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Selling China: Looking Back and Looking Forward

Paul W. Beamish and Andrew Delios[1]

Richard Ivey School of Business, University of Western Ontario, Canada and [1]*Department of Business Policy, National University of Singapore, Singapore*

One of the objectives of Yasheng Huang's book *Selling China: Foreign Direct Investment in the Reform Era* is 'to gain a better understanding of the operations of the Chinese economy in the 1990s as well as its FDI patterns' (p. 69). We have no disagreement with Huang's general argument that for much of the 1990s domestic Chinese firms were less competitive than they would have been if the Chinese government had not favoured state-owned enterprises (SOEs).

Similarly, while acknowledging the positive impact of FDI on China's development, Huang has real concern with FDI's disproportionately large role in the economy. He further feels that 'some of China's FDI patterns may reflect institutional inefficiencies and weaknesses' (p. 67). Again, we have no real disagreement that this was the case in the 1990s.

What we do wonder is what is next for China? Expressed another way, can we expect the 1990s relationship between SOEs, FDI, and China's private sector that was laid out by Huang to remain constant in the second half of the 2000s? We think not.

The reality of writing anything about China is that within a few years, reality changes. Some of the early post open-door articles, and observations about doing business in China bear little resemblance to the Chinese economy of today. See Beamish (1984) for an example. In the past 25 years, China's economy has arguably developed as far and as fast as any major economy in history. And the pace of change does not seem to be slowing. Thus we will argue that the relative share of China's economy held by SOEs, foreign enterprises, and private firms in the 1990s is becoming quite different, only a decade later. In support of this argument and given space constraints, we make five points.

DATA

One of Huang's major data sources was as of 1995: Office of Third Industrial Census (1997). At the time, this was the most complete data source available.

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China's National Bureau of Statistics now conducts annual industrial censuses, and the more recent data in these suggests major changes have been occurring over the decade since the 1995 data were published.

SOE SHARE

SOE share of employment in China has declined dramatically, although the aggregate output of SOEs has not. The government has in recent years sold tens of thousands of (especially) smaller and medium-sized SOEs, and placed priority on about 500 of the larger ones. These larger ones have been undergoing rapid modernization, and many have grown to be competitive on a worldwide scale (Zeng and Williamson, 2003). SOEs employed 240 million people in China in 1999, compared to 436 million in 1994. Employment in SOEs has fallen further since 1999.

A number of China's SOEs are now on the Fortune Global 500 list, and some are now even being permitted to seek out major foreign acquisitions. In late 2004, the Canadian media ran daily stories about one of China's ten largest SOEs, Minmetals, which was in advanced discussions to acquire the Canadian mining grant, Noranda, for US$5.5 billion. During the same period, the Lenovo acquisition of a portion of IBM's business in China was announced. These recent developments, while anecdotal, do not suggest that the 'ideological discrimination' (p. 331) against its own indigenous firms is as much of an issue now in China as it might have been in the 1990s.

PRIVATE SECTOR

Since the late 1990s, reform of the ownership of SOEs has received increased attention from the Chinese government. These reforms began in the early 1990s when the Shenzhen and Shanghai stock exchanges were created. Since the first fourteen firms were listed in 1991, the number of listed companies in China had grown to exceed 1,100 by 2003. Along with this growth in the number of listed companies has come a change in ownership, in which formerly state-owned companies have had their shares transferred into the hands of private interests such as legal person shareholders (which comprises both state-owned firms and private firms), A shares, B shares, H shares, and employee shares. Not all shares are tradable, but the key idea is that companies that were formerly 100% state-owned, were on average just 33% state-owned by 2001, and this proportion of state ownership in China's listed companies continues to decline annually (Delios and Wu, 2005). In 1994, state shareholders held 45% of all shares of all listed firms in China. By 2001, this percentage was 33%.

Although some firms have remained completely controlled by the central government, many others have experienced a major change in their ownership. These 'new' ownership structures include Western-style shareholding companies in which

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private ownership is now possible, and fully privatized SOEs. Other types of 'new' ownership include (A) limited liability firms, which while still owned by the state, have more autonomy but a greater risk of being abandoned if they lose money, and (B) firms where employees hold a portion of the equity.

What is important to appreciate is that the number and proportion of firms in each category is not constant. As some firms succeed, some are now allowed to become publicly traded. As some experience financial losses, some now go out of business. There is of course no 'pure' market economy in place in China, so the local private sector has not grown as rapidly as it might. What is clear, however, is that the private sector's share of industrial output is growing.

FOREIGN FIRMS

The private sector's share is also enhanced by the participation of foreign firms in China's domestic economy. Huang seeks to explain China's FDI dependency. Notwithstanding the 2003 and 2004 surge in FDI in China driven by the euro's rapid appreciation against the US dollar, and consequently the RMB, for a variety of reasons, we believe that the proportion of China's economy dominated by foreign firms will decline in the 2005–2010 period. Here we consider only two of them: the rise of a local managerial class, and lack of profitability.

THE RISE OF A LOCAL MANAGERIAL CLASS

Over the past twenty years, the number of MBA programmes in China has grown from 0 to 90. Coupled with the large number of undergraduates being trained in China and the increasing number of Chinese citizens educated in the West returning to China, there are now record numbers of people available to establish and manage businesses, many of whom have been trained in Western management practices. With the decision of the Chinese government to effectively exit from the SME side of the SOE business, plus the increased ease of establishing private firms, many of these newly trained graduates are looking for, and finding, entrepreneurial opportunities. They are not all seeking positions with foreign-invested enterprises, in part because the foreign firms are not able to meet their salary expectations. Why can the foreign firms not meet their salary expectations? Because they do not have the profits.

LACK OF PROFITABILITY

We evaluated the performance of thousands of companies in China using a massive database on Japanese investment. We looked at an indicator of the profitability of each individual subsidiary, which was available for about 33% of the Japanese subsidiaries established in China. This profitability report was made

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by the general manager of the subsidiary in response to a question in an annual survey conducted by Toyo Keizai. The manager identified whether the subsidiary had a loss in the year, whether it had break-even performance, or whether it made a profit in the year. Based on the responses to this question, we compared the performance of Japanese subsidiaries in China at five points in time between 1992 and 2001. The performance comparison was a simple but revealing one. We compared the mean number of subsidiaries reporting profitable performance by year, and across samples of subsidiaries established in China and in the rest of the world. The trends in performance show a clear downward decline in the reported profitability of Japanese subsidiaries in China, both on an absolute and on a comparative basis.

The absolute decline is shown in the decrease in the percentage of subsidiaries reported to have profitable performance. This percentage fell from more than 70% in 1992, to 62% in 1994; to between 51, 53, and 55% in respectively 1997, 1999, and 2001. Thus the percentage of subsidiaries in China that reported profitable performance went from greater than the worldwide average in the years of 1992 to 1994, to less than the worldwide average in the years 1997, 1999, and 2001.

We should add that this issue of reduced profitability of foreign investments in China is not a function of the fact that many of them are joint ventures. Huang cites a 1996 IFC discussion paper, Miller et al. (1996), which looked at 70 joint ventures in developing countries in support of the view that 'JVs tend to be unstable' (p. 315, footnote 5). Recent research by Delios and Beamish (2004), using a sample of 27,974 foreign subsidiaries, observed that joint ventures and wholly-owned subsidiaries have equal survival rates.

With foreign firms earning lower profitability in China relative to other countries in the world (Beamish and Jiang, 2002), there is reason to believe that many will eventually exit as investors, and replace their investments with contractual arrangements to provide the desired supply of low-cost manufactured products. Domestic firms in China would thereby replace foreign-owned firms in producing these products, for contractual exchange.

CONCLUSION

When reviewing the many excellent points in Yasheng Huang's analysis of foreign investment in China, in the 1990s, one cannot help but wonder whether senior government officials were somewhere privy to early drafts. With the advantage of hindsight in 2005, it is as if they had either independently come to many of the same conclusions, or read his analysis, agreed with many of his points, and started to move in the direction he has advocated: reduced favouritism towards SOEs and FDI, and an unshackling of the private sector. Either way, the dynamism of China's economy will continue to be the focus of important scholarly research such as Huang's for years to come.

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Paul W. Beamish (pbeamish@ivey.uwo.ca) is Director of the Asian Management Institute (ami@ivey.uwo.ca) and Canada Research Chair in International Business at the Richard Ivey School of Business, University of Western Ontario. Much of his research examines international joint ventures. He is also series editor for over 40 casebooks for the China market.

Andrew Delios (andrew@nus.edu.sg) is Associate Professor and Head of the Department of Business Policy at the National University of Singapore. His research examines the international strategy of Japanese firms, and the domestic growth strategies of China's listed companies. He has recently published two books – *International Business: An Asia Pacific Perspective* (Prentice-Hall) and *Strategic Management for Success in Asia* (Wiley).

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