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**From the Maoist to the Post Deng China,  
a process of economic liberalization  
and opening toward the rest of the world  
Implications for Transnational Companies**



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*China is a current phenomenon attracting researches because of its spectacular growth as well as rapid and successful transition from a closed economy to a market-oriented economy. This paper firstly aims at recounting the main reforms undertaken by China in order to realize this dramatic shift. It also permits to identify the key actors and organizations which had played a major role in the process. The second part of the study deals with investigating the reasons why transnational corporations from developed countries are choosing China as an investments' destination; and the possibilities they have to penetrate the market. Then, the emphasis is put on the risks and challenges enterprises investing in China are willing to face.*

*It asserts that Deng, leader of China from 1978 had played a key role within the reform process, and is even considered as the architect of Modern China. He is the one who had initiated measures in order to modernize, liberalize and open the nation toward the outside world. Two decades later, precisely in 2001, the country became a member of the pro liberal and free trade, the World Trade Organization. This step had conducted to deeply integrate China within the international relations. As a consequence the nation is currently one of the major economic and political actors in the globalized world. In addition, the country offers huge opportunities for investments coming from Western companies, regarding its market size composed of consumers with an increasing purchasing power. However, the Chinese environment still presents some weaknesses, mainly due to poor legislation, strong and opaque bureaucracy and a lack of uniformity within the market.*

*The paper concludes that China is going to be one of the main actors of the globalized economy of tomorrow. It will on the one hand expand its presence on each continent, either through financial flows or through FDI outflows. It is also argued that the Chinese phenomenon will lead to a major shift within the international relationship organization with China positioned as a leader.*

*Key words: Key reforms in China, China's accession to World Trade Organization, Foreign direct investment in China, Risks and challenges for companies*

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## **List of abbreviations**

ASEAN: Association of Southeast Asian Nations

CJV: Contractual Joint Venture

EJV: Equity Joint Venture

FDI: Foreign Direct Investment

GATT: General Agreements on Tariffs and Trade

GCS: Group Company System

GDP: Gross Domestic Product

IMF: International Monetary Fund

IP(R): Intellectual Property (Rights)

JV: Joint Venture

M (&) A: Merger and Acquisition

MES: Modern Enterprise System

NFTC: National Foreign Trade Companies

OECD: Organization for Economic Cooperation and Development

OLI: From dunning Ownership, Location, Internalization

RO: Representation Office

SEZ: Special Economic Zones

SOE: State Owned Enterprise

TC: Transactional Costs

TNC: Transnational Companies

UNCTAD: United Nation Conference on Trade and Development

US(A): United States of (America)

USD: United States Dollars

USSR: Union of Soviet Socialist Republics

WIPO: World Intellectual Protection Organization

WOS: Wholly Owned Subsidiaries

WTO: World Trade organization

## 1.0. Introduction

### 1.1. Background of the study

For several centuries, the economic and trade balance has oscillated between a few nations or regions. If we turn back the clock, based on statistics delivered by the League of Nations (1945), we can remind ourselves of the year 1870 when the United Kingdom was a dominant world economic power by producing 31.8 per cent of the global industrial output. It was respectively followed by the United States (23.3 per cent) and Germany (13.2 per cent). The entry into the twentieth century signaled the beginning of a new leader, the United States, which became the first producer of manufacturing products (35.8 per cent of the world production in 1913), while the United Kingdom felt down and its production rate was divided by two (only 14 per cent of the world production in 1913). (League of Nations: Industrialization and World Trade, 1945; in Internet world history source book; URL: <http://www.fordham.edu/halsall/mod/indrevtabs1.html>)

After the ending of World War II in 1945, the political and economic structure started to change. Dickens (2003, p32-33) reports that Japan which had really suffered during the worldwide conflict emerged through an extraordinary economic growth accounting for 10 per cent growth per year in the 1960s, commonly termed the Japanese miracle. The author even goes further by explaining that this was the beginning of the Triad economic domination on the world. The global economic Triad concept was developed by Ohmae (1985) a Japanese economist to refer to the three regions which were leading the world economy as well as the international policy leadership (Wikipedia, consulted 20.03.2011). At that time commercial transactions and diplomatic relations were concentrated between Western Europe, Northern America and Japan. According to Dickens (2003, p58), this can be related to the fact, that these three regions had huge number of customers with significant purchasing power, who were almost appealed by the same type of goods. On the other hand, these three main economic actors also shared their companies, meaning that national entities started to go and settle abroad, through the so-called Foreign Direct Investments (FDI).

All other nations were considered as being peripheries from the Triad. This idea was reinforced in 1945 when the cold war clearly divided the world into three entities, namely the capitalist West (composed of the United States and Western Europe), the socialist and communist bloc lead by the Soviet Republic (including Eastern Europe, South Korea, Vietnam...). Remaining countries were considered as a neutral group and were called countries from Third World. Each of the two dominant powers tried to expand their sphere of influence on the latter. From an economic point of view, it was time for countries around the world to choose between two types of economic systems, precisely between the liberalized capitalism and the rigid and autarkic socialist, communist one.

In 1949, after a long period of revolution, Mao Zedong took control over China and applied his own doctrine namely Maoism to rule the country. The latter is a form of communism which strongly follows the Marxist-Leninist principles that is to say a particularly collectivist vision, punishing personal ambition and opposed to traditional organization of the society, said to be responsible for poverty (Toupictionnaire, <http://www.toupie.org/Dictionnaire/Maoisme.htm>; consulted 20.03.2011).

From this date, the Asian giant had known somber periods of its existence. As for USSR (Union of Soviet Socialist Republics) before, the economy had been centralized and nationalized; the country became poorer and poorer, and had known some drastic food shortages during some years (1959-1960). On the other hand, China sank into a completely closed economy, meaning that trade with outside nations was inexistent.

Mao Zedong died in 1976, and was officially replaced by Hua Guofeng, who had been previously designated by Mao as his successor. However, Deng another political actor who had occupied several cadre positions within the communist party since 1956 became more and more influent. Deng was born in a peasant family, and was sent in France during his studies; where he got the opportunity to discover how Western countries rule. Then, he moved in the USSR where he learnt a lot about principles from Marx and Lenin. From 1978, Deng expanded his sphere of influence and started to rule the daily politics in China. He decided to set up a new policy in favor of modernizing

and opening China to global economy. In other words he desired to set up commercial relations with nations abroad and in particular with the attractive and wealthy West. The starting point of this new era can be perceived through the new establishment of diplomatic relations between China and the United States. In 1979, the United States recognized China as a nation. This date also corresponds to the meeting between Jimmy Carter, president of the United States and Deng, in the country of the former. There Deng visited the NASA organization in Houston, and the head offices of Coca-Cola in Atlanta and Boeing in Seattle. ([http://fr.wikipedia.org/wiki/Deng\\_Xiaoping#Sa\\_r.C3.A9habilitation\\_et\\_la\\_mort\\_de\\_Mao](http://fr.wikipedia.org/wiki/Deng_Xiaoping#Sa_r.C3.A9habilitation_et_la_mort_de_Mao); consulted 21.03.2011)

Deng came back in China with new political orientation for the nation, that is to say liberalization and opening of the economy. In the 1979, China started its efforts toward these new objectives by leading several reforms in almost every sector and activities. This phenomenon was even emphasized by China's wish to join the World Trade Organization (WTO), accessed in December 2001.

Today, China has reached a competitive position in international economy and trade, and plays a significant role on the international stage. According to WTO data, China is now the largest exporter country (9.6% of world exportations in 2010) ahead Germany (9% of world exportations in 2010), the United States (8.5% of world exportations in 2010) and Japan (4.6% of world exportations in 2010). It is also the second importer country (7.90% of world importations), the first being the United States accounting for 12.7% of world importations. (WTO, International trade statistics, 2010)

Furthermore, following the reforms and because of its attractiveness and its huge-sized market, the Middle Kingdom is appealing Northern global firms from all sectors to establish within the country. This explains the growing tendency of FDI inflows started from the 1980s. According to Li (2005), the amount of FDI received by China between 1979 and 2004 was multiplied by 600, from 1.09 hundred million USD in 1979 to 606.30 hundred million USD in 2004.

China is growing at a fast pace; hence it is an interesting domain of research. Obviously it is really gripping to examine the way China managed its liberalization in a relatively rapid period of time. In order to realize it, it seems essential to study all the changes that occurred in China, in terms of economic organization as well as political orientations. Thus, by understanding the Chinese process, we would be able to explain why the nation had succeeded in its opening process and had welcomed numerous foreign companies from developed countries on its territory in a short period of time.

## **1.2. Motivations and purpose of the study**

Motivation for this topic comes from personal fascination with China's current success as well as because of my interest in investigating the Chinese case, as it is a current topic which requires a lot of researches and questions. On the other hand it can also be considered as a model in terms of economic liberalization and opening to the world. The latter is a subject I feel really concerned with and I am really interested in learning about the key factors which had contributed to the Chinese success. Finally, I am curious to examine the factors that have conveyed the global enterprises to penetrate a market still considered as hostile few decades ago; as well as to know how they enter the market.

The main purpose of this thesis is to analyze the process China had followed to reach its current position, as well as to identify key success factors that have permitted to make China one of the most important economic actors. Then, it will deal with drawing an overview of the reasons why enterprises decide to invest in China. Finally, a discussion will be conducted in order to emphasize the limitations and challenges encountered by companies expanding in the Chinese territory.

The thesis is based on five main questions, namely:

- What are the most significant factors of China's success?
- How China had liberalized its economy?
- Why and how transnational corporations are investing in China?

- What are the limits of the Chinese liberalization?
- What are the main challenges companies have to face when entering the Chinese market?



## **2.0. Research methodology**

### **2.1. Research design**

This thesis was built by following an exploratory study. The latter generally aims to better understand the nature of a problem, or a phenomenon. Basically using this method requires previous researches in order to perfectly contextualize the situation as well as to set up solid bases and get familiarize with the studied phenomenon. Thus it should guarantee a comprehensive investigation process for gathering the future information. (<http://www.blurtit.com/q113463.html>; consulted 22.04.2011)

This corresponds to the process I followed to conduct my research. Indeed, I firstly needed to read about the Chinese history in order to identify the main actors, the significant development phases, and the economic and political transformations as a whole. Once I was done with that, I was able to define the boundaries of my thesis, as well as to clearly introduce the main questions I was willing to deal with.

In addition, the fact that my work is based on a current phenomenon, which requires the investigation of causal relations between different past elements and the recent situation, it seemed that conducting an exploratory study was the most suitable alternative. (Saunders, Lewis, Thornhill, 2009, p140)

### **2.2. The exclusive use of qualitative secondary data**

The whole work was realized by using secondary data. Contrary to primary data, they had been previously collected by other people, who made researches on different topics. This means that those researchers did not necessarily have the same objectives or research questions as I, but had gathered data that were interesting for my topic. (Ghuri & Grønhaug 2010, p 99) However, it would have been almost impossible for me to look for primary data. On the one hand, as my work is partly based on past facts, observation was impossible. On the other hand, I did not have the means to go to China or to some global companies head quarters to realize interviews. Moreover, focusing on secondary data offers the possibility to have a large range of

information available, which is really useful when time and finances are limited.

In addition data used are qualitative ones. This is logical when conducting an exploratory study, as they, contrarily to quantitative data, permit to gain insight and construct explanations. Furthermore, quantitative data do not match with the topic, as the latter does not pretend to verify or measure anything. (Ghauri & Grønhaug 2010, p 104, 105)

### **2.3. Case study**

I decided to include a case study within my thesis for several reasons. First, it had permitted to clearly limit and narrow down my researches without compromising its quality, as the findings could have been generalized. Then, it was a way of illustrating the theoretical part of my work. Lastly, I found it relevant to include a more practical dimension to my research. This was also a mean to prove that all the investigations done previously were connected with examples from the current and real life.

Thus, I chose to focus on the retail sector, precisely on large retailers from developed countries which expand in China. This had enabled me to answer one of my research questions, namely “why and how transnational corporations are investing in China?”

The idea of retail sector came in my mind as an obvious base for this part of the study. The fact that it is present in the everyday life and worldwide, constituted the first reason. Indeed, it is impossible to have societies without any kind of shops or stores, despite their format can be diverse from one location on earth to another. On the other hand, I was quite familiar with this kind of business, as I previously wrote reports on the topic.

### **2.4. Theoretical base**

The theoretical part of the work is based on the Dunning’s OLI model (Owner, Location, Internalization), also known as the eclectic paradigm. The latter had been very useful to explain the motivation of Western companies to

invest money in China through foreign direct investment (FDI) flows. Furthermore, the theory was applied to companies involved in the retail sector, in order to have a practical example.

## **2.5. Sources of material used**

Data were found in literature as well as on the internet. Information were gathered in articles, journals, books, encyclopedias, reports either written in the name of world organization, such as the World Trade Organization, the Organization for Economic Cooperation and Development, the International Monetary Fund, etc, or by private previous researchers.

## **2.6. Time horizon**

As it had been necessary to go back to the past history to understand the whole process, this research develops past and recent phenomenon in a chronological way. Furthermore, it can be qualified as a longitudinal study, as the purpose was to investigate changes and development across time. (Saunders, Lewis, Thornhill, 2009, p155)

The starting date is 1979, which corresponds to the beginning of Deng era. However, when it was required some aspects of the Maoist period, prior to 1979 are also taken into account. This permits to guaranty continuity within the history and enable the reader to link the different elements. Indeed it would have been impossible for the latter to understand the events without explaining the situation before the reform period.

## **2.7. Research division**

This study is divided into five main sections, each focusing on one significant aspect. Section 3 introduces the reforms toward liberalization of Chinese economic system. It is composed of a flashback on the Maoist period, and subsequently of an investigation of the main reforms conducted in primary and secondary sectors. The service sector was ignored for two main reasons. Actually it did not add any value to the study. On the one hand it was almost inexistent before the entry of China within the World Trade

Organization. On the other hand, it was fragmented and state controlled making it really challenging to find any relevant clues.

Section 4 is about the way China succeeded to open its economy to the rest of the world. The emphasis is put on the most significant reforms, political measures and organization which had played an obvious role. Section 5 presents the theoretical framework, namely the Dunning's OLI (standing for Ownership, Location, and Internalization) model and is afterwards followed by the study case conducted on the retail sector. The last section is dedicated to study the risks and challenges firms have to deal with when entering the Chinese market, as well as to weigh up the influence they have on companies' FDI decisions.

## **2.8. Limitations, reliability and validity of the research**

This thesis is not aimed at providing deeply detailed information about each point I decided to develop, rather to give the reader some clues about the most important features, so that he could figure the evolution of the Chinese economic situation across time, as well as the changes regarding its position toward international relations.

As the work is based on qualitative secondary data, its reliability might be put into perspectives. Indeed nothing proves that the previous researchers were totally objectives or had themselves based their work on trustful sources. Meanwhile, I tried to limit the possibilities of skeptic behaviors, by taking care that the document used was itself carefully referenced and by multiplying the sources of information. Moreover some findings are based on the study of international organization, which can be seen as trustful, independent and objective. Knowing that the research does not imply the reader to take any position, this possible lack of reliability can be put into perspective.

Finally, the validity of the study may be qualified as high. All the elements dealing with past facts cannot be discussed anymore, and do not have any possibilities to change. In that sense, the validness is infinite. However, as the position of China within the world will change in the future, it is obvious that some of the findings would need to be actualized. For instance, the part

focusing on the Chinese economic and political environment, portrayed in section 6, is going to evolve and it will be necessary to refresh it in some times. It is also the case for section 7 discussing the current challenges. It is possible that they will be out dated in the coming years, as the government continuously integrates new reforms, policies and measures to solve the problems currently occurring.

### **3.0. Reforms toward liberalization of Chinese economic system**

#### **3.1. From Mao's to Deng's directives**

Chinese economy and development directions are carefully planned by the government in the shape of Five Years Plan, which defines economic objectives and reforms for the next five coming years. The latter also indicates the amount of goods or products to be produced, price items have to be sold... This method was adopted in the 1950s by Mao Zedong, and was inspired from the Soviet model, based on collective agriculture and centralized planned economy. During Mao's period, four Five Year Plans were established, whose main objectives are summed up below:

##### **3.1.1. First Five Years Plan, from 1953 to 1957**

The key tasks under this plan were to develop the collective system in Agriculture, as well as to transform all the existing enterprises into state-owned companies. By the end of the plan, the rural reform was achieved and 26 578 communes were listed in function in 1958 (Hays, 2008; <http://factsanddetails.com/china.php?itemid=347&catid=9&subcatid=63>, consulted 21.03.2011). At the same time, no private industry remained.

##### **3.1.2. Second Five Years Plan, from 1958 to 1962, the Great Leap Forward**

Then, according to what is reported by Harms (1996), the Party's priority was to make of China a nation able to compete with England regarding industrialization and more precisely steel production. In order to accomplish this vision, the government ordered the construction of steel plants across the country and mobilized people and financial resources to reach its industrialization objectives. As a consequence, agricultural tasks were neglected and some grain fields were not harvested. Moreover, it is said that the party leaders were so involved in competing against each other that they reported exaggerated figure regarding amount of food harvested. Thus food which was considered as over production was exported. All these features

led to a huge famine in the country by 1959. Finally, the author emphasizes that between 16.5 and 40 million people died until the end of this dramatic experiment in 1961. He even considers the Great Leap famine is the largest in the world.

### **3.1.3. Third Five Years Plan, from 1966 to 1970**

This plan introduced one main goal. There was a priority to solve food problems by developing agriculture quality and variety, in order to build an economy of self sufficiency. As a consequence emphasis was put on more realistic planning and the abandon of fervor and mass movement from rural to industrial activities. ([http://en.wikipedia.org/wiki/Five-Year\\_Plans\\_of\\_the\\_People%27s\\_Republic\\_of\\_China](http://en.wikipedia.org/wiki/Five-Year_Plans_of_the_People%27s_Republic_of_China); consulted 21.03.2011).

### **3.1.4. Fourth Five Years Plan, from 1971 to 1975**

This plan was the continuation of what was engaged previously and was only directed by quantitative production goals, in grains, steel, cotton, coal. ([http://en.wikipedia.org/wiki/Five-Year\\_Plans\\_of\\_the\\_People%27s\\_Republic\\_of\\_China](http://en.wikipedia.org/wiki/Five-Year_Plans_of_the_People%27s_Republic_of_China), consulted 21.03.2011).

### **3.1.5. End of Mao and Deng's perspectives**

By the end of the Maoist period (in 1976), the new government decided to launch a reform campaign in order to modernize China, which at the time was far away from Western powers as well as in late comparing to the newly industrialized countries in the Pacific region, such as Japan, Taiwan, South Korea. Moreover reforms were intended to balance the influence of state on economic activities.

As a consequence, from 1976 the directives within the next Five Years Plans changed dramatically, as the new Chinese leader, Deng was in favor of liberalizing the economy and opening of the country. From that point, a lot of changes occurred in the country. First it permitted the transition from a

command economy, where government regulates supply and prices into a market based economy, characterized by a free price system as well as set by supply and demand. However, this aspect has to be put into perspective, as the government still plays an important role in the Chinese economy. Then, it contributed to make of China one of the most trade dependant country in the world, looking at the part of trade in GDP (Gross Domestic Product). While trade represented 11.2 per cent of the Chinese GDP in 1979 (*China statistical abstract, 2010*), it accounted for 58.6 per cent in 2009. (WTO, Trade profiles 2010, 2010, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Country=CN&consulted 29.01.2011> )

Under Deng, the government decided the way it would implement the reforms and opted for an incremental process. This means that new actions were first tested in one region of China, and were generalized only if the method was efficient and proved results rapidly. Thus it would be always possible to adjust the policies and to be reactive in case of problems or deficiencies. (RS Shinn and R. L. Worden, undated, data from 1987)

This part of the research will deal with the structural economic transformations in China and expose the main reforms conducted within the country since 1976 and the Fifth Five Years Plan, as well as their outcomes.

### **3.2. Reforms in primary sector**

The pre-reform period in the primary sector was characterized by a full state control over agriculture. Indeed, the state was responsible for establishing production plan, defining the crops for the next coming years, the required quantity, as well as procurement and retail prices. Regarding the procurement side, two levels of prices were defined, namely a quota procurement price and an above-quota procurement price which was higher than the former. Meanwhile each price was far behind the potential market price. (Yang, Li, 2008)

The functioning was simple; peasants were planting crops collectively, which they would subsequently sell to the state at the quota procurement state



price, and if there was a surplus, at the above-quota price. Then, the products were sold in state-owned retail shops at state price. (Yang, Li, 2008)

This collective system did not permit high level of production, as the farmers were not motivated, because there was no individual reward, and also because state prices let them into a deep poverty.

Reforms in the agricultural sector were the primary engaged and started in 1978 with the establishment of the production responsibility system whose major point was the breaking down of the commune farms, into individual ones. These were supervised by village collectives (OECD, Policy brief, Agricultural policy reform in China, 2005, pp1-2). The latter leased parcels of land for cultivation purposes as well as tools and machineries to peasant families. The crops were decided by the government but household were in charge of their production, and could dispose of their production surplus (China org, 2009, consulted 29.01.2011, [http://www.china.org.cn/features/60years/2009-09/16/content\\_18534697.htm](http://www.china.org.cn/features/60years/2009-09/16/content_18534697.htm)). On the other hand they were encouraged to reduce their costs, take risks and test new lines of crops on non-occupied land, depending on the comparative advantage of the region.

However, this measure did not have the expected results, and production was not obviously increasing at that period. This can be explained by the fact that property rights were limited, peasants were only land leasers but not owners; as well as by the fact that the state still had full control on prices. This was problematic in a way that it lowered incentives of peasants of supplying labor efforts, using fertilizers and machinery or improving farm technology. As a consequence produced goods were of low quality and the range of varieties was reduced. (Yang and Li, 2008)

These problems explain the second part of the reform on prices and quotas, which started in the 1980s. It was aimed to decrease level of quotas, increase state prices and promote the role of market.

The first step dealt with raising state agricultural procurement prices. Thus, in 1979 prices of grain were raised by 20 per cent, oilseed by 25 per cent and

cotton by 15 per cent. At the same time above procurement prices were also majored between 30 and 50 per cent (Yang and Li, 2008). By 1982 the average agricultural prices were 42 percent higher than their level in 1978 (Sicular, 1988; Lin, 1992). At the same time, prices on agricultural machinery, fertilizers and pesticides were 15 per cent lowered (Xu, 2000). Thanks to this new policy, farmers were more motivated to cultivate, and this was followed by a growth in agricultural average production, as shown in table 1. Under planned economy, the yearly average was about 2.9 percent whereas during the reform, it reached 7.7 percent (Lin, 1992).

*Table 1: China: Average annual growth rates of agriculture, 1952 - 1984*

Subsector	Annual growth rate (%)	
	1952-1978	1978-1984
Crops	2.5	5.9
Grain	2.4	4.8
Cotton	2.0	17.7
Animal husbandry	4.0	10.0
Fishery	19.9	12.7
Forestry	9.4	14.9
Sidelines	11.2	19.4
Agriculture (overall)	2.9	7.7

Note: The low base level is the main reason for fishery's high average annual growth in 1952-1978.

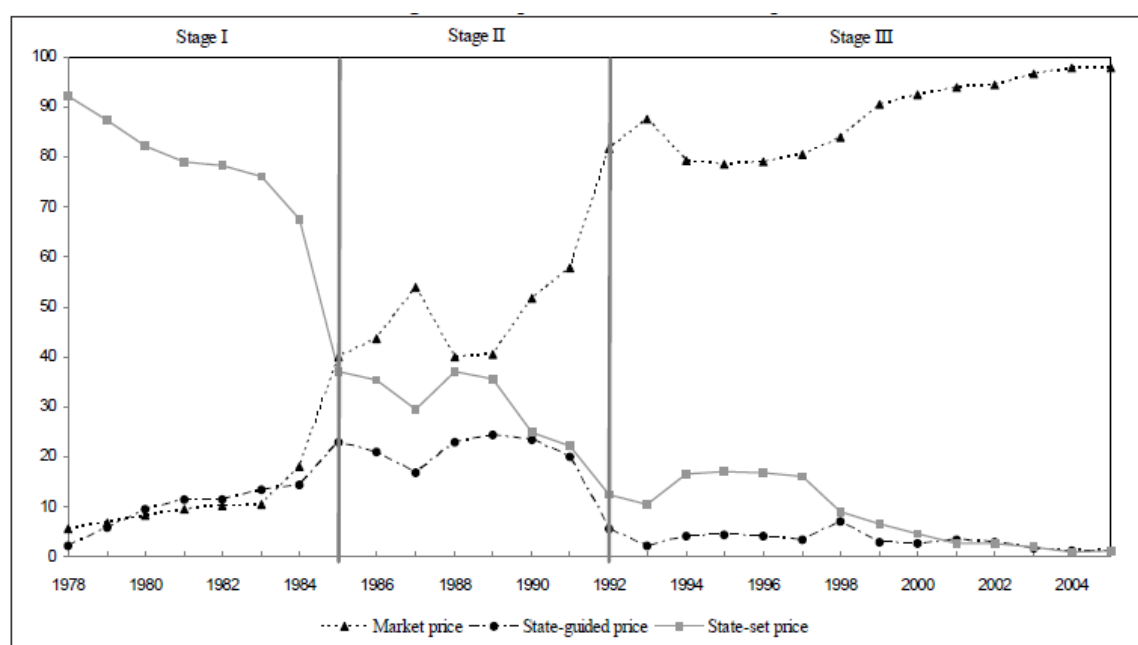
Source: Lin (1992).

The reform continued from 1985 to 1992 by replacing the state monopoly with market system. It was a consequence of the price increasing initiative previously conducted, because it became too expensive for the state to buy all the productions at new price levels (Yang and Li, 2008). In 1985, a new system was established. It eliminated both mandatory production and procurement of agricultural products. Instead, contracts were negotiated with the farmers in terms of production level and prices on certain crops such as: grain, oil and cotton. Apart from that, peasants were free to sell every remaining production to the market price, as well as starting to produce new varieties of crops, livestock farming or aquatic products, for which he could decide the level of production and price (Xu, 2000). This was the starting point of a production diversification in China.

Figure 1 (data from Hu, 2006; CRDR, 1994; in Yang and Li, 2008) shows the share of agricultural products sold at state prices during the reform time. During the first phase, the latter started to decline dramatically, and kept decreasing during the reform period. In 1978, only 5 per cent on the agricultural production was sold at market prices, whereas in 1992 it accounted for 82 per cent and 98 per cent in 2005. We can conclude that 1992 is the starting point of a complete liberalization regarding agricultural products engaged by the government.

Figure 1

China's shares of agricultural product sales at different prices (1978-2004)



Sources: Data for 1978, 1988 and 1990-2005 are from Hu (2006); for 1985-1987 and 1989 are CRDR (1994); for 1980-1984 are based on author's own calculations using NBS (1985); and figures for 1979 are interpolated from 1978 and 1980 numbers.

Source: Yang, Li, 2008

All these reforms have contributed first to grow the agricultural production dramatically and above all expectations. The goal pursued by the nation was self sufficiency and it reached to surpass it and started a new era of abundant, varied food. Moreover reforms also permitted to improve quality of good produced thanks to better storage facilities and refrigerating capacities (Yang, Dennis Tao Li, Yuanfang, 2008). According to empirical studies, it is said to be that half of the growth could be explained by the first part of the reform, namely the household responsibility system. The other half results

from price and market reform because higher prices and market opportunities have encouraged farmers to increase cropping intensity as well as using more productive inputs (Lin, 1992).

### **3.3. Reforms in industrial sector**

The pre reform period in the industry was characterized by a stagnant amount of outputs, produced by State Owned Enterprises (SOE) and a concentration on heavy industry. The state employed a manager to manage the company but kept full control, meaning that the state remained in charge of supplying raw materials and labor, establishing production quotas, investment decisions and fixing sales prices (Wang, 2004). According to Wang (2004), in 1980 90 percent of the Chinese output was produced by these enterprises.

By the middle of the 1980s, reforms started and can be divided into three main stages. The first changes occurred between 1984 and 1992. The aim was to give more autonomy and financial responsibilities to managers. In 1987 the council promoted the “contract responsibility system”, permitting the managers to share parts of the profits which were above what was required by the government. Thus the surplus of money could be redistributed through bonuses among employees, or be used to set up a reserve fund (China labor bulletin, 2007, consulted 14.03.2011, <http://www.china-labour.org.hk/en/node/100153>). They also had the possibility to sell the extra production at the market price thanks to the “dual price system” also set up at that time. By 1989, almost all SOEs had adopted the “contract responsibility system” and the level of output was growing as people were more motivated to work. In July 1992, another amendment was ratified stating that the enterprises’ management could benefit from more rights in setting prices and wages, hiring and firing labor and investing in fixed capital. They were also allowed to start getting involved in foreign trade (Wang, 2004). The next step was to transform SOEs into modern companies by on the one hand clarifying property rights and sharing of responsibilities and authority as well as introducing a scientific form of management. The main idea was to copy western organizations governance structures in order to make companies

more entrepreneurial and decrease government interference (Hassard, Sheehan, Zhou, Terpstra-Tong, Morris 2007). This was elaborated through the MES (Modern Enterprise System) and GCS (Group Company System) program, the latter dedicated to create large companies, internationally competitive (Hassard, Morris, Sheehan, Yuxin, 2010). On the other hand it was decided to separate enterprises from the government and consequently to allow privatization of small and medium sized SOEs. Though only some sectors were concerned by the reform namely consumer goods and heavy manufacture (Woetzel, 2008). According to Wang (2004), half of the concerned SOEs were privatized by 1996, and the phenomenon accelerated. In 1996, private enterprises represented 16.9 per cent of the Chinese companies, whereas in 2001, it accounted for 43.7 per cent (National Bureau of Statistics of China, 2003, quoted in CLB report, p3).

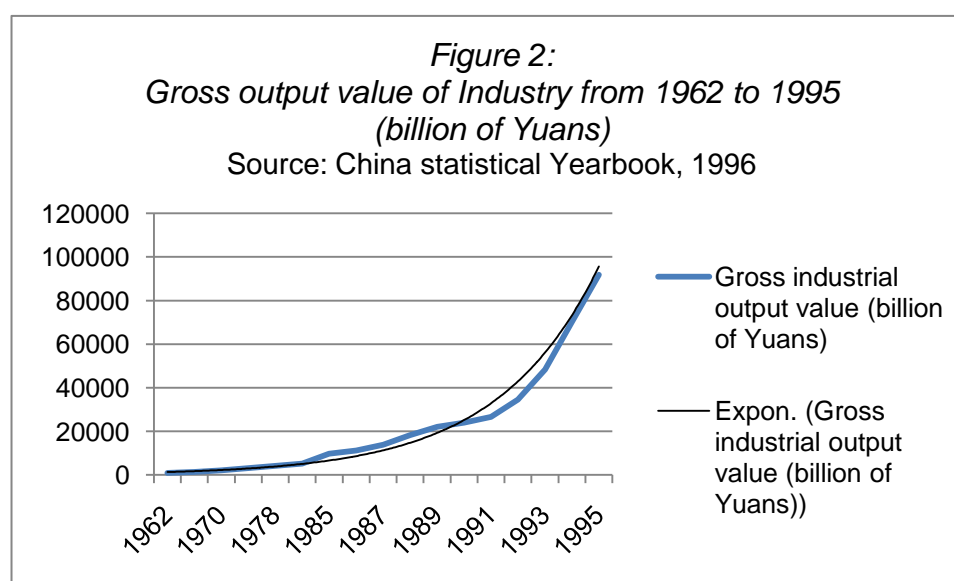
From 2002, the main focus remains the ownership reform. The Chinese central government keeps control only on some large SOEs whose businesses are qualified as crucial for national security and national economy. The other part is directed by local governments, at the regional's scale or even at the town's scale. Table 2 shows which industries are actually concerned by state ownership and precise at which extent it is true. Nowadays, 140 companies are listed as SOEs, they are either fully owned by the state (e.g. the oil company: China national offshore oil corporation) or the state is the major shareholder, holding more than 50 per cent of the organization capital (e.g. the computer maker: Lenovo). All of them belong to one of these seven sectors of activity: defense, power generation, oil and petrochemicals, telecommunications, coal, aviation, shipping (Mattlin, 2009).

*Table 2: The government's state-ownership objectives and approximate number of companies*

Categories	Industries included	Ownership objectives	Number
Strategic and key industries	Defense, power generation and distribution, telecom, oil and petrochemical, coal, civil aviation, shipping	Maintaining 100 per cent state ownership or state absolute control, increasing state-owned assets in these industries	40
Basic and pillar industries	Machinery, auto, IT, construction, steel, base metals, chemicals, land surveying, R&D	Absolute or conditional relative controlling stake, enhancing the influence of state ownership even as the ownership share is reduced where appropriate	60
Other industries	Trading, investment, medicine, construction materials, agriculture, geological exploration	Maintaining necessary influence by controlling stakes in key companies, in non-key companies state ownership will be clearly reduced	40

Source: State Council opinion released 5 December 2006

The SOE reform had permitted a boom in Chinese industrial output rate, as shown in figure 2. In 1978, industrial output accounted for 4,237 billion of Yuan, whereas fifteen years later, in the middle of the reform period in 1990, it increased to 23,924 billion of Yuan, that is to say almost six times more valuable (China statistical Yearbook, 1996, consulted 15.03.2011, <http://www.stats.gov.cn/english/statisticaldata/yearlydata/YB1996e/L12-3e.htm>).



Despite of the enterprises reforms, the Chinese government is still a strong actor of the economy. Indeed, Chinese public or private sector must gain approval from government officials for cross border merger and acquisitions as well as other global activities (Woetzel, 2008). It is also important to mention that the most profitable industries in China belong to these seven state industry sectors, thus the role of foreigners and private investors remains at a certain extent limited (Mattlin, 2009).

## **4.0. Opening China to the rest of the world**

### **4.1. Foreign Trade during pre-reform period**

Foreign trade during pre reform period, before 1978, was characterized by three main features. First, it was monopolized by the state through twelve National Foreign Trade Companies (NFTCs) and their branches, both under direct command of the Ministry of Foreign Trade and Economic Cooperation (World bank report, 1994, pp 24-25). These specific companies were responsible for purchasing export commodities from national producers as well as for distributing import commodities to domestic users (Lichtenstein, 2000). At the time China was following an import substitution strategy, meaning that the latter were only aimed at making up the lack of certain materials in the nation, whereas exports were defined as a way of dealing with production surplus (Lu, 1995, Australian Parliamentary Research Service). However, Imports were limited to raw materials and inputs required for its industrialization process. Moreover it was assumed that exports and imports were perfectly balanced in a way that the former financed the latter (Lin and M. Schramm, 2003).

Secondly, foreign trade was centrally planned and controlled by the government thanks to foreign trade plans respectively divided into export and import plans. The export plan was itself composed of one command plan, which was mandatory, fixed in quantitative terms, applied to certain strongly defined types of products, sold at fixed prices. Even the inputs to reach the plan were furnished by the state. Within the command plan, products were categorized into two groups, namely Category I which could only be handled by few NFTCs and Category II which could be handled by all NFTCs. On the other hand there was a guidance plan which was made of value targets, and for which companies can choose the way they would implement it success. (World bank report, 1994, pp 24-25) In 1986, according to WTO (World bank report, 1994, pp 24-25) 60 per cent of exports were ruled by the mandatory plan whereas only 20 per cent were under guidance plan regulation. The import features' plan were the same as for the export plan.



Finally, foreign trade was ruled according to a centralized accounting system. All earnings from exports were collected by the government in a central budget, which was then used to finance losses due to foreign trade operations (Lin and Schramm, 2003). However even if trade was well balanced and never knew deficits, the system itself was inefficient, on the one hand because the monopolistic nature restricted competition among companies. On the other hand, centralized accounting considerably reduced incentives for efficiency among trading firms as they were aware that losses would be automatically covered by the state (Lin and M. Schramm, 2003).

#### **4.2. Key reforms in the 1980s / 1990s**

As the country was walking toward liberalization and open-door policy, the reform program reached the foreign trade field and was driven by three objectives. First of all, the monopoly should be break in order to encourage competition between firms. Then, central planning should be abandoned to give foreign trade firms financial independence. Finally, market forces should replace governmental policies (Lin and M. Schramm, 2003).

However, the reforms came later within the reform movement. In 1984, China implemented a decentralization policy, allowing NFTC's branches to become financially and operationally independent. This led to a booming number of NFTCs in the country and increased competition among them.

At the same time, namely in 1986, China resumed as member of the General Agreements on Tariffs and Trade (GATT), an organization promoting a free international trade by decreasing the incentives of trade barriers. In fact the nation was one of the founders of the organization in 1948, but quitted it two years later when communism became the leading force. (Reuters, The New York Time, 1988. Consulted, 25.03.2011, <http://www.nytimes.com/1988/04/28/business/china-seeks-gatt-tie.html>).

This reintegration explains the further decisions taken by the state, which decided that Category I exports products would be reduced by half, to reach a number of 21 in 1988, and subsequently a decrease in Category II products

from 120 in 1986 to 90 in 1988. In 1991, mandatory export was abolished. Regarding imports, only 14 products were part of Category I in 1992 and 6 still belonged to category II. Subsequently, China dramatically decreased its tariffs on imports which accounted for 32 per cent before 1992, on 3371 goods by 50 per cent (China Daily business Week, 20-26 Dec 1992, p2 in West, 1993, p7). In addition, the import regulatory duty which represented a tax surcharge from 20 to 80 per cent of the product value on 14 product categories was abolished (World bank report, 1994, p47).

Reforms continued in the 1990s. The system of automatically covered losses due to foreign activities was abandoned, giving more responsibility in terms of managing profits and losses to the companies (Lin and M. Schramm, 2003). In 1994, the first law on foreign trade was promulgated, defining the foreign trade operators, and regulating their activities in an official way.

### **4.3. The role of SEZs**

The specialized economic zones (SEZs) were set up in 1980. SEZs can be defined as “a geographic area within a territory of a country where certain economic activities are promoted by a set of policy instruments that are not generally applicable to the rest of the country”. Firstly, they were established in four coastal cities, namely Shenzhen, Zuhai and Sanhou in Guangdong region and Xiamen in Fujian region before being expanded into fourteen other cities: Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, Beihai. (Wei Ge, 1999)

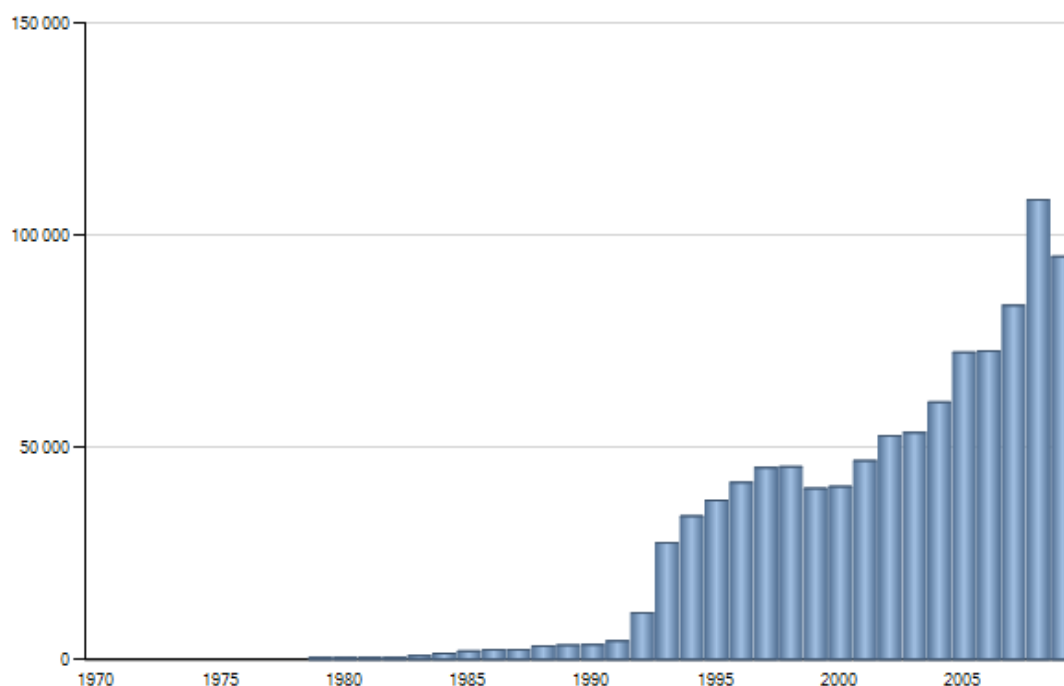
The aim of creating these zones was multiple. On the one hand, they were supposed to hire foreign investments and boost exports in order to reestablish connection with the outside world. On the other hand, they were the showcase of this “open door policy” recently engaged by China (China labor bulletin, 2007, consulted 14.03.2011, <http://www.china-labour.org.hk/en/node/100153>). Finally, SEZs were used as an intermediary for modernizing the country through foreign technology.

In order to attract foreign investors, China proposed attractive solutions whose main aspects are a “light taxation rate”, good infrastructures, and low cost workforce. Regarding the taxation point, overseas companies which decided to settle in the SEZs were exempted of any taxes during the first two years of their activity; then taxes would be discounted by 50 per cent the three next coming years, lastly organization would benefciate of a 15 per cent discount on taxes during their whole existence. (Ernst & Young, 2006) On the other hand, regulations within the SEZs were more flexible in terms of export and import, thus companies could act trade more freely.

This reform was successful in a way that the regions welcomed a lot of FDI. According to Wong (1987) 20 per cent of the FDI received by China in 1985 were located in SEZs regions. Moreover, the areas knew a spectacular growth, for example 58 per cent in Shenzhen, 32 per cent in Zhuhai during the year 1985 (Xu and Chen, 2008, p. 18).

The newly established SEZs had played an important role in establishing links between China and the rest of the world. Imports and exports started to increase significantly from year 1985, few years after SEZs were settled (refer to figure 5, page 43). On the other hand, according to UNCTAD (2011), Foreign Direct Investment (FDI) inflows have steadily increased since 1992. In a decade, they were more than multiplied by five, passing from 11,008 million USD in 1992 to 52,743 in 2002. This also proves that SEZs were successful, see figure 3.

*Figure 3: FDI inflow in China, in million USD, from 1970 to 2009*



Source: UNCTAD stat (United Nations conference on Trade and Development)  
<http://unctadstat.unctad.org/TableView/chartView.aspx>

#### **4.4. Progressive transformation of FDI institutional environment from 1979**

Ongoing liberalization and open door process have led to increase the amount of capital flows from foreign investors arriving in China. As a consequence, it became necessary to adapt the FDI institutional environment.

Basically, FDI regulation in China was based on two mainstays, on the one hand the FDI policy conducted by the government which directly influenced foreign investors' behaviors. On the other hand, SOEs also played a role in FDI regulation by reducing investment possibilities as their sectors of activity were only workable by the state. From 1979, some measures were undertaken by the government to establish a formal FDI environment; aimed at defining the rights and obligations of foreign investors. The whole set of transformation can be divided into four main phases. (Jing and Song, 2003)

#### 4.4.1. First phase: from 1979 to 1986, the Sixth Five Years Plan

The main objective of this early phase was about making law to provide legal status for FDI related activities.

The first official legislation “Equity Joint Venture (EJV) law” was promulgated in 1979 (Fung, Iizaka, Tong, 2002). This permitted *“foreign companies to establish EJV together with Chinese organizations within the territory of People’s Republic of China, on the principle of equality and mutual benefit and subject to approval by the Chinese government”* (Extract from Equity Joint Venture Law Article 1, <http://www.chinesestock.org/show.aspx?id=2046&cid=33>, consulted 04.04.2011). Moreover, when the law was introduced, EJV should be directed by a native Chinese.

Establishment of previously discussed SEZs was also part of the institutional environment, as they were ruled by preferential policies toward foreign capital. However, a lot of restrictions remained at the time. For instance, domestic market entering was still limited to some defined places within the Chinese territory. In addition, accumulated amount of FDI from 1979 to 1986 accounted for an average of only 0.9 billion per year and were mostly dominated by Hong Kong. The latter realized “cross-border manufacturing” of labor intensive products, real estate activities and hospitality business by taking advantage of its proximity with the Guangdong Region. (Jing and Song, 2003)

In order to further the willingness of FDI in China, two legislations were promulgated in 1986, namely the “Provision for FDI encouragement” and the “wholly owned subsidiary (WOS) law” (Wang, 2007). The first was aimed to encourage investments from compatriots based in Taiwan and Hong Kong as well as all the Chinese established overseas (Jing and Song, 2003). The second authorized foreigners to settle fully foreign owned and managed companies in some sectors (Sinova, [http://www.sinova.com/upload/FS\\_CN01-](http://www.sinova.com/upload/FS_CN01-)

#### **4.4.2. Second phase: from 1987 to 1991, the Seventh Five Years Plan**

This phase is characterized by an enlargement of the previously implemented law. The most significant step is the revision of EJV law in 1990 allowing foreigners to act as chairman of the board of director (Fung, Iizaka, Tong, 2002). Meanwhile, Chinese still had to participate in the decision making process and had to occupy key positions (Equity Joint Venture Law, Article 6, <http://www.chinesestock.org/show.aspx?id=2046&cid=33>, consulted 04.04.2011).

In addition, this period was also featured by an increasing confidence in China from abroad nations, thanks to the growing success of Hong Kong regarding its activities on the Chinese market. Despite of that the implications of developed nations within China remained small, because of the foreign exchange regime which made them difficult to retract earned capitals. (Jing and Song, 2003)

#### **4.4.3. Third phase: from 1992 to 2000, the Eighth and Ninth Five Years Plans**

During October 1992, Deng visited SEZs, and delivered a speech aiming at ensuring Western nations that China was now pursuing a socialist market economy. This had contributed to increase the level of trust Western countries had regarding China as well as the primary decisions from the latter to invest in the Middle Kingdom. Subsequently, a set of reforms was accomplished in order to simplify FDI procedures, and standardize their regulation across the territory (Jing and Song, 2003).

According to Wang (2007) FDI inflows had been multiplied by 19.5 times comparing with those received during the second phase, reaching an annual average of 36.08 billion of USD. The government decided to establish "Provisional Guideline for Foreign Investment Projects" was promulgated in

1995. This text classified FDI projects into four categories (**Appendix 1**), namely: Encouraged, Restricted, Prohibited and Permitted, according to the Chinese needs and development priorities (Fung, Iizaka, Tong, 2002). In 1997, this regulation was revised and signaled Chinese willingness to attract high-tech FDI. The latter would benefit from favorable tax policies as well as financial support. Chen and Song (2003) mention that this noticed the passage of Chinese FDI policy from one promoting export to one emphasizing technology.

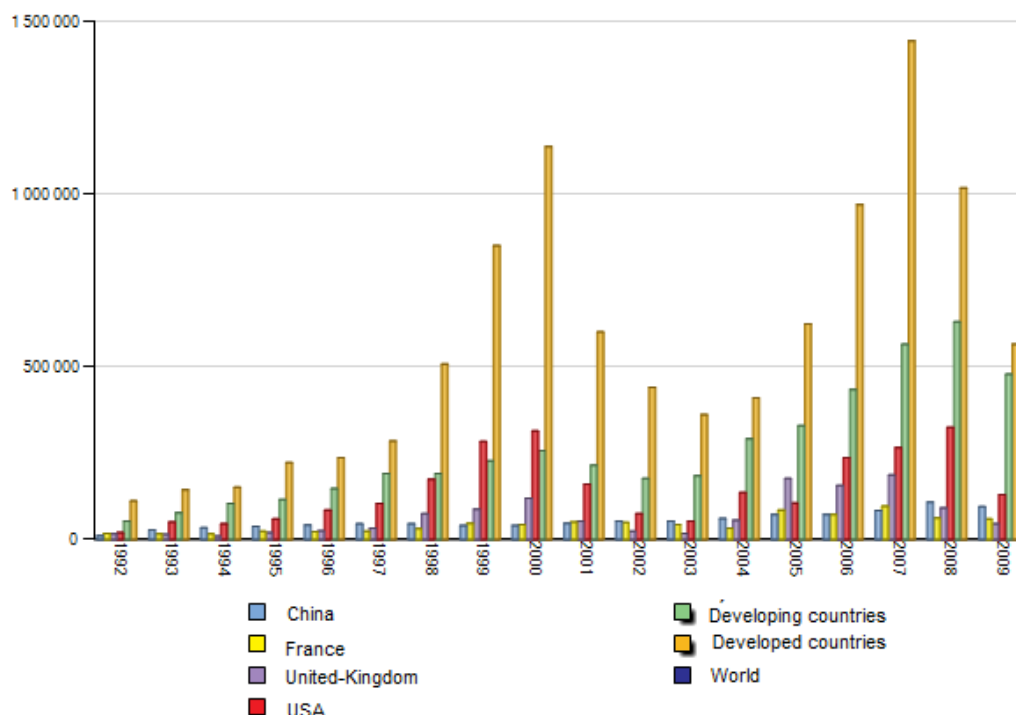
#### **4.4.4. Fourth phase: From 2001, beginning of the Tenth Five Years Plan to present**

Following the WTO accession, the investment market of FDI had loosed restrictions, and had become increasingly fairer toward foreign investors, who are now equitably competing against their native pairs (Wang, 2007). On the other hand, foreign investors were permitted to sell products and services in the domestic market more freely (Jing and Song, 2003).

#### **4.4.5. FDI inflows in China, main trends**

From 1992 China had continually received flows of FDI (Figure 4, created from data issued by UNCTAD (<http://unctadstat.unctad.org/TableView/chartView.aspx>, consulted 05.04.2011) and is one of the main destinations for foreign capitals. It is also noticeable that China is the only developing nation situated at the top of the classification, the others being the USA, France, and the United Kingdom. Moreover, it is also important to emphasize that the amount of FDI received by China were superior to the world average from 1992 to 1997, as well as between 2002 and 2004. The first period corresponds to the establishment of SOEs which had boosted inflows of FDI in China. On the other hand, the second is linked to the WTO accession.

*Figure 4: Inflows of FDI in different world regions, in million of USD, from 1992 to 2009; (source: UNCTAD)*



In 2007, according to US-China Business Council (2008), most of the foreign capitals were invested in manufacturing, 53 per cent; real estate 11 per cent; leasing and business services 6 per cent; transport and storage 6 per cent and whole sales and retails 2 per cent.

According to Zhang, Men and Huang (2004), the Eastern part of the nation basically receives more than 85 per cent of the investments made by foreigners, whereas Central and Western ones account for 15 per cent together.

From the Chinese success perspective, it implies to study the reasons why TNCs (Transnational companies) are interested in investing in the country. This will be discussed in next session.



#### 4.5. Contribution of China's accession to World Trade Organization (WTO)

Another significant step within the opening process of China was its accession to the World Trade Organization, the GATT successor, created in 1995.

The WTO acts in favor of opening the national markets and promotes fair and free commerce of goods and services among nations, by the reduction of trade barriers. The WTO principles are defined in different agreements. These provide legal ground rules for international commerce; essentially through contracts binding governments to keep their trade policies within agreed limits. Furthermore, it emphasizes the fact that rules have to be transparent, meaning that the national regulations have to be accessible to each member (<http://www.wto.org>, consulted 25.03.2011). Every country on earth is likely to apply for entering the international trade body, according to a precise process, divided into four phases, detailed in **Appendix 2**.

Accessing WTO would be for China a great opportunity in a sense that it will confirm the nation willingness to integrate the international economy and continue its opening process. Moreover, it could improve the level of confidence other nations granted to China. After a long period of negotiations, China became the 143<sup>rd</sup> member of the international commerce body in December 2001. The country agreed over 82 commitments (Zhao and Wang, 2009) which can be grouped under the following categories.

- Trade in goods: all tariffs on imported goods should be eliminated or at least reduced by 2004. Moreover non tariff barriers such as quotas on import will be reduced by 2005.
- Trade in services: foreign access in Services would be ensured in various sectors, including banking and insurance, telecommunications and tourism. Foreign Service providers would receive the right to trade and distribute all products by end of 2004 and will be able to import and export all goods except those under state monopoly, (eg. Oil and fertilizers) by end of 2006. Regarding banking activities, foreign

financial institutions will be permitted to provide services without any client restriction by the end of 2006.

- Trading and investment regimes: imported product or foreign companies will have to receive non discriminatory measures and practices. In addition export subsidies were removed as soon as China entered in WTO, except for agricultural products which will continue to be subsidized up to 8.5 per cent of their production value.

(Rumbaugh, Blancher, 2004, IMF working paper)

Chow (2001) summed up Chinese commitments into three features: the lowering of tariffs rates on imports, more openness of the Chinese domestic market to foreign investors, and the revision of some national laws that did not fit with WTO principles. For example regulations about intellectual property right, trademarks and copyrights (Zhao and Wang, 2009).

China's WTO accession had provided a more secure environment in the eyes of foreign countries and this had promoted investment from overseas and greatly expanded trade. For example, China welcomed large new investments from the United States accounted for USD 4.2 billion for year 2004, comparing with the 2 billion invested during the 1999-2003 period. On the other hand, it is noticeable that foreign trade grew dramatically. After the accession, foreign trade grew at an annual average of 35 per cent, that is to say 20 points more than during the whole 1978-2001 period. Figure 5 emphasizes this trade explosion, by showing that Chinese average trade growth had been superior to the world average, and had considerably accelerated from 2001. Moreover, table 3 describes Chinese's share in world export and confirm that the country is playing an increasing role in world trade. (Zhao and Wang, 2009)

Figure 5: Growth in Chinese Trade 1970-2002 (index 1970 = 1)

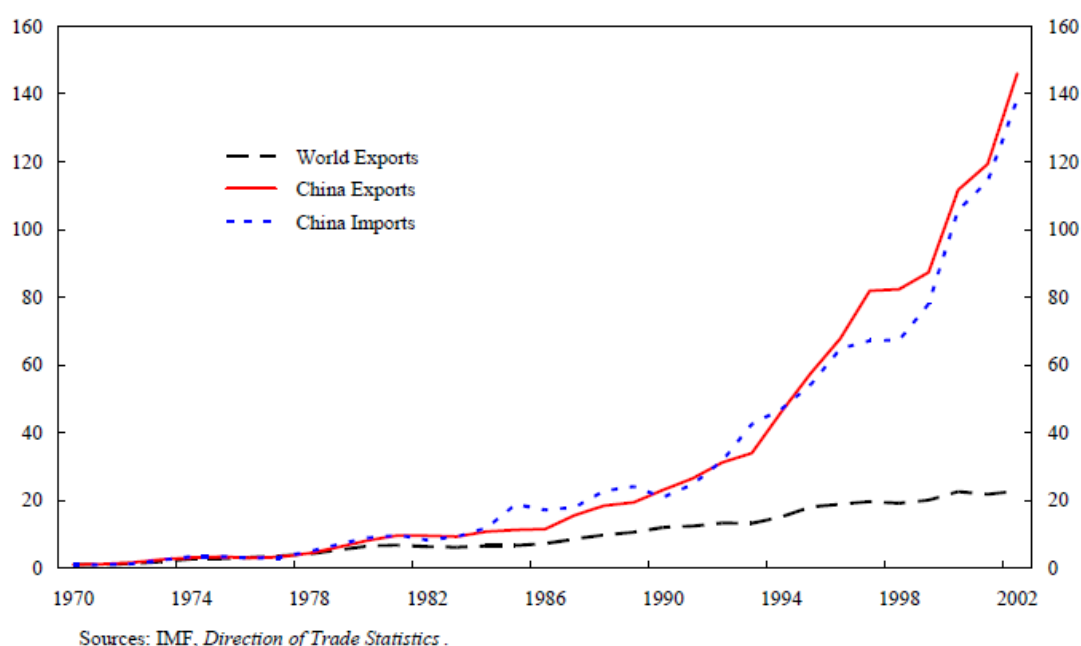


Table 3: Share in world exports (in per cent )from 1960 to 2003

	1960	1970	1980	1990	2000	2002	2003 Jan.-Jun.
China, P.R.: mainland	...	...	1.0	1.9	3.9	5.1	5.8
Germany	10.7	12.1	10.5	12.1	8.6	9.4	9.2
Japan	3.7	6.7	7.1	8.5	7.5	6.5	6.4
Korea	0.0	0.3	1.0	2.0	2.7	2.5	2.5
NIEs 1/	1.6	1.7	3.2	8.1	10.4	9.7	8.8
United States	19.4	15.3	12.0	11.6	12.1	10.8	10.4

Sources: IMF, *Direction of Trade Statistics* and CEIC.

1/ Newly industrialized economies, comprising Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

The second main consequence of Chinese WTO accession is the rising presence of foreign companies within the country. For example, the banking sector, which had been liberalized at that time accounted by the end of 2008, 28 wholly foreign-funded banks, and 196 foreign banks from 46 countries and regions had opened 237 representative offices (China Banking Regulatory Commission (CBRC), 2008 website: [www.cbrc.gov.cn](http://www.cbrc.gov.cn)).

Another point can be seen in the change of Chinese trade composition. According to IMF (Rumbaugh, Blancher, 2004, IMF working paper), in the 1990s, light manufactured goods accounted for 40 per cent of Chinese exports including footwear, clothing and toys; other exported products were

mostly textile and small electronics. After WTO accession, exports were turned to more sophisticated electronics such as office machines; furniture and travel goods. Ouellet (2004) explains that these restructuration are linked with the openness and the fact that China had to use its comparative advantage, as the country was now confronted to more competition coming from outside.

Finally, the new WTO member's government implied a "going global strategy", meaning that it encouraged its competent enterprises to invest abroad and explore foreign trade opportunities and economic cooperation. As a result, many agreements were ratified, among them: the ASEAN initiated by China in 2001, the China Chile in 2006, the China Pakistan Free Trade Agreement in 2007 and the China New Zealand Free Trade Agreement in 2008. China is even exploring new horizons with the Southern African Customs Union with whom it is still negotiating some agreements. In other words, trade regionalization had risen since it became a WTO member. (Zhao and Wang, 2009)

## 5.0. Theoretical framework: the Dunning's OLI theory

Multiple theories tend to explain internationalization of companies. Some of the famous are the Transaction Cost approach, the Uppsala Model and the Dunning's eclectic approach. The latter will be the base of the theoretical work developed in this thesis. Meanwhile, the two other ones are briefly explained respectively in **Appendix 3** and **Appendix 4**

In 1988, John Dunning developed a theory in order to explain international investments decisions made by TNCs. The latter is known under the OLI Paradigm or Eclectic Theory of FDI and explains through three different variables; why, where and how TNCs invest abroad. (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

### 5.1. Ownership advantage

Ownership advantage, or firm specific advantage (O), aims to understand why TNCs undertake activities in a foreign destination. This is based on the assumption that the willing TNC has one or more specific advantages which allow it to overcome the general costs of expanding abroad. Actually it is obvious that operating overseas would be more costly than doing the same on the domestic market due to the differences existing between the two markets. For instance, cultural and legal environment, lack of knowledge about the targeted market, or the extra expenditures to communicate and operate at distance... (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

So, if a firm wants to succeed in settling operation abroad, it must have a core competency that is relatively in the country of destination and that is transferable. Meaning that, the TNC would be able to exploit it once on the foreign market. Dunning (2000, p.83) emphasizes that *"the greater the competitive advantage of the investing firms relative to those other firms and particularly domiciled in the country in which they are seeking to make their*

*investment, the more likely they are to be able to engage in foreign production”.*

The firm specific advantages can be based on knowledge and technology, economies of large size also called advantage of common governance depending on the managers' competencies, or a monopolistic advantage. The latter includes possession or / and exploitation or / and a form of privileged access to every asset, such as inputs, markets... (Dunning, p87; Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

Generally, advantages owned by enterprises may be intangible assets, such as brand name, technology know-how, management capabilities... (Svend Hollensen, 2004, p.52)

## **5.2. Location advantage**

Location advantage or country specific advantage (L), responds to the following question: where to locate? TNCs have to choose a country in which they can conjugate the best their comparative advantages with the specific features of the country of destination in order to maximize their profits. Dunning (2000, p.84, 93) identified a sub-paradigm for the location advantage which could be broken down into three categories, namely economic (E), social (S), and political (P) advantages. Economic advantages are related to attractiveness and level of development of the economic area. For example, quantities and qualities of factors of production, size of the market... Social advantages include the cultural aspects and the psychic distance between home and host country, meaning language difference, attitude toward foreigners. Lastly political advantages represent regulations and policies in force in the foreign country that could affect inflows of FDI, intra-firm trade and international production. (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

Dunning (2000, p93) asserts that an optimum location would include a large and growing market, a large supplement of factors lacked on the domestic

market, lower costs of production in a politically stable country that welcomes FDI.

### **5.3. Internalization advantage**

Internalization advantage (I) focuses on the question: how TNCs go abroad? Basically, TNCs have to choose the way they will organize and exploit their core competencies once in the host country. On this perspective, TNCs have two alternatives, either they can buy and sell goods in the open market through an export system, or prefer an integrated approach based on purchasing or owning entities in the foreign territory (Dunning, 2000, p84, 99).

However, the OLI model argues about the fact that the second solution is more suitable for firms than the first one for several reasons. By following an integrated method, enterprises will be able to avoid tariffs on export as well as opportunistic behavior from a potential licensee abroad. Furthermore, organizations are more able to encounter transactional costs. These are costs appearing when enterprises have to face and overcome market imperfections. They can be for instance related to research and negotiation periods, or communication with another party abroad. Moreover, corporations directly establish on the market are more likely to deal with market risks and uncertainty as they do not depend on the information the foreign party delivers.

Meanwhile, internalization is benefic for TNCs; it is also a costly process in terms of administration costs which requires higher financial resources than other looser enterprise structure. (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

### **5.4. Key points of the theory**

To sum up, the eclectic paradigm or OLI theory explains the existence of TNCs. It permits to understand the reasons why firms go abroad and the choice of location as well as how they will penetrate the foreign market.

TNCs invest overseas to exploit their specific advantages in other countries. They will choose the country of destination by comparing the attractiveness of each in terms of economic, social and political features. Finally, TNCs have a wide range of alternatives regarding the way they will establish in the targeted country, from arm's length international trade to wholly owned subsidiaries. (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011) Table 4 provides an overview of the main assets within each O, L, and I category.



*Table 4: The Dunning's OLI, or eclectic paradigm*

Ownership/Firm Specific Advantages (FSAs): The O Factor
<p><b>Knowledge/Technology:</b> new products, processes, marketing and management skills, innovation capacity, the non-quantifiable knowledge base of firm.</p> <p><b>Economies of large size:</b> economies of scale and scope, product diversity and learning, access to capital, international diversification of assets and risks.</p> <p><b>Monopolistic advantages:</b> privileged or exclusive access to markets due to patent rights, brand names, inter-firm relationships, ownership of scarce natural resources.</p>
Location/Country Specific Advantages (CSAs): The L Factor
<p><b>Economic Advantages:</b> spatial distribution of factor endowments, costs and productivity of inputs, size of market and income levels, international transportation and communication costs.</p> <p><b>Social/Cultural Advantages:</b> cross-country differences such as psychic distance, language barriers, social and cultural factors.</p> <p><b>Political Advantages:</b> political stability, general public attitude and government policies towards TNCs, specific policies that affect TNCs such as trade barriers, taxes and FDI regulations, investment incentives.</p>
Internalization Advantages: The I Factor
<p><b>Natural or Endemic Market Failure (natural imperfections)</b></p> <p>Difficulties in pricing knowledge: information impact, opportunism, uncertainty, public goods characteristic of knowledge, failure to account for all costs and benefits.</p> <p>Transactions costs of making markets under conditions of risk and uncertainty: search and negotiation costs, problems of moral hazard and adverse selection, lack of futures markets and insurance, risk of broken contracts.</p> <p><b>Structural Market Failure (imperfections created by the MNE)</b></p> <p>Exertion of monopoly power: Using oligopolistic methods, such as predatory pricing, cross-subsidization, cartelizing markets, market segmentation, creating barriers to entry that distort external markets and cause structural market failures.</p> <p>Arbitraging government regulations: Exploiting international differences in government regulations such as tariffs, taxes, price controls, and other nontariff barriers.</p>

Source: (Griffin, Pustay, <http://wehner.tamu.edu/mgmt.www/Monteils/3-FDI.htm>, consulted 12.04.2011)

## 6.0. Case study: retailing sector in China

### 6.1. Retailing sector: general definition

According to Cox and Brittain (2004, p 3), retail consists of selling goods or merchandises from a fixed location in small or individual lots for direct consumption by the purchaser. Retail points are generally called either shops or stores. Generally the retailer buys products from a larger seller in large quantities and then offers them in the shops, stores. Retailer can also be applied to service providers who supply a large amount of individuals, such as electricity providers. This kind of retail is excluded from the study.

Retailers are classified according to the kind of product they sell, either food products, or hard goods including electronics, furniture or soft goods to mention apparels, clothing.

Finally, it is possible to identify different types of stores, among them, the most common:

- Department stores which offer a huge assortment of hard and soft goods
- Supermarkets and hypermarkets which mostly sell food
- Discount stores which offer less costly products and are less brand oriented
- Malls where a lot of different shops are grouped under a same roof
- E-sales, selling of goods through the internet  
(<http://en.wikipedia.org/wiki/Retailing>, consulted 12.04.2011)

According to Kantar Retail (2009) in 2009, the 15 leading global retailers (see **Appendix 5** for more details) were all from either European countries or from the USA.

This permits to conclude that the global retail market is lead and even monopolized by firms from developed countries. These enterprises became global as they started to invest and settle abroad, firstly in other Western countries. From about two decades, they have moved their investment destination toward developing countries. This decision comes from the fact

that the retail market in developed countries, such as Europe or Northern America can be now qualified as mature and highly competitive. As a consequence, development and growing perspectives are reduced.

## **6.2. Retail market in China, a progressive liberalization**

The free accessibility for foreigners to the retailing sector in China is a recent feature, dating from the post WTO accession.

Before 1978 and the reform period, wholesale and retail sectors were both under control of the ministry of commerce and the ministry of materials (Lo and Lee, 1994) and foreign investments in these domains were prohibited (Chang, 2009). In 1992 a “provision on investments by foreign merchants in retail commerce” was ratified. It permitted foreign investors to establish Sino-foreign joint ventures in retailing in six cities, namely Shanghai, Beijing, Tianjin, Tsingtao, Guangdong, Dalian; and five SEZ including Shenzhen, Zuhai, Shantao, Xiamen and Hainan. (Lin, 2008; Chang, 2009) However, foreigners were not allowed to own more than 49 per cent of the equities within the JV, except if they came from Hong-Kong. In that case they had the possibility to own a maximum of 51 per cent of the equities (Chang, 2009). Yip (1995) emphasizes the fact that this measure undertaken by the Chinese government had made from China a new development perspective for TNCs. At that time most of the foreign investments were issued by companies from Hong-Kong, Singapore, Japan, Taiwan and Thailand (Strange, Roger 1998).

By 1997, Chang (2009) reports that 24 foreign invested stores had got approval from the central government to start business in China, among them the first global retailer Wal-Mart from the USA. However, at that time hundreds of foreign invested retailing enterprises had already been established as they previously got the approval from either local or provincial governments. These were partly illegally settled as they did not receive approval from the central government, as stated in the Chinese FDI regulation. As a consequence, the central government implemented a session of drastic controls leading to the approval or license revocation from 36 enterprises. 42 others had seen their operations cut back. Lastly, 199

companies had to restructure, meaning that the Chinese part had to higher its part of owned equities. (Chang, 2009)

Despite of these operations, local governments still continued to approve foreign investments within the retail sector. Some companies as the French retailer Carrefour had took this opportunity to penetrate the Chinese market (Chang, 2009).

In 2001, as China acceded to WTO, it committed to open its retail sector by 2006. However, in 2004, that is to say two years in advance; the government decided to release all the restrictions weighing the retail sector. From that time, there were no longer any limitations on firms' size or investment location (Lin, 2008). Furthermore it is said that the government encouraged application from foreign investors who had comfortable financial situation as well as experience in the distribution and international sales. Finally, this legal measure also permitted foreigners to establish WOS in the retail sector. (Chang, 2009)

According to Lin (2008) 70 per cent of the main global retailers in the world are established in China, such as Amazon.com or Carrefour.

### **6.3. Theoretical application of the eclectic paradigm on Chinese retail sector**

In order to explain the choice of global retailers to expand and invest in China, this section presents an application of the Dunning OLI strategy previously developed, on the retail sector in China.

#### **6.3.1. TNCs ownership advantage**

Global retailers from developed countries, such as Wal-Mart, Carrefour, Tesco or Ikea own firms' specific advantages that are workable when expanding abroad. The latter would permit them to do better than the local competitors already established on the foreign market. The core competencies can be classified into two distinct groups. Some are parts of the strengths and strategic directions of the firm, in other words are internal

elements or basic competencies. The others are linked to their architecture, or organizational structure (Henderson, Cockburn, 2000).

⇒ Basic competencies

First of all, retailers have an obsessive customer focus (<http://www.accenture.com/us-en/Pages/insight-high-performance-retail-growth-imperative-hypermarket-summary.aspx>, consulted 15.04.2011), and own the ability to provide global solutions appealing and giving value to the consumers, as well as distancing them from the existing or potential competitors. For example, Metro and Sephora have based their image on curiosity when they establish abroad and arrive on a market where they have the monopoly (Cao, Dupuis, 2008). Then, famous retailers have this operational excellence (<http://www.accenture.com/us-en/Pages/insight-high-performance-retail-growth-imperative-hypermarket-summary.aspx>, consulted 15.04.2011), meaning that they are able to integrate and manage their supply chain efficiently, even if some stores are located far away from the home nation. This can for example be based on the ownership of product conception centers, as IKEA in Sweden; or / and the entire or partly direction of the logistics (Cao, Dupuis, 2008). Another perspective lies in the management capabilities and the ability to be flexible in order to respond to the local demands which might differ from the home country's consumer's expectations. The next point is about the capacity to create a reliable and faith relation on the one hand with the customers once they are targeted, either through discount programs or fidelity cards, etc. On the other hand with the suppliers, by either sharing information with the latter through information systems (Cao, Dupuis, 2008). Or sometimes, global retailers have such a negotiation power on their suppliers, as they are huge customers, that they can influence the latter to settle subsidiaries in the host country, in order to simplify the value chain. Wal-Mart succeeded in this process when they went to Mexico for example.

⇒ Architectural, organizational competencies

According to Chang (2009), one of the specific advantages of the retail leaders lies in their ability to transmit their values overseas. For instance, he emphasizes that Carrefour had managed to make employees from foreign subsidiaries adopt their two core values of integrity and honesty. This initiative permits to sustain corporate quality worldwide, wherever the subsidiaries are located.

In addition, Cao and Dupuis (2008) mention that global retailers are able to centralize some of their activities, for instance the purchase unit. Thus, they guarantee a higher control of the operations at an international scale.

Finally, corporations have innovation and learning abilities, making adaptation to new customers' trends as well as to foreign cultures easier. In the particular case of China, many enterprises have already established either in Taiwan or Hong Kong before capturing the Middle Kingdom market. This was a strategic choice to get familiar with the Chinese culture, as both territories have an environment rather similar to the Chinese one. To quote some examples: Carrefour which settled in Taiwan in 1989 and then in China in 1995 (<http://www.carrefour.com/cdc/groupe/historique/>, consulted 15.04.2011) or Wal-Mart which entered in Hong-Kong in 1994 and established two years later in China (<http://walmartstores.com/AboutUs/7603.aspx>, consulted 15.04.2011).

All these characteristics make retailers willing to internationalize and able to enter the Chinese market, which is an attractive nation, presenting a lot of advantages developed below.

### **6.3.2. China's location advantage**

Dunning (2000 p.165) emphasizes that the economical and political situation of the country or region a firm is seeking to invest are two main aspects crucially affecting the final investment decision.

### 6.3.2.1. Economic environment

Regarding the economic perspective, China is an attractive country for global retailers. First the nation accounts for one quarter of the world consumers, drawing high sales potential. Subsequently Chinese people are getting richer. According to a report published by Thomas White – Global investing (2010), gross national income per capita had been multiplied by 13 between 1978 and 2008; meaning that Chinese have an increasing capacity to spend. This tendency is also confirmed by the positive trend of the evolution of gross domestic product per capita, available in **Appendix 6**. Moreover, the report emphasizes that by 2015 consumption capacity per capita will still grow to reach 2,502 USD from 1,975 USD in 2008. A Mc Kinsey study (2006) even predicts that China would become the third largest consumer economy, approaching the value of the Japanese market in real dollars terms.

Another significant aspect is the rapid development of a strong middle class in the nation. Based on the assumption made by Song and Cui (2009) that people earning from 6,000 to 25,000 USD per year are part of the middle class, the latter nowadays represents 25 per cent of the Chinese population and will increase to 33 per cent by 2020.

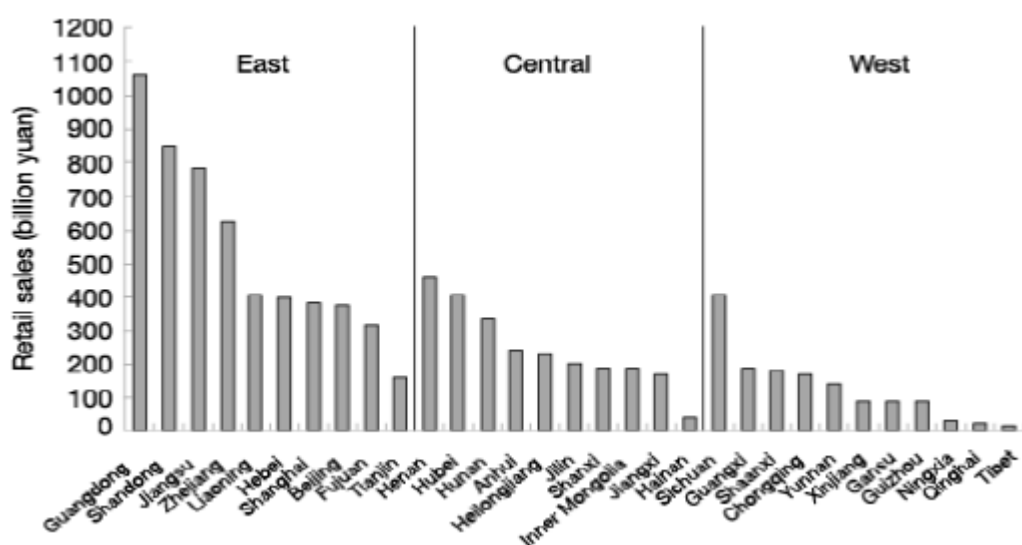
Furthermore the part of wealthy customers keeps rising. In 2008, they accounted for 1.6 million households and are supposed to reach 4 million of them by 2015. Thus, China would become the fourth largest pool of wealthy consumers around the world, behind the USA, Japan and the United-Kingdom. In addition, it is important to mention that this wealthy population is made of young people who are around twenty years old. This aspect reinforces the potential sales within the retail sector. (Thomas White – Global investing, 2009)

Then one must consider sales through the Internet which also represent a huge gap in the retail market. Indeed, China is the world largest internet population, accounting for 253 million people, among them a lot of young and economically active young persons. (Ministry of foreign affairs of Denmark, the trade council, 2008)

Despite of this positive portray, development and economic situation are unequal country-wide. Actually China could be divided into three parts. The Eastern, coastal regions are the richest and most densely populated, as they were the first to be developed through the different measures undertaken by the government, notably the establishment of the SEZs. Then, the Central part of the territory is an area in development which currently grows rapidly. Lastly, the Western locations are the least advanced parts of the country, remaining poorer and deeply rural. (Ambler and Witzel, 2000) Disparities among the different regions are illustrated in **Appendix 7**.

As a consequence, the distribution of retail sales by region is also unbalanced between the three identified areas. As Figure 6 shows, these are concentrated in the East, and low in the West.

*Figure 6: Retail sales in China, by region in 2007*



Source: National bureau of statistics of china, in Ministry of foreign affairs of Denmark, the trade council, 2008

This last aspect of the economic situation in China largely explains the reasons why TNCs in the retail market are more willing to invest in Eastern regions if they want to maximize their profits. Subsequently, this confirms the general tendency mentioned in the previous section.



#### **6.3.2.2. Political environment**

From 2004, investments in the retail sector by foreigners became simpler and currently appear more welcome. Indeed, the latter are no longer mandated to form JV with locals, and are even permitted to found WOS. Then, the scope of action is no more geographically restricted. On the other hand, the minimum capital requirement had been dramatically lowered to 60.460 USD, from 9.7 million USD before 2004. Lastly, the approval procedure had been simplified, meaning that local and provincial governments are now qualified to deliver the licenses. (Economist intelligence unit 2004, [http://www.kpmg.com.cn/en/virtual\\_library/Consumer\\_markets/China\\_Retail\\_and\\_distribution.pdf](http://www.kpmg.com.cn/en/virtual_library/Consumer_markets/China_Retail_and_distribution.pdf) , consulted 15.04.2011)

It is noticeable that policies toward foreign investors in the retail sector are favorable and become smoother across time.

### **6.4. Modes of entry to penetrate the Chinese market**

Basically, a retail company can choose between four entry modes when entering the Chinese market: Sino-foreign equity joint ventures; Sino-foreign contractual joint ventures, also known as Sino-foreign co-operative joint ventures; wholly foreign owned enterprises or representative offices. The choice will be made according to the activities the enterprise is willing to engage, as well as the level of control it wants to have.

#### **6.4.1. Sino-foreign equity joint ventures (EJVs)**

This type of enterprise consists in the joint investment of a Chinese organization and a foreign firm or individual on the Chinese territory. Investments can be made in terms of cash, intellectual property rights, technology, materials, equipments... with the foreigner investing almost never investing less than 25 per cent of the total value. Both nationality has to be represented in the board of directors, which is in charge of managing the entity. The latter is considered as a Chinese legal person meaning that it is allowed to buy land, hire Chinese working force, and construct buildings.

Furthermore the EJV is a limited liability company meaning that investors are not personally liable for the debts the company might make in the future. (<http://www.chinaorbit.com/china-economy/china-joint-venture.html>; consulted 16.04.2011)

#### **6.4.2. Sino-foreign contractual joint ventures (CJVs)**

This type of company is based on the same principles than the EJV. The difference lies in the higher degree of flexibility in terms of contractual freedom and structure. For example, profits and losses are distributed according to the contract and do not depend on the share of investment they initially put in the business. (Sinova, [http://www.sinova.com/upload/FS\\_CN01-0902\\_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf](http://www.sinova.com/upload/FS_CN01-0902_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf), consulted 16.04.2011)

Advantages and disadvantages are the same than in the EJV, as the two models are rather similar.

#### **6.4.3. Wholly foreign owned enterprises**

This model is becoming more and more popular in China. They are founded with hundred per cent of foreign capital and uniquely operated by foreign operators. Moreover these entities permit to limit the responsibility of the investor to the value of the assets he brought in the business. (Sinova, [http://www.sinova.com/upload/FS\\_CN01-0902\\_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf](http://www.sinova.com/upload/FS_CN01-0902_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf), consulted 16.04.2011) On a general perspective this type of investment takes relatively more time than the one required to establish a JV and implies more financial resources and a greater operational experience from the investors. ([http://www.ifuconsultants.com/Forms\\_of\\_Foreign\\_Investment\\_in\\_China\\_en.pdf](http://www.ifuconsultants.com/Forms_of_Foreign_Investment_in_China_en.pdf); consulted 16.04.2011) However, creating a wholly foreign owned enterprise would provide larger benefits to the investor:

- Full independence and freedom to implement the worldwide strategies of the parent company
- Protection of intellectual property rights as well as the technologies imported in China
- Total control of human resources
- Greater efficiency in operations, management and future developments

(<http://www.wfoe.org/>; consulted 16.04.2011)

#### **6.4.4. Representative offices (RO)**

RO are the easiest way to enter in China but offer limited possibilities. As it does not receive the Chinese legal personality, RO do not permit to conduct commercial business as invoicing and signing contracts are both forbidden. This is rather a way of doing market researches and promoting the parent company. This might represent a good alternative to acquire knowledge, gather information, and get known before engaging a company establishment. (Sinova, [http://www.sinova.com/upload/FS\\_CN01-0902\\_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf](http://www.sinova.com/upload/FS_CN01-0902_Four%20Main%20Types%20of%20Foreign%20Investment%20in%20China%281%29.pdf), consulted 16.04.2011)

Finally, from 2006, mergers and acquisitions have been made possible. Thus foreigners can purchase the stock of a non foreign invested company in China, or increase the capital they own in a company, so as to convert the latter into a foreign owned enterprise. ([http://www.ifuconsultants.com/Forms\\_of\\_Foreign\\_Investment\\_in\\_China\\_en.pdf](http://www.ifuconsultants.com/Forms_of_Foreign_Investment_in_China_en.pdf); consulted 16.04.2011) This really represents an opportunity for foreign corporations which are now able to gain control over the JV they previously established.

#### **6.4.5. Modes of entry: variations across time**

Depending on the period of time, the majority of foreign direct investment going to China had taken different forms. At the beginning, establishing joint

ventures was the predominant way to enter the Chinese market. To be precise, contractual joint ventures (CJVs) were the first to be massively set up. Between 1979 and 1982, CJVs represented 46 per cent of the whole FDI inflow. However, this tendency did not last and was even quickly reversed, as it declined during the following years, and represented 20 per cent in the 1990s. On the other hand, the second form of joint venture, namely the equity joint venture (EJV) was thriving. Despite they accounted for only 8.4 per cent of the total investment coming in China between 1979 and 1982, 60 per cent of the new investment realized by foreigners between 1987 and 1989 were made in form of EJV (Fung, Izika, Tong, 2002). Actually, this form of investment had become popular because it permitted companies from overseas to get assistance from the local partner (Zhang, 2002), as well as to gain legitimacy on the market and gather knowledge by limiting financial risks.

After 1990, the share of EJV in the total Chinese FDI inflow started to decrease, while investments in wholly foreign owned subsidiaries (WFOS) were rising. In 2000, the latter accounted for 47 per cent of FDI realized in China (Fung, Izika, Tong, 2002). According to Ali and Guo (2005), this form of investment had been seen more suitable for foreigners, in a sense that they were now able to optimize their local presence by improving their level of control on their offshore activities. This willingness was also conveyed by foreigners involved in JVs who had a tendency to increase the amount of equity they possessed when it was possible.

Since the middle of 2000s, a new wave of investment is growing in the Middle Kingdom, namely the ones realized through mergers and acquisitions (M&A). Before 2002, this investment option was not conceivable, but increasingly the Chinese government had introduced laws to stimulate it. Actually, these legal measures were undertaken within the framework of SOE restructuration and privatization. Consequences for enterprises are huge. They recently have the possibility to totally acquire Chinese established companies, as well as, in a case of JVs, to purchase the equities of the Sino party

(Lin, 2006,

[http://www.lehmanlaw.com/fileadmin/lehmanlaw\\_com/Publications/Mergers](http://www.lehmanlaw.com/fileadmin/lehmanlaw_com/Publications/Mergers)

Acquisitions SL January 2007 .pdf, consulted 25.04.2011). According to Peng (2006), between 10 and 15 per cent of the new investments realized in China in 2005, were M&A procedures.

Meanwhile, M&A operations are highly controlled by the government. They require approval from multiple governmental organizations and are restricted through the same Catalogue regulating FDI generally speaking (Lin, 2006, [http://www.lehmanlaw.com/fileadmin/lehmanlaw\\_com/Publications/Mergers\\_Acquisitions SL January 2007 .pdf](http://www.lehmanlaw.com/fileadmin/lehmanlaw_com/Publications/Mergers_Acquisitions_SL_January_2007_.pdf), consulted 25.04.2011).

## 7.0. Investing and conducting business in China: main risks and challenges

Companies deciding to invest and conduct business in China are attracted by the potential economic return they would get if the operations are successful. Meanwhile, establishing in China presents some risks and challenges which should not be neglected. This section focuses on the main challenging and risky aspects when entering the Chinese market and provides some clues about the behavior enterprises can adopt in order to face them. Meanwhile it is assumed that the list is not exhaustive, as sources of risks and challenges are multiple, and could be the topic of one entire research.

### 7.1. Intellectual Property Rights (IPR)

According to the World Intellectual Property Organization (WIPO) IPR “refers to creations of the mind, inventions, literary and artistic work, and symbols, names, images and designs used in commerce”. (<http://www.wipo.int/about-ip/en/>, consulted 26.04.2011)

Theoretically, IPR in China are protected by both international agreements, under the authority of the WIPO and domestic legislation, through different laws established by National People’s Congress. The most important ones are the Patent Law, Trademark Law and the Copyright Law, respectively implemented in 2000 for the first, and 2001 the two others. They all aim at defining the rights of the IPR owner, guideline for their administrations, etc... One can notice that the national laws are recent. This is linked to the fact that improving IPR regulations in China were one of the conditions to accede the WTO (Moynihan et al, 2004). For more details about the legislation, please consult **Appendix 8**.

Despite this legal context, piracy and IP theft is a major concern in the country, which is even qualified as the “counterfeit capital of the world” (Swike, Thompson, Vasquez, 2008). Moreover, it is said that 15 to 20 per cent of the whole goods sold in China are counterfeits and that 8 per cent of the GDP is realized through the sale of pirated goods (Chow, 2005, <http://www.cecc.gov/pages/roundtables/051605/Chow.php?PHPSESSID=64f>

[dba53766d2c1ae1bc3a4c738dcbb3](#), consulted, 26.04.2011). This phenomenon originates from different sources. First, it consists in a cultural matter. On a Chinese perspective, there is nothing wrong in copying existing products. On the contrary, it is even well perceived and people are proud of themselves if they manage to make a quality copy at lower costs and subsequently to sell it on the market, cheaper than the original. In addition, the Chinese language tends to be full of homophones, that is to say words with similar sounds. This permits them to easily copy the trademarks, by giving their fakes a name which is written differently but still pronounced the same. (Moynihan et al, 2004)

Then, the second problem lies in the looseness of the IPR regulation system. Actually, even if the laws are created at a national level, provincial and municipal governments are responsible for enforcing and implementing them; and it has been observed that local official fails to do it. Furthermore when a company complains about a problem of counterfeit, it has to address its demand to the local court, which is the competent body in this type of request. The issue is that most of the time, people in charge of the local court are connected with the denounced pirates. That is why they will not have any incentive to deal with the case on a fair way. This shows the importance for foreign firms to gain the confidence of the local government as well as to maintain good relationships with it, but this will be discussed in details later. On the other hand, when the cases are arbitrated, the culprit will generally have to pay some penalties. However the latter are trivial comparing to the profits realized by the counterfeits' vendor, that he will continue his activities, despite their illegitimacy. (Swike, Thompson, Vasquez, 2008)

Finally, it is significant to emphasize that piracy or counterfeit threats are present everywhere within the Chinese business environment and that foreign investors have to be highly suspicious regarding all the actors involved in the operations. The first initiators of forging goods or services are most of the time the Sino partners, foreign investors had themselves chosen. For example, in the mid 1990s, Yamaha the motor bike from Japan came entered the Chinese market by investing 93 million USD and settling three joint ventures. For months after, the company was supposed to launch a new

model, but it realized that some copies were already on the market, as one of the local partners had sold Yamaha's technology to one of the rivals. The same story was encountered by Unilever and one of its laundry detergents. (Deng, 2001)

On the other hand, employees can also represent a counterfeit threat, in a sense that they are able to see the daily operations within the company. Thus, if they leave the company for any reasons, they will certainly be able to copy the product or the service they got familiarized with thanks to their former position. Thus, foreign enterprises establishing in China are not willing to develop any research and development activities onshore, because of the huge risk for potential duplication. In addition, managers within the companies will have the tendency to restrict the employees' access within the company only to the proportion of materials they need to complete their work successfully. (Swike, Thompson, Vasquez, 2008)

## **7.2. "Guanxi" or the importance of a good relation network**

The "Guanxi" is a principle originating from the Confucian culture. According to Yang (1994) it corresponds to the development and sustainability of personal relations with any individuals or organizations through the exchange of favors and gifts in order to obtain goods and, or services. Thus people create and organize a network of mutual dependence and create a sense of obligation and debtless among each other.

Nowadays in addition of this traditional view of "Guanxi", two others had appeared, namely the "Business Guanxi" and the "Political Guanxi". The former corresponds to the way managers within enterprises are connected with their suppliers, buyers, distributors and competitors. The latter involves the degree of connection someone has with the various governmental and regulatory offices within the country. (Luo et al, 2008)

It has been proven that both Business and Political "Guanxis" have a high influence on the firm's performance. Companies benefiting from a good "Business Guanxi" are more likely to be informed about the current market trends, strategies implemented by competitors, as well as to gather



information about their associates and different partners, than the ones with lax or inexistent Guanxis. On the other hand, cultivating a high quality of “Political Guanxi” will permit an enterprise to influence decisions makers, at least at the local level. Thus they will be able to get faster answers and approvals regarding their requests, as well as reduce the level of control performed by the authorities on their operations. (Chung, 2010)

The problem arises because it appears that some corruptive methods are used in order to settle “Guanxi” between the government and the enterprises. Luo (2008) emphasizes the fact that the approaches to deal with Guanxi establishment are overlapping with some corruption practices, because of the opportunistic and instrumentalist behaviors of both parties. Ergo “Guanxi” is not anymore a sign of mutual respect and warmth, but rather a sort of illegal contract concluded through bribes or special and exclusive arrangements.

It is quite difficult to concretely describe the conditions in which negotiations take place between the government entities and the companies. Meanwhile, Swike, Thompson and Vasquez (2008) report that some firms investing in China do not hesitate to allocate a portion of the foreign operation budget to what they call “government relationship plans”.

This tends to confirm that China is well known for its bribery practices in business. Furthermore, the country is publicly perceived as corrupted. According to Transparency International, which realizes each year the Corruption Perception Index, the country got a score of 3.5, knowing that the clearest country receives a score of 10 and the highest corrupted of 0. ([http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2010/result\\_s](http://www.transparency.org/policy_research/surveys_indices/cpi/2010/result_s), consulted 27.04.2011)

The general consequence of this wrong side of the Chinese environment is that companies engaging operations within the territory are willing to have highest ex-ante transactional costs than expected. Indeed they have to be ready to lose some money before reaching their objectives.

### **7.3. Differences in business perspectives**

In the past, a lot of enterprises from developed countries had settled Joint Ventures. Thanks to their experiences, it had been possible to notify some major differences in the way Western and Sino business men conceive management and operations. Firstly they do not have the same vision of making business, due to their cultural and social backgrounds. While the primary objectives of Chinese people are to obtain technology and gain management expertise, the one of foreigners is rather to gain market access. Furthermore, they do not have the same expectations in terms of success. Chinese will be focused on short term success, whereas Foreigners are thinking about long term and sustainable growth. Because of these disparities of mind, it had been difficult for foreign investors to conclude reliable partnerships with local entrepreneurs. Thus partly explains the reasons why as soon as it had been possible, foreign investors had established by using other alternatives than JVs. (Deng, 2001)

### **7.4. A poor legal environment**

The existing framework of legal system and regulations is characterized by a lack of transparency, as well as by poorly trained judges and lawyers, making the system ineffective (<http://www.cfr.org/china/chinas-environmental-challenge-political-social-economic-implications/p5573>, consulted 27.04.2011). Furthermore, the application of laws is inconsistent according to the Chinese provinces and regions, making difficult to understand what is legal and what is not. Then one has to assume that the costs of litigations are generally high and that the penalties asked to the culprit are low. This makes the negotiating atmosphere surrounding a contract quite lax, and can enable the local party to easily abuse from its foreign peer. That is why it is recommended to foreigners to rely on their own legislation adviser when conducting business in China. (<http://www.chinasuccessstories.com/2007/09/26/investing-china-risks-opportunities-incentives/>, consulted 27.04.2011)

## **7.5. An heterogeneous market**

Transnational companies investing in China will have to face some marketing challenges in a way that they cannot really consider entering one unified market. This is due to the fact that China can be seen as a grouping of different and specific segments rather than a homogeneous whole. Actually inside of China itself, inhabitants have different values, cultural patterns, lifestyle, traditions, customs, etc. This originates in the geographical and economic disparities characterizing the nation. The Coastal regions are the most developed and contains the richest and most urbanized part of the country. On the contrary, the Western locations remained under developed and deeply rural. In between, the Central part of the nation is currently growing and transitioning from a rural to a more urban society. On the other hand one has also to take into account the unequal infrastructure system. The further a place is from the coastal regions, the less decent roads it offers, and the less airports or railways there are. For example the province of Tibet in North West is almost isolated because of the mountains, deserts and lacks which are situated there. This point also contributes to the disparities existing across the nation. (Cui, Liu, 2000)

As a consequence, people across the country do not behave the same regarding Western products or concepts. For instance, inhabitants within Western regions are not familiar with Hypermarkets and still use small local groceries to supply their households. On the other hand, Eastern regions are full and even saturated of them. Lastly another significant aspect of the Chinese environment is that the use of media is disparate. Basically everybody possesses and watches television, but radio is for instance used at a different level from places to places. The latter is almost unused in coastal regions, whereas it remains common in some other regions like Central China. (Cui, Liu, 2000)

In the light of these economic and social attributes, it seems obvious that TNCs entering the Chinese market will have to consider different marketing strategies, if their initial plan is to target the entire Chinese population. As a

consequence, ex-post transactional costs will have a tendency to be higher than expected. (Cui, Liu, 2000)

## **8.0. Conclusion**

### **8.1. Main findings**

China's spectacular economic growth and increasing power in the world would not have been conceivable without the presence of Deng as a leader from 1978. Sure it would have been some progress made, but maybe not as huge as what was achieved thanks to him. With a precise vision in mind of what were developed nations, he implemented the reforms toward modernization, liberalization and opening. His first conclusive action was to put an end to the commune system. Then he continued by expanding private business ownership and by establishing policies in favor of the exterior world, in order to attract FDI. The latter were considerably initiated by the so-called Chinese Diaspora, that is to say Chinese native people established offshore, for instance in Hong-Kong or Taiwan. As these investors engaged promising businesses, and made profits rapidly, other opportunistic entrepreneurs or companies from Western countries did the same. This pointed out the beginning of a virtuous FDI circle from the developed world. In addition, Deng is from a distance the architect of the Chinese successful shift from a communist and collectivist economy to a market-oriented one.

However, when the reform process began, with the purpose to dramatically transform the economic system it was uncertain whether it would be a success and at which extent. That is why the Chinese government had used an incremental and progressive method in order to implement the new measures. This means that new policies were elaborated, and firstly tested on one or several zones within the country, before being generalized, if they were satisfactory. Thus, the government conserved the opportunity to make some adaptations in case the measures primary initiated did not fit with the expected objectives and targets. This had also been a significant feature belonging to the design of the Chinese success. Indeed trying on a specific location and waiting for results had permitted not to spread new plans which would conduct to failure in the whole country. Hence, China had never had to step backward.

The third feature of Chinese success lies in its accession to WTO in 2001, in a sense that it had largely contributed to open China toward the rest of the world. First it had permitted the nation to enforce its level of credibility among the other 142 members, that is to say almost worldwide, knowing that there are on average 200 countries on earth. Moreover, as the WTO is promoting free trade and the reduction of trade barriers, it can be seen as the symbol of liberalization and globalization. Thus by joining this international body, China had emphasized its shift toward market-orientation as well as its willingness to participate in the global economy. Furthermore, becoming a WTO member had obliged China to deepen its reforms in numerous domains, in order to be aligned both with the organization's requirements, as well as with the member countries, to ensure a high level of transparency in commercial transactions, and apply the non differentiation principle. All these transformations and requirements had conducted China to gain a significant step in the global economy.

By building this new environment, China had had the possibility to attract a lot of FDIs and to increase the size and scope of its trade flows. Nowadays, according to the WTO, trade plays a major role in China's economic growth. It represented on average two tiers of its GDP on a two years period from 2007 to 2009. Moreover, China represents one of the largest actors of international trade, as it is the leader in merchandise export and the second in merchandise import. Lastly it is important to notice that China's main trade partners are developed countries. The main part of Chinese exports is sent to European Union (19.7 per cent of total exports) and the United States (18.4 per cent of total exports). On the other hand, the European Union accounts for 12.7 per cent of the total imports. (China's trade profile, WTO, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=CN>, consulted 30.04.2011)

This tends to show that Western countries and above all the European Union are partly dependent of China. This reinforces the idea that the nation plays a major role in the trade domain and economic flows. This leads to say that the nation will certainly be one of the main actors in the political and economic world in the future, perhaps conducting to a re-shaping of the global political-

economic relations worldwide. One can even think that this had already started, according to the numerous bilateral and regional trade agreements initiated by China in the past years. The main significant remains the ASEAN created thanks to the Chinese incentive to promote a political and economic stability within the Pacific region, where the nation would be the leader.

Another important characteristic of China lies in the fact that it is one of the most popular destinations for FDI coming from developed countries, despite of the numerous risks and challenges existing on the Chinese market, (identified in section 7). This is *prima facie* paradoxical, but on the other hand, it is obvious that TNCs which would not consider China as an investment destination would tend to dramatically reduce their competitiveness, comparing to their competitors who would.

Actually the hugeness of the market (1.3 billion of consumers) and the continuous economic growth (according to World Bank, 8.7 per cent economic expansion are planned in 2011) within the country still make China an opportunistic and attractive destination for FDI, with potential benefits largely overcoming the possible difficulties met. However, one should bear in mind that firms can reduce the risks they are willing to face, by adapting their strategy and budgets. Despite, it is logical to consider that the first Chinese experience for enterprises could lead to some problematic issues. Meanwhile by gaining experience on the market the possibilities of facing risks are largely reduced. As a consequence the Chinese market is no more seen as challenging, but rather as highly profitable. In this perspective, a lot of famous companies had reported their willingness to pursue their expansion in China. For instance, Pepsi Co revealed that it would invest 2.5 billion USD by 2013; Volkswagen, the German automotive company planned to build three new plants, to 2.5 billion USD valuable. To give a third illustration, Marriott Hotel affirmed that it would double its presence on the Chinese market by 2015 ([http://www.timeincnewsgroupcustompub.com/sections/100726\\_ChinaBusiness.pdf](http://www.timeincnewsgroupcustompub.com/sections/100726_ChinaBusiness.pdf), consulted 28.04.2011)

On the other hand, measures undertaken by the Chinese government intend to attract TNCs from developed countries. During the twelfth Five Years Plan

which had just started at the beginning of year 2011, the People's Congress revealed that one of the priorities was the reinforcement of the logistic network within the entire China. For sure, the immensity of the project and its value will attract Western companies. On the other hand, new policies are targeting the development of inland China. In this perspective, it is possible to imagine that some incentives will be created by the government to attract rich Western companies in these locations, as the latter had shown that they largely contribute to Chinese economic growth in the past.

To sum up, China is such attractive that it is difficult to foresee that the interest TNCs have for the nation will decrease in the short term. Given that development possibilities are extending in other regions, and because it remains so much to do in different areas within the nation; there will still be interest for some companies from that or that sector to invest within the territory. On the other hand, the facts that China enforces its regulatory system and is looking for more transparency also provide incentives for companies to continue investing.

However, in the long run, one can think about multiple scenarios. First it is possible that the scope of business possibilities for developed countries will start to reduce, as local enterprises would have gathered enough knowledge to act themselves, as good as Western companies do. Then, in the same perspective, it is conceivable that the level of competition coming from inside the country will intensify and force some companies from developed country to stop expand or even force them to quit the market. It is even imaginable that the tendency will invert, meaning that Chinese companies would invest massively in developed countries and propose same goods and services for cheaper prices. Briefly, it is obvious that Chinese companies and China generally speaking will play a great role in tomorrow's world. They had even already started by deeply increasing their presence in Africa.

To finish, one must understand that China is nowhere near to be a liberalized country, due to the constant and strong presence of the state within the economy. China is a kind of unique economic system, in which one party, the



Communist Party of China (CPC) rules single-handedly the country but also facilitate private enterprise and foreign investment.

This political control over the economy is obvious through different examples. The establishment of the Five Years Plans, with quantitative targets is one of the features conveying the idea of strong directives from the government. Then, the bureaucratic system is another clue, given that authorizations from administration are compulsory and the requirements to get them remain complex and time consuming. On the other hand, the government is also responsible for fixing the rules in which the economy has to rule. This means that the latter has the possibility to implement policies in favor or against some sectors of activity, in order to direct the economy as it wishes. In addition the presence of state owned sector is still high comparing to any other capitalist countries; some sectors such as petrochemical or tobacco production are even under specific state exploitation.

Finally, the image of the Chinese state control is well known by people worldwide. One just has to consider the fact that censorship ordered by the Party is still in practice and that the liberty of expression remains limited. Some companies suffer from it, and fail to establish in China, as the giant internet network Facebook does. This leads to say that the Middle Kingdom still has a long route to do toward full liberalization. Meanwhile nothing asserts that this is the objective of the Chinese giant. It is even conceivable that high state control is part of the Chinese identity, and that the government will do everything to keep it.

## **8.2. Proposition for future researches**

Keeping in mind the fact that China is an ongoing phenomenon, possibilities of research on the topic are huge, but some propositions are coming in my mind. Above all, one can decide to focus on either the primary or secondary sector and implement a deeper investigation of the reforms undertaken and their consequences.

Then, it should be interesting to focus on the way China is present and is increasing its presence abroad, and precisely how they succeed to do it on

each continent. This would take into account the fact that the nation holds a major part of American treasury bonds. Then it would deal with the expansion of China into Africa through FDI outflows, and lastly treat the European case, by zooming on the new investment recently made by the Middle Kingdom, as they currently did in Greece.

Third, it would also be interesting to write about how Chinese companies are starting their internationalization, and the future implications this new phenomenon will have on a global scale.

Next, a wide, controversial but fascinating field of study would deal with the future development of China, by confronting the weaknesses the nation still presents and the strengths it had developed and success to sustain.

Finally, it might be a possibility to identify and isolate the most successful measures and reform processes implemented in China, in order to conceptualize a model of development and economic growth for all other developing countries on the world. However, this is more theoretical than realistic, in a way that a universalistic approach contains its limits. Indeed it would highly depend on the context and the environment in which the country is when starting, the degree of authority retained by its government, its past history...

Anyway, China had been devoted to a lot of researches in the past, because of its extraordinary growth and rapid change of economic direction, and will still be so in the future.

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## Appendix

### Appendix1: FDI Projects categorization

Category	FDI projects
<b>Encouraged</b>	Projects in Infrastructure, undeveloped agriculture, new / advanced technology domains Projects potentially upgrading production function, bettering energy saving and raw material use, improving economic efficiency...
<b>Restricted</b>	Projects where production exceed domestic demand, Projects under experiment or monopolized by the state Projects engaged in exploitation of rare and valuable mineral resources
<b>Prohibited</b>	Projects harming national security, public interest, natural resources, human health...
<b>Permitted</b>	All other projects unmentioned in the previous categories

Source: Fung, Iizaka, Tong, 2002

### Appendix 2: WTO: Application process

Phase 1: The candidate government submits a formal written request for accession. Subsequently, a working group within the WTO is established, whose aim is to study the request.

Phase 2: The period of negotiations between members and the candidate starts, in order to determine terms and conditions of entry, the so-called commitments, as well as their date of implementation.

Phase 3: The third step is the completion of “accession package”. This is the formal documents summing up terms of accession within the “protocol of accession” and their schedule.

Phase 4: The last step consists in presenting the package to the WTO general council and a vote is organized. If two third of the members declare themselves in favor of integrating the candidate nation, the latter will be authorized to join the WTO.

*Source: WTO website*

([http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org3_e.htm); consulted 26.03.2011)

### **Appendix 3: The Transaction Cost Approach (TCA)**

Transaction Cost approach was founded by Coase in 1937, in order to explain the supplementary costs emerging when firms decide to internationalize. The basic assumption of this model is that perfect competition does not exist on the markets. That is why when a seller and a buyer (here an export intermediary) conclude a business, there will inevitably be some “frictions” between them, leading to the so-called transaction costs. These frictions appear because of the opportunistic behaviors emerging from each party, including misleading, confused or distorted information.

In order to avoid such situation and limit opportunistic hazards, the parties will employ governance structures. The most common being the contract which specifies the obligations of each party as well as define a third party, in charge of sanctioning the incongruous acts from the buyer or the seller.

Actually, the transaction cost approach tends to analyze the way cost minimization willingness from the expanding company will influence its structural decisions. Basically, there are two groups of costs:

- Ex-ante costs

These costs include the search costs which are necessary to identify and assess potential export intermediaries. Generally speaking, the more distant and unfamiliar is the market, the higher are the costs. This is due to do the difficulty of gathering reliable information in furthest territories. In addition

come the contracting costs, which emerge during the negotiating process required to reach an agreement.

- Ex-post costs

These are the sum of monitoring costs and enforcement costs. The former refer to the costs required to ensure that both buyer and seller fulfill their obligations. The latter emerge when it is necessary to appeal to the court because one of the trading partners did not perform in an acceptable way.

The assumption is made that the primary objective of firms going international is cost minimizing, that is why they will choose the cheapest solution between externalization and internalization. Both of them implies intermediaries, respectively exports agents and sales subsidiaries. However, the TCA emphasizes the fact that firms will tend to internalize, that is to say vertically integrate their activities, if the “friction” with an external agent is too high.

*Source: Hollensen S, 2004, Global marketing, a decision-oriented approach, third edition, Pearson education limited, page 57-59*

#### **Appendix 4: The Uppsala model**

This Uppsala model was developed in the 1970s by Swedish researchers from the University of Uppsala. By observing the way Swedish Firm established abroad, they suggested that internationalization is a sequential process characterized by a progressive level of commitment in foreign markets.

The main idea of this theory is that companies will tend to prefer entering overseas market by first engaging exports operations, in order to gather knowledge about the new market by limiting financial exposure and risks. Subsequently, enterprises will increase their degree of involvement on the foreign market and begin Greenfield investments in order to own their production or retail entities on the host territory.



Johanson and Wiedersheim-Paul (1975), two leaders of the Uppsala school divided the internationalization process of enterprises into four different stages:

*Stage 1:* No regular export activity

*Stage 2:* Export via independent representatives

*Stage 3:* Establishment of a foreign sales subsidiary

*Stage 4:* Foreign production through foreign established manufacturing units

In addition, the Uppsala model emphasizes two features without them it would be impossible to expand internationally. First, general knowledge based on the resources of the enterprises as well as its operational activities. This type of competencies can be transferred from one country to another, and thus facilitate the internationalization process. Then, the second type is market specific knowledge, assumed to be gained through the firm's international experiences. As a consequence, it is reported that firms with large resources are willing to take larger internationalization initiatives right from the beginning. Second, once companies have gained a lot of experience, it is said to be that they are able to copy their strategy in any market.

Finally, the Uppsala model integrates a geographical dimension by demonstrating that organizations will tend to first establish in countries with a rather similar economic, social and political environment. As a consequence, they will avoid being directly confronted with the "psychic distance" which can be considered as a barrier of entry. Indeed it can affect the flow of information between firms and the market and conduct to internationalization operation failure. Actually, the Uppsala model recommends enterprises to go first in markets they can easily understand.

*Source: Hollensen S, 2004, Global marketing, a decision-oriented approach, third edition, Pearson education limited, page 51-54*

## Appendix 5: Top 15 leading global retailers in 2009

Rank	Brand	Nationality	Brand value, million USD
1	Walmart	USA	41 083
2	Tesco	United Kingdom	22 938
3	Amazon.com	USA	21 294
4	Carrefour	France	14 961
5	E-bay	USA	12 970
6	Target	USA	12 254
7	Auchan	France	10 586
8	The home depot	USA	9 280
9	Aldi	Germany	8 638
10	Ikea	Sweden	6 713
11	Lowe's	USA	6 394
12	Marks and Spencer	United Kingdom	6 029
13	Asda	United Kingdom	5 413
14	Costco wholesale	USA	5 225
15	Best buy	USA	4 929

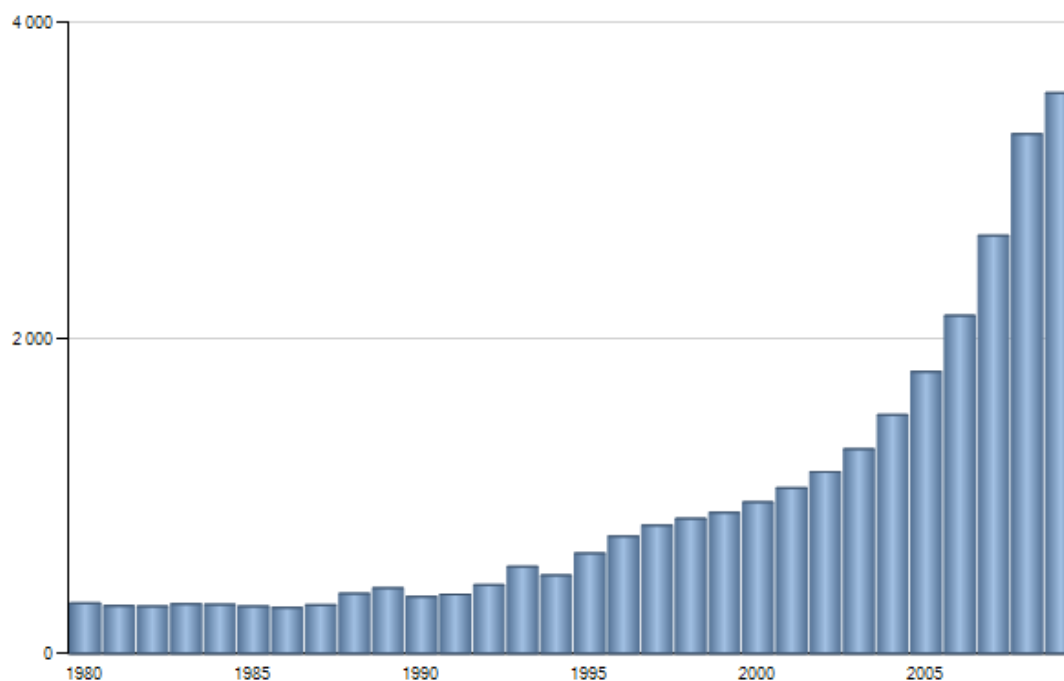
*Source: Kantar Retail, 2009*

## Appendix 6: Economic inequalities

	Share of country's GDP	Nominal GDP / capita in USD 2009	Share of country's area	Share of country's population 2009
East (11 provinces)	58%	5, 868	11%	40%
Center (8 provinces)	24%	2,978	18%	32%
West (12 provinces)	18%	2,658	71%	28%

Source: Table elaborated from data gathered by Marianera (2010)  
<http://www.bancaditalia.it/studiricerche/convegni/atti/chinese-economy/sessione2/marianera/Marianera%5B1%5D.pdf>, consulted 14.04.2011

## Appendix 7: GDP per capita in China, in current USD and current exchange rate



Source: UNCTAD statistic data base

## **Appendix 8: Intellectual property rights legislation in China**

On an international perspective, China has ratified numerous treaties, under the Control of WIPO. The complete list can be consulted on the organization's website:

[http://www.wipo.int/treaties/en/ShowResults.jsp?search\\_what=C&country\\_id=38C](http://www.wipo.int/treaties/en/ShowResults.jsp?search_what=C&country_id=38C)

Regarding the three main Chinese domestic laws, it is possible to consult the official texts online:

Patent law from 2000

<http://www.chinaiprlaw.com/english/laws/laws4.htm>

Trademark law from 2001

<http://www.chinaiprlaw.com/english/laws/laws11.htm>

Copyright law from 2001

<http://www.chinaiprlaw.com/english/laws/laws10.htm>