

Wednesday, June 9, 2010

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“Testimony before the U.S.-China Economic and Security Review Commission”

Hearing on Evaluating China’s Past and Future Role in the World Trade Organization

Prepared statement of Dr. Oded Shenkar

Thank you for giving me the opportunity to appear again before the Commission. In this statement I will briefly review what I see as the benefits (and the liabilities) accrued to US firms from China’s WTO entry, the key areas where China has failed to comply with its WTO obligations, the primary difficulties facing US companies in China, and the impact of China’s WTO accession on US firms that do not directly interact with China by way of trade or foreign direct investment. I will sum up with the repercussions, both positive and negative, of China’s entry into the WTO. When answering these questions which have been outlined by the Commission, I will at times provide an opinion on how some of the above issues are likely to unfold over time.

Benefits to US Firms from China WTO Entry

The benefits that have accrued to US companies from China’s entry to the WTO are substantial. They include the opening of sectors such as retail which have been either closed or severely restricted in terms of ownership structure (e.g., a requirement to form an Equity Joint Venture [EJV] or a Cooperative Venture [CV] structure versus a now permitted Wholly Owned Foreign Enterprise [WOFE]) and region (e.g., investment previously restricted to major cities which is now permitted in the hinterland). In both of these examples, benefits have been substantial. Data show that after WTO succession foreign companies have markedly increased the proportion of their China operations that are wholly owned either by forming a new WOFE or by acquiring the Chinese partner’s stake in an EJV. Better access to the hinterland coincided with a major push to accelerate development in rural areas and in particular in secondary and tertiary cities that are now growing rapidly and provide foreign companies with markets as well as production facilities in price sensitive sectors. For companies such as General Motors, the Chinese market has been a bright (and growing) spot in the midst of a financial crisis and while this EJV dates back to pre-WTO accession it has certainly benefitted from the accession at least in terms of market demand.

In addition to the opening of the domestic market, American and other foreign firms continue to dominate Chinese exports (the last data I have, from 2005, shows Foreign Invested Enterprises accounting for 58 percent of Chinese exports, a very high ratio that is a high multiple of what we saw in Japan and Korea at the time). This percentage was significantly higher in technology sensitive sectors such as IT, attesting to the advantage of foreign players not only in innovative capabilities but also in the various value chain links that underlie global capabilities. I assume this situation to be unsustainable primarily because it is not acceptable to the Chinese leadership that is worried of foreign domination is eager to develop its own “global champions.” Many of the obstacles that I will note later in this testimony are related to that assumption.

Indirect benefits have also accrued to China-engaged US firms in such realms as aviation, where China’s WTO accession played a part in accelerating economic growth which in turn has generated demand for foreign goods, e.g., passenger aircraft, boosting Boeing. Other benefits have been accrued for US firms that import Chinese inputs and components as a way to lower product cost and remain competitive,

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e.g., automotive and appliance makers. The US educational sector has also benefitted from a rise in Chinese demand as a way to upgrade skills which has been partially driven by WTO accession.

Chinese Fulfillment of WTO Commitments

Did China live up to the commitments it made in its WTO accession? The answer to that question is quite complex and at times murky. The yardstick I am using is primarily the set of commitments pledged by China as part of its accession to the WTO as well as the general principles that govern WTO membership which oblige China, like other WTO members.

Non-Discrimination

Chief among the above the above commitments, in my judgment, is the principle of non-discrimination, that is, the agreement to accord foreign players a level economic and market playing field versus other foreign players, and, in particular, versus domestic companies. The Chinese record on non-discrimination is spotty. To be fair, China has opened up to foreign firms much more than most emerging economies, especially Japan and South Korea at the time these economies were at a similar stage. Yet, there are frequent instances of discrimination and in my judgment the situation is worsening and will worsen further in the future. While China has made the vast majority of the formal changes in legislation and regulations that are consistent with the principle of non-discrimination, the record on the ground has often been quite different. It is the nature of this phenomenon that it is very difficult to assess its full scope but in my estimation it is widespread and growing. What I am talking about, for instance, are environmental regulations that are selectively enforced, with the burden on foreign players almost always higher than that borne by domestic players. The obvious result is a significant disadvantage to the foreign player whose cost structure is increased, sometimes to a point of losing competitiveness. It is indeed the case that if you compare similar companies, you will almost invariably find that costs are higher for the Foreign Invested Enterprise than for the local firm. Part of the reason for the difference is a substantial gap in employee wages and benefits but regulation has a lot to do with it, with discrimination in anything from social security payments to the protection of intellectual property rights (IPR) producing discrimination against foreign players. Then again, the extent of the gap varies substantially across various Chinese locals and is often in the hands of local government officials that are not formal signatories or direct parties in negotiations with the United States.

Another example of discrimination is the policy of “indigenous innovation,” which has become a code word for preference accorded to domestic players in procurement by the government and state-owned

enterprises under the guise of promoting innovation. There are indications that this practice is becoming more widespread at an alarming rate.

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Furthermore, it is my expectation that since China is officially bound by the WTO rules to prevent discrimination yet is strategically determined to grow Chinese companies to global prominence, that discrimination will occur on the level of “not-tariff barriers”, that is, that more and more obstacles will be put in front of foreign players in the form of technical standards, variable enforcement, and the such. Corruption, now acknowledged by the Chinese authorities to be rampant at least at the local level, is a classic example of a non-tariff barrier since foreign companies, especially US firms, are less likely to engage in the practice given codes of conduct and the Foreign Corrupt Practices act.

Transparency

Another basic commitment made by China and pledged by all WTO members is transparency. This has not happened. Not only has progress on transparency been very limited, but, given the nature of the Chinese regime, the situation is unlikely to improve much if at all. The Chinese Communist Party (CCP) views information control as being critical to its survival and so access to information must be severely curtailed. The lack of transparency results in the abrupt introduction of new rules and changes in existing rules are made practically overnight and usually without any formal or informal consultation with affected parties. Under those circumstances, local players who have much closer relation to the authorities (not to mention numerous collusion cases where the local player is partially owned by the central or local government) have an opportunity to influence the rule and or will have heads up on the coming changes and thus will have an opportunity to prepare.

The IPR Issue

A specific and extremely important area where China fails to comply with its WTO obligations is the protection of intellectual property rights (IPR). In a prior testimony before the Commissions I have argued that IPR was one of the most important issues for the competitiveness of US firms and that China was quite possibly the main challenge in that area. Given that US firms are usually the innovators and Chinese firms are usually the imitators, and given that IPR related sectors have been globally growing much faster than the rest of the economy, this issue is of critical importance that is not always appreciated. Many people tend to see this as a problem for Warner brothers and Microsoft, but in reality there is hardly a sector, from pharmaceutical to machine making, that is not affected. Unfortunately, many executives are reluctant to openly raise the issue so as not to offend the Chinese authorities and thus jeopardize what many of them see as a very high priority for their companies.

On the positive side, China now has the legal and regulatory infrastructure to handle IPR infringement, however enforcement has been spotty at best and in some respect, the situation is getting worse. Given intense globalization, infringing goods now find their way to international markets including the United States, and with them come other problems, such as defective goods. This obviously undermines the

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sales of legitimate goods, not only those made in China but also those made in the USA and elsewhere, hence an impact on US companies with no China business. Most surveys and my own observations suggest that the problem is not getting better. For instance, while it is true that there are more court cases that result in judgments for the plaintiffs, a close look will reveal that domestic plaintiffs are typically awarded much larger sums than foreign plaintiffs (not to mention that many judgments are not collected). Indeed, I stand by the two scenarios that I suggested in an earlier hearing: The first, that China will undertake *selective* enforcement of IPR, protecting the rights of domestic players much more vigorously than those of foreign firms; the second, that Chinese firms who infringe IPR will benefit from exports into large parts of the world where IPR are openly flaunted. I do not expect the situation to improve because it is often not in the interest of the central government to do so and because the central government is often unable to thwart the support (or at least indifference) provided by local authorities who may see infringing production useful to keep up economic growth and full employment and who are at times even invested in those enterprises.

Finally, as an anecdote, my book *The Chinese Century*, has been censored in China and the chapter dealing with IPR infringement was removed in its entirety in the Chinese edition. Obviously this is something the Chinese leadership does not want to be discussed (that much for transparency). It should also be noted that a lot of Chinese imitation is legal, and that US firms have not done a very good job of either imitating the innovations of others or of defending against the imitation of others (a point stated in my recent book *Copycats*).

The principal difficulties facing US companies in China

IPR violations

as noted earlier, this is a critical issue that is likely to snarl more companies, whether engaged in China or not, and is unlikely to get better. For years I have been hearing foreign executives proclaiming that the situation was not so bad and was getting better. I beg to differ.

Discrimination

Discrimination of foreign companies, as compared to Chinese players, especially those owned and controlled by the government, both central and local persists. I forecast that this problem will get significantly worse over time as China attempts to buttress domestic firms while being prevented from formal discrimination by WTO and other treaties. There is also discrimination versus other foreign

players in the sense that some of those have no qualms about certain practices, such as corruption and bribe paying, which are more of a problem for American firms.

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Pressure to transfer technology

Obtaining foreign technology has been the one constant in three decades of Chinese reforms that saw many changes in policy and an evolution of governance and ownership structures. Such pressures continue today and in my view will not subside but even intensify going forward. The pressure is moving from the transfer of given technologies to the transferring of the ability to develop new technology, hence the pressure to shift Research and Development capabilities to China. Most companies will not admit that they are bowing to pressure on this or other issues, but this often comes from unwillingness to antagonize a government that continues to oversee the economy closely, as it did for centuries. Indeed, in my view many changes that are expected to occur by Western nations are unlikely to take place because they run counter to fundamental aspects of the Chinese political system.

Pressure to play by Chinese rules

The Google case was a stark illustration that China will insist that all players play by Chinese rules. This seems obvious -- after all, all governments demand the same-- until one recalls that the Chinese system is radically different. China is the only major economy that is still under Communist rule, and regardless of whether certain market and industry segments are ruled to be market driven or not (a contentious issue in and of itself), there are major repercussions that come with that. The first is that political objectives come first. There is not separation of powers in China and this fundamental reality, which often escapes outside observers, implies that the executive branch can interfere with anything it deems vital, with the interests of the party paramount. Increasingly, US firms may find themselves to be at odds with a system that insists of censorship and which requires disclosure to authorities rather than to other constituencies (employees, consumers), and this might constitute a formidable non-tariff barriers to US firms in particular.

Finally, it is highly likely that in the next few years we will see multiple acquisitions of US companies, including innovative startups, by cash rich Chinese firms (indeed, a not talked about aspect of the Yuan appreciation will be that US target firms will become cheaper to Chinese buyers). These acquisitions will upgrade the capabilities of Chinese firms, making them much more formidable competitors in China, the United States, and in third countries. The willingness of such firms to do business anywhere without regard to human rights, bribery, or other issues of concern to US firms, will also not produce a level playing field.

Retaliation

The Chinese authorities (and at times, Chinese firms, “patriotic citizens” and others) are likely to retaliate against foreign firms whenever they perceive that their own companies have been discriminated against in foreign markets. Given the increasing involvement of Chinese firms in those markets, one can expect to see more investigations (often unwarranted) against foreign companies on

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anything from supposedly defective products to work practices to predatory pricing and dumping. The first signs are already here.

Impact on US Firms Not Engaged in China

The impact of China’s entry to the WTO on companies not doing business in China is difficult to assess but I would venture that overall it has been quite negative. Domestic US companies are facing increased competition at home and in third countries from Chinese producers whose cost basis they cannot match for a great number of reasons, from a distorted exchange rate to differences noted above such as in regulatory structures. If those companies cannot tap the China market (which by definition this group does not), it is difficult to see how they can benefit from China’s WTO accession while it is quite easy to see the disadvantages. It is difficult to fully estimate the damage but it is possible to look at particular sectors, such as furniture, that have been devastated by Chinese competition. Indeed, those who have not used China to outsource components and or offer Chinese products as part of their product range, have tended to lose out, with many shutting down operations. At the same time, there are sectors, such as retail, that have benefitted handsomely from the ability to source Chinese furniture as well as other products.

Summary

To sum-up, the overall impact of China’s WTO accession varies greatly by sector and individual company, and has benefited the American consumer via the provision of cheaper goods and indirectly by helping to keep inflation under lid and funding US debt. Still, I would estimate the overall impact to have been somewhat negative as far as the long term competitiveness of US industry. Some but not all of the negative impact can be mitigated by anything from training to tap opportunities in China to enhancing efficiencies, but long-term repercussions should be considered as we move into a global economy where China is a major player. This player plays by many global standards but at the same time insists on “Chinese characteristics”, a euphemism for “doing things our own way” but also of making its own rules, often in a way that will make it more difficult for outsiders to win.