

ARTICLES

CHINA'S DEVELOPING AUTO INDUSTRY: AN OPPORTUNITY FOR UNITED STATES INVESTMENT — AND CHALLENGE FOR CHINA'S NEW FOREIGN INVESTMENT LAWS

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1. PROFILE OF CHINA'S AUTO INDUSTRY AS AN INVESTMENT OPPORTUNITY

1.1 *Overview of the Market Potential*

The dawning of the "Age of the Pacific" caught many U.S. industries still napping, and the U.S. auto industry was among the most somnolent. The rapid ascension and now legendary success of Japanese auto manufacturers not only carved out a large share of the U.S. domestic market, but also virtually excluded U.S. automakers from exporting substantial numbers of vehicles to the growing Pacific Basin market.¹ Following closely on the heels of the Japanese producers are the "little tigers" of Asia, such as South Korea, which now has its own highly successful Hyundai automobiles invading the U.S. market.

One of the most recent related developments has been the extensive investment by capital-rich Japanese companies in the United States, including investment in the domestic U.S. auto industry.² Japanese companies in the United States now employ nearly 250,000 Americans, and it is estimated that they will employ more than one million in the next decade.³ The prospects for the U.S. automobile industry's

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¹ The declining value of the dollar, coupled with efforts of Japanese companies to redress the trade imbalance, may result in an increase of U.S. exports to the region in the near future. For example, GM anticipates exporting 4,000 cars to Japan in 1988, an increase from the 3,000 planned for 1987. Schlesinger, *GM to Expand Exports to Japan as Fuji Weighs Expansion of Planned U.S. Unit*, Wall St. J., Nov. 13, 1987, at 6, col. 5.

² See *id.* See also *Where the Jobs Are*, NEWSWEEK, Feb. 2, 1987, at 42.

³ *How to Win Over a Japanese Boss*, NEWSWEEK, Feb. 2, 1987, at 46-47. The most recent Japanese entry in the U.S. auto manufacturing market is Mazda. Among

domestic market continue to be grim.⁴ Chrysler Corporation would not allow public forecasting in 1987 out of fear that it would "spook the market."⁵ The October 1987 crash of the U.S. stock market left the industry facing even greater uncertainties. By the beginning of November, Chrysler announced that it would lay off 3,600 white-collar workers, nearly 10% of its managerial force.⁶ Recently, Chrysler announced that, due to slow sales, it would temporarily close its St. Louis assembly plant, the first such closure since 1983.⁷

General Motors, which has experienced production cuts for some time now, also sees no relief in sight. Even before the stock market crashed in October 1987, GM announced plans to produce 9.3% fewer cars in the fourth quarter of 1987 than it did in the same period in 1986. One of the significant locations for cuts was the New United Motor Manufacturing, Inc. plant in Fremont, California, the GM joint venture with Toyota Motor Corporation. The continued downturn in auto manufacturing also extends to the suppliers of the auto industry.⁸

As a result of economic downturns and declining domestic markets at home, many United States manufacturers, including those in the auto industry, have increasingly taken their manufacturing operations to foreign markets through joint ventures or other enterprises which allow them to set up production abroad.⁹ One of the largest potential markets is the People's Republic of China (China), where one quarter of the world's population resides.

When China first announced its open door policy almost ten years ago, U.S. investors eagerly pursued the China market, and many con-

the top ten Japanese employers in the United States are Nissan Motor Manufacturing Company (automobiles, trucks), Honda (motorcycles, automobiles), and Toyota (automobiles, trucks, vans). *Id.* The latest effort by U.S. automakers to win a share of the import car market is to have cars built in the United States by Japanese companies, but sold under domestic nameplates. Stertz, *Cars Made in U.S. by Japanese Are Unveiled by Ford, Chrysler*, *Asian Wall St. J.*, Feb. 18, 1988, at 2, col.5.

⁴ During 1987, GM announced 17 total or partial plant closings. Schlesinger, *GM Checks in Trade in a Tarnished Public Image*, *Asian Wall St. J.*, Jan. 5, 1988, at 1, col.3. See also Guiles, *U.S. Car Output is Set to Fall to Five-Year Low in First Period*, *Asian Wall St. J.*, Feb.5-6, 1988, at 8, col.5; Witcher, *Foreign Firms Lift Market Share Despite U.S. Auto Sales Decline*, *Asian Wall St. J.*, Jan. 11, 1988, at 5, col. 1.

⁵ *Automakers Are Skittish on Forecasts*, *Wall St. J.*, Nov. 4, 1987, at 6, col. 1.

⁶ At least some of the layoffs had been projected earlier because of the large numbers of managerial employees inherited by Chrysler's recent acquisition of American Motors Corporation. *Id.* at col. 2.

⁷ *Id.*

⁸ *Id.* at col. 1.

⁹ U.S. automakers have expressed increasing interest in communist countries, including the Soviet Union. In 1987, the Soviets initiated preliminary talks with the Ford Motor company regarding several proposed joint ventures. *Preliminary Ford Motor Co. - Soviet Talks could Lead to Possible New Joint Venture*, 4 INT'L TRADE REP. 1585 (Dec. 23, 1987).

sidered establishing manufacturing enterprises there to take advantage of the low cost of labor and presumed access to local consumers. Unfortunately, many of those investors were disappointed because they did not take into account some of the real practical problems, such as limited access to the domestic market and difficulties in the repatriation of capital. However, those that weathered the early economic storms to become established undoubtedly will have an enormous competitive advantage as the domestic market in China continues to open. Among those markets with great potential is China's auto and motor vehicle market, and related industries. The present availability of that market to U.S. investors is a direct result of one of the most profound national policy reversals in modern history.

The People's Republic of China was under the leadership of Mao Zedong, the charismatic leader of the Revolution, from the Republic's establishment in 1949 until Mao's death in 1976. During that period, Mao emphasized China's independence and self-reliance over dependence on foreign aid, trade, and technology. In many respects, China deliberately abstained from full-scale modernization under Mao in order to exclude the bourgeois influences of the West. Through the chaotic years of the Cultural Revolution (1966-1976), China's xenophobic tendencies furthered hostility to the United States and made investment in China unthinkable.

Following the death of Mao and the assumption of leadership by China's current leader, Deng Xiaoping, the nation underwent a rapid and complete policy reversal.¹⁰ Today, Western investment is not only permitted, but is eagerly welcomed by a Chinese leadership determined to modernize as quickly as possible with the assistance of Western technology and capital investment. During the past decade, China increasingly has made investment more attractive through a series of laws, regulations, and political and economic reforms. However, the investment environment still is marred by significant problems. Some of those problems will be addressed below, particularly as they relate to foreign investment in the auto industry.

When the People's Republic of China was established in 1949, the country had no automobile industry of any consequence. Early domestic production of vehicles in China was based principally on copies or adaptations of early Russian vehicles. Today, the auto industry¹¹ has

¹⁰ For a general overview of the reforms, see Lichtenstein, *Legal Implications of China's Economic Reforms*, 1 ICSID REV. -FOREIGN INVESTMENT L.J. 289 (1986).

¹¹ The term "auto industry," as used herein within the China context, embraces the entire range of domestic automobile and motor vehicle production, including not only passenger cars (a small part of China's current production), but also the wide

grown to employ approximately 1.4 million people and has fixed assets of 15 billion yuan (approximately \$4 billion U.S. dollars). However, it remains a backward industry that produces only about 400,000 vehicles of all types annually.¹² Consequently, China continues to be a nation of bicycles as it approaches its second decade of post-Mao modernization efforts.¹³ As a rapidly developing country, China has a large demand for automobiles, and both heavy and light duty trucks. Just as the growing auto industry fueled post-war national growth in the United States, a vibrant auto industry would greatly help China meet the challenge of its "four modernizations."¹⁴ Growth of the automobile industry also will fuel growth in such related industries as steel, rubber, electronics, glass, non-ferrous metals and synthetic materials. In its current state of underdevelopment, however, China's auto industry cannot meet the domestic demand of Chinese users and foreign investment enterprises. Thus, state enterprises must spend large amounts of foreign exchange importing cars, trucks and heavy duty vehicles to meet the shortfall.¹⁵

It is estimated that China only has about 270,000 cars and 230,000 jeeps, used principally in business and trade. With a ratio of only 1 car per 4,000 people, China is among those nations with the lowest auto per capita ratio in the world.¹⁶ In order to meet even modest demands for cars, jeeps, trucks and other vehicles since 1949, China has imported more than one million motor vehicles, costing more than 30 billion yuan.¹⁷ In contrast to large expenditures of foreign exchange to import various kinds of motor vehicles, China invested relatively lit-

range of commercial motor vehicles such as vans, mini-vans, and both light and heavy-duty trucks.

¹² Xu, *Reforms to Decrease Automobile Imports*, China Daily, June 26, 1987, at 1, col. 1.

¹³ There are 416 cars for every 1,000 West Germans, 227 per 1,000 Japanese, 553 per 1,000 Americans, and only one car to every 4,000 people in China. *How China Boosts Her Car Industry*, China Daily, July 3, 1987, at 4, col. 1. The extensive use of bicycles in China, for both personal and commercial purposes, is chronicled in Lu, *China's "Bicycle Explosion"*, TRAFFIC AND TRANSPORTATION IN CHINA 5-13 (What's New in China, No. 14, 1986).

¹⁴ The "four modernizations" are agriculture, industry, science-technology, and national defense.

¹⁵ *How China Boosts Her Car Industry*, *supra* note 13.

¹⁶ *Id.* Ethiopia reportedly has 1.3 cars per 1,000 people, and India (with a national income close to China's) has 2 cars per 1,000. *Id.*

¹⁷ Zhang, *Struggling Truck Industry Revamped*, China Daily, June 21, 1987, at 1, col. 6. In 1985 alone, China imported 356,000 cars at a cost of 10 billion yuan (approximately U.S.\$3 billion). During 1981-85, China imported 100,000 cars at a cost of 960 million yuan. *China Plans to Build More Cars*, China Daily, June 25, 1987, at 1, col. 6.

tle capital in its own domestic motor vehicle industry.¹⁸

Not everyone among China's leadership agrees that China should develop a motorized culture similar to that of the West. However, it is clear that significant expansion of the motor vehicle industry is a vital ingredient in China's national growth. Wang Zhangyi, Vice-Minister of Communication, recently stated that "[t]he development of the transportation industry is one of the crucial keys to the prosperity of our economy."¹⁹

The prospective demand for vehicles is impressive.²⁰ It is estimated that the demand for cars alone will grow to 4 million by the end of this century. A recent research report estimated that the total number of motor vehicles of all types needed by the year 2000 may reach 15 million.²¹ Of the total 3.4 million motor vehicles on China's roads today, an estimated one-fifth are outdated by Chinese standards. The Government reportedly plans to replace old vehicles at the rate of 100,000 to 150,000 per year until 1990.²² A Sino-Japanese study in 1987 predicted that by the turn of the century, China will have between 3.8 and 4.6 million cars, averaging 3.1 to 3.8 cars per 1000 individuals.²³ The achievement of such a goal can be realized only through a major and sustained commitment of China's resources. A market survey estimated that by the year 2000, China will need 2 to 2.5 million cars for official and business use, 1 to 1.5 million private cars, 800,000 buses, and 7.7 to 8.2 million trucks. Altogether, this means the country will need about 13 million motor vehicles, more than four times the 1985 figure.²⁴

Most of the future needs-predictions are based on the nation's business, collective enterprise and governmental needs for motor vehicles. Private individual ownership of cars is rare, but not unheard of.²⁵ The

¹⁸ *Struggling Truck Industry Revamped*, *supra* note 17. From 1952 to 1982, for example, total investment was only about 6.46 billion yuan. By comparison, Japan invested more than 100 times as much in its own automotive industry during the 1965-1974 decade alone. *Id.*

¹⁹ Hu, *Auto Industry Picking Up Speed*, China Daily, June 23, 1987, at 4, col. 4.

²⁰ Currently, the major users of cars and light trucks are state enterprises, collectives, taxi services, tourism enterprises, foreign investment enterprises and small businesses. The principal "users of heavy trucks are the ministries of Petroleum Industry, Forestry, Commerce, Geology and Mineral Resources, Communications, Railways, and the armed forces." *Struggling Truck Industry Revamped*, *supra* note 17.

²¹ *China Plans to Build More Cars*, *supra* note 17.

²² *Auto Industry Picking Up Speed*, *supra* note 19.

²³ *How China Boosts Her Car Industry*, *supra* note 13.

²⁴ *Auto Industry Picking Up Speed*, *supra* note 19. According to Gao Hanyang of the State Economic Commission's Economic and Technical Research Institute, this will require an annual rate of increase of 9.8 to 10.8 per cent. *Id.*

²⁵ Xu, *Private Cars On the Increase in China*, China Daily, April 29, 1987, at 1, col. 1. The Beijing Automotive Trading Center, for example, reported sales of 400 cars

official policy of the State does not allow purchase of private cars purely for personal use, although the growing entrepreneurial spirit in China is producing many businessmen with the means to purchase a car for combined business/personal use. There were an estimated 1,800 privately owned cars in Beijing alone in 1987.²⁶ In a 1987 nationwide survey of China's motor vehicle market, it was found that an increasing number of individuals have the desire as well as the financial means to purchase private cars.²⁷ Once a new home is built, and a refrigerator, television set and washing machine are purchased, there are few high-priced consumer goods remaining for purchase with a cost exceeding 10,000 yuan, with the exception of a car.²⁸

The late 1980's offer a propitious time for foreign investors to become involved in the potentially vast Chinese auto industry. Since 1979, China has pursued an "open door policy" to encourage foreign investment. Through a series of laws and regulations promulgated from 1979 through 1987, such investment became more attractive. At the Thirteenth Party Congress, which convened in October 1987, China's former Premier and new Party General Secretary Zhao Ziyang reaffirmed the Party's commitment to press ahead with the nation's economic development by opening its doors more widely to the outside world, and expanding economic and technological exchange and cooperation with other countries.²⁹ This article will assess the current investment picture in China, with particular reference to opportunities for U.S. firms in automobile manufacturing and related enterprises.

1.2 *Production by Chinese Enterprises*

As might be expected, domestic Chinese enterprises traditionally have focused on the production of commercial vehicles. Both China and Japan began domestic production of heavy trucks in the 1950's. Japan, however, invested the equivalent of approximately 729 billion yuan in its industry between 1965 and 1974. By contrast, China invested only about 100 million yuan in its heavy truck industry from 1952 to 1982.³⁰ Today, China's truck industry has about 76,000 employees, with approximately 100 billion yuan in fixed assets. It plans to have

to individuals during 1983-1986; half were sold in 1986 alone. *Id.*

²⁶ *Id.*

²⁷ *Id.* China's individual bank deposits reached 223.7 billion yuan in 1986, and the annual per capita income continues to rise. *Id.*

²⁸ *Id.*

²⁹ Zhao, *Advance Along the Road of Socialism With Chinese Characteristics*, BEIJING REVIEW, Nov. 9-15, 1987, at 32.

³⁰ *Struggling Truck Industry Revamped*, *supra* note 17.

the capacity to manufacture 60,000 heavy trucks by the year 2000. The principal users of heavy trucks are the ministries of petroleum, industry, forestry, commerce, geology and mineral resources, communications, railways and the armed forces.³¹

One immediate problem with China's heavy truck industry is that it is simply not competitive, largely due to inadequate capital investment and development in the past. Also, the truck industry recently has been retarded by general expense cutting in basic construction, the fall in purchasing power, the rise of diesel oil prices and related cost increases.³²

There already are Sino-foreign joint ventures producing heavy trucks, including the Steyr-Daimler-Puch AG of Austria, Zahnradfabrik Friedrichshafen AG of West Germany and the Eaton Company of the United States. Currently, China's heavy truck industry is concentrating on manufacturing a series of Steyr trucks with Austrian technology from the Steyr-Daimler-Puch AG company founded in China in 1984.³³

The Tianjin Automobile Industrial Corporation, now the largest base for the manufacture of light and mini-vehicles in China, has operated for over thirty years. In 1979, it began to produce light-duty trucks. In 1984, it imported a complete range of new technology from Japan's Daihatsu Company to begin mini-van production. The company currently is concentrating on localizing technology and parts while preparing for increased and expanded production.³⁴

The First Automotive Works (FAW) in Changchun, Jilin Province, was established in 1956 with Soviet aid, and is the cradle of China's domestic automotive industry. Many of the top-ranking Chinese managers and automotive industry officials received their original training and experience at FAW. The FAW principally produces trucks, but it also continues to produce the "Hongqi" (Red Flag) limousines which are used by Chinese dignitaries and government officials.³⁵

The Second Auto Works (SAW) was a spinoff from the FAW, and today, the two companies compete in the manufacture of medium trucks. The SAW in Shiyan, Hubei Province, was designed and built completely by the Chinese. It began production in 1975. To date, SAW

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ Zhang, *Mini-cars Put Into Production*, China Daily Bus. Weekly, April 22, 1987, at 2, col. 1.

³⁵ Zhang, *Nation's Flagship Vehicle Launched in New Range*, China Daily Bus. Weekly, April 22, 1987, at 3, col. 1.

has manufactured about 500,000 5-ton trucks and 2.5-ton field trucks. The emphasis at SAW is on localization.³⁶ In 1980, FAW also organized the First Automotive Group, which now has eight closely linked factories and 143 other factories which provide the group with parts and components.³⁷ In total, China's domestic automotive industry has an estimated 100 manufacturers, more than 500 automotive refitting and bus assembly factories and more than 2,000 automotive parts supply factories.³⁸

1.3 *The Governmental/Industrial Framework*

During the summer of 1987, Vice Premier Li Peng (now Premier) stated that China "should do more to digest and absorb imported technology so as to speed up domestic automobile production."³⁹ In an effort to carry out reform in the auto industry, the State Council recently decided to establish a National Automotive Industry Federation which would assume some of the administrative functions of the China National Automotive Industry Corporation. Li Peng characterized this reform as marking a "new stage in the development of the industry."⁴⁰ The newly organized federation planned to establish a strategic plan for the industry's future development and to make suggestions to the government for the industry's overall planning effort. The Federation will "draft laws and regulations, provide production licenses, and supervise quality control in vehicle plants."⁴¹

At a June 1987 conference held in Beijing, the new Federation adopted a constitution and elected a chairman and eleven standing members to the Federation Board. Chen Jhutao, Chairman of the Board, informed the conference that all automobile enterprises could join the Federation voluntarily. It will serve as a bridge between government and enterprises by overseeing the entire automobile industry.

³⁶ Zhang, *How Mountain Village Became a Major Automotive Centre*, China Daily Bus. Weekly, April 22, 1987, at 2, col. 2. In 1982, SAW established the Aeolus United Automotive Industry Corporation, which has four closely linked automotive factories and 167 other factories throughout the country. Additionally, SAW has centers of education research and development and plans to build a diesel engine plant in Xi-angfan, Hubei Province, near Shiyan. SAW already has exported about 500 trucks worth 3.9 million dollars to other developing countries, and has engaged in overseas marketing programs. *Id.*

³⁷ *Id.*

³⁸ Zhang, *Industry Accelerates Towards Goal of Localized Components*, China Daily Bus. Weekly, April 22, 1987, at 2, col. 5.

³⁹ *Reforms to Decrease Automobile Imports*, China Daily, June 26, 1987, at 1, col. 1.

⁴⁰ *Id.*

⁴¹ *Id.*

The Federation also will provide consulting services and make suggestions to the government. Chen suggested that the Federation will have certain management powers over automobile manufacturers authorized by the government, although those powers have not yet been clearly specified. By mid-summer, 364 vehicle enterprises had applied to join the Federation.⁴²

Clearly, the establishment of a modern automobile industry is a major step for any developing country. It requires the development of an entire manufacturing base with all the support services, raw materials and resource supply systems, energy supplies, and transportation and infrastructure that make it possible to operate a major manufacturing enterprise. It will require more sophisticated marketing of both domestic and exportable products, enormous capital investment, high technology, advanced management skills, a highly skilled workforce, and, of course, foreign exchange for the purchase of imported parts and supplies. It is inconceivable that any country could independently develop all the requisites for a modern automobile industry to compete with established worldwide manufacturers.

The government of Mao Zedong emphasized independence from foreign influence (including investment) to such an extent that the modernization program presently contemplated by China's rulers would not have been possible. Under Deng Xiaoping's leadership, foreign investment is encouraged. One of the first tasks Deng undertook was to develop a modern legal system that would provide security and reassurance to Western investors, and to foster the internal stability that China needs to grow and prosper. The development of a modern automobile industry will continue to challenge China's laws relating to foreign investment despite the progress in promulgating the new legal system.

2. THE LEGAL FRAMEWORK FOR FOREIGN INVESTMENT - POLICIES AND PROBLEMS

2.1 *Overview of Investment Laws and Regulations*

Many laws and regulations affecting economic relations with foreign investors were promulgated in China between 1979 and 1988,⁴³ representing a particularly courageous reform effort in view of the tradition-bound socialist system that operated when the reform movement began.

Under the new economic reforms instituted by Deng Xiaoping,

⁴² *Id.*

⁴³ See generally, volumes 1 and 2, *THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA*, (1987), Cambridge Scholarship Repository, BUSINESS (CCH Australia, Ltd. 1986).

foreign investment in China is encouraged as a vehicle for the prompt admission and assimilation of modern technology, skill and experience to aid in China's modernization. One of the "four modernizations" (the philosophical basis for the reform movement) is the modernization of industry.⁴⁴

Direct foreign investment in China generally assumes one of three forms: cooperative (or contractual) joint ventures, equity joint ventures, or the wholly foreign-owned enterprise.⁴⁵ Cooperative ventures essentially are contractual arrangements by which Chinese and foreign partners undertake specific projects. The contractual arrangements must be approved by Chinese authorities. By 1987, there were 4,390 such cooperative ventures.⁴⁶

The equity joint venture is the major vehicle for manufacturing investments, as the result of Chinese encouragement and the early promulgation of enabling legislation and rules.⁴⁷ By 1987, there were 3,210 equity joint ventures (hereinafter joint ventures).⁴⁸ These joint ventures use Chinese and foreign investment, and are directly operated by both domestic and foreign partners.

More than 70% of the U.S. investors in China have chosen the equity joint venture approach.⁴⁹ In terms of total dollar commitments, the United States is second only to Hong Kong in its investments in China, representing 13.1% of the total foreign commitments. Japan is third, representing 9.8%.⁵⁰

⁴⁴ See *supra* note 14.

⁴⁵ The Chinese define direct investment more broadly than the term is defined in the West, including joint development projects, compensation trade, and processing and assembly arrangements. Joint development of China's national resources (most notably, oil) combines features of both the cooperative venture and compensation trade. Compensation trade involves arrangements whereby Chinese enterprises purchase foreign equipment and technology on credit, and pay off the debts with products produced by the imported equipment and technology. In some cases, the products used for loan payoffs are generated from other sources. Under processing and assembly arrangements, the foreign investor supplies raw or intermediate materials, components and/or parts which in turn are processed, assembled or manufactured, typically on equipment or with technology supplied by the investor according to the investor's specifications. The investor receives the finished product, and the Chinese firm is paid a processing fee. Both the compensation trade and processing and assembly arrangements hold potential for investors who wish to develop parts, and supply and support services for China's auto industry.

⁴⁶ People's Daily, June 8, 1986 (overseas Chinese ed.), cited in Zhang, *Like Bamboo Shoots After a Rain: Exploiting the Chinese Law and New Regulations on Sino-foreign Joint Ventures*, 8 NW. J. INT'L. L. & BUS. 59, 62, n.1 (1987).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ The National Council for U.S.- China Trade, *U.S. Joint Ventures in China: A Progress Report* 99 (1987) [hereinafter JV Progress Report].

⁵⁰ *Id.* at 106.

Generally, the foreign investor contributes advanced technology and equipment, technical and managerial knowledge, industrial property rights and hard currency. The joint venture is a legal entity controlled by legislation whereby profits and losses are distributed according to the proportions of capital contributed by the parties. In contrast, profits and losses under cooperative ventures are allocated according to the contract.⁵¹

Unlike the rapid growth of cooperative ventures and joint ventures, there were only 138 wholly foreign-owned enterprises in China by 1987.⁵² These enterprises are established within Chinese territory by foreigners using foreign investment exclusively. An enabling law facilitating the establishment of such enterprises was promulgated in April 1986.⁵³ Thus, wholly foreign-owned enterprises are still in the experimental stage, and operate primarily in special economic zones.⁵⁴ About half of all Sino-American ventures are manufacturing enterprises, and it was estimated that by 1988, as many as 75 or more U.S. companies would be manufacturing products in China.⁵⁵

2.2 *The Development Dilemma: Limited Production and Rising Demands*

Under the Joint Venture Law,⁵⁶ the enterprise takes the legal

⁵¹ A watershed event in China's recent lawmaking experience was the promulgation of the "Law of the People's Republic of China on Economic Contracts Involving Foreign Interest" (adopted by the Tenth Session of the Standing Committee of the Sixth National People's Congress, promulgated by Order No. 22 of the President of the People's Republic of China on March 21, 1985, effective as of July 1, 1985), *English translation in 2 THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1983-1986* 162 (1987). See generally Zheng, *A Comparative Analysis of the Foreign Economic Contract Law of the People's Republic of China*, 4 UCLA PACIFIC BASIN L.J. 30 (1985).

⁵² Zhang, *supra* note 46, at 62.

⁵³ Law of the People's Republic of China on Foreign-Capital Enterprises (adopted by the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 39 of the President of the People's Republic of China, effective as of April 12, 1986) [hereinafter Wholly Foreign-Owned Enterprise Law], *English translation in 2 THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1983-1986* 254 (1987).

⁵⁴ For a review of the wholly foreign-owned enterprise experience, see generally Goosen, *A Realistic Option: Foreign Wholly-Owned Enterprises in the People's Republic of China*, 4 CHINA L. REP. 31 (1987); Stein, *Wholly Foreign Owned Ventures in China: A Comparison of JM China Ltd., Grace China Ltd. and the New Foreign Enterprise Law*, 4 CHINA L. REP. 1 (1987).

⁵⁵ JV Progress Report, *supra* note 49, at 3.

⁵⁶ Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (adopted by the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 7 of the chairman of the standing committee of the National People's Congress, effective July 8, 1979) [hereinafter Joint Venture Law], *English translation in 2 THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1979-1982* 150 (1987); CHINA LAWS FOR FOREIGN BUSINESS 6-500 (CCH Australia, Ltd. 1985).

form of a limited liability company. The relationship between Chinese and foreign participants is a hybrid organizational form, with elements of both a corporation and a partnership. The foreign participant must contribute at least 25% of the registered capital. Many of the uncertainties under Chinese law were clarified and resolved under the new Chinese Civil Law, which became effective as of January 1, 1987.⁵⁷ Foreign participants in joint ventures may be corporations, partnerships, individuals or other business entities.⁵⁸ Under the new Civil Law, the Sino-foreign joint venture as well as the wholly foreign-owned enterprise can be a legal person.⁵⁹

Unlike the cooperative venture, in which profits are shared according to a negotiated formula established by contract, the Joint Venture Law requires partners to share profits, risks and losses in proportion to each partner's contribution to the registered capital of the enterprise.⁶⁰ Shares of registered capital are transferred only upon the consent of all parties involved. Capital contributions to the venture's formation are made in forms such as cash, capital goods and industrial property rights. When technology or equipment is contributed by the foreign partner, the Joint Venture Law requires that it be "truly advanced and appropriate to China's needs."⁶¹ Contributions made by the partners must be explicitly set out in the joint venture contract and in the articles of association.⁶²

The joint venture is governed much like an American corporation. A board of directors is charged with the responsibility of policy-making. The chairman of the board is appointed by the Chinese partner, and either one or two vice chairmen may be appointed by the foreign partner.⁶³ Responsibilities of the board include selection of the chief operations officers, actions upon articles of association, decisions on all matters regarding production programs, the budget, distribution of profits, pay scales and the termination of business.⁶⁴

The Joint Venture Law is very general in nature, and provides only a skeletal outline for the venture's formation and operation. The

⁵⁷ General Principles of the Civil Law of the People's Republic of China (adopted by the Fourth Session of the Sixth National People's Congress, promulgated by Order 37 of the President of the People's Republic of China on April 12, 1986, effective January 1, 1987) [hereinafter *Civil Law*], *English translation in 2 LAWS OF THE PEOPLE'S REPUBLIC OF CHINA* 225 (1987).

⁵⁸ Joint Venture Law, art. 1 *supra* note 56.

⁵⁹ Civil Law, art. 41 *supra* note 57.

⁶⁰ Joint Venture Law, art. 4 *supra* note 56.

⁶¹ *Id.* art. 5.

⁶² *Id.*

⁶³ *Id.* art. 6.

⁶⁴ *Id.*

weight of these legal developments clearly shows the desire of the Chinese to encourage further investment by foreign firms.

Although the promulgation of such laws and regulations provide significant encouragement for current and potential foreign investors in modern China, their implementation is another matter. For a variety of reasons, many observers of China's investment scene frequently express concern that there is a great disparity between the expressed intentions of Beijing and the law as actually implemented at the local level.⁶⁹ Thus, it is useful to supplement any analysis of such laws with an analysis of the actual experience of investors in Sino-foreign joint ventures.

2.3 *The Early Experience of Sino-Foreign Joint Ventures in Auto Manufacturing*

The modernization of the automobile industry, a vital link in China's industrial modernization, has thus far depended largely upon joint ventures. The first Sino-foreign passenger automobile manufacturing joint venture agreement was signed between China's Beijing Auto Works and American Motors Corporation in May 1983, establishing Beijing Jeep Corporation, Ltd. (BJC or Beijing Jeep). Today, there are three such Sino-foreign joint ventures, including Beijing Jeep, the Shanghai Santana plant operated by Volkswagen, and the Guangzhou Peugeot plant.⁷⁰

Manufacturing enterprises in China face problems that are considered typical in many developing countries, but which are unusual for manufacturing firms accustomed to the conveniences of the United States. For example, investors in China often face problems arising from inadequate energy and power supplies, an inadequate transportation infrastructure and inflexible material sourcing systems. Although

by MOFERT on Jan. 20, 1987), *English translation in id.*; Implementing Measures for the Confirmation and Examination of Export Enterprises and Technologically Advanced Enterprises with Foreign Investment (promulgated by the Ministry of Foreign Economic Relations and Trade on Jan. 27, 1987), *English translation in id.* at 26. Also, see generally Horsley, *China Issues Regulations to Implement Foreign Investment Encouragement Provisions*, 9 E. ASIAN EXEC. REP., Jan. 15, 1987, at 7; Gelatt, *Foreign Investment Provisions: Four More Sets of National Implementing Rules Issued*, 9 E. ASIAN EXEC. REP., Feb. 15, 1987, at 9.

⁶⁹ Interview with Lucille Barale, Attorney with Coudert Brothers, in Beijing, China (July 2, 1987).

⁷⁰ *Joint Ventures Promoting Auto Industry Development*, China Daily, June 28, 1987, at 3, col. 2. The Volkswagen Santana plant in Shanghai was turning out forty Santanas per day by 1987, and assembling some Passat Variants and Audi 100's. Volkswagen's Shanghai plant began operations in September, 1985, and by mid-1987 had approximately 2,000 workers, including engineers and management personnel. *Id.*

western enthusiasm for joint venture investments was great when China initiated its new open-door policy, a number of significant problems soon arose. Some problems were serious enough to threaten a premature demise of the Sino-foreign investment drive.

The legal system itself also has deficiencies which prevent it from being truly responsive to the needs and expectations of Western investors. For example, the concept of due process is noticeably absent from the Chinese legal system. Internal laws and regulations which are made available only to selected Chinese officials remain widely used.⁷¹ Similarly, an air of mystery continues to prevail in the licensing and approval process required under many regulations. Oftentimes, the law or regulation will not designate a responsible official who has the power of approval over requests.

China's leaders are aware of these dilemmas⁷² and appear to be making sincere efforts to improve the system. Although these problems are a continuing source of frustration for foreign investors, they do not imperil the continued viability of direct foreign investment in China. Major problems relating to currency exchange, the repatriation of capital and access to domestic markets, however, do threaten the viability of foreign investment.

2.4 Access to Domestic Markets, Currency Exchange and Repatriation of Capital

In an interview with the author, the President of Beijing Jeep Corp., Ltd., Don St. Pierre, took an optimistic view of the present situation and future of the BJC. He explained, "In recent months we have sent about one million dollars to the States in dividends. Now we have the money we need for expansion, and we're moving into the operations phase."⁷³ The Shanghai Volkswagen plant has also reported profits,

⁷¹ It has been reported that the Ministry of Foreign Economic Relations and Trade (MOFERT) plans to discontinue its practice of issuing secret internal circulars relating to foreign investment, and to begin publishing its future rulings on foreign business operations. *P.R.C.: Secret Regs to be Abolished*, 9 EAST ASIAN EXEC. REP., Feb. 15, 1987, at 5.

⁷² In addition to an increasing number of press reports of investor dissatisfaction, there also have been a number of joint Sino-American conferences and delegations held to discuss concerns and proposed solutions to investment problems. For example, the author was a member of an American delegation to Beijing and Shanghai in June, 1985, led by former U.S. Trade Representative Robert Strauss. Meetings with Premier Zhao Ziyang, the Chinese Supreme Court, the Chairman of MOFERT, and a number of other state and municipal leaders in China covered a wide range of investment-related topics.

⁷³ Interview with Don St. Pierre, President of Beijing Jeep Co., Ltd., in Beijing, China (June 20, 1987) [See also *Legal Scholarship Repository*, 2014].

but has not issued dividends at the time of this writing because of a decision to reinvest the money in production.⁷⁴

The picture has not always been so rosy for China's Sino-foreign auto makers. Many problems surfaced at Beijing Jeep soon after the company's initial establishment. American Motors contributed \$16 million, one-half in cash and one-half in technology, to the effort.⁷⁵ The Chinese partner, Beijing Automotive Works, contributed \$35 million through capital, a plant and equipment. Prior to the agreement, Beijing Automotive Works produced a version of a Russian jeep for sale on the Chinese domestic market. The new joint venture continued to produce the Russian style jeep, and, in 1985, added the popular American Motors "Jeep Cherokee" to production.⁷⁶

Initially, the two joint venture partners agreed that components for the Cherokee would be produced locally. However, there proved to be serious defects in locally produced components which made it impossible for American Motors to proceed with the original plans.⁷⁷ To continue production of the Cherokee, Beijing Jeep was forced to import ninety percent of its parts from the United States. In order to purchase these components, which are commonly sold as kits, Beijing Jeep had to convert the Chinese RMB⁷⁸ yuan obtained from domestic sales into foreign exchange. The Chinese government was cooperative until the spring of 1986, when it restricted all foreign exchange purchases by joint ventures.⁷⁹

As a result of its foreign exchange deficit, Beijing Jeep was forced to suspend production of the Cherokee for two months. Chinese government officials initially were intransigent in their insistence that BJC generate its own foreign exchange. The company found itself in what seemed to be an inescapable dilemma. It did not yet have an export market for the new Chinese-made Jeep Cherokee, although there was a sizeable domestic demand. Additionally, sales to domestic customers were not generating the necessary foreign exchange to buy the U.S.-made kits. The essential kits simply could not be purchased due to the difficulty in freely converting Chinese RMB income into foreign

⁷⁴ *Joint Ventures Promoting Auto Industry Development*, *supra* note 70.

⁷⁵ Clare, *The Business Challenge in China - Separating the Yin from the Yang*, speech delivered at the DOING BUSINESS IN CHINA CONFERENCE at Madison, Wisconsin (Sept. 4, 1986), *reprinted in* 53 *Vital Speeches of the Day*, Oct. 15, 1986, at 18 [hereinafter *Vital Speeches*].

⁷⁶ *Id.*

⁷⁷ St. Pierre Interview, *supra* note 73.

⁷⁸ China's currency is the *Renminbi* (RMB), or "people's money." The standard denomination is the yuan, which now equals about 27 U.S. cents.

⁷⁹ *Vital Speeches*, *supra* note 75, at 19.

exchange.

The Chinese government finally softened its position when BJC was on the brink of closing its operation and pulling out of China.⁸⁰ Agreeing upon the importance of the deal for both American Motors and China,⁸¹ the government conceded and made foreign exchange currency available for the importation of Jeep Cherokee components.⁸² Production of the Jeep Cherokee was resumed during the second week of August 1986, with expectations of creating 2,000 Jeeps by the close of the year.⁸³ Even more important to both the venture participants and China's plans for the auto industry is that the foreign currency deal permits BJC to continue with plans to localize production of Jeep Cherokee components, which in the long run will reduce future demand for foreign exchange.

Early investors in China could have anticipated some of these problems due to the lack of a bilateral investment treaty between China and the United States. Furthermore, China's domestic laws were non-committal, or extremely sketchy at best, on points that should have been of major concern to any prospective investor. China's general lack of experience in western-style lawmaking and in the regulation of foreign investment created an environment that was not conducive to trouble-free investment.⁸⁴ However, China's recent law reform efforts clearly show a desire to improve the investment climate.⁸⁵ Those efforts were undoubtedly motivated by recent declines in foreign investment at a time when the need for foreign exchange earnings had increased.⁸⁶

⁸⁰ St. Pierre Interview, *supra* note 73.

⁸¹ Because it was the first Sino-foreign auto manufacturing plant in China, the eyes of the foreign investment community were focused on this conflict. See Burns, *A.M.C.'s Troubles in China*, N.Y. Times, Apr. 11, 1986, at D4, col. 1; Schiffman, *AMC Jeep Venture Trying to Get Back on Track After Peking Helps to Ease Currency Squeeze*, Asian Wall St. J. Weekly, Aug. 25, 1986, at 4, col. 1.

⁸² *Vital Speeches*, *supra* note 75, at 19. The government arranged the deal through a new system of payments for Jeeps sold domestically (purchased largely by government agencies). Under the previous payment scheme, buyers paid the equivalent of \$19,000 in Chinese currency. Under the new plan, buyers pay \$12,500 in U.S. dollars and the remainder in RMB, providing Beijing Jeep with the hard currency needed to purchase Cherokee components. *Id.*

⁸³ *Id.*

⁸⁴ See Horsley, *Comments on Law and Legal Developments Affecting Foreign Investment in China*, 3 CHINA L. REP. 175, 176 (1986).

⁸⁵ See, e.g., Zhang, *Improving Conditions for Joint Ventures*, BEIJING REV., Sept. 1, 1986, at 4.

⁸⁶ During 1984-85, local bureaucrats were emboldened by an unprecedented degree of discretion in spending, and went on a spending spree using foreign exchange to import many consumer items. The result was a depletion of foreign exchange reserves and overheating of the economy. See do Rosario, *The Cars-and-TVs Nightmare That Dented Reserves*, FAR E. ECON. REV., Mar. 20, 1986, at 91. Contemporaneously, foreign investment began a decline in response that continued during 1987. The first half

The most frequently heard complaint from investors has been the lack of any vested legal right to convert the Chinese RMB into U.S. dollars or other hard currency for repatriation.⁸⁷ In January 1986, the State Council responded to this concern by promulgating regulations governing the balance of foreign exchange income and expenditures in joint ventures.⁸⁸ Although the new Foreign Exchange Provisions are not without problems,⁸⁹ they represent a significant effort to alleviate the foreign exchange crunch felt by so many foreign investors.⁹⁰ One general criticism of the Foreign Exchange Provisions is that they are typically vague, but this may not be an obstacle for a substantial investor who insists on negotiating specific rights in advance.

In October 1986, the State Council promulgated the "Provisions of the State Council for the Encouragement of Foreign Investment"⁹¹ which provide particularly attractive investment incentives for export oriented enterprises and enterprises which provide China with advanced technology.⁹² The Foreign Investment Provisions do not specifically address the repatriation of profits. However, when the Foreign Investment Provisions were announced, the State Council added that enterprises which import components and sell products domestically may continue to "swap" Chinese RMB for foreign currency with ventures that receive foreign currency as payment, but have expenses in RMB.⁹³ Between November and December of 1986, BJC alone exchanged over \$2.5 million in currency with the Great Wall Sheraton

of 1987 saw foreign investment drop 12% from the same period during the previous year. *China's Economic Reforms Don't Impress Foreigners*, Asian Wall St. J., July 27, 1987, at 3.

⁸⁷ Marra, *OPIC Problems in China and Problems Faced by Investors*, 3 CHINA L. REP. 170, 173 (1986).

⁸⁸ Regulations of the State Council Concerning the Balance of Foreign Exchange Income and Expenditure by Sino-foreign Joint Equity Ventures (promulgated on Jan. 15, 1986) [hereinafter Foreign Exchange Provisions] PRC State Council Gazette, 66-68 (Feb. 20, 1986), *English translation in 1 CHINA LAWS FOR FOREIGN BUS.* 6-590 at 8,031 (CCH Australia, Ltd., 1985).

⁸⁹ See generally Note, *Chinese Solutions to Legal Problems: Repatriating Business Profits From the People's Republic of China*, 19 L. & POL'Y INT'L BUS. 385 (1987).

⁹⁰ For example, the thirteen articles include provisions for bartering for foreign exchange (art. 6); making adjustments through separate joint ventures (art. 9); investing excess RMB in Chinese domestic corporations which will return foreign exchange from export income (art. 10); selling of "sophisticated products produced with advanced or key technology" or "internationally competitive products" in the domestic market where the goods are "urgently needed" (art. 4); and selling of "import substitutes" in the domestic market (art. 5). See Foreign Exchange Provisions, *supra* note 88.

⁹¹ Foreign Investment Provisions, *supra* note 66.

⁹² *Id.*

⁹³ St. Pierre Interview, *supra* note 73.

Hotel in Beijing.⁹⁴

At the time of this writing, China's Sino-foreign auto makers and other investors have been trying to work within the system and to test the efficacy of the new laws and regulations that were designed to alleviate some of their major concerns. It remains to be seen, however, whether the foreign currency exchange and the repatriation of profits rules will solve the auto manufacturers' greatest fiscal concerns. The tone of many commentaries during the past two years reflect a certain dissatisfaction, even bitterness, among foreign investors who have tried to work within the Chinese system.⁹⁵ However, more recent reports from the Sino-foreign auto investment community have been adopting an increasingly optimistic view, particularly with respect to monetary and fiscal issues.⁹⁶

2.5 *Special Labor and Employment Problems*

The 1979 Joint Venture Law provided only general guidelines for investors and offered little guidance on questions of labor-management relations. Apparently sensing that this deficiency posed an obstacle to foreign investment, the State Council acted quickly, and in July 1980, promulgated the regulations for "Labour-Management in Joint Ventures Using Chinese and Foreign Investment" (JV Labor Regulations).⁹⁷ The new regulations addressed the issues of recruitment and benefits and dismissal, but nevertheless remained general in nature. Consequently, the Ministry of Labor provided greater details in the 1984 "Procedure for the Implementation of Regulations on Labor Management in Joint Ventures Using Chinese and Foreign Investment" (hereinafter JV Labor Procedure).⁹⁸ Finally, the Foreign Investment Provisions of 1986 were designed to give more autonomy to Sino-foreign enterprises and contained in Article 15 additional provisions on

⁹⁴ *Id.*

⁹⁵ Burns, *Why Investors are Sour on China*, N.Y. Times, June 8, 1986, § 3, at 7.

⁹⁶ Ma, *Beijing Jeep: A Year of Progress*, BEIJING REV., June 22, 1987, at I. Another area also subject to recent reforms is labor-management relations. Early reports from the auto industry have not been very encouraging about progress in this area, which is so vital to auto manufacturing concerns. Beijing Jeep attempted to introduce wage and incentive reforms under the new regulations soon after their adoption, but was frustrated by local "opposition which seemed to come from everywhere." St. Pierre Interview, *supra* note 73.

⁹⁷ JV Labor Regulations, *supra* note 65.

⁹⁸ Procedures for the Implementation of the Provisions for Labour Management in Joint Ventures Using Chinese and Foreign Investment (promulgated on Dec. 24, 1983), [hereinafter JV Labor Procedures], *English translation in CHINA INVESTMENT GUIDE*, 1986 at 471. (1985).

recruitment, wages and benefits and dismissal.⁹⁹ The Foreign Investment Provisions soon were supplemented by regulations promulgated by the Ministry of Labor and Personnel in 1986.¹⁰⁰ Although a detailed analysis of these labor laws and regulations is beyond the scope of this study,¹⁰¹ they are noteworthy because their cumulative effect has been to give the enterprises greater autonomy in managing their own labor-management relations.

As a practical matter, U.S. investors have found that the personnel and labor relations problems in China are quite different than those confronted in the United States, and that solutions are often based upon a totally different concept of the labor-management relationship. For instance, the Chinese tend to employ far more personnel than are needed for any given task. This is directly related to the massive problems of unemployment or underemployment, and to the welfare function of state employment that still lingers under the influence of Mao's "iron rice bowl" system.¹⁰² Although the official Chinese government figure for unemployment stands at a modest two percent, any visitor to China who scratches the surface of industrial relations finds that there are many persons who are "waiting for work", the euphemistic phrase for the unemployed.¹⁰³ Thus, to minimize the impact of real unemployment, Chinese enterprises will generally employ many more workers than are needed. Local unions, labor bureaus and other officials have encouraged similar hiring practices in foreign investment enterprises and strongly discourage or, in some cases, practically prohibit discharges.¹⁰⁴ There is a general shortage of skilled personnel in China,¹⁰⁵ and until recently, little was being done in the area of worker

⁹⁹ See Foreign Investment Provisions, *supra* note 66.

¹⁰⁰ Provisions Concerning the Right of Autonomy of Enterprises With Foreign Investment in Hiring Personnel and the Wages, Insurance, and Welfare Costs of Staff and Workers (formulated by the Ministry of Labor and Personnel with the approval of the Working Group of Foreign Investment and issued on Nov. 10, 1986) [hereinafter Personnel Regulations], *English translation in* 9 E. ASIAN EXEC. REP., Jan. 15, 1987, at 25.

¹⁰¹ For a more comprehensive treatment of the labor reform issues, see Vause and Vrionis, *China's Labor Reform Challenge: Motivation of the Productive Forces* 24 STAN J. INT'L L. 447 (1988).

¹⁰² The "iron rice bowl" concept was the product of extreme leftist thinking during the reign of Mao Zedong, who guaranteed lifetime employment for all regardless of work performance.

¹⁰³ For an overview of the unemployment and underemployment problems, see *generally Reforms Increase Rural Employment*, China Daily, Aug. 3, 1987, at 3; *Low Wages Policy Gives Jobs to All*, China Daily, July 24, 1987, at 4; Dong, *Economic Reform Calls for Millions of New Jobs*, China Daily, April 30, 1987, at 1.

¹⁰⁴ See JV Progress Report, *supra* note 49, at 165.

¹⁰⁵ Under the old Beijing Auto Works regime, the company employed approximately ten thousand employees. This number has been pared down to approximately

training. As a result, foreign investors often must resort to sending their own workers abroad for training or for on-the-job training.¹⁰⁶ When asked whether or not the new foreign investment regulations actually have caused state enterprises to “assist” in providing workers who want to transfer to joint ventures, BJC President St. Pierre responded, “China just does not have trained automotive engineers, so we have not had the problem because we have not called on state enterprises to ‘assist’ us.”¹⁰⁷

3. ADJUSTING TO THE CHINESE BUSINESS CULTURE

3.1 Relationships with Chinese Officialdom

“Getting to the right people” is so important in China that the Chinese have coined a special term for it: *guanxi*. In all relations in Chinese society, whether it is simply obtaining scarce materials, buying a new bicycle of a popular make, or drawing up a major contact to open business negotiations, having the right connection, or *guanxi*, often makes the critical difference between success and failure.¹⁰⁸

To bridge what might be called the “influence gap”, consultants may be of some assistance, particularly during early negotiations. Consultants were used at the start of the BJC joint venture, and are commonly used by many other investors and potential investors in China. This is, of course, not a guaranteed method for success, and the choice of consultant is critical. There has been in recent years a proliferation of so-called “China experts” who lack the necessary understanding of United States-China cultural differences as well as the knowledge of both the law and the labyrinthine system of the Chinese bureaucracy.

When the survival of Beijing Jeep was threatened by the foreign

four thousand workers by its successor, Beijing Jeep. This is, according to St. Pierre, still too many workers, but it does not constitute a serious economic problem. The real problem, according to St. Pierre, is finding the skilled workers necessary for the relatively high technology production of automobiles. St. Pierre Interview, *supra* note 73.

¹⁰⁶ For example, during July 1987, BJC had approximately fifteen employees being trained in Japan, Europe and the United States. It already had sent about 100 employees abroad for training in the past. Periodically, another group leaves for training abroad. *Id.* At Volkswagen's Santana plant, for example, the company established an overall training plan for professionals, as well as for on the job and spare time training. It also sends a number of employees abroad from various sections of the company, including technical production, planning, organization, automatic data processing, production quality control and secretarial. Those who receive training abroad are expected to serve as trainers for other employees when they return. *Joint Ventures Promoting Auto Industry Development*, *supra* note 70.

¹⁰⁷ St. Pierre Interview, *supra* note 73.

¹⁰⁸ “Some of the newer investors haven't developed these kinds of contacts; they are talking to the wrong people. My advice is, find out who the key players are, and

exchange crunch, St. Pierre did not begin to achieve success with the Chinese government until after writing a letter to Premier Zhao Zhiyang.¹⁰⁹ However, the fact that the American Motors Corporation board had voted to withdraw its participation in the joint venture unless some immediate relief was given undoubtedly had a major impact on Premier Zhao's decision to intervene.¹¹⁰ In an effort to avoid a massive pullout of foreign investors which could have been triggered by the international press coverage of Beijing Jeep's difficulties and the likely failure of China's first automobile manufacturing joint venture, the Chinese made major concessions to alleviate the crisis.

Oftentimes, it is not only a matter of complaining to the right Chinese official, but of having the proper person make the complaint. For example, it is the policy of Beijing Jeep to reserve its President as the complainant of last resort in dealings with the Chinese government. Routine day-to-day discussions or confrontations are carried out by the departmental managers. However, not all joint ventures will be as well placed, or have as much *guanxi* as the President of Beijing Jeep.¹¹¹ Beijing Jeep Corporation was in a unique position to put considerable pressure on the Chinese government, due to the substantial size of the investment by American Motors, and because it was a major precedent-setting investment in China's auto industry. Moreover, the matter was not settled until the eleventh hour when the highest ranking Chinese government official intervened as a result of BJC's public protestations and threatened withdrawal from China.

Finally, the problems many of the joint ventures have encountered do not necessarily reflect an intentional flaunting of the law by Chinese bureaucrats or an intent to take advantage of the foreign investors by

¹⁰⁹ St. Pierre described how he began to achieve success during his now fabled confrontation with the Chinese government two years ago:

When I had that problem, I wrote letters to the China National Auto Industrial Corporation, the State Economic Commission, the Ministry of Foreign Economic Relations and Trade, and others. I got no action until I wrote a letter to [Premier] Zhao Zhiyang. Then things started to happen.

Id.

¹¹⁰ *Id.*

¹¹¹ However, St. Pierre insists that Chinese officials are generally very reasonable if one can speak to the right person. He illustrated this point with a problem he had encountered concerning tax rebates under the 1986 Foreign Investment Provisions. Initially, there was considerable difficulty in the interpretation of these articles, and BJC's managers were having no success with local officials in obtaining the tax rebates for the company partners. There was a great deal of red tape and the bureaucratic response was unsatisfactory. By chance, however, St. Pierre met one of the top ranking officials of the Chinese government's tax administration at a social gathering, and discussed the matter with him. A few days later, the Chinese tax official called him and stated: "There is no problem, you will get your tax rebate." *Id.*

the government. Rather, the desired interpretation of law or attitude towards foreign investment sometimes does not filter down to the lower ranking bureaucrats. This problem is systemic in a society which traditionally has not held official rules of law in reverence. The solution will come gradually as the "rule of law"—as Westerners understand that concept—becomes more acceptable within Chinese cultural mores.

3.2 Management Challenges

Business management and organization is another problematic area confronting U.S. investors which likewise has its roots in cultural differences. One of the major problems in most China-based industries is the lack of cooperation among enterprises, governmental departments, and divisions within the same enterprise. Within a Chinese manufacturing enterprise, for example, each department generally conducts itself as an individual fiefdom to which the worker owes his allegiance rather than to the entire enterprise as a whole. As a result, there is very little cooperation or common goal-sharing within the entire enterprise.¹¹²

One of the most promising trends for China's overall development has been the recent focus on general management reform. As the economy undergoes a virtual restructuring under the reformists' guidance, greater independence of managerial authority is viewed as one of the

¹¹² Currently, there is a great deal of speculation in China about reform in the auto industry, and much of the efforts are directed towards the reform of management techniques and strategies. For example, the Aeolus United Automotive Industry Corporation, the largest of its kind in China, recently was cited as "a model for the reform of the managerial system of China's large enterprises." *Wind of Reform in Auto Industry*, China Daily, June 4, 1987, at 3, col. 2. The company reportedly was successful in breaking the barrier caused by departmental and administrative divisions and has "revolutionized" the automotive industry's organizational structure. *Id.*

According to one report, management reform was accomplished through interregional cooperation between enterprises. The corporation has 180 members at present, with 230,000 workers and administrators. This has amounted to the formation of an enterprise group managerial system purportedly beneficial to the state, the local communities, the member enterprises and the workers. *Id.*

The deputy manager of Aeolus, Zhuang Xianchang, recently stated that the corporation made 115,600 motor vehicles in 152 models last year. Aeolus has an annual output value of 5 billion yuan (approximately \$1.5 billion U.S. dollars) and profits of \$800 million yuan, 35 percent of China's total from the industry. Zhuang attributed the success of this enterprise primarily "to the voluntary combination of enterprises for production and technology, and the application of flexible management methods." *Id.*

The Number Two Motor Vehicle Plant is the leading enterprise within the Aeolus Corporation. Chen Qingtai, chairman of the board of directors and director of the plant, stated that the corporation had established a unified management system for personnel, finance, materials, production, supplies and sales. The ownership and the financial structures of the partners remain unchanged. *Id.*

keys to success.¹¹³ Increasingly, the practice of importing foreign managers and management techniques has been used to improve China's management structure. The Sino-foreign enterprises may well prove to be one of the most advanced testing grounds for injecting western management skills into Chinese industry.

4. FUTURE DIRECTIONS FOR CHINA'S AUTO INDUSTRY

4.1 *The Demand for Localization*

What are the directions that are being taken, or should be taken, in the reform of China's automotive industry? Localization is a major goal of the Chinese. However, the 100% localization envisioned by Chinese planners now seems to be an unobtainable goal.¹¹⁴ It is unrealistic to assume that China can develop an entirely new car in the foreseeable future when many developed countries are unable to do so. China's leaders have asserted that before a new car company is established, there should be 70% "local content" before production begins.¹¹⁵ A more realistic view would be the acceptance of gradual localization. Rather than aspire to the development of a whole new automobile for China, technology can be imported to modify an existing model to meet China's special needs.

Since Beijing Jeep has alleviated its cash flow/foreign exchange crisis, it now focuses upon the operational phase of production, and its next big project is the localization of production. This will require the importation of equipment and plants in order to build the needed stamping plant and engine plant. Thus, the challenge has been shifted from importing the parts for continued operation to acquiring capital

¹¹³ See, e.g., Zhao, *Advance Along the Road of Socialism With Chinese Characteristics*, BEIJING REVIEW, Nov. 9-15, 1987, at I, XII. On April 13, 1988, the First Session of the Seventh National People's Congress passed the Law Concerning Enterprises Owned by the Whole People. *Enterprise Law: A Milestone for Reform*, BEIJING REVIEW, May 2-8, 1988, at 24. Among the reforms implemented by the new law: steps are taken to separate enterprise ownership from management powers, the rights and duties of enterprises are defined, the director (manager) responsibility system is implemented, the role of workers and staff is "democratic" or participating management is recognized, and the relationships between enterprise and government are clarified. *Id.*

¹¹⁴ Only about fifteen locally made parts were being used on Shanghai Santanas by mid-1987. The managing director of the plant predicted that up to sixty new Chinese-made parts would be used by the end of the year, and by the end of 1989, the use of locally produced parts in the Santana would rise to about 50% of production. At the Guangzhou Peugeot plant, localization had reached about 18% in 1987, with an ultimate stated goal of 90%. At Beijing Jeep Company, localization had reached 23% in terms of cost by 1987. *Joint Ventures Promoting Auto Industry Development*, *supra* note 70. In terms of parts used, the ratio between imported and local content in 1987 was closer to 90%/10%. St. Pierre Interview, *supra* note 73.

¹¹⁵ St. Pierre Interview, *supra* note 73.

for expansion. Without the necessary capital, however, the rapid localization of automobile manufacturing simply is not feasible in the near future.¹¹⁶ The 1987 acquisition of AMC by the larger and stronger Chrysler Corporation will likely strengthen U.S. ties with the Chinese auto industry. One of Chrysler's first steps after the acquisition was to send its executive vice president to Beijing for talks which resulted in Chrysler's affirmation of the BJC joint venture contract and the resolutions signed thereunder. Particularly important to the Chinese was Chrysler's endorsement of the BJC board of directors' resolution establishing a plan for technical renovation of the company during China's current Seventh Five Year Plan (1986-90).¹¹⁷

On July 21, 1987, China's largest domestic automobile manufacturer¹¹⁸ signed a contract with Chrysler Corporation for the purchase of machinery and technical assistance to develop a new engine production plant.¹¹⁹ If this venture is successful, it may greatly assist in the realization of China's goal to localize production. The new plant will make high quality engine available to other domestic car makers and possibly develop a product for the export market.¹²⁰

As China's use of motor vehicles increases, there will be an increasing demand for the establishment of a Chinese parts industry to reduce reliance upon foreign exchange purchases. A recent report in the *Liberation Daily* cited an acute shortage of auto parts in Beijing, where about 8 million dollars worth of parts is needed each year to repair imported vehicles, but only \$2.7 million worth of parts was imported during 1986.¹²¹ As a result, it is not uncommon to use old automobile parts as sources to repair others.¹²²

Although the potential demand is great, firms contemplating the manufacture of parts in China will face all the labor, quality control and related issues that already have confronted the large manufacturers. Nevertheless, the experience of the earlier investors, coupled with

¹¹⁶ According to Beijing Jeep's President, "[t]he major question for BJC is, can we do what we say we can do—build a modern axle, engine, and stamping plant? I think we can, but it will go slower than anticipated." *Id.*

¹¹⁷ Zhong, *Chrysler Agrees to Back Jeep Venture*, China Daily Bus. Weekly, Aug. 17, 1987, at 2, col. 3.

¹¹⁸ The First Automobile Works of Changchun, Jilin Province.

¹¹⁹ Zhu, *China, U.S. Sign a Large Auto Deal*, China Daily, July 22, 1987, at 2, col. 1. The plant is expected to produce up to 300,000 engines a year for light trucks and cars.

¹²⁰ The agreement was characterized by former Vice-Premier Li Peng (now Premier) as "an event of significance" for China's motor industry and bilateral cooperation. *Li Praises Chrysler Agreement*, China Daily, July 24, 1987, at 2, col. 1.

¹²¹ *China Should Make Imported-Car Parts*, China Daily, May 5, 1987, at 2, col. 2 (summarizing report from the *Liberation Daily*).

law reform efforts by the Chinese, should facilitate progress in future foreign investment enterprises.

4.2 Competition for Scarce Resources

A major macroeconomic problem that will face all participants in China's auto industry, as well as the government's strategic plans, will be the future allocation of scarce resources. It is difficult for many Americans, accustomed to automobiles as a way of life, to imagine the extent to which traditional handcarts, wheelbarrows and animal drawn wagons have served as transport in China even in recent times. In 1953, Daxing County on the outskirts of Beijing began to use trucks when three old American models were first obtained. By the end of the 1950's, it was reported that there were only 147 trucks in use for such purposes as delivering produce to the capital city. Today, Beijing's outskirts have more than 14,500 trucks in use,¹²³ but this does not nearly meet the capital city's cartage and transportation requirements.

The necessary growth in China's transport industry will have significant economic, social and political costs. The development of a massive domestic motor vehicle industry as envisioned by Chinese planners will place enormous demands on China's resources, yet, at the same time, it can fuel significant employment and domestic economic growth.¹²⁴ From 1981 through 1986, China's economy expanded at

¹²³ "The Age of the Truck" in *Outskirts of Beijing*, China Daily, Aug. 17, 1987, at 2, col. 3.

¹²⁴ Limitations on the production of steel, a basic essential to a growing auto industry, illustrates the degree of planning stress which may be caused by growing auto industry demands. Because the quality of Chinese steel is not yet high enough for all auto industry needs, China must import a substantial amount of steel for its auto industry. *How China Boosts Her Car Industry*, *supra* note 13. Presently, about 4% of the country's steel output is used by the motor vehicle industry. As China's auto industry expands, its consumption of domestic steel will increase if there is a sufficient increase in the quality of domestic steel. If not, then there will be a commensurate increase in the amount of steel imported into China, representing an additional foreign exchange drain.

Oil has been one of China's most lucrative exports. Oil has made it possible for China to obtain imports which are needed for auto production and other heavy industries. For example, China's trade with Brazil is substantially an oil-for-steel exchange, to compensate for China's lack of quality steel production. Following two years of sharply increasing oil exports, China replaced Indonesia as Asia's leading exporter of oil in 1985. Woodard, *Impact of Oil Price Volatility on China's Petroleum Industry*, 9 E. ASIAN EXEC. REP., Aug. 15, 1987, at 7 [hereinafter Woodard]. However, the rise in exports now appears to have been only temporary. Net oil exports declined by 8% in 1986, and were projected to decline by 11% in 1987. *Id.* One cause of the problem was the worldwide decline in oil prices. The principal cause, however, was increased Chinese demand. It has been estimated that, in 1983, China's 2.6 million automobiles consumed approximately 13 million tons of fuel, or about 40% of all the oil produced in China that year. *How China Boosts Her Car Industry*, *supra* note 13. By mid-1985,

real growth rates averaging ten percent each year. Key petroleum-consuming sectors such as road and air transport, agricultural machinery and petrochemicals grew between fifteen and twenty-five percent each year during that same period.¹²⁵ China's energy resources generally are in a stage of underdevelopment, and must respond to increasing energy demands as China's auto manufacturing base and economy continue to grow.

China's infrastructure of roads, bridges and transportation networks also will need to grow considerably in order to accommodate the projected growth of motor vehicle usage. While this may not be an immediate problem in areas where highways are not yet congested by auto traffic, there remains large areas of the country with very limited access to modern highways.

5. THE FUTURE OF CHINA'S REFORM MOVEMENT AND SINO-U.S. RELATIONS

China's goal under the Seventh Five-Year Plan (1986-90) is to create production capacity for about 600,000 motor vehicles by 1990, improve the ranges of production and make inroads into the international export market.¹²⁶ Foreign investment in the auto industry appears to be a key factor in the realization of the nation's goals for a modern auto industry.

Political stability in China is essential to the creation and maintenance of an environment conducive to investment by auto makers, parts manufacturers, oil companies and other large potential investors. In that respect, 1987 may be characterized as a potentially traumatic year which nevertheless ended on a relatively positive note.

The ouster of Hu Yaobang in January 1987 from his post as Party General Secretary was a dramatic but revealing commentary on China's ongoing economic revolution.¹²⁷ Little detail is known of the political discord within the Chinese leadership that led to the removal of Hu, the man widely viewed as Deng Xiaoping's chosen successor as the leader of China's 1.2 billion people. This shakeup at the pinnacle of power has been widely viewed as a result of continuing differences

there were reports in China of extensive shortages of petroleum fuels, especially gasoline and diesel fuels. Woodard, *supra*, at 8. If road traffic in China is increased by the anticipated five-fold by the year 2000, domestic consumption of about one-half of China's oil production for that year will result. *How China Boosts Her Car Industry*, *supra* note 13.

¹²⁵ Woodard, *supra* note 124, at 8.

¹²⁶ *Industry Accelerates Towards Goal of Localized Components*, China Daily Bus. Weekly, April 22, 1987, at 2, col. 5.

¹²⁷ *Hu Yaobang Resigns From Top Job*, China Daily, Jan. 17, 1987, at 1, col. 1.

among members of the Chinese hierarchy over the methods to be used in China's experiment in "socialist modernization." To date, however, the fears that this signaled a retrenchment and possible return to the xenophobic tendencies of the past appear to be groundless. In spite of some temporary setbacks, the ambitious drive for modernization fueled by Western investment continues unabated.

Hu Yaobang's fall from grace was more likely a reflection of Deng Xiaoping's pragmatism and willingness to compromise, rather than an indication of any slippage of power on his part. If anything, Deng now appears fully in control. Zhao Ziyang, the progressive and relatively young Premier selected by Deng Xiaoping from his home province, was appointed as acting Party General Secretary after Hu Yaobang's removal. Subsequently, the Thirteenth Party Congress met in late October 1987, and confirmed Zhao Ziyang's regular appointment to that high post. Significantly, Hu Yaobang was not expelled from the Party, nor has he suffered any other official ignominy that would signal a return to the repressive policies of past leadership shakeups. The Party continues to support the modernization drive and further involvement in and reliance upon Western investment.¹²⁸

One of the most commonly debated questions among China watchers is the question of Deng Xiaoping's successor. More than any other single foreseeable event, the appearance of Deng Xiaoping's successor will influence the stability level of foreign investments. This change in leadership will be more a process of evolution than one of institutional selection. Today, Deng Xiaoping's only formal claim to power is his chairmanship of the Party's Military Committee. Although this role is highly significant in a country where police power traditionally has played a major role in government, title alone clearly does not determine the locus of control.

How will U.S. firms fare in the competition for a share in China's auto manufacturing and related markets? The outcome for U.S. firms should be favorable, assuming that both Chinese and U.S. firms weather the current legal, economic and political difficulties.¹²⁹ China's

¹²⁸ See, *Advance Along the Road of Socialism With Chinese Characteristics*, *supra* note 29. Li Peng, who is viewed as more moderate than either Zhao Ziyang or Deng Xiaoping in his views on the need for rapid modernization, was selected as Zhao Ziyang's successor as Acting Premier. Although Li may introduce Western-style reforms more gradually, he clearly is considered part of Deng Xiaoping's pro-modernization camp.

¹²⁹ Political actions in the United States, such as the recent congressional condemnation of alleged abuses of human rights in China/Tibet, Foreign Relations Authorization Act for Fiscal Years 1988 and 1989, P.L. 100-204, § 1243, § 1245, 100th Cong., 1st Sess. (1987), coming in the midst of sometimes strident criticisms of China in the American business press, further strained relations between the two countries. See, e.g.,

opposition to the influences of Western "bourgeois liberalism," which often seems to be directed at the United States, has created a sense of unease among U.S. governmental officials and potential U.S. investors alike. The recent actions of the Thirteenth Party Congress, coupled with the pro-foreign investment laws and regulations of the past year, should assuage many of the investors' concerns.

Despite these problems, however, both China and the United States still have much to gain from increased business relationships. Beijing Jeep's recent recovery has undoubtedly made a major contribution to increased goodwill between China and the U.S. auto industry. As BJC's president has said, "the next big automobile investment will be, I think, by the Americans, because they have the inside track. This probably is true in other industries also. Generally, they like Americans."¹³⁰ During the first half of 1988, significant new Sino-American auto industry deals were consummated or brought under consideration. In January 1988, a \$16.5 million sales agreement was disclosed whereby General Motors would send to China an engine making assembly line which should be producing 150,000 gasoline engines per year by 1992 for light duty trucks.¹³¹ Additionally, GM and Japan's Fuji Heavy Industries Ltd. were considering forming a \$4 billion joint venture agreement with China to manufacture cars.¹³² Chrysler also announced that it hopes to add passenger cars to the line of Jeeps it already produces in China, making it the first U.S. autoworker to produce passenger cars in China.¹³³

In his "Report on the Work of the Government," delivered at the First Session of the Seventh National People's Congress on March 25, 1988, China's new Premier Li Peng identified as a major national objective the development of transport services, which would include the vigorous development of the machine-building industry.¹³⁴ With respect to China's overall strategy of economic development, he said: "We must open China wider to the rest of the world, speed up the growth of an

Kraar, *The China Bubble Bursts*, FORTUNE, July 6, 1987, at 86 ("The Western dream of a billion customers is fading fast. . . . [C]ompanies are being worn down by corruption and rip-off prices.").

¹³⁰ St. Pierre Interview, *supra* note 73.

¹³¹ Ignatius, *Beijing to Buy General Motors Assembly Line*, Asian Wall St. J., Jan. 21, 1988, at 1, col. 3. Chrysler Motors concluded a similar deal with China's First Automobile Works in July, 1987. *Id.*

¹³² GM, *Fuji, Mull China Car Venture*, Asian Wall St. J., Jan. 4, 1988, at 3, col. 4.

¹³³ *Chrysler Seeks Link to Make U.S. Cars at Factory in China*, Asian Wall St. J., Feb. 29, 1988, at 3, col. 3.

¹³⁴ Li Peng, Report on the Work of the Government, Delivered at the First Session of the Seventh National People's Congress (March 25, 1988), reprinted in BEIJING REVIEW, Apr. 25, 1988, at 11, 12, 22, 26, 14.

export-oriented economy in the coastal regions and take an active part in world economic exchange and competition."¹⁸⁵ Thus, the investment environment in China is highly favorable for those foreign firms interested in the auto industry.

There clearly are investment opportunities in China for U.S. automakers and related industries. It is equally clear, however, that the opportunities will be accompanied by many challenges to both parties, including a challenge to the adequacy of China's new laws and regulations on foreign investment enterprises.

¹⁸⁵ *Id.* at 35.