

BEHIND THE OPEN DOOR

Foreign Enterprises in the
Chinese Marketplace

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INSTITUTE FOR INTERNATIONAL ECONOMICS
Council on Foreign Relations

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Preface

No nation is increasing its impact on the global economy as rapidly as the People's Republic of China at the close of the twentieth century. At the same time, few economies are as poorly understood. Hence the Institute has addressed priority attention to China in recent years with publications including Nicholas Lardy's *China in the World Economy* (1994); our recent *Measuring the Costs of Protection in China*, conducted in partnership with the Unirule Institute in Beijing; and a series of working papers by Marcus Noland and others. Richard N. Cooper is currently working on *China's Entry to the World Economy*, our next major release on China.

The availability and comparability of data on China have improved markedly in recent years, but much about the Chinese economy remains mysterious. The conditions of competition and business operation are especially obscure within China, behind its shrinking border barriers to trade. As Edward M. Graham and J. David Richardson chronicle in our 1997 study *Global Competition Policy*, these conditions have become the new frontier of commercial negotiation and frequently create international conflict because they lie outside the competence of the World Trade Organization (WTO). At the suggestion of Leslie Gelb, president of the Council on Foreign Relations, with whose cooperation *Behind the Open Door* was prepared, the Institute decided to address these questions by examining the experience of the foreign business community in China. This firm-specific approach is unusual for the Institute but is essential to the special challenges of gauging China's economic trajectory and judging, for example, whether it will more resemble open-market Hong Kong or dirigiste Japan in the future.

To conduct the study, the Institute and the Council identified nearly one hundred expatriates who provided the bulk of the data for this study. Institute Research Fellow Daniel H. Rosen then used this cohort to develop a comprehensive portrait of the challenges and opportunities facing foreign enterprises in China today. The analysis goes beyond the tricks of doing business, however, setting these foreign experiences in the broader context of both Chinese policy and corporate strategies themselves. The results provide food for thought for policymakers, including those in the United States, who have often mistaken commercial pitfalls encountered in China as policy problems caused by the central government and have underestimated the tendency of multinational firms to create their own difficulties.

Rosen's research also suggests that the positive social impact of foreign enterprises in China has been underestimated. His results depict, for example, a group of expatriates profoundly involved with virtuous reengineering of the employer-employee relationship in China, eager to augment with training and career development the ability of their local workforces to add value and expand the scope of operation.

Rosen's analysis provides both a rich and current picture of Chinese market conditions and responses to some of the most pressing questions facing Western decision makers in China today. Key issues addressed include the WTO negotiations, China's investment environment, and the balance between central and local authorities in directing the Chinese economy. In most cases, the views from the private sector differ significantly from those that permeate official channels and thus offer a fresh perspective on the US-China dialogue.

The book reaches four policy recommendations keyed to the United States: recognizing that some Chinese political reform may proceed faster without US prodding, refocusing policy initiatives on a narrower set of more practical concerns, expanding efforts to negotiate commercial agreements beyond the present WTO agenda, and designing a set of bilateral programs to assist China in building the institutions required to implement the many commitments that are being sought. In addition, Rosen's study raises important, hitherto understudied, questions about the Chinese marketplace itself that business and policy professionals alike will need to contemplate for some time.

Deep thanks go to the Council on Foreign Relations, and especially Les Gelb, for suggesting and contributing substantively to this study. The Council helped to identify and contact the expatriates to be interviewed, made a financial contribution to the project, and hosted formative planning sessions, an event to preview initial findings from the research, and a valuable session at their Hong Kong Forum to critique the penultimate manuscript. This partnership has been extremely rewarding and has greatly improved the final product.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations and private corporations. Major institutional grants are now being received from The German Marshall Fund of the United States, which created the Institute with a generous commitment of funds in 1981, and from The William M. Keck, Jr. Foundation and The Starr Foundation. The present study received generous support from the Freeman Foundation. The General Electric Fund provides financing for our extensive work on Asia. A number of other foundations and companies also contribute to the highly diversified financial resources of the Institute. About 18 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 12 percent from Japan.

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The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. FRED BERGSTEN
Director
November 1998

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Contents

Preface	xi
Acknowledgments	xv
1 Gauging the New Chinese Marketplace	1
Introduction	1
Why Study the Expatriates?	3
A Methodology for Drawing upon Expatriates' Insights	4
Questions Needing Answers	8
Results	15
2 Foreign Enterprise Establishment in China	17
Introduction	17
The Investment Regime	21
Challenges for Foreign Investors	30
Analysis	75
3 Foreign Enterprises and Human Resources	85
Introduction	85
Human Resources and Establishment:	
Pressures Shaping the Labor Contract	89
Human Resources after Establishment	98
Analysis	115
4 Running a Productive Plant	121
Introduction	121
Productivity	122
The Foreign Experience	126
Analysis	152
	vii

5	Ex-Factory China: Distribution, Marketing, and Services	159
	Distribution Rules: A Domestic Trade Policy	159
	Foreign Investors and Distribution	167
	Analysis	193
6	Of Laws and Privileges	197
	Introduction	197
	China's Legal Environment	199
	The Expatriate Experience	203
	Analysis	223
7	Conclusions and Policy Recommendations	231
	Conclusions	233
	Implications	252
	Appendices	
	Appendix A. "Catalogue for the Guidance of Foreign Investment Industries"	259
	Appendix B. Methodology	279
	References	293
	Index	303
	Boxes	
	Box 2.1 Project finance and the approval authorities' perspective	54
	Box 2.2 The incentive pendulum swings	64
	Box 2.3 Technology Digestion and Acquisition	74
	Box 3.1 The importance of localizing management	95
	Box 5.1 Distribution feedback leading to efficient production	162
	Tables	
	Table 2.1 US-China trade, 1980, 1985-97	18
	Table 2.2 Japan-China trade, 1985-97	19
	Table 2.3 China's top trading partners, 1996	19
	Table 2.4 Number of FDI contracts by enterprise form, 1979-97	27
	Table 2.5 FDI in China, 1991-97 and 1979-97	34
	Table 2.6 Enterprise forms, 1997	49
	Table 2.7 Japanese enterprises in China	57
	Table 2.8 Average capital of FIEs in China, 1979-97	59
	Table 2.9 Roundup of issues: establishment	76

Table 3.1	Employment of Chinese by foreigners, 1980–96	87
Table 3.2	Unemployment estimates	90
Table 3.3	Overtime at a southern China FIE, 1997	97
Table 3.4	Local managers' salary increases, 1996–2000	99
Table 3.5	Average annual pay at FIEs, October–December 1996	101
Table 3.6	Per capita income by area, projected	103
Table 3.7	Per capita GDP by province, 1996	103
Table 3.8	Personnel overhead expenses: contribution of an FIE in Shanghai	106
Table 3.9	Roundup of issues: labor	116
Table 4.1	Total factor productivity growth in China's state and collective industries, 1980–92	124
Table 4.2	China's imports, first quarter 1998: SOEs vs. FIEs	127
Table 4.3	Exports of FIEs, 1985–96	128
Table 4.4	China's trade: comparative advantage	130
Table 4.5	DCAC: one year's forecast vs. actual demand, 1996	139
Table 4.6	Overcapacity? The case of the auto sector in 1996	142
Table 4.7	Expanding service operations of a joint venture in Tianjin, 1994–97	151
Table 4.8	Roundup of issues: productivity	154
Table 5.1	Distribution infrastructure growth: structure of freight volume by transportation type, 1978–96	176
Table 5.2	Infrastructure development under the Ninth Five-Year Plan, 1996–2000	177
Table 5.3	China's retail structure, 1980–96	178
Table 5.4	Retail structures in five selected markets	178
Table 5.5	Roundup of ex-factory issues	194
Table 6.1	Round of issues: law	227
Table 7.1	Roundup of FIE issues	233
Table 7.2	High priority, policy-related issues	253

Figures

Figure 2.1	Foreign direct investment in China, 1991–97	18
Figure 2.2	Comparison of commercial regimes, APEC and China	26
Figure 2.3	Strategic trade-offs in the establishment process	29
Figure 2.4	FDI in China by location, 1996	40
Figure 2.5	Approvals for new FIEs by organizational form, 1990–97	48
Figure 3.1	Managers' salary increase, 1996–2000	100
Figure 3.2	Per capita GDP by province, 1996	104
Figure 4.1	FIEs in China's trade, 1980–96	135
Figure 4.2	DCAC: One year's forecast vs. actual demand, 1996	140

Gauging the New Chinese Marketplace

[Specialization] is not a good idea. We do not suggest this even with respect to our own provinces. We advocate all-round development and do not think that each province need not produce goods which other provinces could supply. We want the various provinces to develop a variety of production to the fullest extent. . . . The correct method is each doing the utmost for itself as a means toward self-reliance for new growth, working independently to the greatest possible extent, making a principle of not relying on others[.]

Mao Zedong (quoted in Riskin 1987, 206)

[We must] sail with borrowed boats, exit through other's borders, sing on rented stages, and make money on foreign land.

Qinghai provincial official (quoted in Yang 1997, 57)

Introduction

In the final years of the twentieth century, the United States has little choice but to formulate more practical and effective foreign and commercial policies toward the People's Republic of China. This imperative is made necessary by great economic, political, and social changes taking place in China in recent years. To succeed, the architects of this new strategy will need an accurate and nuanced understanding of the characteristics of today's China and of the directions in which China is most likely to evolve. Making those judgments from outside China is notoriously difficult, and it is not possible to do so unerringly. In the long-dominant strategic formula, China was seen as a transitional economy useful for its geopolitical weight but less critical from the perspective of US global eco-

conomic security; this view has become a poor guide for US policy as China has recast itself in the past two decades from totalitarian quagmire to looming capitalist (but still authoritarian) aspirant. Such transition has created contradictions, both within China and in the configuration of international economic and political power, leaving policymakers divided on how best to proceed. As a result, the evolution of US policy toward China largely stalled in the 1990s.

In order to help in crafting the commercial aspects of a dynamic policy toward China,¹ this study gets "inside" China in a novel way: by using the growing pool of expatriate professionals in China to uncover the country's development patterns. The time for exploring this group's insights is right. The Clinton administration has exhausted the utility of lambasting Beijing and moved toward a new strategic partnership. At the invitation of Jim Sasser, a former colleague turned ambassador, many members of Congress have visited China personally, and with the benefit of firsthand knowledge many have begun to tone down their annual indictments of China's trading status. At the same time, the need for US-China cooperation to address regional economic problems (especially the Asian financial crisis) and security problems (especially South Asian nuclear proliferation) provides a major impetus to find a new approach.

President Clinton's summit trip to Beijing in June 1998 marked a turning point in US-China relations. Though the visit achieved little in concrete terms, it worked to change perceptions of China in the United States and was used by Chinese leaders to demonstrate a new level of public openness in political debate. The results of the visit will require years to tally, but it is already clear that both countries have become much more open to compromise, negotiation, and cooperation.

A window for shaping a more constructive relationship has thus cracked open, but the strategic partnership remains a long way off. As the Chinese neglect public relations and US policy remains incoherent, popular misunderstandings continue to fester on both sides of the Pacific. In the United States, best-selling books such as *The Coming Conflict with China* (Bernstein and Munro 1997) are laden with alarmist predictions reminiscent of past red (and yellow) scares. In China, *Zhongguo Keyi Shou Bu* (China Can Say No), which apes a similarly titled Japanese book, illustrates how paranoid even younger Chinese writers can be about foreign interference in Chinese events.

In short, a new, better-informed strategy for dealing with emerging China must be devised to transcend these mutual misgivings and begin

1. Traditionally, it was maintained that foreign policy required little attention to commercial matters; however, US concerns about China, from human rights to nuclear proliferation, cannot be understood apart from international commercial realities. So whether one admits a commercial policy imperative or merely seeks greater economic understanding in the "realist" vein of traditional foreign policy, the relationship between commerce and policy must be studied.

to reconcile the outdated view of China common in the West with the reality of the surprising new China now taking shape. In the larger bilateral picture, the economic relationship between China and the United States is critical; it is the part on which the political and security demands of the region increasingly depend. Drawing on insights into the economic forces shaping the Chinese marketplace today, this study addresses pressing questions in US-China commercial relations (which requires a discussion of social and political topics as well).

Why Study the Expatriates?

For a number of reasons, China has long been poorly understood in the United States. First, China remains remote from the West linguistically, culturally, and geographically, with the hinterlands beyond the few largest cities more remote still. The difficulties of penetrating the complexities of Chinese society are heightened during this period of rapid change.

Second, Chinese officials often intentionally portray their governing regimes as more monolithic, orchestrated, and disciplined than they actually are, reflecting a long-held belief in the importance of presenting a unified front to foreigners. Too many Americans take this portrayal at face value—and thus mistake China for a bigger, badder Japan of “Rising Sun” vintage (never mind how quickly that bogeyman has fallen away in recent years). Third, even Western enterprises established in China sometimes misrepresent reality in order to curry favor, to talk up the markets or, conversely, to discourage potential rivals from following them into the market. The result is a distorted understanding of Chinese conditions, which can only lead to faulty US policy.

Because of these impediments to comprehending China by analyzing its formal economic regimes from the outside and by relying on normal government channels of interaction, this study brings non-Chinese eyewitness perspectives on present developments to the attention of Westerners. The eyewitnesses are primarily managers of foreign-invested enterprises (FIEs) in China, a growing group of dedicated observers as yet little surveyed for the purpose of policy analysis.² Their views will assist US policymakers in crafting more effective policies toward China, as well as helping analysts to review whether current policy adequately supports the endeavors of US firms in China.³

2. Although this cohort contributes to a literature on doing business in China, the foreign and commercial policy implications of their views are rarely explored.

3. That US outward foreign direct investment is beneficial for both the host country and the United States has been well established (see, e.g., Dunning 1958 for early work; Bergsten, Horst, and Moran 1978; Graham and Krugman 1995 on the reverse case of FDI in the United States; Graham 1996; and Rodrik 1997b for a discussion of the broader effects of globalization).

There are already many thousands of Americans (in addition to Europeans, Japanese, etc.) at work in China, managing as many as 250,000 Chinese employees on their payrolls.⁴ By learning from the expatriates, many of the obstacles to a clear conception of China's position and direction can be avoided. It is not that the opportunity to draw on these experts was overlooked until now. Only recently has the pool of expatriate managers swelled to considerable numbers, and it is now time to exploit this new community of China expertise.

This study aims to reach a number of audiences. The policymaking community in the United States and developed-country capitals will find it useful to examine views from the private sector. Commonly, such views are filtered through so many parties that they have lost much substance by the time they get to policymakers; this study cuts out the filters. Corporate planners and other business professionals view aggressive policies from the US government as a key variable in their China operations, which is one reason why they too will find this analysis important.⁵ Another is that despite their detailed knowledge of their own factories, they sometimes lose track of broader market trends addressed in this book. Academic readers with either general or business-related interests in China will find plenty of new questions worth pursuing, in addition to useful information in the interviews. Finally, Chinese government authorities will find here an honest appraisal of how well (or how poorly) their efforts to provide an attractive investment environment for foreign businesses are faring. The several reasons why Chinese authorities will read this study closely are the subject of one of the conclusions previewed in the executive summary and treated in depth in chapter 7.

A Methodology for Drawing upon Expatriates' Insights

The strategy of learning from the expatriates involved recruiting a set of firms willing to offer access to their managers in China and their frank opinions in return for anonymity. A core group of 13 firms participated; 48 managers from these firms were interviewed, while an additional 40 interviewees outside the core group were added ad hoc. Following their interviews, all reviewed the progress of the study.

4. American Chamber of Commerce in Beijing, "In China, the Twain Meet Almost Everywhere; Public's Association with US Industry, Culture, and Education Grows Daily," *Washington Post*, 24 June 1998, A26.

5. In interviews, several such planners identified US policy swings as the single greatest threat to their commercial success in the Chinese market.

These firms and individuals have unique insights, and the experiences on which they draw are extremely valuable. As the Beijing office director for one US conglomerate remarked in a 1997 speech to a US congressional delegation:

The 17 people in the representative office of my company are in and out of more government offices, in and out of more state-owned enterprises, in and out of more private Chinese companies, and meet with more Chinese officials, managers, intellectuals, and workers in a month than the US embassy political and economic officers see in a year. I make that observation as a former military attaché (personal communication).

As useful as this methodology is, qualifications must be kept in mind. The views presented are oriented toward commerce, without pretense of disinterest. They can be expected to differ from the observations of political scientists, activists, or anthropologists. Moreover, expatriate investors in China and exporters on the other side of Chinese tariff barriers might disagree. For example, a German investor inside China may take comfort in the same external tariffs that are anathema to his exporting rivals in Bavaria.

The number of enterprises that can be involved in such a study is limited. Over 120 interviews were conducted, of which 88 were systematically explored for substance (the rest were culled for material as well, though somewhat less thoroughly). The sample was biased toward US manufacturing firms, but significant discussions with Europeans, Japanese, and overseas Chinese in Hong Kong and elsewhere were also included. A size bias is present, that is, most were large firms. While an effort was made to canvass as broad a selection of industries as possible, not all sectors were examined.⁶

Questionnaires and wide-ranging interviews were used to draw out information from interviewees. Though the study employs academic literature, press reports, and business analyses to flesh out and fill in parts of the story, these interviews were the primary source and determined all the "specific issues" identified. The participants, ranging from directors of China operations to plant managers to lobbyists, were asked to describe both the experiences of their firms in general and the focus of their daily work in particular.⁷ Once the interviews were complete, remarks were grouped together by topic: for example, "comments about firm motivations," "importance of management control," "distribution," "legal issues," or "the role of relationships and connections." After related groups of comments and company documents were put together with

6. See further appendix B, on methodology, which also includes a descriptive list of interviewees.

7. Local Chinese employees also provided background information, but the study intentionally focuses on the expatriate perspective.

published and unpublished materials, principal business functions were assessed. These functions are

- negotiation and establishment (chapter 2),
- human resources and staffing (chapter 3),
- productivity and production management (chapter 4),
- ex-factory distribution and marketing (chapter 5), and
- legal obligations and privileges of ventures (chapter 6).

Though it was rare to find perfect consensus across industries and locations, the comments of expatriates revealed clear patterns and trends.

In addition to discussing broad themes, respondents described specific challenges. These groups of issues are listed in the concluding table to each chapter. The analytic section of each chapter examines the implications of these themes. How should these many topics be thought about, and which of them deserve the most prompt attention from readers concerned with policy? To answer this, four “drivers” of business problems are postulated: transitional problems, self-imposed problems, policy problems, and market structure problems. Distinguishing among these causes helps us to focus on those commercial concerns that foreign policy activism can affect and set aside those beyond the reach of policy intervention. Far too often, all issues regarding China have been seen as policy issues, and if this study does no more than uproot that tendency, then it will have succeeded.

Transitional problems reflect the adjustment of China’s rapidly evolving economy from statism to the market. While Chinese authorities can marginally soften the impact of such problems, they are to a great extent inevitable and must be weathered.⁸ For example, shortages of skilled labor will plague China for some time as a result of high growth rates and inadequate capacity for training key types of professionals. The solution is to develop greater training capacity and the market incentives to pull people into school and then match them with employers. It is important to recognize these transitional adjustments as such, because misdirected intervention on the assumption that they are policy problems could hinder efficient outcomes or make things worse.

One of the least-noted dimensions of the foreign commercial experience in China is the second category: *self-imposed problems*. For many reasons, foreign investors sometimes have entered the Chinese market hastily,

8. Though present (as opposed to past) policy cannot be blamed for transitional problems, it can play an important role in facilitating the process of transition.

sometimes recklessly. Often they have relied on data, partners, and assumptions that would never pass muster at home. The relative dearth of home-country analysts capable of second-guessing managers in China has contributed to these lapses.

But by arguing that they simply use the best information available and that the Chinese market is just too large to ignore, firms hardly answer these criticisms. Once established, foreign investors have often declined to scale the cultural walls that separate the expatriates in the special economic enclaves from the real expanse of the Chinese market. New “compradors”⁹ often make this too easy for them. Therefore, many of the priority themes identified in interviews with foreign professionals in part originate with the firms themselves.

There is no question that many of the phenomena treated in this study involve *policy problems*. Government intervention, only partially lessened by the press of market forces, still pervades China’s economy. New policy activity—some of it virtuous, some misdirected, and some simply bad—issues forth from the seat of power at Zhongnanhai (China’s executive leadership compound in Beijing), as well as from lowly town rat-control boards.

Last come *market structure problems*. These problems are due not to policies in place but to the *absence* of procompetitive policies on the part (primarily) of central authorities. The preventive measures needed to support an open market include antitrust rules and a host of others as the Chinese economy becomes more sophisticated. The policies must address concentration of market power, public and private collusion in restraint of competition, and anticompetitive practices. In their absence, barriers to market entry naturally arise (as do similarly unhealthy efforts to bar *exit* from the market), harming consumers—especially the poorest—and foreclosing opportunities for new entrants both foreign and domestic (that is, other Chinese firms). While these problems are not specifically caused by policy, they cannot be remedied without policy reform.

Beyond identifying the proper drivers behind each business concern that the expatriates identified, this analysis indicates—where policy problems are involved (i.e., policy and market structure problems)—whether the policy problem is central, provincial, or local in nature, and whether the issue is considered high priority by foreign investors. This additional information will help Western policymakers separate policy issues that deserve focused pressure on central Chinese authorities from less immediate concerns.

9. Compradors (a mildly derogatory term from the pre-Communist era) are local Chinese agents of foreign merchants, used as a buffer between local markets and foreign business (see chapter 2).