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# Joint Ventures in the P. R. China

by Wolfgang Klenner, Kurt Wiesegart, Hamburg\*

**China is showing interest in joint ventures in the oil, coal and nonferrous metals sector, in electricity generation, steel and building materials production, in the mechanical engineering, textile and electrical industries, in the transport sector and in the hotel trade<sup>1</sup>. Our article gives an outline of the problems which the future joint ventures in China will encounter.**

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By permitting joint ventures China is introducing a new variant into the international economic cooperation which the People's Republic has intensified since the mid-seventies. It was in 1977 that China first went beyond normal trade relations, and began to show interest in cooperation trade. The first cooperation deals with western partners were signed soon afterwards. In 1978 China broached the question of establishing export zones, and foreign factories were set up a little later at Shenzhen, near Hongkong, and elsewhere. By the end of the same year China began to take an interest in the joint venture arrangements in other countries. The Law on Joint Ventures came into force on July 8, 1979<sup>2</sup>; it provided legal foundations for foreign investments with the aim of promoting joint long-term undertakings.

China thereby relinquished the principle of not accepting any foreign participation in Chinese enterprises to which she had long adhered<sup>3</sup>. Two other long-established principles, not to accept foreign loans and to do without development aid, had already been jettisoned earlier: In the early seventies China accepted medium-term supplier credits for plant imports, by the end of 1978 she expressed interest in untied long-term bank loans, and about the middle of 1979 she inquired in Japan about development aid.

China expects of the cooperation with western industrialized nations that it will give her access to

western capital and modern technologies and management methods. Thus it is hoped to raise the productivity in all sectors of the economy and to provide additional production capacities. Thought is to be given first of all to the bottlenecks in coal, oil and electricity which have emerged in the course of the development to date. China wants to expand her export capacities at an increased rate in order to earn the foreign exchange needed to pay for additional imports.

Soon after easing her trade policy China was able to note that the West was willing to supply modern technologies and grant credits on a substantial scale<sup>4</sup> but she was and is not certain whether western countries can absorb appreciably higher Chinese exports as would be necessary for the repayment of

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<sup>1</sup> Cf., e. g., Hua Guofeng: Report on the Government's Activities, in: Beijing Review, No. 27, Beijing, July 10, 1979, p. 17, 20.

<sup>2</sup> Cf. the unofficial translation in: Beijing Review, No. 29, July 24, 1979, p. 25ff. The official text was published in Renmin Ribao, Beijing, July 9, 1979.

<sup>3</sup> In the fifties the Soviet Union participated in joint ventures in China for the development of the mineral oil industry, the nonferrous metal industry and civil aviation among other fields. Cf. JETRO: China – a Business Guide. The Japanese Perspective on China's Opening Economy, Tokyo 1979, p. 139. – China in turn is engaged in joint shipping enterprises with Albania, Poland, Tanzania and Romania. Cf. *ibid.* and Renmin Ribao, July 24, 1979.

<sup>4</sup> Cf. A. Gutowski, W. Klenner, K. Wiesegart: Situation und Perspektiven der chinesischen Wirtschaft. Verschuldungsnotwendigkeit und Finanzierungsspielraum (Situation and outlook of the Chinese economy. The borrowing requirements and financial scope), Hamburg 1979, p. 117ff.

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the credits taken up earlier. Raw materials like mineral oil and certain nonferrous metals will always find buyers but when China tries to sell products of her manufacturing industry she encounters difficulties because the goods she offers do not match western consumer preferences or run up against western trade barriers.

These are certainly some of the reasons why China has up to now been tardy in availing herself of western credit offers and in certain cases preferred to link the use of foreign machines and installations with corresponding export arrangements (compensation, export zones or joint ventures). This lowers the borrowing requirements and thus the repayable debts. The sale of Chinese products in foreign markets becomes a matter for the foreign partner (Art. 9)<sup>5</sup>. Western firms do not always regard these forms of economic cooperation as the best method of settling business deals because they make flexible adaptation to changing market conditions more difficult and therefore carry a very high element of risk<sup>6</sup>.

Engagements by western enterprises in China are supported by western governments. Their most important motives are probably the desire to safeguard raw material supplies, to increase the sales opportunities for their own industries and to avail themselves of other positive effects of the incorporation of China in the world market. The interests in the Chinese market thus cover an extremely wide range as is shown for instance by the active German support for medium-sized firms in China<sup>7</sup>.

### Technology Transfer

It is stipulated (Art. 5) that the technology brought in by the foreign partner must come up to the modern international standard and besides be suited to Chinese conditions. The West has however evolved modern technologies to suit a highly skilled high-cost workforce and to meet regulations for the protection of

the environment. Technologies suiting Chinese conditions on the other hand must be geared to a labour surplus and lower level of skills. Besides, China may in the present state of development be as yet reluctant to employ expensive environment-safeguarding technologies. This puts western firms in a dilemma<sup>8</sup>.

The express interest in technologies which are modern but also fitting in with Chinese conditions is explained by the concept of development entertained up to now. For more than a decade, until the mid-seventies, it was the stated aim of China to reach and overtake the West's technical standards by drawing on her own strength. The technological solutions evolved in the West were deemed not to suit Chinese conditions, quite apart from their capitalist features which could not be applied to the building of socialism<sup>9</sup>.

This policy of searching for China's own line of development does not seem to have been altogether successful. In important industries like iron and steel, coal and mineral oil western experts and the Chinese themselves judge the technical level still to be about two decades behind the western level. But it is evidently neither possible nor desired to cast off the principles of the previous development concept in their entirety.

All the so far available information suggests that the Foreign Investment Control Commission, which was set up on July 30, 1979, applies three criteria to the assessment of technical processes which are offered by foreign partners: their technical level in relation to the world standard, their rating in relation to the technical level reached in China, and their relevance to the present and anticipated requirements of the Chinese economy.

Which level of technological development will be exported to China in the main is still open. A Japanese study<sup>10</sup> found a positive correlation between the development level of importing countries and the level of the technology imported by the various countries from Japan. The development level of the Chinese economy would accordingly suggest that China's technology imports should on balance be graded with those which in highly industrialized countries like Japan count among "older" or "dominant"

<sup>5</sup> The references relate to articles of the Joint Ventures Law.

<sup>6</sup> Cf. G. Chandler: *Private Foreign Investment and the Developing World*, New York-Washington-London 1971, p. 208f.

<sup>7</sup> Cf. *Ost-West-Kooperation Aktuell*, No. 1, January 1980, p. 8.

<sup>8</sup> The Joint Ventures Law contains a provision that the foreign partner has to make compensation if backward technologies are introduced contrary to agreement (Art. 5). This clause has been received abroad with great misgivings. China is however hardly in a position to make claims for damages if the offered technical processes and installations have been accepted by the Foreign Investment Control Commission. But if misunderstandings occur, in regard to the technologies to be introduced, the foreign partner will have to bear the cost. Precise clarifications and unambiguous specifications must therefore be given in the agreement.

<sup>9</sup> Cf. W. Klenner: *Unternehmensorganisation, Technologie und sozialistischer Aufbau in der VR China (Organization of enterprises, technology and socialist development in the P. R. China)*, in: *Bochumer Jahrbuch zur Ostasienforschung* 1978, Bochum 1978, p. 223ff.

<sup>10</sup> Y. Tsurumi: *The Japanese are Coming*, Cambridge, Mass. 1976, p. 177.

technologies. China will certainly strive to reach world standards in selected industries with the aid of foreign technologies. In a few sectors the technology imports will however probably also serve the aim of enlarging the output capacities and procuring more jobs.

The willingness of western business firms to turn over modern technologies to joint ventures will presumably depend mainly on the expected profits and besides on the assurance that the supplied technology will remain at their disposal in the future and can be mastered by the workforce. If China wants to get modern technologies, she will have to bear such commercial considerations in mind.

China is an assiduous supporter of the dissemination of new technical solutions. But until now these have been made available to Chinese enterprises free of charge, and if this practice continues, the foreign partner will be held back from providing his most modern technologies. Patent agreements would give protection but do not yet exist with China. It remains to be seen whether the tax incentives for the provision of the most modern technologies in the Joint Ventures Law (Art. 7) go far enough to induce foreign partners under these conditions to transfer newly evolved production processes.

### **Socio-cultural Background**

The success of the joint work of the cooperation partners furthermore depends on their ability to find a common basis in spite of the differences between their socio-cultural and political backgrounds. To talk simply of the "western" and the "Chinese" partner is certainly wrong. Some western partners are big concerns with complex and rigidly structured direction and communication systems; others are smaller firms with simple decision-making processes. So the conditions for cooperation with the Chinese partner vary a great deal.

Differences also exist on the Chinese side. There are bureaucratic "economic administrators" as well as dynamic managers with energy and initiative in spite of relatively rigid management structures.

A few fundamental differences between western and Chinese enterprises may nevertheless be pointed out. It is probably because China belongs to the Asian cultural circle that the consensus principle dominates in decision-making. Minorities have not necessarily to submit to majority decisions. A majority vote is not decisive. Mutual consultations in which minority interests are taken into account are considered more

important. Similar to the Japanese Ringgi system, the discussion is on principle continued until a joint solution supported by everybody has been found<sup>11</sup>, and this is usually put smoothly in practice.

The social preconditions for the technical-organizational arrangement of productive operations are also different. All the industrialization successes to date notwithstanding, there is still not as much understanding for modern operational processes based on division of labour and systematic coordination in China as there is in industrialized western countries. But as China wants to learn from the West in this field more than anywhere else, western firms are given the opportunity to give effect to their ideas in this respect. This does not however rule out difficulties in the initial phase.

Other problems can arise from the differences between the economic systems. The economic administration in China derives the targets for the individual enterprise from economic and political overall objectives, with the consequence that social costs and benefits are as a matter of principle rated higher than costs and profits of individual enterprises. The Chinese partners are unlikely to be familiar with the mentality of their western partners who are primarily concerned with the success of the individual enterprise and on this basis enjoy a relatively great scope for individual decisions.

The Chinese authorities are making efforts to develop the economic system so as to give the profit of the individual enterprise a more important place as an indicator of economically desirable results<sup>12</sup>. This would provide a better basis for the communications and cooperation between Chinese and foreign business partners.

### **Ownership and Participation**

The combination in joint ventures of foreign private capital and Chinese state capital has several special aspects. As the grant of opportunities for the participation of foreign private capital is not a matter of course in a state-controlled economy, the Chinese quote Lenin and Stalin as ideological witnesses. When they governed the Soviet Union the country was successfully modernized by the foundation of joint

<sup>11</sup> Cf. W. Klenner: Ordnungsprinzipien im Industrialisierungsprozeß der VR China (Principles of the industrialization process in the P. R. China), Hamburg 1979, p. 122.

<sup>12</sup> Cf., e. g., Rong Yangyan: Tantan jingji tizhi gaige de chufadian he zhuyao yiju (Starting point and important basis of the reform of the economic system), in: Jingji Guanli, No. 10, Beijing 1979, p. 19ff.

enterprises with foreign interests and large-scale importation of western installations.

For foreign firms all joint ventures, whether in developing countries or in state-controlled economies, involve the problem of possible nationalization. When China first embarked on a freer trade policy, this was viewed with scepticism because of the events during the Cultural Revolution. Since then China has made clear her intention to continue on the new course. The West has reached the conclusion that China will be compelled to cooperate if she wants economically worth-while investments. A rupture of economic relations or infringements of agreements would have grievous consequences. Recognition of this fact should, together with the property safeguards<sup>13</sup> in the law itself (Art. 2) and China's acknowledged high reputation as a party to treaties, be sufficient to assuage fears of foreign investors.

China is determined to offer extensive investment opportunities to foreign interests in order to attract as much capital as possible on favourable terms. Foreign investors must therefore acquire at least a 25 % share of joint ventures but there is no upper limit. The foreign capital<sup>14</sup> can be contributed in the form of money, assets in kind, licences and patents<sup>15</sup>. China has thus refrained from emulating other state trading countries, like Yugoslavia, Romania or Hungary, which have limited the foreign shareholding in general to 49 %<sup>16</sup>. In view of their place in the framework of a state-controlled economy the question of majority or minority holdings in joint ventures is evidently not considered very important.

### Management

Two different bodies on both of which the two sides are to be represented are envisaged for the direction of joint venture operations. The Board of Directors which has a Chinese chairman is to lay down the general

business policy. It has the sole right to take decisions on expansion projects, production and business programmes, the budget, distribution of profits, plans concerning manpower and pay scales, the termination of business, the appointment or hiring of the president, the vice-president(s), the chief engineer, the treasurer and the auditors as well as their functions and powers and their remuneration (Art. 6).

The president and the vice-president(s) are responsible for the implementation of the business policy. They can be appointed by the foreign partner.

To go by the information available so far the representatives of the Chinese side have to safeguard China's interest in the incorporation of the enterprise in the state economy and the fulfilment of the set plan targets. The representatives of the foreign partner are given a relatively large scope for action in regard to technical and commercial decisions. China wants to create all prerequisites for giving full effect to the foreign management contribution to the improvement of the production system and the marketability of the products in the world market.

Efficient management structures reaching down to the actual workplaces are required so as to implement the decisions of the directive bodies. In western firms and also in Soviet enterprises powers and responsibilities are strictly allocated and the communication channels are clearly mapped out in advance. In China this kind of operations organization was for a long time frowned upon. The exemplar was an all-rounder who can take on many jobs and together with his fellow workers participates in the solution of virtually all questions of production and management as well technical problems. The result was in very many cases indecisiveness and irresponsibility; for this reason this model was scrapped a short while ago and replaced by a tightly organized hierarchical division of labour<sup>17</sup>. During the present transitional phase, however, there is probably still some resistance to the channelling of information flows and the narrowing of the margin for decision-making, especially on the middle- and lower-rank operational level.

The Chinese have indicated on several occasions their great interest in western organizational know-how and also in the performance-related wage system which is customarily applied in the West<sup>18</sup>. Within the system-related limits which exist in spite of the wish for

<sup>13</sup> According to XNA the "Chinese People's Insurance Company" now also covers political risks as losses incurred through such things as wars, riots, or government requisition, confiscation or restrictions. Cf. Xinhua News Agency, News Bulletin, No. 11320, January 1, 1980.

<sup>14</sup> Joint ventures must be constituted as limited liability companies.

<sup>15</sup> The valuation of the shareholdings must be by agreement between all partners. The Chinese partner may invest the usufruct in real estate in the joint venture (Art. 5) but the state remains in this case the legal owner.

<sup>16</sup> For a comparison with the Chinese law of a number of provisions contained in the joint ventures laws of Yugoslavia, Romania, and Hungary cf. O. W e g g e l: Zum neuen chinesischen Gesetz über Gemeinschaftsunternehmen mit ausländischen Partnern: Wenige Antworten – viele Fragen (On the new Chinese law on joint ventures with foreign partners: Few answers – many questions), in: China aktuell, July 1979, pp. 771-793.

<sup>17</sup> Cf. Hua Guofeng, op. cit. p. 13f.

<sup>18</sup> Cf., e. g., the series of articles in Jingji Guani in 1979 under the heading: Guowai guanli jingyan pingjie.

flexibility foreign managers and experts delegated to the joint ventures could perform a mediatory function. In common with all developing countries China wants to replace foreign specialists by her own ones, at least over the long term. At present however there are – in contrast to most ASEAN states<sup>19</sup> – no binding regulations on the number of foreign employees or the duration of their employment.

Input orders are preferably to be placed in China (Art. 9). Joint ventures, like all export-oriented enterprises, are to receive preferential treatment in the allocation of resources in the framework of the state-regulated procurement and sales system<sup>20</sup>. If required inputs are not obtainable in the Chinese market and must therefore be imported, the joint ventures are to secure the necessary foreign exchange by themselves. It would thus appear that a major consideration in the drafting of the law was that of obtaining technical and organizational know-how as far as possible without impairment of the foreign exchange position. Insurance contracts have also according to the law (Art. 8) to be placed with Chinese insurance companies.

The products of joint ventures are to be disposed of chiefly in foreign markets. As far as possible China wants to make use of the sales and servicing networks and the marketing methods of her foreign partners. Whether the latter will also be willing to let the joint ventures benefit from their goodwill will presumably depend on the ability of the joint ventures to meet their quality requirements.

### Profit Transfer

Western partners who wish for the highest possible return on their capital can count on an equal Chinese interest. The new leadership looks on the size of the profits as one of the most important indicators of performance. There is however no legal entitlement to profits. Joint ventures differ from other forms of cooperation in that the western firms do not acquire a claim to a return. The only indication of the capital return to be conceded to the foreign partner is so far to be found in a Chinese statement that it is intended to use corresponding contracts of foreign firms in other countries as a yardstick<sup>21</sup>. China can exercise a decisive influence on the size of profits through price-

fixing, tax legislation, depreciation guidelines and regulations concerning reserve, premium or development funds (Art. 7).

The profit distribution is based on the financial interest of the individual partners in the joint venture. Tax privileges (Art. 7) and interest payments (Art. 10) are provided in order to induce foreign partners to reinvest earned profits or make deposits with the Bank of China. If profits are transferred, this is in principle to be done only by means of foreign exchange earned by the joint venture itself. Special profit transfer arrangements will be needed in regard to sales by joint ventures in the Chinese home market – this is envisaged as a possibility even though China prefers joint ventures to focus on exports.

### Western Inquiries

To assess the role which joint ventures are likely to play in trade with China, one has to bear in mind the high entrepreneurial risk of this form of cooperation, the permanent need for reconciliation of interests, the existence of bureaucratic regulations or the vagueness or lack of legal provisions. Similar factors in most East European states have kept the number of joint ventures in these countries so far very small. Although appropriate legal provisions were made in Hungary in 1970 already, in Romania in 1971 and in Poland in 1976, there are still less than twenty such enterprises in these countries<sup>22</sup>.

China on the other hand was a few months after the publication of the Joint Ventures Law already engaged in 30 separate concrete negotiations, and in some cases agreement is imminent<sup>23</sup>. In spite of the difficulties western businessmen are hopeful that joint ventures in China will give them, at least in the long term, better opportunities to open up the Chinese market or improved chances to sell products in neighbouring countries of Asia. They set store in the great flexibility shown so far by their Chinese partner, and their confidence has been strengthened by the positive attitude of western governments to trade with China.

<sup>21</sup> For comparison: The return on foreign capital invested in joint ventures in Yugoslavia for instance averaged 17 % in 1972. Cf. P. P I ö t z : Kooperationserfahrungen der Bundesrepublik Deutschland mit Jugoslawien (Experience of the Federal Republic of Germany in cooperation with Yugoslavia), Hamburg 1974, p. 143.

<sup>22</sup> Cf. Handelsblatt, December 24, 1979.

<sup>23</sup> Cf. Xinhua News Agency, News Bulletin, No. 11215, September 29, 1979, p. 27f.; The Japanese Economic Journal, Tokyo, December 11, 1979; Financial Times, January 11, 1980; The China Business Review, Nov.-Dec. 1979, Vol. 6, No. 6; The Magazine of the National Council for US-China Trade, Washington, D. C., p. 64.

<sup>19</sup> Cf. Park Sun-Jo: Gemeinschaftsunternehmen und Indigenization-Strategie in der Dritten Welt. Japans Auslandsinvestitionen (Joint ventures and indigenization strategy in the Third World. Japan's foreign investments), Bochum 1978, p. 87 ff.

<sup>20</sup> Cf. Beijing Review, No. 30, July 31, 1979, p. 10.