

# Chinese economics flashcard



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The social values and history have shaped and formed the economical developments

and the current environment of business in the People's Republic of China.

They

have determined the patterns for negotiation and the Chinese perceptions of

business, and their feelings towards westerners. The implicit and explicit rules

that the Chinese society has on the development of businesses, and the economy

in general, are very important issues for any person going into China to

understand and consider. In order to achieve a successful partnership between

Chinese and Western cultures it is essential to have a basic understanding of history and cultural developments that have shaped the current environment of

business. The three pillars of China are economy, culture, and society.

Economy

The Chinese economy has been formed as a result of centuries of history and development, which reflect the philosophy of China and its current economical

position. China started as a mainly agricultural based society with the subsistence group; the family. For more than 2000 years the Chinese economy

operated under a type of feudal system; land was concentrated in the hands of a

relatively small group of landowners whose income depended on rents from their

peasant tenants. Agricultural taxes levied by the imperial government and crop

yields subject to drought and floods kept agriculture relatively underdeveloped

and organized in small units with the use of primitive methods for basic

subsistence. The conclusion of the Opium War of 1840 formally initiated a period

of Western penetration of China from the coastal treaty ports. Railroads and highways were constructed, and some industrial development began. Such activity

had little impact, however, on the overall Chinese economy. In effect, China was

carved up into a number of competing colonial spheres of influence. Japan, which

tried to attach China to its East Asia prosperity Sphere, was able to create only isolated nodes of a modern economy. The Chinese Communist party emerged in

the 1920s in the midst of a mounting economic crisis caused by foreign intervention and increased landlord influence in the countryside. For more than

two decades, it expanded its control over large rural areas by introducing an agrarian program based on the control of rent and usury, and by giving power to

peasant associations. On October 1, 1949, the Communist party successfully established a unified national government and economy on the mainland for the

first time since the end of the imperial period in 1912. From 1949 to 1952 the

emphasis was on halting inflation and ending food shortages and unemployment.

The new government initiated a land reform program that redistributed land to

300 million poor peasants into cooperative farms. In 1958 the rural people's communes were established, and these dominated agriculture in China until the early 1980s. The commune was based on the collective ownership of all land and major tools by its members, who produced mainly to meet state planning targets and who were rewarded according to the work they performed, although basic necessities were guaranteed to all members. In the urban-industrial sector, state ownership of property and of industrial and commercial enterprises was gradually extended. Industry grew steadily from heavy investment under the first five-year plan, and the state-owned sector achieved an overwhelming importance.

The second five-year plan was introduced in 1958, trying to get China ahead into industrialization. This program was characterized by large investments in heavy

industry and the establishment of small-scale versions of such industries as steel refining. The program, however, caused great disruptions in economic management and in rational economic growth, and in 1960 the program had to be

abandoned. The Chinese economy then entered a period of readjustment, but by

1965 production in many fields again approached the level of the late 1950s.

The

third five-year plan began in 1966, but both agricultural and industrial

production were severely curtailed by the effects of the Cultural Revolution;

a

fourth five-year plan was introduced in 1971 as the economy began its recovery.

After eliminating the vestiges of the Cultural Revolution in 1976, China's

leaders decided to move at a faster pace on all economic fronts to make up for

the loss suffered in the preceding ten years. A fifth five-year program began in

1976 but was interrupted in 1978, when the Four-Modernization program was

launched. It included the modernization of agriculture, industry, national defense, and science and technology. A ten-year plan for 1976-85 stressed improvement in economic management and a larger role for private and collectively owned (as opposed to state-owned) enterprises. This program was

superseded by a more modest ten-year plan for 1981-90, but efforts to attract

Western technology and investment continued, as did a program of incentives to

increase agricultural production. Policies introduced in October 1984 called for

further decentralization of economic planning and for increased reliance on market forces to determine the prices of consumer goods. China has potential to

be the biggest market of the world with 1.3 billion people. Furthermore, it possesses billions of unexplored resources and the biggest and cheapest labor force

in Asia. The size and underdevelopment make it a potential monster that has created interest in every investing and developing country in the world. The

Chinese economy is an increasing economic possibility for anyone. Culture ;

Society Chinese culture and society can be divided into two major periods,

Imperial China and Communist China. The modern Chinese society can be defined as

a combination of centuries of values and communist propaganda achievements. The

imperial China had a strong class system where 90% of the people were poor and

possessed limited resources to develop culturally, socially and personally.

This

situation led to the strength of the large family and the basis for the

distinctive collectivism of China. The well being of the family and the state

are the main goals for any action in society. If actions taken do not contribute

to the family or the society as a whole, then the actions will not be regarded

as proper. Eliminating almost any form of individualistic thinking. The

Chinese

Family is the main economic unit of society. The development of the Chinese

economy is based on the family. The Chinese family is the economic unit in which

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members produce and consume in common. Also, it is the religious unit responsible for the performing of rites required for the well being of the family. The social security of the Chinese family relies on the effective performance and interaction between religion and family. These concepts strongly

clash with western individualism collection of wealth for personal gain. A clear

example of this is the overseas Chinese control family-run business empires that

already dominate much of Asia. They invest billions in China, helping their ancestral homeland become the world's fastest-growing economy. Together, China

and its approximately 56 million offshore Chinese are the most important commercial and political forces for China and reflect, again the family based economic strategy that they follow. In addition to the traditional imperial Chinese society, the Communist values shape and blend into modern Chinese

philosophy. One of the early acts of the Chinese Communist party after it gained

control in 1949 was to officially eliminate organized religion. Previously the dominant religions in China had been Confucianism, Taoism, and Buddhism. Most

temples and schools of these four religions were converted to secular purposes.

Only with the constitution of 1978 was official support again given for the allowance of formal religion in China. The constitution also stated that the Chinese population had the right to hold religious beliefs. Moreover, China has

a long and rich cultural tradition in which education has played a major role.

Throughout the imperial period (221 BC-AD 1912), only the educated have held

positions of social and political leadership. In 124 BC the first university was established for training prospective bureaucrats in Confucian learning and the

Chinese classics. Historically, however, few Chinese have been able to take the

time to learn the complex language and its associated literature. It is

estimated that as late as 1949 only 20% of China's population was literate.

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the Chinese Communists, this illiteracy was a stumbling block for the promotion

of their political programs. Therefore, the Communists combined political propaganda with educational development. Chinese education has been strongly

affected by the communism in China. Since education was for the rich and privileged during imperial age of China. One of the most ambitious programs of

the Communist party has been the establishment of universal public education for

their large population. In the first two years of the new government (1949-51)

more than 60 million peasants enrolled in “ winter schools,” or

sessions, established to take advantage of the slack season for agricultural workers. Mao declared that a dominant goal of education was to reduce the sense

of class distinction. This was to be accomplished by reducing the social gaps between manual and mental labor, between the city and countryside residents and

between the worker in the factory and the peasant on the land. After long

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periods of breaks and changes in policies colleges reopened in 1970-72.

Admission was granted to many candidates because of their political leanings,

party activities, and peer-group support. This method of selection ceased in

1977, as the Chinese launched their new campaign for the Four Modernizations.

The governments stated goals for rapid modernization in agriculture, industry,

defense, and science and technology required high levels of training. Such

educational programs by necessity had to be based on theoretical and formal

skills more than on political attitudes and the spirit of revolution. After the

revolution every thing changed in China. The stability of social values and

structure where the highest achievement for the Chinese philosophy. These values

where already deep in the Chinese culture; however, they were strengthened with

communism and used into the development of China. The Chinese society had become

a combination of strong family and moral values and a country thriving for

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modernization and industrialization. This concept of stability as the highest achievement obstructed the development of China in the past, and still creates problems today. The sole concept of risks disturbs the grounds of Chinese culture in contrast to western society where risk is the main drive for development and investment. Business Development in China The radical change from imperialism and strong class differences to the equality philosophy implemented by Mao Tse Tung created the modern China. Its development from feudalism to communism created a conservative China, with very few attempts to move towards capitalism. It was through the imperial years that mercantilism and trade took place, yet it never flourished, as the capitalistic model westerners know, until China's re-opening to the western world in the 70's. China has always had the elements for development. In fact, they could very well have had an industrial revolution before England. China possessed many key elements that

transformed Europe into a modernized industrial economy (compass, printing,

gunpowder, etc). Nevertheless, there is much more to China than just industrial

and economical development. Thus, when considering developing a business in

China one should always consider the cultural factors that makes the Chinese

society so strong and differentiating it from western societies. The fact that

China wants to grow, does not mean that it will do it with the western models and philosophy, rather it will be with models developed from their own culture.

This is the point that can be attributed to cause most of the problems between

Chinese and Western cultures, and the point to be accepted in order to be successful in developing a successful business relationship in China.

Negotiating in China can be very frustrating. Differences in decision making styles and negotiating tactics cause misunderstanding and tension. Chinese

culture is based on the importance of rituals and ceremonies and so is Chinese

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business. Business meetings are as important as the dealings during receptions.

To exemplify the process of dealing with China in order to develop a productive

relationship we will use the case of Kentucky Fried Chicken in China. This case

includes the different problems and strategies used in the negotiation and development of business in China, specifically in setting up a foreign joint venture. However, the problems that arise and the current working environment of

the Chinese economy cannot be understood without first understanding the history

and the cultural revolutions that have shaped it. This brief outline of the history of China leads insight into some of the problems and the resolutions that a manager for KFC experienced during his venture with the Chinese. KFC in

China In 1986, Tony Wang was Vice President of the Southeast Asia division of

KFC. He had an opportunity of bringing the world's largest chicken restaurant

company into the world's largest populated country. Wang was an experienced

entrepreneur and had been working for KFC for seven years. No other fast food

companies were currently operating in the People's Republic, so Wang did not

have anything to go by and had nothing to help him evaluate the attractiveness

of the Chinese market. The main downsides of operating in China were huge

demands on managerial resources and the low prospects of significant hard

currency repatriation. The first decision that Wang was faced with was where to

open the location of the first KFC. Obviously there were differences from city

to city but a reliable way to evaluate these differences did not exist. Wang was

interested in the enormous potential of the Chinese market, but he knew that

many other companies had failed in similar ventures. Ta-Tung, (Tony) Wang was

born in the Sichuan province in the People's Republic of China in 1944. He moved

to Taiwan when he was young and graduated from the Chong-Yuan University with a

degree in engineering. He later moved to the United States, and in 1973

completed a masters degree in management science from the Steven's Institute of

Technology in New Jersey. He then attended New York University where, in 1975,

he received his post-master's certificate in international business management.

Wang joined KFC in 1975 at the headquarters in Louisville. Wang was convinced of

the large potential for American-style fast food in China. He attended a lecture

by the mayor of Tianjin (the third largest city in China), who spoke of the many

opportunities for investment in his city. Wang was asked by the mayor to sit on

a council to advise on improving the fast food industry in Tianjin. KFC was

currently owned by R. J. Reynolds, who was very interested in getting into the

Chinese market to sell their cigarettes. American smokes were in high demand in

China. Wang had the support of top management. He spoke perfect Mandarin and

English and was as comfortable working in New York as he was Beijing. He also

had experience negotiating with the Chinese. As Tony Wang investigated more and

more into the necessary requirements his concerns began to grow. He knew that

Chinese workers would have problems working under the KFC guidelines, and

time-consuming, expensive training programs would be a necessary requirement. As

well large capital outlays would be needed to find and negotiate a partnership,

to sign a lease and gain operating permits. Wang began to thoroughly research

the Chinese market. The first item that he began to look at was location. The

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reason that this was so important was because the location would have dramatic

impact on the profitability, future expansion to the rest of China, and the managerial resources commitments. Four cities were selected as potential locations for the first store: Tianjin, Shanghai, Guangzhou, and Beijing.

Tianjin – One of the major advantages of Tianjin was the established contacts that Wang had there. As well, it was only one of three municipal governments in

China that were not controlled by the Central Government in Beijing. The major

problem with Tianjin was it lacked a convenient supply of grain-fed chickens.

Local chickens were fed using fish meal fed chickens. This presented a problem

given that the Chinese place great emphasis on freshness and taste. Tianjin also

was not a very popular tourist location. Wang expected most profits to be in Renminbi, but some foreign currency would be needed for profit repatriation and

purchasing needed supplies, which could only be purchased outside of China.

Shanghai – Shanghai has over 11 million people, and is regarded as China's most

prosperous business centre. Shanghai is home to a large variety of Western hotels, business facilities and tourists, however it also is not a very popular tourist spot, because of the pollution and loud noise. The investment could not

be justified if it did not supply an adequate amount of foreign currency.

Shanghai did, however, contain several feed mills and the largest poultry supplier in China. Gangzhou – Gangzhou is located in Southeast China only a short distance from Hong Kong, and is recognized for its preferential treatment

for foreign investment. It has greater autonomy in approving foreign investment

projects, reducing tax rates, and encouraging technological development.

Many

tourists visit Gangzhou because of its close proximity to Hong Kong. As well as any

operations could be managed directly from the existing Hong Kong operations. As

well, Wang did not anticipate difficulty finding a supplier for chicken. Beijing

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- Beijing is the second largest city in China. It is the political and cultural centre and has relatively high levels of affluence and the education of its inhabitants. It is also the tourist centre of China, with many attractions located in and around Beijing. A Beijing location would also give a higher profile. This could be both good and bad. If they received approval from the central government, they would be able to enter the rest of the Chinese market without hassle. However, because of the higher profile, the government might decide that they would not fit in to the Chinese landscape, which would prevent them from ever succeeding. Outside of Beijing there were also numerous poultry farms. Wang knew that the location was the most important detail, and would decide whether KFC would succeed or not. There were currently no other competitors in the Chinese market, so now was the time to strike to take advantage of the situation. The risks were high, and Wang needed to weigh out

these risks to estimate whether the expenses would lead to for a huge gain or a

huge loss. In early February 1987, Wang decided to open operations in Beijing.

This was decided because of Beijing's high amount of tourists and its autonomous

municipal government. However, he was feeling more worried about the venture.

KFC signed a joint venture partnership. Wang's worries were stemming from the

difficulty he had been experiencing getting things done in a city governed by a

bureaucracy that seemed impossible to either understand or work with. He felt

that he would never be able to find a location in the city and government approval was required on everything. Wang was also concerned whether Chinese

workers would be able to meet KFC's demands for cleanliness, quality and service. The establishment of a joint venture was considered essential because

Wang described the Chinese, “completely impossible for us to understand.

In

fact, trying to do so is a complete waste of time.” Trying to understand

investment regulations, winning approval for operating licenses, leases, and

employment contracts could certainly prevent them from proceeding. A local

partner was not required under Chinese law, however Wang felt it would be

beneficial in setting up operations and maintaining continued viability.

Through

ties R. J. Reynolds had with the Ministry of Light, a partnership was formed

between KFC and the Beijing Corporation of Animal Production, a Beijing city

government-controlled producer of chickens. After careful inspection KFC

found

that this would indeed work out, as Animal Production already produced

three of

the approved breeds of chicken required for operations. Negotiations with

the

poultry producer commenced with Mr. Jue Xia, a senior manager in the

Beijing

corporation. Xia felt that it would not be able to meet KFC’s large demand

because they did not have access to large enough reserves of grain. Xia was also

hesitant about KFC's quality standards. However, they thought that a partnership

with a Western firm would be beneficial for them as they would gain

international experience. Xia felt that Tony Wang was unlike most American managers; he was a man he could deal with. The Beijing Corporation helped Wang

find a chicken supplier but they lacked close contact with the government agencies that would be essential to setting up operations. So a third partner was needed. Both partners agreed that the Beijing Tourist Bureau would be able

to meet their requirements. The Tourist Bureau was responsible for the supervision of the construction and operation of all hotels and restaurants in Beijing. They also had a lot of experience speeding up the construction of many

Western hotels, and had many times participated in a joint venture in these operations. During these negotiations it happened that KFC was sold to Pepsico.

During this time KFC was the second largest fast food chain in the world. It was

initially thought that Animal Production had only come on board because of pressure from the Ministry of Light Industry, who wanted to win points with Reynolds, so the acquisition came at a bad time. As it turned out, however, Pepsico's connections with the government in Beijing were even stronger than

Reynolds, so negotiations continued with a renewed interest. To convince the

partners to become part of the venture, Wang offered a guarantee of five percent

return on equity, much better than they could receive domestically. This sealed

the deal in winning over the partners. KFC retained 60% of ownership, The

Tourist Bureau received 27%, and Beijing Animal Production took 13%. This was

the actual breakdown of assets that each partner was contributing to the arrangement. This deal was privately pre-approved as acceptable in negotiations

with the Foreign Economic Development and City Planning Commissions. The

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approval of the partnership also required on the sharing of the corporation.

With one-half coming from KFC and the other half split between the other two

partners. The deal also stated that the chairman would be appointed by Animal

Production and the vice-chairman would be appointed by the Tourist Bureau.

This

concerned Wang because of loss of control over operations. Wang countered by

establishing the new store as a franchisee, with the franchiser being KFC's head

office in Singapore. This would require 3% royalty payments to be paid to the

head office, and require the store to purchase its seasoning mixes from the head

office, both using hard currency. Wang also appointed a day-to-day general

manager in Beijing, who would be appointed by KFC and have control over

operations. Although it seemed like all major challenges were over, they

weren't. The approval of the partnership did not give any operating authority

for KFC in the city. They needed a "Licence to Execute a Business

Activity.” Approval of this required the signatures of the District

government, the Commerce Department, the Taxation Department, the Health

Department, and the Food Supply and Logistics Department. None of these agencies

had any coordination, so approval from each separately was required and this

could take months or years. Tony Wang stated: “ We are pioneers in China, but so are the Chinese. However, whether they want to learn or not is another

story. Many Westerners make the same big mistake in China: they assume that they

can just pay to have the required work done or at least expedited. This just doesn’t work in China. The Chinese are not motivated by a desire to do things

right simply for the sake of doing things right. They don’t want your help in speeding up the process. They just want to avoid problems. And unless we can

convince them otherwise, we are their biggest problem.” A license was

necessary before a lease could be signed, but Wang was worried that a desirable

location might not be found. All buildings and possible space in Beijing is occupied. As well, Chinese regulations stated that new tenants would have to guarantee the employment of any workers left jobless when a new tenant took

over. This worried Wang because he would be stuck with a number of unskilled

Chinese that he would have to employ. Wang wanted the first store that was to be

opened to be big and flashy because it would determine the future success of KFC

in China. This was strategically a good idea but it ran counter to the culture

in China where there was a history of hostility towards Western culture. In

February 1987, a license was issued by the city, allowing KFC to operate in

Beijing. The Tourist Bureau played an integral role in speeding up the

application. Under the license KFC was given a tax remission for two years;

profits in three years, four and five would be taxed at 16.5%, with profits

thereafter taxed at 33% Wang now had to select a site to open the first

location. But no matter where a location was chosen KFC would still require a building permit, as well as hookups for electricity, water, gas, and heating before the store could open. Wang discovered that many of these services were

difficult to obtain, and it was not uncommon for applications to not be processed for months. Another concern was the company's need to secure import

licenses needed to bring equipment into the country: pressure frying machines,

cash registers, blending and cutting equipment for the kitchen. Each item required a separate permit that could take months to attain. During all these negotiations Tony Wang realized that no one had thought to test market the area.

It was known that the Chinese liked chicken. From KFC's success in Hong Kong, it

was assumed that it would be accepted, but no one had had time to find out for

sure and they were forced to cross their fingers. Another problem was finding a

reliable supplier of quality potatoes. If they were unable to do this they would

have to use mashed potatoes, and Wang did not know how the Chinese would receive

this. The largest concern facing Tony Wang was whether or not the Chinese employees could meet the quality, service, and cleanliness requirements.

The

Chinese employees would have little appreciation for KFC's international standards of cleanliness or product quality. Most domestic organisations lacked

any incentive programs, work was seen as something to be avoided, and service

was a foreign term. The KFC organization would not allow the store to open if

these levels were not met. The ironic part was that Chinese consumers would

accept less than what was required. This would create conflict with the

partners. Tony Wang also wondered what KFC would do with the soft currency that

the venture would generate, and wondered whether or not there would even be any

profits. Wang was faced with three options: 1. Pull out – cut the company losses

and avoid negative publicity if the venture failed. This would allow for further research and KFC could try to re-enter in a few years when there was more complete information. 2. Go ahead slowly – taking more time evaluating the situation to make sure the partnerships were secure and the market would accept

KFC, however this would invite competitor response. 3. Go ahead full – the market had high potential for success for KFC, and, with 1.1 billion people, large potential for profits. Wang decided to go full ahead. The location was finally found. The central government approved the lease because Wang sold them

on the idea that the restaurant would represent a symbol and statement of the

People's Republic open policy with the West. The lease was finally approved in

April of 1987, however they did not have the building permit, which would allow

them to make necessary renovations. They also required hookups for gas, water

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and heating. Applications were continually lost or just went unanswered.

When

KFC announced that it would be hiring it was flooded with applications.

Management decided to treat all applicants equally. Referrals would not be accepted. This was a unique move in China where family contacts are usually used

to land highly sought after jobs. This move created conflict with the partners.

Economics