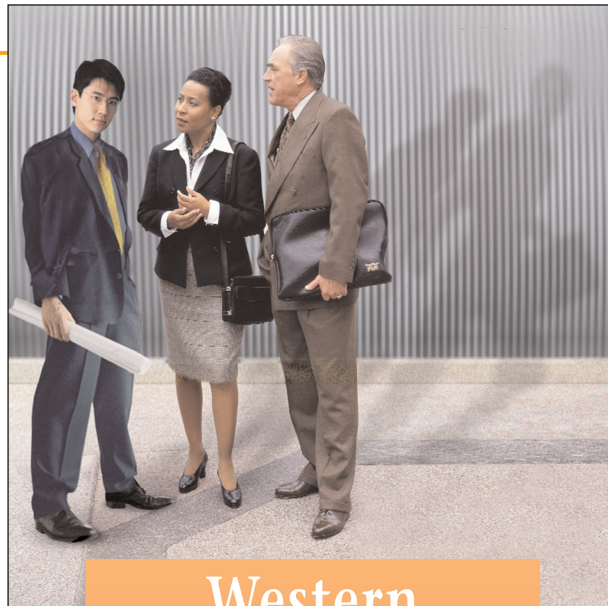
The Need to Manage Business Risk in an Evolving China



China is one of the world's great enigmas; this ancient civilization holds title to being the world's most rapidly growing capitalist economy, at the same time it is the last bastion of Communist dictatorship. The enormity of this contradiction has not in any way inhibited Western business in the pursuit of Chinese investment opportunities. American business has led the stampede to place global production in this awakening Asian giant. However, this fascination with China is not simply an American preoccupation, more than 1,500 German companies have operations in China at present. Total foreign investment in China is over US$400 billion. China exports to the outside world were more than US$509 billion last year, with GDP growth in China averaging 8.3% over the past 5 years.

Western companies looking to expand their Chinese involvement would do well to understand and manage their political risks.

What effect is all this having at home? It is clear that many US-based manufacturers, despite employing some of the world's highest levels of productivity, continue to lose market share and an erosion of their technological advantage to emerging markets, specifically China. The trade numbers are staggering. The U.S. trade deficit with China in the year 2000 ballooned past the $80 billion mark and continues to rise. To put it in simple terms: for every dollar of goods the United States sends to China, they export back six dollars worth. What is significant in this trade is the fact that it's not simply inexpensive textiles and toys that are being exported from China, the two largest categories of products imported from China into the United States are electronics and machinery. It is perhaps no coincidence that since July of 2000 the United States economy has lost over 675,000 manufacturing jobs. Indeed much of the trade deficit the United States is experiencing is a result of U.S. goods to the home market from their production base in China.

It is ironic that the United States maintains a trade embargo on Communist Cuba, a nation with little power or influence, while encouraging the integration of Communist China into the global economy. The reasons for this seemingly contradictory position may be seen to lie in a particular world-view that prevailed after President Nixon's historic visit to China in the 1970's. At the time, engagement with China was considered desirable in that a geopolitical alignment between the two powers would act as a foil against the Soviet expansion. Secretly, the United States hoped that engagement would slowly open the Chinese to Western ways, norms and values. The optimistic view was that as the Chinese private sector became more of a factor in the politics of China, the pragmatic leadership would steer the country towards democracy.

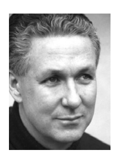
Today a more sinister interpretation is being applied to Chinese motives. Many now believe that China's communist leaders are simply exploiting their own peasant population in an attempt to capture a preponderance of Western industrial production, reduce their present technological disadvantage and expand their already considerable military power at the expense of the United States. Consider the most recent report from the U.S.-China Security Review Commission, which demonstrates a deep and growing skepticism of China's attempts to open to the West and warns of the dangers posed to the U.S. of the present trade relationship. According to the Final Report, "the United States is underestimating the threat to its security, jobs and technological competitiveness caused by exploding trade and financial relations with China." Chillingly, the authors point the finger at U.S. business. *"The rush of multinationals to China is aggravating the US trade imbalance."* In closing, Richard D'Amato, Chairman of the Commission, delivered a stunning broadside to American businesses in China when he said: *"This kind of behavior (investment in China) is not trade; this is global manipulation by companies for their own bottom line."* Business leaders may be forgiven for thinking that improving their company's bottom line was their job, not something to be considered Un-American.

Despite the accent of pragmatists such as Jiang Zemin and his heir apparent Hu Jintao to the leadership of the Communist Party of China (CPC), **there are considerable political and commercial risks to U.S. companies making direct investments in Communist China. Even if we accept that the country is opening to Western values and norms, there is no doubt that China is entering a period of uncertainty – which is to say increased investment risk.** While it is clear that there is a growing middle class in China and this group has substantial asset wealth developed with the encouragement of the Communist government, it is also true that these assets are at risk, daily. The guiding ideology of the CPC is Marxism-Leninism and Mao Zedong Thought. Their stated goal is the establishment of a communist social system—not exactly a ringing endorsement for free market capitalism.

Only when the property-owning classes in China, as a group, have direct and legitimate involvement in the political process can property owners – including foreign investors - enjoy normal western standards of asset security. Let us not forget the historical lesson that political power is the ultimate ownership. This reality is one of the reasons why democracy and capitalism have evolved together so closely in Western history. When and if China democratizes its political system, there will almost certainly be a violent period of change; for the transition from despotism to democracy is almost always resisted by the powers that be. Throughout its 5000-year history there is no precedent

for dismantling monolithic political power in China without accompanying risk to private property and investment.

On the other hand, if, as many in the present U.S. administration feel, China has sinister motives and is manipulating the global economy for political and military advantage, the situation for U.S. business is even more precarious. For it is very likely that China's military, once it is modernized, will become regionally aggressive putting it in direct conflict with US interests. Should such a situation come about, business would be truly caught in the middle, facing increased hostility in China, with the increased likelihood of asset expropriation, with subsequent loss of markets and technological secrets to China. Western companies looking to expand their Chinese involvement would do well to understand and manage their political risks, identify the signs of risk and develop strategies to respond to them. Much like governments have disaster preparedness planning in place, savvy Western business interests in China will want to take steps to protect their physical and intellectual assets and assess their level of risk tolerance.



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