ETLA
ELINKEINOELÄMÄN TUTKIMUSLAITOS
The Research Institute of the Finnish Economy
Lönnrotinkatu 4 B 00120 Helsinki Finland

Sarja B 155 Series

Jyrki Ali-Yrkkö - Catherine Reilly -
Jian-Guang Shen

THE LONG MARCH TO ASIA -
Investing in Asia After the Crisis

Publisher:
Taloustieto Oy 1999

Cover: MainosMayDay Oy, Vantaa
Cover photograph: Jyrki Ali-Yrkkö
Editor: Catherine Reilly

ISBN 951-628-298-9

Printed in Tummavuoren Kirjapaino Oy, Vantaa 1999

ALI-YRKKÖ, Jyrki, - **REILLY**, Catherine - **SHEN**, Jian-Guang, **THE LONG MARCH TO ASIA**. Helsinki, ETLA, Elinkeinoelämän Tutkimuslaitos, The Research Institute of the Finnish Economy, 1999, 156 p. (ETLA B Series, ISSN 0781-6847; no. B155) ISBN 951-628-298-9.

ABSTRACT: The "Asian miracle" ended in the autumn of 1997 when many East Asian economies fell victim to the Asian crisis. In this study, we analyse the reasons for the crisis and its effects on the world economy. We study why market players were unable to predict the crisis and identify the main lessons which both analysts and investors should learn from the crisis.

The Asian crisis has not altered the long-term growth prospects of East Asia. On the contrary, the crisis will help to fix the weaknesses of the East Asian economies. The emphasis is on how the Asian crisis has affected the restructuring of China and Japan. Other economies covered are Hong Kong, Singapore, South Korea, Taiwan, Thailand, Malaysia and Indonesia.

In addition to the Asian crisis, the study also considers the experiences of foreign companies which have invested in China. Through a case study of Finnish firms we investigate the main difficulties which foreign companies have encountered in China and identify the keys to successful investment in China.

KEY WORDS: East Asia, crisis, economic development, foreign direct investment, China, FDI.

ALI-YRKKÖ, Jyrki, - **REILLY**, Catherine - **SHEN**, Jian-Guang, **THE LONG MARCH TO ASIA**. Helsinki, ETLA, Elinkeinoelämän Tutkimuslaitos, The Research Institute of the Finnish Economy, 1999, 156 p. (ISSN 0781-6847; no. B155) ISBN 951-628-298-9.

TIIVISTELMÄ: Kaakkois-Aasian maiden pitkään jatkunut talouskasvu päättyi vuonna 1997, kun monet alueen talouksista joutuivat kriisiin. Tässä tutkimuksessa analysoidaan Aasian kriisin taustoja ja sen vaikutuksia maailmantalouteen. Lisäksi pohditaan sitä, miksi Aasian talouksien asiantuntijatkaan eivät kyenneet ennakoimaan kriisiä ja mitä investoijat ja analyytikot voivat oppia kriisistä.

Aasian kriisi ei ole muuttanut Kaakkois-Aasian maiden pitkän aikavälin kasvunäkymiä. Tilanne voi olla jopa päinvastainen. Kriisi on auttanut korjaamaan talouksissa olleita heikkouksia. Syvennymme tässä työssä Kiinan ja Japanin talouksien rakennemuutokseen. Lisäksi käsitellään Hongkongin, Singaporen, Etelä-Korean, Taiwanin, Thaimaan, Malesian ja Indonesian talouksien erityispiirteitä ja pitkän ajan näkymiä.

Aasian kriisin lisäksi tutkimuksessa paneudutaan ulkomaisten yritysten kokemuksiin toimimisesta Kiinan markkinoilla. Suomalaisyritysten kokemuksiin perustuen kirjassa esitetään yleisimpiä vaikeuksia, mitä yritykset ovat kohdanneet Kiinassa. Lisäksi pohditaan keskeisiä menestystekijöitä, joita Kiinaan investoivan yrityksen tulisi ottaa huomioon.

AVAINSANAT: Itä-Aasia, kriisi, talouskehitys, ulkomaiset investoinnit, Kiina, suorat sijoitukset.

Contents

Foreword

The importance of Asia in the world economy has increased constantly. Over the last 30 years, the East Asian economies have grown extremely rapidly. At the end of 1997, the area plunged into a serious recession. Apart from the local effects, the Asian crisis also had a major impact on the world economy.

The factors that lead to economic and financial crises are often misunderstood. The public debate has centred more on the consequences of the crisis than the reasons which led to the recession. In order to learn from a crisis, it is nonetheless necessary to understand why it happened. In addition to looking at the long-term perspectives of the Asian economy after the crisis, the study also focuses on the economic and cultural factors that caused the crisis and the main lessons which analysts and investors should bear in mind in the future.

The book also includes a survey of the experiences of Finnish companies in China. By studying the experiences and opinions of Finnish firms it is possible to identify the main factors which determine the success of foreign firms in China.

The book has been written by Jyrki Ali-Yrkkö, Catherine Reilly and Jian-Guang Shen.

Helsinki, August 1999

Pentti Vartia

Preface

After the Asian crisis the obvious question is, why did it happen? On the eve of the crisis many analysts who specialised in the Asian economies forecast that the growth outlook for the area was excellent. How is it possible that the experts were unable to predict the crisis, and what can we learn from this? What it the long term outlook for the Asian economies now, after the crisis? How has the Asian crisis affected the economic restructuring of China and Japan as well as the other economies in East Asia? In these study we answer these and many other questions related to the crisis.

In addition to the Asian crisis, we also study the experiences of Finnish firms which have invested in China. We have identified the main problems which foreign firms have encountered in their Chinese operations. We have also uncovered some of the key factors to successful investment in China.

Many people have contributed to the study. Paavo Suni and Olavi Rantala provided valuable insights to the first three chapters. Erlin Yang (China Tekway) has given useful comments and written three case studies. Moreover, discussions with him have helped us to improve the fourth chapter considerably. The insights and comments of Mikko Pilkama were also fruitful. Anni Keinänen has done a careful job in helping us to obtain and analyse the data. We also wish to acknowledge the contribution of all the managers and Finnish trade representatives who gave us their valuable time, with particular thanks to Ilpo Kaislaniemi (Finnpro) and to Heikki Sierla (Fortum). Kimmo Aaltonen and Laila Riekkinen deserve special thanks for their patience and invaluable help with editing the book.

Catherine Reilly and Jian-Guang Shen have co-authored the first chapter. Catherine Reilly has written the second chapter and Jian-Guang Shen the third chapter. The fourth chapter has been written by Jyrki Ali-Yrkkö.

Finally, we would like to thank The Ministry of Trade and Industry for financial support.

Helsinki

August 1999

Jyrki Ali-Yrkkö   Catherine Reilly   Jian-Guang Shen

Finnish summary

Talouteen liittyy myös kulttuuri

Aasian kriisi on tuonut uusia näkemyksiä sekä kriisimaista itsestään että markkinoiden käyttäytymisestä talouskriisissä. Vaikka kriisin taustalta löytyy selviä taloudellisia perustekijöitä, ei kriisin laajuudesta voi sanoa samaa. Sijoittajien epärationaalinen käytös pahensi kriisiä merkittävästi.

Kriisimaiden talouksien perustana olevat tekijät ovat muuttuneet paljon vähemmän kuin yleiset näkemykset näistä maista. Ennen kriisiä puhuttiin "Aasian talousihmeestä" ja "Aasialaisesta kasvumallista". Aasian talouksissa oli nähtävissä heikkouksia, joihin ei kiinnitetty riittävästi huomiota. Kriisin aikana keskityttiin kriisimaiden kielteisiin puoliin ja heikkouksiin. Monien kriisimaiden talouksien nopea elpyminen on osoitus siitä, että taloudet eivät ole romahtaneet. Eräs kriisin tärkeä opetus on, että todellinen taloustilanne ja julkinen käsitys voivat poiketa merkittävästi toisistaan. Tiedotusvälineiden antama kuva on usein liian mustavalkoinen vaihdellen hurmoksesta kaaokseen.

Vastaavasti nykyinen talouksien elpyminen tulkitaan ehkä liian optimisesti. Viimevuotisen talouksien syöksykierteen jälkeen monet asiantuntijat ennustavat vuodelle 1999 selvää elpymistä. Maiden pitkän ajan kasvunäkymät ovatkin hyvät, mutta monet maista (esimerkiksi Indonesia ja Kiina) ovat vielä alkutaipaleella talouksien ja niiden rakenteiden kehittämisessä. Rakenteelliset muutokset ovat tärkeitä myös kehittyneemmissä maissa, kuten esimerkiksi Singaporessa ja Hong Kongissa.

Monet kriisin taustalla olevat tekijät liittyvät enemmän kulttuuriin kuin talouteen. Nämä tekijät eivät muutu parissa vuodessa. Esimerkiksi "kaverikapitalismi" ja informaation läpinäkymättömyys vaikuttivat keskeisesti kriisin syntyyn. Niiden ansiosta todellisen kuvan saaminen maiden ja niiden yritysten taloudellisesta tilanteista oli lähes mahdotonta. Vastaavasti aluetta seuraavien analyytikoiden oli vaikeaa julkaista kriittisiä mielipiteitä maiden talouksista, sillä se olisi voinut vaikeuttaa yhteistyötä kriisimaiden kanssa. Aasiaa seuraavien henkilöiden on hyvä tiedostaa, että julkisesti saatava informaatio antaa helposti liian myönteisen kuvan.

Ulkomaiset yritykset Kiinassa

Talousvaikeuksista huolimatta yhä useampi ulkomainen yritys investoi Aasiaan lähivuosina. Kiinaa koskeva tarkastelumme osoittaa, että paikallisten olosuhteiden tunteminen on keskeinen menestystekijä ulkomaiselle yritykselle. Lukuisat esimerkit maailmalta ovat osoittaneet, että ulkomaisen yrityksen tie Kiinassa on kivinen. Myös monien suomalaisyritysten odotukset Kiinasta ovat olleet liian myönteisiä. Tavoitteita ei ole saavutettu. Toisaalta on muistettava yksikköjen nuori ikä. Kiinasta ei kanneta pikavoittoja, vaan yrityksen on oltava valmis käyttämään rahaa jonkin aikaa.

Monet kustannukset ovat osoittautuneet korkeammiksi, kuin alunperin odotettiin. Erityisesti expatriaattien kustannukset sekä erilaiset kiinteistökustannukset ovat korkeat. Lisäksi myös paikallisen työvoiman kulut voivat nousta korkeaksi. Palkan sivukustannukset ja koulutusmenot nostavat kokonaiskustannuksia huomattavasti. Lisäksi työntekijöiden vaihtuvuus on suurta. Myöskään työvoiman saatavuus ei ole itsestäänselvyys. Etenkin kielitaitoisten ja länsimaisen johtamiskulttuurien tuntevien ihmisten löytäminen on hankalaa. Monet Kiinassa menestyneet ulkomaiset yritysjohtajat ovat todenneet, että menestys riippuu pitkälti hyvän paikallisen johdon ja työntekijöiden löytämisestä. Kiinaprojektin alkuvaiheessa yritysten tulisi kiinnittää huomio siihen, että hankkeen vetäjällä itsellään on tietotaitoa Kiinasta ja Kiinan erityisominaisuuksista.

Monet ulkomaiset yritykset käyttävät paikallisten asiantuntijoiden apua. Länsimaisen yrityksen omat kokemukset yhdistettynä paikalliseen tietotaitoon ovat auttaneet ongelmien ratkaisussa. Luottaminen vain yhteen tahoon on kuitenkin suuri riski. Monet yllätykset voidaan välttää tarkistamalla informaation taustat, mukaan lukien tiedot, mitä on saatu provinssin virkamiehiltä.

Suomalaisyritysten toiminta tulee laajenemaan Kiinassa. Yhtäältä sinne investoivat uudet yritykset. Erityisesti useat Nokian yhteistyökumppanit ovat aikeissa perustaa tehtaita Kiinaan. Yhteisyritysten sijaan yhä useammat uudet tuotantoyksiköt tulevat olemaan kokonaan omistettuja yrityksiä. Tytäryhtiöiden houkuttelevuus on kasvanut, koska niitä koskevia sääntöjä on lievennetty ja koska monet joint venturet ovat kohdanneet merkittäviä vaikeuksia. Lisäksi useat nykyisin Kiinassa toimivat yritykset aikovat tehdä laajennusinvestointeja. Kaiken kaikkiaan Kiinan merkitys Suomelle kasvaa entisestään. Sekä investoinnit että vienti Kiinaan lisääntyvät.

Lopuksi

Aasia tarjoaa kiinnostavan investointikohteen. Kriisin opetukset on kuitenkin hyvä pitää mielessä, sillä monet kriisin taustalla olevat tekijät eivät ole hävinneet. Paikallisen tietämyksen ja kulttuurin ymmärtämisen merkitystä ei voi liiaksi korostaa. Erityisesti tämä koskee yrityksiä, jotka perustavat ulkomaille yksikköjään.

1

THE ASIAN CRISIS

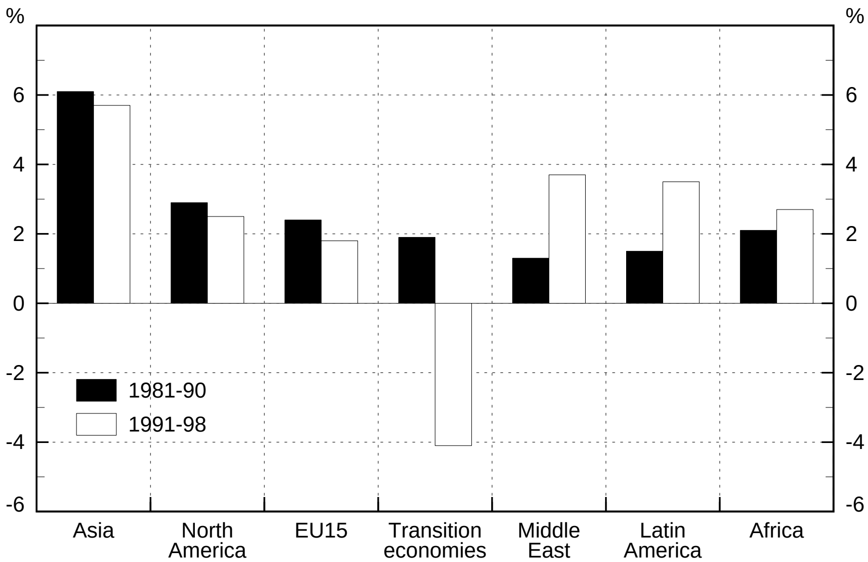
Catherine Reilly - Jian-Guang Shen

In this chapter, we will go through the chronology of the Asian crisis and its effects on the world economy. First, we describe the economic growth process which has taken place in East Asia over the last three decades, and which was often dubbed the "Asian miracle". Next, we go through the main events which constituted the "Asian crisis". We see how the East Asian economies fared under the crisis and what the current economic outlook for the area is like. Finally, we study the impact of the Asian crisis on the world economy.

The Economic Development of East Asia

Growth in Asia[1] has been far faster than in any of the other regions of the world in the past three decades (Chart 1.1). This rapid growth is mainly due to the dynamic performance of East Asia. In this book East Asia consists of Japan, China, the "NIEs" (Hong Kong, Singapore, South Korea and Taiwan) and ASEAN (Indonesia, Malaysia, the Philippines and Thailand). Growth in East Asia has been more rapid than in the other Asian countries: in the 1981-1990 period East Asian growth averaged 7.4 percent a year and from 1991-1998 average yearly growth was 6.2 percent.

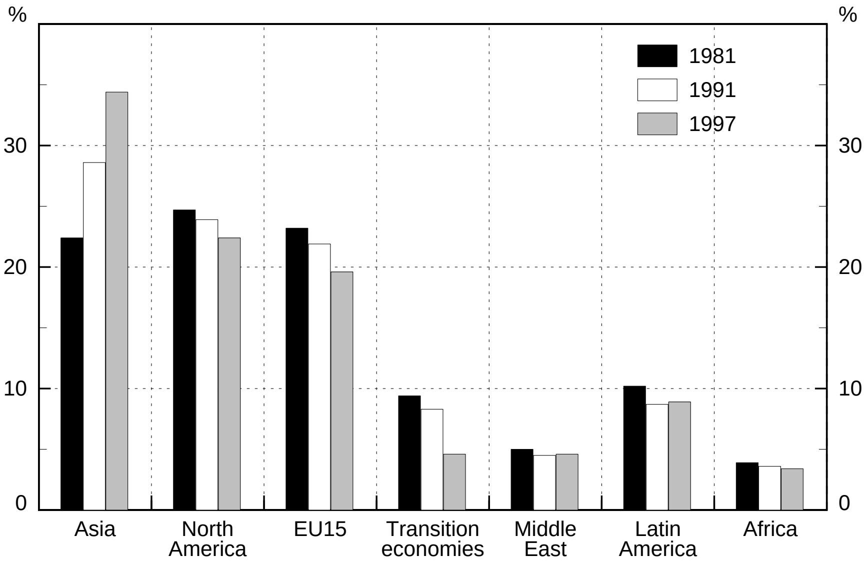
Chart 1.1 World economic growth by region



Source: ETLA.

[1] In addition to East Asia, the IMF definition of Asia used here also includes the less developed countries in South East Asia, Polynesia and South Asia (i.e. India, Pakistan etc.)

Chart 1.2 World production structure, %-shares



Source: ETLA.

As a result of this rapid growth, the importance of Asia in the world economy has also risen considerably (Chart 1.2). In 1997, Asia accounted for a third of world output. East Asia's share of this was 28 percent, which means that the area accounts for a larger share of world output (calculated using purchasing power parities, PPP's) than the European Union or the USA.

The economic growth of East Asia owes much to an abundant, low-cost and relatively high-quality labour force. High domestic savings and investment, as well as export-oriented development strategies have been other important contributors. A generally stable political environment and consistent macroeconomic policies have made it possible for East Asia to achieve long-term economic growth. Foreign direct investment has also played a very important role.

If we take a long-term perspective and regard the recent economic growth in East Asia as a part of the grand process which began with Japanese economic take-off, we find that the pattern of economic growth in East Asia is quite clear. One by one, the backward subregions have caught up with the more advanced nations. This regional phenomenom started in the 1950s and 1960s, when Japan had a very high growth rate. In the 1970s the NIEs replaced Japan as the growth champions and toward the end of the 1980s ASEAN (except the Phil-

Table 1.1 The relative size of the East Asian economies in 1997

	Population, million	GDP/Capita, USD	Share of world output (%, PPP's)*	Share of world trade (exports, %)
China	1200.0	765	11.1	3.3
Hong Kong	6.5	26754	0.5	0.5
Indonesia	199.9	1076	2.3	1.0
Japan	125.6	33420	8.0	7.7
South Korea	46.0	9618	1.7	2.5
Malaysia	21.7	4517	0.6	1.4
Philippines	73.5	1132	1.1	0.5
Singapore	3.7	25939	0.3	1.3
Taiwan	21.3	12800	0.9	2.2
Thailand	60.6	2537	1.4	1.1

* Share of world output: 1996.

Source: ETLA.

ippines) surpassed the NIEs. In the 1990s China had the highest growth rate in the world. As a result of such widespread and sustained growth, East Asia as a whole has an ever more important status in the world economy, although there are still large differences in the stages of development of the individual countries (Table 1.1).

Intra-regional investment and trade played a crucial role in the economic development of East Asia. In East Asia, intra-regional investment took the form of the more developed countries shifting production lines or export bases to the less developed East Asian countries. As local plants started production, they exported most of the finished products to industrial countries or the more developed East Asian countries. For example, exports of household electric appliances increased strongly in ASEAN. Firms from Japan as well as the NIEs mostly built the original production lines and imported the final products. Intra-regional investment and trade effectively created both the production facilities and the external demand that supported the economic expansion in the less developed East Asian economies.

The increase in intra-regional flows of investment strengthened regional economic co-operation and created a high degree of subregional division of labour among the East Asian countries. As Chen (1993) observed, intra-regional investment and trade also "facilitated an extensive industrial restructuring" and "brought about a closely interrelated vertical production structure in the region".

In the Asia-Pacific region, Japan, as the world's second largest economy[2], has always been a major investor. Especially since 1985, as a result of the sharp revaluation of the Japanese yen, many Japanese manufacturing giants have set up numerous production bases in East Asia to lower production costs and reduce direct exports from Japan to the United States. Other developing countries in the region have reached different stages of economic development and produce different types of industrial products. To a certain extent, the NIEs have gone through the phase of industrialisation and currently are working hard to catch up with other developed countries. In the late 1970s, with the their economies growing and labour costs rising, the NIEs began to invest in ASEAN and China. Within ASEAN, Malaysia and Thailand are undergoing the process of industrialisation. Indonesia and Philippines lag somewhat behind. China is at approximately the same stage of development as Indonesia and the Philippines.

Table 1.2 The direction of exports of the East Asian economies in 1997, %

To:	Crisis countries*	Other East Asia	USA	EU
From:				
China	9	46	18	13
Hong Kong	5	46	22	15
Indonesia	12	42	14	15
Japan	18	23	28	16
South Korea	9	37	16	11
Malaysia	10	45	19	14
Philippines	8	36	39	18
Singapore	30	24	18	14
Thailand	10	38	19	16

* Thailand, Indonesia, Malaysia, South Korea, Philippines.

Source: IMF Direction of Trade Statistics Yearbook 1998.

[2] Japan is still the world's second largest economy in terms of current exchange rates. According to calculations using PPP's, China overtook Japan as the world's second largest economy a couple of years ago.

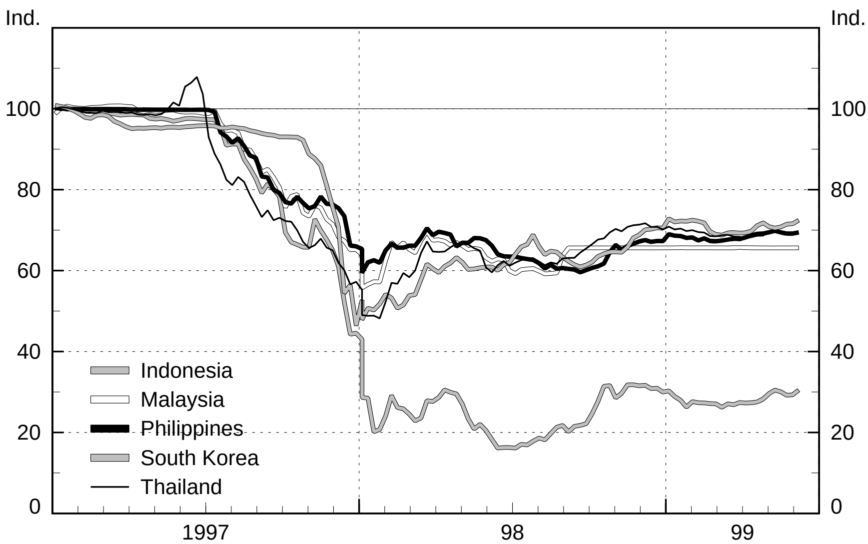
Thus within the Asia-Pacific region, there is a regional division of functions which encourages intra-regional trade and flows of FDI. The differences in stages of development and the strong complementarity in the process of industrialisation allow the countries in this region to pursue an export-oriented strategy simultaneously without hurting each other. The strategy of export-oriented development is commonly deemed a very important factor in the success story of the Asia-Pacific economies.

Intra-regional investment and trade reinforced each other and gave rise to a high level of interdependence among the Asian-Pacific economies. A breakdown of the imports and exports of the Asian Pacific region shows that almost half of the region's trade is now with other economies of the region (Table 1.2). The close economic integration in East Asia is one reason for the wide contagion experienced in the financial crisis in the autumn of 1997.

The Onset of the Crisis

In July 1997 Thailand was forced to introduce a managed float of its currency, the baht, and seek IMF assistance. The baht had been sub-

Chart 1.3 Exchange rates in East Asia, USD/Asian currency, January 1997=100

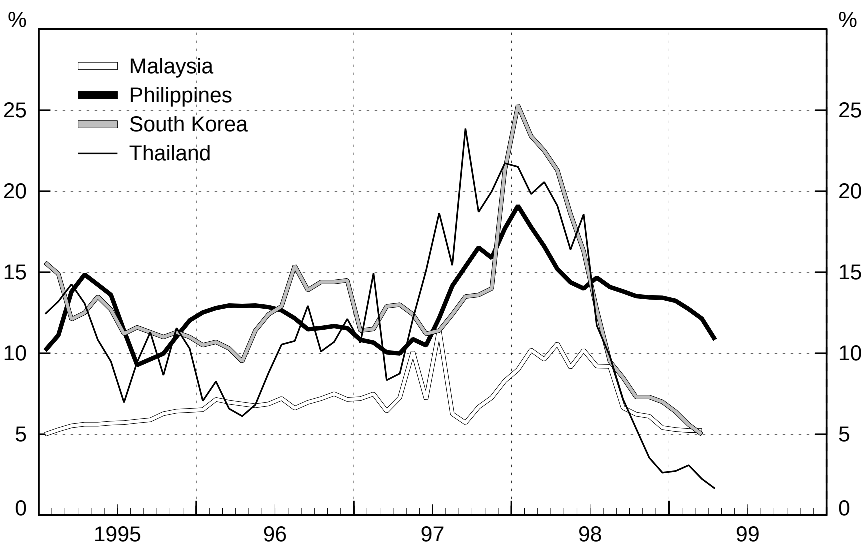


Source: Pacific Exchange Rate Service.

ject to intense speculation since May of the same year. The devaluation of the baht marked the beginning of the Asian crisis. After this other countries in the region which were perceived as suffering from similar problems to the Thai economy also came under attack. Malaysia, Indonesia and the Philippines also found themselves the subject of speculative attacks, and Indonesia and the Philippines widened the trading bands of their currencies. Speculators also attacked the Hong Kong dollar.

Initially, the Thai baht depreciated by about 20 percent and the Indonesian and Philippine currencies lost only 5-10 percent of their value (Chart 1.3). However, the turmoil in the region intensified. In August, Indonesia abandoned the managed exchange rate and its currency depreciated by another 10 percent. In September, the selling pressure on the Malaysian ringgit and the Philippine peso continued. The Malaysian prime minister, Mahathir Mohammed's, inflammatory statements on the dangers of international currency trading certainly did not help to revive investor confidence in the region. All the four currencies affected up to this point continued to lose value and interest rates increased sharply (Chart 1.4).

Chart 1.4 Short-term money market rates in the crisis countries (excl. Indonesia)

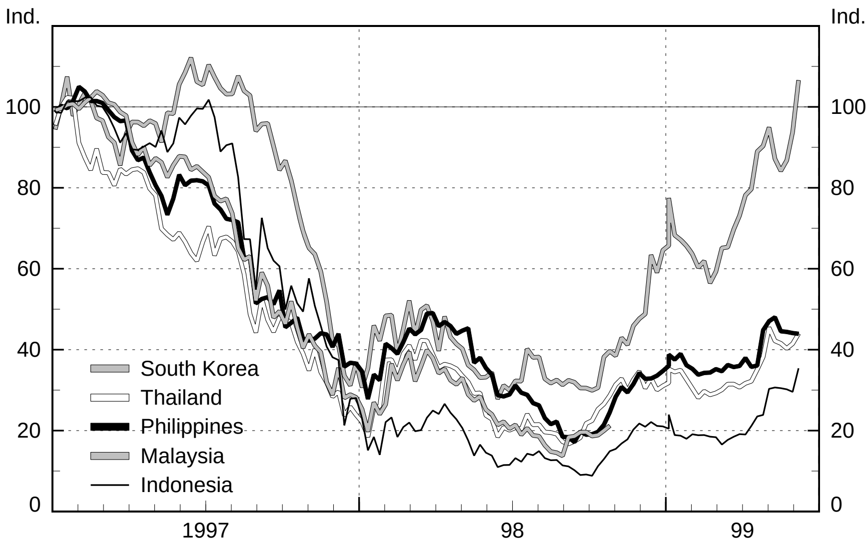


Source: ETLA.

In October, the crisis gained international dimensions. Speculation spread to Hong Kong where the stock market index, the Hang Seng, fell 25 percent in 4 days as investors expected the currency to be devalued. After a brief recovery the index plummeted again, which led to an international loss of confidence. Stock markets all over the world plunged. The Dow Jones fell by 7 percent and trading was suspended.

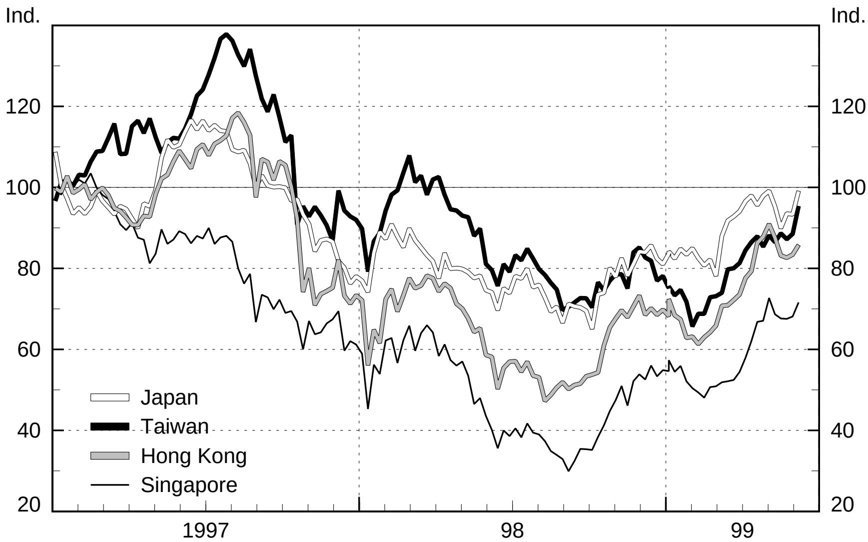
Up to this point, Korea had been relatively unscathed. In November, however, the contagion spread to Korea. Initially, the Korean stock market fell by 11 percent. The currency started to depreciate and the stock market continued to fall. At the end of November, Korea also widened the trading band of the won. This triggered off another fall in all the other East Asian currencies. At this point, the Japanese yen also started to weaken and the Nikkei index fell. In December the situation intensified further. South Korea brought in the IMF, which sent markets down further. Korean short-term interest rates almost doubled. Again, the Thai, Indonesian, Malaysian and Philippine currencies followed the won to even lower levels and interest rates continued to rise. As the South Korean crisis intensified all the regional stock markets were affected.

Chart 1.5 Share prices in the crisis countries, USD, January 1997=100



Source: Dow Jones Indices.

Chart 1.6 Share prices in the other Asian economies, USD, January 1997=100



Source: Dow Jones Indices.

In addition to the five "crisis countries" (Thailand, Indonesia, Malaysia, the Philippines and South Korea) the other economies in the region were also affected by the crisis. Stock markets plunged across the board (Chart 1.5, Chart 1.6). The currencies also weakened in Japan, Singapore and Taiwan, although the degree of depreciation was far smaller than in the crisis countries. The Hong Kong dollar succeeded in withstanding the speculative attacks and maintained its parity with the US dollar, and China also resisted the pressure to devalue.

In the New Year, the devastation of the short-term economic prospects of the region was evident. In most of the crisis countries the situation gradually started to calm down and observers turned their attention to the "economic reconstruction" of the area. Indonesia however plunged into severe trouble as doubts about the political system, civil unrest and the country's ill-advised attempts to introduce a currency board caused investors to lose all confidence in the economy. The rupiah continued to plunge and fell to a level that was only 20 percent of its pre-crisis value against the dollar. Short-term interest rates in Indonesia remained far higher than in the other crisis countries, at levels of 70-80 percent.

East Asia Under the Crisis

East Asia experienced a very difficult year in 1998. There were no signs during most of the year that the Asian crisis was startng to fade. On the contrary, the crisis not only intensified within the region, but also had extensive contagion effects on other emerging markets. Asset prices continued to fall significantly throughout Asia. Only towards the end of 1998 did asset prices recover in some countries.

Japan had been struggling with poor economic growth and structural problems throughout the 1990's, and the onset of the Asian crisis further weakened the outlook for the Japanese economy. In 1998, hopes that Japan would sort out its financial malaise and stage a quick recovery evaporated. Japan plunged into a severe recession, with national output contracting by 2.8 percent. In line with the weak fundamentals, at one point the Japanese yen weakened to nearly 148 yen/ USD, putting enormous pressures on other Asian currencies. The other major economic power in the region, China, also experienced a sharp deceleration in exports and faced mounting pressures to devalue its currency. Although China still attained 7.8 percent GDP growth, the growth momentum slowed significantly.

Out of the East Asian countries, only China, Taiwan and Singapore achieved positive economic growth in 1998. South Korea and Thailand endured the severest depression in half a century while Indonesia suffered the most devastating economic, social and political consequences. Thanks to their favourable fiscal positions Hong Kong, Taiwan and Singapore were able to adopt expansionary fiscal policies to alleviate the pain of the economic slowdown. South Korea, Thailand and Indonesia on the other hand had to cope with the painful adjustment process set by the IMF. Malaysia took the unusual measure of imposing capital controls.

One bright spot in the Asian economies in 1998 was the rapid adjustment in trade balances. Most economies experienced an extraordinary turnaround in their trade balances. For example, Korea ran a trade surplus of USD 39 billion in 1998 compared with deficits of USD 15 billion and USD 3.9 billion in 1996 and 1997, respectively. Although the improvement was driven mostly by falling imports rather than a revival in exports it was encouraging, as an improvement in the trade balance is usually the first step in the adjustment of any economy in crisis.

Most of the crisis-hit East Asian countries hit the bottom at the end of 1998. Since then the situation has improved. Led by South Korea, most crisis-hit economies started to show improvements in financial stability and domestic demand. First of all, asset prices, especially equity prices, have strengthened considerably across East Asia. For example, the Hong Kong stock exchange index in the end of April 1999 was 100 percent higher than its lowest level in 1998. Currencies in East Asia have also appreciated considerably. The Korean won has appreciated over 70 percent against its weakest level in 1997. The strengthening of asset prices is a sign that international investors have confidence in the restructuring of the economies in East Asia. Interest rates across the regional have been falling all the time since the second half of 1998, creating the preconditions for the recovery of domestic demand. The fall in interest rates has not even deterred the inflow of capital or weakened the value of domestic currencies.

In 1999 the real economies across the crisis-hit countries in East Asia will pick up. The recovery will be led by exports. The prospects for East Asia's exports have become increasingly bright mainly due to three reasons. Firstly, the US economy is still very robust. The US is the one of the most important markets for the East Asian economies. Secondly, the level of Japanese imports has been stable. The stronger yen and the huge fiscal package for 1999 will help the rest of East Asia to increase exports to Japan. Thirdly, economic recovery in East Asia will boost intra-regional trade, which is vital for the East Asian economies. As the crisis economies recover and imports begin to pick up, so will regional exports.

Helped by the improvement in external balances, the increase in asset prices and the reduction in interest rates, the crisis-hit economies in East Asia are likely to experience a gradual revival in domestic demand. Economic fundamentals are still weak but the growth momentum is now positive. Nominal interest rates in Asia have fallen significantly, with rates in some countries below pre-crisis levels. Inflation is subdued. The fear of run-away inflation after the currency depreciation did not materialise, and actually inflation in most Asian economies is much lower than expected. Taking account of the huge reduction in domestic demand in 1998, a quick recovery in private consumption and investment is not impossible during the next few years. Currently the biggest threat to the recovery in East Asia is the situation in China and Japan.

The World Economy Under the Crisis

The impact of the Asian crisis was by no means confined to the Asian economies. The turmoil had a profound impact on the world economy and the effects are still visible today, two years after the onset of the crisis.

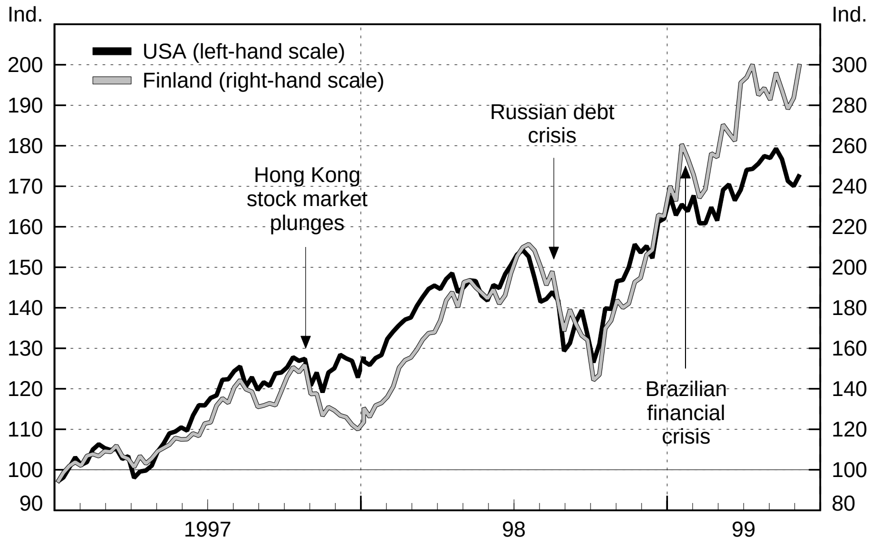
The five "crisis countries" are fairly small economies. Their share of world trade or world GDP is approximately 6-7 percent and as such a recession in the area would not be expected to plunge the world economy into a recession. However, the importance of the whole East Asian area, measured either in terms of world trade or world GDP, has risen considerably over the last 10 years. In 1980 the East Asian area accounted for only 13 percent of world exports and imports, half of which were from Japan. By 1997 East Asia accounted for 22 percent of world exports and 19 percent of world imports. Most of this growth has come from the crisis countries and China, Hong Kong, Singapore and Taiwan. Japan's share of world trade has remained more or less constant.

The fact that growth in the crisis countries has been so rapid partly explains why such a small area should have such a dramatic effect on the world economy. The economies of the crisis countries have been expanding at rates in excess of 5 percent a year. The rapid economic growth in the area has made an important contribution to world economic growth in recent years. The plunge into outright recession has a dampening effect on world growth despite their relatively minor output share.

Initially, most observers expected the Asian crisis to remain a small local affair. However, the sharp drop in the Hong Kong stock market in October 1997 triggered off a worldwide reaction, and markets plunged all over the world over concerns that a major international slowdown was imminent (Chart 1.7).

Although share prices in most industrial countries recovered fairly rapidly, the Asian crisis led investors to adopt a considerably more cautious attitude towards other emerging economies. Investors were far more ready to withdraw funds from any economies exhibiting similar symptoms. The Asian economies had been previously considered the most attractive of the emerging economies, so their collapse obviously made investors wary of other countries at a similar stage of development. The main casualty of the new mistrust towards emerging economies was Russia. The low percentage of tax collection and the large pay arrears of the Russian government had been a concern

Chart 1.7 Share indices, January 1997=100

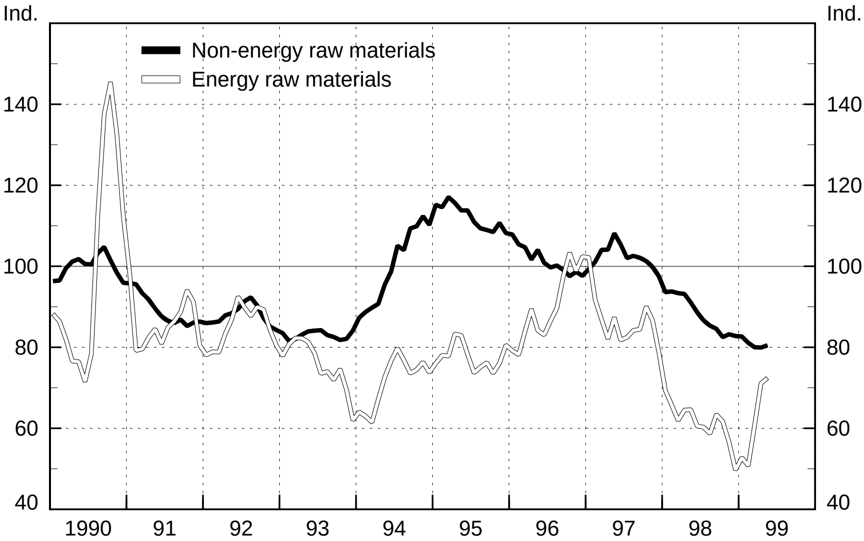


Source: Dow Jones Indices.

for some time, but in August 1998 investors refused to roll over their loans to the government any more. Russia was forced to devalue the rouble and the country plunged into complete economic chaos. The currency crisis which broke out in Brazil in the first months of 1999 was a similar, albeit less dramatic case of investors withdrawing from in emerging economy in the aftermath of the Asian crisis.

Share prices proved to be remarkably resilient in the face of the continual external shocks. In the aftermath of the Russian crisis stock markets in industrialised countries initially fell sharply, but soon recovered to reach even higher levels. The market recovery was helped by the US Federal Reserve (the "FED"), which lowered interest rates twice at the end of 1998. The lower interest rates were not motivated by the state of the US economy, which continued to be remarkably strong. Instead, they were based on fears that the failure of the huge hedge fund, LTCM, could be only the first of a series of failures in major financial institutions. The financial turmoil in Asia caused some highly unpredictable movements on international financial markets. These in turn had devastating effects on LTCM, which was both highly leveraged and deeply involved in derivatives trading. The FED lowered interest rates in order to ease world financial conditions and to avoid a credit crunch and general panic.

Chart 1.8 World commodity prices, USD, 1990=100



Source: ETLA, HWWA Institute.

One of the most immediate effects of the Asian crisis was the dramatic fall in raw material or commodity prices. Asia accounts for a fairly large share of world commodity demand and a very large share of demand growth. The sudden deterioration in the Asian growth prospects meant that many commodity industries would suffer from oversupply, and prices fell as a consequence. Commodity prices started to decline in the second half of 1997 (Chart 1.8). The world price of oil reached its lowest level in 12 years. Prices of many other commodities, such as metals, also plummeted. Low commodity prices were obviously bad news for commodity producers, whose profitability declined as a consequence. However, low commodity prices had some positive implications for the world economy. Falling commodity prices kept import prices and consequently inflation low in most western countries. This in turn allowed the FED and the European Central Bank (ECB) to lower interest rates to stimulate demand and boost growth without fears of inflation taking off.

The Asian crisis was expected to have a major impact on trade flows. In the aftermath of the huge devaluations which the crisis countries went through, their exports would obviously be highly competitive. The economy likely to be most affected was the Japanese economy, which conducts a great deal of trade with the crisis area.

The Asian crisis did have an impact on trade flows. Asian imports contracted sharply in the first stages of the crisis, hurting western exporters. (See box 1.1: Trade with Asia during the crisis – the case of Finland). The contraction in exports was nonetheless offset to a certain growth by strong economic growth in the US and the European Union, and GDP growth in most western economies continued at a healthier rate than feared. Asian exports did not take off as rapidly as initially assumed. Many firms in the area were unable to obtain export financing, which constrained their export possibilities. According to anecdotal evidence, many Asian firms had difficulties in gaining market shares in Europe because they were not able to guarantee the availability of their products. The surge in Asian exports seems to be taking place slightly later than originally expected – it seems likely that it will be most keenly felt this year.

The Asian crisis has caused an enormous amount of turmoil on world markets. It has also had some positive aspects, however. In the wake of the Asian crisis, investors transferred their funds from the emerging markets to safer havens. Most of these funds were transferred to the USA and many of them were invested in US government bonds. As a result, the dollar appreciated and long-term interest rates fell. The strong dollar has helped to cushion the world economy from the effects of the crisis. The strong dollar, together with low world raw material prices, kept import prices low in the US. This in turn helped to keep inflation low, which meant that the FED was able to lower interest rates without fear of inflation taking off. The exceptionally strong growth performance and low inflation of the US economy in the last couple of years owe a lot to the Asian crisis. Without the crisis, inflation in the US would probably have been higher. The FED would almost certainly have had to raise interest rates some time ago and GDP growth would have been slower.

Secondly, a result of the strong dollar, the European economies enjoyed a high level of cost competitiveness, which boosted European exports and GDP growth. Falling raw material prices also kept inflation and hence interest rates low in Europe. As a consequence the European economy also enjoyed relatively strong growth last year despite the adverse effects of the crisis on exports.

Commodity prices have already started to recover from the crisis. In the long run the crisis might conceivably raise commodity prices. Lower profitability for commodity producers means that some capacity will be removed from the market, as e.g. the majority of world metals producers are currently operating at a loss. Expansion plans will also be postponed. For example ambitious plans to expand paper pulp producing capacity in Asia threatened to lead to worldwide overcapacity and undermine prices. Currently many Asian producers have scaled back investment plans, which in the long run should lead to healthier price levels.

The crisis countries face another difficult year in 1999, even though the severest stage of the recession is over. The consensus of opinion is that most of the crisis countries will return to a fairly rapid growth path within a few years. As a consequence of the sizeable currency depreciations and the difficult business environment Asian firms are currently extremely cheap. Most global Finnish companies already have some operations in Asia, and some companies have taken advantage of the situation to acquire Asian firms at a reasonable price. For example Enso purchased one fifth of the share capital of a Thai paper producer. Raisio Chemicals and Kemira have both invested in South Korean Chemical producers. The Federation of Finnish Metal Industries and Exports Finland have both organised trips to Asia for Finnish firms interested in investing in East Asia. Investments in Asia will probably increase in the near future.

Most of the countries in the area will probably emerge from the current crisis with stronger institutional structures, more efficient financial market regulation and better long-term growth prospects. Many western economies will benefit from lower inflation and cheap investment opportunities. The crisis may also raise commodity prices to healthier levels in the long term. Nonetheless, the short-term adjustment costs in terms of lost output and unemployment are huge, and many emerging economies are suffering as a result.

Box 1.1

Trade with Asia during the crisis – the case of Finland

Finland was one of the European countries with the highest level of exposure to the Asian markets before the crisis. Exports to Asia had increased very rapidly in the first half of the 1990's. In 1990, exports to East Asia accounted for only 4 percent of Finnish exports, whereas by 1997 slightly over 12 percent of Finnish exports went to East Asia. The growth was due mainly to increasing exports to the crisis countries and to China. Japan's share remained more or less constant.

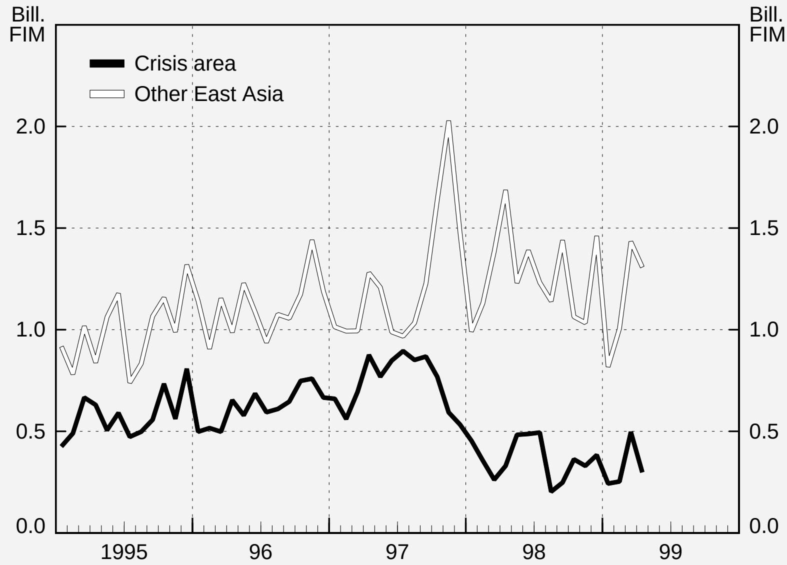
Finnish exports to Asia are concentrated in a couple of industries. The industry with the highest level of dependence on the Asian markets is the machinery industry. Before the crisis, 21 percent of machinery exports went to East Asia, 13 percent of these precisely to the crisis countries. East Asia is also an important export market for the electrical machinery industry (telecommunications equipment belongs to this industry), which relies on East Asia for 18 percent of its export markets. For the rest of Finnish industry, the East Asian markets accounted for only 8 percent of exports and the actual crisis countries accounted for only 2 percent.

The Asian crisis has had a large effect on export flows. Exports to the crisis area dropped quite markedly in the autumn of 1997. In 1998 exports to the crisis area were half the level of the previous year, and there are as yet no signs of recovery. Exports to Japan, Singapore, Hong Kong and Taiwan also fell. Exports to China nonetheless almost doubled because of large paper machine deliveries.

The effects of the crisis on the machinery industry were clearly visible. Order books fell and production stagnated. Of the other Finnish industries, the most severely affected were the paper, basic metal and chemicals industries. Although these industries engage in relatively little direct trade with Asia, the fall in world commodity prices lowered their export prices and led to poorer profitability.

The impact of the crisis on Finnish imports has been fairly small. Whereas Finnish exports to Asia increased rapidly during the 1990's, the share of imports coming from Asia remained more or less stable. Before the crisis 11 percent of Finnish imports came from East Asia. Almost half of these came from Japan and only 1.8 percent from the crisis countries. Although imports from East Asia have increased after the crisis, the crisis area still only accounts for 2.3 percent of Finnish imports and East Asia for slightly over 12 percent. As the trade shares are so small the

Finnish exports to East Asia, monthly data



increase in imports from the crisis area has barely affected the Finnish market.

The largest impact of the Asian crisis on Finnish imports has been through the fall in world commodity prices. Import prices of raw materials fell 4 percent in 1998 as a result of low international commodity prices. Import prices of manufactured goods fell very slightly. As in other industrialised economies, this has helped to keep inflation under control. Raw material prices, most notably oil prices, have now started to recover from the crisis. This in turn will cause inflation to accelerate slightly – indeed, the effects of higher oil prices are already visible. Higher raw material prices will also benefit the Finnish export industries and improve their profitability.

2

WHAT CAUSED THE CRISIS?

Catherine Reilly

In order to learn from the Asian crisis, it is necessary to understand why it happened in the first place. In this chapter, we will go through the main factors which caused the crisis and explain what role each of them played in the creation of the Asian crisis. We will also identify the main lessons which investors and analysts can learn from the crisis. In the analysis we will concentrate on the actual "crisis countries" (Thailand, South Korea, Indonesia, the Philippines and Malaysia). Although the crisis affected all the countries in East Asia, these are the five countries which suffered extremely severe devaluations and where the crisis, which subsequently affected all East Asia, started.

Fundamentals Caused the Crisis, Panic Made It Severe

Two main explanations have been advanced for why Asia suddenly plunged into a severe financial crisis. The first is that the crisis was caused by weaknesses in the Asian economies, "fundamentals". The alternative explanation is that the crisis was unwarranted and caused by the irrational behaviour of financial markets.

A lively debate has sprung up over the origins of the crisis. Interpretations obviously vary, but most commentators accord some weight to both of these arguments. Generally speaking, there is a consensus that the economies suffered from some fundamental weaknesses and that a temporary slowdown was probably in order to correct the macroeconomic imbalances that had arisen during the 1990's. However, these weaknesses were not severe enough to provoke a crisis of the magnitude that ensued. Irrational behaviour and panic also play a part in the unfolding of the crisis. There is some justification for the claim that investors behaved irrationally both before and after the onset of the crisis, and thereby plunged the countries into a severe financial crisis which could probably have been avoided.

There is also a general consensus as to which were the fundamental reasons that the Asian economies were plunged into a financial crisis although again, the weight accorded to each argument varies. The most important factors were:

- Rapid credit expansion
- Inadequate financial regulation
- Unsuitable exchange rate policies
- Inappropriate allocation of investment
- Careless investors

We will go through these factors in the next section and describe the role which they played in the Asian crisis.

Rapid credit expansion

Domestic credit expanded extremely rapidly in the crisis area in the 1990's. The area attracted large net capital inflows from international markets, as rates of return in East Asia were expected to be higher than in other markets. This, together with the process of financial market liberalisation, made credit abundantly available. Although nominal GDP increased rapidly, lending expanded even faster (Table 2.1). Most of this lending was to the private sector, indeed in many countries the public sector actually showed a surplus.

Table 2.1 Growth of domestic credit less growth of nominal GDP in the Asian economies

	1993	1994	1995	1996	1997
Indonesia	4.3	7.0	2.7	5.5	8.2
South Korea	1.7	4.0	-0.5	8.7	15.3
Malaysia	1.0	-2.0	13.6	14.5	15.4
Philippines	122.1	4.2	18.8	26.3	18.6
Thailand	10.4	15.1	7.6	2.2	31.5

Source: IMF International Financial Statistics.

Rapid expansion of domestic credit leads to a number of problems. Firstly, the assessment of credit risks deteriorates, as lenders are not able to accurately evaluate loan applications due to the rapid rate of increase and the percentage of poor credit risks tends to increase. The same sort of a process applies to the use of the credit. When investment is increasing very rapidly, investors do not have sufficient time to accurately evaluate the returns on the investment to be undertaken. As a result the investments which are undertaken are often of poorer quality than when credit is less freely available, and the return on investment is lower. The lower quality of investment also means that the credit risk of the lender deteriorates. (Krueger, 1998)

The rapid expansion of domestic credit also tends to inflate asset prices. This effect was clearly visible in the East Asian econo-

Table 2.2 Composition of debt in the Asian economies

	Total external debt as per cent of 1996 GDP	Short-term debt as a percentage of total debt, June 1997
Indonesia	49	24
South Korea	23	67
Malaysia	38	39
Philippines	59	19
Thailand	59	46

Source: Goldstein (1998), Goldstein & Hawkins (1998).

mies. A large share of the obtained credit was invested in real estate and equities, which in turn pushed asset prices up. The rise in asset prices in turn exacerbates the process of credit expansion, as borrowers are able to use the inflated asset prices as collateral for further borrowing.

Although domestic credit expanded very rapidly, the actual levels of external debt of the crisis countries were not as such particularly alarming when compared with other emerging economies (Goldstein, 1998). What was exceptional was the high proportion of short term financing in some of the countries. In Korea the share of short-term debt was as high as 67 percent. (Table 2.2). A large share of this short term financing was foreign currency denominated. This made borrowers very vulnerable. Short-term debt can be withdrawn more easily than long-term debt, as lenders can simply refuse to renew the loan when it expires. Foreign currency debt, on the other hand, makes borrowers very vulnerable to changes in the exchange rate.

By letting domestic credit increase at an uncontrolled rate the authorities seriously undermined the stability of the banking system and made it extremely vulnerable. When one element of the system, namely the exchange rate, came unstuck, the whole system disintegrated. Interest rates rocketed and when the currencies were released from their pegs. The value of foreign debt rose and asset and real estate prices plunged. Debtors with foreign currency borrowings suddenly found themselves faced with debts far larger than they had anticipated and which in many cases they were unable to honour. The value of investments and collateral fell. The result was a huge increase in non-performing loans and a serious banking crisis.

Inadequate financial regulation

A great deal of discussion has focused on the role of corporate governance and financial regulation in the Asian crisis. It is generally recognised that inadequate financial regulation and weak public and private sector governance, with the consequent lack of transparent reporting, were among the root causes of the crisis.

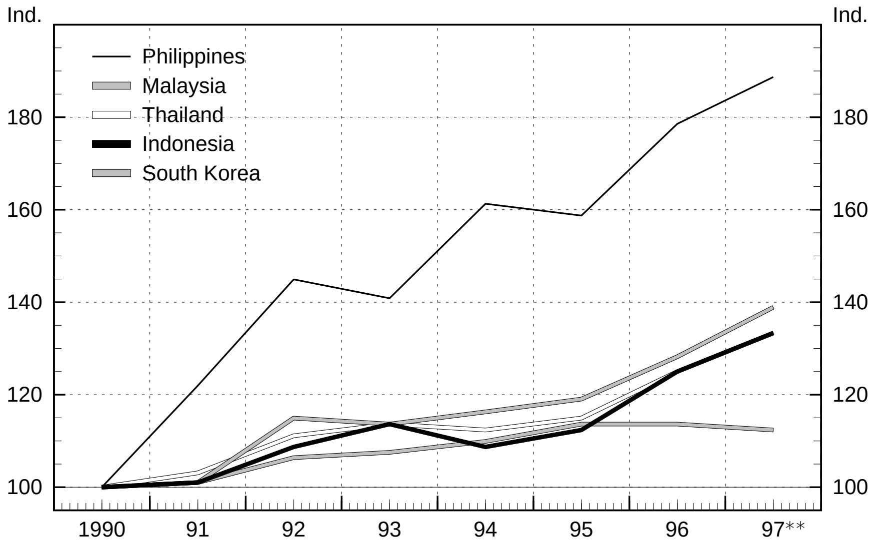
The Asian economies deregulated their financial systems and allowed access to the global financing system without first installing the necessary legal, regulatory and supervisory structures. Financial regulation and supervision of financial institutions was totally inadequate for countries integrated into global capital markets. For example, many Asian countries did not implement the Bank for International Settlements' (BIS) guidelines on risk management and capital adequacy. Supervision was also lax. The uncontrolled credit expansion that took place in the crisis countries would not have happened if financial markets had been well supervised. The build-up of a large proportion of short-term credit is also convincing evidence of inadequate supervision.

Corporate governance was not up to international standards either. In many countries, companies were not required to adhere to a common set of accounting standards. Legislation regarding bankruptcy was undeveloped and risk management practices were either non-existent or insufficient. (Kearney, 1999).

Lack of supervision and transparent reporting also made it easier for "crony capitalism" to run rife. In many cases, the government deliberately interfered in the markets to further the interests of small, favoured groups. Lending was often "connected lending" or "relationship banking" under which the political or business connections of the debtor were more important than the financial viability of the loan.

Opaque reporting, insufficient supervision and pervasive "crony capitalism" meant that for an outsider, obtaining a realistic picture of the financial state of an enterprise was extremely difficult. It also meant that in many cases the financial health of the enterprises was indeed poorer than if they had been subject to more strict supervision and transparent reporting rules. The need to encourage countries to adopt international regulatory standards and to enforce transparent reporting is one of the foremost reforms brought up by the crisis.

Chart 2.1 Real exchange rates in East Asia, 1990=100*



* An increase means appreciation.
** 1997=March.

Source: Radelet & Sachs (1998).

Unsuitable exchange rate policies

Many East Asian countries and all of the crisis countries had exchange rates which were pegged to the dollar or to a currency basket based on the dollar through the 1990's. Pegging the exchange rate to an international currency is common practice in emerging economies as it helps to stabilise the currency. However, it does mean that the currency of the emerging country does not reflect the fundamentals of the emerging country. In the Asian case, the value of the currency was mainly determined by the dollar. This meant that when the dollar started to appreciate against both the yen and the major European currencies in 1995, the effective exchange rate of the Asian countries against their trading partners also appreciated, despite the fact that most of the countries had sizeable current account deficits.

Real exchange rates[3] in most crisis countries appreciated in the second half of the 1990's (Chart 2.1). This was due to both the

[3] The real exchange rate is the exchange rate adjusted for differences in price levels between the two countries The degree of real exchange rate appreciation is fairly sensitive to the assumptions used, and different authors obtain different results. Baig and Goldfajn (1998) consider that real exchange rates hardly appreciated at all, but most authors consider that real exchange rate appreciation did weaken the competitiveness of the economies.

Table 2.3 Current account balance as a share of GDP in the Asian economies

	1993	1994	1995	1996	1997
Indonesia	-1.9	-2.0	-3.4	-3.4	-1.4
South Korea	0.3	-1.0	-1.9	-4.7	-1.8
Malaysia	-4.7	-6.2	-9.7	-5.0	-5.3
Philippines	-5.5	-4.6	-2.7	-4.7	-5.3
Thailand	-4.9	-5.4	-7.9	-7.9	-2.0

Negative=deficit, positive=surplus.

Source: Asian Development Bank.

appreciation of the dollar and the fact that inflation rates in East Asia were slightly higher than in the countries to which the currencies were pegged. Goldstein (1998) finds that by 1997 exchange rates in the crisis countries were 4-12 percent overvalued (with the exception of South Korea, which was undervalued). As a result the countries were less competitive on international markets and exports suffered. This was particularly serious because most of the countries had sustained considerable current account deficits[4] all through the 1990's (Table 2.3). Some countries were also negatively affected by a terms of trade shock. E.g. in the case of South Korea, the price of an imported good, oil, rose and that of the important export item, semiconductors, fell.

According to Kochhar, Loungani and Stone (1998), the weight of the dollar in the currency baskets used by the Asian economies was roughly five times the weight that would have been appropriate on the basis of their trade with the US. Pegging the exchange rate to a currency basket of the main trading partners, with an emphasis on the Japanese yen rather than the dollar, would probably have improved the situation somewhat. However, the overvaluation of the exchange rates does not explain the onset of the crisis very well, as the degree of overvaluation was far smaller than the subsequent rate of depreciation. Having a fixed exchange rate under conditions of relatively free international capital flows would probably have caused some problems whatever the chosen currency.

[4] As a point of comparison, the Finnish current account deficit in the beginning of the 1990's before the devaluation was about 5 percent.

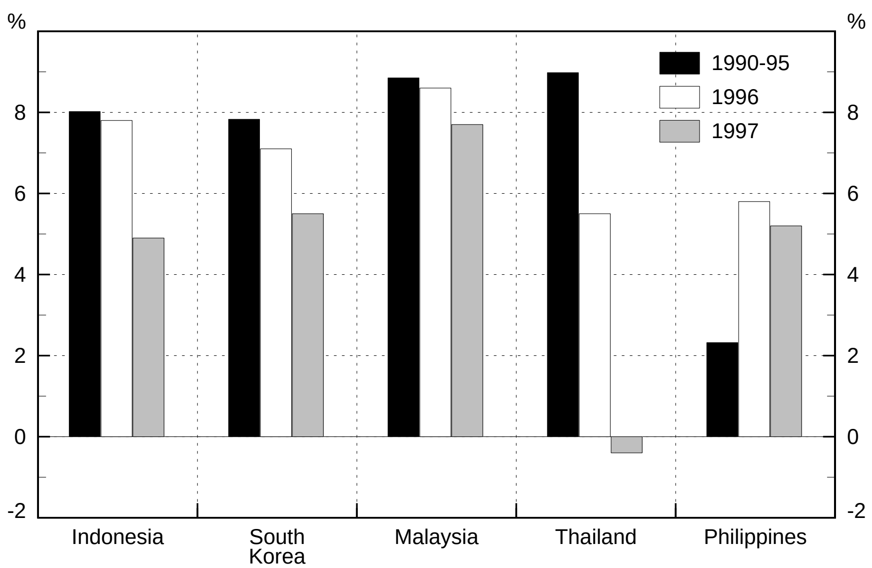
With a fixed exchange rate, many borrowers probably did not consider currency risk too much of a problem, particularly as the currencies had maintained their pegged exchange rates for several years. Banks acted as intermediaries for borrowers who wished to take advantage of the lower interest rates to be obtained on international debt. As a result, a large share of borrowing in the crisis countries was denominated in foreign currency and at short maturities. This led to considerable liquidity/currency mismatch and made the economies very vulnerable to any changes in the exchange rate. Goldstein (1998).

The excessive accumulation of short-term and (largely unhedged) foreign currency denominated debt would of course not have been possible under adequate financial sector regulation and supervision. As it was, the exchange rate peg led borrowers to underestimate the risks involved in foreign currency borrowing. This greatly exacerbated the effects of the crisis when the countries were forced to relinquish the exchange rate peg.

Inappropriate allocation of investment

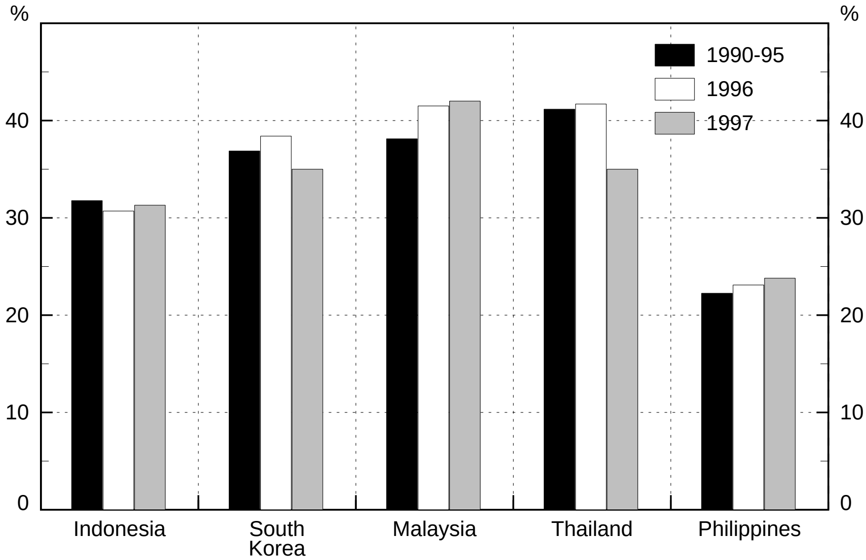
The Asian economies had a history of high growth rates which clearly surpassed those of most other emerging economies leading to talk of

Chart 2.2 GDP growth in East Asia



Source: ETLA.

Chart 2.3 Investment as a share of GDP



Source: ETLA.

the much-touted "Asian miracle". Although the miracle was disputed, the area was nonetheless considered the most attractive of the emerging markets and succeeded in attracting a great deal of foreign investment. The high growth rates experienced in the past may have induced overly optimistic beliefs that growth would continue at the same rate in the future.

Initially in the 1950's and 1960's, high growth rates in the NIEs (Singapore, South Korea, Hong Kong and Taiwan) reflected the switch over from import protection to a more externally oriented growth strategy. As the allocation of resources became more efficient the economies grew very rapidly. (Krueger, 1998) As the production structure of the economy was labour intensive the investment rate remained fairly low, although investment and consequently capital stock increased very rapidly. A similar process took place in the ASEAN economies a couple of decades later (Fukuda & Toya, 1998).

Growth rates in all the above economies continued to be very high in the 1990's (Chart 2.2). Growth also continued to be driven by rapid increases in saving and investment (Chart 2.3). However, the investment rates in the economies had risen considerably, as it was no longer possible to maintain rapid growth of investment with low investment rates (Fukuda & Toya, 1998).

The high rates of investment expenditure in the Asian economies were often cited as positive aspects and as justification for high future output rates. Investment rates in most Asian economies were well over 30 percent, whereas e.g. the OECD average is about 20 percent. However, this interpretation misses several important points. Firstly, although investment was increasing rapidly, there is some evidence that the efficiency of investment was falling. One measure of the overall efficiency of investment is the ICOR or "incremental capital output ratio". The ICOR is the investment rate divided by the rate of output growth. Corsetti, Pensetti & Roubini (1998) find that this ratio was higher, i.e. the productivity of capital was lower in the 1993-1996 period than in the 1987-1992 period. This indicates that the efficiency of investment had fallen.

The composition of investment expenditure also supports the hypothesis that the quality of investment had fallen. The composition of bank lending indicates that particularly in Thailand, Indonesia and Malaysia, an increasingly large share of bank loans was used to finance real estate investment (Table 2.4). Anecdotal evidence also indicates that an increasing share of investment was in property and other domestic oriented industries.

Investment in property as such is not necessarily inefficient – indeed, it can be hugely profitable, although the amount of office space empty in East Asia today indicates that there was probably some over-investment. The fact that a large share of investment was in property was a problem because the Asian economies were financing their investment with foreign borrowing and large current account deficits. It is generally considered that financing investment with foreign borrowing is acceptable, as the investment will increase the productive ca-

Table 2.4 Estimates of the share of bank lending to the property sector

	end 1997
Indonesia	25-30%
South Korea	15-25%
Malaysia	30-40%
Philippines	15-20%
Thailand	30-40%

Source: Goldstein (1998).

pacity of the economy and its ability to earn export revenues with which to repay the loan. However, investment in property or other domestic sectors does not directly increase exports unless it indirectly increases the productivity of the export-producing sector. In effect, financing a real estate boom with a current account deficit is closer to financing consumption than investment and as such will eventually lead to an adjustment in the current account and a fall in domestic consumption.

A lot of the investment in industrial capacity was probably also sub-optimal. This was a particular problem in Korea. A great deal of investment was in industries such as steel, pulp or semiconductors. Not only do these industries require heavy capital investment, many of them also already suffer from world wide overcapacity. The long-term profitability of these industries is not particularly good, and if a large amount of new capacity suddenly comes on the market it risks depressing world prices and further eroding profitability.

Careless investors

There seems little doubt that a deterioration in economic performance in the Asian economies was justified by fundamentals, or that the economic policies pursued in the area had made the economies very vulnerable to a change in circumstances. However, fundamentals do not explain the huge currency depreciations or the exceptionally severe recession that the economies were plunged into. Many of the currencies suffered from some degree of overvaluation (although even this claim is not universally accepted – see e.g. Baig and Goldfajn, 1998) but the degree of overvaluation was certainly far less than the 30-80 percent that the currencies subsequently depreciated.

Foreign investors themselves were guilty of complacency and inadequate risk management. The Asian economies had experienced extremely rapid growth over the previous years, and this probably led to over-optimistic beliefs that such growth would continue in the future. Unrealistic output perspectives, in return, probably led to incorrect assessments of returns on investment and risk. (Corsetti, Pesenti & Roubini, 1998). Another reason that the Asian economies attracted so much investment was that the 1990s were a period of low interest rates and abundant global liquidity, and the Asian economies were considered the most attractive of the emerging markets. (Goldstein, 1998).

The devaluation of the Thai baht raised concerns about the sustainability of the currency peg in other countries in the area that suffered from similar problems, namely a current account deficit, inflated asset markets and a weak banking system (Kochar, Loungani & Stone, 1998). The devaluation of the baht acted as a "wake-up call" to foreign investors, reminding them that risks could actually materialise. They subsequently panicked and scrambled to withdraw their money. The rapid reversal of capital flows then caused the huge currency depreciations which in turn triggered off the bank and corporate failures and a massive recession.

The Asian countries could not have exposed themselves to excessive short term and foreign currency borrowing if no one had agreed to lend them money. Moral hazard was not limited only to Asian banks, borrowers and governments. Western investors continued to pump money in despite being aware of many of the risks associated with the Asian economies. Most of these investors were highly sophisticated international banks who, in hopes of high returns, appear to have relaxed their own risk management practices. The banks apparently assumed that any profit would be theirs to keep but any losses would be covered by a bail-out organised by either the Asian governments or the IMF. This constitutes a clear case of moral hazard.

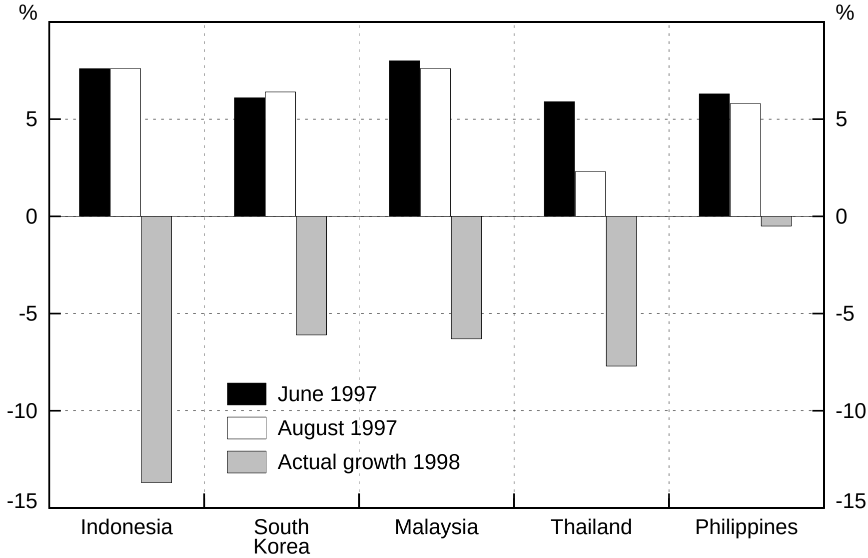
Why Did Analysts Fail to Predict the Crisis?

One of the main questions which has risen after the Asian crisis is why the legions of economists and analysts tracking the area failed to predict the crisis. In the first half of 1997, forecasts of GDP growth in 1998 predicted extremely rapid growth in most countries. As the consensus forecasts (Chart 2.4) show, virtually no-one was predicting even a significant slowdown in the area, let alone a full blown financial crisis. The international rating agencies also totally failed to anticipate the rapid deterioration in the creditworthiness of the Asian economies. Even in August 1997 after the devaluation of the Thai baht most observers expected the rest of the region to escape relatively unscathed and totally failed to predict the dramatic falls in output which took place in 1998.

Forecasters rarely predict crises

The slowdown in growth in the Asian economies should not have come as a surprise to observers. Most of the economies that subsequently

Chart 2.4 Forecasts for 1998 GDP growth in the crisis countries



Source: Consensus Forecasts.

plunged into crisis had developed considerable imbalances, which at some point would probably have to be rectified in a period of slower growth. According to Krueger (1998), three key variables are generally considered predictors of foreign exchange and financial crises. These are:

- The degree of overvaluation of the (real) exchange rate
- The overexpansion of domestic credit
- The size of the current account deficit

As we have seen, most of the crisis countries suffered from most of these symptoms several years before the crisis broke. Many economists did indeed point out that property markets were overheating and that current account deficits were alarming large. Other economists (e.g. Paul Krugman) had voiced doubts about the sustainability of the "Asian miracle" and had predicted that growth in the area could not continue at such a rapid pace. However, most of these sceptics predicted a gradual slowdown, not an acute crisis.

In fact, economic forecasts rarely predict actual crises. Economists are usually able to identify a country's economic problems. How-

Box 2.1

The main characteristics of financial crises

The Asian crisis was the latest in a series of financial crises to have hit the world economy over the last decade. Some recent examples of financial crises are the Finnish currency and banking crisis in 1991-2, the ERM currency crisis in 1992-3 and the Mexican debt crisis in 1994.

Financial crises can be divided into three main categories, namely currency crises, banking crises and foreign debt crises. In a **currency crisis** a speculative attack on the currency leads to a devaluation of the currency or forces the authorities to defend the currency by using international reserves or by raising interest rates. In a **banking crisis**, actual or potential bank runs or failures may force the banks to suspend international convertibility of their liabilities. The authorities often have no option but to intervene to prevent this by providing financial assistance, which inevitably is on a very large scale. A banking crisis may become so severe that it becomes a systematic financial crisis, in which the domestic payments system no longer functions properly. In a **foreign debt crisis** a country is unable to meet payments on its sovereign or private foreign debt.

All the three types of crisis are preceded by a build-up of fundamental economic imbalances, such as unsustainable current account deficits, misaligned exchange rates or asset price bubbles. These imbalances will at some point lead to a correction, but the correction need not necessarily come through a crisis. Whether or not economic imbalances are

ever, it is extremely difficult to predict whether the imbalances will be solved via a gradual adjustment process or via a full-blown crisis. Forecasters tend to assume that adjustments will take place gradually. The possibility of a crisis is generally included as a possible scenario, not as the main forecast[5].

The reason that predicting whether or not a crisis will occur is so difficult is that for a crisis to happen, something has to trigger it off (see box 2.1: The main characteristics of financial crises). In the ab-

[5] The United States is currently a good example of a country which is suffering from economic imbalances: a large and widening current account deficit, overvalued share prices and a negative savings rate. Although all forecasters are aware of these problems, virtually no-one is predicting the collapse of the US economy, although the possibility of a crisis is the subject of much discussion.

corrected via a crisis depends essentially on the size of the imbalances, the credibility of the policies proposed to resolve them and on the degree of robustness of the country's financial system.

For the situation to escalate into a crisis a triggering event, which causes a sudden loss of confidence in the currency or banking system, is also required. For example in the Asian crisis, the devaluation of the Thai baht triggered off a loss of confidence in all the other economies which were seen as suffering from similar weaknesses. Speculators attacked these currencies and investors withdrew their funds from these countries, which in turn lowered the countries' foreign reserves and provoked the collapse of the pegged exchange rate system.

Elements of currency, banking and foreign debt crises may be present simultaneously, or one type of financial crisis may lead to another. The Asian crisis initially started off as a currency crisis. This then triggered off a banking crisis, which at least temporarily achieved systematic proportions. There were also elements of a foreign debt crisis, as e.g. South Korea and Indonesia were forced to reschedule their payments on foreign debt.

Obviously the larger the imbalance and the less robust the system, the higher the probability of a crisis. Basically, a financial crisis arises when a country that already suffers from a high degree of vulnerability is affected by an economic or financial disturbance and the policies to resolve the situation are not considered credible.

Source: IMF 1998.

sence of such a triggering event the economy may well go through a gradual process of adjustment. It is fair to say that it is possible to reliably identify when an economy suffers from imbalances that make it vulnerable to crisis. Identifying the events which could trigger off a crisis is more challenging, but forecasters are generally able to identify the most likely candidates. Predicting the exact timing of a crisis, however, is virtually impossible.

Financial market overshooting and contagion

If something does trigger off a crisis, the chain of events from then on is extremely unpredictable, as crises often contain elements of irrationality and herd behaviour. In the case of the Asian crisis, fundamentals indicated that the crisis countries suffered from considerable imbalances. The devaluation of the Thai baht triggered off a crisis of confidence in all the countries in the region. What is puzzling, however, is the severity of the crisis. It is difficult to justify the huge reversals in capital flows and the subsequent currency depreciations that affected the whole region. Most observers agree that exchange rates depreciated far more than was needed to balance the current account or than was justified by the degree of exchange rate overvaluation.

Baig and Goldfajn (1998) find considerable evidence of financial market contagion during the Asian crisis. The correlation between the financial markets in the five crisis countries during the crisis period was far higher than the traditional relationship. For example, foreign lenders demanded far higher interest rates in all five countries after the Thai devaluation and the correlation between interest rates in the crisis countries was considerably higher than before the devaluation.

The sudden increase in the level of correlation indicates that, rather than analysing each country separately, investors were treating them as a homogenous group. Shocks from one market were rapidly transmitted to other markets, which meant that a shock in one country destabilised the entire region. Investor behaviour appears to have been partly irrational and certainly to have contained an element of panic. As a result the changes in exchange rates and capital flows were far larger than warranted by fundamentals, i.e. there was considerable overshooting.

Under these circumstances, it was not possible to use the fundamental relationships which existed before the crisis to analyse the situation because these relationships had, at least temporarily, broken down. This partly explains why even after the devaluation of the Thai baht analysts failed to foresee the full extent of the crisis.

Another possible explanation for why analysts under-estimated the crisis at the onset is the increasing use of derivatives. Kearney (1999) points out that a considerable amount of over-the-counter derivatives trading was probably involved in placing capital in the Asian economies. Derivatives were used mainly to bypass regulators and consequently there is no reliable information on the exact extent of derivatives trading. These "invisible" capital flows can have highly unpredictable outcomes and may be one explanation for why the exchange rate reaction during the crisis was so unexpectedly severe.

Asian sensitivity to criticism censured analysts' reports

Analysts, economists and rating agencies obviously came in for a great deal of criticism after the crisis for failing to sound the alarm on the Asian economies in advance. Euromoney (1997, 1998) conducted a thorough post-mortem into just why analysts got it so spectacularly wrong.

To a certain extent, the analysis performed in Asia genuinely was of poorer quality than in e.g. the US. Both analysts and investors were less experienced, which meant that analysis was less sophisticated. However, there is another side to the story. Many analysts claimed that they had identified many of the problems in the area, but were unable to publish the results because of Asian hostility to criticism.

"Face" is extremely important in Asia. Economists or analysts who published unfavourable reports of the countries in the region risked upsetting governments and antagonising their Asian business partners. This could endanger their business activities in the area and lead to them being barred from government business such as privatisation. Euromoney (1997) cited the example of the Morgan Stanley economist Barton Biggs, who advised investors to withdraw from the Hong Kong stock market. The president of Morgan Stanley's joint venture partner in China, the China Construction Bank, publicly criticised Morgan Stanley for encouraging investors to abandon the Hong Kong Market and indicated that their business relationship could be damaged. Morgan Stanley's chairman for Asia-Pacific was forced to issue an apology. When Jardine Fleming advised investors to sell their Thai stocks and criticised Thailand's over-investment economy a Thai magazine, Hun Thai, started a virulent campaign against the foreigners whom it claimed were trying to bring the market down. Similar examples exist in Malaysia and South Korea.

Rating agencies faced similar problems. Governments and companies view a credit downgrade as an insult. For example, Moody's decision in March 1997 to revise the outlook for Indian[6] sovereign debt from stable to negative was interpreted as a serious insult and provoked a storm of abuse (Euromoney 1998). Nor did the government take kindly to the questionnaire which the rating agency used to gather information for the rating. Some politicians considered that they

[6] India is of course not one of the East Asian countries. The example nonetheless serves to illustrate the problems that international investors may encounter in their dealings with emerging economies all through Asia.

impinged on India's sovereignty and that India should not deign to reply to the questions.

Analysis exists for the information of the investor, however, and the fact that analysts "knew" but simply weren't letting on is little consolation for the investors who sustained considerable losses in the area. Many analysts claimed that while unwilling to publish sensitive material, in one-to-one talks they would voice their honest opinions. Investors who had personal contact with the analysts therefore had access to better information than those who relied only on printed analysis. The lesson to be drawn from all this is that publicly available information on the Asian economies probably has a positive bias, and as such should be interpreted with caution.

Main Lessons Learned From the Crisis

Understanding why the crisis occurred and why it caught most observers on the hop helps us to understand which were the main mistakes made by regulators, analysts and investors and how we can avoid these pitfalls in the future. The IMF, the World Bank and various other institutions have already produced numerous studies on the steps that policymakers should take to improve the efficiency of the international regulatory environment and the global financial system. The need to enforce an efficient supervisory framework on both the domestic and international level and to improve the transparency of financial reporting is paramount. More attention should also be paid to the role played by over-the-counter derivatives. Many initiatives to improve the functioning of the global financial system are already under way.

Investors and analysts also have a lot to learn from the crisis. Investors should certainly indulge in a revision of their own investment and lending practises. The Asian countries could not have indulged in excessive short-term and foreign currency borrowing if creditors had refused to lend to them. Although it is true that the crisis countries suffered from opaque reporting, crony capitalism and relationship banking, none of this should have come as a surprise to investors. As Kearney (1999) points out, even mainstream university textbooks mention these issues as problems encountered when doing business in Asia. The sophisticated international banks engaged in lending to Asia chose to disregard these risks and relax their own risk management criteria and were therefore very much instrumental in their own downfall.

There is also plenty to learn on how to interpret the available analysis. First and foremost is the fact that the Asian cultures do not readily tolerate criticism and that anyone voicing their (albeit justified) critical opinion is likely to be sanctioned. Any published analysis emanating from the Asian region is therefore likely to be positively biased. This is an important point to bear in mind for both investors and economists. For example, economists working in Europe do not generally carry out their own analysis of the Asian area, rather they rely on the analysis produced by their colleagues in Asia. If this is biased so is the subsequent analysis done in Europe.

Another lesson in the same vein is that in times of severe structural breaks forecasts generally tend to underestimate the magnitude of any changes. As we saw in the Asian crisis, the exchange rate reactions were extremely large, far larger than could possibly have been predicted on the basis of "fundamentals". In times of crisis past relationships will break down and panic or herd behaviour on part of investors can cause considerable overshooting. Baig and Goldfajn (1998) found that the correlation between the financial markets in the crisis countries increased suddenly after the Thai devaluation to a level far higher than in any previous period. This implies that the behaviour of investors changed and that past relationships were no longer valid for analysing the future.

Precisely because relationships change in times of crisis predicting the precise timing of a crisis is well nigh impossible. No one could realistically have predicted the exact onset and outcome of the Asian crisis, or of any other crisis for that matter. However, analysis can identify the probability that such a crisis will occur and in the Asian case most of the warning signs were flashing. In this sort of a situation it would certainly be helpful if analysis stressed the existence of these warning signs even if not forecasting the actual onset of a crisis and if investors also heeded them in time.

The high investment rates in the Asian economies were often considered positive factors which reinforced the view that growth would continue to be very rapid. However, the quality of investment is at least as important as the quantity. When the foreign borrowing is financing a domestic construction boom it is actually more or less equivalent to financing a consumption boom. The currency is then vulnerable to speculative attack because investment in construction (or consumption) does not increase the economy's export earnings and its ability to pay back the debt. It is therefore important to look at the composition of investment as well as its level. The same goes for borrowing. Most of the Asian countries did not have excessively high levels of foreign debt. What they did have were excessive levels of short-term debt, which made them very vulnerable to speculative attack. Once again, the composition of borrowing was more important than its actual level.

On a more general level, as Goldstein (1998) points out, "*rapid expansion of bank and nonbank credit, cum high concentration of credit to the real estate and equity markets, is almost always a harbinger of trouble in developing and industrial countries alike*". To continue on the same theme, financial market liberalisation, particularly when combined with a fixed exchange rate regime, also seems to be a harbinger of trouble in developing and industrial countries alike. The banking crises in Finland and Norway at the end of the 1980's are good examples of problems encountered when liberating financial markets. It is to be hoped that the next group of countries which engages in financial market liberalisation finally manages to get it right.

Currently, the crisis countries appear to be staging a surprisingly rapid recovery. Forecasts for economic growth for this year have been steadily revised upwards and all the countries except Indonesia are expected to show positive growth this year. The stock markets in the area have started to recover and the current accounts are all showing strong surpluses. Particularly South Korea and Thailand have assiduously carried out the reforms recommended by the IMF, which will strengthen their economies and resolve some of the structural problems which caused the crisis. Nonetheless, the region will still suffer from the after-effects of the crisis for some years to come. We should also beware of once again taking too optimistic a view of the area. International sentiment tends to swing from wild euphoria to total panic, and currently we are probably at the optimistic end of the scale. Although the countries are tackling many of the problems which caused the crisis these issues could still reoccur in the future. Crony capitalism, an aversion to transparent reporting and the importance of "face", to name but a few, will not disappear over night. These countries have traditions and cultures which reach back thousands of years, and these will not be eradicated in two years of economic crisis.

3

THE EAST ASIAN ECONOMIES

Jian-Guang Shen

The Asian crisis revealed the weak sides of the East Asia economies. Although there are certain common characteristics, each individual economy in the region has its own unique structural features. The variety of economic structures in the various economies both determined their performance under the Asian crisis and, later, the measures taken to pull them out of the crisis. The emphasis in this chapter is on how the Asian crisis affected the restructuring of China and Japan. Other economies that are also discussed include Hong Kong, Singapore, South Korea, Taiwan, Thailand, Malaysia and Indonesia. Finally, the long term outlook for East Asia is spelled out.

China

Basic statistics on China, 1997

Population, million	1200	
GDP, billion USD	918	
GDP growth during 1970-90	10.1	
GDP growth during 1991-98	10.6	
GDP per capita, ppp	3330*	
GDP per capita, USD	765	
Domestic savings, % of GDP	42	
Agriculture as a share of GDP	17	(1970: 42%)
Industry as a share of GDP	55	(1970: 45%)
Services as a share of GDP	28	(1970: 13%)
Main export destinations	Hong Kong, USA, Japan, Germany	
Main import sources	Japan, USA, South Korea, Hong Kong	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

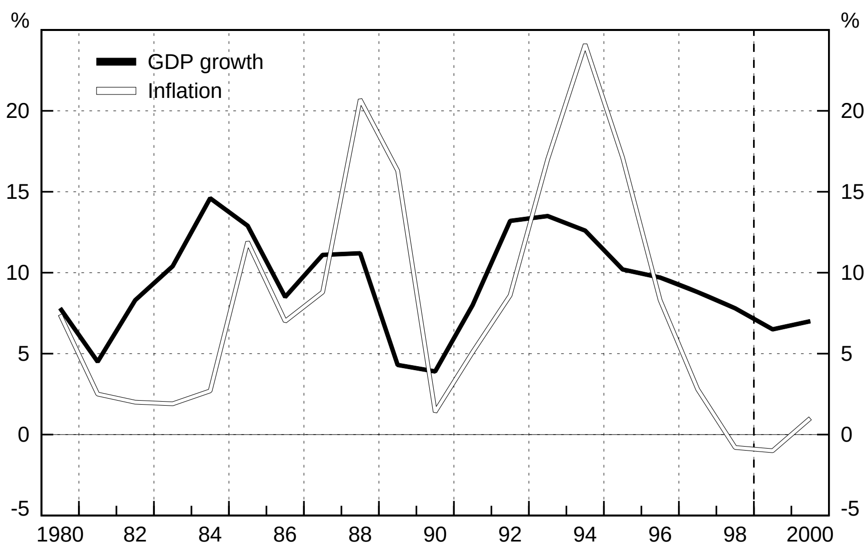
With a population over 1.2 billion, China is the world's most populous country. Measured in terms of purchasing power parity, China is also the world's second largest economy. According to the World Bank, China's share of world output is over to 10 percent. However, in terms of nominal US dollars, China ranks 7th in the world.

China experienced three decades of a central planning system until 1979. Then China began to transform its economy into a market-oriented one (see box 3.1: Economic reform in China). Unlike Russia, where attempts to adopt a market economy have led to a drastic decline in production, China has changed the old system gradually. China's incomplete market system and inconsistent macroeconomic policy have often resulted in wide economic fluctuations. However, in general, the Chinese economy has progressed very well since 1979. During the past 20 years, the average growth rate of GDP for China has been approximately 10 percent.

The adverse impact of the Asian crisis on the Chinese economy has been worse than intitially expected. The Chinese economy will face a very difficult period during this and the next few years. However, the risk of an acute financial crisis or the collapse of the Chinese economy is still small. The devaluation of the Chinese currency, the renminbi (RMB), is also unlikely for the time-being, though the possibility of modest devaluation after 1999 is increasingly high.

The Asian crisis represents an acute, short-term shock to the Chinese economy, and its consequences are becoming increasingly pronounced. But the deeper and most fundamental problem confronting China is the need for structural adjustments in various levels and areas of the economy. The Chinese government has embarked upon huge infrastructure investment projects in order to address short-term problems such as a slow-down in growth. Although there is continuous progress in macro-level structural changes, the external circumstances are too grim and the domestic situation too sensitive for any big push in economic reform this year. Already now, the severe unemployment situation due to state-owned sector reform has caused widespread concerns about social stability.

Chart 3.1 China's economic development since 1980



Source: ETLA.

China's premier Zhu Rongji's US visit gave renewed hope that China would join the WTO before the end of this year. WTO membership would provide a fresh momentum for structural changes in the Chinese economy. However, the adverse impacts on the economy are huge. Whether China is ready for these drastic changes is far from certain.

Box 3.1

Economic reform in China

Economic reform was launched by Deng Xiaoping at the end of 1978 to revive the Chinese economy. The key themes were reforming the existent economic structure and opening China to the world. The reform greatly changed Chinese society and brought about a tremendous improvement in the Chinese economy and in living standards. Economic growth since then has been spectacular.

In contrast to the transition process in Russia and East Europe, economic reform in China does not have a clearly designed blueprint. Instead, the reform process has been managed on a trial and error basis, which is termed as 'gradualism', or, sometimes, as 'piecemeal'. The reform started in rural areas, simply because the most severe and urgent problems existed in the rural sector, especially in agriculture. As Fan Gang puts it, the shifts in reform objectives, or reform targets in the process reflect, 'the increasing knowledge in China about the merits of different resource allocation mechanisms' and 'the changes in the social balance among various interest groups and the changes of economic structure resulting from the process of reform and development itself'.

The reform stage has gone through the following four periods:

1. Focus on Agriculture and Special Economic Zones (Dec. 1978 - Dec. 1984)

The Chinese economic system started to change at the end of 1978 from a centrally planned system to a market-orientated direction. The reform started in the large, depressed rural sector, featuring a rise in the prices of most agricultural products and a new system of leasing land to all rural households. The reform immediately yielded huge productivity progress and liberalised rural labour. Rapid increases in rural incomes, combined with high savings, facilitated the formation of a non-state industrial sector – township enterprises – which have experienced exceptional expansion ever since.

Another significant step was the establishment of four special economic zones, SEZs, including Shenzhen. These four areas attracted the first wave of foreign direct investment from Hong Kong and Taiwan through preferential treatment. Important reform measures were also experimented with in the SEZs before they were introduced to other parts of China.

2. Urban Economic Restructuring (Jan. 1985 - May 1989)

After most people were convinced of the great success in rural reform, emphases were placed on restructuring industrial enterprises in cities. The key objectives were to liberalize commodity prices and to enhance the efficiency of state-owned enterprises (SOE's). To achieve price liberalisation, price controls were phased out gradually, and the condition of demand and supply became the dominant force in price determination. At the end of this period, price controls on most consumer goods were abolished.

Other impressive results included the emergence of different types of industrial enterprises. Private enterprises were allowed and township enterprises experienced rapid expansion. The share of SOE's in industrial output declined steadily.

In 1985, several laws governing foreign direct investment were enacted and China's coastal areas were opened for foreign investment. Foreign capital started to pour in after that year. The number of wholly foreign-owned enterprises and joint ventures increased rapidly. Despite a brief break after 1989, the momentum has continued ever since. The wholly foreign-owned enterprises and joint ventures have been enjoying rapid expansion and are playing an increasingly important role in the Chinese economy.

However, the traditional macroeconomic policies were either ineffective or were conducted inappropriately during 1987-88. In addition, the liberalization of the prices of many commodities resulted in soaring inflation, which reached almost 28 per cent in December 1988.

3. Consolidation (June 1989 - Dec. 1991)

After the Tiananmen tragedy on the 4th June 1989, concerns about social stability became predominant. Further reforms of the financial markets and in SOE's were postponed. Administrative measures, such as restrictions on fixed-asset investment and price freezing were taken in order to contain inflation. As a result, inflation declined dramatically, from over

16 percent in 1989 to 1.4 percent in 1990. Meanwhile, economic growth slowed substantially. Even in this period, reform continued, albeit cautiously, in certain areas. A notable example was the opening of the first two stock exchanges in China, one in Shanghai, the other in Shenzhen.

4. Acceleration (Jan. 1992 - Dec. 1995)

A fervent call by Deng Xiaoping in January 1992 to speed up reform proved to be a powerful stimulus to the reform process. In 1992, for the first time, 'a socialist market economy' was officially endorsed as the reform objective. This was, of course, instead of a combined 'planned-market economy'. A series of important reform measures were taken and the reform process accelerated greatly. Various experiments with transforming the SOE's into independent corporations running for profit were made across the country. Reform was accelerated in all areas of the economy. In certain service sectors, including retailing, foreign investment was allowed. New inland and Yangtze areas were opened to foreign trade and investment. Prices were further liberalized. From January 1994, the dual exchange rate system was abolished so that the exchange rate was determined in a nation-wide swap market. This represented a great advance towards the free trade principle and capital account liberalization. Later, the RMB became further convertible on current account terms. Another important step was the fiscal reform in 1994. The central themes were the introduction of the Value Added Tax and the division of fiscal resources between central and provincial governments. A preliminary legal institution came into being in this period, including the enactment of the Company Law and the Central Bank Law. During this period, economic growth surged again from a low in 1990, reaching a peak in 1993 with an annual GDP growth rate of 13.8 percent. This was accompanied by high inflation, which rose to 24.1 percent in 1994.

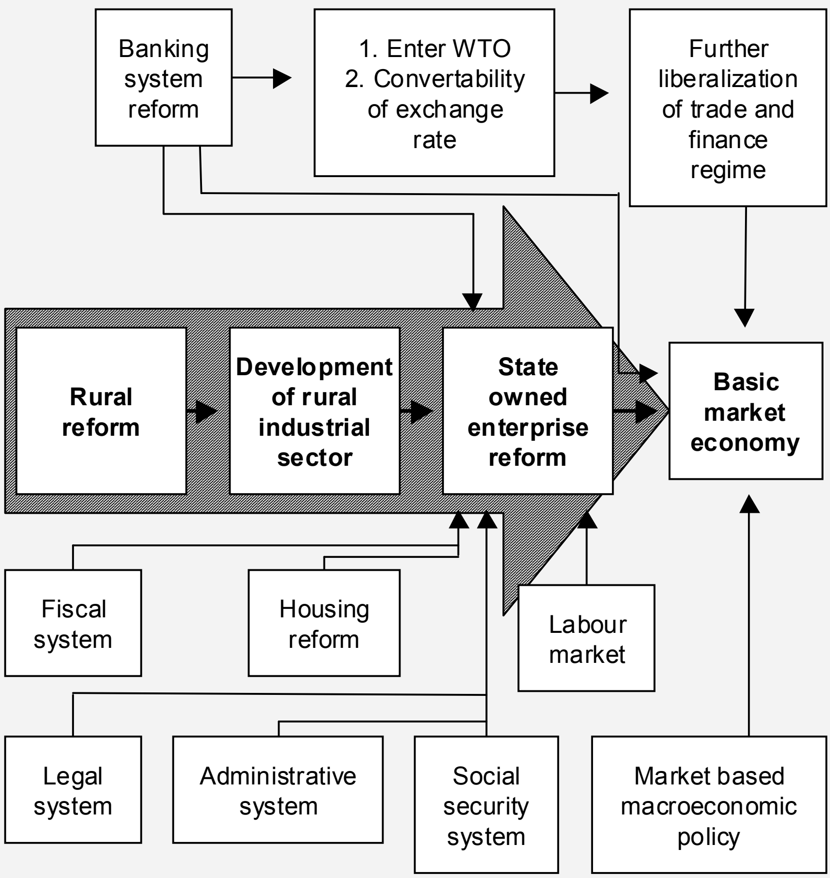
5. All-out market reform (Jan. 1996-)

The previous period was marked by a rapid expansion of credits and an investment boom. However, problems of overheating and wasteful investment arose in 1995. Since 1996, the reforms have focused on a more stable macroeconomic environment by tightening monetary policy and promoting market mechanisms.

Despite all the efforts to create a basic market system, there is still a huge amount of work left to be done. The principal task is the reform of state-owned enterprises (SOE's). Problems to be solved in this transitional period include:

- Completing the institutional foundation of a market system, including an integrated legal system, a clear definition of property rights, effective macroeconomic monitoring methods, etc.
- Inducing effective corporate governance and accountability in all enterprises
- Creating a market-oriented banking sector
- Strengthening the fiscal resources of the central government so as to provide basic social services such as health care and education to all of the population, to focus on key infrastructure projects and to assist poverty-stricken provinces
- Addressing personal as well as regional income disparity

China's reform agenda towards 2000



Recent economic development

The Chinese economy achieved a combination of high growth and low inflation in 1997 before the Asian crisis had showed any impact. GDP grew by 8.8 percent and consumer prices rose by only 2.8 percent. Compared to previous years there was a big change in the composition of demand growth. Exports became the driving force in economic growth, whereas domestic demand was lacklustre. Exports surged by about 21 percent year-on-year whereas growth of imports were modest. Foreign investment played an important role in the growth of the economy, accounting for over 15 percent of total fixed investment. On the other hand, domestic demand was weak. Fixed-asset investment growth dropped to 9 percent, down from 12.5 percent in 1996. Companies held back on investing in new projects, and banks became more careful about lending. The growth of retail sales also fell to 10.7 percent, compared with 13 percent in the previous year.

The Asian crisis that broke out in the latter part of 1997 has had a serious impact on the Chinese economy, primarily through the following three channels:

1) Foreign direct investment and exports have been the locomotives of China's rapid growth in recent years. East Asia as a whole is the predominant source of China's inward foreign direct investment and its biggest export market. China received over 70 percent of its FDI from Asia. Asia also accounted for over 40 percent of China's exports. Weak FDI and exports have depressed domestic demand.

2) The East Asian economies, especially Hong Kong, have played a vital role in opening up the Chinese market. Hong Kong also serves as a financial centre for China. A dozen of China's leading state-owned companies have been listed in the Hong Kong stock exchange and more are expected. The stock market crash in Hong Kong slowed this process.

3) As the value of currencies in other East Asian countries have collapsed, the real effective exchange rate of the RMB has appreciated considerably. As a result, China's competitiveness compared to other economies in East Asia has weakened considerably.

The timing of the crisis was particularly bad for China because the reform of the State-owned sector had entered a critical stage. There was a marked tension between the need to deepen structural reform and the need to maintain social stability. Economic activity decelerated in 1998 with GDP growing by only 7.8 percent, compared with 8.8 percent in 1997 and 9.7 in 1996.

Private consumption led the economic downturn in 1998. The sluggish private consumption was due to soaring unemployment and weak income growth. It was estimated that over 10 million workers were laid-off from SOE's (state-owned enterprises). This massive unemployment also caused social unrest in some areas. In addition to these workers, the government announced that nearly four million civil servants would be made redundant over the next three years. As a result, private savings rose to an unprecedented level. The rising savings rate was a natural response to a deflationary environment, increasing job insecurity and diminishing social welfare.

China's exports, a driving force in its economic growth in 1997, started to suffer in the middle of 1998. The growth of exports declined sharply, plummeting into negative territory in the latter months of 1998. Foreign direct investment also slowed significantly.

Sluggish private and external demands depressed the growth of industrial production. Industrial enterprises suffered from declining profitability because of weak demand and deflation. The output-sales ratio continued to grow and industrial enterprises had a huge build-up of inventories. As a result, the profits of industrial enterprises fell significantly. The slip in profitability prompted firms to scale back investment plans, which also depressed business investment.

Owing to rather weak domestic demand, China officially entered a period of deflation in middle of 1998. In addition, the currency depreciation elsewhere in Asia not only depressed import prices but also exerted serious downward pressure on the price of raw materials. The retail price index fell by 2.1 percent in 1998.

The Asian financial crisis prompted the Chinese government to act urgently to reform China's financial system. The slowdown in the Chinese economy and reform in the SOEs exerted increasingly high pressures on the weak financial institutions. Bad loans increased substantially and the banks suffered huge losses due to the violation of regulations and criminal activities in the financial sector. In 1998, the central bank ordered takeovers or merges of several small- and medium-sized insolvent financial firms. The Asian crisis complicated the task of cleaning up the financial sector. At the end of 1998, GITIC, The Guangdong International Trust and Investment Corporation went under with gross debts of over USD 4 billion. This was the first major state-owned financial institution to go bankrupt in China. The event alarmed international investors, who had taken for granted the bailout of major financial institutions by the central government. Subsequently, foreign creditors tightened lending to all other Chinese firms and banks, which greatly weakened China's ability to raise funds in the international market.

Economic restructuring is painful

It is a fact that currently China's industrial production is decelerating, unemployment is soaring, and people are saving more instead of spending. In addition, China's dubious statistics probably overstate economic growth, as exemplified by the divergence in the ratio between electricity consumption and economic growth. Of course the recent rapid expansion of high tech industries and service sectors has changed the pattern substantially. Nevertheless, the real growth rate is probably much lower than the statistics show.

However, we should view the Chinese economy in a broader perspective. Since China is carrying out the most profound restructuring program since its the reforms started, it is natural that the economy will suffer some setbacks.

The current restructuring program in China is an attempt to solve problems accumulated over the past 20 years. The fundamental reason for the present difficulties is the drastic economic transformation that is occurring in China. The enforcement of a "hard budget" on the State-owned sectors is resulting in large-scale, real or virtual bankruptcies and in massive unemployment. The disciplining and restructuring of the financial sector is leading to a reduction in inefficient investment, to which the current huge capacity surplus is attributable. The macroeconomic consequences of the combination of this transformation and the Asian crisis are unfolding at this particular moment.

China has experienced fundamental changes in the structure of its economy. Since 1996, the supply of most capital and consumer goods has surpassed demand and the Chinese economy is no longer an economy of shortage. Infrastructure bottlenecks, though still a big hindrance to economic development, are disappearing rapidly. The rapid transformation of most sectors in the economy has resulted in friction and imbalance.

The reform of SOEs has reached a critical point. SOE's have been inefficient users of capital. Now SOE's have to be more accountable to the market. Unlike in the past, the high growth in industrial production was partly attributed to the accumulation of high inventories of unsold goods. Banks used to pump money into loss-making SOE's just to keep workers employed. This situation is clearly unsustainable. The current difficulty in the Chinese economy is, to a large extent, the result of the endeavors to reverse this situation. Banks now are responsible for their own profitability and they have tightened their lending significantly since 1996. Firms have lost their channels for funding the production of unmarketable products and are being forced to de-stock. Thus industrial production has inevitably slowed.

The restructuring of SOEs and the trimming of the state bureaucracy have resulted in rapidly growing unemployment. SOEs are allowed to lay off redundant workers and partially separate their welfare obligations such as housing, education or health care. However, a new uniform social welfare system has not been set up. A major concern at this moment is how to deal with the growing unemployment situation. The rising unemployment rate has resulted in changes in the expectations of the household and in a real decline in incomes.

Immediate policy measures are limited

China is now taking measures on different fronts to stimulate the economy. The main measures include expansionary monetary and fiscal policies as well as a further deepening of institutional reforms.

The People's Bank of China, the central bank, has cut bank reserve requirements and trimmed interest rates seven times since May 1996 to stimulate domestic demand and to slow savings deposits. The latest cut was in on 9th of June 1999, when the benchmark one-year rate for RMB deposits was cut from 3.78 percent to 2.25 percent, and the one-year lending rate from 6.39 percent to 5.85 percent. It was the first time since the first cut in 1996 that the spread of deposit and lending rates has been three percentage points. This suggests that the focus of this latest move is to encourage consumption and help improve state banks' profitability. Previously, the cuts in interest rates were mostly aimed at lowering the interest burden on state enterprises. In addition to the cuts in interest rates, the central bank also encouraged commercial banks to ease their lending criteria.

In addition to easing monetary policy, China is adopting an aggressive stance on fiscal policy. The government formulated a budget with a record-high deficit of 150.3 billion yuan for 1999. Accordingly, the government decided to issue RMB 316.5 billion in treasury bonds, compared with RMB 280 billion last year, to finance the deficit and boost bank lending. Infrastructure investment, which includes the construction of roads, railways, telecommunications infrastructure, housing and water conservation, is on the priority list to receive funds.

The structural reforms will only have a long-term impact. Currently fiscal policy is probably a more effective way to stimulate the economy in the short-term. However, the immediate effectiveness of the expansionary monetary and fiscal policies are far from certain. Moreover, credit risks are increasing as commercial banks are being encouraged to lend. Now commercial banks are facing the difficult task of reducing bad loans while expanding lending in an unfavorable market environment. To stop more layoffs, China has recently revived the practice of extending "policy loans" to loss-making SOEs. Together with plans for huge infrastructure investment, China's fiscal burden is bound to increase rapidly.

The final impact of this strategy of massive investments depends not only on the stimulative effect of public investment, but also on the efficiency and competency of the public administrative system. Corruption and the misuse of the funds in infrastructure investment are widespread. The central government recently decided to stop allocating funds to one province due to problems related to the misuse and waste of specific investment funds.

Structural reforms have continued

Despite the huge challenges facing China today, the central government is still firmly committed to the structural reforms which will, hopefully, address the structural and systemic problems affecting both the economy and society. It is probable, however, that due to the Asian crisis, the measures will be less radical than previously envisioned.

In addition to its expansionary policy stances, China has taken several important measures to create a fairer market economy system.

First, when Mr. Zhu Rongji became Premier in March 1998, a series of decisive measures concerning administrative reform were announced. The purpose of the reform was to lessen government interference in the market and to improve government efficiency by establishing a small and efficient government. Eleven ministries were either merged, scaled down, or abolished altogether. The overall target was to cut the number of civil servants by 4 million (half the current total) over the next three years.

Second, in the end of 1998, China's leadership ordered the nation's military, police forces and judicial organs to stop running their business empires. Enterprises controlled by these institutions were to be transformed to normal state-owned or joint ventured firms. Since the middle of the 1980s, these organizations had been allowed to engage in business in order to compensate for the fall in funding from the central government. As these organizations had certain privileges, it was alleged that they were responsible for smuggling huge amounts of goods. In some cases, the illegal activities and unfair competition which these enterprises indulged in caused huge losses or even the disruption of production in domestic firms. Furthermore, the annual tariff losses due to such smuggling activity were enormous. Thus, the move was essential in improving order in the domestic market and lessening lawlessness in the economy.

Third, the central bank reorganized its structure in order to diminish local government interference and intensify banking sector supervision. Originally, each province in China had a branch of the central bank. The head of the bank branch had to report both to the bank headquarters and to the provincial governor. Thus regional governments could interfere with monetary policy. After the reform, the central bank had only eight big regional branches, with their heads only reporting to the headquarters. In this way the central government was in a better position to conduct monetary policy and supervise banking sector. Moreover, commercial banks are now allowed to operate more independently. In the end of 1998, China issued USD 32.5 billion in bonds to bolster the capital ratio of China's four biggest state-owned banks[7]. Although these banks have huge bad loans, the majority of the bad loans of these banks can be viewed as policy loans, which are more like fiscal transfers from the central government to the loss-making SOEs. In addition, asset management bodies within these four banks have been set up to deal with the bad loans. The ongoing financial system restructuring is aimed at creating a competitive and well-supervised financial market with healthy and vibrant commercial banks.

Fourth, the role of the private sector was strengthened. In March 1999, China's constitution was amended in the national congress so that the private sector was regarded as equal to the state-owned sector. Previously, the private sector was regarded as complimentary to the state-owned sector. The amendment improves the legal status of the private sector and is likely to boost the development of this sector.

Finally, The Chinese government is still committed to joining the World Trade Organization, WTO (see box 3.2: China's WTO membership).

---

[7] They are Bank of China, China Agriculture Bank, China Construction Bank and Bank of Industry and Commerce.

Short-term prospects: no quick recovery

China is now facing a tough battle in boosting its sluggish economy. In the short term, the outlook is rather gloomy. Externally, its Asian neighbors are struggling to recover from the severest depression in four decades. China's exports declined in the first quarter of 1999 and are not likely to recover quickly. Internally, China is undergoing a difficult process of economic restructuring. Private consumption and investment have been weak and will remain so in the near-term. The only factor that supports growth right now is public investment. However, there are constraints on the effectiveness of this fiscal measure.

China is not likely to have a financial crisis like other Asian economies, as it has high savings rates and large trade surpluses. The likelihood of a liquidity crisis in the domestic banking system is very small. Most foreign capital is in the form of direct investment, so we will not see a massive flight of foreign capital. Chinese banks have combined deposits of nearly USD 700 billion, thus the possibility of a credit crunch is also small.

The easing in mortgage lending and the ongoing house ownership reform have encouraged rapid growth of private purchases of residential apartments. In Shanghai alone, 77 million square meters of flats were sold to individuals in the first quarter of 1999, representing a growth rate of over 80 percent over the same period last year. Office buildings are in a state of massive oversupply, but enormous potential remains for housing development. Furthermore, the commercialization of housing will boost the wealth of households. The general pick-up in the housing-market is hoped to eventually support both consumption and construction over the next few years.

The Chinese government predicted 7 percent GDP growth for 1999. For the first time, any growth targets set were not mandatory and the figures were meant to be estimates only. According to our judgement, China's economic growth will ease to 6.5 percent this year and accelerate to 7 percent in year 2000. In 1999 the deflationary trend has intensified. Next year while the economy accelerates slightly, inflation will still be extremely subdued.

In the long run, the questions of whether China can establish a law-based, open and fair market environment and whether Chinese firms will be able to upgrade their products and become competitive are vital for the country to sustain high growth. China has two strong advantages, namely unlimited cheap labour and a huge domestic market. The production capacity can be utilized in the agricultural sector, transportation, environment protection, and residential construction as well as in high-tech industries. The restructuring of the Chinese economy will have a significant impact on China's growth performance and potential over the next few years.

Box 3.2

China's WTO membership

After thirteen years of negotiations, China has recently been pushing very hard to join the World Trade Organization, WTO. The concessions China announced in April 1999 during Premier Zhu Rongji's visit to the US gave renewed hope that China would join the WTO before the end of the year. China's latest concessions were enthousisatically embraced by the US business community and agricultural sector. The reason that a deal was not made during Zhu's trip was that the US administration was afraid of congressional objections. But after the trip, even US lawmakers pushed the administration to lock in a WTO deal.

China's concessions are widely regarded as substantial. China has offered to open its domestic market in most manufacturing industries, telecommunications, financial services and agricultural sectors much earlier than previously expected. Moreover, non-tariff measures would be curbed. WTO membership would force Chinese enterprises in all sectors to compete globally.

The Asian crisis caused a severe deterioration in the external environment which impaired China's efforts to reform its State-owned sector and restructure its economy. Internal problems, such as government interference and a backward financial system, hindered the further liberalization of the economy. The government's strategy of sustaining high growth through domestic demand is now facing tremendous difficulties. Thus, China's entry into the WTO is a strategic consideration of China's policy makers. WTO membership would anchor China firmly in to the global economic system and provide fresh momentum for structural change in the Chinese economy. Competition could bring about efficiency and more foreign direct investment would stimulate the economy. Other benefits would include the end of the annual review of China's Normal Trade Relations status by the US and the cancellation of discriminatory trade measures, such as textile quotas, by other countries. Besides, the tariff reduction would have only a limited impact, as China's effective tariff is already very low because of widespread smuggling and wide-range tax breaks for foreign investors.

However, it still raises the question of whether China is ready for this drastic change. The benefits of WTO membership for China are mostly long-term in nature, such as more respect for market forces and improved allocation of resources. But the short-term pain is obvious. After China's accession, deflationary pressure would intensify, as prices would be driven down by heated competition. Many state-owned sectors will face accelerated competition from abroad in a short period of time. More layoffs of workers are expected when numerous State-owned enterprises would be either sold, or closed down, or merged with other ones. Thus the unemployment rate could soar from the current, already high level. One estimate put the increase in unemployment due to the WTO accession at more than 20 million.

One study by China's Development Research Center of the State Council summarizes the consequences of China's WTO membership. The main results are that China would gain significant economic efficiency. This would not be evenly distributed among sectors and the agricultural and automobile industries would suffer the most. Unemployment would be a significant adjustment cost.

Apart from some industries, such as textiles, footwear, toys and consumer electronics, which are mostly likely to benefit from China's WTO membership, most other industries would face a tough competitive environment in the near future. Particularly, the banking and insurance, telecommunications, automobile, machinery, steel, chemicals and high-tech industries would be affected significantly. Even in the textiles industry, the US demands that quotas on China's textile exports be extended until 2010. If that comes to pass, China's short-term benefits will be minimal.

The concessions have hurt a broad spectrum of interest groups inside China, who favour a more gradualist approach to WTO membership. Government bureaucrats would lose powers related to permit granting. Managers of state-owned banks and enterprises would face much tighter deadlines and have to meet more stringent profitability requirements. Inland regions, which depend heavily on agricultural products, have strong reservations about the agriculture accord, as the agreement would result in hefty imports of American wheat, fruits, meats and poultry, which already suffer from domestic over-supply. The strong reaction from anti-WTO groups is likely to harden China's stance in the coming negotiations. Further concessions beyond than those already offered to the US are not likely.

China's accession to the WTO with huge concessions is a risky, but necessary strategy under the current situation. The biggest headache, however, is the social tension caused by unemployment. Already now, social unrest due to unemployment has caused widespread concerns. The measures taken by the government are primarily to lessen corruption and to speed up the formation of competitive, state-owned conglomerates. China's growing private sectors are being counted on to provide more jobs for the laid-off workers from the state-owned sectors. WTO membership will quicken the pace of the development in the private sector.

Devaluation not likely in 1999

The Chinese currency, the renminbi (RNB), is pegged to the US dollar. The Asian crisis has placed tremendous pressure on the remninbi's peg. In addition, domestic pressure to devalue has been growing. In the short term, the restructuring of the economy has had a contractionary effect. Exports have been falling since the middle of 1998. In 1999 China faces a major challenge, as the Asian economies are likely to start their export-led recovery. China's loss of competitiveness is likely to worsen its external balance and lower foreign investment inflows. If China's exports continue to decline, the devaluation lobby inside China will be very strong. Currently the black-market rate for the RMB in China is 10 percent weaker than the official rate. It is a sign that devaluation expectations are building up even inside China.

However, the devaluation scare has proved to be premature in the past two years. Many factors are against a hasty devaluation.

First of all, the price level in China are falling rapidly. Deflation is a natural adjustment process that China is undergoing when the option of devaluation is ruled out. China's real exchange rate has actually depreciated. Thus the need for nominal devaluation has diminished.

Since China has a closed capital account and a non-convertible currency, China is much less vulnerable to market pressures and speculative attacks. China has discouraged inflows of "hot money" and instead emphasised foreign direct investment, which brings technology, human capital and capital. Furthermore, China's exposure to foreign liabilities is rather limited. The external debt amounts to just around 18 percent of GDP and 80 percent of total exports, both indicators are far less than the critical level. The debt service ratio is also rather low. In addition, the term structure of China's external liabilities is much better. The majority of foreign debts are of medium or long-term maturity. Short-term debts are rather modest and do not pose any thread to liquidity.

Moreover, the accumulation of huge foreign exchange reserves should provide a cushion against the adverse effects of a slowdown in exports. China's foreign exchange reserves have grown steadily as a result of a strong trade surplus and solid increases in foreign direct investment. At the end of April 1999, foreign exchange reserves were close to USD 150 billion.

The devaluation of the RMB would unleash a new round of currency contagion in Asia, including a dismantling of the Hong Kong dollar peg. Any competitive advantage China might gain through devaluation could be lost quickly through the dynamics of currency contagion. In addition, the brighter growth prospects in the rest of East Asia and the stabilization of most currencies in the region lessen the pressures on the RMB.

China's leaders have repeatedly pledged to keep the yuan stable despite a slowdown in exports and foreign investment. China will not easily relinquish its hard-earned reputation. Any change to this strategic decision is bound to be slow and gradual.

Taking account of all these augments, it is likely that China will maintain its currency peg in the near future.

China's concessions in the WTO negotiations (disclosed unilaterally by the US trade representatives)

Market access

- Full market access for domestic distribution
- Immediate tariff reductions
- No future tariff hikes
- Elimination of quantitative retractions
- Compliance with existing multilateral agreements on information technology, and financial services

Agriculture

- Tariff reduction from 20-45 to 3-19 percent (average 17 percent) by 2004

- Elimination of all quantitative restrictions
- Elimination of export subsidies

Industry

- Full trading and distribution rights for foreign firms
- Reduction of average tariffs from 24.6 percent to 9.44 percent. Two-thirds of the reduction by 2003 and full reduction by 2005
- Wood & paper tariffs to 5-7.5 percent from 12-25 percent
- Chemicals tariff reduction from around 35 percent to 5.5-6.5 percent
- Auto quotas phased out by 2005

Services

- Phase out all restrictions on domestic distribution and allow 100% foreign ownership in 3-4 years
- Allow 49 percent of foreign ownership in all telecom services and 51 percent in paging and value added services in 4 years
- Eliminate all geographical restrictions for insurance licenses on foreign firms in 2-3 years, allow 51 percent foreign ownership in life insurance after one year, and 51 percent foreign ownership in non-life insurance immediately and 100 percent after 2 years
- Banking under discussion
- Securities under discussion
- Permit foreign majority ownership in professional services except for practicing Chinese law
- Allow 49 percent foreign participation in the distribution of video and sound recording, majority foreign ownership in 3 years for construction, renovation, ownership and operation of cinemas
- Remove all restrictions on foreign owned hotels in 3 years and foreign travel agency services

Specific

- Eliminate trade and foreign exchange balancing provisions requirements
- Cease enforcing local content requirements
- No WTO-incompatible mandatory technology transfer requirements

Source: Morgan Stanley Dean Witter Research.

Japan

Basic statistics on Japan, 1997

Population, million	125.6
GDP, billion USD	4197.5
GDP growth during 1970-90	4.3
GDP growth during 1991-98	1.1
GDP per capita, ppp	23420*
GDP per capita, USD	33420
Domestic saving, % of GDP	14
Agriculture as a share of GDP	2
Industry as a share of GDP	38
Services as a share of GDP	60
Main export destinations	USA, Hong Kong, South Korea, China
Main import sources	USA, China, South Korea, Indonesia

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

Japan is the biggest economy in Asia and the second biggest in the world in terms of nominal US dollars. After the Second World War, Japan enjoyed a long period of rapid economic growth. The emergence of Japan as an economic power in the global arena greatly improved the position of Asia in the world economy.

The Japanese economy, which had been enjoying a spectacular boom in the 1980s, suffered a tremendous setback in the beginning of the 1990s. The burst of the 'bubble' economy had devastating consequences for the economy. Asset prices plummeted over 50 percent and have not yet recovered. Sluggish private consumption and depressed business investment kept the economy in a long period of recession.

Japan has served as an important market and source of capital for other Asian economies. The stagnation in the Japanese economy in the 1990s has weakened the Japanese contribution to the rest of Asia. In addition, concern over the state of the Japanese economy probably partly explains the magnitude of the Asian crisis.

A decade of sluggish growth revealed enormous structural problems in the Japanese economy. During 1991-98, the Japanese economy expanded at an annual average rate of 1.1 percent, down from

4.3 percent during 1970-90. The huge difference in national income in terms of purchasing power parity and nominal dollars demonstrates the peculiar structure of the Japanese economy. Japan has very competitive manufacturing industries, but a backward service sector. Particularly the financial sector is much less efficient in channelling resources to most profitable areas than its Western counterparts.

These structural problems are the reasons behind the futility of the efforts of the Japanese government to stimulate the economy. After several attempts, the government has realised the limitations of fiscal and monetary policy measures and is undertaking structural reform. The increase in foreign investment in 1998 indicates that his process has been positively perceived by foreign investors.

The Japanese fiscal stance in the 1990s

In order to revive the economy after the collapse of asset prices, the Japanese government has pursued an expansionary fiscal policy. From 1993 to 1997, the government released six packages totalling 50 trillion yen, over 10 percent of the GDP. The fiscal expansionary stance pushed economic growth higher, especially in 1996, but it failed to induce a sustainable recovery. Moreover, the prolonged economic slowdown and massive fiscal stimulus packages resulted in a sharp deterioration of the fiscal position in Japan. The general government fiscal balance changed from a surplus of 1.5 percent of GDP in 1992 to a deficit of 6 percent in 1998.

In 1996, the economy grew strongly, mainly due to the fiscal packages and the rebuilding of the earthquake-hit Kobe region. Then the government mistakenly regarded this as a genuine recovery and started to consolidate its fiscal position. Fiscal policy was tightened significantly in 1997. The effects of the combination of a hike in the consumption tax, the abolishment of some income tax concessions as well as cuts in public investment projects were immediately reflected in a notable slow-down in economic activity.

In 1997, GDP growth in the first quarter was rather robust, but in the other three quarters, economic activity slowed down sharply. The hike in consumption tax from 3 percent to 5 percent in April was blamed for the change. However, it is really surprising that a 2-percentage increase in consumption tax would have such a big impact on the economy. Actually, the Japanese economy had never really entered a path of autonomous recovery after the bubble economy had burst in 1991. It was the fiscal stimulus measures that had kept the economy from recession all the time. The consolidation of the fiscal position in the first half of 1998, combined with the sharp reduction in private consumption due to tax increase, contributed to the slowdown in the economy. The austere fiscal stance, combined with fallout from Asia's currency crisis and a domestic credit crunch born of Japan's financial woes, depressed corporate and consumer sentiments and drove the economy into a severe recession in 1998. Japan experienced its worst economic recession in the post-war period, with its GDP declining by 2.8 percent in 1998.

Faced with a faltering economy and the prospect of intensifying the financial crisis in Asia, the Japanese government reversed its early stance of fiscaltightening and announced a series of emergency measures after the end of 1997. In March 1998 the former Hashimoto government unveiled a fiscal stimulus package worth over 3.3 percent of the GDP, or 16.5 trillion-yen (12 trillion yen in real demand stimulus). But this package was meant to neutralize the restrictive fiscal stance and was too late to revive the economy.

In August 1998, the newly elected Obuchi government pledged to cut taxes by more than 6 trillion yen permanently, four trillion in income tax and two trillion in corporate tax. The income tax cut started in January 1999 and the corporate tax cut in April 1999. The latest supplementary budget also included an increase in government investment spending of 10 trillion yen from autumn of last year.

The government fiscal deficit will increase substantially. Although the Japanese government announced that deficit-financing bonds would be used to fund the tax reduction, in the longer term, the burdens will still be on the taxpayers. Of course, the expanding fiscal deficit and gross debts will pose a threat to the stability of the economy in the long run.

This fiscal package is expected to prevent the fragile Japanese economy from slipping deep into depression. However, it is still too early to say whether or not this package will facilitate a self-sustained recovery. Moreover, the restructuring of the financial sector will be essential to the restoration of consumers and investors' confidence.

The Japanese financial difficulties and the 'Big Bang' plan

Japanese financial institutions had been struggling with huge bad loans ever since 1990, when assets prices fell by over 50 percent. The financial sectors had been very weak. Some financial institutions had used illegal measures to conceal their losses in order to survive. The Asian crisis in the summer of 1997 worsened Japan's economic outlook. The revelations of bad loans prompted the bankruptcy of several financial institutions. The situation in Japan further intensified the Asian crisis.

The financial system in Japan has been long regarded as closed, highly regulated and backward. Japan boasts household savings of 1200 trillion yen, the highest in the world. Yet more than half is held as bank deposits, which are earning less than 1 percent annual interest. With the society aging rapidly, Japan can no longer afford this waste of resources. Against this background, the Japanese government unveiled a reform package to deregulate the economy, particularly in the financial sector. The "Big Bang" deregulation of the Japanese financial system started in April 1998. The following presents a list of consequences that have happened or will happen:

- On April 1, 1998, brokerage commissions on trades of 50 million yen or more were liberalised. Commissions on smaller transactions will be liberalised by December 1999. Foreign exchange controls are to be lifted with no restrictions on the numbers of participants in foreign currency trades.

- In March 1999, all restrictions on derivatives were lifted. Banks are allowed to sell investment trusts, which were previously only offered by brokerage houses. Non-bank financial institutions are permitted to issue corporate bonds for lending purposes. Banks could may also freely sell certain types of fire and life insurance policies.

- Between September 1999 and March 2000, banks will be allowed to conduct equity businesses.

- By the end of 2001, the banking, insurance and securities industries will be allowed to engage in each other's businesses through subsidiaries.

The "Big Bang" plan is meant to promote competition and enhance the efficiency of the Japanese financial system. Nevertheless, competition from foreign financial firms will heat up dramatically. Especially at this moment, most Japanese financial institutions are struggling with bad loans and unhealthy assets. One estimate shows that Japanese banks hold about more than 580 billion USD in questionable or bad loans, more than double original estimates.

The deepening Asian crisis has intensified the economic difficulties in Japan. The huge devaluation of Asian currencies added great pressure on the Japanese economy. The Asian crisis has heightened the problem, since Japan's financial institutions have substantial exposure to the region. For instance, according to the Bank for International Settlements, BIS, Japanese banks make up 56.4 and 37.7 percent of total international lending to Thailand and Indonesia at the end of 1997, respectively. Asia's total outstanding debt at the end of 1997 reached USD 381 billion, of which 30.1 percent was held by the Japanese banks. Indonesia alone attracted 30 billion USD from Japanese investors in 1996.

The stabilization of the Asian crisis is a good piece of news for the Japanese financial sector. In addition, the implemented reforms have recently started to bear fruit. The huge amount of public capital injected into the financial firms has strengthened the balance sheets of viable banks. Domestic financial institutions themselves have accelerated the process of consolidation through mergers or take-overs. Foreign financial firms have become very active recently in the Japanese market. Although there is still a long way to go, there is now a general sense of relief that the financial reform and structural change of the Japanese economy have started.

Short-term prospects

The prospects for the Japanese economy in 1999 depend much on the effectiveness of fiscal policy. The means of monetary policy have been exhausted. The Bank of Japan lowered its overnight rate to 0.15 percent in the beginning of 1999. Interest rates have already been low for a long time. It has been suggested that Japan should inflate its economy by increasing the money supply. However, there is really not much room for effective monetary policy at this moment.

The fiscal packages announced in April and November 1998 had some effect on public investment in the beginning of 1999 when there were some encouraging signs in the Japanese economy. Finally, after a long period of contraction, GDP registered positive growth in the first quarter of this year. In the beginning of this year, housing starts had positive growth year on year for the first time in over two years, while industrial production picked up and inventories slid downwards. Construction starts were also up, with the public sector component particularly strong. In a broader context, consumer confidence is improving. Retail sales picked up at the end of 1998 and are set to improve in the coming months.

However, the road to economic recovery is still long and uncertain. The unemployment rate reached a record high level in Japan's post-war history. And household income continued to fall, despite the fillip from consumption vouchers.

Thus we expect small negative growth this year, at -0.5 percent. The key is whether the fiscal package could initiate a self-sustained recovery in the coming years. We expect better growth, at 1 percent, in 2000. But there remains a substantial risk that growth will turn negative again at the end of 1999 as the effects of the fiscal packages fade.

In the long-term, structural reform is the key to recovery. The financial sector "Big Bang" is especially important as it concerns the effective allocation of resources.

The bright point is the increase of foreign investment in Japan. In 1998, a record high level of foreign direct investment poured into Japan to take advantage of the newly deregulated markets in the service sectors, such as retailing and financial services.

Hong Kong

Basic statistics on Hong Kong, 1997

Population, million	6.5	
GDP, billion USD	173.9	
GDP growth during 1970-90	8.3	
GDP growth during 1970-90	4.0	
GDP per capita, ppp	24260*	
GDP per capita, USD	26754	
Domestic savings, % of GDP	32	
Agriculture as a share of GDP	0.2	(1980: 0.9%)
Industry as a share of GDP	16	(1980: 32%)
Services as a share of GDP	84	(1980: 67%)
Main export destinations	China, USA, Japan, Germany	
Main import sources	China, Japan, USA, Singapore	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

Hong Kong is a city-state with one of the highest levels of per capita income in the world. Hong Kong is also an important global financial centre, particularly in foreign exchange trading and the syndicated loan business.

The Hong Kong economy is very competitive. The government has adopted a policy of "positive non-interventionism". The essence of this policy is to maximise the role of markets in government policy-making. The role of the government is to maintain a level playing-field for all competitors. The government seldom interferes with business decisions and has little room to manoeuvre in either monetary or fiscal policies.

The Hong Kong dollar has been pegged at 7.74 per USD since 1984. Hong Kong has the currency board system, which means that each Hong Kong dollar issued must be backed by the corresponding amount of USD. As a result, the central bank is not able to conduct its own monetary policy. Interest rates in Hong Kong follow closely the movement of the US interest rates. As for fiscal policy, the government levies some of lowest income and corporate taxes in the world. The import tariff is almost zero. A large part of the government's revenue comes from the sales of public lands. It also spends little money on public investment. In addition, the government doesn't own any big firms. The government sector accounts for a very small share of GDP.

The Hong Kong economy is very much service-dependent. The service sector accounts for nearly 85 percent of GDP. Real estate, financial services and tourism are the most important sectors of the economy.

The economic relations between Hong Kong and China are extremely close. Since the beginning of the 1980's, Hong Kong has been the most important trading partner and source of investment for China. Hong Kong businessmen have taken advantage of low labour costs in Guangdong, the Chinese province nearest to Hong Kong, and have moved the majority of their manufacturing bases there. The importance of manufacturing for the Hong Kong economy has declined steadily. In 1980, the beginning of China's open door policy, industry accounted for 32 percent of Hong Kong's GDP, while by 1997, the share had declined to 16 percent. The other three NIE's experienced little change in this share. When Hong Kong moved its manufacturing bases to China, it retained the marketing and trade-finance functions. Thus Hong Kong acted as the trading port and the financial centre of China in the 1980's

The transfer of manufacturing bases to China made Hong Kong easily the most important source of foreign investment for China. Hong Kong's status as a global financial centre is also important for Chinese firms seeking international funding. By the second half of the 1990s, many prominent Chinese state-owned companies were listed on the Hong Kong stock market. These were commonly known as "Red Chips".

In 1998, Hong Kong experienced its worst economic recession in several decades.GDP declined by 5.1 percent, contrasting sharply with the 5.3 percent growth in 1997. The Hong Kong economy is now experiencing a rapid and painful adjustment process. Real estate prices are falling, the private savings rate is rising and domestic demand is declining. In addition, Hong Kong's service sector is enduring a sharp downturn due to the regional crisis. Tourism was hit particularly hard. However, Hong Kong's net export position has improved since the weakening domestic activity has depressed import demand.

The unemployment rate in Hong Kong rose to 5.8 percent at the end of 1998 from 2.5 percent in 1997. Hong Kong has not experienced such a high level of unemployment since 1981. Furthermore, the pace at which unemployment has increased is also unprecedented.

Hong Kong has retained the peg of the HK dollar with the US dollar. Although the Hong Kong government's intervention in the stock market in last autumn was widely condemned by international financial players, in our view the intervention was necessary and hugely successful. Not only was manipulative activity curbed and the value of the currency maintained, but also stock prices have kept rising since the end of the intervention. In sharp contrast to what many market analysts claimed at the time – that the fair value of the Heng Seng index was below 7000 and that government intervention would not be able to maintain the index above that level – the index is currently almost double that level without any government intervention. In retrospect, had the Hong Kong government not intervened, the Hong Kong market would have become an "automatic cashier" for big hedge funds and the Hong Kong would have been forced to relinquish its dollar peg, which would have subsequently intensified the Asian crisis.

After the market intervention by the government, international investors actually returned to the Hong Kong stock market, particularly after the Federal Reserve had cut interest rates in October 1998. The rise in Hong Kong dollar deposits, both in absolute terms and in the share of total deposit, is an unambiguous sign that confidence in the currency peg has returned. This should continue to reduce the risk premium on the Hong Kong dollar.

Facing the severest recession in four decades, the government tried to relieve the immediate economic pain. It unveiled a USD 10 billion tax rebate, two major projects and sweeping financial reforms in the early March 1999. A pay freeze on the 189 000 civil servants and another 140 000 employees of government-subsidized bodies was announced to cut government expenditure. In a move to help reduce the deficit and set a benchmark for sale of government assets, the Government would privatize a minority stake in the Mass Transit Railway Corporation in the next financial year. A Disney theme park (the second in Asia) might be built in one island, which is likely to greatly promote tourism in Hong Kong. Another big infrastructure project, a high-tech industry area, is under consideration. The project, often-called "cyberport" will cost USD 13 billion to build. Among all the measures, the most dramatic move is an one-off tax rebate of 10 percent of profits tax, salaries tax and property tax.

The monetary environment is also conducive to recovery. The three-month inter-bank interest rate has slid down sharply, due to the reduced pressures on the Hong Kong dollar and the Federal Reserve's rate cuts. In addition, the decline in loan growth relative to that of deposits is also a significant factor in pushing down short-term rates.

In response to the stimulus policy stances and the return of investors' confidence, asset markets have already recovered greatly. However, Hong Kong may not escape negative growth this year, but economic growth will accelerate to 2 percent in year 2000.

Singapore

Singapore is another city-state with one of the highest per capita incomes in the world. Singapore is also an important global financial centre, particularly in foreign exchange and equities trading.

Just as Hong Kong is to China, Singapore is the most prominent financial and trade centre for Southeast Asia. Singapore also has a very competitive economy, ranking 2nd during 1995-99 in a competitive study by the Institute for Management Development, IMD. However, unlike in Hong Kong, the government plays an important role in guiding the economy.

The Singaporean economy is also highly dependent on service sectors, but some manufacturing industries such as electronics or petrochemicals are also significant.

Basic statistics on Singapore, 1997

Population, million	3.7	
GDP, billion USD	96.0	
GDP growth during 1970-90	7.1	
GDP growth during 1991-98	7.3	
GDP per capita, ppp	26910*	
GDP per capita, USD	25939	
Domestic savings, % of GDP	52	
Agriculture as a share of GDP	0.1	(1970: 2.2%)
Industry as a share of GDP	34	(1970: 36%)
Services as a share of GDP	66	(1970: 61%)
Main export destinations	USA, Malaysia, Hong Kong, Japan	
Main import sources	USA, Japan, Malaysia, Thailand	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

The severe recession in Southeast Asia inevitably reduced economic growth in Singapore, which serves as a financial and business centre in the region. However, the economy of Singapore performed better than expected amid the regional crisis and grew by 1.5 percent in 1998. Growth decelerated steadily throughout the year, with the Singapore economy slipping into recession in the second half of the year. The unemployment rate surpassed 4.5 percent at end of 1998.

Singapore's exports suffered significantly due to the deepening recessions in 1998 in most parts of Asia. The relatively strong currency against other regional currencies exacerbated the decline of exports. In addition, Singapore is much too dependent on the electronics industry. Total trade shrank by 7.5 percent in 1998, led by declines in re-exports and imports.

Nevertheless, Singapore's current account surplus rose to USD 29.5 billion, as slower industrial activity, lower domestic consumption, and a decline in inventories saw fewer merchandise imports and an improved trade balance. However, the surplus was offset by a larger net outflow in capital and financial accounts, which swelled to USD 29.9 billion, from an outflow of USD 6 billion the year before, reflecting a reversal in the flow of bank and other liabilities, and smaller direct investment inflows.

The manufacturing sector shrank by 0.5 percent in 1998, against a growth of 4.5 percent a year ago. Support for the sector came largely from strong growth in the chemicals industry. The electronics industry was later affected by excess capacity in semiconductors and disk drives.

The government played an active role in reviving the economy. The overall wage level was cut by 15 percent. The government also gave tax rebates and increased public expenditure. More significantly, the government deregulated the financial market and gave incentives to multinational firms to set up regional headquarters. As the regional economies started to recover, Singapore was among the first to benefit. One indicator, the composite leading index, rose in the final quarter of 1998 while business expectations in manufacturing, commerce and services have also turned less negative. We expect Singapore to experience a significant recovery in 1999 and 2000, with GDP growth reaching 3.5 percent and 4.5 percent, respectively.

South Korea

Basic statistics on South Korea, 1997

Population, million	46.0	
GDP, billion USD	442.4	
GDP growth during 1970-90	8.9	
GDP growth during 1991-98	5.4	
GDP per capita, ppp	13080*	
GDP per capita, USD	9618	
Domestic savings, % of GDP	33	
Agriculture as a share of GDP	6	(1970: 30%)
Industry as a share of GDP	44	(1970: 24%)
Services as a share of GDP	50	(1970: 46%)
Main export destinations	USA, China, Japan, Hong Kong	
Main import sources	USA, Japan, China, Saudi Arabia	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

When the Asian crisis first broke out in Thailand, few expected to see South Korea slip into deep trouble. South Korea just surpassed a GDP per capita of ten thousand USD at the end of 1996. The OECD, the “rich man's club” had just admitted South Korea as its second Asian member. The strength of the Korean economy was also demonstrated by a number of large conglomerates that were world leaders in certain sectors, such as steel, shipbuilding, microchip, electronics, automobiles, etc. Thus the collapse of the South Korean economy not only was a surprise, but also marked the escalation of the Asian crisis.

Why did South Korea, the world's eleventh largest economy, fall into a deep crisis and have no choice but to ask for help from the IMF?

Korea's problems were mostly related to its industrial structure, the chaebol system. Chaebols, large conglomerates that are controlled by families, dominated the Korean economy. Each chaebol had hundreds of units, with very diversified interests. The five biggest, Hyundai, Samsung, Daewoo, LG and SK, contributed a significant share to total industrial output.

Over the past decade, the chaebols grew significantly by borrowing and then investing heavily in an array of business. In many cases, gaining market share was the main goal and little attention was paid to profits or returns on investments. Thus the chaebols expanded rapidly, particularly in the past several years. The average debt ratio of the five biggest chaebols was over 400 percent in 1997. However, as long as the chaebols were able to grow and find new demand, of which a significant share was from abroad, it was easy for them to get loans. The liberalisation of the Korean financial market in 1995-96 further facilitated the expansion of credit.

With easy loans from the money market, Korean companies built huge amounts of capacity in various industries. Already by the end of 1996, over-capacity was a big problem, as demand did not grow fast enough to warrant the huge investments carried out earlier. The crisis in Southeast Asia suddenly put a spotlight on the surplus capacity and over-indebtedness of Korean firms. Foreign investors started to panic, once the debt ratio of the chaebols was revealed in October 1997, even though they had had the same debt ratio for the previous few years. When foreign investors fled the country and refused to extend loans, a liquidity crisis broke out because the chaebols had many short-terms loans denominated in foreign currencies. Thus in the case of South Korea, it was the liquidity crisis that triggered the currency and banking crises.

As previously stated, South Korea enjoyed competitiveness in a number of industries. The huge depreciation of the currency further enhanced the competitiveness of these industries. Exports surged in volume terms and industrial production picked up with a vengeance. It was not surprising that South Korea later emerged as the first country to recover from the crisis.

Moreover structural changes have been taking place, thus increasing the confidence of international investors in the economy. First of all, the Korean government under the new president Kim Dae-jung took decisive measures to rebuild the financial sector and liberalise the labour market. A dozen banks were either merged or nationalised and the labour market became more flexible, though both measures intensified the severe unemployment problem.

Secondly, the government mediated the restructuring of the chaebols. Since the Asian crisis, more than 20000 small and medium sized firms have failed. Even the larger corporations have suffered significantly. But the biggest five have remained almost intact. Under these circumstances, the Korea government used the power of financial supervision to force the restructuring of the biggest five chaebols. The main point was to streamline each of the biggest five chaebols' business into three to five core industries through sales, mergers and asset swaps among each other (see box 3.3: The restructuring of Daewoo). The five chaebols also agreed to cut the number of their affiliates by half in one year. The main purpose was to allow the chaebols to concentrate on their core competencies, impose greater transparency on management and eliminate cross guarantees. The results of these restructuring measures will produce more competitive world leaders in certain areas.

The restructuring measures, as well as the original strength of the economy made international investors return with a vengeance. Korea is the first country to emerge from the Asian crisis. The Korean economy has been showing many positive signs recently. Exports and industrial production have started to pick up. Capacity utilization has also risen and inventories have declined notably. The current account surplus widened to USD 40 billion in 1998, nearly 13 percent of the GDP.

The agreement between the government and the five biggest conglomerates marked a remarkable breakthrough in economic restructuring. In addition, the government's privatization program is an important element. The authorities intend to sell their remaining stake in steel-maker POSCO this year, and to considerably reduce their stake in Korea Telecom over the next two years. The sale of 51 percent of the nationalized Korea First Bank is evidence of the government's commitment to privatization and willingness to accept foreign owner-

Box 3.3

The restructuring of Daewoo

Daewoo is Korea's third-largest chaebol. It announced its restructuring plan at the end of 1998. It intends to:

- Cut the number of subsidiaries from 41 to 10 through mergers, sales and spin-offs as well as through swaps and liquidations
- Pull out of the electronics and telecom businesses, while concentrating on trade-construction, automobiles, heavy industry and finance service
- Trim payrolls by 15000 workers
- Lower the debt-to-equity ratio from 343 percent at he end of 1998 to 181 percent by the end of 2000

Daewoo's deal to swap its electronics business with Samsung's automobile subsidiary is particularly highlighted. Daewoo Electronics Co. is the second biggest home appliance producer in South Korea. With sales of USD 2.7 billion in 1997, it has 28 assembly plants overseas. The swap would greatly strengthen Daewoo's capability to compete in the automobile market domestically and globally. Before the Asian crisis, there are over 5 car manufacturers in South Korea. After this planned swap deal, there will be only two car producers in South Korea, Hyundai and Daewoo, with annual output capacity of 3.1 and 2.2 million units, respectively. Meanwhile, Samsung would emerge as a major producer in the global electronics market.

ship. Recently HSBC purchased a controlling share of a major commercial bank, the Seoul Bank.

On the domestic front, demand is stabilizing, and the economy's contraction is beginning to moderate. With a surge in exports and stability in domestic demand, manufacturing production is also beginning to recover. Meanwhile, wholesale and retail sales turned positive in year-on-year growth after negative growth for thirteen months. Particularly, automobile sales have jumped over 100 percent. Surveys of firms have also revealed an intended increase in capital investment. Although the unemployment rate remains high, layoffs are moderating.

In the beginning of 1999, the economic recovery in South Korea was remarkable. Industrial output in March showed the highest monthly growth since February 1995. Production of semiconductors and vehicles led the surge in industrial production. The average factory-operating rate has risen steadily and inventories have continued to fall sharply. Investment in machinery and plants has risen steadily in line with strong production. Domestic machinery orders soared, compared with around 50 percent fall in 1998.

Foreign exchange reserves have surged and FDI has witnessed a big increase. FDI surged during 1998, rising from USD 0.13 billion in January to USD 1.37 billion in November. The external accounts are still Korea's strongest fundamental point. The current account surplus has resulted in a substantial accumulation of international reserves. According to the Bank of Korea, usable foreign exchange reserves reached USD 50.1 billion in January 1999. The large reserve accumulation has reduced the economy's vulnerability to balance of payments pressure.

Inflation decelerated sharply following the first-quarter jump but now is almost subdued on a month-over-month basis. Interest rates have fallen mainly because banks are flooded with liquidity. The strong external balance position helped steady the currency in 1998. It also allowed nominal interest rates to decline. Falling interest rates have helped stabilize the real economy

To boost domestic demand, the Korean government plans to lower interest rates on consumer loans, cut taxes and advance most fiscal spending to the first half of this year. The budget deficit is likely to reach 5 percent of GDP this year.

We expect the Korean economy to grow by 6.5 percent this year and 5.5 percent next year. Inflation will gradually pick up, rising from 1.5 percent this year to 2.5 percent next year.

Thailand

Thailand has made extraordinary economic progress over the last couple of decades. The economy expanded at an average rate of 7.9 percent during 1970-90. In the beginning of 1990, the economic growth accelerated reaching 8.9 percent during 1990-1995.

It was not a total surprise that Thailand was the first victim of the Asian crisis. The economy was already in a state of overheating in 1996. This was highlighted by a massive amount of unsold real estate. Soaring asset prices in the beginning of 1990s had fuelled a wave of speculation in the real estate sector.

Basic statistics on Thailand, 1997

Population, million	60.6	
GDP, billion USD	152.7	
GDP growth during 1970-90	7.9	
GDP growth during 1991-98	5.0	
GDP per capita, ppp	6700*	
GDP per capita, USD	2537	
Domestic saving, % of GDP	33	
Agriculture as a share of GDP	11	(1970: 30%)
Industry as a share of GDP	42	(1970: 26%)
Services as a share of GDP	47	(1970: 44%)
Main export destinations	USA, Japan, Singapore, Hong Kong	
Main import sources	Japan, USA, Singapore, Malaysia	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

There was no doubt that the Thai economy was overheated before the crisis. Inflation was 5.9 percent in 1996, compared with an average of 4.4 percent during 1981-90. Asset prices rose at a much faster pace. The current account deficit accounted for 7.9 percent of GDP in 1995-96. When exports slowed significantly in 1996, the shortfall of the current account balance was filled by short-term foreign loans. Many financial institutions and industrial firms were also involved in real estate investment financed by short-term, foreign loans. It was estimated by the Bank for International Settlements that the share of bank lending to the property sector in Thailand was around 30-40 percent. In addition, short-term debts accounted for 46 percent of total foreign debts, which was the second highest in the crisis-hit economies.

With long-term currency stability and the government's repeated pledge to defend the currency, a large share of these foreign loans were not hedged. When speculators attacked the currency in the summer of 1997 the Thai currency, the baht, depreciated rapidly by over 50 percent. The subsequent debt burden, as well as a severe credit crunch destroyed many banks and firms that were engaged in the real estate market. Asset prices plummeted making the repayment of the debts unlikely. A full-blown currency and financial crisis resulted.

Initially, the impacts of the Thai crisis were underestimated by most observers. Thailand itself accounted for a very small share of global output and trade. However, the Thai currency crisis quickly evolved into a major financial crisis across Southeast Asia, which further worsened the situation in Thailand.

The IMF came to the rescue. In addition to extending urgent loans, the IMF's strategy focused on two areas. The first was to tighten monetary policy, that is, to raise interest rates to attract foreign capital, stem capital flight and stabilize currencies. The IMF also stressed market mechanisms and fiscal discipline. The second was to force structural reforms, such as the overhaul of the financial sector and an improvement in corporate transparency.

The methods used by the IMF were (and still are) subject to debate. Critics claimed that the IMF strategies were part of the problem, as tight monetary and fiscal policy didn't succeed in stemming capital flight, but merely destroyed the real economy. The restructuring of the financial institutions under crisis also intensified the credit crunch. Nevertheless, the IMF defended its methods, claiming there were no alternatives to those measures taken.

Following the agreement with the IMF, the Thai government shut down 56 insolvent financial firms and required the re-capitalisation of all other financial institutions. In 1998, the government took further measures to tighten loan classifications and provision standards.

However, re-capitalising the financial institutions proved to be a difficult task. The government unveiled a package on financial sector restructuring on August 1998. Only 9 banks and 24 financial firms were allowed to continue operation, while the rest were either merged, nationalized, or liquidated. In addition, the government also provided capital to help re-capitalization and corporate debt restructuring.

1998 was a bad year for Thailand. GDP declined by 9.4 percent and private consumption plummeted by 10.7 percent. Manufacturing production contracted 10 percent. However, there were also positive signs. Farm production increased by 3 percent in volume terms and the number of overseas tourists visiting the country increased substantially.

For the entire year of 1998, export value decreased by 6.8 percent, mainly due to the drop in export prices. Actually, export volume increased by 8.1 percent. On the other hand, import values decreased by 33.8 percent, reflecting a decline in both import prices and in volume. Overall, the current account balance in 1998 registered a surplus of USD 14.2 billion, compared with a deficit of USD 14.4 and 3.1 billion in 1996 and 1997, respectively.

Thailand has made significant progress in economic restructuring after the IMF-led rescue efforts. Thailand was the first economy to fall victim to the Asian crisis. By the end of 1998, it seemed that it would also be among the first group to step out of the depression. Economic activity has stabilized, industrial production and exports have started to pick up, the current account balance is showing a huge surplus and inflation is subdued. In addition, interest rates have fallen significantly and the banking reform is proceeding.

The increased liquidity in the money market has resulted in downward adjustments in deposit and loan rates. The spread between the loan and deposit rates has also narrowed. Inflation has continued to fall. In March 1999, the Thai government announced a fiscal package of 130 billion baht to stimulate domestic demand. In addition to the increase in public expenditure on public investment and job creation, the value added tax, VAT, was lowered from 10 percent to 7 percent. This year the government fiscal deficit will reach 6 percent of GDP. Economic growth will increase greatly this year, at 3 percent. Next year the growth rate will reach 3.5 percent.

Taiwan

Basic statistics on Taiwan, 1997

Population, million	21.3	
GDP, billion USD	272.7	
GDP growth during 1970-90	8.9	
GDP growth during 1970-90	6.3	
GDP per capita, ppp	..	
GDP per capita, USD	12800	
Domestic savings, % of GDP	25	
Agriculture as a share of GDP	3	(1980: 8%)
Industry as a share of GDP	35	(1980: 46%)
Services as a share of GDP	62	(1980: 46%)
Main export destinations	USA, Hong Kong, Japan, Germany	
Main import sources	Japan, USA, Germany, Hong Kong	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

The structure of the Taiwan economy is in sharp contrast to that of South Korea. Unlike in the Korean chaebol system, in Taiwan, small and medium sized firms dominate the market. Small and medium-sized firms have to stay competitive in order to survive. They are also less capable of pursuing debt-financed expansion than large conglomorates like the chaebols. In addition, Taiwan's main export industries concentrate on high-tech industries, such as electronics and information technology. These are the main reasons why the economy of Taiwan has held up relatively well amid the regional turmoil. Whereas in 1998 most of the economies in the region contracted shparly, the Taiwan economy expanded by 4.8 percent.

The Asian crisis has nevertheless had a negative impact on Taiwan's net exports. The relatively strong Taiwan dollar and weak demand from Taiwan's main trade partners in Asia are the main reasons for the plunge in the trade surplus. Towards the end of 1998, a contraction in business investment and a slowdown in exports resulted in the deceleration of economic activity. Deteriorating asset quality hurt the profitability of the banking sector. Recently, close to a dozen listed companies reported financial failure due to too high a debt ratio and alleged stock market manipulation. Moreover, the latest money supply data have confirmed that a credit crunch is putting pressure on Taiwan's financial system.

The government has announced emergency rescue measures including the suspension of trading in the problem companies, and the introduction of a stock market stabilization fund (3 percent of total market capitalization). In addition to these measures, the central bank has aggressively pumped up liquidity and lowered interest rates. It cut the rediscount rate and raised the interest rate it pays on banks' required reserves. The central bank's aim is to further lower bank funding costs and encourage a fall in interest rates. This expansionary monetary stance will continue, as the inflation rate is very low.

Taiwan's foreign currency reserves reached USD 90.3 billion at the end of 1998. In the last quarter, it increased by USD 6.1 billion and foreign reserves have now reached their highest level since November 1995. This indicates that there is no real problem of capital flight and investors' confidence in the Taiwan economy has not faded. All in all, Taiwan will benefit from a strong US economy and the recovery of East Asia this and next years. GDP growth is expected to reach 5 percent in both this and next years.

Malaysia

Basic statistics on Malaysia, 1997

Population, million	21.7	
GDP, billion USD	98.0	
GDP growth during 1970-90	6.5	
GDP growth during 1991-98	6.7	
GDP per capita, ppp	10390*	
GDP per capita, USD	4517	
Domestic saving, % of GDP	47	
Agriculture as a share of GDP	12	(1980: 23%)
Industry as a share of GDP	48	(1980: 36%)
Services as a share of GDP	41	(1980: 41%)
Main export destinations	Singapore, USA, Japan, Hong Kong	
Main import sources	Japan, USA, Singapore, South Korea	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

The Malaysian economy was in many respeects regarded as a model economy in Southeast Asia. The economy has expanded very fast during the past three decades and it doing relatively well before the crisis. After Thailand fell victim to the speculative attack in July 1997, Malaysia also suffered from massive capital flight.

alaysia took the controversial step of imposing capital controls to contain the effects of the crisis. On September 1, 1998 Malaysia imposed strict curbs on capital moving across the border and fixed the exchange rate at 3.8 ringgit/USD. In addition, the Malaysian ringgit would become worthless outside of Malaysia from 1st October and foreign portfolio investment had to remain in the country for at least one year. These drastic moves were taken to allow the government to contain serious contagious impacts of the crisis and to sort out urgent problems in the economy.

The move was highly criticized by international investors. Many predicted at the time that the measures taken by the Malaysian government would almost certainly lead to a dual exchange rate system with the rate in the black market weaker than the official rate. Some believed that Malaysia would been cut-off from the flow of international capital for a long time. The Malaysian Prime Minister, Mahathir

Mohamad's comments that the crisis was the result of manipulations and speculative attacks by western hedge funds did not inspire confidence in western investors, either.

However, the currency and capital controls didn't destroy the Malaysian economy. Instead, the situation actually improved. The local currency stabilized, interest rates declined, exports in U.S.-dollar terms started to pick up and consumption stopped falling. Now the stock market has surged and ailing banks are being restructured.

The trade balance turned into a huge surplus in 1998. In addition, the control on capital movement stemmed capital flight. Thus foreign exchange reserves continued to increase. At the end of January 1999, foreign reserves stood at USD 27.7 billion, rising over 38 percent over the level just before the controls went into effect.

n addition to achieving an economic rebound, Malaysia has made progress in re-capitalising troubled financial institutions and solving the problem of non-performing loans. During the last few months, Danaharta, the government's asset-management organization, has worked with over a dozen different financial institutions to handle a large proportion of the non-performing loans.

In the last quarter of 1998, Malaysia was actually the best in the region in terms of export performance, with exports growth in double digits in December compared with the same period in the previous year. We expect the Malaysian economy to grow by 2.5 percent in 1999 and accelerate to 4.0 percent in 2000.

Although the Malaysian economy has weathered the crisis relatively well, the currency and capital controls have had their cost. Foreign direct investors played an important role in building up Malaysia's export industries as well as in transferring new technology. The capital controls badly dented their confidence in the Malaysian economy.

The Malaysian government emphasized that the currency and capital controls were temporary. Thus a problem will arise when the controls come to an end. Foreign portfolio investors, who held assets amounting to roughly 10 percent of the Malaysian stock market capitalization, were shocked to learn that they would be unable to withdraw their capital from Malaysia for one year. These investors may withdraw capital from Malaysia as soon as the control is lifted. This will cause another round of panic in the country.

To prepare for the possible withdrawal of funds, Malaysia has introduced a new policy that subjects principal and profits on portfolio investment to a graduated series of levies that hinges on when the funds were brought into Malaysia and how long they have stayed in the country.[8] The announced measures are limited to foreign portfolio equity investment in Malaysia – other capital account restrictions have not changed.

Malaysia's experience in dealing with the crisis is very instructive and provides a valuable point of comparison to the methods used by the IMF. The conventional measures employed by the IMF often initially cause a severe loss of output and massive unemployment. If the reason for the crisis is primarily contagion from neighbouring countries, the imposition of capital control for a limited period of time may be a viable alternative.

Indonesia

Basic statistics on Indonesia, 1997

Population, million	199.9	
GDP in billion USD	215.0	
GDP growth during 1970-90	6.6	
GDP growth during 1991-98	4.5	
GDP per capita, ppp	3310*	
GDP per capita, USD	1076	
Domestic savings, % of GDP	30	
Agriculture as a share of GDP	15	(1970: 35%)
Industry as a share of GDP	43	(1970: 28%)
Services as a share of GDP	42	(1970: 37%)
Main export destinations	Japan, USA, South Korea, China	
Main import sources	Japan, USA, Germany, South Korea	

* 1996.

Source: The World Bank, The Asian Development Bank, ETLA.

[8] Money brought into the country after February 15, 1999 is exempt from taxes on principal repatriation. Profits are taxed at 30 per cent if taken out before one year; 10 per cent otherwise. Principal brought into Malaysia on September 1, 1998, and repatriated less than seven months later, on or before March 31, 1999, is subject to a tax rate of 30 per cent, but profits are not taxed. Principal left in the country for seven to nine months from September 1, 1999 repatriated after March 31, 1999, but on or before May 30, 1999) is taxed at a 20 per cent rate, but the tax on profits is again zero. Principal held for nine to 12 months from September 1, 1999 (repatriated after May 30, 1999, but on or before August 31, 1999) is taxed at 10 per cent but the tax on profits is zero. There is no tax on the principal invested in Malaysia on September 1, 1998, if the funds remain in the country for more than 12 months, but profit remittances are taxed at 10 per cent. The tax treatment of this group is equivalent to that on investments undertaken after February 15, 1999, and left in Malaysia for more than one year.

Indonesia is the biggest country in Southeast Asia, in terms of territory, population and national output. However, in terms of per capita income, Indonesia is among the poorest in the region.

The collapse of the Indonesian economy during the Asian crisis demonstrated the importance of political and social aspects with regards to economic performance. Indonesia had been ruled by president Suharto for 32 years.Under the Suharto dictatorship there were enormous problems of social tensions among various races and religious groups as well as political oppression. The Suharto family was alleged to be involved in vast amounts of businesses in Indonesia.

The Asian crisis dealt a big blow to Indonesia and quickly revealed all these problems. The mismanagement of the economy was also further magnified. Initially, the Suharto regime took seemingly decisive measures to rescue the economy. Indonesia negotiated with the IMF and closed down several insolvent banks. But the reopening of one of these closed banks controlled by one of Suharto's sons scared international investors. The implementation of the rescue measures such as the breakdown of state monopolies and the rise in interest rates were simply too painful for the ruling group to swallow.

At one point, the Suharto regime planned to introduce a currency board system to defend the currency. However, the plan was later rejected as unfeasible. The IMF rescue package imposed strict conditions on the restructuring of the economy and forced an immediate increase in interest rates. The tightening of fiscal policy lowered the subsidies on essential goods, which resulted in soaring inflation. Massive unemployment and popular resentment led to violent and often bloody mass demonstrations which finally forced Suharto to resign in the middle of 1998.

The then vice president, Jusuf Habibie became the new president. This did not entirely stop the social unrest. Nonetheless, the situation has gradually stabilized.

The Indonesian economy collapsed in 1998. GDP contracted severely, by 13.7 percent. Meanwhile, inflation soared by 57.6 percent, largely due to a surge in prices of essential goods.

Business investment led the decline in economic activity. Capital flight continued and foreign direct investment plummeted. Private investment plunged by 40.9 percent in 1998, and the approved foreign investments fell nearly 50 percent from last year.

Although exports continued to slide, the sharp decline in imports resulted in a large improvement in the trade surplus. The current account continued to improve due to depressed import demand and a sharply depreciated currency.

The recovery of the economy depends very much on the democratic process in the country. The first peaceful democratic elections in June 1999 were very promising. We expect a much less negative change of national output in 1999, at -1.0 percent. In 2000 the economy fully recover and reach a growth rate of 3.5 percent.

Long-term Prospects

The worst of the Asian crisis is clearly over. While the East Asian economy is still in a process of recovery, it is too early to assess the overall consequences of the crisis on the future development of the Asian economy. Nevertheless, judging from what has happened or is happening in East Asia, it is possible to make some conjectures about future economic development.

The main conclusion is that after the crisis, the East Asian economy is on a more solid basis for sustained growth. The crisis has served to reveal some of the backward features[9] of the Asian economy and to correct parts of them. The structural reforms undertaken in many East Asian countries have made them more open, competitive, transparent and rule-based. All these translate into a healthier economy in the next century.

East Asia is becoming more open to foreign investment and competition. Before the crisis, restrictions on foreign ownership were common in most East Asian countries. Particularly the ownership of financial institutions was restricted.

The financial institutions in East Asia have improved since the crisis. Most countries have reformed their financial institutions and have strengthened their system of supervision through the central banks. Commercial banks are being forced to use more prudent methods to manage their books. The whole financial system is becoming more transparent. Korea and Thailand have introduced serious measures to re-capitalise banks. Short-term private foreign debt has been reduced significantly. And corporate restructuring is under way.

[9] Various forms of monopoly and rent-seeking behaviors by the policy makers were not rare in East Asia.

With the exception of Japan, most of East Asia is still in the process of industrialisation. Japan has entered the stage of post-industrialisation. The NIE's have mostly gone throught the process of industrialisation and are on the threshold of becoming wealthy societies. The industrialization in Malaysia and Thailand has taken off, and is proceeding. China, Indonesia and other economies in the region are just about to take off or are in the middle of taking-off. Thus in this grand process, the growth potential of the less developed economies is tremendous. With huge populations and rich natural resources, the possibility of long-term sustained growth in most East Asian economies is still high.

In this respect, China's potential for sustained high growth will be particularly huge, if the Chinese government continues to pursue market-oriented reform and open door policy. China has laid a solid foundation for continuous change towards a market economy for the past twenty years. Private and other non-state sectors already account for a majority share of national output. Physical bottlenecks to further economic development are not as significant a hindrance as before, but the lack of a "rule of law" and increasing environmental problems have become primary concerns for long-term growth. Political and social stability is certainly important in the current situation, however, the abuse of power or corruption by officials not only deters economic development, but also endangers social stability. Thus reforms on the social and political fronts also need to proceed.

Japan has suffered almost one decade of sluggish growth in the 1990s. Now Japan is starting to seriously consider structural reforms to its economy. The difficulties in the economy prompted many in Japan to re-consider its financial system, education system, corporate governance culture and attitude towards foreign investment. Japan has the ability to change and the beginning of next century will see a more open market and a more flexible economy in Japan.

Although the NIE's had different experiences during the Asian crisis, the long-term prospects for these economies are bright. Taiwan and Singapore have withstood severe shocks and have managed to achieve positive growth in 1998. This fully reflects the flexibility and viability of these two economies. After the crisis, these two economies will continue to perform well. Although South Korea and Hong Kong suffered huge output losses, the fact that both economies recovered quickly after huge shocks demonstrates the competitive natures of these two economies. These four economies have all found their niche areas in the regional as well as global economy. To sustain long term growth, Hong Kong needs to reduce the cost of doing business in the territory and to strengthen its status as the "port of China". Singapore needs to create a freer and more competitive environment for multinational firms. South Korea needs to restructure its corporate system and create more concentrated and competitive enterprises. Taiwan needs to sharpen its technological capability and become more innovative, as the economy is more and more dependent on high-tech products.

In Southeast Asia, Malaysia is in the best relative position. The currency and capital controls are likely to be phased out in the near future, when the East Asian economies recover. If the restructuring of the banking sector remains on course, the export industries will resume their vigour and domestic demand will steadily increase. The main task for the government is to regain the confidence of international investors. Actually, fast economic growth and better investment opportunities will do more than anything else to attract foreign investment.

Thailand was praised by the IMF for pursuing vigorous structural reforms. Foreign investors have started to pour a large amount of capital into Thailand. The banking sector reform is the key to the success of the restructuring of the economy. The participation of foreign banks in the domestic financial market gives reason for optimism. Indonesia will face a tougher task rebuilding the economy, or on a deeper level, rebuilding the while nation. The Asian crisis may serve Indonesia well, as the old political system and social order were destroyed during the crisis. If the democratic process continues in Indonesia, the huge potential of the economy will be realised. Endorsed with rich natural resources and a large population, Indonesia has huge potential in sustained and high growth. Although road to a more democratic and stable society is long and uncertain, the recent peaceful general election gives reason for an optimistic outlook.

The quick recovery of some crisis-hit economies has demonstrated the resilience of these economies. The East Asian economies will not experience the sluggish economic performance that Latin America went through in the 1980s.

In order to sustain long term high growth, East Asia also faces several challenges.

It is of primary importance for the East Asian economies to upgrade their technological skills and to transfer from labour-intensive industries to more knowledge-intensive sectors. Competition in labour-intensive products from the Chinese and Indo-Chinese economies pose a huge threat. The massive amount of surplus labour in China makes it extremely hard for other economies to pursue growth strategies led by labour-intensive exports.

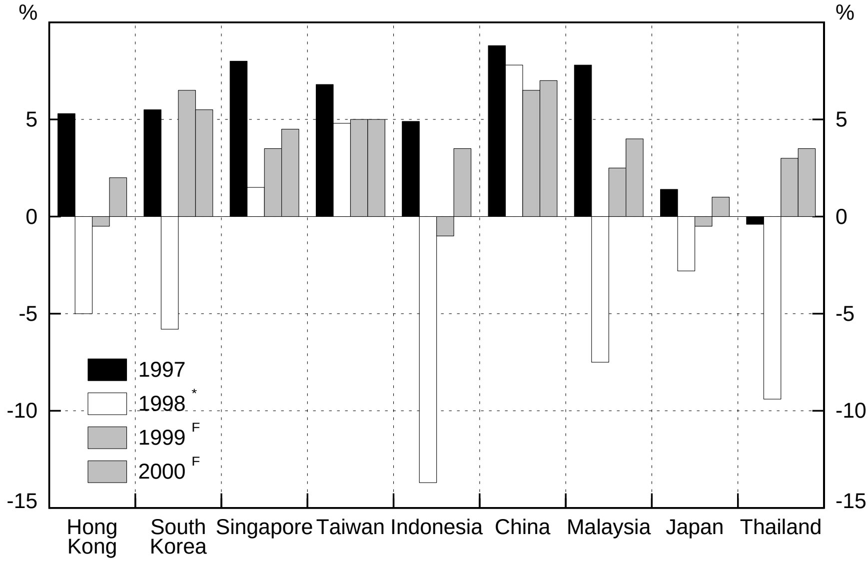
On the other hand, Japan is the most advanced economy in the region. Japan has a huge amount of surplus capital and excels in technology and manufacturing. Thus other economies in the region will have to specialize in certain areas where they enjoy a competitive advantage. In the financial services sector, Hong Kong and Singapore have a unique advantage. The Southeast Asian countries could concentrate on electronics and other manufacturing industries that might be transferred from Japan and the NIE's. Beside their rich endowments in natural resources, the agricultural and tourist industries could be strengthened. Of course, there are plenty of areas in which an individual country could over-take the more advanced ones. The advancement of the South Korean industries has challenged the leading role Japan has played in certain areas for long time. Taiwan excels in computer-related industries.

The Asian crisis has revealed the vulnerability of an overall dependence on exports. The tradition of export-oriented strategies in East Asia has been critically reassessed since the crisis. Now is the time for Asia to move away from a primarily export-led strategy to a more balanced development strategy. East Asia has a huge population with enormous purchasing powers. The industrialization and urbanization will naturally stimulate domestic demand. However, there is much room for investing in human capital in East Asia. Education, medical care and social services are among the weak points of East Asian society. More investment in these areas will further promote growth in domestic demand and ensure long-term growth.

Finally, regional cooperation needs to be intensified to promote growth and to cope with future disturbances.

Regional cooperation in East Asia has developed spontaneously from mutual dependence to the vertical division of production and labour. It is a result of free trade and capital transfer within the region, rather than any deliberate efforts by the governments. The different stages of economic development in different countries and the changing pattern of comparative advantages in countries over time are the main forces behind the regional cooperation framework. Intra-regional trade and investment are the main vehicles for fulfilling the formidable task of transferring certain industries from more advanced economies to less advanced one.

Chart 3.2 Real GDP growth in 9 Asian economies



Source: ETLA.

Intensifying regional cooperation and the inability to cope with the Asian crisis justify the calls for a formal institutional framework within East Asia. Proposals have been made for various forms of economic unions to promote regional welfare. A formal institutional framework may further foster economic growth in the region if it can deepen the division of labour in the region and strengthen the competitive advantages of the individual economies involved. Somehow, whatever regional economic zones may come into being, it is certain that a freer and more open regional cooperation system is the right choice.

4

INVESTING IN CHINA

Jyrki Ali-Yrkkö

知己知彼
百战不殆

Know yourself and know your opponent,
and you won't be beaten even in a hundred battles.
Old Chinese saying

In this chapter, we first go through some prior studies concerning business in China. After that, the rest of the chapter focuses on Finnish companies and their experiences in China. We begin by giving a broad overview of the operation of business units, and continue by looking at the determinants of their investment decisions. Next, we consider the success of business units and the factors behind the outcomes. Furthermore, we focus on special topics which are good to take into account if some company is going to establish a unit in China. The last two sections conclude and consider future challenges to foreign companies in China.

Previous Studies of Business in China

Since adopting the open door policy towards the outside world in 1979, China has approved more than 300,000 foreign firms. The rapid expansion of inward foreign direct investment (FDI) has left China the second largest host country for FDI between 1993 and 1997 (UNCTAD 1998). Record levels of investment poured into China in 1996 and 1997. While an earlier flood was led by Hong Kong and Taiwan manufacturing investment geared towards the export market, the new wave involved a much higher proportion of American and European companies looking to sell in China.

The increased significance of China for world business has led to a large number of studies concerning the Chinese business environment. The spectrum of literature covers issues like the expansion of MNC (multinational companies), joint ventures, profitability and management.

Almost all major MNCs have taken positions in China. They have also expanded their operations as they obtain more experience. The global market expansion is a sequential process where each stage includes unique characteristics with new challenges (Table 4.1). for successful expansion it is necessary to closely monitor the environment in order to recognise opportunities and threats.

A large amount of literature concerning foreign companies' operations in China deals, unsurprisingly, with joint ventures. The joint venture has been the dominant foreign entry mode in China, accounting for 71 percent in 1995 and 69 percent in 1996. Multinational companies (MNC) have often used joint ventures or alliances in newly emerging economies. The help of a local partner is often seen as essential for successful entry. Moreover, Chinese regulations and legislation favoured a joint venture as the operation mode of a foreign company. Recent developments have, however, created a downward trend in joint ventures. Due to the difficulties in co-operation between part-

Table 4.1 Stages of global expansion

	Key concerns & objectives	Mode & scale	Operations managament	Marketing startegies	Human resources
Preparation	Market research, estimation of demand, political risk, financial feasibility	Middlemen, service, offshore office, representative office with a small staff	Market research, feasibility study, transaction cost analysis	Advertising and promotion to create consumer need awareness and to stimulate demand	Middlemen, expatriates, training, relocation support and performance
Entry	Establish beachhead operation, transfer of capital and management, ensure smooth transition	Single local market, representative office and the first joint venture	Transfer capital, equipment, technology and personnel, business plan implementation	Focus on brand recognition and consumer preference, establish distribution channels	Expatriates & bilinguals, transfer of technical and managerial know-how
Expansion	Sales growth, market share, new product development and distribution	Expand to other regional markets, establish national headquarters, increase local partnerships	Localise supplies and production, management iniative and motivation, and meeting competition	Encourage brand preference, expand distribution network, manage channel relations	Combination of local and expatriate management, team building and increased training of locals
Experienced	Customer loyalty, competition, co-ordination and rationalisation	Expand to marginal markets, wholly owned subsidiary	Co-ordination among branches, achieve cost effectiveness, and improve post-sale service	Sales force development, focus on consumer promotion and post-sale service	Localisation of human resources, motivation and creativity, long-term human relation development

Source: Cui (1998).

ners, more and more companies have started to favour whole-owned business units.

The success of an international joint venture depends heavily on the choice of local partner. Before choosing the partner, it is essen-

Table 4.2 Criteria for partner selection

Strategic attributes	Organisational attributes	Financial attributes
Marketing competence	Organisational leadership	Profitability
Relationship building	Organisational rank	Liquidity
Market position	Ownership type	Leverage
Industrial experience	Learning ability	Asset efficiency
Strategic orientation	Foreign experience	
Corporate image	Human resource skills	

Source: Luo (1998).

tial to identify the required characteristics for partner selection and the relative importance of the criteria. The criteria for partner selection can be divided into three categories, namely strategic, organisational and financial (Table 4.2).

Strategic attributes include marketing competence, relationship building, market position and corporate image. Organisation related criteria mirror things issues such as organisational leadership, ownership type, learning ability, foreign experience and human resource skills. Financial attributes include profitability, liquidity, leverage and asset management. Luo (1995) and Shankar (1990) have stressed the importance of the local partner's marketing competence. Particularly skills in personnel direct marketing are essential to the market performance of a JV in China (Luo 1995).

Some studies (see, e.g., Luo 1998) have considered the benefits and caveats of the different ownership modes of Chinese partners. State-owned companies usually have an advantage in terms of industry experience, market power and production facilities. They may also have privileged access to state-instituted distribution channels. On the other hand, non-state-owned companies usually have greater strategic flexibility and fewer conflicts within the company (Luo 1998).

Due to the careful selection process required, finding a suitable partner usually takes 1-2 years. Furthermore, proper negotiations will require plenty of time; for different cultural backgrounds and economic starting points make negotiations more complex. Also, the Chinese partner must inform its administrative branch (Kaukonen 1994). It has to deliver a lot of information about the JV to both local authorities and, in some cases, the central government.

Eiteman (1990) gave some suggestions for joint venture negotiations. Firstly, he recommends that one should let the Chinese partner know that there are also other countries interested in getting the investment. Secondly, the negotiating team should stay together for the several years that negotiations might take. Thirdly, express clearly whether you are producing in China for the domestic market or for export. Fourthly, keep the alternatives clear. Don't succumb to the idea that an eventual investment in China is essential.

In order to avoid problems in the future, it is important to put as much in writing as possible (Davidson 1987). Furthermore, avoiding an abstract level by concretising and using examples make the co-operation easier in the future. It also is good to agree on the terms of employment of expatriates and the role of the auditor (Kaukonen 1994).

Even after going through a careful process of partner selection, problems in co-operation may appear. Several studies have revealed the difficulties and problems firms have faced.

Problems arising from the different objectives of partners are common. Expectations of the local and foreign partner from a joint venture are different and may be incompatible. The Chinese partner's aim is often to obtain advanced technology and to promote exports,

Table 4.3 Localisation of managers in some large companies in China

	ABB	Ericsson	Unilever	Hoechst
Number of employees in China	3000	2500	5000	3680
Number of managers	200	240	230	213
% of which are local managers	60 %	50 %	65 %	73 %
Training target, per annum	7 man-days	5 man-days	10 man-days	Not available
Evolution	Plan to increase localisation ratio to 92 %	Localisation plan: 60 local managers promoted every year	Only a few key functions will remain in expatriate hands	Plan to increase localisation degree and to keep only a few key functions in expatriate hands

The data is based on interviews, 1996.
Source: Lasserre & Ching (1997), modified.

while the foreign partner may wish to achieve lower productions costs or to enter China's domestic market. Conflicts have also appeared in issues such as staffing, technology, source of inputs, quality requirements and the target market (Martinsons & Tseng 1995, see also Hamill & Pambos 1996). The JV will not be a success story if both parties are trying to get separate benefits from each other rather than jointly develop the business by working together (Hamill & Pambos 1996, Tai 1988).

In addition to joint ventures, managing people in China has also interested researchers. Numerous previous studies have highlighted the problem of the unavailability of skilled employees (see, e.g., Harvey 1996, Cui 1998, Sergeant & Frenkel 1998). Keen competition in the labour market for skilled employees has led to wage inflation and the high rotation of employees. Due to the scarcity of qualified personnel, a number of companies train local employees themselves. The greatest challenge is to teach the Chinese managers how to run a profit-oriented operation (Davidson 1987). Although many foreign companies still maintain expatriate managers, a localisation of management has become essential for continuous growth (Cui 1998, see also Siu & Darby 1995). The localisation also reduces expatriate costs and offers better career prospects for local employees (Lasserre & Ching 1997).Thus many large MNCs operating in China have a substantial proportion of Chinese managers (Table 4.3). Despite increasing localisation, most companies, however, want to keep some control in expatriate hands.

The literature also covers studies focused on expatriate choices and problems which expatriates have faced. In many cases, unsuccessful expatriate choices have been based on technical and managerial skills without considering the cross-cultural adaptability of potential expatriate managers (Sergeant & Frenkel 1998). According to Björkman and Schaap (1994), many expatriates have faced problems when they have tried to build relationships or transfer western style management practices to China.

The hardships and problems have also affected performance. The empirical evidence suggests that making a profit in China is not an easy task. The failure rates of joint ventures have proved to be high (see, e.g. Swierczek & Hirch 1994, Willet 1992). However, there are also opposing cases. In 1984-85, about two-thirds of the 47 US companies having a JV in China announced that they had achieved their performance expectations (Davidson 1987, see also Osland & Cavusgil 1996, Stelzer et. al. 1992).

So what is the key to success in China? A number of studies have given different kinds of suggestions. Most of them have stressed the importance of relationships (Hamill & Pambos 1996, Martinsons & Tseng 1995, Tai 1988, Luo & Chen 1997, Sergeant & Frenkel 1998). According to Tai (1988), it is essential that a foreign company should not aim to make money fast. A company which considers entering the Chinese market should have long term objectives and be able to afford to wait years to make profits.

As one expatriate answered the question about his company's performance "S*uccess cannot be determined on a traditional time frame. Ask us in five to seven years"* (Eiteman 1990). According to Aiello (1991), the key variable determining a MNC's profitability in China is the ability of the parent to sell commodities to the subsidiary.

During last few years, a number of foreign companies have established wholly-owned companies instead of joint ventures in China. These companies wanted to avoid the potential problems between the partners in a JV. The wholly-owned company as an operation mode has also become more attractive, since many restrictions and regulations have been removed. The Chinese authorities have also noticed the problems of JVs, and they have given more possibilities or alternatives to foreign companies.

In the following sections, we will study the experiences of Finnish companies in China in order to obtain a more concrete idea of the main pitfalls and opportunities that foreign companies may encounter in China.

A Broad Overview of the Finnish Companies in China

The importance of Chinese business to Finnish companies has risen in recent years (see box 4.1: Case Nokia – the significance of China is growing). In 1998, China accounted for 3 percent of Finnish exports. The main products were telecommunications equipment. In addition to exporting, a number of Finnish firms have units in China.

In this study, we have surveyed the activities of Finnish firms operating in China in order to understand the main issues which they have faced on the Chinese market. The material for this was obtained through interviews and a questionnaire (see Appendix). The study con-

Table 4.4 Most important Finnish companies with a production unit in China

	Business sector
Nokia	Telecommunications
Kone	Elevators and escalators
Valmet	Paper and board machinery
Neles Controls	Valves
Elcoteq	Contract manufacturing
Santasalo-JOT	Industrial Gears
Reima-Tutta	Garments
Polarcup	Food packaging
Outokumpu	Copper products
KWH Pipe	Piping

centrates on firms which have invested in China, i.e. firms which do not have any business units in China are not included.[10]

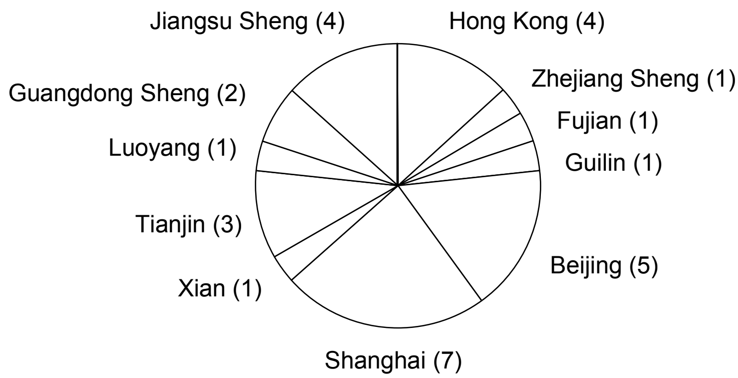
There are about 120-150 Finnish business units operating in China. Some 30 of them are production units, about 50 are sales and marketing units and the rest are representative offices. The number of production units will increase in the near future, for a number of the Finnish firms have ongoing plans to start production operations in China. The Chinese units of the Finnish firms operate in numerous industries, but most of them, however, are somehow related to the telecommunications or the metal and engineering industry (Table 4.4). In addition to manufacturing companies, there are also companies operating in the service industry, e.g., consulting, maintenance and software development.

Finnish companies have became interested in investing in China as recently as the 1990's. In late 1980's, most of the Finnish units in China were representative offices or marketing and sales units. One exception was Raute, which established a production unit there in 1984. Since 1993, the number of the Finnish production units has increased considerably. In addition to the production units, the number of the

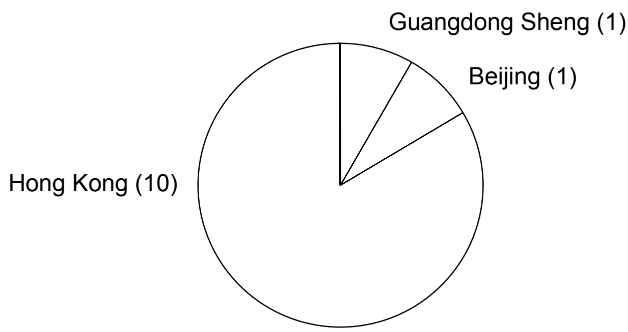
[10] The list of Finnish companies operating in China was collected from different sources, including the Finnish Foreign Trade Association, and commercial representatives of Finland both in Mainland China and Hong Kong. The total number of foreign units was 122, and the number of parent companies was 57. The whole research population level 44 per cent of the foreign units, and 67 of the parent companies returned the questionnaire. In addition to the mail survey, we also interviewed the representatives of some companies both in China and in Finland.

Chart 4.1 Business units by area, frequencies

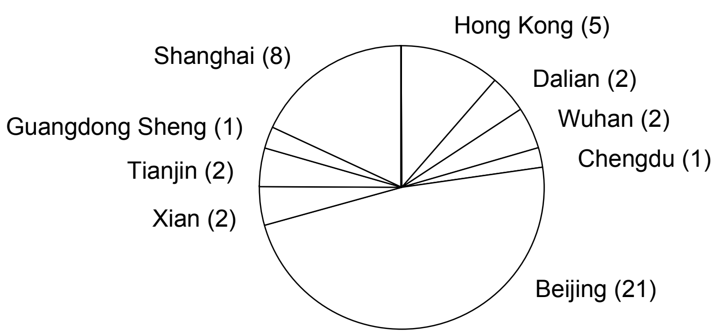
Production unit



Marketing and sales



Representative office



representative offices has also risen, as many companies have established these offices in order to promote their business in China.

The location of different types of business units deviates from each other. While most of the representative offices are located in the big cities of Mainland China like in Beijing or Shanghai, almost all the marketing and sales units are located in Hong Kong (Chart 4.1). Production units have been distributed in a much wider area than representative offices or marketing and sales units. One reason for this lies in differences in cost levels. Land, rent and construction costs are considerably higher in big cities like Beijing and Shanghai than in other areas like, e.g., Xian or Tianjin. In addition, labour costs may be even ten times higher in the metropolis' than in the countryside.

In the near future, the production units will be established more in the smaller cities than in Beijing or Shanghai. Most of them will be located in areas designed for foreign companies like in industrial parks and special economic zones. Infrastructure in these areas is more developed than in other areas.

Why Do Companies Invest in China?[11]

An investment decision consists of several factors. Companies seek an area which provides a competitive environment with a number of beneficial features. No one factor alone is able to explain the foreign activities of multinational companies. Furthermore, different companies give weight to different factors. While some companies seek, for example, market or potential demand, some others search for access to natural resources or aim to lower production costs.

A number of factors have been suggested as the main explanations for foreign direct investments. The most common determinants include market size, wage rates, duties and tariffs, country risk and distance to market (literature survey, see, e.g., Dunning 1993).

We asked the Finnish companies how different factors have affected their investment decisions. In table 4.5, the motives to invest have been divided into the following three classes: market seeking investments, resource seeking and cost factors, and other factors (see Dunning 1992).

---

[11] This chapter is based on Ali-Yrkkö (1999).

Box 4.1

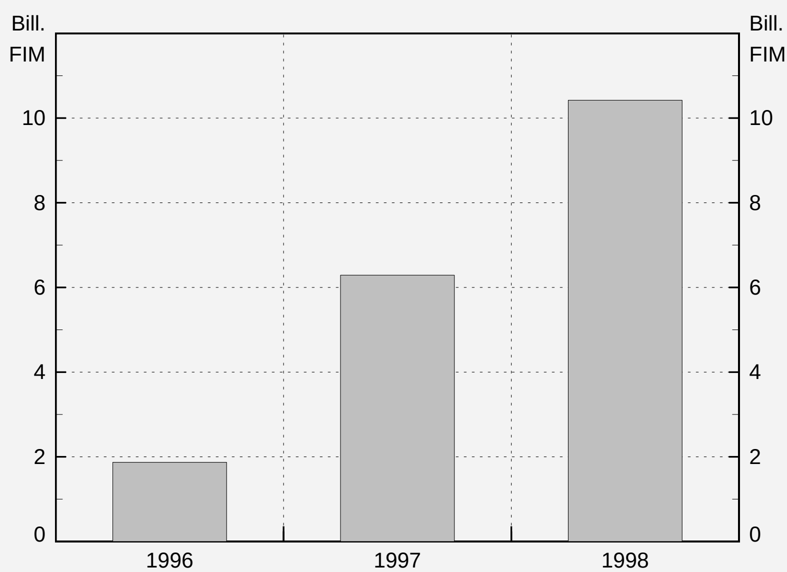
Case Nokia – the significance of China is growing

Nokia is the best known Finnish company operating in China. At the end of 1998, the Asia Pacific area accounted for 23 percent of Nokia's sales. With 6 joint ventures and one wholly owned company it has more than 3000 employees in China. The first representative office was established in Beijing in 1985 and the first joint venture in 1993. In addition, nowadays Nokia has a global R&D unit in Beijing. Nokia sells various products in China including wireless networks, fixed networks and mobile phones.

The GSM business of Nokia started in China after Nokia got their GSM-systems on the certification list of the MII (Ministry of Information Industry). After the certification Nokia was able to make offers to the PTA's (Post and Telecommunication Administration). The first delivery was made to the Beijing PTA in 1994. Initially, all products and equipment related to the GSM were imported from Finland. Since then, Nokia has established several production plants in China.

The importance of China for Nokia has increased year after year. In 1998, China was the second largest market area (USA was the largest).

Net sales of Nokia in China



Market seeking motives

Market seeking has been the most important motive in investing in China. The huge market size combined with the rapidly growing economy has attracted firms into China. The presence of competitors has also affected firms' investment decisions and pulled more foreign companies into China. Postponing the investment decision would have given the competitors too large an advantage, particularly since it's a well known fact that things take time in China, i.e. creating the right relationships takes time.

Resource seeking motives

In addition to an interest in selling products to the Chinese market, a number of companies have had plans to start exporting from China to other countries. Motives to export are twofold. On the one hand, companies try to seek new customers, but on the other hand, a part of these exports to third countries will substitute for the exports of the group's other units. One reason for the substitution may be lower production costs. Particularly cheap labour costs reduce manufacturing costs in China. In many cases, companies just switch the production area without any change in the total turnover of the company. However, the availability of skilled workers is not self-evident, thus it may be difficult to find qualified personnel, particularly in special economic zones and big cities.

Another reason for switching the location of production is to shorten the distance to the market. Transporting heavy raw materials inflicts high costs which can be avoided by using local sources. Therefore, the availability of local raw materials is essential for some firms. Particularly base industry companies are dependent on locally produced raw materials. Some of these and other companies also stated that the high price of energy had a negative effect on their investment decisions.

Tax and other fiscal incentives offered by the host government have also contributed to investments. The traditional protectionist instrument of governments has been to impose tariffs and customs duties, and China has also used these instruments in order to restrict imports. Foreign companies can avoid these payments by establishing local production in China. Furthermore, the government has attracted inward investments by offering different kinds of tax relief. Tax holidays have also contributed the investment decisions of the Finnish companies. The taxation system has not been a major determinant, but the tax holidays have provided an additional incentive to establish a manufacturing unit in China.

Other factors

A number of the companies had exported to China before they started a manufacturing operation. This follows the idea of the stepwise internationalisation process, meaning that after exports operations the company will move to more demanding operation modes such as manufacturing abroad (Luostarinen 1970).

The evidence on the effects of previous technology transfer on investment decisions is mixed. In some cases, the earlier technology transfer encouraged the company to invest in China. The Chinese company wanted to co-operate with the initial provider of the technology. In these cases, the foreign company has developed an excellent position for joint venture negotiations. On the other hand, the technology transfer has also had negative effects. The transferred technology has provided a chance for the Chinese company to compete against the original supplier on the same market. The initial provider has lost its ability to compete against local competitors with similar technology but with lower production costs and better relationships.

In addition to these factors, more and more medium size companies invest or will invest in China in order to follow their global customers. The Chinese operations of the main customers pull their suppliers and subcontractors into the same market.

Why not invest in China?

After consideration, a number of the Finnish companies have decided not to invest in China. One of main reasons for the negative investment decision seems to be the consequences of the Asian crisis. Firstly, the potential market has diminished, and the expected growth rate of GDP is not so fast anymore. Secondly, China has partially lost its relative competitiveness to other Asian countries. For instance, due to the devaluation of the won, South Korea has become a competitive place to start a production operation. Furthermore, some companies are scared of the possibility of devaluation, and therefore their investment decisions have been postponed.

Another determinant affecting a negative investment decision is the lack of sufficient information about the Chinese market. Mar-

Table 4.5 Factors affecting the investment decision (production units), frequencies, N=20

	Very positive 2	Positive 1	No effect 0	Negative -1	Very negative -2	Mode
Market seeking						
High demand	13	5	2	0	0	2
Main competitors	6	10	4	0	0	1
Finding a good partner	7	5	2	4	2	2
Co-operation with the partner	5	5	5	2	3	0
Resources and costs						
Contacts with subcontractors	1	4	12	3	0	0
Price of energy	0	4	10	4	2	0
Availability of raw materials	3	6	9	2	0	0
Labour costs	8	10	1	1	0	1
Availability of unskilled workers	1	5	9	4	1	2
Availability of skilled workers	0	11	5	4	0	1
Transport costs	1	4	7	4	4	0
Tax relief	2	13	4	1	0	1
Customs duties and tariffs	3	8	5	3	1	1
Other taxation	0	7	11	2	0	0
Production for export	2	12	4	2	0	1
Other factors						
Efficiency of work force	0	4	4	11	1	-1
Company's earlier technology transfer	2	3	9	5	1	0
Earlier exports	3	8	6	3	0	1
Legislation	0	3	9	7	1	0
Financing	0	5	9	4	2	0

keting studies and research play an important role in a successful entry to China. Furthermore, obtaining accurate market information is a problem.

Some companies have carried out market studies for their products, and noticed that there are no markets for their goods. Moreover, there are also cases in which the market study has revealed that the price level required to be able to compete against local companies was too low (See boxes 4.2 and 4.3).

Box 4.2

Company Y – why not to invest in China

Company Y is part of a world wide, well-known electrical equipment manufacturer and engineer with more than 2000 employees in Finland. The turnover of Company Y in 1998 was 3 billion Finnish marks.

The first visit to China by the representatives from Company Y was made in 1993. Afterwards, the top management of Company Y decided to study the possibility of establishing a joint venture (JV) in China. The final decision to support financially the implementation plan of a JV was made in 1995.

There are several reasons that made Company Y decide to have a JV in China. Firstly, the difference in manufacturing costs between Finland and China is high. In China there are about 10 local manufacturers in the same field of business as company Y and the production costs of Chinese local manufacturers are much lower than in Finland. These 10 Chinese local manufacturers are located in different provinces with their own market areas and market shares. A JV with the local manufacturer, would make it possible to enter a target Chinese market area. The local partner's inventory and infrastructure facilities could be utilised as well. Secondly, although such special equipment and machines made by Company Y had not yet been produced locally in China, the import duties, manufacturing costs in Finland and distance related costs, e.g. transportation, delivery, insurance etc. made exporting to China difficult. In addition, the need for local technical support and the presence of demanding Chinese local end-users made Company Y determined to have a JV in China. Thirdly, special requirements oflocal customers , such as terms of payment because of the lack of foreign currency, the Chinese internal power and authority system preference to import equipment from abroad had to be considered. Furthermore, exporting to China generally is done through on-going project s and sub-contracting in China. This is result of a special characteristic of theChinese market in which sales are based more on personal relations and contact than in western business to business practice.

Therefore for Company Y's products, which are electrical components, selling from Finland directly to China was difficult. The local JV would make this easier, particularly if Company Y's local JV could offer local end-users competitive quality and acceptable prices.

Company Y had several key criteria for choosing local Chinese partners:

1. The partner candidate should have a significant local provincial market share.

2. The market in the partner candidate's province should be sufficient and well developed. From the viewpoint of the whole market in China, the market share of the partner candidate's province should be high as well.

3. The partner candidate should a high level of technology. The partner candidate's current production or products should be compatible with Company Y's.

4. The partner candidate's financial situation should be good, and debts in banks and obligations to employees should be healthy.

5. The partner candidate should basically be interested in having a JV with Company Y. The partner candidate should be actively co-operative, and facilitate the required documents and materials requested by Company Y.

Due to their high market shares in China and good infrastructure facilities, two partner candidates in the north-western and eastern parts of China were considered. A letter of Intent (LOI) was signed with one Chinese local partner candidate in 1995. However this partner candidate did not deliver the LOI to the local authority to continue the establishment procedure. This partner candidate was not determined to have a JV with Company Y. It was not confident that a JV with Company Y would be profitable. Then Company Y started to negotiate with other local partner candidates. Meanwhile, a comprehensive Chinese local market study was carried out and completed in March 1998.

The market study showed a negative result regarding the overall local market and the partners' situation in China. Firstly, Chinese local manufacturers, which are owned by the Chinese state, are financed by Chinese banks rather than by the market. Chinese banks are owned by the Chinese state as well. This does not allow Chinese manufacturers to have a healthy financial situation. Secondly, the total cost is not calculated correctly. The overall pricing situation in China has ruined the market, i.e. the market price does not cover the total cost of the JV plus the profit requirement. Local Chinese manufacturers are surviving by increasing their debt in Chinese banks. This also makes the terms of payment very difficult. It may take a very long time to receive your payment after you sell your products. Moreover, a JV will result in many lay-offs from the local partner's factory, and the local partner candidate often has a requirement to be able to cover the laid-off employees' compensations from the profit of the JV. Other important results of this market study, such as the lack of a transparent legislation system in China, high-contextual information exchange and the lack of rules and regulations in Company Y's field of business made it clear that it would have been difficult for a JV to be profitable after its establishment.

Therefore, even if the second Chinese local partner candidate was willing to have a JV with Company Y, Company Y decided to withdraw its plan to have a JV in China.

There are about 5-10 major international manufacturers in the same business line as Company Y around the world. At the moment there is no JV in China yet. Company Y knew that at about the same time when it was negotiating in China, other international manufacturers were doing the same thing. However in the end, it seems that these international manufacturers have drawn similar conclusions as Company Y.

Note: The case has been written by Erlin Yang, Ph.D., China Tekway Oy Ltd.

Box 4.3

ERKA Oy – why not to invest in China
Silokalliontie 3
04250 Kerava

ERKA Oy is a Finnish company which produces equipment used in the construction industry. ERKA Oy has 12 employees and its turnover in 1997 was about 50 million Finnish marks. One of company's product lines is a concrete vibrator that is used widely in building and construction sites.

China Tekway Oy Ltd, a Chinese business consulting and business services company, conducted one market survey for ERKA Oy in January and February 1997. The purpose of this survey was to gain general knowledge of the local Chinese market, the price level, local Chinese manufacturers and any other European competitors performing in China. This information, would help ERKA to determine whether it would be possible to export or to have a local joint production in China.

China Tekway Oy Ltd selected ERKA's most sold product – high frequency poker vibrators with different capacities. The market research was conducted in two areas in China, Beijing municipality and Shandong province. These two areas were selected because of their local fast-growing infrastructure and construction development.

High frequency poker vibrators have been used widely in construction sites in China. There are many Chinese manufactures and producers of similar products. Popular Chinese poker products are generally made in Qingdao, Jinxiang, and Shanghai. The market prices of Chinese-made high frequency pokers with similar capacities were 8-10 times lower than ERKA's export prices. If we also consider extra costs such as transportation and local import tax, these would make the price difference even wider. However, technically ERKA's products have advantagescompared to locally-made Chinese products in terms of mobility, lifetime and efficiency.

There were no European or other foreign poker products sold in Beijing, nor in Zibo and Zaozhuang cities of Shandong province where the marketi research was conducted. Interviews with local poker product dealers revealed that Chinese-made pokers sold very well, and that foreign products were too expensive to import and sell. They were not interested in representing foreign poker products, although some of them had got in touch with German concrete vibrator producers.

Based on the fact that the price difference between ERKA-made and Chinese-made products was significant, and that there were no other European-made products sold in China, ERKA's management group decided not to continue to market their products in China. Technical co-operation or joint production with local Chinese manufactures and producers will also be considered in the near future.

Acknowledgement: The writer wants to thank Mr. Kari Nikola, Sales Manager of ERKA Oy for his help and support in this case study.

Note: The case has been written by Erlin Yang, Ph.D., China Tekway Oy Ltd.

In addition to these determinants, the companies mentioned issues like difficulties in finding credible partner and feasible subcontractors. Excessively tough local competition has also created an unwillingness to establish a production unit in China. Also, unclear legislation has hampered the investment decision. A number of the respondents felt that the legislation and rules not only were fuzzy, but that they were also very unstable.

Have the Chinese Business Units been Economic Successes?

'The attitude of local managers and employees towards efficiency and European business culture has made it necessary to have more Finnish staff in the company than originally planned.'

Despite the increasing number of Finnish companies in China, little is known about the performance of these units. Nor do we know much about the factors which have affected the success of the Chinese business units.

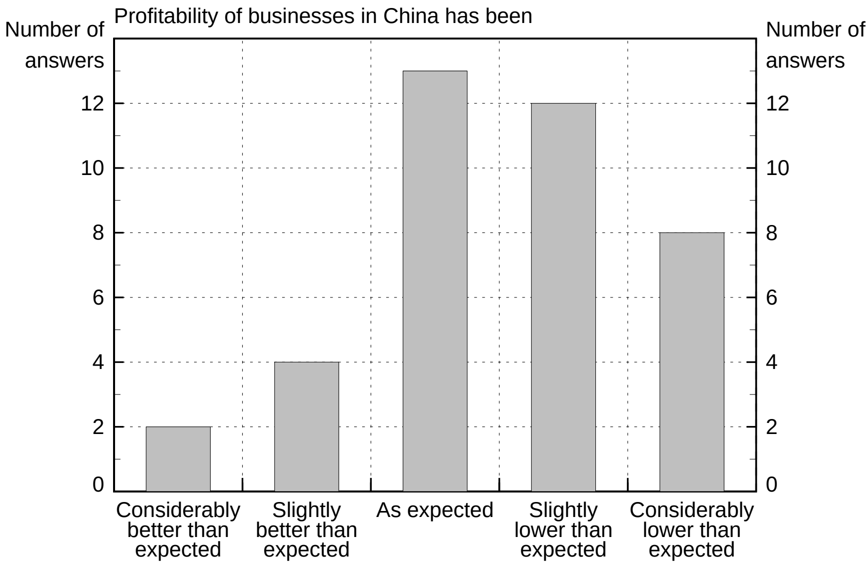
The enormous size of China may give a misleading view about the potential market. Different areas deviate remarkably from each other. Infrastructure, the level of technology and education and even culture vary between areas.

A number of the companies have understood that the way to the Chinese market will not be simple. More than two thirds of the companies said that their Chinese unit has been allowed more time to achieve the target level of profitability than group's other foreign business units. The performance targets of the units located in Hong Kong have, however, been set at the same level as in other foreign units. Similar situations can be seen in productivity differences. The productivity (turnover per employee) is much lower in Mainland China than in Hong Kong.

Performance of the units

Because it is very difficult to get exact performance numbers, we asked the companies whether the profitability of the Chinese units had ful-

Chart 4.2 Performance of the Chinese business units



filled their expectations. The answers reveal that making a profit in China is not an easy task. About half of the companies have not reached their target level of profitability (Chart 4.2). Although there are success stories (see box 4.4: Case: Neles Controls – good results with a good partner), only six companies stated that they have performed better than expected. In spite of the current situation, the companies are, however, optimistic about their future prospects. Over two thirds of the companies anticipate that their profits will improve during 1999.

One reason for the current dissatisfaction and, on the other hand, positive future expectations, may be the short operating time of the units in China. Most of the Finnish companies have operated in China for just a few years. Due to the very different circumstances in China and their lack of experience, it's not surprising that business is not very profitable during the first years but that better performance is expected later on.

"There are lots of retailers who will eventually try the Chinese market – they realise that if they don't open a store they'll never learn how the market works or how to take advantage of it"
Far Eastern Economic Review, November 26,1998.

Box 4.4

Neles Controls – good results with a good partner

Neles Controls is a business division of the Rauma Corporation, the global machinery company. With 2 400 employees and an annual turnover amounting to 1.9 billion Finnish marks, Neles Controls represents 20 percent of Rauma's annual turnover. Neles manufactures valves for the process industry, particularly for companies operating in the paper, oil and gas and chemistry industries.

In 1988, Neles bought the American company, Jamesbury. Before the acquisition, Jamesbury had begun to consider business possibilities in China. A business unit of a big, state-owned company had been selected as a partner candidate. After Neles' acquisition of Jamesbury, the JV negotiations continued, thus in 1991 the JV called Shanghai-Neles-Jamesbury was established on the basis of the existing production unit. According to the agreement, Neles's investment includes cash and technology, and the partner provides the operating valve factory.

The targets of the JV were:

From Neles's point of view

- to manufacture Neles-Jamesbury's products for the Chinese market and for export
- to operate as an importer of Neles-Jamesbury's products
- to take care of the after sales operations of Neles-Jamesbury's products
- to utilize subcontracting possibilities in China

From the partner's side of view

- to get new technology
- to acquire knowledge of western-style management
- to improve productivity
- to utilize the JV status, meaning
    - better wages and salaries
    - a free use of currencies
    - an independent exports-operation
    - the possibility to travel abroad

After the JV was established, the local partner appointed the general manager of the JV and Neles appointed the vice general manager. Nowadays, almost all employees are local, and the vice general manager is the only permanent expatriate. The general manager speaks English fluently and he also understands the western style of management. He is considered to be an important success factor of the JV.

The business unit has been profitable from early on and the turnover has grown by 15-30 percent every year. In 1998, net sales will be about USD 13 million with 320 employees. Originally, Neles had 25 percent of the shares, but later on Neles increased its share to 50 percent. This option was negotiated in the original JV contract.

The co-operation between Neles and the local partner has been successful, and Neles has had very good experiences with the partner. The partner has also been satisfied because its targets for the JV have been achieved.

Neles would like to develop the business unit further by investing more money and arranging the marketing and sales operations differently. However, the partner does not see any reason to make changes because the business unit is growing and is profitable. One problem from the partner's point of view may be that it is not able to invest more money in the JV. Neles has suggested that if Neles invests more money it would get a larger share of the JV as compensation. Until now the partner has refused to lower its own stake.

Financing is now a problem for Chinese customers. This means that the share of outstanding money may be substantial. In China, terms of payment are much longer than in the western countries, and the collection of receivables can be difficult. The JV of Neles also sells its products to other foreign companies operating in China. These companies have no problems with financing their purchases.

According to Neles experiences of how to invest in China: "*It is important to consider whether a joint venture or a wholly owned foreign company would be a more suitable form for a business unit. With the JV, it is easier and faster to enter the market, but the success of the JV requires finding a good partner. In a joint venture it is important that the partners understand each other and that both can benefit from the venture. On the other hand, if the decision is to start with a green field project (100 % owned) it takes a lot more time and more investments to get started*".

The unsatisfactory performance raises the question of what determines the outcomes. We asked the Finnish companies what factors had affected their performance and which costs had exceed expectations.

The business environment has proved to be complex. Legislation, the level of infrastructure, corruption and working with the authorities have caused a lot of inconvenience for the companies. Furthermore, a number of different costs have proved to be much higher than the firms had originally expected.

The costs of apartments and offices are extremely high in China. Particularly, in big cities, like Beijing and Shanghai, the property costs are even higher than in western countries. Normally, a foreign company acquires flats for expatriates and also pays the rent. The rent for a two-room flat can be 5000 dollars a month.

However, due to the Asian crisis, there is a clear oversupply of offices and prices have fallen considerably in 1999.

Expatriate housing costs combined with the reasonable Chinese wage level make the labour costs of one expatriate as much as 10-20 times higher than one local employee. Despite the high expatriate costs, the future development of the number of expatriates will be twofold. About one third of the respondents are going to increase the number of expatriates, and one third will keep it at the same level during the next five years. Therefore, at least currently, most of the companies feel that successful activity requires the presence of expatriates. They want a part of the control maintained in expatriate hands. Furthermore, particularly companies which have wanted give a fast start to their business unit, have begun their China operations with a large number of expatriates.

In addition to expatriates, the labour costs of local employees have also exceeded expectations. Keen competition for experienced people with good language skills has led to a rapid increase in salaries. Particularly in metropolises, labour costs have proved to be quite high.

The social fees for employees increase the labour costs and at least in some areas, the social fees have increased substantially during last two years. Furthermore, different kinds of training and education costs raise the total labour costs. Despite their high education level, employees need a lot of training and this requires both time and money.

Taxes and different kinds of fees, charges and other payments to authorities have been higher than expected. In China, there are many different taxes which firms must pay. A number of the companies consider that taxation issues are also quite unclear for Chinese officials. Laws and orders are so superficial that the interpretation of rules varies between different bureaus. A foreign company does not know whose orders it has to follow, and in some cases the foreign companies have not received promised tax relief.

Similar situations have emerged in operating with customs. Importing the products and operation through customs is time consuming. A huge number of different kinds of permits and licences are needed, requiring a lot of paper work. Thus, time and also patience is needed in all issues related to importing and working with customs. Furthermore, every province has its own regulations, and the rules often change very rapidly, even overnight. In order to solve problems and questions, one has to put in a lot of effort on one's own. Local experts or lawyers are able to provide substantial help in these questions, but finding good, competent experts is often difficult. Furthermore, leaning on only one source is risky. Therefore, by checking the background of all information, the company can avoid harmful surprises. In any case, all this will take time. On the other hand, as one manager commented '*nothing is impossible, when you find the right channels*', meaning that good relationships with the authorities are also valuable in this case. Customs laws have been written on so general a level that the interpretation depends on the person. With personal relationships, the treatment quickens and the company may even enjoy customs and tariff relief.

"The only difference between guanxi and corruption is that in guanxi you don't use pure cash"

One thing which became evident in many contexts, is the corruptive atmosphere. Bribery is present everywhere and at all levels. However, not all the firms have faced the requirements of bribes, but some of the companies say that they have no chance to make business without bribes. Despite the Chinese government's attempts to root out corruption, it is still a serious problem in China. Westerners should, however, remember that the Chinese concept of corruption differs from western-style thinking.

Creating and Managing Joint Ventures

"The importance of selecting a local partner cannot be stressed strongly enough"

Since the political changes towards economic reform and the open door policy in 1979, foreign direct investment has been allowed in China. In the same year, the joint venture law was introduced. During 1979-1985, joint ventures' accounted for over 90 percent of total FDI. was over 90 percent. Establishing a JV was seen as the best way to enter the Chinese market. Moreover, until July 1991, joint ventures received more favourable tax treatment than wholly-owned companies.

During the 1990's, more and more foreign companies have established wholly-owned subsidiaries in China. Experience has proved that operating with a joint venture often causes severe problems.

Good co-operation with the partner is not self-evident. Common objectives and common benefits of the JV are essential for successful co-operation. Sometimes it can be difficult to reach mutual benefits with the partner. Both partners often seek to maximise their own welfare rather than that of the JV as a whole. The Chinese partner is often interested in a local strategy. It wants to improve its own competitiveness and increase sales by acquiring knowledge and technology from abroad. The foreign partner, however, often has its own view, which differs from that of the Chinese partner. In addition to the Chinese market, the foreign partner may aim to find a favourable location in which to manufacture products for a broader area.

In addition to different aims, numerous cultural differences also make co-operation between the Chinese and western companies difficult. Chinese politics has been based on communism for tens of years, thus it is clear that doing business with western companies may cause conflicts.

The importance of carefully selecting a local partner cannot be overemphasised. As one manager said "*The most important issue when forming a JV is selecting the partner. Always check the background of a potential partner carefully*". It is certainly worthwhile using enough time and money to look for and select a partner. In most cases, the success of a JV heavily depends on the operations of the partner.

One of the main things when selecting the partner is its position in the market. The partner should have market knowledge and experience in the same business area. A big player usually has good connections with authorities, thus well-known companies may also have the power to influence the administration at all levels. If the western company takes care of its relationships with officials and authorities on its own, it will probably create a lot of work and trouble for the company. Direct connections with ministries help the company to get approvals and licence. In addition, relationships may help the joint venture to win new customers. The phrase "first become friends and only after that, business" is well suited for companies operating in China.

The partner's ability and willingness to invest is one central issue in the selection of a partner. The partner should be willing to develop the joint venture. Sometimes this can be a problem because the partner does not want to make any big changes to the JV. Therefore, several companies stated that one criterion used to choose the partner was that the partner should have a minority share in the in the JV. *"Never let a local partner have any rights to stop decision making, always maintain majority voting power"* was what one interviewee said.

However, the aspiration to develop the JV is not enough. The partner has to have the ability to finance its investment. Quite often, the partner provides the land for the building but is not able to put up cash for the JV. One indicator of the ability to make a capital contribution is profitability. Furthermore, weak profitability may also imply weaknesses in technological and managerial fields. In sum, the strength of the partner's economic position may be one selection criterion when choosing the partner.

Most of the joint ventures with high performance reported that the success is dependent on finding a skilful local GM or deputy GM. Local managers with knowledge of the western management style and language skills have been irreplaceable for these firms.

Co-operation with the partner

Despite careful selection, it is possible that there will stillbe difficulties in co-operation with the partner. We asked the companies what kind of experiences they have had regarding co-operation with their partners.

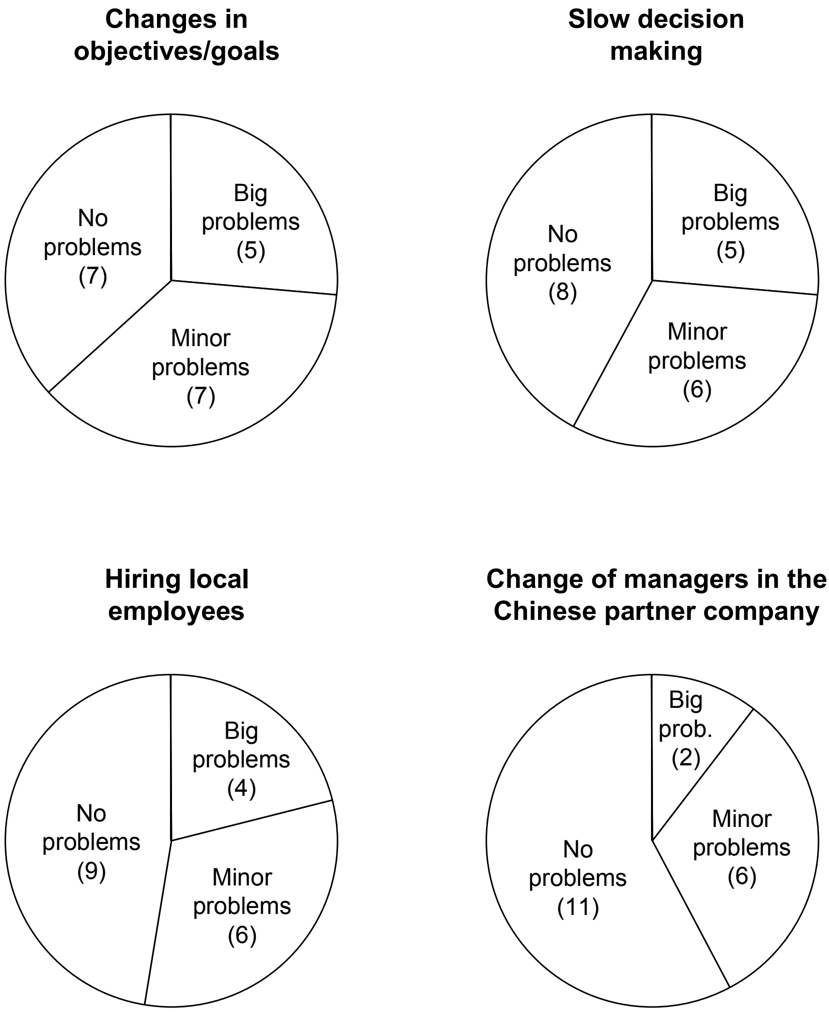
Many Finnish companies have faced problems with hiring employees, changes in objectives, slow decision making and the fast rotation of managers in the partner company (Chart 4.3). In many 50/50 joint ventures, the partner chooses the manager who is responsible for personnel administration. Some employees are often hired from the partner company. One problem that has emerged is that in China, jobs in joint ventures are highly sought after. In some cases, the Chinese partner has selected employees not because of their abilities or suitability but rather because of personal connections or guanxi. From the foreign company's point of view skills, including language skills, should be the most important criteria when hiring employees. Some companies feel that the local manager retains too many people in the JV, thus productivity (turnover/employee) has fallen short of targets. The excess capacity of personnel concerns particularly the JVs based on an existing production unit.

A number of Finnish companies have ended up in the situation where the partner has changed the objectives. Due to unrealised plans or budgets, the partner has changed its goals regarding, for example, sales or profit. There has been a desire to modify prices, terms of sale and material sourcing arrangements. Changes may also be a consequence of the replacement of managers in the partner company, which has been quite common.

One of the main interests of the local partner is often to get new technology. A foreign company should be extremely careful when transferring technology in China. In some cases, the local partner has used the transferred technology for the benefit of the parent company's other business units rather than for the benefit of the JV. This has led to a situation where the partner has turned into a competitor

Chinese decision making is often very slow. One reason for slow decision making may be the fact that influential power and the responsibility in different organisational levels are distributed differently than in western countries. Top managers have a lot of influential power, but middle management has little possibility of making decisions. The power is in the hands of the top managers, meaning that they also decide smaller issues. This leads to inefficiency and slow decision making. Avoiding uncertainty may be another reason for the slow decision making. The decision could later be proved to be wrong, leading a loss of face. As one manager commented, *"for the Chinese, changes are even more disgusting than for Finns"*. However, younger managers bear the risk more than older managers, so risk taking has increased in China. From the westerner's point of view, the Chinese management style appears more hierarchical than in western countries. As one

Chart 4.3 Problems with the partner



Finnish director noted "*our Chinese department managers kept very strict discipline*".

But this is not the whole picture, for in some joint ventures the situation is quite opposite. "*The tight and over-authoritarian management style of Finnish directors does not work in China*" was one Chinese manager's opinion (Riikonen 1994). Furthermore, horizontal co-operation between the departments is difficult and needs practice, as does team work.

Box 4.5

Neste Polyester (Kunshan) Co. Ltd – investing without a partner

Neste Chemicals is a business division of the Neste Corporation, which is one of the largest industrial companies in Scandinavia with 8,700 employees and a 1997 turnover of 45.7 billion Finnish marks. Neste Chemicals has 2,600 employees and a 1997 turnover of 5.8 billion Finnish marks. In past years, Neste Chemicals has been the fastest growing division within Neste Corporation. Neste Chemicals produces and markets adhesive resins, oxo products, unsaturated polyester resins and gelcoats and paper chemicals.

At the beginning of the 1990's, Neste Chemicals started to study its business possibilities in China. A marketing analysis was carried out and the possibility of having a local Chinese partner was studied. The product that was chosen for exploring the Chinese market was unsaturated polyesters, which is one of the key know-how products that Neste Chemicals owns. This was due to the fact that traditional materials in China such as wood and metal were being replaced by lightweight and durable reinforced unsaturated polyester plastic products.

Several criteria were used for selecting local Chinese partners. These were mainly the business positions of the potential local Chinese partner in China, its reputation in business and local communities, its products and quality and its marketing and distribution strengths. Based on Chinese market analysis, a business unit of a large Chinese state-owned company in the South of China was selected as a partner for the establishment of an on-going joint venture.

A letter of intent was signed by both parties to agree upon establishing a joint venture in China. There were frequent visits by management people and the on-going project manager from Neste Chemicals to China. The meetings, discussions and negotiations had been friendly and smooth. Neste Chemicals had prepared the final business contract that was to be signed by both parties. The joint venture was to be set up after both parties had signed this business contract.

From the viewpoint of Neste Chemicals, the investment in an on-going joint venture project was to be a small-scale business unit, which would produce highly market-oriented products. Therefore it needed a more effective management system and structure than the system and structure of Chinese, state-owned companies. Neste Chemicals had realised that a newly established joint venture with Chinese local partners would inevitably be affected by the Chinese partner's management system. This would have had a negative impact on the business development of the joint venture. The products of the on-going new company were to have been, however, very market and customer oriented. The total investment in the joint venture was at this point relatively small. It was therefore decided that it would be much easier to operate such a production business unit if there were less administration and bureaucratic interference.

Another alternative was then considered, i.e. to have a wholly Neste-owned company in China. A field study showed that the Chinese government and local authorities were very positive and supportive towards foreign investment in a wholly owned company in China. For example, the Kunshan Economic and Industrial Zone, which is about 50 km away from Shanghai, was particularly attractive to Neste Chemicals. There was no wholly foreign-owned company from the western countries in the Zone yet. The local government showed a strong interest and a high level of support towards Neste's wholly owned factory project.

On the other hand, the study on local legal, policy, infrastructure and environment showed that Kunshan was an ideal location to choose. In 1994, the top management of Neste Chemicals decided to set up the wholly Neste-owned factory in Kunshan Economic and Industrial Zone, instead of having a joint venture with the former Chinese local partner.

The newly established Neste Polyester (Kunshan) Co. Ltd received its business licence in the beginning of 1996. In the two years of the starting up period, it became a profitable company. Most significantly, after the two year operation, the local management of the company, from General Manager, Production Manager, Quality Manager to marketing persons, are all local Chinese.

Neste Chemicals has started to consider further new investments in China.

Acknowledgement:

The writer wants to thank Mr Pertti Silanterä, Senior Vice President of Neste Oy Chemicals and Mr Heikki Sierla, former General Manager of Neste Polyester (Kunshan) Co. Ltd. for their help and support in this case study.

Note: The case has been written by Erlin Yang, Ph.D., China Tekway Oy Ltd.

Box 4.6

Company X – check your potential partner's background carefully

Company X is a small company that manufactures kitchen furniture. It was established in 1973. In 1997, the turnover of the company was about 16 million Finnish marks. The main customers are retail dealers, but the company also sells its products directly to private customers. Nowadays the company exports about 30 percent of its production.

The company's China project started in 1994 when the First Secretary (in 1994) from the Embassy of China contacted Company X. In this project he acted as a consultant, a researcher and he also recommended the local partner, the Beijing Great Wall Construction and Engineering Corporation. The local partner was a municipal company, and the representative of the partner claimed that they had more than 27 000 employees. Later on, it was revealed that actually the number of employees was only 100.

Originally there were also other Finnish parties in this project but due to difficulties in financing, they withdrew. Hence Company X became the only Finnish party. The final agreement for the establishment of the joint venture was signed in February 1996. Company X desired to have majority ownership of the joint venture, thus the ownership was divided so that Company X got 54 percent and Chinese partner 46 percent of the shares. Company X appointed four of the seven members of the board. The managing director was named by company X while the local partner chose the chairman of the board of directors. The production capacity of the JV was laid out to be 10 000 kitchen sets a year, of which the local partner promised to buy 3 000 sets. To this date, the partner has not been able to buy any sets.

Soon after the agreement was signed, Company X delivered machinery and cash to China. The amount of the total investment of X was roughly USD 1,5 million, of which the share of machines and cash were both about USD 600 000, and the rest was different kinds of technology. The local partner was to take care of the construction of the factory and the hall of residence.

All the machines were delivered before the end of May 1996, in order to avoid rising taxes and customs. The installation of the machines and equipment was done by Finnish expatriates from Company X. In addition, they instructed the local personnel on how to use the machines.

However, due to the lack of electricity, the production of the JV started a year later than originally planned. Because the JV could not operate, the expatriates returned to Finland after they had taught the employees how to use the machines. Hence Company X did not have any representatives in China for several months. When the representatives of Company X returned to China, there were not any employees trained by the Finns left. The partner had laid off all the trained employees.

There was also another problem arising after Company X had delivered the machines to China. When the equipment arrived in China, a Chinese official inspector examined the value of the machines. He claimed that the total value of the equipment was under the agreed amount, thus the local partner required compensation by cash. Company X disagreed, so for compensation the local partner and X decided together to lower the amount of the partner's duty to invest in construction. Later on, X demanded that an official inspector should also check the value of the building constructed by the partner. The partner was not willing to do that. The reason became evident later. The local partner did not even own the building. After hard negotiations the local partner agreed to acquire the building for their possession.

There was great confusion in the accounting of the JV. An audit disclosed many disagreeable things. First, it was revealed that the partner or its representative had used JV's money for his personal consumption and other illegal issues. Secondly, the thermal power plant was financed by JV's money, when it was agreed that the finance should come from the partner-company. In addition, it turned out that the partner had falsified signatures for the minutes of the board meetings.

Due to the many difficulties, the JV has been revoked. Nowadays, the former JV is operating as a co-operative corporation, where the local partner owns the construction and Company X the machines, existing cash, and stock. Possible profit or loss will be divided between the local partner and Company X. The activities of the joint company have, however, been rented out to a third party. Company X intends to withdraw from this joint company and China in a few years.

As advice to companies, that are going to invest in China, the managing director of company X suggests that '*you should be very careful when you choose your partner*'. Secondly, '*be the one who acquires an interpreter, don't let the local partner do that*', and finally '*risks in China, especially in production projects, can be too high for small companies like us*'.

One reason that the malpractice of the partner-company was possible was that Company X did not have a permanent representative in China. Therefore there was nobody who could have controlled the partner. Trusting the partner and the consultant (ex-First Secretary) turned out to be extremely expensive for Company X.

Note: The case is based on interview with the general manager of Company X.

Special Topics to be Taken into Account

Hiring local employees

Almost all the Finnish companies operating in China have at least some Chinese employees. In production units, most or even all of the personnel are local people.

Finding good employees has been quite difficult in China but nowadays, the availability of skilled labour has improved. However, it still is difficult to find competent local managers. As one Finnish director put it *"It is difficult to find management people with experience and knowledge in western management thinking and with a good knowledge of English"*.

The recruiting process in China may be different than in western countries. In order to avoid difficulties and postponements, it is good to carefully define job descriptions with exact requirements and qualifications of applicants before starting the process. Experience has shown that the search process takes more time in China than in western countries. The problems encountered can be very surprising. For example, many companies have faced the situation that applicants don't have passports, thus their ability to travel is limited. Sometimes, the previous employer has taken away the employee's passport when he or she has left the state-owned company.

Retaining employees is always difficult, but due to the different background of a foreign company, it is particularly difficult abroad. The experiences of the Finnish companies concerning local employees vary. Some companies have succeeded very well in retaining employees and some have faced serious difficulties.

In general, experiences surrounding local labour are positive. The most often mentioned positive experiences concerning local employees are that they are hardworking and interested in studying. According to one manager *"the Chinese are capable and they are prepared to work hard"*.

Successful working with local staff requires, however, clear deadline setting and communicating by issuing simple and clear directives. A number of executives commented that local employees are interested in studying and learning new things. People are ready to use their time for studying, and they are quite fast to learn new things. Due to the lack of experienced local employees, foreign companies prefer to hire young people with a good basic education and then train employees by themselves. In addition to the skills needed in daily routines, the training program typically includes subjects like working in teams, quality concepts, western-style management thinking, and language skills. Furthermore, the key persons will be sent abroad to get additional training.

One of the biggest problems concerning local employees seems to be a lack of language skills. Even if an employee-candidate has good grades in English on paper, it does not always mean that he/she really has those skills. By interviewing the applicants in English, the company can avoid the situation where all communication between employees requires interpreter.

Moreover, skilled employees are hard to keep. After local employees have been trained by the foreign company, they notice that there is demand for their skills in the labour market, so many of them change jobs (see box 4.6: Company X – check your potential partner's background carefully). Therefore, one big problem for foreign companies is the rapid turnover of employees, especially of white-collar workers. Employees are also often lost to competitors. Some companies have tried to avoid the fast rotation by paying higher salaries from early on. Another way is to provide sufficient promotion opportunities. Some firms have a feeling that the Chinese are interested in making easy money, so they are going after money. Regardless of the reasonably low level of salaries in China, high salary inflation makes keeping skilled employees difficult.

So, how should an employer act in order to retain employees? The key word is loyalty. Without it, companies have to rehire people all the time when old employees change jobs. Personal involvement requires open communication between directors and employees. By going around the factory, discussing with employees and listening to their opinions, managers are able to create personal relationships with personnel. This, combined with awarding and truly caring for employees, plays an important role in creating loyalty. The western way of doing business, in which the employer does not show very much personal involvement, is often too straightforward in China.

Cultural differences

The cultural differences between western countries and China are so numerous that it would be impossible to cover all these in this study. Therefore, we are concentrating on the central issues which came out in our research. It is important to remember that the background of several cultural differences lies in old philosophies and religions. The Westerners generally know too little about Confucianism, Buddhism and Taoism.

The need to understand the local culture cannot be stressed strongly enough. Such understanding allows managers to reach correct conclusions and decisions about business with Chinese.

One of the cultural differences is a time frame which is not used as a scarce resource. From the Westerner's point of view, things take time in China. This issue has often been left without sufficient attention. "*Projects are always postponed*" is a common clause heard from a foreigner. The whole concept of a deadline is rather different from in western countries. One manager reported his frustration in negotiating the formation of a JV:

> "*There never was time for the deep discussion about plans and proceedings. All the time we had different kinds of free time programs and meals*".

The time frame is related to effectiveness. The attitude of local managers and employees towards efficiency differs considerably from western countries. Communism has meant that most of the companies are owned by the state. Instead of profitability, jobs and their constancy have been the main targets of the state-owned companies. The companies have earlier offered life-long jobs to their employees. Particularly, people who live in cities enjoyed this, so called 'iron rice-bowl". A working unit, "danwei", gave apartments to their employees, and big units still contain their own kindergarten, health centre and even cinema. The permanency of a job has, however, a reverse side – changing one's job or company has been limited in state-owned companies.

A tendency to think of employees first and the company's interest second seems to be very common in China. Particularly, joint ventures based on existing production units have suffered from low productivity. From the foreign company's point of view, there often are too many employees in the JV, but reorganisation can prove to be an extremely difficult task. The local partner is not willing to make changes which cause job reductions, thus it is important to find a solution, where the western efficient management style and the Chinese management style based on traditional culture, meet each other. In sum, finding the right management style with reasonable flexibility, balancing all the factors, is the key to development.

"Expatriates are often too straightforward"

Communication in China differs from the western style. Getting angry or raising one's voice in negotiation causes a loss of face. If one has to cancel promises, it causes a loss of face. If, for example, the local partner has not kept its promises it is not worth trying to prove it, because in any case, the Chinese partner will not be able to admit it. Instead, the western partner should discreetly bring the problem to light so that both parties understand the matter and agree on which issues to change in the future. Equally, the western partner should understand that the Chinese partner will express any dissatisfaction or complaints in the same discreet manner rather than voicing open criticism.

Horizontal communication between departments and even persons has also proven to be quite different from what western people are used to. Information exchange is transmitted vertically but not horizontally, leading to situations where departments or colleagues do not know the what the others are doing. Due to these difficulties in interaction, everybody seems to compete against each other instead of cooperating.

"For the Chinese, contracts are intermediate stages, not final results."

In China, the concept of a contract differs significantly from the western view. While a contract is the final outcome for westerners, it can be just a sign of intention for Chinese. Thus, after the contract has signed, the discussions will continue.

Box 4.7

The experience of company Z – hiring and retaining suitable employees is difficult

Selecting the right partner is maybe the most crucial thing surrounding the success of a joint venture. In most cases, the local partner takes responsibility for marketing and sales, so market access depends on the partner's operations. It would be extremely difficult for the foreign company itself to introduce its products into the market. It is a great benefit if the partner-candidate has previously done business with western companies or if the employees of the partner already have experience in working with western countries. There will always be cultural differences between the western company and the local partner, but if the partner has previous experience with western companies, the culture shocks could be less severe.

Establishing a joint venture will take time, for example getting all licenses from authorities can be time-consuming. Furthermore, agreeing on all the details between the foreign and the local partner is not a rapid process. "Guanxi" or good relationships with the authorities promote better or faster processing of the issues. Getting to know the right people and becoming friends will take time, so patience is a virtue in China. Thus, a partner's good relationship with the authorities and ministries could be one criterion in the selection of a partner. In JV negotiations, a professional interpreter is essential and of course it is ideal if the interpreter also understands the substance of the negotiation .

In many cases, the foreign partner appoints the general manager of the joint venture and the Chinese partner appoints the deputy GM. This was also the case for company Z. The deputy GM was responsible for personnel administration and licensing issues. At the beginning of the co-operation, the foreign and the local partner had different requirements concerning recruitment of local employees. From company Z's point of

"Business is built on relationships"

The significance of relationships, "Guanxi", is emphasised in China. Cherishing relationships requires reciprocity meaning that favours have to be in balance. Due to reciprocity, the Chinese do not hesitate to ask for favours from the company or person with whom they have Guanxi. The importance of Guanxi also came out in our view, English was essential when hiring new employees, but the deputy GM did not sufficiently emphasise this issue.

One problem with local employees was rapid employee rotation. After the local employees were trained by company Z, the employees noticed that there was demand for their skills in the labour market, so many of them left the company.

A foreign joint venture is not able to hire local employees from all over the country. It can retain personnel only from the area where the JV is operating. One remainder from the past is the practice of registering the employees, meaning that companies have to keep a register of their staff. Many state-owned companies can offer a life-long job to their employees, but if the employee wants to change jobs, he/she has to pay a "transfer payment" when his/her register is transferred to other company. This so called "iron rice-bowl" is still a common habit in China.

Company Z has faced some costs which have turned out to be higher than expected. Firstly, operating with customs has been troublesome because the customs' regulations and instructions can change very rapidly. One morning you could be informed that some regulation has been changed during the night and everybody has to follow these new rules. Secondly, different costs relating to the certification of their products for the Chinese market have proved surprisingly high. Thirdly, the Chinese wages and salaries have risen faster than the company expected.

In the western sense there is not a well functioning banking system in China, thus financing can be problem for companies. Also, collecting receivables may be difficult because the invoice will not automatically be paid. Sometimes one has to go to the customer and ask them for money. Also, the meaning of the interest rate is unfamiliar, particularly outside the biggest cities. The invoice could have been unpaid over the past two years, but this does not mean that the debtor will pay interest on the debt.

Note: The case is based on an interview with the representative of company Z.

questionnaire, as the following examples demonstrate: *"First be friends. It seems to be most important to first build deep and warm relationships with your customers and suppliers, and then you can do rather good business."* or *"Through Guanxi, our company quickly and smoothly got all the necessary licenses and approvals"*. Good relationships are essential not only with customers but also through the whole the business chain, from the suppliers of material to authorities and customs. As one manager commented: "*After we established a good relationship with the manager of the local* *electricity distributor company, the problems in the availability of electricity disappeared immediately".*

Moving Towards Local Production

The increased amount of foreign direct investments in all industrial countries has intensified the debate about the impact of FDI. In this section, we consider the impact of China operations on the Finnish economy. The main question is, does the foreign production increase or decrease the export from the home country?

Most of the Finnish representative offices and sales units import at least some of their products from Finland. A more interesting question concerns, however, the impact of production in China.

Only a few companies stated that the production in China had decreased their exports. In fact, in many cases the reverse is trues, i.e. the local production has promoted the Finnish exports of most of the companies. The impact of local production is two-fold. Firstly, when companies have made an initial investment or when they have expanded their operations, a substantial number of the machines have been imported from Finland. The spectrum of imported machines is wide including parts of paper machines, crushers, assembly machines etc. Secondly, local production has boosted exports from Finland. The Chinese unit has imported intermediate products from the group's other units. Usually, most of these products have been made in Finland. Despite the localisation challenge, the future looks quite similar. Local production will also probably increase exports from Finland in the future.

It is nonetheless important to remember that the Chinese authorities are very interested in the degree of localisation of foreign production units. The Chinese interpret local production as an indicator of commitment. The improved credibility and confidence has brought new business opportunities. The government of China tries to push foreign companies to produce a larger share of their products in China, rather than importing parts from abroad. Tight foreign exchange balance controls put pressures on foreign companies and have lead to the situation where foreign companies circulate their invoices through, for instance, Hong Kong. This particularly concerns cases where both seller and buyer are foreign-owned companies.

The localisation concept includes employees as well as manufacturing. A number of the Finnish companies reported that the greatest challenge of the future is related to the localisation of the organisation. At the moment, top level management usually consists of expatriates, but expatriate costs are so high that maintaining competitiveness brings pressures also to use more and more local employees in management positions. The problem is that local people need a lot of training. The challenges of the near future are to transfer western style management thinking to locals and to delegate and promote free communication across not only vertical, but particularly horizontal levels. Moreover, the whole atmosphere concerning self-initiative needs to change. Most local people are not used to making initiatives or using their creativeness in their work. Training local workers and changing their attitudes will take a long time.

Conclusions and Future Prospects

In the 1990's, a number of Finnish companies have invested in China. Nowadays, there are about 150 Finnish business units. The spectrum of industries is wide, but most of them are somehow related to telecommunications, or metal and engineering industries.

The experiences of Finnish companies in China vary considerably. Some companies have succeeded very well, and some have faced severe problems inflicting heavy losses.

The business environment has proved to be complex. Legislation, the level of infrastructure, corruption and working with authorities have caused a lot of inconveniences for the companies. Therefore, it is important to make careful marketing studies and research before starting business in China, for it is difficult to get accurate information concerning the Chinese market.

A common opinion of the representatives of successful business units is that success depends heavily upon finding a capable local manager and skilled employees. Hence, in the early stages of the China project, it is important to make sure that the person who is responsible for whole project is knowledgeable about China and Chinese special characteristics. Only with sufficient information on China will the project manager be able to collect a competent team for himself. Thus, by spending enough time and money on training the project manager and finding local staff with good knowledge and the right attitude, the company can avoid lot of hardships in the future.

Not only recruiting, but also keeping personnel has proved to be difficult. The key word is loyalty. In order to create loyalty, managers have to establish personal relationships with their employees. The commitment can be reached by showing personal involvement with reciprocal respect. From the Chinese point of view, the western style of management is more business-oriented, whilst the Chinese emphasise deeper personal relations.

Patience is a virtue in China. The whole concept of a time frame is rather different from Western countries. Time is not a scarce resource. In addition to this different concept, a massive bureaucracy inflicts postponements and a huge amount of paper work. Particularly, getting permits and licenses is a slow process. Laws have been written on so general a level that the interpretation of rules varies between different bureaus. Therefore, it is important to have a good knowledge of laws and regulation. Even more important, however, is the experience and knowledge acquired by living through different kinds of problems is more important. In order to succeed, western companies should accept that things take time in China and should also use local experts to resolve legal matters when necessary.

A number of different costs have proved to be much higher than firms had originally expected. Particularly, expatriate housing and other property costs are extremely high. Moreover, the labour costs of local employees have also exceeded expectations, if the training costs, high salary inflation and low productivity are taken into account

Most of the foreign production units in China are joint ventures. Experience has proved that in many cases, co-operation with the local partner has not been without difficulties. Different cultural backgrounds combined with language problems produce troublesome situations which must be solved. Successful co-operation requires common objectives and benefits in the joint venture. The JV will not succeed if both partners are seeking their own instead of the JV's interest. Therefore, the most important issue when forming a JV is selecting the partner.

A number of foreign companies reported that a lot of harm is avoided by using local experts. A western company's own experiences, combined with the knowledge of local specialists, has helped companies to resolve their troubles, but relying on only one source may be hazardous. Many harmful surprises can be avoided by checking the background of all information, including the promises of the province.

The number of Finnish companies operating in China will increase in the near future. Presently, there are about 25-30 Finnish production units, but a number of companies have announced their intentions to invest in China. More than 15 companies have made it known that they will start production operation during 1999-2000. Instead of a joint venture, more and more companies are going to establish a wholly-owned company in China. Joint venture as an operation mode has lost its attraction because of the legislation of wholly-owned companies has been liberalised and because of the difficulties which joint ventures have faced. In any case, we will see that the flow of foreign companies to China will continue.

5

CONCLUSIONS

The Asian crisis has taught us some important lessons about the countries which were affected by the crisis and about the functioning of markets during the crisis. It seems fair to say that while a slowdown of the Asian economies was justified by the fundamental economic imbalances which had arisen in the region during the 1990's, a crisis of the magnitude that ensued was not. The severity of the crisis owes a lot to the partly irrational herd behaviour of investors in the region.

The fundamental situation in the economies has changed far less than the general perception of it. Before the crisis, there was a great deal of hype about the "Asian miracle" and the "Asian growth model". After the crisis, the analysis has concentrated on the negative aspects of the Asian economies. It is quite true that the Asian economies suffered from weaknesses which perhaps were not sufficiently recognised before the crisis. However, this does not mean that all the positive aspects of the economies have disappeared or that the Asian growth model should be totally abandoned. The rapid recovery which many of the economies in the area are currently experiencing is a good indication that the economies did not experience a total collapse. As a general lesson, the underlying situation usually changes far less than public sentiment, which tends to veer from euphoric to wildly pessimistic. This is exacerbated by the media, which tends to take an excessively one-sided stance on issues.

Equally, we should beware of interpreting the current recovery in excessively optimistic terms. While the fall in output last year was severer than anyone predicted, economists are currently revising their forecasts for this year upwards as the countries are staging a rapid recovery. The long-term growth outlook for most of the countries in the region is good, and the crisis has forced many countries to implement reforms which will strengthen their economies. However, many of the countries (such as Indonesia or China) are still at relatively early stages of development and will have to implement considerable structural reforms in order to achieve this growth. Structural adjustments are also important in the more advanced countries, such as Singapore and Hong Kong. The problems which caused the crisis – particularly those like "crony capitalism" which are more cultural than economic in nature – will not disappear totally in two years of crisis. Investors and observers should still be wary of the issues which caused the crisis, as many of them may still rear their heads in the future.

Cultural issues seem to have played an important role in the build-up to the crisis. Crony capitalism and opaque reporting meant that it was difficult to obtain a reliable picture of the true financial situation of enterprises in many Asian countries. Similarly, independent analysts found it difficult to publish critical opinions of the Asian economies, as due to the Asian aversion to criticism this could endanger their business connections in the area. We should be aware that publicly available information may well contain a positive bias.

Ever more foreign companies will establish business units in Asia in the coming years. Our case study of China reveals that in order to make a profit in China, it is vital to understand local conditions. Some companies have been very successful, but a number of companies have made heavy losses. A common opinion of the representatives of successful companies is that success depends heavily on finding a capable local manager and skilled employees. It is important to make sure that the person who is responsible for recruiting local people has excellent knowledge of China and its special characteristics. Without such know-how, the probability of succeeding in China is low. The importance of thorough preparation and "doing your homework" before embarking on investment in China cannot be overemphasised.

To sum up, Asia offers many interesting opportunities for investors in the future. Investors should not however forget the lessons of the Asian crisis, as many of the factors which caused it still exist. Generally speaking, investors should improve their own knowledge of local conditions to better understand what they are investing in. This is particularly important when establishing foreign business units, as knowledge of local culture is vital if the venture is to be a success.

Glossary

ADB:	Asian Development Bank.
Appreciation:	A currency gains value, i.e. less of the domestic currency is needed to buy the same amount of foreign currency.
ASEAN:	Indonesia, Malaysia, the Philippines and Thailand.
BIS:	Bank for International Settlements.
Chaebol:	A term for the large South Korean conglomerates.
Credit crunch:	In times of crisis banks reduce their lending so much that even healthy firms are unable to obtain financing for their operations.
Crisis countries:	Thailand, Indonesia, Malaysia, South Korea and the Philippines.
Currency basket:	The value of a currency can be fixed relative to a "basket", i.e. the weighted average of several currencies.
Currency board:	A fixed exchange rate system, in which the quantity of money in an economy is directly determined by its foreign reserves.
Current account:	The current account balance consists of the difference between exports and imports of goods, services and payments to factors of production. If imports exceed exports, the current account is in deficit and the country is borrowing from abroad. If exports exceed imports, the current account shows a surplus and the country is paying off its foreign debt.
Deflation:	A economy suffers from deflation when the overall price level is falling.

Depreciation:	A currency loses value, i.e. more of the domestic currency is needed to buy the same amount of foreign currency.
Devaluation:	The value of a currency with a fixed exchange rate is changed so that the domestic currency depreciates.
East Asia:	In this book, East Asia comprises Japan, China, Singapore, Hong Kong, South Korea, Indonesia, Malaysia, Thailand, Taiwan and the Philippines.
Effective exchange rate:	An exchange rate which is calculated as the weighted average of the exchange rates of the country's main trading partners.
Fiscal policy:	Economic policy conducted using government spending and taxation.
Fixed exchange rate:	The value of the currency relative to another currency/currencies is fixed.
FDI:	Foreign direct investment. The investment is carried out in order to form a permanent economic relationship and the foreign investor owns over 10 percent of the acquired firm.
FED:	The US Federal Reserve, the Central Bank of the United States.
Floating exchange rate:	The value of the currency relative to other currencies is not fixed, it "floats" according to market forces.
GDP:	Gross domestic product. The sum of the value added of all the sectors of the economy. Value added is obtained by subtracting the value of intermediate inputs from the sales value of production.
IMD:	Institute for Management Development.
IMF:	International Monetary Fund.
MNC:	Multinational corporation.

Monetary policy:	Economic policy conducted using exchange rates or interest rates.
NIEs:	Hong Kong, Singapore, South Korea and Taiwan.
OECD:	Organisation for Economic Co-operation and Development.
Pegged exchange rate:	See fixed exchange rate.
Portfolio investment:	Investment in shares which is temporary in nature and in which the investor owns less than 10 percent of the acquired firm.
PPP:	Purchasing power parity. This is an artificial exchange rate constructed on the basis of prices of identical goods in different countries. PPPs are often used in international comparisons because they are more stable than market exchange rates and they reflect the domestic purchasing power of consumers better than market rates.
Real exchange rate:	The exchange rate adjusted for differences in price levels between the two countries.
RMB:	Renminbi. The Chinese currency. The currency unit is also known as the yuan.
SEZ:	Special economic zone.
SOE:	State-owned enterprise.
Trade balance:	The difference between a country's exports and imports of goods. If a country exports more than it imports, the trade balance shows a surplus. If imports exceed exports, the trade balance shows a deficit.
WTO:	World Trade Organization.

References

Aiello, P. (1991). Building a Joint Venture in China, The Case of Chrysler and the Beijing Jeep Corporation, Journal of General Management, 17(2), pp. 47-63.

Akamatsu, K. A. (1962). Historical Pattern of Economic Growth. The Developing Economies, preliminary issue, No.1.

Ali-Yrkkö, J. (1999). Suomalaisyritysten investointimotiivit Kiinassa, monograph.

Asian Development Outlook (1994). Oxford: Oxford University Press.

Baig, Taimur & Goldfajn, Ilan (1998). "Financial Market Contagion in the Asian Crisis", IMF Working Paper 98/155.

Björkman, I. & Schaap, A. (1994). Outsiders in the Middle Kingdom: Expatriate Managers in Chinese-Western Joint Ventures, European Management Journal, 12(2), pp. 147-153.

Chen, E. K. Y. (1993). Foreign Direct Investment in East Asia. Asian Development Review: studies of Asian and Pacific economic issues. Vol.11, No.1. Asian Development Bank.

Corsetti, Giancarlo & Pesenti, Paolo & Roubini, Nouriel (1998). "What Caused the Asian Currency and Financial Crisis? Part 1: A Macroeconomic Overview" NBER Working Paper Series 6833.

Cui, G. (1998). The Evolutionary Process of Global Market Expansion: Experiences of MNCs in China, Journal of World Business, 33, pp. 87-110.

Davidson, W. H. (1987). Creating and Managing Joint Ventures in China, California Management Review, vol 29, pp. 77-93.

The Global and Domestic Impact of China Joining the World Trade Organization (1998). Development Research Center of the State Council of China.

Dunning, J. H. (1993). Multinational Enterprises and the global economy, Addison-Wesley Publishing Company, Great Britain.

Dutta, M. (1992). Economic Regionalizaton in Western Europe: Asia-Pacific Economies. American Economic Review. May.

Eiteman, D. (1990). American Executives' Perceptions of Negotiating Joint Ventures with the People's Republic of China: Lessons Learned, Columbia Journal of World Business, 25, pp. 59-67.

Euromoney (1997). "Worth the paper it's printed on?", December 1997, pp. 48-50.

Euromoney (1998). "Caught with their pants down?", January 1998, pp. 51-53.

Fan, Kang (1994). "Incremental Changes and Dual-track Transition: Understanding the Case of China", Economic Policy, December 1994, pp. 99-122.

Fukuda & Toya (1998). "Sources of Economic Growth in East Asian Economies: Why Did Capital Stock Grow So Rapidly?" Paper presented at the OECD Symposium "Structural Aspects of the East Asian Crisis" 16-17th November 1998.

Goldstein (1998). "The Asian Financial Crisis: Causes, Cures and Systematic Implications", The Institute for International Economics, Washington.

Goldstein & Hawkins (1998). "The Origin of the Asian Financial Turmoil", Discussion Paper 9805, The Reserve Bank of Australia.

Hamill, J. & Pambos, M. (1996). Joint Ventures in China: 'Same Bed, Different Dreams', Asia Pacific Business Review, 3(2), pp. 26-46.

Harvey, M. (1996). The Selection of Managers for foreign assignments: A Planning Perspective, Columbia Journal of World Business, 31(4), pp. 103-118.

Huang, D. & Shirai, S. (1994). Information Externalities Affecting the Dynamic pattern of Foreign Direct Investment: The Case of China, The International Monetary Fund.

IMF (1998). "Financial Crises: Characteristics and Indicators of Vulnerability" in "World Economic Outlook, May 1998".

Jakobson, L. (1997). Miljoona totuutta – vuosikymmen Kiinassa, Kirjayhtymä, Helsinki.

Kaukonen, E. (1994). Joint Venture -yritykset: Suomalaisten yritysten mahdollisuus, teoksessa Kiinan kaupan käsikirja.

Kearney, Colm (1999) "The Asian Financial Crisis", Quarterly Economic Commentary February 1999, ESRI.

Kochhar, Kalpana & Loungani, Prakash & Stone, Mark R. (1998). "The East Asian Crisis: Macroeconomic Developments and Policy Lessons", IMF Working Paper 98/128.

Krueger (1998). "East Asian Growth: Retrospect and Prospect", Paper presented at the OECD Symposium "Structural Aspects of the East Asian Crisis" 16-17th November 1998.

Lasserre, P. & Ching, P-S. (1997). Human Resources Management in China and the Localisation Challenge, Journal of Asian Business, 13(4).

Li, Shantong & Wang, Huijiong (1997). "Prospects and Problems of China's Economy", ETLA discussion paper No. 621.

Lun, Ng (1997). The Perils of China, Far Eastern Economic Review, 7. August.

Luo, Y. (1995). Business Strategy, Market Structure, and Performance of International Joint Ventures: The Case of Joint Ventures in China, Management International Review, 35, pp. 241-264.

Luo, Y. (1998). Joint Venture Success in China: How Should We Select a Good Partner? Journal of World Business, 33(2), pp. 145-166.

Luo, Y & Chen, M. (1997). Does Guanxi influence firm performance? Asia Pacific Journal of Management, 14, pp. 1-6.

Luostarinen, R. (1970). Foreign operations, Helsinki School of Economics, Helsinki.

Martinsons, M. & Tseng, C-s. (1995). Successful Joint Ventures in the Heart of the Dragon, Long Range Planning, 28, pp. 45-58.

MOFTEC (1992). Summary of China's Foreign Investment Policy, Ministry of Foreign Trade and Economic Cooperation, Beijing.

Mujunen, L. (1994). Kansainvälistyminen ja alueellinen eteneminen - suomalaisyritysten kansainvälistyminen ja alueellinen eteneminen Kaakkois-Aasiaan, Helsinki School of Economics, B-148.

Osland, G. & Cavusgil, S. (1996). Performance Issues in US-China Joint Ventures, California Management Review, 38, pp. 107-130.

Pere, T. & Törrönen, M. (1996). Characteristics of Foreign Subsidiaries of Finnish Companies in the Asian-Pacific Region, Pro Gradu, HKKK.

Radelet, Steven & Sachs, Jeffrey (1998). "The Onset of the East Asian Financial Crisis", Paper presented at the NBER Currency Crises Conference, 6-7/2/1998.

Riikonen, T. (1994). Yhteisyrityksen perustaminen, toiminta ja ongelmat Kiinan tasavallassa. Pro Gradu, Vaasan Yliopisto.

Ruffin, R. J. (1993). The Role of Foreign Investment in the Economic Growth of the Asian and Pacific Region, Asian Development Review: studies of Asian and Pacific economic issues. Vol.11, No.1. Asian Development Bank.

Sergeant, A. & Frenkel, S. (1998). Managing People in china: Perceptions of Expatriate Managers, Journal of World Business, 33(1), pp. 17-34.

Shen, Jian-Guang (1996). "FDI, Knowledge Spillover and Economic Growth in East Asia", ETLA discussion paper No. 547.

Shen, Jian-Guang (1998). "Will China Devalue its Currency?", Merita-Nordbanken Economic Revue, 3/1998.

Shenkar, O. (1990). International Joint Ventures' Problems in China: Risks and Remedies, Long Range Planning, 23, pp. 80-90.

Siu, N. & Darby, R. (1995). Management Development and Customer Orientation: the Case of Foreign Joint Ventures in the People's Republic of China, Asia Pacific Business Review, 2(2), pp. 60-74.

Stelzer, L., Chunguang, M. & Banthin, J. (1992). China Business Review, 19, pp. 54-56.

Swierczek & Hirch (1994).

Tai, Lawrence S. T. (1988). Doing Business in the People's Republic of China: Some Keys to Success, Management International Review. Vol. 28, 1/1988.

World Bank. (1993). The East Asian Miracle: Economic Growth and Public Policy. Oxford: Oxford University Press.

Yong, W. (1997). China Daily, 1st of September 1997.

Appendix: Questionnaires

THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY (ETLA)
Address: Lönnrotinkatu 4 B, 00120 Helsinki, Finland
Tel: +358-9-609 900 Fax: +358-9-601 753

CONFIDENTIAL
Questionnaire (for business units of Finnish/Finnish related companies in China)

The subject of this study are Finnish and Finnish related companies which have business units in China or Hong Kong. This questionnaire should be answered by the company/business unit director. The responses should concern only one business unit.

Name________________________________Tel.___________________
Fax.____________________

Company/Business
Unit____
Location____
Name of the Finnish parent/partner company
____
Business
sector____
Main products
____
____

Shares of ownership in the Chinese business unit:

Finnish partner/parent company	%
Other Finnish partners	%
Chinese partner	%
Other partners	%

The business unit is located in:

1) Special Economic Zone or Economic and Technology Development Zone
2) High and New Technological and Industrial Development Area
3) Other special zone,
   where?____
4) Not in a special zone

Operation mode and starting year. If your business unit's operation mode has changed, please indicate also the year since which it has operated in its present form.

	In operation since year
Production Unit	
Research and Development Unit	
Marketing and Sales Unit	
Representative Office	
Purchasing Unit	
Other, what? ________________________________	

How did the following factors affect your company's choice of location for the business unit? (please circle the option that best describes the importance of the factor for your company)

1- very positive effect, 2-positive effect, 3- no effect, 4-negative effect, 5-very negative effect.

	Very Positive				Very Negative
Expected demand	1	2	3	4	5
Proximity of customers	1	2	3	4	5
Proximity of subcontractors	1	2	3	4	5
Construction expenses in the area	1	2	3	4	5
Rental expenses in the area	1	2	3	4	5
Labour costs in the area	1	2	3	4	5

Availability of work force	1	2	3	4	5
Taxation	1	2	3	4	5
Good transport service	1	2	3	4	5
Availability of raw materials which raw materials? ____________________	1	2	3	4	5
Connections with the local officials	1	2	3	4	5
Some other factor, what? ____________________	1	2	3	4	5

Turnover

	1996	1997	1998 (est.)
Turnover of the business unit, 1000 $			

Number of employees

	1996	1997	1998 (est.)
Number of employees in the business unit			

Has your company had problems with fast rotation of local work force?

Yes ☐ No ☐

Capital Expenditure:

	1996	1997	1998 (est.)
Capital Expenditure, 1000 $			

How does your business unit finance the investments?

Loans	%
Loans from the group	%
Internal finance	%
Equity	%
Other	%

If your company does not presently have production operations in China, are you planning to start production operations during 1998 or 1999?

Yes ☐ No ☐

Please evaluate how the following factors affect your company's investment decisions in China. (please circle the option that best describes the importance of the factor for your company)

1- a very positive effect on investment decisions, 2-a somewhat positive effect on investment decisions, 3- does not affect investment decisions, 4-a somewhat negative effect on investment decisions, 5-a very negative effect on investment decisions.

	Very Positive				Very Negative
Expected demand in China	1	2	3	4	5
Contacts with subcontractors	1	2	3	4	5
Need to be present in the same market as main competitors	1	2	3	4	5
Finding a good partner in China	1	2	3	4	5
Cooperation with a partner in China	1	2	3	4	5
Price of energy	1	2	3	4	5
Availability of raw materials which raw materials? ________________	1	2	3	4	5
Tax relief for foreign companies in China	1	2	3	4	5
Avoiding Chinese custom duties and tariffs	1	2	3	4	5
Other taxation factors	1	2	3	4	5
Labour costs in China	1	2	3	4	5
Availability of unskilled work force	1	2	3	4	5
Availability of skilled work force	1	2	3	4	5
Efficiency of work force	1	2	3	4	5
Transport costs from Finland to China	1	2	3	4	5
Company's earlier technology transfer to China	1	2	3	4	5
Company's earlier exports to China	1	2	3	4	5
Production in China for export	1	2	3	4	5
Insufficient knowledge of Chinese legislation	1	2	3	4	5

Availability of financing	1	2	3	4	5
Other, what? ____________________________________	1	2	3	4	5

Export Operations of the Business Unit:

	Year 1996	Year 1997	Year 1998 (est.)
Exports as a share % of turnover	%	%	%

Has the profitability (return on invested capital) of your business unit in China been:

1 Considerably better than expected
2 Slightly better than expected
3 As expected
4 Slightly lower than expected
5 Considerably lower than expected

How do you expect the profitability of your business unit to develop during year 1999 when compared to 1998?

1 Considerably better
2 Slightly better
3 No change
4 Slightly weaker
5 Considerably weaker

If your company is a joint venture, what were the most important decision making criteria when choosing the Chinese partner?

____
____
____
____
____

Please evaluate how successful the cooperation with your partner has been considering the following issues:

1- No problems 2-Minor problems, 3-Big problems

	No Problems		Big problems
Changes in the objectives/goals	1	2	3
Slow decision making	1	2	3
Change of managers in the Chinese partner company	1	2	3
Hiring local employees	1	2	3
Other,what?____________________________ ____________________________	1	2	3
Other,what?____________________________ ____________________________	1	2	3

Which costs have been higher than expected in China (e.g. tax increases)?

____
____
____
____
____
____

Which cultural factors have had an effect on the operations of your company in China, and how?

____
____
____
____
____
____

Thank you for your views.

THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY (ETLA)

Address: Lönnrotinkatu 4 B, 00120 Helsinki, Finland
Tel: +358-9-609 900 Fax: +358-9-601 753

Questionnaire (for the Finnish or Finnish related parent company) CONFIDENTIAL

The subject of this study is Finnish and Finnish related companies which have business units in China or Hong Kong. This questionnaire should be answered by the person who is responsible for the company's/business division's operations in China. The questionnaire is in two parts: the first part concerns operations in mainland China, and the second part operations in Hong Kong. The questions are the same in both parts.

Business operations in MAINLAND CHINA

Name of the company ______________________________

Your answer concerns: ☐ the whole group
☐ one business division,
which one?__ ____________________

How many of each type of business unit does your company have in mainland China?

	Year 1996	Year 1997	Year 1998 est.
Representative Office			
Marketing and Sales Unit			
Production Unit			
Research and Development Unit			
Purchasing Unit			
Other, what? ____________________ ____________________			

Does the productivity (turnover/employee) of your company's business units in mainland China differ from those of your company's other foreign business units? How does it differ?

____

____

____

____

____

Are the business units in mainland China allowed more time to achieve the target level of profitability than your company's other foreign business units?

Yes ☐ No ☐

Please evaluate how the following factors affected your company's decision to locate some activities in mainland China. (please circle the option that best describes the importance of the factor for your company)

1- a very positive effect, 2-a somewhat positive effect, 3- no effect, 4-a somewhat negative effect, 5-a very negative effect.

	Very Positive				Very Negative
Expected demand in China	1	2	3	4	5
Need to establish contacts with customers	1	2	3	4	5
Need to follow present customers	1	2	3	4	5
Need for close cooperation with local subcontractors	1	2	3	4	5
Need to be present in the same market as main competitors	1	2	3	4	5
Finding a good partner in China	1	2	3	4	5
Price of energy	1	2	3	4	5
Availability of raw materials Which raw materials? ____________________	1	2	3	4	5
Tax relief for foreign companies in China	1	2	3	4	5
Avoiding Chinese custom duties and tariffs	1	2	3	4	5
Other taxation factors	1	2	3	4	5
Labour costs in China	1	2	3	4	5
Availability of unskilled work force	1	2	3	4	5
Availability of skilled work force	1	2	3	4	5
Efficiency of work force	1	2	3	4	5
Transport costs from Finland to China	1	2	3	4	5
Company's earlier technology transfer to	1	2	3	4	5

China					
Company's earlier exports to China	1	2	3	4	5
Production in China for export	1	2	3	4	5
Insufficient knowledge of Chinese legislation	1	2	3	4	5
Availability of financing	1	2	3	4	5
Establishing regional headquarters in China	1	2	3	4	5
Other, what? ______________________________	1	2	3	4	5

If your company has production operations in mainland China at the moment, how does this affect: (please tick the option that best describes your company's situation)

	Increase	No effect	Decrease
Exports from Finland to China at the moment			
Exports from Finland to China after three years			

What positive and negative experiences do you have of hiring local employees in mainland China?

____
____
____
____
____
____
____

How do you expect the number of expatriates in mainland China to develop in your company?

	Increase	No change	Decrease
During the next two years			
During the next 2-5 years			

Has your company had problems with fast rotation of local work force in mainland China?

Yes ☐ No ☐

If your company does not at the moment have production operations in mainland China, are you planning to start production operations during 1998 or 1999 ?

Yes ☐ No ☐

If you previously considered establishing a production unit in mainland China but decided NOT to invest, what were the main reasons?

____

____

____

____

____

____

Thank you for your views.

Company and division__________________________________

Name________________________________Tel.__________

Fax____________