DOING BUSINESS IN CHINA: INVESTOR BEWARE

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ABSTRACT

China remained a completely closed economy, not open to any Foreign Direct Investment (FDI) till the early 1980s. During the 1980s, China, under the leadership of Deng Xiao Peng, began to liberalize its economic policies and opened the Chinese markets to foreign investors. The FDI that poured into China over the past two decades is well over $250 billion. China's recent entry into the World Trade Organization (WTO) is now attracting a fresh wave of foreign investors into China. However, many multinational corporations that entered China are facing many insurmountable problems in doing business in China. The experience of Pepsi-Cola is a case in point. Over the past two generations, Pepsi invested over $500 million of FDI in China but it is yet to make any profit. The main problem faced by the foreign investors is the absence of rule of law in China. Some of the other problems areas include dysfunctional relationships with Chinese joint venture partners, pervasive corruption that extends even to the Chinese courts and absence of trust and transparency in business dealings. The Pepsi experience in China in facing these problems is presented in this paper.

INTRODUCTION

With the advent of Mao Tse Tung's Cultural Revolution in 1966, China became a communist country (People's Republic of China) with a rigid, centrally controlled Marxist political and economic ideology. Mao's communist policies included collectivization of most of the land and property, elimination of the landlord class, weakening of the urban bourgeoisie, and the elevation of status of peasants and the working class. Under his firm centralized rule, the entire Chinese economy, with the largest population in the world, was kept closed to foreign investors (Jonathan, 1998). Over the next three decades, Mao's isolationist, communist economic policies brought China to the verge of economic ruin. After Mao's death, the political leadership that succeeded Mao started to see the futility of their closed economic policies and began to liberalize China's closed markets by gradually opening them to foreign direct investment (FDI). Most of the credit goes to Premier Deng Xiao Ping who launched his "Open Door" policy in 1979 and opened China to foreign investment. Under his new liberalized economic policy, tax incentives were granted to foreign investors for doing business in certain specified geographical regions in China. These incentives were later extended to other areas (Desouza [1]. Prompted by the tax incentives and also attracted by the huge Chinese markets and cheap labor, FDI started pouring into China. With practically little FDI before 1979, China registered an astronomical $240 billion of FDI by 2000 (Mahon [3].

PROBLEMS OF DOING BUSINESS IN CHINA

At the outset, foreign investors were encouraged to joint venture partnerships with the Chinese government or private business organizations. Among all the available business alternatives, joint ventures have become the vehicle of choice for many foreign investors in China and the Chinese government was arranging and providing the Chinese partners to foreign investors. Thus, the joint ventures have become a sort of arranged marriages between foreign investors and the domestic partners. Even though they are unfamiliar with the unique and untested Chinese business environment, foreign investors entered into major long-term commitments in China hoping to reap rich returns. Many of them sustained huge losses. Many others got eventually disillusioned and just left. The major problems of doing business in China include lack of understanding the unique culture of the Chinese partners of the joint ventures, bureaucratic roadblocks, corruption in the regulating agencies, vague and unevenly applied laws and regulations, primitive infrastructure (Wong, et. al.,[8]).

The joint ventures are supposed to be built based on friendship and trust. Many Western companies coming into China have encountered problems even at the stage of negotiating joint business ventures. One of the most salient aspects of forming the joint ventures is to use these to formulate a cooperative strategy to achieve mutual benefit. Yet, many times during the negotiations, the Chinese team would "make sudden demands, apparently to put the western negotiators in a disadvantageous position" [Zhao [10]).

THE PEPSI CHALLENGE

Pepsi Company has been doing business in China for nearly two decades. In 1994, Pepsi Company (Pepsico) started a joint venture with a market capitalization of $2.5 million. Soon, Pepsi became serious competitor to Coke which entered China three years earlier. Even though Coke had twice as many bottlers in China as Pepsi, it was unable to vanquish the new challenger in the soft drink market. As Yoon [9] observes, "by focusing fiercely on the youth market, Pepsi has not managed to eat into Coke's market share but also became the Chinese teenagers' favorite brand". Wonacott and Legget [7] found that a recent marketing and advertising blitz gave Pepsi an edge over Coke in many major cities in China.

With all the recent successes, Pepsi is having serious problems with its joint venture partner in China. According to Wall Street Journal [6], "Pepsi's China story is a classic cautionary tale". As reported in the Journal, Pepsi has invested over $500 million in China over the past twenty years and is yet to make dime of profit. Pepsi entered into a joint venture partnership in 1994 with the most incongruous partner for a beverage business. Pepsi's Chinese partner, arranged by the Chinese government, Sichuan Radio and Television Development Company, a local bureau of the State Administration of Film, Radio and Television department which regulates the Chinese media.

This arranged marriage of Pepsi and its Chinese partners is now on the rocks. Pepsi alleges that their Chinese partner, Hu Fengxian who is also the chairman of Sichuan Radio and Television Development Company, spent lavishly, expensed luxury cars and went on European vacation junkets without the approval of Pepsi. The dispute deteriorated rapidly when the local Chinese employees of the joint venture threatened Pepsi auditors who were trying to visit the plant to inspect the books (WSJ [6]).

Pepsi is now trying to terminate the joint venture altogether and applied for arbitration. Pepsi requested for arbitration to take place in Stockholm because Pepsi believes that it can have a fair hearing in Europe rather than in China (Wonactt and Legget [7]). Pepsi preferred to go to Stockholm because, as reported in The Economist [5], China has one of the worst legal systems in the World. As in many developing countries, judges in China are poorly paid and are therefore susceptible to corruption. There is no rule of law in China, only rule of man. According to Richardson [4], a major problem with the Chinese legal system is that the ministries have, and very often exercise, the power to introduce internal documents without prior announcement. In many cases, taking recourse to local courts or arbitration in China has proved useless. Therefore, a preferred practice for all cross border contracts is to specify in the joint venture contracts that any arbitration would take place outside China, in Stockholm, Hong Kong or Singapore (Richardson [4]). Pepsi's travails are not expected to be over even if Pepsi receives a favorable ruling in the arbitration because Pepsi will still have to approach the local Chinese courts for enforcement of the ruling (Wonacott and Legget [7]).

China's recent entry into the World Trade Organization (WTO) is giving some hope to foreign investors in China. WTO has required China to implement the necessary economic reforms within five years to maintain its membership. In order to meet the requirements, China must somehow establish rule of law. As the WSJ [6] maintains, until China establishes the rule of law and reforms its corrupt judiciary, the prescribed rule in China is "Investor Beware".

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