INDIA, CHINA AND AMERICA INSTITUTE
1549 CLAIRMONT ROAD, SUITE 202 ● DECATUR, GA 30033 USA
WWW.ICAINSTITUTE.ORG

Doing business in China: A risk analysis

Karthik Jayaraman

Journal of Emerging Knowledge on Emerging Markets
Volume 1 Issue 1
November 2009

Doing business in China: A risk analysis

Karthik Jayaraman
Fudan University &
The Norwegian School of Management

Journal of Emerging Knowledge on Emerging Markets
Volume 1 Issue 1
November 2009

Challenges faced by a Western company that wishes to outsource production to China

China is considered the factory of the world, China accounted for 13.2% of all the manufacturing in the world and is set to overtake USA as the number one destination for manufacturing [2]. China offers access to low cost raw materials and cheap labor, which is attractive to western manufacturing companies [20]. Outsourcing to china by western companies can be either through contract manufacturers or wholly owned subsidiaries [1] of parent western firms. Western companies face various challenges to outsource their production to China. The World Bank publishes an annual report on countries favorable for doing business and China ranks poorly at 83 among over 160 countries listed [3].

Political Challenges

China has been under the communist party rule for many decades. The communist party exercises absolute power over legislations and economic & cultural institutions. Unlike western economies where the government promotes transparency for doing business; in China rules and regulations are not so transparent or absolute. Large manufacturing businesses can come under various regulations and bureaucracies, China promotes a form of social network called *guanxiwang*, where *guanxi* [10] is the relationship between the individual and the entities of the network. Due to lack of transparency and corruption the

https://digitalcommons.kennesaw.edu/jekem/vol1/iss1/7
DOI: 10.7885/1946-651X.1006

guanxiwang or the social network with people from the communist party can help western businesses avoid red tape and bureaucracy.

Unlike in the west, where building relationships has less importance due to the strict laws and a culture that supports contractual obligations, in China, one relies on one's *guanxiwang*, Without *guanxi* a westerner entering China is like entering an abyss, which is also exemplified by the famous Chinese saying "*turning at the temple door without a pigs head*" [5]. Understanding *guanxi* is a challenging process for a westerner and building a *guanxiwang* is often a time consuming process, so it is prudent for a western company to recruit the right people with the appropriate *guanxiwang* to overcome these challenges.

Legal Challenges

Strict laws and patents in economies of the west protect domestic and foreign businesses, whereas in China, the legal system is loosely defined, giving rise to various loopholes in the law. China's accession to the WTO has brought with it the inclusion of international business laws and patent rights amendments, but even today it is common to see technology being stolen either by the employees of the outsourced firm in China or by a Chinese competitor in the country.

"Shanzhai" or the copycat culture is an integral part of the Chinese society; the society is predominantly Confucian and the Confucian tradition promotes individuals sharing what they create with the society to promote greater harmony. Hence anything from shoes to cell phones are copied and sold openly in markets across the country. China today is the world's largest producer of counterfeit products [5]. The wordings of the Chinese laws are often vague and can be interpreted in many ways. Laws on trade, intellectual property rights, labor and taxation are often refined which leads to complexity in interpretation of the laws. This also leaves room for manipulating the law further by the local lawyers against western businesses [6]. Even though there are stated laws against IP infringement in the Chinese Law, certain provincial governments can block these laws.

The Chinese look at the market place as a battlefield, this is exemplified by the popular Chinese saying "*shang chang ru zhan chang"*. Chinese competitors compete aggressively against western businesses and are known to apply strategies from the "*Bing Fa*" or the *art of war* [7]. The confusion ideology promotes the "rule of man" over the "rule of law" and hence some of these patent violators, especially the ones from the drug industry see copying and patent violations as part of the greater good for the Country as they copy western drugs and sell them at affordable prices to the Chinese people. Hence western companies that plan to outsource manufacturing to China should be aware of these legal challenges. One way of preventing these issues is to have a strong *guanxi* with the locals or to make sure that sensitive technology is not outsourced to China.

Cultural Challenges

China has evidenced thousands of years of history, culture and traditions. The way Chinese people behave today is the result of its historical transformations, which is very different from the transformations witnessed by western societies. Hence the modern day Chinese culture is very different from the cultures of the west. The cultural aspects of the Chinese are immensely reflected in the business world, for example, A CEO in the western world is normally looked upon as a consensus builder or as an individual who debates and discusses strategies with their employees and then executes the strategy, whereas in China the leader is looked upon as the sole decider and executor of strategies. There is a strict hierarchy in the Chinese business culture, which is very different from the business culture of some of the west countries.

Mianzi or the Face culture is an integral part of doing business in China, face is everything for the Chinese people, which also helps them maintain their *guanxiwang*. So making a Chinese employee look bad in front of others would have hidden consequences beyond what was intended. *Mianzi* has three main components, which are "giving face", "saving face" and "losing face", these are integral parts of the Chinese culture and hence western businessmen are expected to build a form of cultural sensitivity to handle *Mianzi* or the face culture in China, when they plan to outsource their production.

Junzi refers to the person of character, the Chinese value people with good character and strong moral values, hence western managers losing integrity in front of their Chinese counterparts either by showing anger, grief or aggression is considered weak or unacceptable in China. So to run a successful wholly owned outsourcing unit in China, the western businessmen need to understand and overcome these cultural challenges.

Challenges in Negotiations with the Chinese

Negotiating with the Chinese for outsourcing contracts often involves a *Zhongjian Ren* or intermediary as western business men are often looked upon as outsiders and the Chinese tend to trust each other more during negotiations, which is different from the west.
The Chinese are very formal, *Shehui Dengji* (Social Status) plays a very important role when it comes to the way people are addressed. Unlike in the west where businessmen often call each other with first names, in China business men or women are often addressed formally with their titles [9].

Chinese are very indirect when it comes to refusing an outsourcing deal, it is impossible to expect a straight yes or no answer from the Chinese unlike in the west. Terms such as *"koalu kaolu"*(we will think about it) *or yanijiu yixia* ("we have to study the case somewhat more") and *keneng (*maybe) almost always means refusal or disagreement. This is very different from western businesses where negotiations are often direct [9].

In business relationships, the Chinese seek stability, trust and harmony (*hexie / hemu*), unlike in western negotiations where a complex discussion is broken into multiple parts and negotiated separately and conclusions arrived quickly, Chinese meetings are usually long meetings otherwise called *kaihui* (Endless meetings), the Chinese like to discuss the whole picture instead of separate parts. The Chinese like to build consensus or *Zhengti Guannian* (Holistic Thinking) unlike their western counterparts who are often very individualistic in

https://digitalcommons.kennesaw.edu/jekem/vol1/iss1/7
DOI: 10.7885/1946-651X.1006

their thinking during a negotiation process. This fundamental difference in the way of negotiations could be a challenge to both the Chinese and the westerners.

Challenges related to Quality

Over the last few years China has been in the news for all the wrong reasons related to quality. Some of the recent scams were the Sanlu milk powder scam [11] and the children's toy scam, where the toys were painted with cheap but harmful lead based paint [12]. Quality has been a major concern for western outsourcers to China. Popularly called the "*quality fade*", Chinese manufacturers deliberately and secretly increase profit margins by compromising on quality over many runs of manufacturing thus putting western outsourcers to risk. In the west manufacturing is done with high quality and to the specification of the contract, which is very different from China, So western outsourcers have to be very careful with quality checks when it comes to outsourced products from China and should have clearly defined outsourcing contracts.

Challenges faced by a Western company that wishes to sell its products in the Chinese market

China has the world's largest population and is among the top three economies of the world in terms of GDP. With a large population, China offers tremendous opportunities for western businesses to sell their products to Chinese consumers. A lot of successful western businesses have failed in China over the past few decades [21]. The following discussions look at the various challenges faced by western companies who want to sell their product in the Chinese market.

Challenges in Scale and Demographics

China is a vast country with a massive population, Western businesses are often at awe about China and think that the 1.3 billion people could become a large customer base, but in reality China is a complex market. 850 million people in China live in the impoverished countryside; their life is harsh, uncertain and poor [5]. 536 million people live in the urban areas out of which 247 million people are considered middle class and have an expendable income. The middle class earns over $5000 per head over the period of an year [22] but one must also consider the fact that the Chinese are the largest savers in the world unlike some western countries such as the US where the consumers have massive spending power and a culture that promotes spending.

China is a massive landmass of about 3.7 million square miles and is as big as the European continent. The Chinese market varies from region to region; costal areas around Shanghai, Guangdong and Dalian are advanced and possess good infrastructure and transport facilities, whereas other interior regions are under developed. About 250 million people live in China's urban areas or the 88 cities with population greater than 750,000; the culture and spending power of the people in the coastal region, tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzen) , tier 2 cities (the next 24 biggest cities) and tier 3 cities (the other small cities) are very different from one another. Hence for a western company to succeed they need to understand these Demographic differences.

Challenges related to market behavior

The Chinese market is unique in many aspects, many western companies have tried to sell their product as-is in the Chinese market and failed miserably, these are not some small unknown brands but large mega brands that have been successful for many decades and different markets. To be recognized as a brand in China, one needs to market and advertise the Chinese way [4], marketing and branding in China should carry a strong Chinese cultural overtone to be successful in the mainland.

Successful western companies such as Google and eBay have failed to become market leaders in China [13]. The lesson learnt from the failure of these companies is that they *"did not understand the localization factor"*, Google and e-bay initially did not localize their product to meet the specific needs of the Chinese market; local Chinese players such as Baidu and alibaba.com understood the Chinese consumer needs and quickly capitalized on the *"demands for localization"*. Local Chinese companies have had tremendous success despite being the underdog due to localization [14].

The Chinese market is one of the largest and most heavily competed markets in the world. Chinese competitors have the tendency to compete head on with global players on price and win over the market. Hence western companies that think they could demand a high premium on their product in China would be in for a big surprise, a way to combat this threat is to have a low cost lean operation in China and compete on a reasonable price level against the Chinese competitors. A lot of western companies make the mistake of taking old products or technology into China, thinking of it as an underdeveloped third world country. But the fact of the matter is: China has new western players entering the market frequently with the latest technologies. Chinese companies visit Europe and US at regular intervals scooping for latest technological advances. Hence if a western company enters China with an old technology thinking that the Chinese customers would not notice, the western company would be at a huge disadvantage. Therefore for the long run, western companies should *"Think Chinese but act western"* and sell the right product at the right price to be successful in the Chinese market.

Economic instability & Trade policy Challenges

China is the world's second largest economy [15] and is among the fastest growing economies of the world. When western companies move to China they have to consider the economic stability of the country and prepare themselves for the various risks due to changes in fiscal policy, monetary policy, trade policy and other macro economic factors. China's economy is mostly dependent on exports from the manufacturing industry [16] and hence China has tried to maintain a steady peg of the Yuan against the US dollar [19]. Foreign economists suggest that the Yuan is undervalued by as much as 40% [6]. Hence a change in the Yuan can impact the profitability of the western business operating in China. Due to high economic growth there has been a strong demand for semi and highly skilled labor all over China. The labor costs have steadily increased over the last 5 years and the government has increased the minimum wage level. This will impact operating costs in

https://digitalcommons.kennesaw.edu/jekem/vol1/iss1/7
DOI: 10.7885/1946-651X.1006

China and hence a western company planning to operate in China will have to factor in this risk.

China joined the WTO in 2001 and since then has had various laws and legislations that have improved the trade and investment scene in the country [17]. In China over 150 laws govern the flow of trade and investments in the country. Some of these laws can be confusing and ambiguous. The local policies favor local players, the banks in China lend out large sums of money to local businesses and would make sure that these local businesses succeeded, hence local laws and regulations are made ambiguous and complicated to make local Chinese players succeed in the market. The fiscal policy promotes taxation in various forms; local governments go to the extent of waiving taxes and reducing duty within their legal control to promote local firms, which can be used as a cost advantage by the local players to wage a price war against western enterprises. China offers special economic zones to promote FDI in the country, these SEZ's offer various freedoms in the way of subsidies [17] to western enterprises but most of these are located in the costal areas and the scene is quite different in the western and interior regions in China. In summary western enterprises need to be aware of macro economic risks before they start their operations in China or face the possibility of failure.

Some of the most important differences and similarities in the above mentioned scenarios

More than any other market in the world, western businesses needs to understand the culture of the Chinese if they choose to either sell their products in the Chinese market or outsource their production to China. The concept of *Guanxi* (relationships) is like insurance for western businesses to be successful in China if they choose to sell products. China is a country based on connections; when it comes to outsourcing, if the contract obligations are not met by the Chinese company, a western business owner can use his or her *Guanxiwang* (Social network) to resolve the dispute. So understanding *guanxiwang* and successfully implementing *guanxi* is key to doing business in or with China. The level of *guanxi* will vary if one plans to outsource or sell products in China, one would need a larger *guanxiwang* if one plans to sell a product in China and this would be much smaller if a western business wants to outsource its production to China.

Understanding *Mianzi* is again crucial to run a company and sell products in China, a western business person cannot lose face or make their Chinese employees lose face in front of others, to sell products and run a large outsourcing operation western businesses should understand the concepts of giving face, losing face and saving face [23]. This might not apply to a great extent if a western company wants to just outsource production to a Chinese firm, especially if there would be no direct involvement of western businesspersons running or managing the day-to-day outsourcing operations in China. If a western company wants to sell its products in China, it needs to have a local Chinese manager or senior executive who would run and manage the business which might not be the case if western firms want to outsource their production to local Chinese firm.

In conclusion as stated in the art of war "*Know the enemy and know yourself; in a hundred battles you will never peril*", western business persons should have a strong understanding of China's history, culture, demographics, political and economic situation, if they want to sell their products in the Chinese markets but relatively less if they plan to outsource their production to a local Chinese firm.

References

1) http://su.diva-portal.org/smash/get/diva2:196203/FULLTEXT01

2)http://www.newser.com/story/34652/china-set-to-surpass-us-as-largest-manufacturer.html

3) http://www.doingbusiness.org/ExploreEconomies/?economyid=42

4) How to do business in china by Michale Shen, ISBN: 0805964436

5) Myths about doing business in China by Harold Chee with Chris West, ISBN: 140394458X

6) Doing business in China : Accessing the Chinese business environment for Norwegian enterprises - Masters Thesis at BI - GRA 69971, Hedvig Grande Estensen, 2007

7) The Art of War for Executives: Ancient Knowledge for Today's Business Professional by Donald G. Krause, ISBN: 0399534105

8) http://hbswk.hbs.edu/archive/3714.html

9) Doing business in the new China by Birgit Zinzius, ISBN: 0313361584

10) Doing business in China: The importance of networks and relationships, A case study of Norwegian firms in Shanghai - Masters Thesis at BI - Karen Marie Vasli and Marie Skogholt Hansen.

11) http://www.chinadaily.com.cn/china/2009-03/21/content_7602649.htm

12) http://www.consumeraffairs.com/news04/2007/06/china_senate02.html

13) http://digitalwatch.ogilvy.com.cn/en/?p=118

14)http://www.businessweek.com/the_thread/techbeat/archives/2006/12/ebays_china_cha.html

15) http://www.economywatch.com/economies-in-top/

16) CHINDIA Rising by Dr. Jagdish N Seth, ISBN: 0070657084

17) Emerging markets century by Antoine Van Agtmael , ISBN: 0743294572

18) One billion customers by James McGregor, ISBN: 074325841X

19) China's Revival by Dr. Arne Jon Isachsen (working paper series) : http://home.bi.no/fag87025/pdf/wp%201.09.pdf

https://digitalcommons.kennesaw.edu/jekem/vol1/iss1/7
DOI: 10.7885/1946-651X.1006

20) Drivers of Success for Market Entry into China and India by
Joseph Johnson & Gerard J. Tellis : http://www-rcf.usc.edu/~tellis/ChinaIndia.pdf

21) http://www.web2asia.com/2008/09/25/lessons-learned-the-roadmap-into-chinese-e-commerce-for-western-companies-lessons-learned-on-e-business-in-china

22) http://www.wikinvest.com/concept/Rise_of_China%27s_Middle_Class

23) http://www.hrworld.com/features/trendwatcher-working-china-081508/