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International Business Agreements in the People's Republic of China

Readings and Materials

Editors:
Ralph H. Folsom
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Dedicated to our siblings,
who carry on the tradition of support and family we value:

Ellen Folsom Lister
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PREFACE

The economy of the People's Republic of China has enjoyed explosive growth for over a decade and all signs indicate that the pace will continue. Indeed, various studies suggest that China's economy will become the largest in the world early in the 21st century. This reality has drawn international traders and investors like bees to honey. They have negotiated and signed an ever growing number of international business agreements in the PRC.

In this book we have gathered together and edited outstanding articles by leading law and business authors. These articles are drawn primarily from United States journals and reviews, but the legal and management issues treated in them are germane to all businesses in the People's Republic. We have also included copies of major PRC laws relating to international business, as well as sample joint venture, sales and commodity agreements. We hope that this collection of materials will prove useful to lawyers, business executives, government officials, students and others seeking an understanding of the dynamics of PRC international business agreements.

This book commences with a contextual introduction by the editors, followed by chapters on negotiation, the political environment, import/export, technology transfer and joint venture agreements, subsidiaries, management, marketing and distribution, and dispute resolution.

This is our first endeavor of this type, although we hope to edit additional volumes relating to international business agreements in other parts of the world. We welcome your suggestions and comments for proposed volumes, as well as the next edition of this one.

ABOUT THE EDITORS

Ralph H. Folsom is University Professor of Law at the University of San Diego. Professor Folsom has regularly served as Director of USD's Institute on International and Comparative Law in Paris, France. He is a graduate of Princeton University, Yale Law School, and the London School of Economics where he received a Master in Laws degree. Professor Folsom spent two years as Lecturer in Law at the University of Warwick in England and two years as an attorney and Professor in Residence with the United States Federal Trade Commission. He has been a Visiting Professor of Law at Monash University in Australia, at the University of Hong Kong and at the University of Paris, as well as a Senior Fulbright Research Scholar at the Institute for Southeast Asian Studies in Singapore.

An active consultant and member of the California and Connecticut bars, Professor Folsom teaches and specializes in international business law. Among his many writings are the following books, some of which are co-authored: *European Union Business Law*, *State Antitrust Law and Practice*, *International Business Transactions and Law in the People's Republic of China*.

W. Davis Folsom is a Professor of Business Administration at the University of South Carolina-Aiken, where he serves on the University's International Studies and the South Carolina Consortium for International Studies committees. Dr Folsom is a graduate of Rutgers University, and he received his doctorate in agricultural economics and marketing from the University of Connecticut.

Dr Folsom is actively involved in consulting for both local and international clients including economic impact, customer satisfaction and market research studies. He has published in numerous regional, national and international journals including: *The Journal of Market Intelligence and Planning*, *International Journal of Tourism, Recreation and Research*, *Business Association of Latin American Scholars*, and the *Southwest Journal of Business and Economics*. He and Professor Ralph Folsom recently authored an interdisciplinary book entitled *Understanding NAFTA and Its International Business Implications* (Richard D. Irwin/Matthew Bender, 1996).

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CHAPTER 1

Introduction

AN INTRODUCTION TO INTERNATIONAL BUSINESS AGREEMENTS IN THE PRC

Ralph H. Folsom and W. Davis Folsom

The context in which PRC international business agreements are shaped has changed rapidly and radically since the end of the Cultural Revolution (1976). This introduction by the editors sets the stage for this book—the explosive growth of business and markets in the PRC. Yet the opening of China to foreigners has been a controlled event, as the evolution of its contract, investment and technology transfer law and business practice illustrates. International business agreements have a role to play, but China is hardly an example of 'frontier capitalism'.

It is difficult to label the Chinese economy in 1996. Many actions in China today appear contradictory. China could be called a developing economy with all the infrastructure, poverty, literacy, and other social problems associated with less developed countries. It is also the third largest economy in the world and predicted by many to surpass the US and Japanese economies early in the next century. In addition, China retains much of the apparatus and rhetoric of a centrally planned economic system while new laws and policies encourage domestic private enterprise and international business agreements.

China in 1996 faces two major sources of turmoil: the anticipated leadership/direction conflict when Deng Xiaoping dies and bottlenecks resulting from over a decade of double-digit economic growth rates. The future of China after Deng involves more than just the question of who will become the next head of state. One question is what will be the future of state-run enterprises? State-run enterprises represent over 40 percent of China's industrial output and a larger percentage of employment. But in 1994 almost half were losing money while commanding large percentages of scarce investment capital. State-run enterprises are an important economic force in 1996, but support for socialist economic entities has clearly declined among Chinese citizens. A Gallup survey in late 1994 found that only 4 percent of Chinese respondents 'subscribe to a collectivist philosophy of totally giving oneself in service to society'. Party members fear people's anger at the party's special privileges and corruption. Officials of state-run enterprises have become reluctant to make new deals and are backing away from previous commitments fearing that in the future they may be charged with 'catering to foreign interests'.

In February 1995 Zhou Beifang, a mainland Chinese businessman, was arrested for 'unspecified commercial crimes'. Zhou, who has family connections with Deng Xiaoping, engineered the expansion of Shougang Corporation into the Hong Kong Stock Exchange and used his perceived connections to parlay business holdings

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Adapted in part from R. Folsom and M. Gordon, *International Business Transactions* (1995); © West Publishing Co, and used with permission.

worth over $1bn. But at the same time, one sign of the new capitalist/consumer orientation in China is represented by government plans to increase the number of credit cards in circulation from 7m to 30m in 1995.

In addition to the communism/capitalism conflict in China, economic policy problems are becoming more pressing in 1996. Rapid economic growth over the last fifteen years has been facilitated by expansionary monetary and fiscal policies, greater openness to foreign investment, and an array of trade policies sometimes opening trade and sometime pursuing import-substitution goals. As Mexico learned in the 1980s, there are limits to import-substitution economic development, and as any economic textbook will caution, expansionary monetary and fiscal policies eventually lead to inflation. When currency in circulation rose by over 50 percent in the first half of 1993, China's monetary authorities tightened credit controls reducing monetary growth, but continued economic growth added to inflationary pressures. By 1994, price controls were expanded, temporarily slowing inflation rates. But price controls create other problems, shortages and bottlenecks to production.

Much of the economic growth in China over the last 15 years has been facilitated by foreign capital and technology using cheap local labor. The lack of development of domestic labor skills, and the inability of infrastructure investment to keep up with industrial expansion constrain future growth. A bidding war exists among industrial enterprises for skilled labor and managerial talent, while state enterprise employment policies mask underemployment problems. Truck and rail transport delays are the norm rather than the exception. In some parts of China factories are subjected to scheduled downtime due to a lack of electricity. Most electrical utility plants are coal-burning. Coal transport requirements reduce already scarce available space in the rail system for shipment of other materials and products. If that famous economic forecaster, Rosy Scenario, were to visit China in 1996 she would probably write a 'classic' economic report. 'On the one hand' China is huge, rapidly growing, industrious economy while 'on the other hand' China faces many problems for both domestic and international business.

The Retreat from State Enterprise

According to the 1982 Constitution, the state sector is the leading force in the economy of the People's Republic of China. Starting in the early 1980s, there was a quiet retreat from this position. The amount of China's industrial output produced by state enterprises steadily dropped, accounting for just 43 percent of output in 1993. Correspondingly, during the 1980s, there was rapid growth in the number and economic significance of foreign, private and collective enterprises. These enterprises accounted for over half of the gross domestic product (GDP) of the People's Republic by the late 1980s. They were an engine of economic growth and jobs. In 1988 and again in 1993, the Constitution of the PRC was amended to affirm the development of these sectors as a supplement to the state economy.

Prices and Markets

A broad trend towards free market economics (taking goods off 'the plan') was apparent in the People's Republic during most of the 1980s. The number of products allocated through central planners dropped from 250 to 20 by 1988. The share of industrial output and retail sales subject to state planning dropped to 30 percent. Nevertheless, China's economy remains regulated. The government's central administration fixes prices for important consumer and producer goods, and local economic bureaucrats also set prices and control supplies. The fixed price has little to do with actual costs. Reregulation of previously deregulated areas was the trend between 1988 and 1992. Late in 1992, the PRC lifted price controls on most production materials, including petroleum, copper, lead, aluminium, certain types of steel, and many machinery and electronics goods. This left about 110 production items subject to central or provincial price controls. By the end of 1992, only seven agricultural commodities (including grain, cotton and tobacco) continued to be regulated in price. In early 1994, however, government use of price controls was in fashion again, affecting a wide range of agricultural and petroleum products.

Price controls go to the heart of government regulation of the Chinese economy. No other area has provoked more controversy in the drive for economic reform. Price controls are a litmus test on the progression or regression of the economic reform movement. The status of these reforms sends important signals to foreign investors in the PRC.

Broad price reforms have been tested in the city of Guangzhou (Canton). The *Beijing Review* reported in 1987 on some of the problems encountered with Guangzhou's price controls:

> Under China's old price structure, prices reflected neither the true value of the goods nor the relationship between their supply and demand ...
> – The purchase prices for farm and sideline products were unduly low, and selling prices were still lower than the purchasing prices. The state had to subsidize them.
> – The prices of manufactured goods were high, but the prices of minerals, energy and raw materials were too low. For example, the 1978 profit rate for state-owned industrial enterprises was 21 percent, 43.19 percent for light industry, 47.68 percent for the textile industry and only 0.46 percent for coal. Due to their low prices and meager profits, household goods like soap, matches and toilet paper were often out of stock.
> – The price of commodities bore no relation to quality. For a long time the state set a unified price for every kind of commodity.
> – Charges for transport, urban public utilities and services were unduly low. For example, it cost just five to 20 fen to ride a bus. Every year the municipal transportation and communications company lost 1m yuan.[1]

The Guangzhou reforms involve far fewer fixed prices on agricultural and industrial goods than previously. There are, instead, more prices floating within limits and more free market prices. Indeed, the overall proportion of goods subject to fixed prices decreased dramatically. Only key commodities such as grain, oil, fuel and medicines, along with transport fares, rent, water rates, electricity, tuition and postage are subject to fixed prices. Floating prices are allowed for services and recreational activities such as hotel rooms, concerts and the theater. Free market prices govern more than half of all prices, including most food items. However, the state still buys some foodstuffs and subsidizes their retail price in off seasons. The total amount of subsidization has been declining. The Guangzhou experiment in broad price deregulation provides a model which has been spreading throughout China.

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[1] September 24, 1987 at pp.14–15.

Cartels, Monopolies and Competition

The tensions inherent in moving China's planned economy into the marketplace are evident in its regulatory law. China has, for example, an unusual collection of laws supporting competition and encouraging collaboration. Regulations Concerning the Promotion of Economic Combinations were adopted on a provisional basis in 1980. These regulations encourage state enterprises to voluntarily participate in economic combines by signing a contract. Producers and processors of raw material might, for example, execute such a cartel agreement. The regulations provide that combines can enjoy incentives in the marketing and supply of products.

Regulations Concerning Development of Socialist Competition were also provisionally issued in 1980. Under these regulations, state enterprises are given more power to decide on production, marketing, finance, and the like without interference from local authorities. No monopoly of any commodity is allowed other than those (such as the state tobacco monopoly) designated by the government. Although these regulations give priority to the government's economic plans, state enterprises may produce in excess of plan quotas. In addition, authorities cannot create local monopolies, or forbid the sale locally of products that are made elsewhere. These regulations were incorporated into the Anti-Improper Competition Law of December 1993. This Law does not address abuses of market power by state enterprises.

The government is thus in a legal position which allows it to choose between economic combines or socialist competition. Prior to 1989, the trend was clearly in the direction of more competition and fewer state authorized cartels. Indeed, as market forces increasingly came into play the capitalist phenomenon of 'multifarious monopolies' reared its head. New regulations were adopted by the State Council to combat these practices. No enterprises or trade associations may establish a 'monopoly price', regardless of whether the state has set a ceiling price for the relevant product or decreed that it is subject to a floating or free market price. The state will punish offenders and replace monopoly prices with 'reasonable' ones. China's answer to monopoly pricing is thus reregulation of markets, not a greater promotion of competitive alternatives. This is a step backwards from the development of a market economy, one which the Chinese explain by reference to the infant state of their economic system. There may be some legitimacy to this explanation, but monopoly pricing controls could undercut the progress toward deregulation of markets and attraction of foreign investors.

China and the World: From Isolation to Open Doors

Under Mao Zedong, China followed trade and investment policies of economic isolation and self-sufficiency. These policies were partly a response to past economic exploitation of the country by foreigners. They also reflected communist ideology and a rejection of the economic tenets of modern capitalism. Since the Cultural Revolution, the People's Republic has opened its doors and law to world trade and investment as part of its modernization and development strategy. This reversal is most evident in its relations with Hong Kong, Japan and the United States, China's three leading trade partners. Nearly 40 percent of China's GDP is now involved in foreign trade.

Even after the 1989 resurgence in the power of economic traditionalists, the PRC has continued to be receptive to world trade and investment. In the period following

Tiananmen Square, however, once enthusiastic foreign investors became cautious and were constrained by their banks and governments. Recentralization, austerity and contractions in China's economy hurt their existing investments. Though the doors remained open, many but not all foreigners hesitated to enter. The Taiwanese, Singaporeans, South Koreans and (more deliberately) the Japanese led the return to trading and investing in China. Broadly speaking, this reflects a growing trend, the Asianization of China's international economic relations. It portends diminished influence for the United States in Chinese trade and investment policies. Indeed the US share of total contracted foreign investment in the PRC declined from 11 percent in 1989 to 6 percent in 1994.

United States Export Controls: From Trading With an Enemy to Trading With an Ally

Prior to 1972, according to United States' policy, trading with the PRC was treated as trading with the enemy. Trade relations between the US and the PRC began to improve following the signing of the Joint Communiqué (Shanghai Communiqué) by President Richard Nixon and Premier Zhou Enlai on 28 February 1972 in Beijing. The Communiqué focused primarily on a summary of the US and Chinese points of view on global politics (eg, the war in Vietnam, the situation in Korea, and the status of Taiwan) without attempting to reconcile them. In addition, it suggested the desirability of increasing people-to-people contacts, trade between the PRC and the US and exchanges in 'science, technology, culture, sports and journalism'. However, the United States continued to enforce numerous restrictions on trade with the People's Republic, after 1972. Export controls limited the shipment to the PRC of most United States goods. High tariffs (known as 'Column Two' or 'Smoot–Hawley' tariffs) prevented substantial import of Chinese products into the United States. Trade relations changed dramatically, however, in 1979 with the resumption of formal diplomatic relations between the US and the PRC and the adoption of the United States–People's Republic of China Agreement on Trade Relations.

Under the 1979 Agreement, the United States granted most-favoured-nation tariff status ('Column One' tariffs) to goods of PRC origin. Tariffs on Chinese goods dropped dramatically and US imports quickly rose. The United States also removed most of its export controls over nonstrategic trade to China. US export control regulations were amended to create a unique category ('Group P') for the PRC which permitted more exports to China than to many other communist nations. A further loosening of controls occurred in 1983, just before President Reagan visited the PRC, when export trade with China was shifted to 'Group V'. This shift allows exports to the PRC on a basis comparable to most other noncommunist nations with which the United States trades. Indeed, the Departments of Commerce and Defense, which principally administer US export controls, even authorized the export of substantial quantities of military products to China. Transfers of strategic technology also expanded. Much of the liberalization in trade in the 1980s, especially that relating to military equipment, can be attributed to the desire of the US government to sway the PRC towards its side in what it saw as a triangular power relationship involving the US, China and the former Soviet Union. In June 1989, however, the Bush Administration suspended military cooperation with the PRC in response to events surrounding the 1989 Democracy Movement. Goods on the munitions control list were banned from China trade. These limitations also affected nonmilitary sales, such as Boeing 757s, because any product with a component on the munitions control list could not be sold to the PRC.

Since 1980, Chinese imports and exports have benefited from US Export–Import Bank financial support, although this has been slow in forthcoming after Tiananmen Square. Eximbank loans and loan guarantees are available for products with 51 percent or more US content. In 1980 because the United States and China exchanged diplomatic notes on investment guarantees, US Overseas Private Investment Corporation (OPIC) loans, insurance and guarantees have also been extended to China. Should OPIC make payment to any US investor or trader in China, the PRC will recognize OPIC's rights to the claims of that person. However, participation in OPIC programs has been denied since Tiananmen Square. There are additional gaps in China's foreign investment relations. One notable omission is the absence of a bilateral investment treaty with the United States. A breakthrough investment treaty signed with Japan may presage the filling of this gap. In sum, but for recent Democracy Movement sanctions, US law as now applied to the PRC much more closely resembles trading and investing with an ally than with an enemy.

United States–PRC Trade and Investment Disputes

Trade and investment disputes between the United States and the People's Republic regularly emerge. For example, private US investors owning property in prerevolutionary China or holding imperial government bonds commenced litigation in the early 1980s against the PRC in the federal courts. This litigation threatened to undermine the lump-sum claims settlement agreed upon in 1979 by the US and the PRC. That settlement released assets frozen by both governments since 1949 for the purpose of paying claimants; however, the US litigants were disgruntled with their return of only 40 cents on each dollar of their investments. One default judgment was actually entered against the PRC which has always disclaimed liability for the 'odious debts' of prerevolutionary China. The lump-sum claims settlement was eventually upheld by the US federal courts, but not before economic relations were frayed.

In recent years, disagreements have arisen about the volume of Chinese imports of United States grain, the export of Chinese textiles and goods produced by prison labor to the US, Chinese shipments and purchase of military goods and technology in the Middle East (particularly since the Gulf conflict), and the alleged subsidization and dumping of Chinese goods in the United States. China ameliorated some of these concerns by signing the Nuclear Nonproliferation Treaty in 1991 and by agreeing to multilateral controls over the shipment of missiles in 1992. Chinese military sales to Pakistan caused President Clinton to further restrain in 1993 the flow of military goods and technology to the PRC. But in May 1994, the US liberalized controls on the transfer of computer and telecommunications technology to the PRC and declined to seriously sanction nuclear technology transfers to Pakistan in 1996.

In addition, the United States, after goods shipped through Hong Kong are considered, finds itself with a mounting trade deficit with the PRC (second only to Japan). However, when the corresponding *declines* in trade deficits with Taiwan and Hong Kong are factored in, the US trade position since 1987 with 'Greater China' shows a net reduction in deficit. This reflects the movement of export industries to the mainland as Hong Kong and Taiwan have become high-cost centers.

United States Tariffs on PRC Goods: The Issue of Human Rights

Another divisive trade-related issue involves US application of the 'Jackson–Vanik