

# **ASSESSING THE POLITICAL AND INVESTMENT RISK CLIMATE OF THE PRC: A SAB-MILLER CASE STUDY**

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Assignment presented in partial fulfilment of the requirements for the degree of Master of Arts (International Studies) at the University of Stellenbosch.

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April 2004

I, the undersigned, hereby declare that the work contained in this research assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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**ABSTRACT**

This research assignment has investigated the overall nature of the investment climate in the People's Republic of China (PRC). The investment climate was analysed using a Political Risk Analysis (PRA) framework, whereby the PRC was scrutinised closely for its most defining socio-economic features and, especially, for its most salient political risk factors. Based on this, the assignment evaluated this climate with specific relevance to the investment plans of the South African company SAB-Miller.

Since its accession to the World Trade Organisation (WTO) in 2001, the PRC has intensified its economic restructuring process, a necessary and inevitable process, in order to comply with the terms of the WTO framework. This period of adjustment has heightened the anxiety over the strength of the Chinese economy, and the repercussions and/or opportunities for the multinational SAB-Miller. To remedy this uncertainty, this assignment has drawn up an in-depth qualitative scenario, in order to forecast the major trends of the PRC's short-term socio-political future. The main findings of the assignment indicate that a 'high-road' scenario is the most likely to occur in the PRC in the short-term. Clearly, this favourable forecast is dependent on the continuation of the current economic and socio-political restructuring process in the PRC.

With regards to the main macro-political risks factors, the assignment draws attention to several critical areas of concern. Firstly, the lack of legitimatisation from the 'bottom-up' is a worrying feature, especially in light of the growing economic disparities between citizens and between provinces. Secondly, the financial and governmental sectors need a thorough restructuring, according to WTO criteria. Thirdly, the fragmentation of the market inside the PRC undermines the potential of the PRC government to diffuse the benefits of economic growth and to absorb the downsides of globalisation. Micro-specific risk factors for the company SAB-Miller are focussed predominantly on the speed and the depth of the implementation of the guidelines of the WTO. Especially with regards to the lowering of intra-

provincial trade barriers and the efficacy of the distribution networks. Lastly, SAB-Miller should eliminate any risk factors, which may originate from inside the company's behaviour, such as the effects of its adopted labour policies. Lastly, it should maintain a clear level of transparency in their associations with governmental institutions. Throughout the assignment, these risk factors will be investigated and related to the overall political risk climate and utilised to draw conclusions concerning the potential of the investment plans of SAB-Miller.

## **OPSOMMING**

Hierdie werkstuk het die beleggingsklimaat van die Volksrepubliek China (VRC) ondersoek. Die beleggingsklimaat is ontleed deur gebruik te maak van 'n model vir Politieke Risiko Analise (PRA), waarby die VRC sorgvuldig onderwerp is aan 'n ondersoek van sy mees kenmerkende sosio-ekonomiese faktore en van die belangrikste risiko faktore. Hierop gebaseer, het die werkstuk ook die beleggingsklimaat ontleed met spesifieke betrekking tot die beleggingsplanne van die Suid Afrikaanse maatskappy SAB-Miller.

Sedert toetreding tot die Wêreld Handelsorganisasie (WHO) in 2001, het die VRC sy transformasie proses versnel ten einde te voldoen aan die WHO se toelatingskriteria. Hierdie tydperk van aanpassing het kommer gewek oor die Chinese ekonomie asook oor die gevolge daarvan vir die maatskappy SAB-Miller. Om hierdie onsekerheid aan te spreek het die werkstuk 'n kwalitatiewe scenario voorgestel, ten einde die hoofpunte van die VRC se sosio-ekonomiese kort-termyn toekoms vooruit te skat. Die gevolgtrekking van hierdie werkstuk toon aan dat 'n 'high-road' scenario die waarskynlikste is gedurende die kort termyn. Dis ook duidelik dat die gunstige vooruitskattings afhanklik is van die voortsetting van die huidige sosio-ekonomiese transformasie proses van die VRC.

Met betrekking tot die vernaamste makro-politieke risiko faktore het die werkstuk aandag gegee aan verskeie kommerwekkende aspekte. Eerstens, die gebrek aan elektorale regmatigheid van die 'grond-af', waarskynlik in die lig van die toenemende ekonomiese verskille tussen burgers asook tussen provinsies. Tweedens, moet die finansiële- en staatssektore grondig herstruktureer word volgens die WHO riglyne. Derdens, ondermyn die fragmentasie van die mark van binne China die mag van die VRC se regering om die voordele van die ekonomiese groei gelykmatig te versprei, asook om die nadele van Globalisasie te absorbeer. Mikro-spesifieke risiko faktore vir die SAB-Miller maatskappy het hoofsaaklik gefokus op die spoed en die diepgang van die implementering van die WHO riglyne. In besonder met betrekking tot die hoë interprovinsiale handelsbelemmerings en die optimale effektiwiteit van die verspreidingskakels. Laatstens, moet SAB-Miller enige

risiko faktore elimineer wat as gevolg van die maatskappy se eie gedrag kan ontstaan, byvoorbeeld die maatskappy se arbeidsvoorwaardes. SAB-Miller moet ook 'n duidelike aanspreeklikheidsfunksie daarstel, in hulle betrekkinge met Chinese staatsinstellings. Deur die hele werkstuk word hierdie risiko faktore ondersoek en in verband gebring met die algemene politieke risiko klimaat, en word ook gebruik om gevolgtrekkinge te maak aangaande die potensiaal van SAB-Miller se beleggingsplanne.

## **ACKNOWLEDGMENTS**

At the completion of this assignment, I would like to thank my supervisor Dr. Charlotte Brink for her timely help at critical moments. Furthermore, I would like to thank the entire Department of Political Science, especially Dr. A.J. Leysens and the Mevr. Magda van Nieukerk for their council and support.

Without the enthusiastic presentation of the coursework by all the relevant professors and lecturers over the years, this assignment would not have been tempted nor brought to fruition. I am very much indebted to them all.

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# **1. POLITICAL RISK MANAGEMENT METHODOLOGY**

## **1.1. Introduction**

In 1978, the People's Republic of China (PRC) then under the leadership of State President Deng Xiao Ping, embarked on a mission to modernise the Chinese economy, to redefine its socio-political structures and to break with its self-imposed international isolation. As a result, the world's most populous country entered the global trading regime and quickly established itself as an adept participant in the global economy. From that time onwards, the PRC has radically, though incrementally, embarked on a course sending the PRC into a market-driven economy, albeit with 'Chinese Characteristics.'<sup>1</sup> This new aim of direction has propelled the PRC towards astonishing growth rates for consecutive years. For instance, in 1999, the PRC experienced a Gross Domestic Product (GDP) rate of 7.1% to 7.3%; in 2000 it saw a rate of 8.2% to 8.4%; and in 2001, it saw its rate levelled off slightly at 7.3%<sup>2</sup>.

The World Trade Organisation (WTO) rewarded the PRC for these achievements in December 2001, welcoming it into the trading alliance as a new member. As never before in its history, China (the self-appointed Middle Kingdom) has opened its arms to the rest of the world. However, the PRC is facing the daunting task of restructuring itself, politically, socially and economically. It is the highly interdependent nature of these three problem areas that increase the risk factors for Foreign Direct Investment (FDI) in China. By evaluating the achievements and/or failures of the PRC government in each of these categories, one can arrive at a tentative medium (1-3 years) to long-term (5-8 years) forecast for the FDI climate in China.

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<sup>1</sup> Langlois, J.D.Jr. (2001): The WTO and China's Financial System, p.610

<sup>2</sup> The Economist (2002): Economic Data, p.1 & De Standaard (2000): China: Een Rijzende Ster? p.2.

This evaluation is structured around five chapters that will each in turn investigate specific aspects of the PRA of the PRC for SAB-Miller. The first chapter of this assignment intends to clarify the employed methodological techniques as well as to remedy certain problems inherent to PRA methodology. In the second chapter, the assignment will give a brief overview of the PRC's economic profile, followed by the explanation as to why this economic profile has attracted the attention of worldwide Foreign Direct Investment (FDI) and the logic behind that flow of FDI.

The third chapter starts off by tracing the developments of the Chinese political economy from 1978 until post-1993. After the major opening and the subsequent boom of the Chinese economy, it has become clear that certain major restructuring processes are necessary, if the PRC is to continue on its present *élan*. Therefore, this chapter will proceed to outline the recent political developments that are linked to these restructuring processes, including the investigating into the continuity of governmental policies, the issue of corruption and the very important matter of incapacitation of the Chinese state.

The fourth chapter of this investigation will deal specifically with the PRC's structural economic liabilities, namely the restructuring of its financial sector, the reform of its State-Owned Enterprises (SOE's) and the growing social inequalities. This chapter will also deal with the fragmentation of the market inside the PRC and the implications this fragmentation will have on the PRC, after its recent accession to the WTO. The final chapter will attempt to investigate the sector-specific opportunities, techniques, policies and problems for SAB-Miller in the Chinese market.

Though the initial focus of Political Risk Analysis (PRA) is mostly on the negative effects and outcomes of political risk, it is also as Kraysenbuehl (1988:32) narrates: "not only the task of foreseeing a deteriorating situation; it is equally important to find new opportunities where the degree of political risk is diminishing." This major relevance of this study is that it proceeds to show that, despite the diverging and sometimes quite contradictory scenario

outlooks for the further socio-economic evolution of the PRC, it remains a highly attractive investment market for consumer goods of high quality and international allure. Though the study identifies the gaps and uncertainties of investing in China, it also clearly indicates that the potential for astute investors is very lucrative. This report will therefore investigate the risk factors of and the opportunities inherent in the niche-market of lager and beer products in the PRC. Since the South African multinational SAB-Miller has already acquired a strong foothold in the Chinese market, this report will therefore place more emphasis on *risk management* issues, as they pertain to SAB-Miller's sector-specific investments.

## **1.2. Defining the Parameters**

At the outset of any risk analysis and of a risk management investigation, it is necessary to bring forward a useful working definition. In the literary review of this subject matter, one is immediately confronted by a plethora of different definitions<sup>3</sup> of the matter. This report will define Political Risk Analysis (PRA) as “the analysis of the possibility that factors caused or influenced by government political decisions or other unforeseen events in a country will affect business climates in such a way that investors lose money or not make as much money as they expected, when the initial decision to investment was made,” (Brink, 2002:10).

The report will consist of three major risk assessments, namely a socio-political risk assessment, an economic risk assessment and a financial risk assessment. Following the example of Erb, Campbell and Viskanta (1996:30) the political assessment will rely predominantly on expert's advice and qualitative descriptions of the present -and future- political climate in the PRC. Secondly, the economic risk assessment will be founded upon an objective analysis of hard and quantitative data, as is available on the PRC's economy. Lastly, this report will use a mixture of hard, quantitative

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<sup>3</sup> For overview of conceptual definitions see J.D. Simon. 1982. “Political Risk Assessment: Past Trends and Future Prospects.” P.63-64.

data and soft, qualitative information, to deal with the risks generated by financial risks.

As Brink (2002:5) states: “risk models should be adaptable and flexible, in that they can be reconstructed to suit industry and investor specific, micro-circumstances. The use of a certain method of analysis greatly influences the investment decision, as well as the reliability and validity of the eventual product.” This report, therefore, will develop a scenario of the PRC at present and its intended course in the future. The reason why such a flexible, qualitative model of PRA is chosen, lies in the fact that scenarios allow for a better strategic thinking by the investor *vis à vis* the PRC. Secondly, it clearly improves the timing and flexibility of decisions and responses to changing socio-political circumstances, which are particularly prone to rapidly change overnight. Lastly and most importantly, they can be modified or re-oriented quickly to the suit the future gains or opportunities for the astute investor in an ever-changing environment.

### **1.3. Methodological Problems of Data Interpretation**

It has become a mainstream assumption that the data provided by the Chinese statistical bureaus and the media are “plagued by problems of conceptualisation, missing data, incorrect reporting, sampling errors, inconsistency of mirror statistics and other pitfalls,” according to China expert Lardy (2003:249). As such, much if not all of the official economic and financial indicators should be treated with severe caution and apprehension. This assumption therefore makes it extremely difficult to choose and employ the right methodology to assess any risk factors of the PRC economy. However Lardy (2003:254) exposes this assumption to be factually incorrect and his main conclusion is that “it would appear difficult, if not impossible, to explain China’s [economic] performance without real economic growth that is reasonably close to the official data.” Therefore, an analysis of China’s economic performance should not shy away from utilising the official data, especially if such data can be compared, analysed and complemented by the intelligent use of ‘objective’ secondary sources. This report therefore, makes use of various official statistics and analyses, combined with secondary

sources of authoritative status, in order to get a complete and accurate picture of the PRC's investment climate.

## **2. THE ECONOMIC PROFILE OF THE PRC**

### **2.1. A Bird's Eye View of the PRC Economy**

Despite sporting a massive population of over 1.261.832.482 people (a 2000 est.) the PRC has achieved tremendous national economic performance, by consistently maintaining a high GDP growth rate for nearly two decades. In the last few years, during 2000 to 2002, the PRC achieved an impressive 7% to 8% growth rate. Preliminary governmental data shows a GDP growth rate of about 9.9% year-on-year in the first quarter of 2003, the fastest pace since 1997 (The Economist, 2003:1). One can draw three main conclusions from this data. First of all, it re-affirms China's position as the fastest-growing economy in Asia and its stellar growth to an international powerhouse. Secondly, this shows that China now has one of the largest economies in the world, second only to the United States, in terms of Purchasing Power Parity (PPP), (Hendrischke, 2003:270). Thirdly, the PRC has become the world's sixth largest trading economy in 2001, surpassing, for instance, Canada in the amount of trade value. To put that into perspective, while overall world trade fell by 4% in 2001, China's trade rose by 7.5% in the same year, (Lardy, 2003:258). By any standard that is an impressive statistic.

Despite these robust figures and impressive growth rates, China has experienced some negative setbacks in 2003, especially considering the long-term impact of the Severe Acute Respiratory Syndrome (SARS) epidemic that plagued Hong Kong and Mainland China in the beginning of 2003. This epidemic is estimated to impact on the 9.9% growth rate figure of 2003, by leveling it off at about 7.5% to 7.4% towards the beginning of 2004 (The Economist, 2003:2). This growth rate, however, should be sufficient to maintain the momentum of the Chinese economy, during its current state of transformation. The targeted GDP growth rate expected for the years 2001 to

2005 is 7% per annum, as postulated in the Tenth Five Year Plan by the CCP, (Hendriscke, 2003: 270; Zhu Rongji, 2003; Zeng Peiyan, 2003).

In terms of foreign trade and investment, the volume of China's foreign trade exceeded \$474.300m in 2000, through which it accumulated a foreign currency reserve of about \$218.698m in 2001, according to Hendrischke (2003:278-279). It is an interesting indicator of the Chinese economy that foreign enterprises contributed 52.1% of overall Chinese imports and 49.9% of its exports, during the year 2000. Since the peak of FDI investment in 1998 of \$40.398m, the FDI rate has slightly leveled off, yet this should be countered, if not reversed, with the PRC's acceptance of and entrance into the WTO. The main crux here is how fast and how thorough the PRC can start to comply with WTO standards and regulations, and how successfully it can implement them. The mere signatory accession to the WTO should increase the FDI rate in China, initially with about 0.5% to 1.5% and by 2005 the PRC should entertain a FDI account exceeding \$100 bn, (Liew, 2001:54).

China's current-account surplus will fall from \$35.1 billion (2.7% of GDP) in 2002 to \$17 billion (1.1% of GDP) in 2004, according to *The Economist* (2003:1). Hendriscke (2003:279) cushions this negative trend by claiming that "China's foreign debt is extremely favourable, since its record in repaying foreign debt is sound." Domestic debt, on the other hand, is far less favourable. By 2001, government's debts amounted to approximately 80% to 100% of GDP. "Internationally a debt-to-GDP ratio of 60% is seen as a crisis indicator," (Hendrischke, 2003: 272). It is specifically this debt-to-GDP of the CCP government that should be closely monitored as an indicator to the success or failure of the ongoing financial sector restructuring.

Entrance into the WTO 'club' should contribute an additional increase in GDP growth of about 2% to 3% in the immediate future, despite the negative effects of massive restructuring, short-term lay-offs and the retrenchment of excessive personnel and employees of the public sector. It is reassuring to see that China had a per capita purchasing power parity of \$3.800 in 1999

(CIA World Fact book, 2000), and this figure has incrementally risen since. This indicates that the section of the Chinese population labeled the ‘middle class’ has risen steadily in the PRC. The Economist (2002:3) estimates that this portion of the population exceeds the mark of 300 million people. This indicates that a burgeoning consumer potential exists in this section of the Chinese population, especially in the Eastern Seaboard provinces, where there is great profit potential for astute investors who have located themselves in that market. SAB-Miller is one of them, as it has already purchased breweries in these areas and is well advised to remain active in these affluent provinces.

In terms of the economic policies and its socio-economic planning, the PRC government has admitted that its most immediate focus should be on agrarian reform and on the re-balancing of wealth between the booming Eastern Seaboard provinces and the less prosperous inland areas, a plan known as the “Great Opening of the West”. The achievement of success in these critical areas of concern will go a long way in mitigating the macro-level socio-political and economic risk factors of the PRC. The primary focus of this plan is to achieve economic growth, by allowing for the free ‘marketisation’ and the ‘internationalisation’ of its national economy, in order to propel growth to the backward provinces of China, on par with the growth rates in the affluent Eastern provinces. A more detailed account of regional disparities, rural and urban unemployment, as well as the impact of these issues on the investments plans of SAB-Miller will be given below. Before these critical issues are explored in detail, it must first be explained why FDI is such a critical issue for the investor as well as for the host country.

## **2.2. Why Consider Investing In The First Place?**

An *a priori* assumption of investment forecasting is that an increase in FDI has a beneficial impact on the economy of a developing country. Countries that attract large amounts of FDI will experience more economic development, and will, as a consequence, exhibit less macro- and micro

economic and financial risk factors, as the host countries tailor and modify their economies according to the established global rules. Fortunately for investors all over the world, this assumption finds strong backing in recent studies of international economic development, (Loungani & Razin, 2001); (Mallampally & Sauvart, 1999) and (Ewe-Ghee, 2001). According to Ewe-Ghee Lim (2001) a country with a liberal investment climate will greatly benefit from FDI and it will experience a stronger spill-over of technology and know-how, resulting in a contagion effect from the FDI into the host country, by means of an extended clustering of business opportunities and through market information. As such "the combination of cutting edge technology, exporting into competitive world markets and the clustering of foreign investor activity, will all tend to generate substantial spill-over and externalities through strong backward linkages to indigenous suppliers," (Ewe-Ghee, 2001:5). Recent developments in China, such as its increased share in FDI and its WTO accession, clearly show that the PRC is establishing a fairly liberal investment climate, specifically in order to capture these important technological spill-over for future economic prosperity.

Yet, before we can focus on the risks inherent when investing in developing countries, it is important to categorise and separate various types of FDI. Unlike short-term capital inflows, such as portfolio investments and other kinds of financial inflows (for instance bank loans), that are notoriously volatile, FDI is far more committed to and much more focussed on longer-term considerations. Unlike the herding behaviour of short-term capital investors, FDI has proven to be remarkably resilient, especially in Asia during the aftermath of the Asian economic crises of the late 90's. This resilience is explained as the result of the advantages of and logic inherent in a liberal investment climate and in the unrestricted flow of capital, especially through FDI. Loungani and Razin (2001:6) state that "international capital flows reduce the risk faced by owners by allowing them to diversify their investments and lending. Secondly, the global integration of capital markets can contribute to the spread of the best practices in corporate government, accounting rules and legal traditions". Finally, Loungani and Razin claim



that the global mobility of capital limits the ability of host governments to institute bad policies. Therefore, for both the investors as for the host country, FDI represents a win-win situation.

From the perspective of the firm, growth in FDI makes the world a relatively safer, more integrated marketplace. From the side of the host government, the presence and activities of foreign firms in the domestic market makes equally sense. The dominant trend in developing countries (and arguably no better example of this exists than in China) is one that is geared towards instituting a policy framework, in such a way as to accommodate for FDI growth. As Mallampaly and Sauvart (1999: 35-36) correctly indicate, there is a strong correlation between the intensity of the supply and distribution links between domestic firms and their foreign affiliates and the capabilities of those domestic firms to capture the (in) direct spillover, which results from FDI. This spillover is important especially in terms of the relevant transfer of technologies, the building up of skills, innovative capacities, development of more efficient managerial practices and easier access to international marketing networks. The relationship between SAB-Miller and the PRC government is a prime example of this statement. As such, SAB-Miller finds itself in a strong position in terms of its access to the Chinese market, as will be explained in detail below.

A strong word of caution is needed in this debate. As Loungani and Razin (2001:8) clearly write “a high share in FDI of total capital inflows may be a sign of a host country’s weakness, rather than its strength.” In terms of the Chinese market, this is undoubtedly a correct warning. Yet, this should not be misunderstood or even over-dramatised. Because of the relative underdevelopment of the PRC as a market economy, due to historical factors, foreign firms often preferred to invest directly into the PRC. The logic behind this is that “FDI is more likely than any other form of capital flows to take place in countries with missing or inefficient markets. In such settings, foreign investors will prefer to operate directly in the market, rather than rely on local financial markets, suppliers or legal arrangements,” (Loungani & Razin, 2001:8-9).

Another important determinant and effect of FDI in China has been the emergence of Special Economic Zones (SEZ), through which the PRC government created an important 'asset' in its quest to attract FDI. The Chinese government has been competing with other developing countries for the biggest share of FDI. The success rate of that competition is dependent on the correct policy frameworks and the pursuit of new strategies to attract FDI and outbid fellow developing competitors, in the race to capture international finance. The Chinese government has been able to attract foreign investors not only through a market-based policy framework, but also because foreign companies "seek a combination of cost reduction, larger markets and creative assets that can help them maintain a competitive edge," (Mallampaly & Sauvant, 1999:37). On each of these points the PRC scores fairly high. The creation of tax exemptions for foreign firms, the establishment of clustered economic zones through SEZ's, the flexible labour market practices, not to mention the immense size of its market, have all propelled the PRC to the front of that international FDI race. As Mallampaly and Sauvant (1999:36-37) conclude, it will be more critical in the future to establish and develop "the distinctive combination of location-bound advantages and especially 'created assets,' that a country or region can offer to potential investors."

An important reason to why SAB-Miller has considered investing in the PRC is linked to the motivations found in horizontal (or market-seeking FDI) and the vertical (or production-cost minimizing) motive of FDI, (Ewe-Ghee, 2001:11). Horizontal FDI aims to reduce the costs involved in supplying the Chinese market from its home country of South Africa. By duplicating its existing breweries in the PRC or by joint ventures with Chinese breweries, SAB-Miller can become more competitive by ways of closer market access, anticipating changing consumer preferences, and by acquiring the ability to respond more quickly to the changing investment climate.

Secondly, the vertical FDI motive involves minimising production costs by outsourcing the manufacturing process of the beer to local breweries. This way, SAB-Miller can capitalise on lower input costs founded upon the utilisation of a locally based, more economically viable workforce, for which the PRC is renowned, if not notorious. Additionally, the presence of SAB-Miller breweries in the booming provinces of China, especially in the SEZ's, gives the company the benefit of being close to the production and consumption patterns of these economic clusters. When taking both motives of investment into account, it is clear that SAB-Miller has tailored its investments plans according to both vertical and horizontal FDI motives. As such, SAB-Miller has become a very astute investor and the result is that SAB-Miller's investments have been highly lucrative so far and will remain so in the medium-to long-term.

### **2.3. A New Window Of Opportunity?**

Since December 2001, the PRC has committed itself officially to the WTO's regulatory framework whereby the PRC has pledged to liberalise its economy in order to increase investment and competition opportunities for foreign and domestic businesses alike. However, due to the exceptional situation the PRC finds itself in, juggling socialist and capitalist paradigms simultaneously, their commitment to the WTO also elicits much scepticism and disbelief. As Ka Zeng (2001:125) indicates, the PRC will have to adopt a "new growth paradigm" with a clear and transparent commitment to economic restructuring, market liberalisation and institution building, if it is to sustain its economic growth. Yet due to the immense restructuring process of the Chinese economy that cannot be realistically performed overnight, the WTO members should be alert to delays and circumventions of WTO standards by the PRC. Authors Lague (2001), Gilley (2001), Murphy (2001) and Fewsmith (2001), all acknowledge that in assessing the PRC's transformation, one should rather abstain from pressing for full compliance and acceptance. Rather one should pay attention to the issue of "*acceptable non-compliance* [as] WTO members, in identifying clear parameters for

acceptable behaviour, can play a constructive role in encouraging China to accelerate its transition to full compliance,” [Italics added] (Potter, 2001: 908).

Undeniably, the biggest responsibility lies not on the shoulders of the international trading community but squarely on the shoulders of the PRC government, to succeed in their restructuring process. Yet, despite the fundamental *volte face* of the PRC government and its metamorphosis from its erstwhile isolated communist past into a market-driven global player, it is still hampered in its endeavour by the fact that there are deep structural problems within the PRC. These structural problems, if not effectively resolved, can become potential game-breakers for long-term investors and for the necessary continuation of FDI. In order to understand the deeply embedded structural problems of the PRC, one must carefully assess the recent history of China’s political economy. The following brief overview will locate the PRC’s current economic position, by analysing the major trends as they have panned out, since the reforms initiated under Deng Xiao Ping in 1978.

### **3. TRENDS OF THE PRC'S POLITICAL ECONOMY**

#### **3.1. DENG XIAO PING'S INCREMENTAL REFORMS**

When Deng Xiao Ping initiated the reformation process of the PRC's economy, he was faced with an internationally isolated, underdeveloped and highly centralised country. With laudable foresight Deng Xiao Ping concluded that the PRC had to implement socio-economic and political reforms if they were to modernise, prosper or even survive in the future. With the benefit of absolute obedience, he dropped the centrally planned economy in favour of a more market driven one in the hope of propelling China's economic development to new heights. The amazing economic development of South Korea and the other 'Asian Tiger' economies during that era surely provided the PRC with a guiding beacon and some additional incentives. Their unfortunate economic crises in the late 1990's should have added some additional economic lessons to the CCP too.

Socially, the reforms shattered one of the most resilient features of the PRC, namely the tenet of the "Iron Rice Bowl", providing social security, from cradle to grave, to all of its (state-employed) citizens<sup>4</sup>. To this day, laid-off workers from State Owned Enterprises (SOE's) are still classified and referred to as *Xiagang* workers, who, though unemployed, still receive some sort of benefit from their previous employers. In 1999, these urban workers numbered approximately 10 million<sup>5</sup>.

Economically, Deng Xiao Ping's initial reforms provided a 'win-win' situation for all sections of society. This highly prosperous era lasted until about

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<sup>4</sup> For more detail see: N.C. Hughes.1998. Smashing the Iron Rice Bowl, p.67-77.

<sup>5</sup> S. Wang. 2000. The Social and Political Implications of China's WTO Membership, p.382.

1993. In those 15 years, the Chinese economy doubled its per Capita income in only 9 years, compared to the USA who needed 47 years to complete that same feat<sup>6</sup>. According to the World Bank (2001: xiii) the rural population in China in 1978 living under the 1\$ per day breadline was about 260 million. During the 1990's that number came down to 106 million or roughly 11.5% of the total rural population. According to former Prime Minister Zhu Rongji (2003: viii) that number is now even lower, estimated at 28.2 million. This official figure, on the other hand, relies on a less stringent breadline benchmark.

Politically, the new era heralded an improved governing system. In 1980, Deng Xiao Ping produced his declaration on "Some Principles On the Party's Internal Politics," a document intended to limit internal strife and resistance against the structural reforms. It limited the duration of party positions to a two-term length, and it enforced a strict retirement age. It reduced intra-party conflicts and it augmented the qualification and educational standards for the members of the Chinese Communist Party (CCP) and the National Peoples Congress (NPC). This has propelled a new breed of technocrats into positions of power, a political development that is in line with the needs of China, as its government is faced with the ever-growing complexities of managing a developing country of such vast proportions.

### **3.1.2. Consolidating The Reforms**

With the demise of Deng Xiao Ping in 1993, Jiang Zemin continued on the *élan* of his predecessor. According to Gilboy and Heginbotham (2001:29) China's international trade had quadrupled from \$112 billion in 1989 to \$474 billion in 2000! Though these figures are impressive by themselves, they obscure the deep underlying structural problems besieging the PRC, and which may, if left unresolved, hamper or even reverse China's socio-economic development.

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<sup>6</sup> M. Pei. 1998. Is China Democratising?, p.74.

Firstly, the PRC has to bridge a tremendous distributive impasse between its prosperous industrial coastal regions and its severely underdeveloped agricultural regions in China's West and South-West. According to Wang (2000:375) these distributive conflicts may "divert attention, energy and resources from productive uses to bargaining over the distribution of rents and burdens of globalisation." Secondly, these conflicts might create "sub-optimal investment levels," especially in the regions where sustained investment is crucial. And lastly, these conflicts might cause severe social disruptions, inhibit consensus building and undermine the formulation of clear and critically-needed developmental policies. Clearly such a scenario will undermine the potential of SAB-Miller to reach out to the full extent of the Chinese market, as well as undermine the implementation of developmental policies of the central government. As will be shown later, the CCP has enticed investors into those developing regions with preferential policies in order to ameliorate the situation and bring these regions up to speed.

What makes these regional disparities so important is the interrelated complexity of the matter and the impact those disparities might have on future economic development. The inter-provincial disparities are widening continuously, with the disparities already being extremely large. For instance Shanghai's per capita GDP was about 4.5 times the national average, while the Western province of Guizhou was measured at only 37% of that same national average<sup>7</sup>. In terms of growing national economic inequality, the PRC had a GINI coefficient of 0.32 in 1980 compared to a coefficient of 0.43 towards the late 1990's, while some sources place it higher at 0.59, (Wang, 2003: 41; Conaky, 2000:2). The implication of this is that Chinese society is exhibiting a growing tendency of highly uneven distribution of wealth. With the GINI coefficient growing as it is, the population is being fragmented between those who have an excessive amount of wealth as opposed to those who have barely sufficient. This trend is highly worrisome.

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<sup>7</sup>M. Pei. 1998. *Is China Democratising?*, p.389.

The complexity of the matter is that the disparities are compounded by social, structural, ethnic and environmental factors, all compounding and obscuring a swift resolution of the discrepancies. The decentralisation of fiscal policies and the marginalisation of the poorer provinces severely weakens the national government's capacity to extract the necessary taxes and, concurrently, to efficiently re-invest these taxes in the development of the struggling hinterland provinces. Rampant corruption, bureaucratic mismanagement and agricultural inefficiencies further compound the underdevelopment of those Western regions. The result is a massive influx of unskilled labour from the countryside into the already overcrowded cities of the prosperous coastal regions, causing hyper-urbanisation. If this urbanisation continues to occur without a controlled governmental policy, it may well become a trend which could exacerbate social tensions, especially if the urban economic growth rates are insufficient to not only alleviate urban poverty but also to absorb, in as much as possible, the massive influx of peasants.

The implications of this trend for SAB-Miller are twofold. The only solution for the CCP government to remedy this growing social malcontent is to lure and entice FDI into China in order to absorb as much as possible of the unemployed labour force. Therefore, the CCP has relaxed its restrictive investment climate tremendously. This implies that SAB-Miller will benefit from preferential policies designed to attract and trap FDI in the PRC. On the other hand, in a social climate that is in a full transition, mood swings, social unrest and protests are not to be ruled out. Though, the overall outlook for the PRC is positive, these social developments are to be monitored at all times by SAB-Miller.

## **3.2. RECENT POLITICAL DEVELOPMENTS**

### **3.2.1. Continuity of Government**

Besides the numerous macro-economic risk factors, which pertain to all foreign enterprise, such as the liability of the financial sector and the high



levels of non-performing loans, political and social reforms are the most critical issues to the evolution of a liberal investment climate in the PRC. Akhter and Lusch (1987:89-92) define political risk as “the manifestation of the internal adjustment process within a society, whereby a society, as a social structure, reconfigures itself. Political risk is an inherent adjustment process which prevails in every society in varying degrees.” Clearly, the critical factor is the ability of the PRC government to allow this reconfiguration to be exacted so that the socio-economic climate in the PRC is conducive for business.

Despite the massive restructuring of numerous redundant SOE's and the resulting lay-offs they (will) generate, the Chinese Communist Party (CCP) still aims to keep a strong hand over the PRC in terms of its political objectives and its social agenda. The major, as of yet, unresolved question is whether the PRC can continue to develop its neo-liberal economic policies without any substantial liberalisation or democratisation of its socio-political structure. Differently put, can the economic growth rate be maintained without allowing for any genuine democratic participation by its citizens?

The number of unemployed workers in urban and rural areas is expected to swell with China committing itself to the WTO framework, and by China's continuing economic re-organisation. In order to cope with the increasing societal discontent that flows from this re-organisation, the CCP aims to both liberalise the economy and to a small extent civil society, yet simultaneously maintain a firm grip on the state apparatus, through limited public participation. The long-term viability of this strategy is still heavily debated, Gilley (2003), Wang (2003), Pei (1998, 2001, 2003), Miles (2002) and He (2003).

Politically, the PRC is still highly centralised implying that the Communist Party-run state exhibits a remarkable stability in terms of governmental transitions and in terms of the stability of its socio-economic policies. In November 2002, at the 16<sup>th</sup> Party Congress, PRC President Jiang Zemin

stepped down in favour of Hu Jintao. Despite this peaceful and smooth transition, the leadership of the PRC is still perceived to be “a dictatorship of an ever-expanding circle of a self-selecting elite,” (Miles, 2002: 5). Yet, this does not necessarily imply the formation of a negative forecast or as an important political risk factor; maybe just the opposite, at least for the short-term.

In his study of the new generation of political leaders in the PRC, Li Cheng (2000:13) argues, “this generation of leaders is more diversified than previous generations in terms of formative experiences, political solidarity, ideological conviction, career paths and occupational background.” Freshly elected PRC President Hu Jintao is flanked by his generational colleagues, the most important of which are Zeng Qinghong, Wu Bangguo and newly elected Prime Minister Wen Jiabao. These men, Li Cheng (2000:23) concludes, are “compared to their predecessors, far more flexible and less dogmatic in responding to the socio-economic pressures and political demands within the country.”

Yet, despite their more pragmatic approach, these Fourth Generation leaders are still negatively inclined towards opening up the country’s democratic potential. Favouring incremental changes over radical reforms, the new Chinese leadership maintains the absolute rule of the CCP over the PRC state. As Minxin Pei (1998:79) stated, the PRC government clearly views the “opening up of political process to mass democratic participation, as a recipe for chaos.” This view might very well hold a grain of truth. In such an enormous country, at such a critical time in its evolution, stability in terms of policy, agenda and implementation is of the utmost importance. Certainty in terms of its policy framework commitments, which can be expected as long as the CCP remains in power and in control, will go a great deal in assuring investors and analysts, as well as safeguard the steady inflow of FDI.

Yet it should not be overlooked that the PRC is continuing to plot along a dangerous route of opening up economically, while rigidly holding on to political absolutism. A result of this dichotomy is that the PRC is “a non-

adaptive, brittle state that is unable to cope with an increasingly complex and robust society,” according to Gilboy and Heginbotham (2001:26).

Despite the incremental experiments with democratic elections in villages and townships, the PRC, on the political front, remains a highly centralised state. The lack of popular participation and legitimisation from the bottom-up clearly undermines the democratic capabilities of the PRC. This is most visible in such things as taxation and national policy implementation. The result of it all is the accumulation of all kinds of strains and stresses that might lead to the possibility of a chaotic episode in China’s political governance structures. Minxin Pei (2002: 101) has focussed on three main measures to identify the breakdown of traditional CCP leadership. Firstly, the CCP is experiencing “a shrinkage of its organisational penetration.” Secondly, as a result of the former, the CCP is losing its ideological appeal and authority amongst the masses, who feel alienated. Finally, Minxin Pei (2002) believes that through widespread corruption and nepotism, the CCP is losing not only obedience from the masses, it is also losing its internal discipline.

### **3.2.2. Corruption**

The topic of corruption in the PRC is not only a highly contentious issue, it has also become a very public one. As stated earlier, the decentralised fiscal structure of the PRC gives ample reason and opportunity for self-enrichment by local and provincial governments. At present, corruption in the PRC is measured at “the equivalent of anywhere from 10 to 20 percent of GDP,” (Gilley, 2003:23). The relevance of corruption to foreign investors and SAB-Miller in particular, is that, according to Mauro (2002:2), corruption “affects investment and economic growth, as it alters the composition of government spending, often to the detriment of future economic growth.”

Because of the relative weakness of institutional and legal frameworks in the PRC, the CCP still maintains a relatively tight control over the governing elites at state and provincial level. The CCP still appoints its ‘cronies’ to the

most valuable posts, based solely on political affiliation and not necessarily on merit. As such, the power of the CCP is still very much entrenched at all levels of the state. Yet with the liberalisation of the economy, these political appointments are increasingly supplemented by the appointments of members of the bourgeois middle class, specifically by affluent capitalists, a new dominant force in the Chinese economy.

As such, Susan Lawrence (2001:40) warns of the emergence of a “business mafia” or more broadly of the “corporatisation of the Chinese state.” A well-founded fear is that these domestic capitalists will use their power and leverage to skew the free workings of a capitalist market, by arranging state protection and favouritism for their particular enterprises. These fears are specifically relevant to the more autonomous and parochial provinces, far removed from Beijing’s oversight, (Lawrence 2001; Murphy, 2001). This corporate protectionism will be dealt with later when the micro-level risk factors for SAB-Miller are outlined, further on in this report.

The causes of corruption are often found in the low wages of civil servants, in the price control mechanisms installed in the Chinese economy, in the intra-provincial trade barriers, and in sociological factors, such as nepotism and the *guanxi* network system. The interpersonal networking system of China, called *guanxi*, is an indispensable cultural feature of business and governance in the PRC. As Johnson (1997:272) states, “corruption arises, to a significant extent, out of, and is symptomatic of, these tensions between the definition and scope of acceptable business practices. Guanxi relationships are *a basis of privileged access.*” [Italics added].

It is in this context that gift-giving and people’s networking should be viewed. By giving entrepreneurs direct access to important government officials, business can be conducted in a Chinese market that is still growing and adapting to free market principles and meritocracy. According to Johnson (1997:272) the frequency of corruption could also be seen as a relatively positive process for specific businesses. His theory states that corruption, or less specifically ‘gift-giving,’ is a sort of “social lubricant,” between business partners, provided of course, that with time and effort this

institutionalised corruption gets replaced by more transparent and normative business practices. Yet for the time being 'gift-giving' or just plain corruption are issues foreign businesses cannot avoid when operating in the PRC. This thorny issue affects SAB-Miller as well and it should be handled with care.

Precisely this trend towards better normative business practices is gaining ground in the PRC. The Chinese government has been making great strides towards the clamping down on corruption and by publicly shaming the corrupt officials. As former PRC President Jiang Zemin stated in 2000, "severe punishment must be inflicted on those who have defied the law and committed crimes. No matter how high their posts, they will receive their punishment," (Rongxia, 2000:13). However, despite this official tough stand on corruption, Bruce Gilley (2003:22) is far more reserved in his assessments of the PRC's newly discovered anti-corruption stance. As he states, "the processing of high level corruption cases in the Party remains a matter of political expediency, a smokescreen for factional battles at the top."

With the traditional cultural feature of *guanxi*, the occurrence of corruption in the PRC will never be completely eliminated. And as stated earlier, this cultural feature is as much a gateway to the right contacts and opportunities, as it is a drain on efficient resource allocation and merit-based evaluations. Additionally, these privileged sources of contact might become sources of embarrassment for a company, if their business dealings are publicly revealed and thus shamed. This is an important point to remember for SAB-Miller, as this constitutes a micro-risk factor.

### **3.2.3. State Incapacitation**

The deep-levelled entrenchment of corruption and the inability of the central government to effectively counter it is a clear sign of the weakness of the PRC state. According to Shaoguang Wang (2003:38) the PRC has a "capacity deficit," causing the steady yet incremental disintegration of the PRC. With the GINI coefficient hovering around 0.43 in 2002, compared to 0.32 in 1980

(Wang, 2003:41), the CCP is steadily losing its power and its resources. Wang (2003:40) distinguishes two distinct phases in the socio-economic development of China. From the start of the liberalisation under Deng Xiao Ping in 1978 to 1993, there was a “win-win” situation for all segments of society. Yet from 1993 to the present, the economic liberalisation is providing a clear distinction between the winners and the losers. In 2003, for instance, “China has forecast an increase in unemployment of 0.5% to 4.5%, equal to more than 7 million people, although some officials estimate that the figure is much higher,” (Business Report, 2003). Since 1998 over 30 million workers have lost their jobs in the closing down of SOE’s and an estimated 20 million urban job-seekers will enter the labour market each year, (Pei, 2003:75). Now the question is, can the PRC market create sufficient space and employment for these urban and rural job seekers?

Despite its capacity constraints, the PRC government has gone to great lengths in order to re-establish itself as the prime organiser of society. As mentioned above, the PRC has a decentralised tax structure, but “while the 1993-94 fiscal and tax reforms introduced elements of fiscal federalism, the overall reforms were clearly intended to enlarge the central government’s share of total government revenue,” according to Yang (2003:45). Through its reforms, the share of the total budget revenue of the central government levelled off at 52.4% in 2001 and the total budgetary revenue as a percentage of GDP rose from a low of 10.7% in 1995, to 17.1% in 2001, (Yang, 2003:44). This reverse process of “bringing the center back in” is a necessary step in order to address regional disparities, underdevelopment and poverty in China, according to Chung (2001:121). By aiding the development of horizontal and vertical cooperative networks between provinces, the central government can play “an indispensable role by raising the levels of regional specialisation by lowering inter-provincial market barriers through its macro-policy regulations,” (Chung, 2001:148).

The process of “bringing the center back in” is an inevitable and necessary process for the PRC government. In terms of strengthening the state, it would do well in boosting political, economic and cultural nationalism

(Schubert, 2001:150), if it is to avoid the mounting challenges to state authority through the “sub-institutional and socio-psychological transformations in the periphery, as a warning signal of the waning regulatory and ideological supremacy of the CCP.” A clear sign of this emancipation of the periphery is given by Chung (2001:141). Instead of adopting a passive attitude in economic empowerment or instead of just waiting for Beijing to institute preferential policies, periphery provinces are increasingly organising themselves into powerful lobby groups to promote their own needs and agendas.

The most relevant of these associations are the “Regional Economic Coordination Association of Southwest China and the Shanxi-Gansu-Sichuan Economic Cooperation Zone,” to name but a few. Through these associations the ‘central *vs* periphery’ relationships are much more likely to yield beneficial outcomes in terms of market integration, relaxation of tariff barriers and other impediments to the functioning of free market trade. By doing so, the CCP should strengthen these regional institutions and relationships, as they are sorely needed in order to build a cohesive state and a unified national front.

This rebuilding and the re-invigoration of the CCP state is a prerequisite for the survival of the PRC. Democracy “precisely because it allows the widest possible competition for political power and therefore institutionalises uncertainty demands a highly effective state that can keep the nation’s business moving forward despite political turnovers,” (Wang, 2003:41). The demise of the CCP authoritarianism could very well lead to the total fragmentation of the Chinese market and even lead to territorial disintegration. Therefore, the institutionalisation of mechanism that aids the development of a unified state is a prerequisite for successful economic activities. In this light, the process of “bringing the center back in” is a beneficial and highly desirable one, for domestic and international investors alike.

## **4. STRUCTURAL ECONOMIC LIABILITIES**

### **4.1. STATE-SECTOR RESTRUCTURING**

#### **4.1.1. Financial Institutions and Liquidity Risk**

Despite massive economic improvements in the last two decades the PRC still faces a daunting restructuring process. A great part of China's economy has been kept artificially afloat through the bailing out of State-Owned Enterprises running at great losses, "resulting in poor management, overstaffing, high debt, outdated products and technologies, excessive social welfare burdens and high tax rates," according to Heytens and Karacadag (2001:4). By artificially propping up these state-run businesses and keeping them afloat, the People's Bank of China and other state commercial banks (SCB's), have issued many non-performing loans (NPL's). At present, these NPL's are measured to stand at a whopping 25%-50%, depending on private or public figures. These NPL's are clear indicators of the economic risks in the PRC. Several authors such as Holz (2001), Wall (1998) and Dernberger (2001) and Lague (2001) have all cautioned against the possible implosion of the financial system in the PRC, potentially causing highly disruptive shockwaves. As Holz (2001:367) warns the investor:

*"A continuous decline in state net worth is a risky strategy as trust in the state banking system could wane and lead to widespread bank runs. The economic and political implications of a collapsing financial system, wiping out a large part of accumulated household savings will undoubtedly be severe."*

David Wall (1998:7) clearly states that the main function of a banking system is "to provide a mechanism for financial intermediation, to transfer



the savings of deposit holders to borrowers, who can use the assets productively.” Since the Chinese have a high savings ratio, on average more than 40%, the banks should be in a good position to extend credit lines and investment assets. Even in the more underdeveloped rural provinces savings ratios have increased from less than 10% in 1980 to over 67% in 1998 (Hendrischke, 2003: 272). Therefore, the CCP has extended the prerogatives of State Commercial Banks (SCB) in order to strengthen the commercialisation of their lending operations. According to Heytens and Karacadag (2001:4) the reforms were initiated to diversify the opportunities for lending by the public at these SCB’s, “while taking steps to commercialise [them] and hold SCB’s accountable for their own operations and financial results.”

The critical factors for the success of these reforms is the continuation of public trust in the state banking sector and sustained governmental oversight in the reformation process of the financial sector. If, however, the trust in and the control over the financial sector were to crumble, the stage could be set for the “Lardy Dilemma,” (Wall, 1998:9). This dilemma states that when the people lose trust in the banking sector, they will *en masse* withdraw their savings, causing a run on the banks. This will then lead to the crumbling of the already fragile banking sector. As Wall (1998:9) concludes “inflation will be the result and the banking system will face the sort of crisis that has already occurred in other Asian economies.” This is a sobering thought and an area of great concern to SAB-Miller’s current and future investments.

The tensions faced by the banking sector come from two major sources. Firstly, the banking sector is still slowly gaining its feet in a market economy. Concretely, this means that most staff and personnel of the banking sector are not as highly qualified as their developed nation counterparts, resulting in a much slower and less efficient banking service. Secondly, the decentralisation of the Chinese market also affects the banking sector. Often, David Wall (1998:8) claims, the banks do not really

understand “whose interests the local branches are supposed to serve. Local authorities have a good deal of influence over local branches,” especially in the domain of employment, political influence and career development of the banking staff. As such, the banking sector has become a strategic puppet between the periphery and the centre, at the detriment of the national economy, on which all depend. Given the size of the Chinese state, divided into numerous provinces, the resulting power struggles between the centre and the periphery are inevitable. As such, the financial sector is certainly in a precarious position.

When in the past inefficient SOE's required financial injections or bail-out loans, the banking sector always acted as a prop-up, pressurized either by the central or the local government. However, in the last few years, it has become clear that the PRC government is increasingly abandoning its ideological claim over the financial sector, as well as over its SOE's, resulting in many of those SOE's closing down operations. Yet despite these hands-off governmental policies, the entire banking system in China is in need of a drastic overhaul, if it is to function according to WTO standards. As Potter (2001: 602) concludes his analysis of the PRC financial sector:

*"In order to comply with the requirements of the WTO, China has begun a wide-ranging campaign of revising existing legislation and administrative regulations. Substantive law in many economic sectors, including customs, foreign exchange, taxation, intellectual property, enterprise law, bankruptcy and pricing and other areas will need to be revised to accord with WTO requirements."*

#### **4.1.2. State-Owned Enterprises (SOE)**

In his review of the bankruptcies of China's state sector enterprises, Carsten Holz (2001:367) touches upon the degree of difficulty one faces in analysing the economic performances of these SOE's. Some of these state-owned companies deliberately falsify their scorecards in order to hide embarrassing financial losses, or else, in order to bolster their image to the central or local governments. Some SOEs located in particular provinces underreport their earnings in order to escape excessive levies and taxes by local governments,

a direct result of the decentralised fiscal structure and the ‘centre-to-periphery’ competition. This *caveat* is issued by Heytens and Karacadag (2001:5), who specifically refer to the difficulties inherent in interpreting the corporate financial data, produced by SOE’s. They claim that “enterprise accounting and reporting practices need to be strengthened so that lenders can make accurate assessments of the true financial conditions and risk profiles.” With this in mind, the analysis of SOE (in)efficiency is indeed a daunting task.

In his analysis of state-sector reforms, Kenneth deWoskin (2001) clarifies the reasons why the progress made in SOE reforms is so critical for foreign investors, in our case for SAB-Miller. Firstly, with the proliferation of locally based breweries, SAB-Miller can investigate the health, productivity and viability of certain state-owned breweries, in order to consider entering into joint ventures or partnerships or in order to complete any acquisitions of existing companies. Secondly, monitoring the emergence of market-driven SOE’s is paramount to the assessment of the degree of competitive forces in China. As deWoskin (2001:14) states “the more SOE’s reform, the more they can benefit from the natural advantages of being domestic.” Lastly, the direction and pace of the reforms of SOE’s, specifically in the beer industry, is a clear indication of the maturation and/or saturation of the PRC market. All three are clearly important aspects for SAB-Miller and each point will affect the promulgation of investment strategies in the PRC.

Since 1993, there has been a measurable improvement in the way state sector enterprises are run. Improvements in terms of property rights regulations, obedience to market forces, separation of powers between management and government and a remarkable increase in the quality of management skills all contributed to the rise of a more modern enterprise system in the PRC. According to Chen Jiagui (1998:14-15) the main focus of SOE reforms lies in the continuation of either letting redundant SOE’s file for bankruptcy or by allowing small to medium sized SOE’s to “merge, annex or co-operate across boundaries of regions, departments and ownership.” By

allowing for the survival of the fittest, the most adaptive SOE's should be able to remain in business and this should strengthen the quality of free-market competition. An increase of FDI in specific fields will further aid the development of international managerial practices and more efficient resource allocation, as discussed above.

The main problem of bankruptcies and SOE mergers is the dismissal of superfluous employees, especially when keeping in mind the absence of social security nets for these employees. According to Jiagui (1998:14) "statistics show that about 20% of the workers in SOE's are superfluous." It is unlikely that these can remain employed in their current positions for much longer and this does not bode well for the precarious socio-political status quo. The critical factors, therefore, lie in the ability of the PRC government to attract FDI from abroad in order to create new job opportunities, and in its commitment to building adequate social security nets, that will stem the tide of anger at the rising employment figures.

#### **4.1.3. Unemployment and Social Safety Nets**

In their evaluation of the reform process, Feltenstein and Nsouli (2001:34) argue that the incremental reform trajectory chosen by the PRC is a more beneficial one. They claim that by deliberately choosing a gradual approach over a "Big Bang" approach, the PRC is able to "maximise inter-temporal social welfare, taking into account the social discount rate, subject to various financial and structural constraints." More clearly put, this means that through generating the necessary amount of economic growth, the PRC can sustain its process of shedding state sector employment, as long as the private sector can absorb the retrenched workers, and as long as the state is willing and able to provide for a social security net for those who fall out of the working economy.

This is collaborated by Zhu Rongji (2003: vi) and Elisabeth Croll (1999), with the latter maintaining that despite the market reforms and the liberalisation of the economy, the state should still remain the primary care-taker for the disadvantaged, who find themselves unemployed or unemployable because of the economic reforms. As Croll (1999:673) states “social stability and political authority are dependent on the government’s ability to reform the social welfare provisioning.” The CCP should attempt to continue with the practices of social insurance, social services and the social relief tenets that it employed through its SOE’s, especially for those *Xiagang* workers, who have lost their jobs and income, but who are still (albeit technically) employed by the state. Croll (1999:681) further describes the social welfare provisioning as a key priority on the national reform agenda not merely in order to meet the changing requirements of the market economy, “but also because its very absence is impeding the emergence of a market economy and [thereby] raising the spectre of economic stagnation and social unrest.”

Athar Hussain (2000:8) has identified that the trend of rising urban poverty has accelerated since 1993, when the second part of the Deng Xiao Ping’s economic reform process started. Before 1993, the PRC’s economic reforms were largely a win-win situation, but since then, the reforms have clearly started to separate the winners from the losers. As he states, “the official head count of the urban population below the poverty line is around 13 million, which implies an urban poverty rate of about 3.3% to 3.5%.” The cause of this urban poverty lies in the sharp increase in lay-offs during the reforms of redundant SOE’s, in the erosion of the enterprise-based social welfare system and lastly, in the relative inability of the central government to develop a new social safety net for the unemployed and the unemployable.

Unfortunately, this trend of lay-offs due to restructuring will persist for the short-term future. The critical factor in this restructuring process is the ability of the private sector to create new job opportunities and by doing so, snatch up as many of the unemployed as possible. Athar Hussain (2000:11) adds that the immediate concern for poverty relief lies in the ability of the

central government to allocate enough budget revenues to city governments, so that they can create and implement a city-based health insurance and poverty relief scheme for the urban unemployed. As Minxin Pei (2002:204) correctly points out “China’s health system ranked 144<sup>th</sup> worldwide, placing it among the bottom quartile of World Health Organisation members.” This information is relevant as, according to John Chan (2001:5), “the UN predicts 10 million HIV cases by 2010 in China, two thirds of which will be located in the rural areas.” We have already noted that a mass exodus towards the cities is already under way, so these concerns are not to be taken lightly. Clearly, the government needs to augment its health and social services expenditure to cities and provinces in order to manage the potentially devastating effects of an eroding social safety net.

Yet admittedly, this outcome depends squarely on the *ability* and *commitment* of the central government to free those resources for the relevant cities. At present approximately 100million workers and employees participate in some form of unemployment insurance programmes and 1.37million people drew unemployment insurance benefits, according to Hendrischke (2003:274). The continuation of these social welfare programmes however, rely on the ability and commitment of the Chinese government. Despite the institutional commitment to these expenditures, their verbal commitments are seriously jeopardised by the incapacitation of the PRC state because of its fragmented and inefficient fiscal system, as will be explained later on.

## **4.2. MARKET FRAGMENTATION**

### **4.2.1. The Agricultural Sector**

As mentioned above, the CCP has committed itself to restructuring its agrarian sector, particularly in light of its accession to the WTO. According to Lardy (2003:255) the Development Research Center of China’s State Council has calculated that with the accession to the WTO over 11.1million

jobs will be lost in the agricultural sector. The PRC has since time immemorial been a self-sufficient agrarian producer, but since the liberalisation of the economy, agriculture as a share of GDP has declined continuously. In 1980, it was still 30% as opposed to less than 17% in 1999, (Hendrischke, 2003:274). In terms of its total national labour force, however, the PRC still has 53.6% employed in the rural sector. Clearly, this decline in profitability of the agricultural sector and the resulting exacerbation of rural poverty will lead directly to an increase in social discontent and also to hyper-urbanisation.

On a positive note, Hendrischke (2003:274) indicates that despite the decline in rural sector profitability, there has been a marked increase in township and village enterprises (TVE), a sector outside official government control. It is calculated that by 1998, these TVE employed 125 million people, or about 28% of the total rural labour force. According to Nicolas Lardy (2003: 265) 354 million people were employed in the rural sector in 2000. Yet, with the rise of TVE's and the "Opening up of the West," the CCP aims to gradually reduce these numbers to more economically viable levels. Lardy (2003: 265) concludes that "China has already absorbed a very substantial portion of the costs of restructuring its economy, necessary to operate successfully in a more competitive, global environment." As such, Lardy indicates that the shrinking of the agricultural sector is a beneficial and irreversible trend for the development of the PRC.

#### **4.2.2. Fiscal Decentralisation and Provincialism**

When Deng Xiao Ping initiated the restructuring process of the PRC, the erstwhile highly centralised Chinese market has essentially become internally fragmented and susceptible to market distortions as a result of this decentralisation process. With the reforms much economic and political power has been devolved towards provincial governments, who have received a certain amount of autonomy in terms of establishing prices, tariffs and other trade-distortion barriers. The reasons for this devolution of power can be extracted from three main developments, which have characterised the

development of the Chinese state since 1978. According to Yifu Lin and Liu (2000:4), the first of these developments is that the economic reforms allowed and pressed for much greater involvement of non-State Owned Enterprises, such as private firms, joint venture-ships with foreign companies, township enterprises and foreign enterprises to freely contend in the growing market economy.

Concurrently, the Chinese state has been shedding the heavy financial burden of inefficient SOE's to the benefit of those locally-based and efficiently run non-SOE's, according to the logic of the market and the survival of the fittest. Secondly, with these economic reforms came the logical result of extending political autonomy to provinces, especially in the areas of decision-making and accountability. Finally, the outcome of these reforms clearly exhibited that the process of fiscal decentralisation allowed local governments to take much more control and responsibility over their economic performances. With their fate and prosperity in their own hands, provinces started to take on more responsibilities for economic growth, and as such started benefiting the PRC's economy as a whole.

However, this process of power devolution has been compounded by two, often antagonistic, types of decentralisation. On the one hand, one gets administrative decentralisation, where political power is transferred to lower tiers of government, in which there are clear winners and losers in terms of decision-making power, settled in favour of the local governments *vis a vis* the central leadership in Beijing. Secondly, one has market decentralisation, where the market, at least in theory, should allocate resources efficiently according to the workings of free market logic. In practice, however, the newly acquired administrative decision-making powers, in the hands of provincial governments, often block the rational implementation of a market-based economy in favour of local protectionism and provincial parochialism. It is because of this negative development that the CCP has attempted to check the devolution of power, as to contain it within acceptable boundaries. The success of this 'containment policy' and the success of re-establishing a unified tax and trade regime throughout the entire PRC is an important



evolution for SAB-Miller, as it will affect the level of SAB-Miller's access to the entire Chinese consumer population.

As Breslin (1999:17) indicates "inter-provincial trade remains remarkably low as a result of provincial authorities acting to protect their local producers." An astonishing example of this local protectionism is given by Gilley (2001:17) who writes that a bottle of Beijing's Yanjing Beer, which sells for the equivalent of 18 cents in the capital, will cost about \$1 in the remote Sichuan Province, as a result of provincial fees and taxes. Bruce Gilley (2001:18) explains the origins of these provincial rivalries by linking the evaluation of local cadres by the CCP, on the basis of the economic growth record of their assigned locality. As such, "local authorities are obsessed with local GDP growth rates (the leading criteria for evaluating party cadre performance) and so make full use of their administrative powers to assist local producers, sectors and industries."

On top of that, local governments continued to carve out their own economic fiefdoms *vis à vis* the central government. For instance, in terms of the fiscal rights and duties, assigned as the prerogative of the provincial government, most taxes are collected and calculated by provincial branches of government. As Breslin (1999:19) narrates "through creative accountancy local authorities could underreport their real wealth and thus reduce the tax revenue they passed on to the central authorities." These perfidious and disjointed practices are continuing to undermine the equal development, evolution and distribution of prosperity throughout the entire PRC.

At present, the PRC has 27 relatively autonomous provincial governments, as well as numerous special Export Processing Zones (EPZ) and Special Economic Zones (SEZ), such as the Shanghai Economic Region. Because of these particular economic zones, the PRC central government has been unable to draft, implement and control policy from the centre, leading to a situation, in which provinces and regions compete against each other in such a way, that it actually undermines the overall economic growth potential of the PRC. The result of the Deng Xiao Ping's economic reforms

led to “the fragmentation of the domestic market and the distortion of regional production away from patterns of comparative advantage,” (Young, 2000:1091).

This ongoing process of power devolution towards the provinces has resulted in the establishment of local fiefdoms, more concerned with the economic growth of their province, regardless to the logic of comparative advantage. With the central government relinquishing control over prices, tariffs, outputs and budgets, “these functions have been taken up, albeit in a less systematic fashion, by local governments. Thus, China has moved from having one central plan to having many mutually competitive central plans,” (Young, 2000:1129).

Yet, despite this rather unfavourable trend of power devolution, some analysts claim that fiscal decentralisation has “made a significant contribution to economic growth, which is consistent with the hypothesis that fiscal decentralisation can increase economic efficiency,” (Yifu Lin and Liu, 2000:18). Their reasons for investigating this hypothesis are based on the assumptions that local governments have better access to relevant information concerning the presence or absence of market opportunities in their location. Secondly, through their autonomy the local governments will be pressed by their constituents to perform responsibly and adequately. Finally, the principle of power devolution, or more accurately, the empowerment of local governments, should incite entrepreneurial dynamism, provide incentives for opportunism and strengthen personal involvement by local officials to spur on economic growth. As Yifu Lin and Liu (2000:16) correctly state:

*“For provincial governments the incentives to invest are stronger under a decentralised fiscal system than under a centralised one, because the former affords provincial governments a greater share of returns that may be generated by additional investment.”*

Despite the sound argument of pro-decentralisation, the most critical question revolves around whether or not *national* economic integration is a prerequisite for successful *international* economic integration? As Jiawen Yang (2002: 35) correctly writes “a fragmented national economy may not be

able to reap the claimed benefits of globalisation or international economic integration.” In his investigation of the intra-country integration of China, Jiawen Yang (2002:49) states that although China has a vast collection of small and medium sized firms, it has:

*“Very few large conglomerates, whose businesses can span all over China and/or have established significant presence in overseas markets. Those many thriving small and medium sized firms have limited access to markets beyond their respective starting localities.”*

This lack of nationally recognisable, cross-provincial conglomerates is another telltale indicator of the economic disintegration of the Chinese market. The reality of the matter is that, as Bruce Gilley (2001: 16-19) and Alwyn Young (2000: 1091-1135) narrate “there is every indication that the economy of China, while opening up internationally, has become fragmented internally.” China’s inter-provincial rivalry is such that “the domestic economy has become more and more fragmented, riddled with local protectionist measures ranging from crude roadblocks to sophisticated technical standards,” (Gilley, 2001:17).

This is arguably one of the most important risk factors for SAB-Miller’s productivity and profit margins. The inability of the PRC national government to unify its domestic market undermines SAB-Miller’s potential for free and fair access to the entire Chinese market. With regards to the fragmentation of the market, SAB-Miller should pay attention to two main issues. Firstly, because the breweries are all located in the Eastern Seaboard provinces, its penetration into the Western provinces is undermined by the fragmentation of the Chinese market and the relative isolation of hinterland provinces. Therefore the careful monitoring of the evolution of this inter-provincial rivalry is a key concern to SAB-Miller. Secondly, because of the unfair market regulations the competitive edge of SAB-Miller is undermined by a plethora of competitors, who might remain in business solely because of local protectionism and not because of market logic.

To counter this negative outlook for FDI, the Chinese State Administration of Taxation (1999:13) has unequivocally declared that:

*“To ensure fairness in liability, promote competition on an equal footing and gradually grant national treatment to foreign funded enterprises, taxes on Chinese and foreign-funded enterprises will be unified, although necessary preferential taxes maintain.” [Italics added].*

These “necessary preferential taxes” refer squarely to the tax exemptions for FDI in certain specified areas, where the PRC government wants to boost economic growth. According to Li Ning (2000:17) income tax, for instance, for FDI is 15% while that for domestic firms is 33%.” The reasons for this preferential treatment are clearly visible in the speech by former Premier of the state council Zhu Rongji (1999:19):

*“We should take full advantage of China’s social and political stability and sound macroeconomic conditions to try to absorb as much FDI as possible, particularly investment from famous transnational corporations and improve the way foreign funds are used.”*

Despite the accession to the WTO, and the explicit rule of free competition on equal footing, it remains unlikely that the PRC government will abolish the preferential tax treatment for FDI, especially as FDI is earmarked as the main vehicle for economic growth and for the absorption of retrenched workers. So for the short-term future at least, FDI will retain its privileged status in the PRC.

### **4.3. ASSESSING THE IMPLICATIONS OF WTO ACCESSION**

Since December 2002 the PRC has become a participant in the WTO, whereby it is obliged to conform to certain international standards and procedures with regard to trade issues. Despite the amount of obligations that the CCP government has taken on, it can also use its new position as a means to establish itself as an economic powerhouse on the international scene. Yet opinions are divided as to whether or not the PRC will be able to conform to the many WTO rules and regulations, which the government accepted by signing the accession treaty, (Yang, 2000; Gilley, 2001; Biers, 2001). This sceptical attitude is the result of the massive restructuring task that CCP government has to implement concurrently with the implementation of these new rules and regulations. As long as the necessary success in this drastic reformation of the economy is still underway, the

experts remain sceptical with regards to the PRC's ability to implement WTO standards and regulations.

#### **4.3.1. Acceptable Non-Compliance**

Qingjiang Kong (2001:1184) states that any member state of the WTO is faced with two critical aspects that accession forces upon signatory members. The first is the internal implementation and enforcement of the details of the accession agreement. Secondly, the member state has to show tolerance towards relinquishing some economic sovereignty by allowing external overseeing of its domestic affairs by the relevant WTO organs, in cases of disputes. In such a dispute between member states, for instance in terms of non-compliance, the "refusal of a WTO member, involved in a dispute dealt with by a WTO panel to take recommended compliance measures, would lead to unilateral retaliation," (Kong, 2001:1185). Despite the CCP's good intentions by signing the agreement, the question still remains: can the PRC comply, apply and enforce all of the WTO regulations? Surely no one doubts that the PRC is evidently liberalising its economy and that it is specifically aiming to affect its market reforms, in line with WTO principles. Yet surely it is unrealistic to demand immediate and full compliance from the PRC. It is already very encouraging that the PRC is showing increased commitment to and compliance with international treaties and protocols. As such, the PRC should not be judged upon too harshly without extending to them a delay-period of approximately 5 years.

Yet some important lacunae still exist in the PRC's socio-economic structure that might complicate the enforcement of the WTO agreements. China has a poor track record in terms of legal independence or even established rule of law. Actually, as Kong (2001:1189) states "it is the rule through law rather than the rule of law," that exists in the PRC at present. Secondly, increased social pressures could lead to a diminishing adherence to the WTO's principles and these social pressures might intensify the belligerence of the population. This could lead to a dangerous situation if the intensity of the social discontent forces the CCP to renege some or all of its duties and

obligations towards the WTO. Though unlikely, this scenario if it does happen, could be at the expense of imploding the entire economy. Lastly, and most importantly, the “non-institutional central-local relationship,” (Kong, 2001:1192) still blocks a countrywide implementation of international law and regulations. The reasons and origins of this are mentioned and outlined above. Again, SAB-Miller is well advised to monitor the developments of this ‘center *vs* periphery’ power struggle, as it may well be *the* most critical socio-political risk factor.

According to Kong (2001:12066) the PRC government needs to strengthen four main aspects in order to secure compliance. First, they need to amend or repeal inconsistent domestic laws, which conflict with WTO standards. Secondly, it needs to create a framework through which international law and practice can be incorporated into the Chinese legal system. Thirdly, it needs to press for uniform administration of the standards and agreements. Lastly, it needs to create “an independent, fair and effective administrative legal system and a judicial review system,” through which a market economy can flourish and the rule of law can be implemented.

#### **4.3.2. Strengthening Democratic Participation**

What most analysts agree upon, however, is that in the short-term the impact of the WTO accession will raise the stakes for the CCP government in two ways. First, it is critical that it continues its socio-economic restructuring process, and sees it through. Secondly, it needs to increase the level of democratic participation for the newly emerging socio-economic interest groups of society to a workable minimum. According to Wang (2003: 42) the only way the CCP government can alleviate the stresses and strains of the accession is by consolidating the process of “democratic state building, namely to strengthen essential state governing capacities while institutionalising inclusive participation and public contestation.” As mentioned above, these newly emerging socio-economic elites are gaining a foothold in CCP agenda setting, yet this process is still obscure and without real accountability or public scrutiny.

One of the most important stumbling blocs in extending public contestation and inclusive participation is caused by the nature of the Chinese constitution as it is “similar to other socialist constitutions, in that it gives the CCP a monopoly of political power and it rejects the notions of division in checks and balances of power,” (Yang, 2000:438). With such a constitution, basically a manifesto for unfettered CCP government, democratic participation is an alien concept to the Chinese state. As such, genuine democratic participation is very much dependent on the pragmatic goodwill of CCP officials and limited provincially based township and village elections.

Despite the relative stalemate in the democratisation process, an intrinsically related, yet far more critical process needs to be monitored more attentively. Xiaokai Yang (2000:473) calls this process the “Dual Track Approach,” of the CCP government. Simply put, the CCP has, ever since its reforms began, always applied two different sets of economic principles for domestic players and for foreign enterprises, to the detriment of local firms. Similarly, it has applied a different course of socio-economic development in the Eastern Seaboard provinces *vis à vis* the underdeveloped landlocked Western provinces. The result is now that there is a distributive impasse, obstructing the fair extension of the gains of economic prosperity evenly across the entire nation. As Yang (2000:473) predicts “the dual track approach may exacerbate the inefficient inequality of income distribution, further institutionalise state opportunism and corruption, lower moral standards and increase social tensions.”

The critical factor here is whether the CCP government will use the momentum of WTO accession to either rectify this dual track approach or if it will entrench it even further. Ideally, WTO accession should “stimulate demand from Chinese citizens for constitutional rules that relate to economic and judicial game rules.” (Yang, 2000:441). If this opportunity is not grasped either by the Chinese citizenry or by the CCP itself, the prediction that state opportunism (i.e. the process whereby the rule maker, the rule enforcer and the rule arbitrator are the very same state apparatus)

will further entrench its detrimental hold on the economy, might very well sour the overall restructuring process.

It is clear that in the short-term there will be very clear economic winners and losers, after the WTO accession, a process that actually already started in 1993, after the second phase of Deng Xiao Ping's reformation. In his evaluation of the implications of the WTO accession, Shaoguang Wang (2000) argues that these distributive conflicts might hamper economic development. As Wang (2000:376) clearly states:

*"When the state lacks the capacity to manage conflicts and social tensions run deep, it would be hard for the state to coordinate social interests on stabilisation and growth-promoting policies, not to mention enlisting the support of most social groups in making short-run sacrifices, at times of exogenous shocks and macro-economic crises."*

It is clear that the governance deficit of the CCP will be exacerbated, but what is less clear is whether this deficit will lead to any significant change in the PRC's economic policies. One of the biggest indicators of this lagging governance deficit is found in the lack of tax compliance by the citizenry and the inefficient fiscal system. In a system where tax collection is incomplete at best, and in a system where the taxpayer has no meaningful voice in the allocation and expenditure of the taxes, the taxpayer feels little incentive to pay his dues. As such, the governance deficit is most critically felt in government's revenue budget. As Wang (2000:378) clearly states distributive conflicts are easier to remedy in a system where tax collection is connected with increased participation. "Only when the government possesses such a strong extractive capacity can it play the distributive role," which is unlikely to occur unless the taxpayer is given an "institutionalised voice" in the budget allocation.

The question of winners and losers in the post-WTO PRC is largely focussed on the fate of farmers and retrenched urban workers. With the influx of agricultural produce from outside, the Chinese farmer will be hardest hit, especially since he already occupies one of the most disadvantaged positions in Chinese society. It is a tentative estimate that between 13 to 15 million farmers will be unemployed between 2000 and 2010 (Wang, 2000:397). The



result will be an influx into the modernised urban Eastern provinces. The urban workers of those provinces are already suffering themselves under the restructuring processes. Wang (2000:398) estimates that number of unemployed urban workers to be around 25 to 30 million. Add the major influx of rural unemployed to the growing number of retrenched urban workers, and the employment situation in China is looking quite bleak. As such, the prediction that the PRC needs to maintain a minimum growth rate of 7%-9% per annum is of crucial importance.

Yet some authors (Wang, 2000; Biers 2001) claim that the PRC will not be able to achieve that rate, and even if they were to, they still would be unable to stem the negative trend of retrenchments. This assertion is highly disputed by others (Feltenstein and Nsouli, 2001; Fewsmith, 2001 and Rongji, 2003). The critical factor separating the positive scenario from the negative scenario outlook is the ability of domestic investments and FDI to create employment opportunities; their ability to absorb retrenched workers and, thus, stimulate the overall growth of the economy. An additional tool employed by the CCP government is the utilisation of limited but highly effective labour unions to operate, assist and retrain retrenched workers and give them some voice in the restructuring process.

The All China Federation of Trade Unions (ACFTU) is specifically charged with these tasks. It remains fair to say that ACFTU does not have the pervasive presence that their name implies. In order to attract foreign and domestic investors, some provincial governments have limited or blocked the operations of trade unions. Secondly, it is no surprise or secret that the PRC is a highly attractive FDI market precisely because it is able to provide a cheap and abundant labour force, without too much institutional hassles and restraints.

Yet any FDI that does not employ some level of unionisation is posing a risk to itself. This is a fair warning for SAB-Miller, as its labour practices might mitigate or exacerbate such sector-specific risks. As Leong Liew (2001:55) claims, through setting minimum labour standards, labour productivity may

rise instead of merely just increase the costs to the company as “working conditions, according to efficiency-wage economic models’ arguments, have a direct bearing on labour productivity.” Also, let us not forget that with the rise in importance of labour and human rights abuses to the general public, no multinational can afford to exploit abusively and get away unscathed. As Liew (2001:59) concludes, multinationals have much to gain in having a reasonable labour union. The situation of SAB-Miller in this respect is very similar to what the CCP government faces on the national level. Since the social costs of retrenchments and downsizing are to be borne by the workforce, established collective bargaining between labour and state is critical, as labour depends on the state for social benefits and health securities, in the same proportion as the state needs the support, acquiescence and cooperation of the labour unions for the continuation of the restructuring process.

## **V. SECTOR-SPECIFIC ASSESSMENTS**

### **5.1. SAB-MILLER'S ACHIEVEMENTS**

The focus of this section is to describe the risk management policies available to SAB-Miller, wishing to elaborate on their existing investments in the beer and lager industry of the PRC. The company, South African Breweries-Miller Limited (SAB-Miller), has already acquired control of numerous breweries in China since it entered the PRC in 1994. These acquisitions bring SAB-Miller's production capacity up to nearly 27 million hectolitres per annum in China (O'Hagan, 1998:1), more than it produces in its home country of South Africa. In terms of its international statistics, (Klein, 2003:12), SAB-Miller is the second largest brewer in the world, active in over 122 breweries across 40 countries and employing approximately 45.000 employees. At a turnover of \$1.9 billion and with earnings of over \$581m in the year 2003 (until March) alone, SAB-Miller is quite clearly a major player in the global beer industry. In its annual global production, SAB-Miller had a volume of 115.8million hectolitres of lager. As shown in its recent mergers and acquisitions of international breweries, specifically in the PRC, SAB-Miller is eager to augment their massive production levels and as such achieve even higher turnovers.

By doing this, SAB-Miller has proven to be one of the few successful companies to have invested in the PRC. Considering the track record of most MNC's investing in China, this is a formidable feat. According to Roy

Bagattini, managing director of SAB-Miller's China operation, their success lays in the fact that SAB-Miller:

*"Has tailored both its product and operations to its location. We usually buy a local brewery, rather than building our own, and then upgrade it under local management to produce local beers for specific second-tier markets, rather than competing on the high end."*(Kurlantzick, 2002:1).

Evidence of this tactic is to be found in their recent acquisition, to the value of 29.6% of the Chinese brewer Harbin, the oldest brand in China, for \$87 million in cash (Klein, 2003:12). Through its joint venture-ship partner China Resources Breweries, SAB-Miller has taken a claim in 30 breweries in over 9 provinces. Yet not only SAB-Miller has been busy snatching up existing breweries. In terms of its Chinese competitors, it should be noted that the Beijing based Yanjing Brewery, China's second largest brewer, has taken control of rival Huiqian Brewery Group, in the industry's first takeover involving two publicly traded Chinese companies, (Business Report, 2003). This indicates a rising maturation of the beer industry in the PRC.

The Yanjing Brewery claims it wants to become one of the world's 10 largest breweries by 2005. This information is relevant to the SAB-Miller group in two ways. First, it is a sign of the vitality and profitability of the Chinese market. Secondly, direct competition of a Chinese brewer could make a much larger impact on the sales and earnings of SAB-Miller, than for instance another foreign brewer. In a developing country with a daunting restructuring agenda, foreign firms might become the target of consumer boycotts in a possible wave of nationalism and xenophobia. As such, SAB-Miller should do well to analyse the mood swings of the consumers, as well as maintain an acceptable socio-economic profile and exhibit corporate responsibility, especially since its industry is one that creates socially disruptive behavioural patterns, through alcoholism and the related disintegration of societal structures.

An important micro-risk factor for SAB-Miller's investments is the existence of an inefficient distribution system in the PRC. At present, this distribution system is a hybrid mixture of "old state-planned networks coexisting with

market-oriented forces,” (Zhang, 2001:1247). The main issue here is that because this chain of distribution is still very inefficient and unregulated, it undermines the price-competitiveness of SAB-Miller’s product to the consumer. As Zhang (2001:1250) states “foreign exporters meet a regulatory barrier, which obliges them to transact with a Chinese middleman and entitles the latter to mark-up the price when reselling it downstream to the end-user.” This inefficient canalisation and intermediation process, however, is an established practice, but one with a negative impact for foreign investors. Clearly, SAB-Miller has a dilemma as to which middleman to use and to what extent this choice will affect SAB-Miller's price competitiveness.

Luckily, WTO standards block the continuation of this practice. Through the WTO agreement, the PRC needs to amend this inefficient practice and grant national treatment to foreign producers and allow them direct access to end-users, without local middlemen, thereby cutting the regulatory barriers and hence increase the competitiveness of the product. As such, SAB-Miller is strongly advised to monitor developments in this area, and if need be, lobby for compliance either to the PRC government or through the WTO dispute mechanisms. This example clearly demonstrates the need for continual monitoring of the situation. Since SAB-Miller is already inside the PRC market, it needs less a risk analysis report of the PRC, as it needs a *risk management* report, enabling them to deal effectively and timely with unforeseen occurrences. Since the major risks to SAB-Miller are largely limited to the ones outlined above, SAB-Miller can decisively formulate long- to medium-term risk forecasts and also implement the correct risk management strategies. With this in mind, the next section will investigate the necessity of risk management policies and show how they can be implemented and evaluated.

## **5.2. Risk Management Policies**

In the above-cited statement by its managing director Roy Bagattini, it is evident that SAB-Miller has done more than just ‘tailor its operations to its location’. What this statement reveals is that SAB-Miller has done a

thorough risk analysis and that it has in place a comprehensive risk management and risk mitigation strategy. As Brink (2002:27) states “the aim of a political risk management technique is to reduce a firm’s exposure and vulnerability to political risk without having to drastically change the firm’s strategy.” As a MNC, SAB-Miller is operating in an environment unlike that of its South African home nation. Operating in a different culture under a different legal system with different values and customs clearly complicates the management of the company. Besides the complexity of day-to-day activities, the MNC is caught between the complexities of the host country socio-economic dynamics, intrastate dynamics, environmental dynamics and all the possible permutations of the previously mentioned. Devising a risk management policy is, therefore, not such a straightforward issue.

The ripple effects of these ever-changing circumstances affect the functioning and efficiency of the company continuously. So it is quite understandable that every company needs to have a risk management policy in place, as well as have various contingency plans and thorough risk insurance. One such investment insurance agency is the Multilateral Investment Guarantee Agency (MIGA) “a World Bank initiative, designed to promote and protect direct investment projects in developing countries,” (Brink, 2002:22). Basically, it gives investors insurance against political risks, such as against host government actions, expropriation, restrictions on currency transfers, etc. MIGA can provide long-term insurance for companies and also serves as a “forum for the discussion of investment policies and problems and contributes in a variety of ways to the reduction of barriers to international direct investment and improved investment climates,” (Brink, 2002:23). Clearly, it is in SAB-Miller’s interest to acquire such insurance and to adhere to the advice of such a forum. Foresight and insider knowledge are paramount in mitigating the possibilities of risks occurring and affecting the company.

However, when the company investigates micro- and macro-risks, it should not be blinded by the impression that risks solely originate from *outside* the company. As Brink (2002) rightly indicates, companies can often become

risks to themselves, in their bid to approach host governments for the development of certain privileged relationships<sup>8</sup>. In China specifically, this is a sound yet sly tactic, as it can backfire with catastrophic consequences. For instance, in case the incumbent provincial government gets expelled, relieved of office or subverted, those with close relationships might become a source of embarrassment to the new leadership. Worse still, the company itself might become an agent of political instability and ultimately a risk to its own investments. SAB-Miller should therefore be cautious in its necessary relationships with Chinese government officials. This caution does not imply that a regime change is imminent in the PRC, in the short- to medium-term. What it means more specifically is that with any provincial leadership being appointed by Beijing, close ties between business and government might become a source of embarrassment, in case of a sudden and unexpected leadership change. This is not an uncommon feature for a political system, where governmental appointments are made outside official electoral proceedings, and solely by the deliberation of the CCP caucus in Beijing.

Obviously, the relationship between government and company is never one of equal footing. Companies are involved with socio-political factors in as far as they pertain to the company's potential losses or gains. Governments, by function of their office, need to keep abreast of the socio-economic and political needs of their constituent population, even in an autocratic state as is China. These two fundamentally conflicting motivations can sour relationships between host government and foreign investor quite quickly. Therefore, any company should always attempt to moderate their desire for privileged access and influence, so as to make "provision for the right to influence macroeconomic and social policy makers, though, as the privileged party, not secretly but openly and in concert with labour and consumer groups," (Brink, 2002:25). Only in such a way can SAB-Miller acquire a say in the policy formulation process, concurrent with keeping a (relatively) neutral image, a necessary stance for the mitigation of any risks, which may originate from the company's business policies.

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<sup>8</sup> For a critical and detailed account on how to deal with Chinese business partners and government officials, reading Wang, Zhang and Goodfellow's 1998. Business Culture in China, is a must.

Despite their conflicting motivations, governments and MNC's need one another. SAB-Miller must appreciate the role played by the Chinese government in establishing the rules of free market competition, in providing a climate conducive to the exploitation of competitive advantage, in the transference of knowledge and in the area of human development, not to mention in maintaining the basic infrastructural necessities, such as roads, ports, customs, etc. As Brink (2002:7) unequivocally states "to the MNC, the host government can represent the key to the local market or access to resources, that provide new opportunities for profit, growth, and the improvement of its competitive position." As such, an optimal relationship between SAB-Miller and the provincial or national government is a prerequisite for successful business and an integral part of a coherent risk management policy.

### **5.3. Risk Management Techniques**

Companies, however, need to establish a risk analysis and risk management plan prior to investing in a country. After this critical initial step, there are two standard techniques of managing, reducing, avoiding or minimising the impact of political or economic risk factors. First, one has the 'integrating technique' that aims to integrate the MNC into the host society, by appointing local managers, by adopting local custom-specific practices, so as to give the MNC less the appearance of a 'foreign' company. Brink (2002:6) identifies therefore "polycentrism," as a key concept in this technique. Instead of ethnocentrically directing the company according to home nation rules, customs and values, the MNC aims to adapt and fit into the host society by pulling in local knowledge and know-how. SAB-Miller has achieved laudable progress with this technique in the PRC and it is therefore advised to continue with this successful technique.

However, such an approach leaves an MNC open to host nation interference, a lack of global focus and it can undermine the formulation of a global strategy necessary for an MNC in order to reach uniform global standards in



its services and products. It is with this downside in mind, that SAB-Miller must always have a 'protective technique'. This technique is described by Brink (2002:11) as:

*"To discourage host government interference, or in the event of interference, minimise the firm's potential losses. Protective techniques generally provide for the non-integration of the foreign operations into the host country environment."*

This 'protective technique' deals predominantly with production issues, managerial styles, financial considerations, research and development (R&D) and marketing policies, which the MNC aims to keep to itself so as to fashion them according to its specific global outlook. Getting too caught up in the 'integrating techniques' could make the MNC lose focus of the bigger picture, as well as blind it to a changing global frame of opportunities. As such, a correct and healthy balance between these two techniques is a must for SAB-Miller.

SAB-Miller has a track record in China that proves just how successfully it has balanced these two techniques. Through one of its latest acquisitions, SAB-Miller has invested in a joint venture with the Chinese CRE Beverage Limited in the Northeast Jilin Province, acquiring 49% of their shares. It has done similar joint ventures with three other Chinese breweries in Shenyang, Shenzhen and Dalian. These are clear examples of how to integrate a South African company with Chinese partners, and thus far, it has proven to be a huge success for all parties. However, taking up joint venture-ships does not make SAB-Miller a full-blown integrationist. Understandably, SAB-Miller has withheld the rights to and patents of its products and its manufacturing technologies from its Chinese business partners. It is in balancing the inherent risks of cooperation and in achieving a decent consensus between the South African and the Chinese partners that the middle way is found. The abundant evidence of SAB-Miller's success should go to prove that SAB-Miller is clearly successful in the PRC, because it is correctly combining both techniques. SAB-Miller should elaborate on these successes and maintain their investment strategies that integrate both these techniques.

So, in a short summary, one can identify five steps that need to be taken in order to assess the potential risks and the consequent managerial responses. According to Brink (2002:26) the first step is identifying the relevant stakeholders: home-and host governments, trade unions, civil society, suppliers, etc. The combined knowledge and expertise of all these groups can give an accurate picture of the “do’s and do not’s” of foreign investing and these groups will most certainly highlight some potential pitfalls for the company. Secondly, after the initial intelligence gathering has finished, the MNC can analyse the extent of its obligations and responsibilities towards these stakeholders and it can start to identify market opportunities, as well as abandon or modify less profitable investments.

As a third step, a MNC’s must continue the process of data gathering, so as to make “provision for the constant monitoring and analysis of a host country’s policy environment, specifically with regards to the impact its policies might have on a specific industry’s and host country’s overall investment climate,” (Brink, 2002:27). At numerous occasions the socio-political and economic developments specifically relevant to SAB-Miller’s investments have been highlighted. These areas of concern need to be monitored over time and they require continuous and ongoing assessment so as to enable SAB-Miller the time to respond to any potential problems before these can crystallise into full-blown risks, whether of macro- or micro-level importance.

Fourthly, a MNC must always be on the lookout for unforeseen challenges and risks. Vigilance is a necessary attitude and it cannot be substituted for anything else. As a last step, MNC’s must make a conscious decision to respect and balance both home- and host government customs and values. Corporate responsibility is increasingly gaining momentum and scrutiny in the global arena. A MNC aiming to become a global player cannot simply exploit and pollute some regions irresponsibly without being held accountable or somewhat responsible. It needs to make sure that the company itself does not become a source of instability to its own

investments. We have already touched upon the various ways in which SAB-Miller might become a risk to itself. So, clearly, it is advised to closely scrutinise its own practices so as to minimise the possibilities of company-based risk factors.

It is in balancing these five steps that SAB-Miller can attempt to calculate and evaluate eventual socio-political risks. As Brink (2002:25) concisely states:

*“Political risk management entails the constant updating of these plans in an attempt to adapt the organisation to internal and external socio-political and socio-economic changes, and in doing so, favour flexible over rigid planning, assuming that MNC’s have the resources (financial and human) to plan and act flexibly.”*

Political risk analysis is more of an art than a science. MNC’s, therefore, have to become adept at sensing the covert and overt risks and opportunities inherent in foreign investment. Only by understanding their roles in the host society and by doing a thorough job of assessing and investigating the socio-economic climate can risks be calculated and effectively managed.

## **CONCLUDING REMARKS**

This report has attempted to demonstrate that the investment climate of the PRC is a relatively stable and highly profitable one. In terms of the investments made by SAB-Miller it has already achieved remarkable successes. Its future plans of expanding investments should be hinged on and assessed by the evolution of the PRC’s restructuring process. Monitoring the critical macro-level socio-economic and political developments should indicate the health of the PRC’s investment climate. At present, that climate is stable and with the effects of the WTO accession filtering through, the Chinese economy should be strengthened considerably in the medium-to long-term. Yet, there can be no substitute for eternal vigilance with regards to the impact of the restructuring process on the PRC’s economy.

The main points of caution on a macro-economic level are based on the rural/urban prosperity and unemployment problem. The development in this area is critical for the assessment of the level of societal (dis)content and also for the level of acquiescence by the population with the ongoing restructuring process. Secondly, a macro-level factor of concern is the structural underdevelopment, as it is manifested by an inefficient fiscal structure. The fragmentation of the fiscal, the political and the market structures is the direct cause of this underdevelopment, and as such the ongoing 'tug of war' between the provinces and the centre will be paramount in the resolution of this grave concern.

Thirdly, the success rate of SOE's reform will be a critical example of the health of the Chinese economy and a good barometer of how committed the PRC is to the implementation of the WTO framework. Intrinsically linked to this is the restructuring process of the financial sector. This process will be highly relevant to the survival of the Chinese economy as a whole and it depends mainly on sustaining trust in its banking sector. With many outstanding NPL's to numerous defunct SOE's, the banking sector in the PRC is in dire need of reform. Quite clearly, the importance of this reform cannot be understated, as it is the linchpin of a healthy and correctly functioning economy. As a last macro-economic risk factor, any astute investor should closely monitor the level of success of the government in the provision of social safety nets. The provision of these safety nets is a necessary development in order to cope with societal discontent, resulting from the massive restructuring process. The critical factor here is the intensity of the commitment of the ruling party to create these nets and to allocate sufficient funds from their budgets to counter the inevitable pauperisation that retrenchments will force upon millions of farmers and urban factory workers. Clearly, urbanisation, housing, crime and health concerns are all logical extensions of the provision of social safety nets, or the lack thereof. Although, there are all clearly macro-level risks, they pertain to any investor in any PRC sector.

Sector-specifically, SAB-Miller should monitor the worrisome market fragmentation in the PRC, which clearly augments the risks of the made investments by lowering the profitability of the acquired breweries. With the market heavily fragmented, SAB-Miller loses its possible outreach to all of the Chinese consumer groups across the PRC. Even if they do manage to transport their products to the most remote corners of China, the existing trade barriers and high tariffs might undermine any price competitiveness that may flow from the logic of vertical and horizontal FDI in the PRC. Clearly, this is one of the most important risks to SAB-Miller.

Secondly, the continued existence of the 'Dual Track Economy' of the PRC might exacerbate the tensions of the uneven playing field, as it exists for both domestic and foreign enterprises. Since, FDI is given preferential treatment, a definite bonus for SAB-Miller, some domestic breweries will inevitably use their provincial contacts to resist fair competition with SAB-Miller. This implies the possibility that provincial breweries will use their privileged contacts with the provincial governments to lobby for higher tariffs and/or unfair trade practices against SAB-Miller, which will be at the detriment of SAB-Miller's product competitiveness.

This raises the last important micro-level risk, namely the use (or not) of local distribution systems and Chinese middlemen at the expense of price competitiveness. In this instance, as with the above-mentioned unfair-trade practices, SAB-Miller has the option of bringing their complaints before the WTO or before a Chinese Court of Law. Though that is completely within the boundaries of the law, such drastic actions might make SAB-Miller highly unpopular in a fairly nationalistic China. As such, SAB-Miller might be posing the biggest risk to itself, by its very own actions. Clearly, this is a very sensitive issue to SAB-Miller and as such it needs to proceed cautiously in the initial stages. SAB-Miller is well advised to consider, in the eventuality of such unfair trade discrimination, to allow the PRC a grace period of approximately 5 years. Keeping the enormous restructuring task of the CCP government in mind, such a period of grace should be in proportion to the

enormous profit-potential SAB-Miller stands to gain from the Chinese market. After that period, the PRC should have internalised the WTO agreements much more profoundly, so that any legal arbitration of trade disputes can take its course, without the possibility of a dramatic backlash.

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