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Global sourcing with China: the challenges faced by small US manufacturers

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Abstract

When the People's Republic of China joined the World Trade Organization in 2001, the US had to contend with an increasing economic trade deficit, as low-cost Chinese manufactured exports poured into its shores. China has since risen from the economic shambles following Mao's failed Cultural Revolution to become one of the world's superpowers, with its economy growing almost 10 percent per year. It has become a haven for multinational corporations and entrepreneurs who were enticed by the prospect of having few worries about minimum wages, pensions, benefits, unions, antipollution laws or worker safety regulations.

In the face of the growing trade deficit trend between China and the US, American manufacturers should be asking what they can do to survive the tidal wave of Chinese imported goods. One option that merits consideration is global sourcing with Chinese businesses. Small US manufacturers must understand how to use off-shore capability to their own advantage and to the benefit of their customers. In this light, Sino-US macroeconomic forces as well as the legal and financial requirements of doing business with China must be understood. This article discusses the intense global competitive pressures that many small US manufacturers face and the issues and challenges they must confront in order to survive and even prosper.

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1. Introduction

In December 2001, the People's Republic of China (hereafter "China") joined the World Trade Organization (WTO) and became the multilateral trade body's 143rd member (China Today [2001]). Although this provided a major boost to American companies that export to China, it has also resulted in an increasing economic trade deficit for the US, which has been swamped by low-cost Chinese manufactured goods (Global Sources [2003]).

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China has undergone a stunning transformation from the economic shambles following Mao's failed Cultural Revolution to its current position as one of the world's superpowers (Fishman [2005]). The explosive growth of almost 10 percent per year has been fueled by multinational corporations and entrepreneurs aggressively moving to establish trade with China, where they had few worries about minimum wages, pensions, benefits, unions, antipollution laws or worker safety regulations (Fishman [2004]).

Is the growing trade deficit trend between China and the US going to stop soon or maybe even reverse itself? Even with the heavily reported severe acute respiratory syndrome (SARS) threat, the long-term answer is no. The question that small US manufacturers should be asking is: what can they do to survive the tidal wave of Chinese imported goods? The answer is global sourcing in cooperation with Chinese businesses.

The notion of blended manufacturing—the combining of operations in the US with outsourced production from China—appears to be a good solution. Small US manufacturers must understand how to use off-shore capability to their own advantage and to the benefit of their customers. In order for this to work, the underlying Sino-US macroeconomic forces as well as the legal and financial requirements of doing business with China must be understood. This article discusses the intense global competitive pressures that many small US manufacturers face and the issues and challenges they must confront in order to survive and even prosper.

2. China and WTO status

China was one of the original signatories to the GATT (General Agreements on Tariffs and Trade; a precursor to the WTO) in 1948. Membership remained with the Taiwanese (Republic of China) government until rescinded in 1971. In the same year, the People's Republic of China was recognized as the official Chinese government by the United Nations and granted status to GATT. The WTO was established in 1995 and China's official accession was granted in 2001.

China has experienced tremendous economic growth over the past 20 years. This expansion has been fueled by vigorous reforms in government policy resulting in gross domestic product growth rates averaging near 10 percent annually. With such expansion, an array of new jobs and investment opportunities has been created in China. The effect of the 'China miracle' (the transformation from an inward-looking, planned economy to a more market-oriented, trading country) has greatly affected the global economy, influencing such things as consumer choice and investment location.

WTO membership was China's best option for sustaining its economic growth and reforms, which have continued to spur the growth of its domestic economy as well as encourage more foreign direct investment. Since achieving full WTO status in 2001, the country has seen continued judicial and regulatory reform, business privatization, and tremendous growth in its labor markets. China is now an active participant in the formulation of rules that govern international trade and investment. It is also able to defend its trade interests using WTO's dispute-settlement system. In short, China is now a full-status global economic power.

With China's rapid economic expansion, some structural weaknesses in its economic system have surfaced. The dilemma for China has been how to best continue the dual momentum of economic growth and structural political reform. China's WTO membership resulted in increased unemployment in the short term as state-owned enterprises were restructured or completely eliminated in the face of international competition. Statistics released by China's Ministry of Labor and Social Security in 2002 showed that over the five-year period from 1997 to 2001, 27 million people were laid off from state-owned enterprises as a result of industrial restructuring and economic reform (ClariNews [2002]). Recent figures show China now boasts a work force of 730 million people, of which 490 million live in rural areas and 240 million live in urban areas (China Ministry of Foreign Trade and Economic Competition [2003]). The statistics also reveal that the number of retirees from state-owned enterprises have risen to 33 million. According to government reports, the average monthly pension is 625 yuan (the Chinese currency measure), equivalent to about $72. China's large population, with many retired and unemployed workers, places a huge burden on the country's economic system.

Other disadvantages of WTO membership concern the decline of the agricultural sector, where increased imports have led to lower prices and incomes for rural Chinese citizens. This has resulted in mass migration to urban centers in eastern China; it is estimated that over 90 million people have moved into Chinese cities since the early 1990s (China Daily [2003]). China must continue to achieve strong economic growth in order to absorb the migration of the rural work force into the urban industrial labor force.

China's entry into the WTO has aroused passionate and mixed emotions among American business executives, economists, and politicians (Skoff [2003]; Stundza [2002]). Proponents of trade with China feel that it will help the US consumer through lower prices, make American industries more competitive, and provide increased exporting opportunities with the largest consumer market in the world (Gurdon [2002]). Opponents of free trade with China are of the view that millions of manufacturing jobs will be relocated from the US and the overall economy will be badly damaged in the long term by China's attainment of WTO status (Save American Manufacturing Organization [2003]).

3. Economic analysis

Since China joined the WTO in 2001, some sectors of the United States manufacturing economy have found their competitive positions altered and significantly weakened. Small American component manufacturers (i.e., plastic injection molding, die casting, stamping, forging, turning, etc.) have found Chinese manufacturers to be formidable competitors. A few US businesses have even attempted to retaliate by encouraging the establishment of tariffs and other economic impediments to lessen the flow of Chinese imports (Skoff [2003]). Some have gone so far as to call it 'America's other war' (Stundza [2002]).

A cyclical analysis of 28 industries by the Manufacturers Alliance reported that during the three-month period from October through December 2002, only 17 percent of US manufacturers reported positive year-over-year growth (Meckstroth [2003]). The industries hit the hardest were household appliances; electro-mechanical, measuring, and control instruments; fabricated metal products; electronic components; material handling equipment; and electrical lighting equipment. Since 2000 it has been reported that the US has lost 2.2 million manufacturing jobs—mostly to China (Torinus [2003]).

Some of the achievements reported in the press regarding China's economic miracle are exaggerated; however, there are many aspects in which the accomplishments are not entirely unfounded. For example, China's total exports increased almost 20 percent during 2002; furthermore, the annualized rate of Chinese export growth to the US during this period was almost 25 percent compared to the prior period (China's General Administration of Customs [2003]).

There are two primary reasons for the rapid growth in Chinese exports and the displacement of US jobs. The first has to do with China's cost of labor. Gross manufacturing wages in China averaged about 80 US cents an hour in 1988 or 5 percent of the average American wage (Department of Commerce [2000]). Given the loss of millions of jobs in the state-owned sector of the economy, it is likely that wages remain at this level.

China also has a seemingly infinite supply of workers. The government recently promised to spare no effort to reach the projected target of creating over eight million new jobs for urban residents in 2003, and the central government will subsidize new business efforts in order to confine its registered urban unemployment rate to 4.5 percent or less (People's Daily [2003]). Therefore, China does look as though it could out-compete the US in the manufacture of almost anything labor-intensive, and this is exactly what has been happening since 1995. Over 70 percent of China's exports today are labor-intensive items, which include shoes, garments, toys, furniture, and other mass-assembled items.

China's foreign trade volume exceeded $600 billion in 2002, moving them from the sixth position to the fifth in overall world trade (China Ministry of Foreign Trade and Economic Competition [2003]). The forecast for 2005 is for China's foreign trade and overseas investment to grow again by over 15 percent, with projections of almost 10 percent gross domestic product growth in 2005. This growth is the result of China's specific advantage with labor-intensive exports—mainly daily-use consumer goods that are exported around the world.

These economic statistics do not tell the entire story about the growing trade imbalance between China and the United States. It is not only labor-intensive goods that are being exported from China, but high-technology and major industrial goods (i.e., computers, semi-conductors, cars, and other capital-intensive goods) as well. For example, BMW, Honda and General Motors have recently opened automobile manufacturing operations in China. In the 2003 report on China's national economic development plan, the Minister of the Development Planning Commission reported impressive results in China's high-tech and capital-intensive industries (Peiyan [2003]):

> "Our industrial structure continues to improve. Competitive high-tech industries that possess proprietary intellectual property rights are emerging. The industrial output value of our high-tech industries grew by 23% in 2002. There has been stable development in traditional manufacturing industries. State-owned and industrial enterprises generated 562 billion yuan in profit in 2002, 20.6% more than in the previous year."

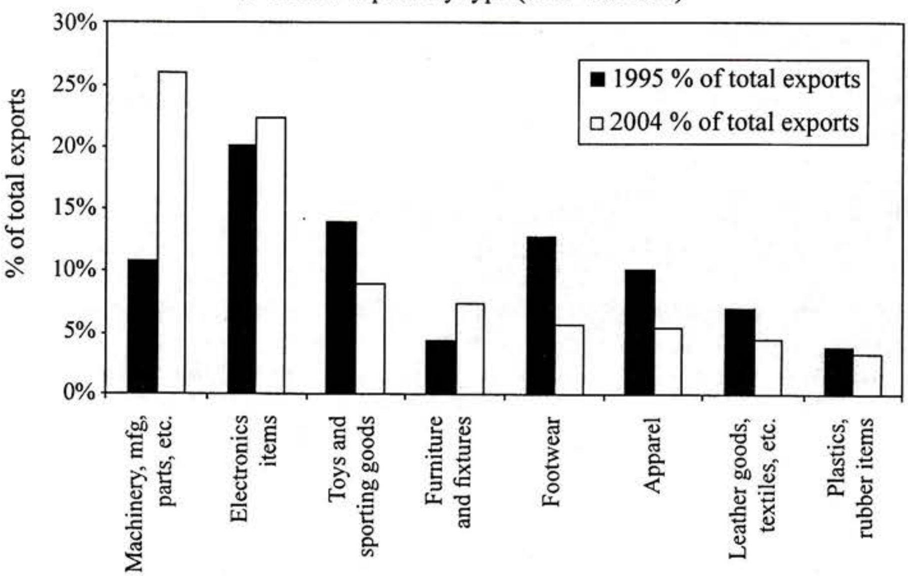
Figure 1 shows the annualized growth rate in China's exports to the US during the period 1995 – 2004 (US International Trade Commission [2005]). There are some significant observations regarding the data. First, the annual growth rate of these items in most cases was in excess of 15 percent. Secondly, the list of major export items to the US represents not only labor-intensive goods, but also high-technology items. For instance, machinery and electronic item exports to the US grew by over 25 percent annually since 1995 and now constitute the largest category of exports to the United States. While China still exports a significant amount of labor-intensive items (i.e., footwear, apparel, and leather goods), as a percentage of total exports these items are decreasing and higher value-added items are increasing.

Those against China's entry into the WTO in 2001 have argued that the Chinese would move into higher margin, higher value-added products. Data compiled over the past two years by the US International Trade Commission may prove them correct as China's export of high technology items has expanded since 2000. The sale of electronic and computer-related items to the US have soared by about 50 percent annually since 2000. The labor-intensive items (i.e., footwear and toys) also grew, but by less than 10 percent annually. It appears that most of the marginal increase in China's exports to the US has consisted of high-technology and capital-intensive items.

The President's Council of Advisors on Science and Technology stated recently that they are "concerned that high-tech manufacturing and the production of semiconductors is shifting to Taiwan, Singapore, and China" (Manufacturing and Technology News [2003]). For instance, the share of Dell Computer parts sourced from Asia in 2002 was estimated to be 60 percent, with the parts purchased from

China alone totaling about $3 billion in 2002. The increase in computer parts purchased from China and other Asian countries is likely to be 100 percent by 2004 (Bloomberg News [2003]). The movement of high-technology manufacturing from the US to China appears to be the next major economic trend.

Figure 1. China's most significant exports to the United States
% of total exports by type (1995 vs. 2004)



Source: US Department of Commerce, International Trade Association, Trade Compliance Center

Classical macroeconomic theory suggests that differences in countries' wage rates should be reflected in divergences in their productivity levels, and that any misalignment should be smoothed out over time. This provides little solace to many US manufacturers who fear that the time lag with China could be painfully long. Millions of people are moving from the countryside into the eastern Chinese cities, while at the same time state-run enterprises are dismissing huge numbers of workers. This dynamic results in a massive pool of surplus labor, estimated to be as high as 25 million workers, which helps explain why Chinese wages have been rising less quickly than productivity since 1996 (International Monetary Fund [2003]).

Economic theory would also posit that another way to offset a country's rapidly rising productivity would be through currency appreciation. China, however, has a fixed exchange rate (held at 8.28 yuan to the US dollar). The Chinese government has been considering the idea of floating the currency, but it worries that full convertibility could expose China to the sort of currency crisis that hit southeastern Asia in the late 1990s. That calamity affected first and foremost the Asian banking system, and China's leaders have determined that their developing financial system is not yet able to sustain a major currency shock. Therefore, it is not likely that US manufacturers will receive any help in the short term in the form of an increase in the value of the yuan to the dollar.

Due to the availability of inexpensive surplus labor, Chinese businesses have an enduring competitive advantage over US small manufacturers burdened with high wages and exploding health care costs. This enormous economic advantage, much to the chagrin of American companies, is likely to continue in the foreseeable future. To make matters worse, capital-intensive industries that usually purchase the outputs of small US manufacturers are moving more of their operations to China.

Since China earned entry into the WTO in 2001, many multinational companies have begun moving their manufacturing and technology bases to China. General Electric recently opened its third global research center in China and announced a corporate goal to generate $5 billion in revenues and $5 billion in Chinese sourcing purchases by 2005 (General Electric [2003]). Wal-Mart has also expanded its Chinese-sourced purchases. It is estimated that the world's largest retailer will increase its Chinese-sourced purchasing to $15 billion by the end of 2003 and to $30 billion by 2006—an annual growth rate of nearly 30 percent (China Daily [2003]).

The National Association of Manufacturers (NAM), which represents many small American firms, recently documented the loss of over two million manufacturing jobs in the United States since the beginning of 2000 (NAM [2003]). Interestingly, NAM has blamed a portion of the job losses on the steel industry tariffs imposed by President Bush and Congress in 2001. The American Iron and Steel Institute (AISI) has countered that "these job losses are not the result of high steel prices. There are many factors responsible for the US manufacturing recession, from the value of the dollar, to slow demand, and high health care costs. Also, jobs are moving to China because of lower wages and managed exchange rates, not because of steel prices" (AISI [2003]). So even within the US manufacturing industry, opposing views have arisen regarding the loss of production-related jobs to China.

While American manufacturing trade associations point fingers at one another, some small manufacturers are lobbying the federal government for action. In January 2003, a delegation of 13 Congressional members visited China to survey the situation. This excerpt from the report of one of the representatives to his constituents painted a bleak picture for US manufacturers (Sanders [2003]):

> "In 2002, the United States acquired a record-breaking $100 billion dollar trade deficit with China. We exported approximately $22 billion in goods and services to them, while we imported over $120 billion. In the last year alone, our trade deficit with China increased by over $15 billion. We should

> be mindful that our trade imbalance with China is not only related to 'low end' manufacturing like sneakers and toys. Increasingly, China is manufacturing and shipping to the United States more sophisticated products in electronics and electrical machinery. As China rapidly expands its numbers of engineers and technological base, there is no reason to believe that that trend will not continue, endangering more and more high-paying US jobs."

So what did Sanders and other members of the congressional delegation offer as a solution? They stated that America should do everything possible to build on the positive and friendly relationships with China that have been developing since the end of the Cold War. Sanders stated that "we should help provide them with the kind of expertise they need to develop a system of law, democratic institutions and a cleaner environment." While the effort to build a closer and more positive relationship with China sounds good, it does nothing to stem the flood of US manufacturing jobs moving overseas.

The American public is beginning to notice more articles in the popular press about the demise of the manufacturing sector (USA Today [2002]). Stories about US blue-collar workers losing lifetime jobs held at such behemoths as Kodak, General Electric, Ford, and Caterpillar are appearing with greater frequency. The basic message, as told in the USA Today story, is that "many of these factory jobs are being cut as companies respond to a sharp rise in global competition. Unable to raise prices—and often forced to cut them—companies must find any way they can to reduce costs and hang onto profits. Jobs are increasingly being moved abroad as companies take advantage of lower labor costs and position themselves to sell products to growing and promising markets abroad—like China."

Some organizations and think tanks have predicted the demise of US manufacturing if China gained WTO status, as illustrated in the following: "China's entry into the WTO will result in the loss of more than 600,000 jobs in the US" (Economic Policy Institute [May 1999]). "If China is granted permanent WTO status, Americans will lose 607,000 manufacturing jobs (Teamsters Online, "The China Deal" [March 2000])." An estimated 817,000 jobs will be lost" (United Auto Workers [April 12, 2000]). "One million jobs will be lost in the next decade due to the China trade deal" (Economic Policy Institute [May 16, 2000]).

Strong lobbying efforts by multinational businesses and trade associations, such as the US-China Business Coalition, countered these arguments. For instance, the US-China Business Coalition stated the following in 2000 regarding China's acceptance to the WTO:

> "No matter the number, union projections of job losses are baseless. The US-China bilateral agreement on WTO accession is a one-way agreement: the US makes no trade concessions, lowers no US tariffs, nor removes any import protections any earlier than it otherwise would. These projections are based on a simplistic extrapolation of trade deficit figures. In fact, if Congress

approves China's favored national trading status, the US will have stronger job protections. The safeguard against import surges from China under the US-China bilateral WTO agreement is stronger and more specific than current US Section 201 law. By prohibiting China from imposing technology transfer, export performance, and import substitution requirements on investors, the WTO agreement would allow US firms to supply Chinese markets from US factories, instead of manufacturing in China."

As more electronic, automotive, medical, and consumer products are manufactured in China, domestic component manufacturers that supply those parts must be responsive to the changing customer demands. In short, because of extreme global competitive pressures, many customers are demanding that small US components manufacturers lower their prices. To survive in today's global economy, small domestic manufacturers must look to sourcing products from China or even relocating some of their operations off-shore. Working with Chinese government-managed or privately-controlled businesses will be no small task for some small US manufacturers. As daunting a challenge as it seems, it is now a near necessity that American manufacturing managers understand the legal and financial requirements of doing business with China.

4. Key business law and financial contracting issues

As concluded in the previous section, small US manufacturing firms interested in global sourcing must comprehend the various business law and financial contracting issues that exist when dealing with China. It is critically important for US manufacturers to recognize the importance of protecting intellectual property and distribution rights when dealing with Chinese businesses. By understanding the legal and financial requirements of doing business with China and by having a good relationship with offshore manufacturers, US domestic producers can successfully outsource and/or relocate some of their production operations to China.

Many domestic manufacturing firms will likely be faced soon with the difficult decision of whether or not to relocate some or all of their operations to China. The choice of whether to transfer large-volume production facilities to China is complicated; however, many original equipment manufacturers (OEM) seeking higher quality and low per unit costs have already made the move to China. Many of the Chinese suppliers, who are exporting to the US or providing components to on-shore OEMs, are private entrepreneurial companies and state-owned enterprises that already have modern equipment, excellent manufacturing processes, and strong management. While most of these firms lack full-service supplier design capabilities and international connections, they are eager to partner with American firms that possess these skills. Developing joint venture relationships with key Chinese suppliers is likely to be critical to surviving the global export battle for small US manufacturers. This section looks at the business law, financial contracting, and intellectual property right issues associated with dealing with Chinese businesses as global source partners.

4.1 Business structures for foreign investment opportunities in China

There are currently four foreign investment operating structures available to US firms interested in doing business with China, namely:

- Representative office
- Equity joint venture
- Cooperative joint venture
- Wholly foreign-owned enterprise

The avenue chosen by a US business entity or investor is dependent on many factors. These include: how active the business wants to be in China; the industry they are investing in; and whether or not a Chinese partner is necessary, either because it is required by law or in order to benefit from the partner's experience and access to the Chinese market (Lehman, Lee and Xu [2003]).

The most popular form of establishment is a representative office, but it has a limited scope of activities. Representative offices may not conduct direct business activities and are limited to actions such as market research and relationship building. In practice, some representative offices that are opened by US firms in China exceed their business scope and flirt with negative legal ramifications. In most instances, if a US business entity wants to legitimately carry out long-term profitable business activities, it is necessary to set up a joint venture (JV) with a Chinese partner or establish a wholly foreign-owned enterprise.

Since China's WTO status, there has been a rush to take advantage of both the cheap manufacturing facilities, and the chance to capture some of China's massive market; this has significantly increased the number of Sino-American JV partnerships (Devonshire-Ellis [2003]). The Chinese government has encouraged their manufacturing businesses to seek long-term security in foreign sales by collaborating with overseas partners, especially American businesses. Foreign partners often make it easier for Chinese firms to break into new global markets by utilizing their existing infrastructure, sparing these firms the cost of duplicating these at their expense. While partnering with a Chinese firm sounds good initially to most US firms, it is useful to note that China's business history is littered with thousands of cases of unhappy partnerships and broken dreams. Much of this is actually due to foreign partners not being aware of the laws, being naïve about the Chinese society, or assuming they can operate as if they were in the United States.

The following is a brief summary of the operating structures available to foreigners investing in China:

4.1.1 Representative office

Most US firms initially choose to set up a representative office in order to gain experience and acquire a better understanding of the size and potential of the Chinese market or outsourcing opportunity (Paglee [2001]). Firms initially use the representative office to lay out long-term goals and to oversee their other business operations or joint ventures in China.

The advantages of a representative office are that it is simple to register and is an inexpensive way to establish a legal presence in China. A representative office functions as a liaison between the US business entity and related industries in China. Often, representative offices engage in market research, render advice, collect information, and coordinate activities in China with prospective customers and potential partners.

A disadvantage of a representative office is that no direct business activity can take place (i.e., sales contracting, invoicing, arranging for the importation of goods, etc.). The foreign entity is restricted from engaging in certain activities and may not receive fees for services they provide, directly generate income, or sign contracts which indirectly generate income. Representative offices are allowed to negotiate contracts which can be later signed in the name of the business entity located outside China.

According to China's State Administration for Industry and Commerce (SAIC), foreign representatives must register a representative office within six months of establishing a business presence in China. Those who have not obtained approval or have not gone through the procedure for registration are not permitted to undertake business operations in the capacity of the foreign business entity. Failure to comply with the registration requirements can result in a fine of 10,000 renminbi (RMB) fine or about $1,150. [Note: In Chinese, renminbi means "People's Currency" and it is the basic unit of the yuan].

The registration of a representative office is required in order to lawfully employ Chinese nationals, to open a bank account, to import personal effects duty-free, to import office equipment without an import license, to obtain direct telecommunication lines, to display signs with the company name, or to use business cards that identify the company's presence in China. The representative of a company is unable to obtain a multiple entry visa or legally rent an apartment without a commercial domicile registration booklet obtainable only after the registration of the representative office has been completed.

4.1.2. Joint ventures

Joint ventures can serve as an entry vehicle into China, a country that restricts the amount of foreign investment. They also allow a US firm to gain easier access to Chinese partners who have resources in place, such as a distribution network or a quality manufacturing facility. The use of a joint venture can significantly lessen a US firm's overall cost of market entry into China; however, it is important that the partnership is properly structured.

There are two types of joint ventures in China: the equity joint venture and cooperative joint venture. The equity joint venture is less flexible and must operate in the form of a limited liability company, which means that the personal wealth and property of the actual individuals who are responsible for the company are shielded from corporate loss. The equity JV is the most commonly used foreign investment structure because it is the oldest business structure allowed in China, it is mandated by law for most types of foreign investment, and directly benefits the Chinese economy. Under an equity joint venture the foreign party normally provides technology, management expertise, and capital. The equity JV is a benefit to the foreign entity since the Chinese partner may have an established distribution network and may be able to help cut through some of the Chinese bureaucratic 'red tape.'

The requirements needed to set up a joint venture would include: a feasibility study; letter of intent; joint venture contract; and articles of association. The minimum equity investment by the foreign party is 25 percent; certain capital investment minimums are also required, but these vary by industry.

The most significant difference between equity joint ventures and cooperative joint ventures is the allocation of profits. In equity JVs, profits must be allocated according to the ratio of the capital contributions made by the partners. In other words, if one party puts in 40 percent of the capital investment, they will receive 40 percent of the total profits. Equity joint ventures are the preferred investment vehicle for most manufacturing joint ventures.

Once a joint venture is registered, the entity is considered a Chinese legal entity and must abide by all Chinese laws. As a legal entity, the joint venture is free to hire Chinese nationals without interference from government employment industries, so long as they abide by the Chinese labor law. Joint ventures are also able to purchase land and construct their own buildings, privileges prohibited to representative offices. It is interesting to see how far 'Red China' has progressed during the past decade.

Normally the operation of a joint venture is limited to a fixed period of time, i.e., from 30 to 50 years. In some cases, an unlimited period of operation is allowed, especially when the transfer of advanced technology is involved. Profit and risk-sharing in a joint venture are proportionate to the equity of each partner in the joint venture, except in cases where there is a breach of the joint venture contract.

There are specific requirements for the management structure of an equity joint venture. Every equity joint venture shall set up a board of directors, of which the number of members shall be determined through negotiation by the parties involved in the venture and shall be stipulated in the equity joint venture contract and articles of association. The chairman and the vice-chairmen shall be decided through negotiation by the parties to the venture or shall be elected by members of the board of directors. If the Chinese investor assumes the office of the chairman, then the foreign investor, or the other party, will normally assume the office of the vice-chairman and vice versa.

The board of directors shall decide the major issues of the equity joint venture in accordance with the principle of equality and mutual benefit. The offices of general manager and vice-general managers (or factory director and vice directors) are typically assumed separately by the parties to the venture.

The technologies and equipment used by the foreign investors as investments in a joint venture must be considered to be advanced and satisfy the future economic needs of China. A foreign investor who uses backward technology or equipment intentionally and deceptively shall be liable for the losses of the joint venture, if any. It is also important that the US partner protect its patents and trademarks, as will be discussed later. Intellectual property should be properly registered in China as being the US firm's property, if it wants to retain control over the use of these assets in China. Technology transfer can be paid to the US partner in the form of royalties from the JV; however, it is again advised to consult an appropriate legal entity to ensure that the contracts are properly in place and that the partner understands the full legal and tax implications. For example, in China the withholding tax on royalty contracts is at a rate lower than the profits tax, so it is important to have the JV agreement properly structured.

4.1.3. Wholly foreign-owned enterprises

Wholly foreign-owned foreign enterprises have gained particular significance with regard to China. The Chinese government had been gradually loosening restrictions on the amount of foreign ownership permitted during the 1990s. Upon entry into the WTO, China has firmly committed itself to not merely permit, but encourage these investments as long as these will prove beneficial to Chinese society as a whole.

A wholly foreign-owned enterprise is basically a wholly owned subsidiary of the foreign business. These are restricted to fewer business sectors than joint ventures and the enterprises must further develop the Chinese economy and use some degree of advanced technology. The approval and registration procedure is similar to the establishment of the joint venture. As a general rule, foreign investments of US$15 million or more are given automatic approval, although formal approval is also required by the local governmental or economic development zone authorities.

Concern by US partners has been expressed in the past with regard to the protection of patent and intellectual property rights. As discussed in the next section, China has recently passed laws in accordance with international standards to protect those rights. Nevertheless, when such concerns do remain, the foreign investor has the option of maintaining total control over operations by setting up a wholly foreign-owned enterprise, foregoing the advantages and risks that a joint venture might offer. In that case, it is important that the US company be familiar with the intricacies of dealing with Chinese governmental authorities at all levels, as well as possess the ability to set up a functional foreign enterprise.

Many investors prefer wholly foreign-owned enterprises to joint ventures because this gives them full control over their business. There are certain industries, however, in which wholly foreign-owned enterprises cannot be established, although this list is getting shorter and shorter. Also, some investors choose to cooperate with a Chinese partner to form a joint venture for strategic reasons. In general, wholly foreign-owned enterprises have gained in popularity, mainly because they are easier to establish now than prior to China's WTO entry.

4.2 Financial contracting

Direct-sourcing involves a US entity establishing a purchaser/vendor relationship with a Chinese business. The US entity importing is responsible for managing the relationship, establishing the quality control requirements, and negotiating and auditing the contractual terms. This section deals with the financial contracting terms.

Contracting is an area of business where US and Chinese investors tend to have conflicting or at least different views (Lehman, Lee and Xu [2003]). Generally, American companies like to use a standard contract and simply reformat or add new matters and clauses to fit the circumstances. The Chinese counterpart may regard the contract as a sign that the two parties have reached a trusting relationship rather than having signed a binding document and may request further concessions after the signing. In any case it is necessary to document everything involving the business relationship. This ensures that there will be fewer problems in the future regarding rights and obligations, especially if the management personnel have changed since the beginning of the business relationship.

Chinese contract law has gained greater acceptance following China's accession to the WTO (Ling [2002]). In common now with other world jurisdictions, the law of contract is at the heart of the market economy in China. This law has been recognized by the national legislature and demonstrated in practice. China's law of contract was overhauled during the course of negotiations for China's WTO membership in the late 1990s. This was done by unifying different existing contract law and administrative decrees. The reform process reflected not only China's political determination to address the legal deficiency in relation to international contracting standards, but also its firm commitment to further reform and to a market economy.

One of the most notable results of the change in the contract law was to subject all market players—including foreign parties—to the same set of rules (McKenna [2003]). In addition, three fundamental principles of contract law that have long been recognized in other developed markets (freedom of contract, good faith, and promoting the making of transactions) are predominantly emphasized in China's new contract law.

There is still some popular folklore about when a contract is a contract in China. Much of this probably comes from the fact that many Chinese businessmen have been energetic negotiators of contracts, and one long-held negotiating strategy has been to pretend that what was agreed upon yesterday does not apply today. The contract law of China was drafted to solve the problem of the occasional failure to honor contracts by providing legal recourse for all parties. The contract law also sets out a number of instances where a document which appears to be a contract can be either void, rescinded freely at the option of a party, or valid but unenforceable in China.

China's contract law specifies various technical requirements for contracts, but in general contracts with technical deficiencies (non-compliance with one or more of the usual clauses that a contract of that type should contain) may still be enforced in whole or in part. An issue sometimes missed by foreign investors in China is that certain basic defects such as lack of fairness, violation of social norms, and a few other basic requirements, can cause a contract to be unenforceable in China.

The requirement of fairness is contained in Article 5 of the Chinese contract law. A Chinese judge or arbitrator can decide what is or is not fair according to his or her own standards, which need not be the same as the standards usually used by the parties to the contract. Chinese standards of fairness are not necessarily the same as an American businessperson's concept of fairness. Because the requirement of fairness, in the expression of the obligations and rights of the parties to the contract, is a basic requirement, a contract lacking in fairness could be either void, rescindable at the option of the innocent party, or unenforceable against the innocent party (based on the best judgment of a judge or arbitrator).

Standard contracts in particular are required to be fair to the party that is not permitted to negotiate the terms of the contract. Some guidance can be gleaned from the law on standard contracts as to what Chinese legislators consider "fair". For example, it is considered unfair to exempt one's self from liability or to increase the liability of the other party in circumstances where the other party does not have an opportunity to negotiate such terms.

The requirement of social acceptability, contained in Article 7 of Chinese contract law, requires that the parties to a contract respect Chinese public morals, and avoid disturbing the social or economic order, or harm public interest. This article also requires contract parties to comply with all Chinese laws and administrative regulations. If the violation of law is a minor infraction, the non-complying portion of the contract can be severed and the valid parts of the contract remain in force.

If a contract or parts of a contract are invalid, the non-complying party may owe damages to the other party or sometimes to third parties arising from acts undertaken in performance of the contract. This avoids permitting a contract party to benefit from non-compliance with the law. Under WTO, contract clauses requiring foreign exchange balancing cannot be enforced under the terms of China's accession to WTO.

It is fair to say that China has made considerable progress with regard to international contract law. Most small US firms desiring to deal with China are still advised to utilize legal counsel in reviewing financial contracts; however, the field has been leveled substantially since China's accession to the WTO.

4.3 Intellectual property law

China's economy is shifting to a knowledge economy, and protecting intellectual property rights has gained considerable importance since the country's entry to the WTO in 2001 (Xihe [2002]). The four main areas in Chinese intellectual property (IP) law are: patents, trademarks, copyrights, and trade secrets (Lehman, Lee and Wu [2003]). Intellectual property laws protect intangible assets, which can often be among a company's most valuable assets. For example, intellectual property laws protect Budweiser's name, Disney's characters, GE's logo, and Coca-Cola's secret ingredients. Besides protecting businesses, these laws also protect consumers, businesses, artists and inventors.

Before commencing foreign sourcing activities, American companies should take steps to protect their intellectual property. For example, companies can prevent foreign partners from pilfering intellectual assets and using those assets to produce competitive knock-off goods. Table 1 describes the types of basic IP (Whyte, Hirschboeck and Dudek [2003]).

Table 1. Intellectual Property Law protections

Type of IP	*Protects*	*To Obtain Protection*
Patents	Inventions	Apply for it
Copyrights	Creative works	Create it
Trademarks	Symbolic information	Use it
Trade secrets	Company secrets	Hide it

Patents can be used to protect machines, devices, components, compounds, articles of manufacture, compositions of matter, processes, software, methods of making or using or doing something, business methods, ornamental designs, asexually reproductive plants, etc. In general, design patents last for 14 years from the date the government issues the patent, while current utility and plant patents last for 20 years. To obtain a US patent, an inventor must submit a patent application to the US Patent and Trademark Office.

China has recently enacted a new patent law which penalizes the counterfeiting of another's patent with up to three years of imprisonment. Previously, design patents in China lacked substantive examination prior to approval, meaning that such rights were often granted in breach of earlier existing rights. The remedies of original right owners have now been strengthened. For instance, design patents may not conflict with another's prior legal rights, and the rights of an original patent holder shall prevail over those of a later patent-holder in the case of a dispute. Prior legal rights cover trademarks, copyrights, enterprise names, and unique packaging or branding associated with well-known products, among others.

Offering for sale infringing goods is now considered an illegal activity in China, meaning that preemptive action can be taken against those offering to sell infringing goods, but who have not participated in their manufacture, distribution, or wholesale. Prosecuting patent infringements in China is now easier as pre-litigation injunctions and requests for evidence preservation are now more readily accepted by the court, provided there is sufficient evidence and that the plaintiff provides a guarantee. The reality, however, is that China is a huge country and administrative remedies can still be problematic.

A trademark is designed to protect both businesses and consumers. A trademark is a distinctive mark, logo, or symbol that is used to identify a product. For example, the large "M" on McDonalds' sign is an example of a trademark. Because a customer associates a certain service or result with a symbol or marking, it would be unfair to let that mark be used in a different industry or manner. To protect a trademark is to protect the reputation of a business, while at the same time ensuring that a customer is able to relate that trademark with a certain type of product.

The newly revised Chinese trademark law extends protection to three-dimensional signs, geographical indications, collective trademarks and certification trademarks. Courts in China are now authorized to order an infringing party to cease its use and in some cases order property preservation. The practice of reverse passing-off, which occurs when a trademark is removed from goods and another trademark is put on in its place for the purposes of further sale, is now recognized as an infringing activity. Previously, the practice was to separate an infringing trademark from the goods on which it was displayed, destroy the infringing trademark, and return the goods to the infringing party. Under the new law, the Chinese Administration for Industry and Commerce (AIC) must destroy all infringing goods, regardless of whether or not the trademark can be removed – and fines may now also be issued. While areas of conflict still exist, the new trademark laws have significantly strengthened China's commitment to hold counterfeiters and trademark violators liable for their acts.

A copyright does not apply to concrete objects like inventions or businesses, but is used in the art industry. A copyright is the legal right of a composer, writer or exclusive owner of an artistic work to control how that work is used. Works that can be copyrighted include novels, music, video, computer software, and fine arts. The work must be of a creative nature to be able to receive a copyright. Also, a copyright cannot protect the ideas of an artist, only the expression of those ideas. Unlike patents, copyrights do not have to be registered by the authors with the US government. The author must, however, register the work to bring a lawsuit and obtain statutory damage. The Copyright Office examines applications to ensure compliance with basic formalities, and then issues a Certificate of Registration. Copyright protection begins the moment the author fixes the work in a tangible medium; it generally ends 50 years after the author dies.

The new Chinese copyright law clarifies the nature of copyright protection, confirms its ability to be assigned, and prescribes the contract terms for copyright assignment. The fair-use doctrine, which under the previous law allowed for certain uses of copyrighted material without permission from the owner, has been restricted. Radio and television stations must now pay for the use of published music, but are not required to notify the copyright owner in advance.

Stronger copyright enforcement measures in China have been introduced to combat copyright infringement, and the burden of proof is now placed on the party suspected of infringement. Any publisher, manufacturer, or distributor who cannot present authorization for their copying other people's books will now be held liable. Preliminary injunctions and orders for the preservation of evidence may now be granted prior to litigation, whereas previously these would only be granted if a party had filed an action. Damages have been increased and a higher level of statutory compensation is now available for the economic loss suffered by the copyright owner or where the illegal income derived by the infringing party is difficult to determine.

Trade secrets generally refer to a secret formula, pattern, device, process, or technical know-how. An entity uses a trade secret to manufacture an article of trade and yield a competitive advantage over others who do not know or practice the secret. State tort laws in the US, in conjunction with unfair competition laws, prohibit unauthorized trade secret disclosures. Unlike patents, trade secrets are not registered with the US government, and they do not expire. They do, however, lose their protection status if the subject matter becomes common knowledge.

The new criminal law of China went into effect in 1997. In this law there is a section regarding crimes of infringing intellectual property that pertains to trade secrets. The law on trade secrets specifies that anyone committing a violation can be imprisoned for up to three years. The following are deemed to be illegal under China's laws: 1) obtaining a right proprietor's trade secret by stealing, luring, intimidation or any other unfair means; 2) disclosing, using, or allowing another person to use an illegally obtained trade secret; or 3) in breaching the agreement with, or going against the right proprietor's demand for keeping confidentiality by disclosing, using or allowing another person to use the trade secret in question.

Under Chinese laws, "trade secret" refers to any technology, information, or business operation information, which is unknown to the public, can bring about economic benefits to the right proprietor, has practical utility, and about which the proprietor has adopted secret-keeping measures. The "right proprietor" refers to the owner of the trade secret and the user of the trade secret, who is permitted by the owner of the trade secret.

The last several years have seen continued progress in the protection of intellectual property rights by the Chinese government. Strong statements by government leaders have demonstrated the government's understanding of the widespread economic losses suffered by Chinese and foreign firms alike due to IP violations. Moreover, the government leaders clearly understand that the lack of IP protection is a severe constraint on the development of creative products. Investments in research and development cannot be made without a reasonable assurance that the resulting intellectual property will be protected long enough to earn an economic return. Software designers, authors, filmmakers, musicians, and others cannot earn a living if their products are immediately pirated. Additionally, the export of counterfeit and pirated products is expected to increase as trade is stimulated by China's accession to the WTO, increasing the risk of friction with trading partners and damage to China's international reputation. The high priority given to IP protection by the Chinese government has been expressed in its continual promulgation of legislation, administrative regulations, and enforcement guidelines.

5. Other important legal and business contracting considerations

Doing business with Chinese firms for the first time is challenging in many respects. For small US firms importing from China, there are several key steps that must be considered regarding logistics, contracting, and business finance. This section deals mainly with key contracting considerations.

International commercial terms (often referred to as 'incoterms') officially identify the buyer's and seller's responsibilities in regard to the risk in the delivery of a product, and the costs of delivery (Scott [2000]). Incoterms are internationally accepted commercial terms defining the respective roles of the buyer and seller in the arrangement of transportation and other responsibilities, and clarifying when the ownership of the merchandise takes place. They are used in conjunction with a sales agreement or other method of transacting the sale. There are 13 items generally considered under Incoterms 2000 which, when associated with a quoted price and a specific point or location, clarify the responsibilities and costs for each party (International Chamber of Commerce [2003]). They indicate such details as who chooses the freight forwarder, who is responsible for securing insurance of the shipment, who arranges and pays for the transportation, who is responsible for duties and taxes, who is responsible for preparing the necessary documentation to clear customs in the country of exportation and the country of importation, mode of transport, required place of origin and destination (port or airport), and others.

Incoterms are intended to be universally understood, but are often used inappropriately, which leads to controversy and dispute. All of the 13 items covered by the incoterms carry associated risks and costs, which can vary greatly from country to country and company to company. Also, contrary to popular belief, the incoterms do not specify when transfer or ownership takes place.

The most common methods of payment are open account, documentary collection, letters of credit, and cash advances. Each offers different levels of protection to the importer and exporter at varying costs. Country regulations may dictate the method required but, in most cases, the choice is influenced by the commercial risks, buyer-seller relationship, the industry norms, and ultimately, the level of risk that each is comfortable in taking.

First-time transactions are the most challenging. While the Chinese vendor looks for some assurance of payment, the domestic buyer is looking to reduce its risks in choosing the best method of payment. For example, if the buyer has concerns that the foreign supplier can ship on time or provide the required documents for US Customs, extended terms may have to be negotiated. First-time buyers may also have quality concerns and may want to have an inspection take place as part of the condition of payment. Under these circumstances, a letter of credit may best serve both parties.

Logistics cover a wide spectrum of areas, from documentation, export clearance process, landed cost, transit time, product safety, insurance coverage, multi-mode transportation, on-time delivery, brokerage, US Customs compliance, and final delivery. Carrier and freight forwarder decisions are often made on the basis of who provides the lowest rates without realizing the risks and eventual higher costs the importer may incur through inferior service.

In all situations, the domestic buyer will need strong support in the areas of international law, finance, and logistics. International trading is far more challenging than dealing with a customer in New Jersey—the way terms are structured can greatly impact profit margins and the business risks.

5.1 Foreign exchange control in China

An important point that most American business people need to remember is that the Chinese economic experiment with free markets is still in its infancy. For a country of over 1.2 billion people, the financial institutions are extraordinarily immature. In addition, since Mao Tse Tung's 1949 communist revolution, two generations of Chinese have grown up in a non-capitalist society. It is going to take some time for the Chinese financial infrastructure to develop and the society to fully trust Westerners in business trade. As a result, the Chinese government maintains strict control over foreign exchange receipts and payments.

All foreign exchange receipts and payments in China fall under either a current or capital account. The current account covers trade and labor service receipts and payments, as well as one-way transfers in foreign exchange. No restrictions are imposed by the Chinese government on international settlements and transfers under the current account. The capital account covers foreign exchange receipts and payments in respect of direct investment, loans of all kinds, securities, and direct investment. The Chinese government maintains stringent control over foreign capital accounts.

5.1.1. Current account

Upon approval by the Chinese State Administration of Foreign Exchange (SAFE), a foreign-invested enterprise (FIE) may open a foreign currency account with a designated bank by presenting its "Foreign Exchange Registration Certificate" and other supporting materials. For foreign exchange received under the current account, the foreign firm may retain a certain amount within the limits prescribed by SAFE to conduct normal business activity. Any excess portion has to be deposited in a designated state-controlled bank.

When a foreign company has to make external payments within its business scope, it may draw the required amount from its Chinese foreign currency account and any shortage can be made up by purchasing exchange with Chinese yuan or renminbi at designated government-controlled banks. The following are observed: 1) repatriation of after-tax profits and dividends to any foreign investors of a foreign entity can be made from the foreign currency account or at designated banks by presenting the board of directors' profit distribution resolution; 2) the after-tax wages and other legitimate incomes in renminbi of a firm's Chinese employees may be converted into foreign currency and remitted at designated banks upon presentation of relevant supporting documents; and 3) after-tax share dividends that are payable in foreign exchange may be remitted from the foreign currency account or at designated banks upon presentation of the board of directors' profit distribution resolution (Wong and Ngai [2003]).

According to SAFE regulations, foreign companies are required to register each export shipment. Upon receipt of the export revenues in foreign exchange, each transaction will be verified and duly cancelled against the registration made earlier. For external payment in foreign exchange for imports, each transaction will likewise be verified and recorded (TDCtrade [2003]).

5.1.2. Capital account

Investment capital in foreign exchange contributed by a foreign investor and Chinese parties to the FIE must clear through the capital account. Other transactions, such as external debts and foreign exchange loans extended by Chinese financial institutions to the FIE, must also be recorded and maintained in the capital account. Foreign exchange revenues generated by the foreign-controlled firm and other foreign exchange receipts must all pass through the capital account. The account is closely monitored by the Chinese government to ensure the foreign entity's full compliance with the relevant regulations.

For investment capital in foreign exchange contributed by the foreign and Chinese parties to an FIE, a capital account must be opened in a Chinese bank. The foreign exchange deposits in this account can be used to pay for current account expenditures as well as SAFE-approved capital account expenditures. For capital received as the result of issuing shares by a foreign entity, a securities account must be opened. Payments from this account must be only for the purposes stipulated in the prospectus approved by SAFE officials. Payments from the capital account of FIEs include the repayment of loans and other offshore investments (i.e., common and preferred stocks). For investment abroad, the source of funds has to be examined by SAFE before an application is filed with the competent approval authority. Upon the grant of approval, the funds may be remitted out of the country.

When a foreign entity is terminated and assets are liquidated, all applicable taxes must first be paid in accordance with the relevant SAFE regulations before any amounts are returned to the foreign parties. These funds must be remitted through designated banks or carried in person out of the country. Foreign exchange belonging to the Chinese partner must be remitted through a designated bank.

Should any foreign investor in a FIE wish to reinvest their dividends in renminbi or foreign exchange in China, it has to apply to the local foreign exchange administration by submitting the relevant documents. Upon presentation of valid proofs to a SAFE official, the reinvesting investor can increase its stake in the Chinese-based business.

Employees of organizations with legal entity status in China may keep their foreign exchange. They may open foreign currency accounts at designated banks in accordance with the relevant regulations. All legitimate renminbi incomes of these personnel may be converted into foreign currency and remitted out of China at SAFE-designated banks upon presentation of valid proofs and invoices. Such exchange may also be remitted or carried in person out of China upon presentation of valid proofs. Should resident personnel sell their personal items, equipment or appliances brought into China from abroad or purchased in China, they may convert the renminbi proceeds into foreign currency and remit it out of the country through SAFE-designated banks by presenting their business registration certificate or personal identification document and the sales proof concerned.

The foregoing details presented regarding the current and capital accounts serve to highlight the bureaucratic processes required to bring funds into, and take proceeds out of, China. As clearly illustrated above, the movement of funds into and out of China is cumbersome and extremely restrictive. American investors must understand that the Chinese business model is designed for long-term partnership and that the restrictions on the flow of funds into and out of Chinese ventures are designed to prevent the exploitation of Chinese resources, which occurred regularly prior to 1949.

5.2 Foreign exchange

The currency of China is the renminbi (RMB). It is also referred to in the financial press as the Chinese yuan (CNY). Currently, the renminbi or yuan is fixed or pegged to the US dollar with only slight periodical adjustments by the Bank of China (BOC) according to the fluctuations of the dollar. During the 1970s, China used an effective rate, which was pegged to a trade-weighted basket of 15 currencies, in their foreign exchange transactions. In the 1980s the effective rate was placed on a controlled float based on developments in the balance of payments and the exchange rates of China's major competitors. In the early 1990s, the Chinese authorities worked towards putting the exchange rate regime on a more market-oriented basis. The renminbi was allowed to adjust frequently based on foreign currency market developments; however, the onset of the Asian crisis in 1997 compelled the authorities to abandon this approach in favor of a rigid peg to the US dollar, a policy that has persisted to the present.

China's decision not to devalue its currency in 1997 was widely applauded at the time for preventing a further round of competitive devaluations in Asia. It is believed that China's ban on futures trading in the yuan shielded China and Hong Kong from the worst effects of the crisis. Still, the Chinese economy did not totally escape the Asian crisis unscathed. Between 1997 and 1998 unsanctioned outflows in China's capital account nearly doubled despite the rigid capital controls, reflecting a rise in China's perceived 'country risk'.

At the time the Asian crisis was brewing, China experienced widespread layoffs resulting from the reform of its state-owned enterprises. Rising unemployment, combined with other reforms that reduced China's provision of welfare services, encouraged individuals to substitute saving for consumption. With falling export growth due to the Asian economic crisis and a rise in the marginal propensity to save, the Chinese economy experienced a contracted demand and a deflated price level. The decelerating prices tended to increase real interest rates contributing further to a slow-down in China's economic growth in the late 1990s. In 1998, official government statistics reported a slowdown of GDP growth from 9.6 percent in 1996 to 7.8 percent—still impressive rates of growth.

Since the late 1990s, the Asian region has stabilized considerably because of decreased political and economic risks in Indonesia, Malaysia, the Philippines, Thailand and South Korea. Significant regulatory reforms within the legal and financial systems in these countries and an improvement of macroeconomic fundamentals reduced the vulnerability of these countries' currencies to speculative attacks.

China's economy began to rebound in the late 1990s and exports have risen sharply in the early 2000s. Domestic retail sales have accelerated, suggesting increased consumer confidence, and minor consumer price inflation re-emerged after virtually continuous deflation since October 1997. China's economy is currently creating almost 10 million new jobs per year and the trade surplus is at an all-time high. It appears that China survived the Asian crisis almost unblemished.[1]

5.2.1. Fixed exchange rate

Given the current developments, observers of China's foreign exchange rate policy, including the International Monetary Fund, have begun to question the appropriateness of an ongoing peg of the yuan to the US dollar. For the past two decades, China's policymakers were concerned that the yuan would depreciate if it was a floating currency (as probably would been have the case during the Asian currency crisis).

The State Administration for Exchange Control (SAEC), which is under the direct control of the People's Bank of China (PBC), administers all phases of exchange control. The Bank of China (BOC) implements the foreign exchange plan and is the principal foreign exchange bank of China. The following chart shows the yuan to US dollar exchange rate since January 2000. For several years, the rate has remained fixed at about 8.277 yuan per US dollar, as shown in Figure 2.

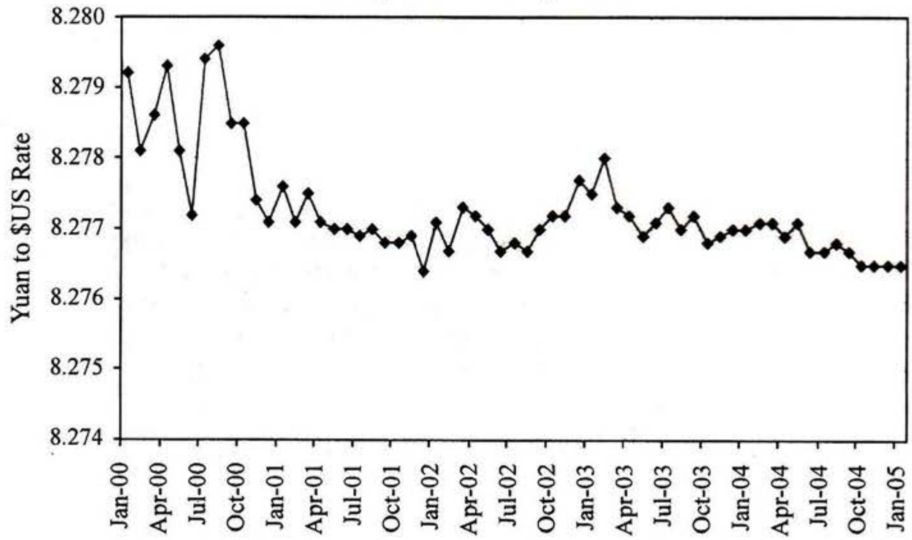
The possibility of removing the yuan's exchange rate peg to the US dollar and allowing it to float freely in world markets has been debated recently (Clifford [2001]). A key issue is whether the US dollar peg directly influences price stability in China, as is the long-held belief of Chinese policymakers. The answer depends in part on the extent of the China / US trade balance, the importance of China's other global trading partners, and on the specific goods that are traded with particular partners. While a constant US dollar exchange rate may stabilize the prices of some tradable goods, other bilateral rates could be quite volatile, thus potentially contributing to price instability.

Since foreign commerce with the US now constitutes the largest share of China's surplus trade balance, a fixed exchange rate with the dollar exerts a powerful stabilizing effect on the price level. The decision to remain fixed with the dollar, however, is not completely clear because Japan is China's dominant import supplier and a major export market. Additionally, Europe is gaining importance as a trading partner with China. The extent to which trade flows with Japan and Europe can be

[1]However, a new economic concern has recently arisen for China. Fear of the disease, SARS, is starting to cause immeasurable economic and commercial harm around the world, particularly in sections of the Asia-Pacific region. SARS has been causing the worst economic crisis in Southeast Asia since the wave of bank failures and currency devaluations that swept the region in the late 1990s. In April 2003, the economies of Hong Kong, Singapore and Taiwan began shrinking, and the economies of Malaysia and Thailand will probably follow suit. Even China's booming industrial expansion is beginning to slow down because of SARS, according to Andy Xie, an economist with Morgan Stanley (Bradsher [2003]). The key questions are: how severe is SARS and how long will the economic impact be felt? Chinese officials are reportedly working quickly to address the outbreak, but the summer of 2003 will be important in determining the overall impact on Chinese and American manufacturing relations.

protected, while maintaining a fixed exchange rate with the US, is a difficult issue for Chinese policymakers. There is reason to think that the gains of moving to a floating exchange rate could be substantial for Chinese businesses, given that they currently have no direct means to insure against European and Japanese foreign exchange risk. Until China liberalizes the capital account and allows forward rate hedging, the argument for floating exchange rates remains implausible (Kwan [2002]).

Figure 2. Exchange Rate (Yuan to $US)
January 2000 - January 2005



Source: http://www.economagic.com

Table 2 shows the relationship of the Chinese yuan to other major world currencies as of February 2005. The yuan is pegged to the US dollar, as is the Hong Kong dollar; therefore there is no significant relative change in the yuan versus these two currencies. It is important to note that the United States and Hong Kong are China's largest export markets. The yuan (like the dollar) has had a weak twelve months relative to most other foreign currencies. The yuan fell versus the euro and yen by almost 3 percent the past year. It is important to note that the European Union and Japan represent the third and fourth largest export markets for China. As the next table shows, it is no wonder that China is considering moving to a fixed market basket exchange rate or a floating rate, given the decrease in the value of the yuan the past year.

China's gross domestic product is projected to rise in excess of 9 percent in 2005, while Japan's growth rate is expected to be 0.5 percent for the same time period (Eyman [2003]). China is expected to continue to post strong exports to the US, Japan, and Europe and draw in large amounts of foreign direct investment because of an official exchange rate that keeps the Chinese yuan artificially weak against the major global currencies.

The floating yuan-yen currency exchange rate, which is a direct function of the dollar to yen floating exchange rate, affects US businesses in their dealing with China. As shown in the following table, the yen has risen substantially versus the yuan—rising over 14 percent since 2003—even though China's economy is booming and Japan's is stagnant.

If the yen were to continue to rise versus the dollar, the yuan's effective exchange rate, or the weighted average of the yuan's values against the currencies of China's major trade partners, would continue to decline commensurately. The opposite situation holds true if the dollar were to rise relative to the yen. Therefore, US businesses are greatly influenced by China's fixed exchange rate. For instance, if the yen were to rise against the US dollar, American and Chinese exports would be less expensive for Japanese consumers and producers; however, given the current trends in world trade, China would likely be the bigger winner. If the yen were to fall versus the dollar, American and Chinese exports would be more expensive, but Japanese imports into China would reduce the cost of their inputs, giving China an even greater economic advantage. In summary, China's fixed exchange rate versus the dollar gives them a significant economic advantage over the United States in world trade—despite their currency falling versus the euro and yen.

Will China move away from a fixed US currency exchange rate? In January 2003, Zhu Min, the general manager of the Bank of China warned that the purchase of dollar-denominated investments on a large scale by China may not be sustainable (Spannaus [2003]). Because of its huge trade surplus with the United States, the Chinese government is in essence receiving dollars for its American exports, and then exchanging them for US Treasury securities. In fact, China has become one of the world's five largest holders of US Treasury securities. This announcement may signal the beginning of a shift in Chinese economic policy towards a floating yuan, which would require American firms to hedge their Chinese assets and forward purchase contracts. One further precursor of the possible changes ahead is reflected in the Chinese currency black market (ChinaOnline [2002]). Demand for the euro has picked up substantially, while demand for the US dollar on China's black market has shrunk.

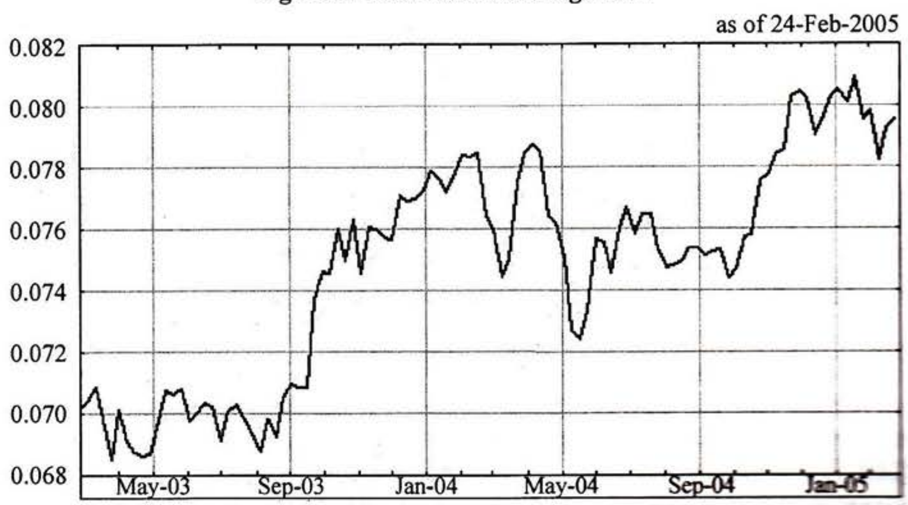
It has been reported that the Chinese policymakers are purposely depressing the value of their currency (Chang [2003]). This maneuver would ensure that their products remain competitively priced in foreign markets. As illustrated previously, the peg to the dollar means the Chinese currency has slid considerably in the past year, with some analysts stating that the yuan is now undervalued by as much as 15 percent. Further decline of the dollar in the future would probably add to that figure, which will continue to permit the Chinese economy to flourish at the expense of the United States.

Table 2. Chinese Yuan as of Friday, February 25, 2005

Currency	*CNY per*	*per CNY*	*per CNY 1 Year % Change*
Australian Dollar	6.49351	0.15400	-1.29
Brazilian Dollar	3.13480	0.31900	-13.41
British Pound	15.84284	0.06312	-0.31
Canadian Dollar	6.67557	0.14980	-8.93
Euro	10.92061	0.09157	-2.74
Hong Kong Dollar	1.06112	0.94240	0.30
Indian Rupee	0.18979	5.26910	-3.60
Japanese Yen	0.07871	12.70500	-2.76
Mexican Peso	0.74410	1.34390	0.07
New Zealand Dollar	5.96659	0.16760	-5.31
Norwegian Krone	1.32083	0.75710	-8.93
Singapore Dollar	5.07357	0.19710	-2.94
South African Rand	1.42187	0.70330	-7.59
South Korean Won	0.00821	121.79000	21.83
Swedish Krona	1.20322	0.83110	-4.55
Swiss Franc	7.08215	0.14120	-1.40
Thai Baht	0.21565	4.63720	-1.69
US Dollar	8.27815	0.12080	0.01

Source: Yahoo 2005. http://yahoo.finance.com

Figure 3. Yuan Yean exchange rate



Source: Yahoo 2005. http://yahoo.finance.com

Other countries, including Japan, are openly complaining about Beijing's currency manipulation. "Because this is an issue that concerns the interests of many countries, the related nations need to have a thorough talk," according to Japanese Finance Minister Masajuro Shiokawa (Chang, 2003). There is even talk that the G-7, the world's leading industrial democracies, will take up the issue of China's currency, though at this point no action is expected. Japan and other nations could take matters into their own hands and manipulate their own currencies downward if the Chinese insist on maintaining the peg. For a Chinese economy that depends increasingly on exports to keep its economy going, a series of competitive devaluations would be disastrous. Therefore, China cannot escape global trends indefinitely and it is likely that as China fully integrates into the world economy their currency will have to trade freely versus all other global currencies. Depending on the extent of the SARS or 'Asian bird flu' outbreak, this could happen as early as 2006.

Arbitrage, which is the act of striking offsetting deals among various markets simultaneously to obtain an arbitrage profit, only exists if an observed rate in one currency market is not consistent with a cross-rate (ignoring transaction costs). Because of the speed in which markets trade, profit opportunities are likely to be arbitraged away quickly, meaning that cross-rates are, for the most part, consistent with observed rates. Because triangular arbitrage occurs across various markets, generally only foreign exchange market makers have an opportunity to profit since they deal with lower bid-ask spreads, lower transactions costs, and can watch the markets almost continuously seeking out opportunities. Since the foreign exchange markets are very active—there are only limited opportunities to identify profitable possibilities and the transactions have to take place almost instantly—they are not available to the average investor.

An experiment was done with the Chinese yuan to see if it was possible to obtain arbitrage profits in the foreign currency market. The following tables show the cross currency rates as of February 2005. Like the Chinese yuan, the Hong Kong dollar is also pegged to the US dollar. Therefore, knowing the exchange rates between major currencies allows for the determination if any arbitrage opportunities exist with regards to the Hong Kong dollar and the Chinese yuan.

The construction of various triangular arbitrage combinations of the Hong Kong dollar, US dollar, Japanese yen, and the Chinese yuan resulted in no arbitrage profit. This exercise suggested that the foreign currency markets with regard to the Chinese yuan are efficient.

5.3 Cash management and banking

Even a year after China's entry into the WTO, the complete development of cash management in China was still hamstrung by government regulation (DeRamos [2002]). Inter-company lending and co-mingling of joint ventures are still considered illegal in 2003. As such, subsidiaries with surplus funds cannot technically support subsidiaries in deficit, and as far as cash management is concerned, related companies in China are unrelated regarding the movement of funds.

Table 3. Benchmark currency rates (as of February 25, 2005)

	USD	EUR	JPY	GBP	CHF	CAD	AUD	HKD
USD	1.0000	0.7575	105.2300	0.5221	0.8558	1.2392	1.2739	0.1282
EUR	1.3202	1.0000	138.9246	0.6892	0.6486	1.6360	1.6818	0.0971
JPY	0.0095	0.0072	1.0000	0.0050	90.0901	0.0118	0.0121	13.4898
GBP	1.9155	1.4509	1.4509	1.0000	0.4470	2.3737	2.4401	0.0669
CHF	1.1685	1.5419	0.0111	2.2373	1.0000	0.9425	0.9170	0.1498
CAD	0.8070	0.6113	0.6113	0.4213	1.0610	1.0000	1.0280	0.1589
AUD	0.7850	0.5946	0.5946	0.4098	1.0905	0.9728	1.0000	0.1633
HKD	7.7996	10.2960	0.0741	14.9400	6.6777	6.2941	6.1235	1.0000

Above is a chart designed to display the cross rates of eight major world currencies. Scan across the chart to find the rate of exchange between any two of these currencies.

USD: U CHF: S.S. Dollar wiss Franc GBP: British Pound AUD: Australian Dollar
CAD: Canadian Dollar HKD: Hong Kong Dollar EUR: Euro JPY: Japanese Yen

Until recently, cash management in China was not even in the electronic age. Couriers traveled hundreds of miles, hauling bags of cash to deposit counters to settle payments. Checks were hardly used as they had a ten-day shelf life and could only be issued to beneficiaries in the same city. Now, most of the uncertainty is gone, thanks to the introduction by the Bank of China of a national inter-bank clearing system. Before the Bank implemented the system in 2001, making a payment from one province to another, or even one bank to another, was a protracted event. Today, customers know that if they make a payment via the clearing system, the beneficiary will get the funds tomorrow, because nearly all major banks in major locations are connected (Cheung [2002]).

5.3.1. Banking system

China has a multi-tiered banking system with the People's Bank of China (BOC) at the center. During the past ten years, the BOC has been increasingly acting as a central bank, transferring its commercial activities to other institutions. Unlike the Federal Reserve, the BOC is not independent because it still reports to the State Council, an executive organization of the Chinese government.

In its central bank capacity, the BOC lends to commercial banks, trades in government bonds, and controls interest rates and reserve requirements. The four largest banks in China are the state-run specialized banks, namely, the Agricultural Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank, and the Bank of China. To extend loans in support of selected government policies, China established three policy banks in 1994, namely, the Agriculture Development Bank, the Export and Import Bank of China, and the State Development Bank.

As of 2002, the five international commercial banks currently in operation in China were the Bank of Communication, China Everbright Bank, China International Trust and Investment Corporation Industrial Bank, China Minsheng Bank, and Huaxia Bank. In addition, nine regional commercial banks serve their specific regions within China. All of the policy, national, regional, and cooperative banks are relatively small in size compared to the state-run banks. Also, the Chinese government appoints most of the bank presidents because it usually holds a majority ownership. The finance, investment, and leasing companies, as well as foreign banks all currently play a supplementary role in the system (Cheung [2002]).

Most banks in 700 cities in China are linked to the system; however, few Chinese businesses use the inter-banking system. As late as 2002, most Chinese companies made and received third-party payments and collections by check. The reason most companies don't use the system is because the charges, which are set by the government, are too high. For now, the main route is still the independent electronic fund transfer systems of the four major state banks. In these cases, payments in which the remitter and the beneficiary are within the same bank are cleared in-house (Liu [2002]). The banking system is still developing and the four major banks still do not have branches at all locations. Suppliers and customers often find it necessary to open accounts with each of the country's 'four banks' to meet each others' obligations on time. Since WTO membership required foreign banks to be allowed to operate in China, changes are in the offing. At least three foreign banks in China have formed alliances with all of the Chinese state banks which allow foreign companies to receive payments from customers with bank accounts in any of the 'big four's' 26,000 branches in the country. On the downside, foreign banks have not been able to operate in all provinces in China, although this is changing.

5.3.2. Credit lines

Like other international banking services, credit lines are routinely provided by the major Chinese state banks to their clients. Short-term credit lines include loans, letters of credit, letters of guarantee and bills of exchange within one year, tender guarantees, performance guarantees, advanced payment guarantees, customs duty payment guarantees, and maritime guarantees. Any independent legal entity can apply to a Chinese bank for the management and operation of its short-term business in the form of a credit line.

6. Conclusion

China has made dramatic improvements in the areas of cost, capacity, quality, and manufacturing process capabilities during the past decade. American manufacturers that want to use China as a low-cost manufacturing and sourcing base need to mobilize quickly because the global economic race has already begun. Less than two years after its acceptance into the WTO, China offers a considerably developed and comprehensive manufacturing base—one that is growing by at least 15 percent annually. China has undergone significant economic changes and reforms the past ten years and is now a major global economic power. Some of the remaining issues that concern foreign investors and trading partners deal with include foreign exchange and cash management; however, the Chinese financial system is advancing rapidly.

Global sourcing has advantages, as well as hidden costs and risks. Failure to understand these issues and costs can offset the advantages and even reverse any potential savings. This paper has attempted to identify the crucial areas of concern that US manufacturers must be aware of as they firm up a global sourcing strategy with Chinese businesses. Various issues related to the economic environment, business law, and finance have also been discussed.

So while there are many attractive opportunities involving trade with China, many small US manufacturing firms face international legal and financial risks with which they are not accustomed. These include the risk of the repatriation of after-tax profits and dividends, and the lack of Chinese foreign currency futures or forward contracts to protect foreign-based assets and liabilities. Add to these the inherent difficulty in arranging bankers' acceptances and letters of credit with Chinese bankers from the perspective of the small US manufacturer. The experiences of many CFOs from global companies point to the various issues and problems encountered when operating in, or trading with, China (Slater [2002]). Delayed payments by Chinese customers, foreign exchange constraints set by the local regimes, bureaucratic 'red tape,' intellectual property infringements, and a lack of trade financing services by the state-owned banks are just some examples. Though developed in a steady phase the past decade, the Chinese legal and financial sectors are still immature and presently can only provide a limited range of protection and services.

Given the intense pricing pressure from offshore competitors, small US manufacturers need to strongly consider a global sourcing strategy. While this option presents many significant benefits, the domestic producer must also be aware that there are substantial risks and pitfalls in international trade. One thing is certain, however: waiting for changes in US trade policy to level the playing field appears to be the most risky approach to this serious and real business challenge.

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