executive recruitment modeled on foreign recruitment firms. For the most part, foreign companies use FESCO as a benefits-management tool—the foreign company pays a monthly fee per employee, and FESCO takes care of the local employees' state-supported benefits. Local nationals will rarely work without such a benefit system in place.

Local newspaper advertisements (mostly in Chinese) serve large blue-chip companies such as The Coca-Cola Co., Hewlett-Packard Co., and IBM Corp. well, because their names resonate with every local young professional. On-campus recruiting is also effective for large MNCs and firms that prefer "blank-slate" employees, who can be trained in the firm's corporate culture and business methods. Networking and referrals work best for companies that have some experienced local staff. These companies can offer incentives to such employees to refer similarly skilled friends and even relatives. Companies less familiar with China and those who have entered China with a small investment, perhaps in the form of a foreign representative office, tend to recruit employees through job fairs or FESCO.

The Internet has played a greater role in recruitment over the past 18 months, with both China-based personnel firms and headquarters posting vacancies on their sites. Job searching on the Internet seems to work well for local candidates with 4-5 years of experience in MNCs who are comfortable using the Internet. The Internet has been less popular among entry-level staff, fresh graduates, and very senior local staff. Most senior staff prefer to use foreign executive recruitment firms to find their next positions, as they feel these firms will garner them the best deal with the greatest amount of privacy and confidentiality—an important consideration when they are looking for their next job on the job.

The advantages of using a private recruitment firm are numerous, with speed and experience heading the list. Recruitment firms, apart from FESCO's recruitment arm, are relatively new to the China market—the first one, Norman Broadbent International, was established in China in 1992. Since then, all of the world's top executive recruitment firms have set up China offices. And in 1995, hundreds of local recruitment-services firms began opening in China, operating mostly out of the first- and second-tier cities. Many South- and Southeast-Asia-based recruitment services firms also now have branches in China.

—Rebecca McComb

duced performance, they now realize the wisdom of keeping a critical number of expatriates on the ground in China.

Nineteen ninety-five also marked a turning point for MNCs in that they began hiring experienced, English-speaking, local human resources managers. This was, in essence, the beginning of true localization: the Chinese human resources manager was charged with finding all staff for the MNC by tapping into his or her local connections and network. While the majority of lower-level employees were already PRC nationals, it was not until a local human resources manager was hired that localization could be implemented at higher management levels.

Until the senior expatriate management supported the notion that a local human resources manager was required to find and retain great local staff, the localization policy also could not be integrated into the company's business plan. In many cases, this policy is working well, and MNCs are finding qualified local staff more easily. Most companies now aim to staff all positions, including the president or CEO of their China operations, with PRC nationals within the next decade.

Looking elsewhere in Asia

Since many MNCs find that their local staff is not yet experienced enough to assume the most senior positions, they have hired senior managers from the Asia-Pacific region—usually from Hong Kong, Taiwan, or Singapore for linguistic and cultural reasons.

Though these managers from the Asia-Pacific region are heavily recruited either by internal human resources departments or by external professional recruitment firms, those without any China training or the necessary "mentor" qualities are no better or no worse than their Western counterparts sent from outside the Asia-Pacific region. The only advantage is that generally these managers speak Mandarin either basically or fluently, which helps them communicate with the local staff. While managers from Asian countries are not necessarily better at building strong relationships with local staff, they usually communicate better with MNC headquarters than do local managers simply because of their years of professional experience abroad and exposure to colleagues of different nationalities.

The costs of employing managers from the Asia-Pacific region and Western expatriates are similar, with the exception of return trips home, which are cheaper for the regionally located manager, and perhaps increased costs of sign-on and sign-off bonuses. There are roughly equal numbers of Western and Asian managers at the moment, with managers coming from Asian countries becoming more popular in the last year or two as companies trim the number of expensive Western expatriates. At the senior level, it seems that local PRC managers are currently fewest in number, because they lack equivalent experience.

Keeping ahead of the recruitment game

Today the local candidate pool and the general workforce adapt quickly and easily to hiring teams' requirements. These requirements vary tremendously, depending upon the company and the position being filled. But the general characteristics MNCs look for in a local managerial candidate include fluent written and verbal English; a minimum of 5-7 years experience in a particular field; a university degree, preferably an MBA; leadership and initiative abilities; creative problem-solving skills; and a professional attitude.

At present there are strong local candidates in managerial fields, including finance, engineering, human resources, and sales. However, because there are fewer qualified candidates than positions available, valuable employees change jobs frequently in order to gain the best benefits, financially and professionally. As a result, MNCs often suffer if their strategy is not one step ahead of the volatile recruitment game.

For instance, companies hiring any local candidate should have retention tools and benefits policies beyond the minimum state-supported benefits (*see The CBR*, May-June 1998, p.50). These might include incentive bonuses for reaching a specific target, training abroad, and reimbursement of MBA schooling in China on a part-time executive basis. Career-pathing and counseling should be offered and monitored closely from the beginning. It is particularly important in China not to renege on promises made during hiring, not only for obvious ethical reasons but also because of the importance of such promises to retention.

Some companies have come full circle: having pushed too hard on localization, and paid the price in terms of reduced performance, they now realize the wisdom of keeping a critical number of expatriates on the ground in China.

The next decade

The next 10 years of human resources strategy in China promises a continuing shift to reliance on local staff. Though localization is integral to the ultimate success of any MNC in China, regionalization is an interim, or potentially even longer-term, solution for many companies.

In 1999, most large foreign companies are staffing their entry-level positions with young locals, particularly fresh university graduates. Middle management also consists of local staff with several years of experience. In middle management, there might also be one or two local expatriate hires interfacing between middle and upper management levels. Upper management consists of a mix of Western professionals on 3-4 year contracts, Asian managers coming from neighboring Mandarin-speaking economies, and perhaps one or two local high-flyers.

By 2009, the entry and middle-management levels of most MNCs in China will consist entirely of local staff. In the upper level of strategic management, there might be one or two managers from the region and perhaps one or two Western expatriates working on a short-term basis, say for a 3-6 month period. But there will also be several local nationals holding positions at the senior-management table—perhaps even making Asia-Pacific regional decisions for the company. 完

Guanxi: Grease for the Wheels of China

Scott D. Seligman

Chinese have raised "connections" to an art

Forget the organization charts. Forget the formal structures that make up any Chinese corporation or government unit, or any explicit set of regulations or procedures that specify who is supposed to do what to whom. As anyone with a modicum of experience in the PRC can tell you, the key to getting anything important accomplished in China lies not in the formal order, but rather in who you know, and in how that person views his or her obligations to you.

The Chinese call this concept *guanxi*. The term literally means "relationships," but in this context it translates far better as "connections." Of course it is by no means unique to China: Western society is hardly without its own concept of "pull." It's just that the Chinese have raised *guanxi* to an art. It pervades the social order, and nowhere more than in today's PRC.

If you have *guanxi*, there is little you can't accomplish. But if you don't, your life is likely to be a series of long lines and tightly closed doors, and a maze of administrative and bureaucratic hassles.

The *guanxi* system existed under orthodox Communism, but the stakes were generally fairly low, at least by today's standards. In the 1970s, Chinese were not generally permitted to go abroad, it was nearly impossible to change one's work unit, and there were few goods in the stores worth having and little money with which to buy them. Back then, common people tended to use *guanxi* to get access to theater tickets, a work unit automobile for a personal errand, or commodities or small favors that—while not easy to come by—did not involve large outlays of cash.

Today, however, in an era of multimillion dollar deals, fierce competition, and international travel, *guanxi* can count for a great deal more. Foreign and local companies alike spend heavily to establish and maintain relationships with those who run and influence China's powerful government organizations and state-owned conglomerates. The payoff may be personal, ranging from a job or foreign university admission for a senior official's child to a discreet but technically illegal transfer of funds into a Hong Kong bank account. Or it may be organizational, such as cutting the Chinese party in on a deal as a means to secure the connection. The outsiders then count on the *guanxi* they have established to protect them from overly burdensome regulations or costly changes in government policy, or to prolong the terms of a profitable sweetheart deal.

A very personal thing

While *guanxi* may be organizational, at its heart it is a relationship between two people who are expected, more or less, to give as good as they get. A Chinese individual with a problem, personal or organizational, naturally turns to his or her *guanxiwang*, or "relationship network," for help. Surely among this array of acquaintances—relatives, classmates, colleagues, neighbors, and friends—is someone who has pull at this hospital, that school, or that regulatory body.

If a Chinese is angling for a job in the film industry, for example, he or she might ask "Whom do I know who can get me in the

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door at the Shanghai Film Studio?" If no one comes to mind, the next question would be, "Whom does one of my friends know?" A person is not limited to his or her own *guanxiwang*, but may tap into the networks of those with whom he or she has *guanxi*. In other words, if you approach me for help, the "deliverable" may be a request to someone else I know to do you the favor.

This is why Chinese work assiduously to cultivate new friends, especially friends in high or strategic places who may be useful sometime in the future. Foreigners, who are presumed by many to be wealthy and well-connected, are often targeted. The expression "*duo yige guanxi, duo yitiao lu*"—"one more connection offers one more road to take"—really says it all.

This is not to cast aspersions on the motives of any given Chinese seeking a new friendship. Like people everywhere, Chinese make friends with people they find interesting or attractive, and no ulterior motive need necessarily be present. But it is also true that a person's position, power, money, social status, and connections all factor into a Chinese person's assessment of a potential friend, perhaps more consciously than in other places.

Given the importance of *guanxi*, if a Chinese enters a new situation and finds him- or herself without any connections, the first order of business is generally to establish some. This is precisely why Chinese who move overseas—to places as far away as North America or as close to home as Hong Kong—have traditionally established organizations based on place of origin in China or surname, such as the Ningbo Residents Association or the Mei Family Association. The common surname or common place of origin is in fact little more than an excuse to help new arrivals establish some beneficial relationships, find a job and a place to live, or borrow some money.

The need to establish *guanxi* occurs in China even at the most prosaic level. One Chinese who moved to Beijing from a remote province and who was determined to find work faced a major hurdle because he had no *guanxiwang* in the capital. Even today, it's difficult to find decent employment in China without one, since jobs too frequently go not to those best qualified, but those best connected. This man's solution was to strike up a friendship with his landlady, who eventually helped him find a sales job at a nearby clothing store managed by her friend. He knew that the way to find a job was not to pound the pavement or to make cold calls. Rather, it was to spend time and energy building relationships in order to find his way to someone who would open a door for him.

WHAT *GUANXI* CAN DO

There are few rules in China that can't be broken, or at least bent, by people or firms with the right *guanxi*.

Consider the story of a firm that needed to clear a shipment of goods through the Shanghai Customs Bureau, which shows the power of *guanxi* to grease gears that have ground to a complete halt. While the company was duly registered to do business in Guangzhou, its Shanghai office was technically a representative office, enjoined from profit-making activities (*see* p.5). Because of this, Shanghai Customs did not believe itself empowered to clear the shipment—or else simply chose not to do so.

It soon became clear to the company's foreign manager that no amount of arguing with the Customs official in charge would change his contention that the paperwork should be processed in Guangzhou, and so the goods just sat there. The solution came in the form of a friend in the freight-forwarding business whose *guanxi* with Shanghai Customs was excellent. All it took was a quick phone call; the shipment cleared the next day.

One important reason for the pervasiveness of the *guanxi* system in China is the relative lack of a reliable legal system. In a nation that has traditionally depended little on laws, personal power has always been the key to getting things accomplished. Conversely, the entrenched nature of the *guanxi* system has proven to be a powerful obstacle to establishing anything resembling rule of law in the PRC, and is probably the biggest headache of would-be legal reformers in China. However, it is undeniable that even when they live in countries where the legal system is well developed and the law impartially enforced, Chinese still rely heavily on their *guanxi* networks.

Guanxi, especially with the powerful, can also offer protection. China is full of people and places said to have been "protected" by the late Premier Zhou Enlai during the turmoil of the Cultural Revolution. Though he, too, was attacked, Zhou never completely lost his prestige and his long, protective shadow saved many from persecution and destruction.

One important reason for the pervasiveness of the guanxi *system in China is the relative lack of a reliable legal system.*

Conversely, undeserving people sometimes find refuge through *guanxi*. Associates of deposed Beijing Mayor Chen Xitong reportedly got away with rampant acts of corruption while Chen was in power, because no one dared blow the whistle on them. It was only after Chen was arrested that anyone had the courage to clean house in the municipal government, and many were brought to justice.

Good *guanxi* is a renewable resource. A Chinese woman who had lived abroad for a decade and returned to Beijing lost no time finding out exactly where her university classmates were working. She had been out of touch with most of them for several years, and many had risen to high or strategically important positions. Despite the hiatus, her *guanxi* was still there for the renewing, as classmate relationships, in particular, are very important in China. She soon was able to call on these former friends for favors and information.

But *guanxi* can also be an exhaustible resource. An initial favor is surely granted when it is owed, and is also often provided based on no more than the promise that the ledger will some day be put into balance. But one cannot continue to seek favors indefinitely based on a historical debt, because when the debt is judged to be paid, the sense of obligation may cease.

For instance, if Mr. Wang was instrumental in helping Ms. Liu find housing in the days of Beijing's notoriously tight real-estate market, she would have surely been good for the occasional introduction or discount in the future. But at some point, perhaps after Mr. Wang asks for a very large favor, Ms. Liu may well decide that he has been

In today's China, relationship networks are well within the grasp of foreigners who wish to cultivate them.

adequately paid back for services rendered, and feel no more obligation to him. Whenever possible, therefore, Chinese instinctively try to keep the economy of favors in rough balance.

It is such a reflexive reaction for a Chinese to fall back on his or her *guanxiwang* that he or she may ask favors when they may not even be necessary. I once asked an employee in my company to get me a very basic piece of information—the name of China's third-largest city. I thought it would be a relatively easy task to look it up in a reference book or make a quick phone call, and expected him to report back to me within a few moments. When more than an hour passed and there was no word from him, I tracked him down and asked him what he had managed to find out. The answer was nothing.

Why? Because his friend at the State Statistical Bureau was out of the office that morning, and would not be back until the afternoon. He had given no thought to asking whoever answered the phone at the bureau for the information. Even for such a simple request, *guanxi* was the path of choice.

FOREIGNERS AND *GUANXI*

Guanxi is not only a catalyst for getting things accomplished in China; it is equally often also a formidable obstacle. When a foreign company sued a Chinese firm that had taken delivery of a piece of merchandise but failed to pay for it, the local court found in favor of the plaintiff. But when the customer was found to be without sufficient funds to pay for the goods, and the foreign company decided to go after the offender's parent company, it all fell apart.

Why? Because suing the parent company meant approaching the court in the district in which the parent was domiciled. And that court had absolutely no interest in taking the case. As a low-level court official explained, "We don't even know you, and owe you nothing. But we've got an excellent relationship with the company you want to sue. Why should we risk it for you?"

What this case shows—in addition to the lack of an independent judiciary in China—is the importance to foreigners and foreign organizations of building *guanxi* networks of their own. Good relationships with the customs bureau, the tax bureau, the local administration for industry and commerce, and the myriad of other regulatory organizations charged with oversight of foreigners and their affairs, are as good as gold in China.

The good news is that in today's China such relationships are well within the grasp of foreigners who wish to cultivate them. Often all it takes is an overture—a conversation, a meal, or a favor.

Foreigners who live and work in China may become integrated into the *guanxiwang* of those with whom they come in contact—sometimes unwittingly. As components of this network, they are expected to play by Chinese rules, which are not always to their liking. In particular, there may be a host of expectations that may not be clear at the outset of the relationship and that may be unacceptable to the foreigner.

The Chinese tend to extrapolate from their own system and assume that the rest of the world works along a similar set of principles. This means they often view foreign friends as windows to benefits in the world outside China. Thus, if you are Canadian, you are assumed to be able to coax favors out of the Canadian Embassy or consulates, and facilitate admissions into Canadian universities as well as visas for Chinese who wish to visit, study in, or emigrate to, Canada. You may well be asked to deliver on such an expectation, however unfeasible. And if you fail to deliver, you may be labeled as *bugou pengyou*, or "not enough of a friend."

Then, too, the Chinese often do not distinguish clearly between the world of the personal and the world of the organizational. This means a personal friend may ask for an organizational favor. Since you and I know each other well, for example, would you please send your company's travel business to my friend's travel agency? Or, since my mother and your mother were classmates, will you use your influence to get a high-ranking official to come to the event my organization is planning?

The distinction between the personal and the professional is obvious to foreigners and often matters a great deal to them. It is important to note that Chinese expectations notwithstanding, foreigners are well within their rights to draw their own lines as to what they are and are not prepared to deliver for those with whom they have established *guanxi*. Just because the Chinese may be willing to bend the rules does not mean that foreigners must do the same. Most Chinese can be made to understand a foreign friend's own ethical limits once these limits are explained. It may be wise to steer clear of those who cannot, however, as more often than not such relationships are problematic.

Chinese may also differ from Westerners in the level of delicacy with which they approach asking for favors. The establishment and use of *guanxi* may be accomplished very deftly, but equally often it can be entirely lacking in subtlety. When someone you know but have not seen for months or even years shows up on your doorstep bearing a gift, it isn't hard to figure out that the inevitable request for a favor is coming. Westerners are far more coy in acknowledging that any tit-for-tat is going on in a relationship; Chinese, on the other hand, see these things in far more pragmatic terms.

Chinese generally feel freer to ask for favors earlier in a relationship than Westerners do. To be sure, only an uncouth Chinese will hit a stranger up for a favor on the first meeting, but by the second or third get-together a new friend is generally considered fair game for a request. One generally waits a decent interval before putting new *guanxi* to work. But in the eyes of many foreigners, Chinese often accelerate this process.

Unlike foreigners, who may feel quite put upon when asked for favors—especially personal favors that involve the use of organizational resources—Chinese are often very eager to be of service if they have it in their power to assist. This is true for two reasons. First, doing a favor for a friend is inherently face-enhancing; it shows you are a person of some means or ability (*see* p.37). And second, every favor you do builds your "credit" column on the balance sheet that governs your relationship with the requester. You are, in essence, banking chits against the day that you will be the one who needs a favor.

Guanxi for sale

The importance of *guanxi* in navigating the bureaucracy in China cannot be overstated, and in recent years it has become a commodity that is increasingly for sale. Many of the sons and daughters of high-ranking cadres, in particular, have set up "consulting" shops or "service" companies and offered their ability to mobilize their own *guanxiwang*, and those of their parents, to the highest bidder. Even the children of former officials not currently in favor can make a living by becoming middlemen in business deals, since their own *guanxi* networks were generally established as early as elementary school and include a full complement of the offspring of still-powerful senior cadres.

Nor are foreigners excluded from this game. Several former foreign government officials who established relationships with counterpart Chinese officials while they were in office now operate their own consultancies. One of the reasons this works so well is the

> ***The importance of* guanxi *in navigating the bureaucracy in China cannot be overstated.***

Mianzi: About Face

Why will a Chinese of minimal means enter into mortal combat with a well-heeled friend over a check in an expensive restaurant, but watch in abject horror as a group of Americans at the next table uses a calculator to determine who owes what—down to the penny? Why will a Chinese employee who wants to quit an unpleasant job deal only in pleasantries when she faces the boss, even as her Western counterpart uses the exit interview to detail all the offenses of which the boss has been guilty?

And why will Chinese managers stick stubbornly to an announced policy, even when subsequent events prove it to have been irretrievably misguided, and where Western bosses would long since have reversed themselves?

The answer is face.

In both English and Chinese, "face" can mean not only the area between the forehead and the chin, or a flat surface, but also an intangible commodity that is vital to a person's reputation, dignity, and prestige. In this last area, however, the Chinese concept is better defined than the Western one. Westerners are accustomed to the twin concepts of *losing* and *saving* face; these are metaphors we use and understand. But the Chinese do us one better; they are also very adept at *giving* face—enhancing someone else's esteem through compliments, flattery, or a show of respect.

No one can say how much money has been wasted, how many people toppled from power, or how many friendships have been destroyed over something that belongs so utterly to the realm of the abstract. Yet to Chinese, and to most of their Asian brethren, face is serious business, and no less so for its lack of tangibility. Those who wish to live, work, or do business in China ignore it at their peril.

Nine points about face

1. Together with money and power, *mianzi* is one of three key motivators that govern behavior in China today.

2. A public insult, chastisement, or similar affront to personal dignity results in a loss of face. But simply contradicting someone in front of another, or declining an invitation on a weak pretext, may also cause a loss of face. Even the simple act of refusing a request can be an assault on *mianzi*, which is why Chinese often label things "inconvenient" or "difficult" rather than rejecting them out of hand.

3. Losing control of yourself in any way—whether anger, grief, angst, or any other emotion—always constitutes serious damage to *mianzi*. This includes drinking alcohol to the point of losing self control.

4. Rescinding an order can also be construed as a loss of face, which is why Chinese leaders may cling adamantly to policies, even when subsequent events prove them irrelevant or misguided. For a leader to change his or her mind is to appear to succumb to pressure or to admit error, both of which involve losing face.

5. Losing face is justification for retaliation. The price exacted may be as low as an apology or as high as a corresponding loss of face.

6. Organizations have face, too. Ministries, corporations, and bureaus all have reputations to worry about; so do entire countries. Jingoism in China today is strong enough to color the Chinese view of nearly any situation involving foreigners, whether justified or not, and assaults on face may be detected where they are not intended.

7. Chinese spend far more time thinking about face, and see its relevance in far more situations, than foreigners do. Chinese can be counted on to view their human interactions through the "face" lens; each and every one represents an opportunity to give, receive, save, or lose *mianzi*.

8. Things that make others look up to you, or envy you, also confer face on you. Actions that build the ego give face. Doing a favor for a stranger introduced to you by a close friend confers *mianzi* on the introducer. Praising someone to his or her boss is also face-enhancing.

9. Face is so important that it is justification for spending money even if a Chinese has little of it. Money that might be set aside for a rainy day or spent on something functional may instead be used to purchase designer clothing and accessories, or to entertain at expensive restaurants.

—Scott D. Seligman

For every Westerner who would rather peddle his car to a used-car lot than sell it to a cousin, there is a Chinese who would prefer to sell to a friend or relative.

loyalty on the part of Chinese officials to their "old friends." While the foreign government official may now be out of power, he or she is still likely to be granted an audience with a Chinese official if it is requested—even if the purpose of the meeting is clearly to advance the fortunes of a corporate client.

Much has been written about the Chinese preference for doing business with "old friends," and while this bromide can surely be overstated—one may qualify as an "old friend" as early as the second meeting—the statement is essentially true. While Westerners typically have a decided aversion to the thought of selling something to a friend or relative, many Chinese actually prefer it. For every Westerner who would rather peddle his car to a used-car lot than sell it to a cousin, there is a Chinese who would prefer to sell to a friend or relative. Most Chinese believe that the very connectedness they feel to a friend or relative can help resolve the potential conflicts inherent in any business transaction.

Similarly, a Chinese is generally far happier to hire a relative than a stranger, because he or she believes it diminishes the danger of malfeasance. A blood relative, after all, can be counted on to think twice about doing anything that would cause his or her patron to lose face or assets. A Westerner would probably worry about being accused of nepotism for doing the very same thing. He or she might be almost apologetic about recommending a relative or a close personal friend for a job, bending over backwards to point out the person's qualifications for the job to drive home the point that the candidate is not being endorsed merely because of the relationship.

Consider the case of a very lucrative contract that was under discussion for more than a year between a large Chinese state-owned enterprise and two multinational firms. After months of formal negotiations, the Chinese unit elected to continue the discussions with one of the competitors. It happened to be the one that was then employing the son of the principal Chinese negotiator—and at a substantial salary. This despite the fact that the chosen supplier's equipment was demonstrably less compatible with Chinese equipment already in place than that of the other competitor. Further, the son's position with the winning company was well known to everyone on the Chinese side. Either no one felt that the deal was compromised by what would appear to a Westerner as an obvious conflict of interest, or—far more likely—no one dared pipe up because of the prestige of the chief Chinese negotiator.

Guanxi in high places is something to which everyone aspires, because those at the top have power and fairly large and powerful *guanxiwang* of their own. But *guanxi* need not be high-level to be effective. When a major multinational corporation failed to file paperwork in time to ensure the annual renewal of the registration of its representative office, the State Administration for Industry and Commerce (SAIC) offered the company a stark choice: pay a confiscatory fine or lose the registration, and with it the company's ability to operate legally in China.

After much hand-wringing, the management decided to try back-channel routes to SAIC through *guanxi*, but none of the company's senior advisers was able to help. Though they knew ministers and State Council members, they did not know any local SAIC officials. Ever more desperate as the days ticked away, the management eventually discussed the problem openly with all of the company's employees, at which time an entry-level clerk came forward. It turned out that she had gone to high school with the daughter of a local SAIC director. After several phone calls and a banquet, the registration was renewed, with no fines paid. Such is the power of *guanxi*. 完

SAIC Inspections, *continued from p. 5*

sentative office in China. Therefore, if any dispute arises between a representative office and another entity in China, the principal company located outside China will be the primary party to any ensuing arbitration or litigation. The representative office is not a legal entity and will not be a party to litigation or arbitration.

Foreign-invested enterprises

There are three types of FIEs in China: equity joint ventures (JVs); contractual or cooperative JVs; and wholly foreign-owned enterprises (WFOEs). Chinese authorities prefer the joint-venture forms, which generally require the foreign partner to provide technology, management expertise, and capital.

Many foreign companies prefer to set up a WFOE, in part because they are harder for the Chinese authorities to control. However, for that same reason, governmental approval can be more difficult to obtain. Approval for this type of enterprise is usually granted to larger foreign companies that have been in the Chinese market for some time and want to invest additional money to build production facilities.

According to China's Registration Rules of Legal Persons and Implementation Rules (Registration Rules), an FIE may establish branch or representative offices, depending on its operational needs. To date, however, only foreign insurance companies and banks have set up branches, and both of these industries are covered by separate regulations. Unlike a representative office, a branch office may engage in business activities, including sales, on behalf of its principal company. However, it is not a legal entity—the principal company bears all legal liabilities. A branch office must also adopt an independent financial system.

If an FIE wants to establish a branch office, the required registration procedures must be completed at the local AIC. According to the Registration Rules, the name of a branch office must start with the name of the company, followed by the name of the city, and ending with the words "branch office." (A similar rule applies to representative offices.) Branch offices must also have a fixed operating place with facilities; a management structure with a designated person in charge; the necessary capital and employees; an appropriate business scope; and an appropriate financial accounting system. Once the local AIC approves the establishment of a branch office, a China business license will be issued. This lawful certificate allows the branch office to engage in business operations within the approved business scope, order a chop, and open a bank account.

An FIE may also establish a representative office under rules similar to those for foreign representative offices. In contrast to a branch office, a representative office is only required to have a suitable name and a fixed office with a designated person in charge.

Many FIEs have sales offices in different cities. If a sales office is to engage in business operations directly, it should be organized as a branch office. However, if it will only engage in liaison work for its principal company, it should be organized as a representative office.

Currently, doubts surround the issue of whether a company can engage in business in one city if it only possesses a business license from another city. In 1996, SAIC issued an internal report to its Qinghai provincial branch indicating that there is no precedent on the issue. However, it has yet to take an official position on the matter. While it is likely that local SAICs will regard this as an illegal business practice, the question has yet to be resolved.

In China, compliance plans have evolved from simple policy statements into sophisticated management tools that involve all job levels and phases of operations.

Inspections are here to stay

Unannounced AIC visits will continue until violations cease, as problems with multinationals' legal status are at the root of the inspections. To solve the problem, many companies are now instituting internal compliance plans. In China, compliance plans have evolved from simple policy statements into sophisticated management tools that involve all job levels and phases of operations.

It is recommended that FIEs work with compliance officers, who can act as watchdogs within the organization to ensure compliance at all offices and at all levels. For example, staff members of representative offices, which are barred from selling, should not greet customers with nametags that read "Salesman." Having a plan that covers all potential corporate-status violations—and designating a responsible individual to implement the plan—should alleviate many of the concerns raised by unannounced government visits.

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Shipyards Adrift

China takes steps to buoy its shipbuilding industry

Paul Woodward

This is a tough time for China's shipbuilders. Long among the more successful traditional industrial enterprises in terms of export earnings and technology, they have been rocked by a powerful combination of changes: government restructuring, the Asian economic crisis, and a global slump in maritime markets.

These forces have threatened to weaken an industry that has been one of China's export powerhouses. Exports from China's shipyards accelerated rapidly throughout the 1980s, and by the 1990s, China's shipyards ranked third in the world behind Japan and Korea, which each account for roughly 40 percent of the world market. According to the *China Daily*, China exported vessels worth $1.73 billion, making ships the country's single most important machinery export item in 1998. The China Shipbuilding Trading Co. ranked 15th among all of China's exporters in 1996. Other key manufacturers include Shanghai's Hudong and Jiangnan yards, Dalian New Shipyard (DNS), and Guangzhou International—the only major PRC shipbuilding company listed on the Hong Kong Stock Exchange (*see* Figure 1).

At their peak in 1998, China's yards were all but auctioning off scarce berth spaces to shipowners who were concerned that they would be unable to build their targeted tonnage. Some yards were booked solid for two years or more. Now, those same yards are looking at empty order books within 18 months.

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New structures

For almost two years, there have been rumors of a radical restructuring of China State Shipbuilding Corp. (CSSC), the quasi-ministerial entity that has controlled China's yards since 1982 (*see* p.43). Understood to be an integral part of the state-enterprise reform program, the restructuring aimed to make shipyards more competitive and divorce their military and commercial functions. (Shipyards have been building both warships and commercial vessels for the People's Liberation Army.) Debates over particular structures, rivalries between the major shipbuilding centers in Dalian and Shanghai, and uncertainty over the central government's role have delayed this separation significantly.

Among the first signs that serious change was afoot was the 1998 formation of the China Shipbuilding Industry Association and the appointment of then-CSSC President Wang Rongsheng as its first president. These moves echoed the first real steps toward separating the commercial shipowning functions of the Ministry of Communications (MOC) from its activities as regulator and infrastructure developer. The association's formation foretells the restructuring of shipyard ownership.

During the second quarter of this year, it has become clear that the restructuring will involve two distinct steps. First, companies that formerly constituted CSSC will cede their military and technical activities to the Commission for Science, Technology, and Industry for National Defense. Second, two new conglomerates will be formed to take over the commercial activities of the shipyards.

The exact structure of these two companies is slowly becoming clearer. Under the original plan, a "North Shipbuilding Group" and a "South Shipbuilding Group" were to be built around China's two most powerful shipyards, Dalian New Shipyard (DNS) in Liaoning Province and Shanghai's Jiangnan Shipyard. As long ago as October 1997, Liaoning provincial officials predicted that a Liaoning "super yard" would be formed, combining the resources of Dalian Shipyard, DNS, and Bohai Shipyard. DNS is the only yard in China with a dock large enough to build very large crude carriers (VLCCs), oil tankers of 250,000 deadweight tons (DWT) or more. This dock was built—with much technical difficulty—over a decade, beginning in 1985. DNS thus views itself as the flagship of China's modern yards.

Located near the site of China's first modern steel vessel shipyard, Jiangnan also claims supremacy in the industry. Many professionals in the industry have some connection with Jiangnan and Shanghai Corporation of Shipbuilding Industries, CSSC's Shanghai subsidiary—Jiangnan is overseeing construction of the $500 million Waigaoqiao Shipyard in Pudong. According to Jiangnan officials, the Waigaoqiao Shipyard will be China's largest when completed in 2000.

Those in charge of the shipbuilding industry's restructuring apparently felt that the north-south structure would offer too little opportunity for central influence or coordination of management and technical development. Technical experts within the industry regard management reform as the next step in the industry's development. So restructuring proposals have apparently shifted to plans for a more complex geographical mixture of yards.

The latest reports indicate that CSSC will be split into two groups: China State Shipbuilding Corp. (CSSC) and China Shipbuilding Industry Corp. (CSIC). Both companies will be headquartered at the old CSSC offices in Beijing and will be headed by a former CSSC deputy general manager. How the existing yards will be divided among the two groups is not yet entirely clear, but it seems that the original Shanghai/Dalian split will be retained in these two structures—with CSSC centered in Shanghai and CSIC focusing on Dalian (*see* Table).

Shipbuilding Realities

China's restructuring occurs at a time when new ship orders are down worldwide—by as much as 20 percent this year, to roughly 35 million DWT. This downturn reflects the highly cyclical nature of the international maritime industry. Both ship-owning and shipbuilding face a combination of overcapacity in world shipyards, which leads to over-building; the time lag between the placement of new building orders and completion (an average of 12-24 months); the dramatic flexibility in vessel supply, which is due to the wide variety of ways to scrap ships (often dictated by steel price cycles, which do not necessarily match maritime-trade cycles); and the industry's sensitivity to international trade trends.

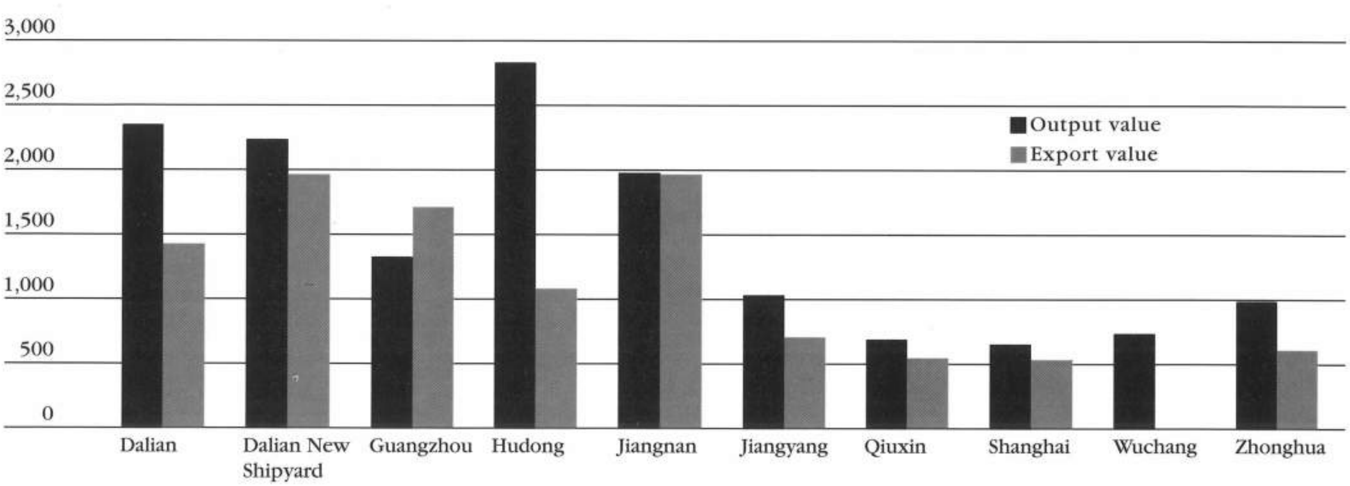
Technical experts within the industry regard management reform as the next step in the industry's development.

New orders have, however, been slipping in China for several years (*see* Figure 2), as a result of increased costs and renewed competition from Korean firms, including Daewoo Corp., Hyundai Motor Co., and Halla Group. In addition, Chinese yards, having recorded successful sales in 1995-96, are full through the middle of next year.

Choppy Waters

One of the most pressing concerns is the tough competition China's shipmakers are encountering internationally—China is having a hard time matching low international prices. Ship pricing is complex and driven by international market forces. Because many vessel types are basic products easily replica-

Figure 1
Vessel Output and Exports of Selected PRC Shipyards, 1998 (in RMB million)



SOURCE: Asian Strategies Ltd.

Not only are production costs in China higher than those in Japan and Korea, but devaluations of the Korean currency have further weakened the competitiveness of Chinese yards.

ble in shipyards around the world, yards in China are likely to be driven as much by what global competitors are offering as by actual costs. Some experts claim that international prices are now lower than they were 10 years ago.

The actual costs Chinese shipyards face can be considerable. According to industry sources, 95 percent of vessels made for export are built with imported materials or equipment. Certain ship types require special grades and qualities of steel unavailable in China, which must be imported from countries such as Japan. And some ships are produced under licenses that require royalty fees to be paid to the foreign owner of the technology.

Not only are production costs in China higher than those in Japan and Korea, but devaluations of the Korean currency have further weakened the competitiveness of Chinese yards—in 1998 a DNS vice president actually asked the central government to consider a devaluation. And the China Shipbuilding Industry Association and Chinese Chamber of Commerce of Machinery and Electronics Importers and Exporters (CCCME) urged the government to offer shipbuilders zero-tax treatment and special export subsidies. In response, Beijing has reduced export duties on shipbuilding products. Rebates on the 17 percent export duty were increased from 9 percent to 16 percent in October 1998. But CCCME claims that this is still short of what is required.

Another crucial issue, and one that the yards share with so many of China's traditional industries, is the impact of bloated workforces and the subsequent social costs the yards must bear. DNS, for example, is having difficulty securing enough contracts to pay its 4,300 employees. It does not help that shipbuilding remains labor intensive even with Japanese automation technology. While a typical shipyard in China may employ 9,000-12,000 people, a comparable facility in Japan could well have as few as 900-1,500 employees.

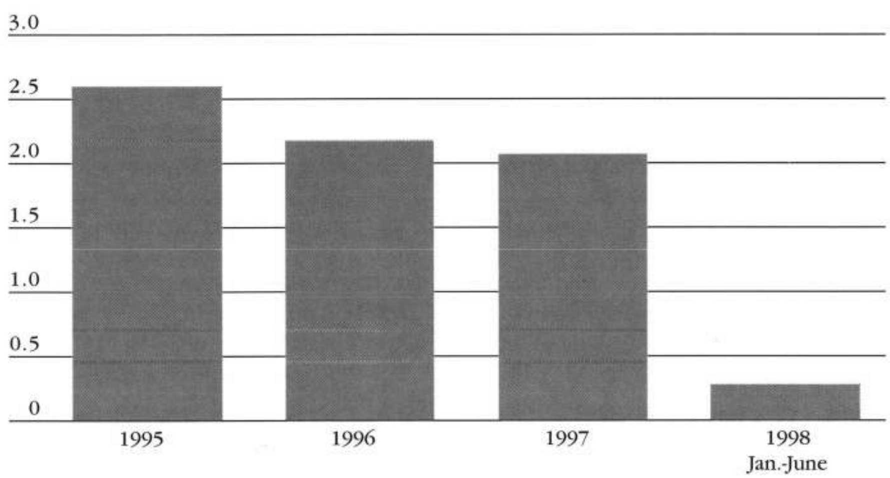
FOREIGNERS AT THE DOCK

Like many countries, China long regarded shipbuilding as a strategic industry unsuitable for foreign investment. But there have been numerous joint ventures and technical cooperation agreements with other countries in the marine-equipment sector on everything from main diesel engines and navigation and communications equipment to fixtures and fittings for crew quarters on the ships.

The first substantial change in this regime occurred in 1991, when the au-

FIGURE 2
TONNAGE ORDERED IN CHINA, 1995-98

MILLIONS OF DEADWEIGHT TONNE ORDERED



SOURCE: Asian Strategies Ltd.

CHINA'S NEW SHIPBUILDING GIANTS

COMPANY	CHINA STATE SHIPBUILDING CORP.	CHINA SHIPBUILDING INDUSTRY CORP.
Head of Preparatory Group	Chen Xiaojin, former deputy general manager, CSSC	Huang Pingtao, former deputy general manager, CSSC
Interim Board Members	Hu Minghe, chief economist and production bureau chief, CSSC	Huang Hui, chief, China Ships Research Institute
	Jin Caihuan, general manager, Shanghai Corp. of Shipbuilding Industries	Yu Shichun, director, Dalian Shipyard
	Wang Shusen, finance bureau chief, CSSC	Li Changyin, general manager, Xi'an Shipbuilding Corp.
	Li Zhushi, general manager, CSTC	Zhang Biyi, finance bureau deputy chief, CSSC
	Sun Wennian, general office director, CSSC	Hu Jizheng, military bureau chief, CSSC
		Chen Tianli, general manager, Kunming Shipbuilding Corp.

SOURCE: Asian Strategies Ltd., China State Shipbuilding Corp.
NOTE: China State Shipbuilding Corp. facilities in Xi'an and Kunming manufacture marine equipment.

thorities permitted a German company to take over a small yard in Shanghai, subsequently renamed Shanghai Edward Shipyard. After an extensive renovation, in 1996 this yard started building liquidfied natural gas (LNG) carriers mainly for European clients. China allowed this development because LNG carriers are high-technology vessels that it hopes to produce domestically. In this, China is not alone—shipbuilding is one of those industries in which every country aims to move beyond the production of basic, commodity-type products (in this case, bulk carriers and simple general cargo ships) towards higher-technology vessels.

Also in 1996, China entered into a number of new ventures with Japanese and Korean shipbuilders, among others, looking to take advantage of China's low labor rates. Both Hyundai Motor Co. and Samsung Group of Korea announced plans to produce "blocks" (pre-fabricated ship sections) in Dalian and Ningbo, respectively. Samsung's project is particularly interesting, as Ningbo is not currently a major shipbuilding center. Ningbo's port, however, boasts much deeper water than neighboring Shanghai and is often spoken of as a possible center for future deep-water port development and a new, large shipyard.

Meanwhile, China Ocean Shipping Corp. (COSCO) announced plans to develop a $100 million facility in Jiangsu Province with Japan's Kawasaki Heavy Industries Ltd. This facility is designed to help COSCO meet its vessel-replacement needs in the next century. Other joint ventures include a Singaporean investment in Yantai, Shandong Province, which should help the local petroleum industry produce vessels.

Nautical Milestones

It appears that the days when China's shipyards operated as competitively as governmental departments are past. Today's trend is clearly toward commercialization of shipbuilding operations to compete with yards in Japan and Korea, as well as potential rivals in Eastern Europe and India.

China's shipyards appear to have made good progress over the past 20 years in improving the quality and timeliness of their products, and should become world players on par with Korea and Japan in the next 10-15 years. But in order to do so, they must effectively restructure the management of their businesses to survive intense commercial pressures. Success partly depends on how well Beijing is able to balance the development of a competitive shipbuilding industry against the familiar problems of state-enterprise reform. 完

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A Maritime History

A shipbuilding industry of some kind has been developing in China since the launch of the first modern Chinese steamship in Shanghai in 1860. For their first 80 years, however, these shipyards were relatively insignificant, serving China's river and coastal trades but producing few vessels of international significance.

In the early 1950s, the Communists took over the yards and began to build up their capacity, aiming to fulfill China's naval requirements and develop a viable merchant fleet. With the exception of a few ships built for fraternal Communist-bloc joint ventures such as the Sino-Polish shipping company Chipolbrok, these new yards were of little relevance to the international maritime community.

The opening of the Chinese economy to the world in the late 1970s, however, stirred international interest in these yards. Initially, Shanghai and Ningbo shipyards received orders from Hong Kong companies keen to reestablish ties with China. These ships were a series of relatively simple 27,000 deadweight-ton bulk carriers. Soon Europeans began to place orders as well. By the late 1980s, Chinese yards had embarked, with mixed success, on much more sophisticated ships, including a car carrier and container ship for German owners.

Formed in 1982, China State Shipbuilding Corp. (CSSC) combined major yards previously grouped separately under the No. 6 Machinery Ministry and the Ministry of Communication (MOC). MOC retained responsibility for a number of smaller yards producing coastal vessels and repairing ships. CSSC has a centralized Beijing-based sales operation called China Shipbuilding Trading Corp. (CSTC). CSTC in turn owns sales subsidiaries in Hong Kong (China United Shipbuilding Co.), Germany, and the United States. Though foreign owners are supposed to place their Chinese orders through CSTC offices, most shipowners and shipyards prefer to work directly with each other. Thus, CSTC has increasingly been sidelined throughout the negotiating and technical specification processes.

Despite its competitive disadvantages, CSSC, through CSTC, has gradually been growing more sophisticated in presenting itself to, and dealing with, the international shipping community. China's presence at major international maritime trade fairs has also been increasing. The better-coordinated and increasingly sophisticated Chinese shipbuilders are likely to be of some concern to Japan and Korea. But how well the Chinese yards will be able to expand their international presence following the reorganization remains to be seen.

—Paul Woodward

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China Prepares for the Millennium Bug

Even though China is taking steps to prepare for the year 2000, foreign companies are hedging their bets

Sheila Melvin and Sophie Zhao

China's Y2K readiness situation looked pretty bleak back about a year ago. Awareness of the Y2K problem was low and government interest in understanding and resolving it weak. Foreign company representatives who met to discuss the situation and its potential risks found that they had little information to share, but lots of anecdotes.

One company had asked a provincial government official about its year 2000 preparations and been told, "Year 2000? China has no plans to participate in the Olympics." An official of a major state-owned enterprise (SOE) had responded to the same question by asking, "Why do you want to talk about that? It's only 1998!"

However, as is so often the case in China, once high-level leaders began to focus on the problem, rapid progress was made. In August 1998, the State Council issued Notice No. 124, entitled Concerning the Resolution of the Year 2000 Computer Problem. The notice was sent to governments in all provinces and regions, and to all ministries and commissions.

In no-nonsense language, the notice resolved bureaucratic infighting over Y2K jurisdiction by assigning the Ministry of Information Industry (MII) overall responsibility for leading the nation's Y2K efforts. Zhang Qi, who was active on Y2K issues in the Ministry of Electronics Industry prior to its dissolution, was appointed Y2K Czar. All non-military central-government commissions, ministries, and agencies were ordered to deliver monthly Y2K progress reports to MII. The State Economic and Trade Commission's Y2K Commission was separately tasked with ensuring that the SOEs under its direction resolved their Y2K problems.

To complement government efforts, the media were urged to increase Y2K propaganda and education. The finding and fixing of all Y2K bugs was to be completed by March 31, 1999, preliminary testing of these fixes by June 30, 1999, and final testing by September 1999. The notice concluded with a stern warning: "Solution of the Year 2000 problem is mandatory. If a department or unit ignores this problem and its professional responsibilities and serious losses and consequences ensue, then action will be taken against the person in charge."

The one base left uncovered by the State Council notice was funding. With few exceptions, all governments and business units are responsible for the cost of solving their Y2K problems. In the immediate aftermath of this announcement, some foreign equipment suppliers were thus pressured by local customers to fix equipment—and even entire systems—for free, or to provide replacements. This "you supplied it, you fix it" attitude, which was reinforced by statements by some government officials, caused many foreign companies to exercise extreme caution in providing Y2K-related assistance for fear that such aid would lead to demands they could not meet.

Fortunately, officials quickly recognized that such statements did more harm than good to their goal of making China Y2K-compliant. Y2K Czar Zhang softened her tone, publicly acknowledging that liability was a complicated issue. As time has passed, government statements have

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stressed the need for cooperation in resolving the problem and indicated that Y2K-related lawsuits will be discouraged.

The State Council notice was followed by a national teleconference convened at Premier Zhu Rongji's request in late August 1998 and attended—virtually—by key officials from across the country. The teleconference was presided over by heavy hitters, including MII Minister Wu Jichuan, and served to inform the localities that this was one central-government order they had best not ignore. Several more national Y2K teleconferences have been held at periodic intervals, and all of them have been given considerable publicity.

Having been delegated Y2K responsibility by Beijing, provinces began to redelegate the actual work of finding and fixing Y2K problems. In most provinces and cities—including Beijing and Shanghai—this responsibility has gone to the local "informization leading groups," many of which have established Y2K task forces. These task forces are responsible for liaising with key utility providers and industries to see that their Y2K problems are identified and fixed.

Learn from Shanghai

The US-China Business Council's Shanghai office established a Y2K working group in September of last year composed of Council member companies with major manufacturing plants in Shanghai. The group's basic goal has been to understand Y2K preparedness among key utility providers—power, water, and telecommunications—and agencies—the General Administration of Customs, the Civil Aviation Administration of China (CAAC)—so that Y2K risks could be better gauged and contingency plans made.

The group's first meeting in September 1998 was dominated by complaints and worries. Individual company efforts to meet with local agencies and bureaus had been unfruitful—most had replied that it was not their problem but Beijing's. Key local utility suppliers had looked mystified and replied that Y2K would not affect them—it was a banking problem. Engineers were generally well informed, but they lacked clout and could not get their leaders to focus on the problem. Nobody was even certain what government body was in charge of Y2K in Shanghai.

However, by the end of the month bureaucratic responsibility had been clearly delineated and Vice Mayor Chen Liangyu had held a series of meetings with bureau and enterprise leaders in Shanghai. The vice mayor emphasized the importance of resolving the problem promptly and properly, and issued a call to arms: Remember the Hong Kong airport! Remember the floods! The Y2K problem could be even worse!

Representatives of the Shanghai Informization Leading Group (SILG) Y2K Task Force met with the Council and expressed a willingness to meet with companies. At a Council Y2K group meeting organized shortly thereafter, SILG officials spoke openly and bluntly about the problems confronting them. They cited embedded chips as the number-one technical problem. Company offers to provide information about addressing the embedded-chip issue were happily accepted. But the Council Y2K group's requests to meet directly with the Y2K leaders of key public utilities were gently ignored. Individual company efforts to get more detailed information on such things as power transmission systems and manual back-ups were mixed—sometimes questions were answered and sometimes the old "state secrets" excuse was given.

On Christmas Eve last year, Shanghai Mayor Xu Kuangdi made well-publicized visits to several major SOEs to check their progress on resolving the Y2K problem. He was the first high-level Chinese leader to make such an inspection; the attention paid to Y2K in Shanghai increased noticeably thereafter. By January, SILG had agreed to help Council companies meet with representatives from key utilities and the banking industry. In a meeting cosponsored by the Council and an ANZ Bank-led Y2K working group for foreign banks, officials from the People's Bank of China (PBOC) and the power and telecom bureaus gave detailed reports on Y2K progress to date and the major outstanding problems. Subsequent meetings have greatly eased the worries of member companies and enabled them to draw up contingency plans based on knowledge rather than fear.

Y2K-awareness efforts undertaken by the Shanghai government include a Y2K hotline (the number is 8-2000, which sounds like "dial 2000" in Shanghai dialect) and a television sitcom called "The Millennium Bug." The city has been singled out nationally for its positive and progressive approach to resolving the Y2K problem, and a Shanghai-based enterprise—Bao Steel—has separately been lauded as the best-prepared SOE.

The US-China Business Council's Shanghai office established a Y2K working group in September of last year composed of Council member companies with major manufacturing plants in Shanghai.

At the end of June, pursuant to the August 1998 State Council notice, Shanghai issued its own notice stating that the Y2K problem is now "at a crucial stage." The Shanghai notice called on all departments at all levels to "pay much attention, intensify leadership, organize forces, and clarify responsibilities, to conscientiously work on the Y2K problem in all areas." It added that any departments or units "derelict in their duty" would be held administratively responsible and legally liable.

Shanghai is not out of the woods so far as possible Y2K problems go—much remains to be fixed. For instance, though the telecom bureau has been furiously conducting repairs, testing is difficult because it does not want to interrupt phone service. And the bureau suspects that some office buildings have not repaired internal systems, but it cannot require them to do so. However, companies generally assess the risks of serious interruptions to operations as low to medium and are satisfied with the information available from relevant authorities.

Solve well the Y2K problem

A representative from the Beijing Informization Leading Group's Y2K Task Force addressed the Council's China

Generally speaking, aviation, banking, securities, and insurance are thought to be the most thoroughly prepared sectors.

Operations conference in March of this year. Like his Shanghai counterparts, he provided detailed information on his city's progress in addressing this problem. The US Embassy has been following China's Y2K situation closely and has prepared a number of excellent reports, including detailed analyses of Beijing's preparations. All of these are posted on the US Embassy website (*see* below). The online embassy reports also include accounts of Y2K conferences hosted by MII at which ministerial and provincial representatives have provided general information on Y2K preparedness.

Generally speaking, aviation, banking, securities, and insurance are thought to be the most thoroughly prepared sectors. Early reports that the head of every Chinese airline had been ordered to fly on New Year's Eve were subsequently denied, but are indicative of the seriousness with which CAAC is tackling the problem. Testing has been completed and air traffic control contingency plans will be in effect for immediate implementation through March 2000. Foreign experts believe that the only Y2K-related problem may be inter-airline transfers of tickets.

PBOC took the lead in addressing the Y2K bug long before it was on anyone's agenda. On two weekends in June and July, commercial banks, credit cooperatives, and postal-savings outlets nationwide temporarily suspended operations and moved computer clocks ahead to December 31. A third such

China-Related Y2K Websites

English-Language Websites

US Embassy Beijing Reports on China's Year 2000 Challenge
www.usembassychina.gov/english/sandt/index.html

China Y2K National Conference: Guarded Optimism, May 1999
China Y2K: A Look at Beijing's Infrastructure, March 1999
Beijing Y2K: The Bug and You! February 1999
China Gets Ready for Y2K: An Overview, January 1999
PRC Y2K Czar Zhang Qi Fights Apathy, November 1998
China Y2K Update: US Business Concern Grows, May 1998
China Y2K: Big Banks Worry, Government No Money, February 1998

Chinese-Language Websites

PRC Ministry of Information Industry Year 2000 Computer Problem Guide
www.mii.gov.cn/year2000.htm

Beijing Municipality Y2K Webpage from Beijing Informization Office
2000.beijing.gov.cn

Shanghai Municipality Informization Office Y2K site
www.y2k.sh.cn

Guangdong Province Y2K site
www.year2000.gd.gov.cn

A list of Chinese official Y2K websites and computer-industry magazine articles on Y2K can be found at
www.usembassy-china.gov/english/sandt/y2kgov.htm

Chinese-Language Y2K Press Clippings and Private Webpages

On the US Embassy Beijing webpage, see *PRC Net Info-Benefit: Full-Text Newspaper Searches*, a report explaining how to search the full-text databases of some Chinese newspapers for Y2K and other information online.

Search for Y2K articles on Chinese newspaper and magazine websites by typing in the characters for 2000 *nian wenti* [Year 2000 Problem] or *qiannian chong* [Millennium Bug]. Chinese official Y2K publications prefer "Year 2000 Problem" while "Millennium Bug" appears much more frequently in the daily press.

English-Language Information on Y2K in China

The website of the Chinese government official English-language newspaper *China Daily*—at www.chinadaily.net or www.chinadaily.com.cn—has a searchable database of articles that have appeared in that newspaper over the past three months.

Once you have registered free of charge you can search on the Hong Kong SAR Y2K Millennium Bug Site.

General Y2K Websites

IBM Corp.'s Website
www.ibm.com/ibm/year2000/

Japanese Government's Y2K Website
www.kantei.go.jp/foreign/y2k/index.html

Chief Information Officers Council Committee on Year 2000 Information Directory
www.itpolicy.gsa.gov/mks.yr2000/cioy2k.html

Electric Utilities and Year 2000 www.euy2k.com

Federal Y2K Commercial Off-the-Shelf Products Database
www.y2k.policyworks.gov

Information Technology Association of America
www.itaa.org/year2000

The US President's Council on Year 2000 Conversion
www.y2k.gov

The Year 2000 Website www.year2000.com

The Y2K Website www.y2k.com

US Federal Gateway for Year 2000 Information Directories
www.itpolicy.gsa.gov/mks/yr2000/y2khome.htm

Y2K News www.y2knews.com

test is planned for September 18 and 19. Problems were reportedly uncovered, but that is the purpose of such testing. Insurance testing has followed the PBOC schedule, and securities exchanges in Shanghai and Shenzhen have also conducted extensive testing and are now preparing contingency plans. All securities companies are required to release reports on their preparedness levels by December.

Electric-power providers have made significant progress in repair and testing. At an August conference co-sponsored by the US Foreign Commercial Service in Beijing, Zhang stated that there were problems remaining and the government would make funds available to correct them. Nationwide power system checks will be conducted in September, under the auspices of the State Technological Supervision Bureau. Massive power outages are not expected, but small ones could occur.

Rail freight—but not passenger services—was cited by Zhang as a major problem area since many railroad districts do not have the money to purchase software upgrades. She also expressed fear that some SOEs lacked money for repair and testing. Other remaining problems cited by the Czar include lack of Y2K awareness; lack of attention from SOE leaders; lack of coordination among different departments; lack of capital; lack of knowledge concerning embedded-chip Y2K problems; extensive problems in the system environment; and little experience with risk assessment. Zhang also stated that China is late in starting contingency planning, a fact that worries many foreign companies that would like to have some understanding of the priority system that will govern allocation of power, water, gas, and other utilities in the event of emergency.

Less is known about Y2K preparedness in China's interior and smaller localities. The general sense is that the extent of computerization is lower outside the major cities, but so is the level of Y2K awareness and the ability to repair and test.

Control what you can, prepare for the rest

Sensing that the Chinese government is doing everything in its power to ensure a smooth transition to the next millennium, many companies have begun to concentrate on their own contingency plans. The Council's Shanghai office Y2K working group met in early August to discuss this topic.

Unsuprisingly, the manner in which companies are handling contingency planning depends greatly on corporate policy and type of industry. Safety is a paramount consideration, and most companies are preparing a Y2K safety plan that covers such things as emergency lighting and communications. Most companies are planning to continue with business as usual during the Y2K "rollover"—and are thankful that the year 2000 starts on a Saturday. However, many have drafted shutdown plans, just in case there is a major problem with utility supplies.

Those companies whose plants cannot survive a power outage without serious damage to equipment have purchased additional generators and are planning a "warmdown" for the Y2K rollover. During the warmdown, essential equipment will be kept running but no product will be produced during the December 31-January 1 period. On the other hand, some companies that can shut down operations with relative ease are simply planning to close during the rollover period. And certain companies with worldwide manufacturing operations intend to shift production to facilities outside China if serious work interruptions occur.

Worries about the Y2K readiness of key materials suppliers trouble some companies more than the risk of temporary utility interruptions. They fear that if key suppliers have not properly prepared—or if transportation services are seriously disrupted—their own ability to produce will be affected. Supply-chain readiness is not an issue that seems to have been considered by most SOEs. (Of course, some major SOEs don't have supply chains since they own and operate everything they need for manufacturing, including the power supply.) Anxious companies are thus researching alternate suppliers and may increase inventories of crucial materials. One company expressed the fear that if it became necessary to resort to overseas suppliers, State Administration of Foreign Exchange-related difficulties might emerge when trying to pay for the imports. As a result, how much foreign exchange to keep on hand has also become an issue.

Non-industrial companies do not need to plan for as many contingencies as do those that manufacture. However, they still have contingency plans, which will allow them to handle accounts and the like without networked computers, or even by hand—the abacus is a highly recommended back-up for computerized accounting systems.

All employees should have a copy of their company's contingency plan and be trained in how to implement it.

The art of contingency planning

Y2K contingency planning is a tricky business. How much time, money, and effort should a company spend preparing for an event the risks of which are impossible to predict?

There is no easy answer to this. But whatever the extent of contingency plans and preparations made, it is crucial to be certain that the plan is actually deployed. All employees should have a copy of the contingency plan and be trained in how to implement it. Any assumptions made in the plan must be clear to all. Testing the plan and even drilling employees in implementation is recommended, though many companies are unwilling or unable to stop operations in order to test.

Most contingency plans tend to focus on surviving a disaster, but plans must also be made for resumption of normal business operations when the problems have passed. It is also important to remember that the December 31-January 1 rollover marks the beginning of potential Y2K problems, not the end. Experts believe that many problems will not emerge until month's end—especially with billing processes, and the like—and that the February 28-29 leap-year rollover may also prove problematic.

The Japanese Prime Minister's office has posted a detailed guide to Y2K contingency planning on its website, and IBM Corp.'s website features a guide to rollover planning.

"You have to control what you can and prepare for the rest," summed up one Council Y2K group member. 完

China Investment Manual, Second Edition

Edited by Donald J. Lewis. Hong Kong: Asia Law & Practice, 1998. 729 pp. (Vols. 1&2) $265 softcover.

China Investment Manual draws upon the expertise of leading authorities on PRC investment and business law to provide a comprehensive overview of the legal issues underpinning the PRC's current investment environment. The manual covers topics ranging from accounting to zones, including contracts, how to select investment vehicles, intellectual property, employment and management practices, and customs. These volumes also provide a solid introduction to PRC government agencies involved in investment policy- and decision-making at both the national and local levels.

China Investment Manual is an important resource for companies with operations in China, as well as for firms looking to invest there for the first time. Each section opens with a brief overview referencing pertinent PRC laws, followed by information, legal analysis, and interpretation. The section on holding companies, for example, details preconditions for application and application procedures, registered-capital and capital-contribution requirements, the scope of business permitted under the holding company structure, and foreign-exchange and tax issues.

One of the strengths of the manual is its ability to present in an integrated fashion important issues that may confront an investor in China. Throughout each section, key laws that may have an indirect impact on the main issue covered appear in bold type and refer the reader to other sections of the manual for additional analysis. This approach provides the reader with a broader understanding of the full range of issues that must be considered when evaluating the PRC's investment regime. *China Investment Manual* is a valuable reference guide for foreign investors trying to navigate the maze of Chinese investment laws.

—Jeremie Waterman

Jeremie Waterman is Business Advisory Services associate at The US-China Business Council in Washington, DC.

The Economics of Energy Policy in China: Implications for Global Climate Change

By Zhang Zhongxiang. Cheltenham, UK: Edward Elgar Publishing Ltd., 1998. 279 pp. $85 hardcover.

In *The Economics of Energy Policy in China: Implications for Global Climate Change*, Zhang Zhongxiang, a research fellow at the University of Groningen in the Netherlands and a professor at the Center for Environment and Development at Beijing's Academy of Social Sciences, searches for an economically feasible way to reduce carbon dioxide emissions in China. Meticulous in his research, Zhang analyzes the Chinese energy system and the applicability of several international models to China. He also develops his own model to better describe the effects of carbon dioxide abatement on the Chinese economy.

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As a result of his research, Zhang concludes that the joint implementation (JI) method—by which more-developed countries invest in carbon abatement technologies in less-developed countries—would be the best method for reducing global carbon emissions. Because the same amount of money spent in a less-developed economy produces a greater effect than in a more-developed economy, the JI plan leads to greater efficiency in the world's energy systems.

Zhang also explores alternative fuels, including natural gas, nuclear power, and hydropower, as well as wind, solar, and tidal energy. He determines that the cost of building the requisite hardware and transporting the electricity makes many of these alternative energy sources inefficient. Because of their greater carbon abatement benefits, hydro- and nuclear power are more plausible alternative energy sources.

For the layperson, reading Zhang's study is like hunting for truffles in a forest: you know they are out there, and while plunging through the underbrush to get to them isn't easy, it is worth the effort. While the technical writing can be thorny, the study is so well done that one still comes away from the hunt with a good understanding of the economically feasible methods of carbon abatement in China. The major flaw in the study is the incompleteness of Zhang's model. He does, however, suggest incorporating a more realistic institutional structure in a future study. Given the changing nature of the PRC economy, future studies with a more complete version of Zhang's model will no doubt prove useful for analyzing China's environment.

—Lissa Michalak

Lissa Michalak is the publications assistant at The CBR.

Pacific Economic Outlook, 1999-2000

By Pacific Economic Cooperation Council, 1999. Washington, DC: United States National Committee for Pacific Economic Cooperation. 80 pp. $32 softcover.

The eleventh *Pacific Economic Outlook, 1999-2000 (PEO)* provides an economic forecast for the Pacific Rim region, drawing on the expertise of leading economists from 19 of the 24 member economies of the Pacific Economic Cooperation Council. (Brunei Darussalam, Pacific island nations, Russia, and French Pacific territories are not included this year.)

The concise volume begins with a summary of the regional economy in 1998, noting that Australia, Canada, and the United States performed exceptionally well, while Colombia, Hong Kong, Indonesia, and Japan performed poorly largely because of structural problems. Lessons of the Asian crisis are also summarized. The generally optimistic outlook for 1999-2000 finds Pacific countries' monetary and fiscal policy, international trade, and balance of payments encouraging. *PEO* does, however, warn that serious trouble could arise in the region should China, Japan, or the United States—the three engines of regional economic growth—experience severe recession. A *renminbi* devaluation, potential Y2K problems, and elections in several countries could also cause difficulties.

The main body of the book devotes a chapter to each of the 19 economies. These chapters summarize economic performance in 1998, discuss problems and trends specific to that economy, and finish with a forecast. In the case of China, *PEO* highlights declining household consumption, foreign investment, trade, deflation, unemployment, and the government's attempts to stimulate investment and consumption. *PEO* predicts that GDP, exports, imports, investment, and prices will rise slightly over the next two years. Surprisingly, it indicates that China's GDP may rise to 8 percent in 2000, a rosier forecast than other analyses.

Perhaps most useful to readers are the six tables at the end of the book, containing major indicators for each economy.

—Virginia A. Hulme

Virginia A. Hulme is assistant editor of The CBR.

China Markets Yearbook 1999

Edited by Shaomin Li and David S. Tse. Hong Kong: City University of Hong Kong Press, 1999. 1,148 pp. $325 hardcover.

In compiling *China Markets Yearbook 1999*, Shaomin Li and David S. Tse have put a wealth of information at our fingertips. This volume, the sequel to *China Markets Yearbook 1997*, reports on 563 markets in China from coal mining to water supply. The bilingual book is based on the results of the 1997 PRC State Statistical Bureau survey of enterprises.

Laid out in a user-friendly table format, each industry report begins with a market snapshot detailing the industry's percentage of China's total industrial sector, revenue growth rate, the percentage of profitable firms in the industry, and the top province for that industry in terms of revenue. The table lists general industry statistics, including total number of firms, employees, revenue, profit, debts, and assets. Such information is also available by type of company ownership as well as by size, region, and province. In addition, the table features 4 years of selected industry indicators. Users will also find information on the top 10 firms, wholesalers, and cities in the industry according to production.

Finally, *China Markets Yearbook 1999* includes a brief glossary of terms used in the volume and provides general information on each province, such as population, GDP growth rate, and per capita income.

—Darlene M. Liao

Darlene M. Liao is assistant editor of The CBR.

Wenlin 2.0

Oakland, CA: Wenlin Institute, Inc., 1998. $150 CD-ROM.

Wenlin 2.0, a software for learning Chinese, is a great resource for any student of Mandarin Chinese—it is fast, has multiple functions, and is easy to use. It can serve as a basic Chinese word processor and features a searchable dictionary. The program provides correct pronunciation of and stroke order for writing a character, in addition to recognizing handwritten characters. Users can also search the database for both definitions and examples of character usage.

A Windows-based software, Wenlin allows users to move among different tools. Characters can be entered into the computer by typing the pinyin, followed by 1, 2, 3, or 4 for the proper tone. Hitting the "convert," or "/," button brings up a list of all characters with this pronunciation. If a tone is not assigned, the software will provide a larger list of all the characters with that pinyin spelling.

Wenlin's help section facilitates the use of more advanced functions such as designing flash cards, editing the dictionary, and searching the complete database. Although it would suffice as a Chinese word processor for beginning to intermediate students, Wenlin does not claim to be a substitute for standalone Chinese word processors. It is, however, compatible with most other Chinese word-processing programs, so a Wenlin document may be cut and pasted into other applications or vice versa.

Wenlin is also useful for China businesspeople who may need a quick, in-depth reference guide. And Wenlin allows those who have an intermediate understanding of Chinese—or are good speakers but illiterate—to put their spoken words on paper. The speed and ease of character lookup is truly Wenlin's greatest strength. The program should increase the reading and writing ability of any student of Chinese.

—Gregory S. Heslin

Gregory S. Heslin is the business manager of The CBR.

THE ERA OF JIANG ZEMIN

BY WILLY WO-LAP LAM. SINGAPORE: SIMON & SCHUSTER, ASIA PTE LTD., 1999. 452 PP. HK$165 SOFTCOVER.

Willy Wo-Lap Lam is a veteran observer of the Chinese political scene. In his new book, *The Era of Jiang Zemin*, Lam paints an incredibly detailed picture of the personal and policy challenges facing China's top leadership. As Lam weaves his story, President Jiang Zemin emerges less as the helmsman leading China boldly into the 21st century than as an aging leader muddling through the day-to-day operations of the country while focusing on his own public image. By the end of the book, readers may sense that the Chinese president is particularly weak when called on to think creatively about solutions to China's looming social and economic problems.

This book's most significant contribution is its analysis of how, since the mid-1990s, Jiang and Premier Zhu Rongji have been actively re-centralizing China's governmental authority and strengthening state links to the Communist Party, links that were deliberately weakened under Deng's leadership in the 1980s. The author depicts Jiang and Zhu not as the liberal, market-driven reformers portrayed in the Western press, but as neo-conservatives who envision a strong central-government hand in China's economy at both the national and local levels. Lam's analysis of how Jiang has used the issue of corruption, and the power of a revived Public Security Bureau, to outflank his challengers is fresh and insightful.

At times, Lam's analysis of Jiang and Jiang's era overlap, so that it becomes difficult to separate the leader's policy initiatives from developments or policies set in motion long ago. Lam's discussion of the increased political role of the People's Liberation Army (PLA) is also interesting but lacks enough supporting information to be persuasive. The emphasis on factionalism in the PLA is also excessive in places.

The fast-paced text is packed with detail and can leave readers less familiar with the names and positions of Chinese personalities and agencies fumbling for a government chart of who's who. But hang in there, for the text is rich. As always, Lam's insights on China's senior leadership are instructive and leave us clamoring for more.

—Karen M. Sutter

Karen M. Sutter is director of Business Advisory Services at The US-China Business Council in Washington, DC.

CHINA IN THE NEW MILLENNIUM: MARKET REFORMS AND SOCIAL DEVELOPMENT

EDITED BY JAMES A. DORN. WASHINGTON, DC: CATO INSTITUTE, 1998. 416 PP. $24.95 HARDCOVER, $15.95 SOFTCOVER.

China in the New Millennium probes the question of how China can resolve the paradox of promoting a market economy while maintaining a dominant role for the state in economic planning. The collection of essays also discusses the expansion of personal freedoms in China that resulted from the country's market opening. The authors maintain that China's prosperity in the next century will depend on the willingness and ability of China's leaders to promote the continued interaction of market economy and personal autonomy.

This book consists of five parts with essays by experts on China's economy, including Justin Yifu Lin, Minxin Pei, Nicholas Lardy, and Jose Pinera. In Part I, authors examine the current tension in China's economy caused by state-owned-enterprise reforms and lingering banking problems.

Part II studies Hong Kong as a potential model for a free economy on the mainland. The success of Hong Kong's non-interventionist economy bears significant implications for China's future. If China can copy the Hong Kong government's "hands-off" approach to business and the economy, it could do even better than Hong Kong, given its larger resources.

Part III addresses the most serious issues facing foreign businesspeople and enterprises in China: China's attempt to join the World Trade Organization; its ability to open up specific sectors such as telecommunications and foreign exchange; and its evolving relations with the United States as it grows in economic stature.

Part IV analyzes the development of China's civil society at a time when the market economy poses enormous challenges to the historical tradition of a political economy. The book suggests that the government holds the key to this dilemma.

Part V explores the constitutional, fiscal, and regulatory changes that China must make to become a free economy. These include a streamlined tax system and constitutional limits on government's right to tax and spend.

China in the New Millennium deserves the attention of anyone interested in the direction of China's economy. While the book does not provide all the answers to the problems plaguing China's economy, it does provide a framework for gauging China's market potential in the next century.

—Ada Wong

Ada Wong is a Business Advisory Services intern at The US-China Business Council in Washington, DC.

Wesley Yin

The following tables contain recent press reports of business contracts and negotiations exclusive of those listed in previous issues. For the most part, the accuracy of these reports is not independently confirmed by *The CBR*. Contracts denominated in foreign currencies are converted into US dollars at the most recent monthly rate quoted in the International Monetary Fund's *International Financial Statistics.*

Firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in *The CBR* by sending the information to the attention of the editor.

SALES AND INVESTMENT *May 15 - July 15, 1999*

Foreign or Hong Kong party/Chinese party **Arrangement, value, and date reported**

Agricultural Commodities and Technology

OTHER

World Bank
Approved loan for improving irrigation systems in the Guanzhong Plain of Shaanxi Province. $100 million. 5/99.

Banking and Finance

CHINA'S IMPORTS

Beijing Brighton STAQ Electronics Systems Ltd., a subsidiary of Brighton Technologies (US)
Will expand the STAQ Online stock trading network to 50 cities. $1.8 million. 6/99.

INVESTMENTS IN CHINA

Bush Corp. (US)/China Xinhua Financial Corp., a joint venture between Xinhua News Agency and China Nonferrous Metals Industrial Trade Group
Established venture capital project to attract investment for emerging high-technology firms. 6/99.

Cyber City Capital LLC (US)
Will launch a private equity fund to invest in high-technology start-ups. $10 million. 5/99.

OTHER

Chase Manhattan Corp. (US)
Opened branch office in Beijing. 6/99.

Citigroup Inc. (US)
Began conducting *renminbi* business in Shenzhen, Guangdong Province. 6/99.

Abbreviations used throughout text: ADB: Asian Development Bank; BOC: Bank of China; CAAC: Civil Aviation Administration of China; CNAIEC: China National Automotive Import-Export Corp.; CATIC: China National Aero-Technology Import-Export Corp.; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNOOC: China National Offshore Oil Corp.; CNPC: China National Petroleum & Gas Corp. ETDZ: Economic and Technological Development Zone; ICBC: Industrial and Commercial Bank of China; MII: Ministry of Information Industry; NA: Not Available; NORINCO: China North Industries Corp.; P&T: Posts and Telecommunications; PBOC: People's Bank of China; SEZ: Special Economic Zone; SINOCHEM: China National Chemicals Import-Export Corp.; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; SPC: State Planning Commission; UNDP: United Nations Development Program; UNICOM: China United Telecommunications Corp.

Sun Hung Kai Properties (Hong Kong)
Acquired a 20% stake in a $50 million venture-capital fund sponsored by Beijing Enterprises Holdings and San Francisco-based WI Harper Group. $10 million. 5/99.

Chemicals, Petrochemicals, and Related Equipment

INVESTMENTS IN CHINA

Orgavyl Chemical Industries Sdn. Bhd. (Malaysia)/China Qianzhou Orgavyl Chemical Industries Co. Ltd. (Fujian)
Established joint venture to manufacture adhesives, inks, pigments, coatings, and plastic and rubber products. (Malaysia:51%-PRC:49%). $1 million. 6/99.

International Finance Corp./Chengdu Huarong Chemical Co. Ltd.
Established joint venture to produce high-purity potassium hydroxide. $19.2 million. 5/99.

OTHER

Kodak China Co. Ltd. (US)
Finalized syndicated loan with ABN AMRO Bank, Bank of America, Bank of Communications, Bank of Tokyo-Mitsubishi, Banque Nationale de Paris, Citibank, Commerzbank, Credit Suisse First Boston, Deutsche Bank, First National Bank of Chicago, HSBC, ICBC, ING Barings, Sanwa Bank, and Standard Chartered Bank. $250 million. 7/99.

Dow Chemical Co. (US)/OCT Import and Export Co. Ltd. (Guangdong)
Commenced joint-venture operation to import and export petrochemical products. 5/99.

Genencor International, Inc. (US)
Increased its stake in its joint venture with Wuxi Enzyme Factory. (US:80%-PRC:20%). 5/99.

Consumer Goods

CHINA'S INVESTMENTS ABROAD

Hai'er Group (Shandong)
Will build a refrigerator production plant in South Carolina. 7/99.

INVESTMENTS IN CHINA

Japan Tobacco Inc./Shanghai Gaoyang International Tobacco Co.
Will jointly produce two Japanese cigarette brands. 5/99.

The Procter & Gamble Co. (US)/Chen Paper Co. Ltd. (Jiangsu)
Signed letter of intent to buy paper mill in Suzhou, Jiangsu Province, and rights to the Tender and Delight towel brand. $113 million. 5/99.

OTHER

Unilever Plc. (UK)
Received approval to merge its joint ventures in Shanghai—Shanghai Lever, Shanghai Ponds, Shanghai Soap Co., Ltd., and Unilever Toothpaste. 7/99.

Benckiser N.V. (Germany)
Increased its stake in joint venture with Power 28 Group of Hubei Province by 30%. (Germany:90%-PRC:10). 6/99.

Electronics and Computer Software

CHINA'S IMPORTS

Alcatel (France)
Will provide Shanghai P&T Administration with its ADSL solution to develop the Shanghai Infoport multimedia project. 7/99.

Golden Fortune Investments Ltd. (Canada), MultiCyber Internet Ltd. (Canada)
Will provide Shanghai Information Town Real Estates Co. Ltd. with Wireless Internet and Local Area Network services to develop the Infoservice Tower in Pudong New Area, Shanghai. 7/99.

Astea International Inc. (US)
Will supply HDRQ Solutions (Guangdong) with the Chinese version of its ServiceAlliance software, a customer-service management tool. 6/99.

Cisco Systems, Inc. (US)
Will provide 139 additional IGX 8400 wide-area ATM switches and network management for the third phase of China's National Financial Network. 6/99.

Cisco Systems, Inc. (US)
Will supply Guangdong P&T Administration with equipment and facilities to develop a data communications network. $200 million. 6/99.

Datacraft Asia Ltd. (Singapore)
Will expand the digital data network in Shandong Province. $2 million. 6/99.

InFocus (US)
Will supply data/video projection systems to Shanghai General Electronic Co. Ltd. 6/99.

Internet Image, Inc. (US)
Will supply Sun Microsystems China Ltd. with 60 copies of its Java-based system management platform, TargetLink. 6/99.

NetUSA (US)
Will develop email, web-hosting and web-paging services for Guangzhou Information Industries Co. (GZIC), Guangdong, in exchange for rights to market GZIC's website in North America. 6/99.

Worldgate Communications, Inc. (US)
Will provide Hunan Multimedia Communications Bureau with high-speed Internet and email access to the cities of Changsha and Hengyang. 6/99.

CollegeEdge (US)
Received approval from the PRC Government to provide Chinese students with Internet-based counseling services on applying to US universities. 5/99.

INVESTMENTS IN CHINA

China Tone Software Group Corp. (Hong Kong)/ Information Centre of Guangzhou Economic and Technological Development Zone (Guangdong)
Established joint venture to develop and process equipment for the computer, Internet, and telecommunication networks. $15 million. 7/99.

Culturecom (Hong Kong)/Chinese Academy of Sciences
Established joint venture to develop a Chinese computer operating platform. 7/99.

Group Sense Ltd. (Hong Kong), Lernout & Hauspie (Belgium-US)/Huajian Electronic Corp. Ltd., a Hong Kong-based enterprise group of the Chinese Academy of Sciences
Established joint venture providing English-language learning solutions for Internet-connected handheld devices. 7/99.

Zi Corp. (Canada)/China Huayu Ltd., a Hong Kong subsidiary of the Ministry of Education
Established joint venture to develop and distribute a Chinese-character input system for the education sector. 7/99.

Aniche Inc. (US), Power Direct Inc. (Canada)
Established joint venture to operate a Chinese entertainment and shopping website called "giftstakes.com." 6/99.

Cathayonline Inc. (US)
Has acquired 100% of Sichuan Torch Information Technologies Co. Ltd., an Internet service provider. 6/99.

Siemens AG (Germany)/Legend Holdings Ltd. (Beijing)
Signed contract to produce personal computers under the Siemens brand. 6/99.

Compaq Computer Corp. (US)/Star Computer Co. Ltd. (Fujian)
Established joint venture to develop the electronic commerce market. $30 million. 5/99.

Metromedia China Corp., subsidiary of Metromedia International Group, Inc. (US)/China Products Firm (NA)
Established joint venture to develop and operate electronic commerce systems. 5/99.

OTHER

Statistics Analysis System Institute (US)
Set up branch company in Shanghai. 7/99.

ChinaMallUSA.com Inc. (US)
Received license to market goods and services directly to the Chinese populace through its website. 6/99.

ChinaMallUSA.com Inc. (US)/China Township Enterprise Investment Development Corp. (CTEIDC) (Beijing)
Will bring 500 CTEIDC member firms into its online network. $1.5 million. 6/99.

ChinaMallUSA.com Inc. (US)/*People's Daily*
Formed strategic alliance to promote e-commerce through the online version of the *People's Daily*. 6/99.

Golden Fortune Investments Ltd. (Canada)
Received approval from the Chinese Science Committee to integrate wireless Internet technology into the existing Chinese network. 6/99.

MyWeb Inc.com (US)/Xinhua News Agency
Will jointly develop an interactive news website. 6/99.

Omni Doors Inc. (US)/China National-Info Beifang Internet Tech Development Co., Ltd. (NA)
Will jointly develop www.WebOfChina.com, a Chinese e-commerce website. 6/99.

Engineering and Construction

OTHER

JGC Corp. (Japan)
Established subsidiary in Shanghai to facilitate bidding for industrial plant engineering projects. 7/99.

World Bank
Approved loan for the construction of a key section of highway connecting Fuzhou, Fujian Province, and Shenzhen, Guangdong Province. $200 million. 6/99.

World Bank
Approved loan to finance the construction of the Wuhan-Changsha expressway. $350 million. 6/99.

World Bank
Approved loan to finance soil erosion reduction and land/water resources improvement projects along the Yellow River. $150 million. 5/99.

Environmental Technology and Equipment

CHINA'S IMPORTS

American Technologies Group, Inc. (US)
Will supply China National Water Resources & Electric Power Materials & Equipment Co., Ltd. with The Force, an automotive combustion product. 6/99.

INVESTMENTS IN CHINA

Bremen University (Germany)/Zhejiang Provincial Energy Research Institute
Established joint-venture research institute focusing on energy and environmental protection in Hangzhou, Zhejiang Province. 6/99.

Engelhard Corp. (US)/SINOPEC
Established joint venture in Shanghai to manufacture and market auto-emission catalysts. (US:40%-PRC:60%). 6/99.

OTHER

ADB
Approved loan for water quality improvement and flood control project for Suzhou Creek in Jiangsu Province and Shanghai. $300 million. 7/99.

World Bank
Approved loan to improve water quality in Chengdu, Deyang, Leshan, Luzhou, and Zigong cities in Sichuan Province. $152 million. 6/99.

Food and Food Processing

CHINA'S EXPORTS

Cuidao Holding Corp. (US)
Signed contract to import and distribute products of Changyu Pioneer Wine Co. of Yantai, Shandong Province. 7/99.

INVESTMENTS IN CHINA

Goodman Fielder Ltd. (Australia)
Acquired 90% of Shanghai Van Den Bergh Co. Ltd., a vegetable oil company. $10 million. 7/99.

New World Development Ltd. (Hong Kong)/Shandong Long Feng Flour Production Co.
Established joint venture to produce flour in Yantai, Shandong Province. (Hong Kong:90%-PRC:10%). $6.7 million. 7/99.

China Prosperity International Holdings Ltd. (Hong Kong)
Acquired interest in a corn processing plant in Harbin, Heilongjiang Province. (Hong Kong:90%-PRC:10%). $19 million. 6/99.

Medical Equipment and Devices

CHINA'S IMPORTS

Zila Ltd. (UK)/Shanghai Hunting Medical Science Co. Ltd.
Will provide Shanghai Hunting Medical Science Co. Ltd. with OraTest oral cancer detection product for five years. $15 million. 6/99.

OTHER

Chindex International Inc. (US), Trex Medical Corp. (US)
Signed agreement for the distribution of Trex Unicath cardiac catheterization labs in China. 6/99.

Metals, Minerals, and Mining

INVESTMENTS IN CHINA

American Xtal Technology, Inc./Inner Mongolia Mining, Nanjing Germanium (Jiangsu)
Entered into a 25-year agreement to mine germanium in Inner Mongolia. 6/99.

Billiton Plc. (UK)/Yunnan Dianxi Geological Exploration and Mining Development Co., Yunnan Lanping Nonferrous Metals Co. Ltd.
Established joint venture to develop a 200,000 ton per year zinc-lead project. $1.4 million. 6/99.

Simsen International Corp. Ltd. (Hong Kong)/(NA)
Established joint venture with four PRC companies to mine nickel, copper, and cobalt in Xinjiang Uygur Automonous Region. (Hong Kong:23%-PRC:77%). 6/99.

OTHER

Teck Corp. (Canada)
Acquired White Silver Mountain mining project in Gansu Province from Minco Mining and Metals Corp. (Canada). 7/99.

Miscellaneous

CHINA'S IMPORTS

Garner Holt Productions (US)
Signed contract to make animated display figures for the Meridian View Center in Shenzhen, Guangdong Province. $1 million. 6/99.

INVESTMENTS IN CHINA

Times Publishing Ltd. (Singapore), Times-Ringier Ltd. (Hong Kong)/Shanghai Printing Group Co.
Established commercial printing and publishing joint venture in Shanghai. (Singapore:40%, Hong Kong:10%-PRC:50%). $10.4 million. 7/99.

OTHER

Korean Broadcasting System (S. Korea)
Will provide Chinese broadcasting stations with 10 television programs and satellite broadcasting receivers. $467,000. 6/99.

World Bank
Approved loan for improving water supply and sanitation in Anhui, Fujian, Guizhou, and Hainan provinces. $46 million. 6/99.

World Bank
Approved loan to provide health and education benefits to Inner Mongolia, and Gansu and Qinghai provinces. $160 million. 6/99.

World Bank
Approved loan for improving quality of undergraduate science and engineering programs in 28 universities. $70 million. 5/99.

Packaging, Pulp, and Paper

INVESTMENTS IN CHINA

Brighton Technologies Corp. (US), Orient Packaging Holdings Ltd. (Hong Kong)
Will jointly lease Yangzhou Mill, a production facility of Yangzhou Zhonghua Paper Ltd., Jiangsu Province. $2.4 million. 6/99.

Toray Industries Inc. (Japan)/Yizheng Chemical Fibre Group Corp. (Jiangsu)
Established joint venture to produce polyester film for industrial packaging. $25.2 million. 6/99.

Petroleum, Natural Gas, and Related Equipment

INVESTMENTS IN CHINA

Digital Gas (US)/Taichang Co. (Shandong)
Will jointly drill oilfields in Shengli, Shandong Province, and Daqing, Heilongjiang Province. 6/99.

OTHER

Phillips Petroleum Co. (US) /CNOOC
Established an equal-stake partnership in the exploration and development of the Xijiang oil field in the South China Sea. 7/99.

Pharmaceuticals

CHINA'S IMPORTS

Chiron Corp. (US)
Will supply the Lanzhou Institute in Gansu Province and Sino Pharma, a holding company of Beijing University, bulk vaccines for flu, rabies, rubella, and hepatitis. 7/99.

Amarillo Biosciences, Inc. (US)
Will supply North China Pharmaceutical Corp. of Shijiazhuang, Hebei Province, with components of interferon lozenges for treatment of hepatitis B. 6/99.

INVESTMENTS IN CHINA

Sanhe Kailong Biopharmaceutical Co., Ltd., a subsidiary of Dragon Pharmaceuticals Inc. (Canada)
Will acquire 75% of Nanjing Huaxin Biopharmaceutical Ltd. in Jiangsu Province, the largest Chinese producer of erythropoietin. 7/99.

Power Generation Equipment

CHINA'S IMPORTS

The Leningrad Metal Works (Russia)
Will supply Lianyungang nuclear power station, Jiangsu Province with two 1,000 MW turbines. $120 million. 7/99.

Hydro-Quebec International (Canada)
Will supervise China Power Grid Development Corp.'s construction of power network from the Three Gorges to Changzhou, Jiangsu Province. $2.85 million. 6/99.

Ponte Di Archinede Co. (Italy)
Will collaborate to build world's first tidal power station in the Zhoushan islands, off the coast of Zhejiang Province. 6/99.

OTHER

Hydro-Quebec International (Canada), Public Service Enterprise Group Inc. (US)
Will invest $50 million each in Hong Kong-based Meiya Power Co. for power plant projects in the PRC. $100 million. 7/99.

American Electric Power (US)/Henan Electric Power Development Co., Nanyang City Hensheng Development Co. Ltd. (Henan)
Began joint-venture commercial operations of Pushan power plant, Henan Province. 6/99.

World Bank
Approved loan to create wind-generated and solar-powered electricity to supply Inner Mongolia, Hebei, and Fujian provinces, Shanghai Municipality, and rural areas in the northwest. $135 million. 6/99.

NA (Germany, US)
Approved loan to China Construction Bank for importation of power generation facilities for expansion of Dezhou power plant in Shandong Province. $150 million. 5/99.

Property Management and Development

INVESTMENTS IN CHINA

China Prosperity International Holdings Ltd. (Hong Kong)
Has acquired interest in Shing Lung International Hotel in Jinan City, Shandong Province. (Hong Kong:80%-PRC:20%). $33 million. 6/99.

Discovery Hotel Group Ltd. (US), Starwood Hotels & Resorts Worldwide Inc. (US)
Will jointly launch Sheraton's Four Points Hotels in Beijing, Shanghai, and Guangzhou, Guangdong Province. 6/99.

HomeLife Inc. (US)
Signed letter of intent to purchase a 220,000 sq ft manufacturing plant in Anhui Province. 6/99.

Pan Pacific Public Co. (Singapore)/Xinhua Bookstore (Shanghai)
Opened bookstore in Xinhua Plaza, a 28-story retail book and reading center in Kunming, Yunnan Province. $23 million. 6/99.

OTHER

Asian Star Development, Inc. (US)
Obtained license to operate "6-12" convenience store chain in Sanya City, Hainan Province. 6/99.

Yaohan Corp. (Japan)
Sold its 19% stake in Shanghai Yaohan department store joint venture to Shanghai No.1 Department Store. (Japan:36%-PRC:64%). $7.5 million. 6/99.

Telecommunications

CHINA'S IMPORTS

Digital Microwave Corp. (US)
Will supply UNICOM with digital microwave radios for the expansion of the GSM network in Guangdong Province and Chongqing Municipality. $10.4 million. 7/99.

Wavecom (France)
Will supply TCL Industrial Holdings Ltd., Guangdong Province, with 200,000 WISMO modules for GSM handsets. 7/99.

British Telecommunications Plc. (UK)/China Telecom
Signed agreement to provide end-to-end solutions for global frame relay service to and within China. 6/99.

Decibel Products Division, a unit of Allen Telecom Inc. (US)
Will supply an unnamed cellular operator with 5,000 base station antennas to expand its GSM wireless network. $6.6 million. 6/99.

Glenayre Technologies, Inc. (US)
Will supply Hunan Telecom Paging Co. Ltd. with infrastructure equipment to expand high-speed paging network in Hunan Province. $3 million. 6/99.

Guangdong-Nortel Telecommunications Switching Equipment Ltd., a joint venture of Nortel Networks (Canada)
Will provide Shaanxi Telecom Great Wall Mobile Communications with CDMA Metro Cell high-capacity multicarrier third generation-ready based stations. $10 million. 6/99.

Nera ASA (Norway)
Will supply SDH radiolines system and related engineering services to Xinjiang P&T Administration. $6.4 million. 6/99.

Nortel Networks (Canada)
Will expand its participation with China Telecom in developing a CDMA network in Xi'an, Shaanxi Province. $10 million. 6/99.

Oy Nokia AB (Finland)
Will expand the GSM network in Yunnan Province. $170 million. 6/99.

RF Micro Devices, Inc. (US)
Will supply Beijing Xinwei Telecom Technology Co. with radio frequency integrated circuits for its fixed wireless phone system. 6/99.

VIP Calling, Inc. (USA)
Announced partnership with UNICOM to provide international IP telephony solutions. 6/99.

Computer and Technologies Holdings (Hong Kong)
Will provide Zhejiang Mobile Communications with a broadband TCP/IP network. $3.3 million. 5/99.

LM Ericsson AB (Sweden)
Will supply Guangdong Mobile Communications Co. Ltd. with mobile equipment to expand the GSM network in Guangdong Province. $290 million. 5/99.

CHINA'S INVESTMENTS ABROAD

Pilatus Group (India)/Automatic Manufacturing Ltd. (NA)
Established joint venture to manufacture and market caller ID machines in New Delhi, India. (India:51%-PRC:49%). $5 million. 7/99.

INVESTMENTS IN CHINA

Tampa Bay Investments Ltd., a subsidiary of Belair Enterprises (US)/Guangzhou South China Telecom Co. (Guangdong), a unit of UNICOM
Established joint venture to explore and develop the telecommunications market in Guangdong Province. 7/99.

KKD Corp. (Japan)/Shanghai P&T Administration
Established joint venture to provide consulting, system integration, and maintenance for the telecommunications network in Shanghai. (Japan:49%-PRC:51%). $700,000. 6/99.

Guangdong Nortel Telecommunications Switching Ltd., a joint venture of Nortel Networks (Canada)
Will invest in local manufacturers of wireless infrastructure equipment in Guangdong Province. $30 million. 5/99.

LM Ericsson AB (Sweden)
Will increase investments to its nine joint ventures by the year 2000. $600 million. 5/99.

OTHER

Beijing Global Net Communication Technology Co. Ltd., a joint venture between Global Telephone Communications Inc. (US), and Beijing JinXunDa Telecommunication Technology Development Co. Ltd./Government of the PRC
Received business license for its GPS project in Beijing. 6/99.

CDMA Development Group (CDG)
Announced admission of UNICOM as a CDG member firm. 6/99.

Telenetics Corp. (US)
Opened sales office in Beijing. 6/99.

ITXC Corp. (US)
Will serve as the carrier for China Telecom in its pilot Internet telephony network. 5/99.

Singapore Telecommunication Ltd./Shanghai P&T Administration
Signed agreement to explore opportunities to exchange telecommunications services. 5/99.

UNICOM
Received permission from MII to take full control of four mobile phone networks partly owned by the People's Liberation Army. 5/99.

Textiles and Apparel

OTHER

FiberVision, LLC (US)
Will expand its polypropylene fiber production through Suzhou FiberVision Nonwoven Products, Ltd., a new subsidiary in Jiangsu Province. 6/99.

Transportation

CHINA'S IMPORTS

Cubic Transportation Systems, a subsidiary of Cubic Corp. (US)
Will supply Guangzhou Metro Corp. in Guangdong Province with automated fare collection systems. 7/99.

Thai Rung Union Car Plc. (Thailand)
Will develop body parts, jigs, and dies for Zhengzhou Nissan Automobile Co. in Henan Province. 6/99.

Adtranz GmbH (Germany), Siemens AG (Germany)
Will supply China National Machinery Import and Export Co. with 2,800 km of track, 17 electricity substations, and a Scada conduction technology system. $187 million. 5/99.

Alstom (France)
Will supply Shanghai with 28 six-wagon subway trains. $220 million. 5/99.

BMW Rolls-Royce, a joint venture between BMW AG (Germany) and Rolls-Royce Plc. (UK)/China National Aero-Technology International Supply Corp., Liming Engine Manufacturing Corp. (NA)
Signed long-term contract to supply engine parts and to develop research facilities. 5/99.

Denso Corp., Toyota Tsusho Corp., affiliates of Toyota Motor Corp. (Japan)
Will supply electronic toll collection systems at the Yangtze River Bridge, Jialing River Bridge, and Jialing Shimen Bridge in Chongqing, Sichuan Province. $460,000. 5/99.

Sabre Group (US)
Will develop year 2000-ready airline system operations control center for China Southern Airlines. $10 million. 5/99.

CHINA'S INVESTMENTS ABROAD

Villes Group (Colombia)/Wuxi Rubber Group Corp. (Anhui)
Established joint venture to produce tires for motorcycles. (Colombia:20%-PRC:80%). $4.5 million. 5/99.

INVESTMENTS IN CHINA

Bridgestone Corp. (Japan)
Acquired 60% stake in an existing joint venture between Japan's Mitsui & Co. and Shenyang Santai Tire Co. Ltd. in Liaoning Province, producing truck and bus tires. $21.7 million. 7/99.

Electrobike, a subsidiary of BAT International (US)/Suzhou Machinery Holding (Jiangsu)
Signed agreement to produce 2,000 electric bikes. 7/99.

Elf Aquitaine SA (France)/Qingdao Guangyuanfa Group Co. (Shandong)
Signed letter of intent to jointly produce modified road bitumen for asphalt. 7/99.

Volvo AB (Sweden)/China National Heavy Truck Corp.
Established joint venture in Jinan, Shandong Province, to manufacture and distribute heavy trucks. $576 million. 6/99.

OTHER

BMW Group (Germany)
Opened a 12,000 sq m sales and service center in Beijing. 7/99.

Circle International Group, Inc. (US)
Will provide Konka USA, Ltd. of Shenzhen, Guangdong Province, with global transportation and logistics management. 7/99.

Airbus Industrie (France)/Aviation Industries of China
Will expand cooperation in the development of the A318 series and the manufacturing of A320 wings. 6/99.

Castrol and Bundy China Automotive (UK), Coventry University (UK), Johnson-Matthey (UK), Ricardo Engineering (UK), Queen's University (UK)/Shanghai Academy of Environmental Sciences, Shanghai Environmental Protection Bureau, Shanghai Jiaotong University, Tongji University (Shanghai)
Will establish the Centre of Excellence, an automotive technology and environmental protection institute, in Shanghai. 6/99.

Ho Wan Genting International (Malaysia)
Acquired concession rights from Long Chang Expressway Development, Long Da Construction, Long Jia Construction, Long Li Expressway Development, Long Ma Expressway Development, and Long Yi Construction of Heilongjiang Province, to operate toll roads. $704 million. 6/99.

Shanghai General Motors, a joint venture between General Motors Corp. (US) and Shanghai Automotive Industrial Corp./China Construction Bank, ICBC
Will provide financing to consumers for purchases of Buick sedans. 6/99.

Volkswagen AG (Germany)/Government of the PRC
Received permission to develop a compact car at its Shanghai-Volkswagen Automotive Co. joint venture. 6/99.

Toyota Motor Co. Ltd.
Opened auto technology consulting and development center in Tianjin. $9 million. 5/99.

Council ACTIVITIES

Beijing Hosts EPA, Talks SOE Reform

The Council's Beijing office hosted a delegation from the US Environmental Protection Agency (EPA) on July 14. Led by Paul Schwengels, program manager of the Climate Policy and Programs Division, the delegation consisted of EPA officials and representatives of EPA contractors such as the US National Renewable Energy Laboratory. The group discussed several new EPA initiatives in China, including cooperation in the marketing of clean-energy technologies and a study on natural-gas policy and utilization in China. The clean-energy project will focus on boilers, electric motors, wind power, and clean-coal technology. All of these projects resulted from the April meeting of the US-China Forum on Environment and Development, convened by Vice President Al Gore and Premier Zhu Rongji.

State-owned-enterprise reform was the focus of an August 25 meeting featuring Edward Steinfeld, a professor at the Massachusetts Institute of Technology and Qinghua University who has specialized in SOE reform issues (*see The CBR*, March-April 1999, p.56).

Washington Discusses WTO, Y2K

Professor Wang Yong, visiting fellow at the Pacific Council on International Policy at the University of Southern California and assistant professor and director of the International Political Economy Program at Beijing University, shared his views on China's bid to join the World Trade Organization (WTO) with member companies at a July 20 meeting. Wang addressed three questions: why WTO negotiations have moved so slowly; why negotiation sped up in 1999; and what the negotiations indicate about the changing political landscape in China (*see The CBR*, July-August 1999, p.42).

The Council also hosted a Y2K meeting on August 25. The session featured Zhang Qi, czar of China's Y2K Task Force and director general of the Ministry of Information Industry's Department of Information Products, along with a delegation of representatives from China Telecom, the People's Bank of China, the State Economic and Trade Commission, China Securities Regulatory Commission, and other PRC bodies.

Shanghai Focuses on Y2K

Representatives from Council member companies shared their Y2K concerns at an August 6 meeting in Shanghai. In addition to discussing their companies' contingency plans, representatives pinpointed potential problems in manufacturing, transportation, and public expectation, among others.

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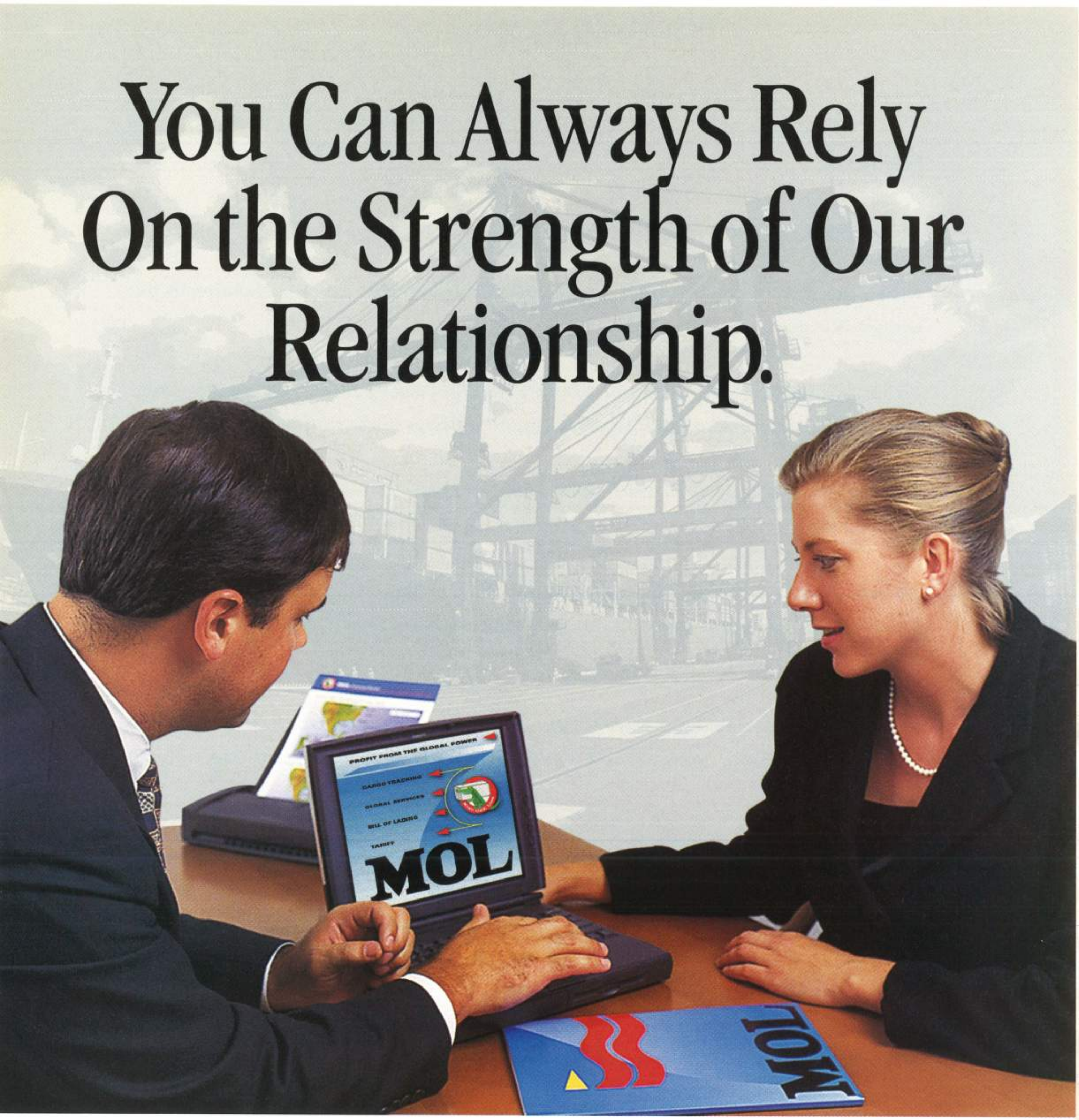

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