

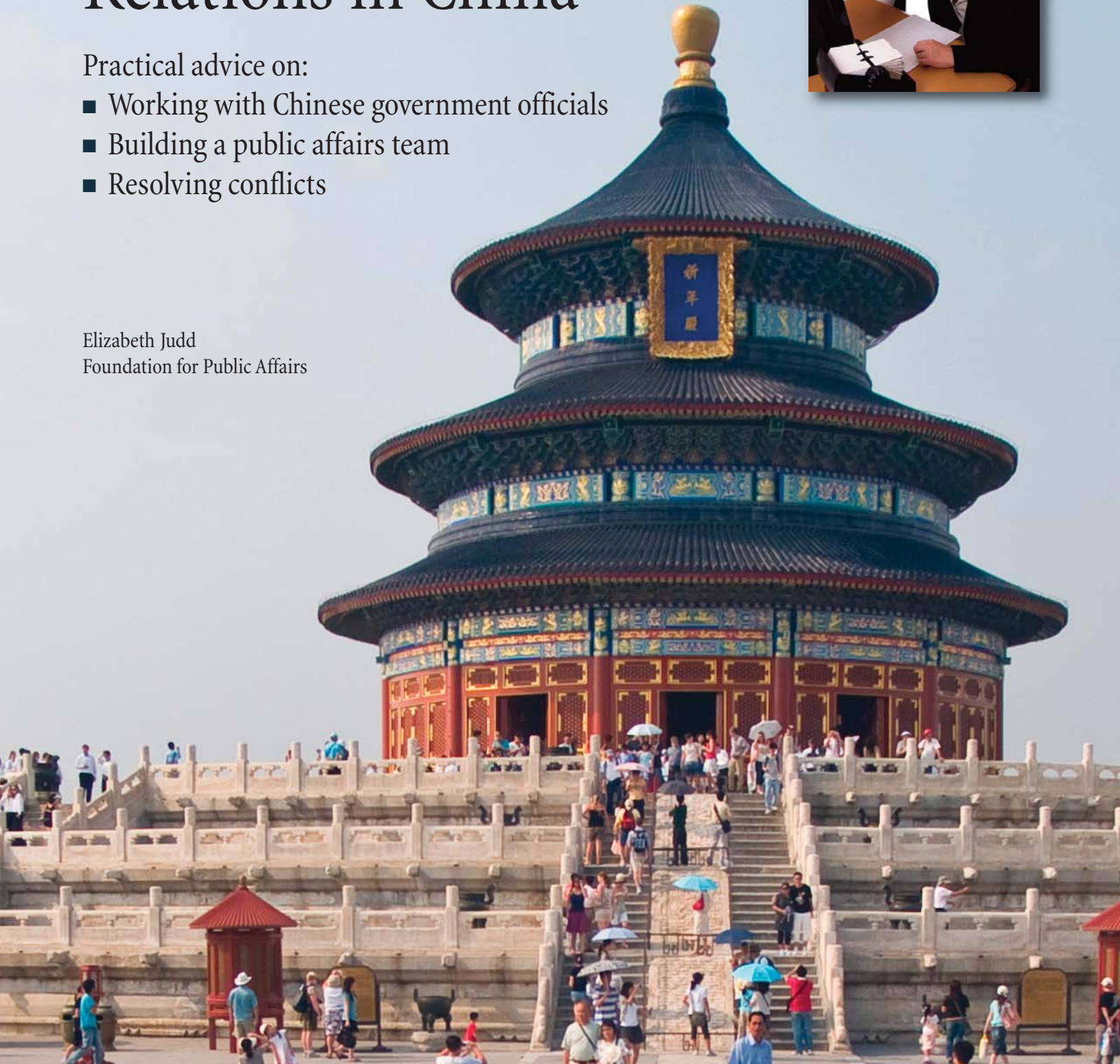
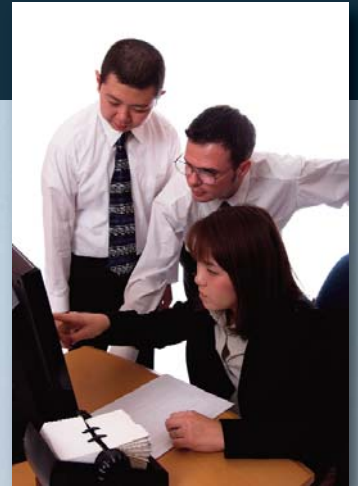
Good Guanxi

Managing Government Relations in China

Practical advice on:

- Working with Chinese government officials
- Building a public affairs team
- Resolving conflicts

Elizabeth Judd
Foundation for Public Affairs





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Managing Government Relations in China

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FOUNDATION
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Designed by Bonnie Heiston



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Introduction: When Worlds Collide

In 2000, when Starbucks opened an outlet in the Forbidden City, the outcry from dismayed Chinese citizens and newscasters quickly escalated into a public relations fiasco. The *China Consumer Journal* called Starbucks' presence "no different from slapping China's 1.2 billion people and 5,000-year traditional culture in the face." And an online campaign spearheaded by Chinese TV personality Rui Chenggang collected more than half-a-million signatures after it accused Starbucks of undermining "the solemnity of the Forbidden City," according to BBC News.

The arrival of Starbucks in one of China's oldest and most revered historic spaces, home to 24 emperors before the end of imperial rule in 1911, represented one of the classic cultural collisions that multinationals hope to avoid at all costs. Needless to say, when U.S. companies venture into vastly different countries with historical preferences and priorities that they don't quite grasp, they need to tread cautiously until they learn the terrain.

China — the largest consumer market in the world with a population that now exceeds 1.3 billion — is endlessly appealing to U.S. companies. Some enter China to sell either a product or service to the Chinese market; others want to produce goods less expensively in China for sale at home or abroad. Still others are drawn by attractive economic development incentives. But no matter what a multinational's strategy is, the journeys tend to have some common denominators.

While companies like Microsoft, McDonald's, General Motors, Procter & Gamble, Yum! Brands (owner of the Kentucky Fried Chicken franchise), and even Starbucks represent dazzling success stories, they've all experienced growing pains. Almost every U.S. company has made a number of serious gaffes in China, but the best have learned from these mistakes.

“Chimerica”

Any traveler to the Middle Kingdom will immediately be struck by a number of obvious differences between American and Chinese cultures. And yet China hands also note a panoply of unexpected similarities, something Michael Lord, an associate professor at Wake Forest University's business school, captures in his neologism "Chimerica." Both countries span vast geographies and are blessed with not only space but abundant natural resources. Both populations are undeniably entrepreneurial even though the governing political parties hew to quite different ideologies.

The Chinese appreciate and admire American business acumen and want to learn from us through technology or knowledge transfer. Similarly, American businesspeople are closely watching the Chinese. "In the middle '90s we were telling China secrets of our success, and now we're trying to find out the secrets of their success," says Reed Hundt, former Federal Communications Commission (FCC) chairman and a consultant at McKinsey, acting as strategic advisor for China Telecom and China Mobile.

James McGregor, author of *One Billion Customers*, also comments on the resemblances between China and the United States. China, he writes, "has a continental-size domestic market that sets businesspeople worldwide salivating, a population of ambitious, risk-taking entrepreneurs who can use the country's massive domestic market to build world-class products and businesses, and, by virtue of its size and stature, can force others to deal with it on terms it dictates."



Western companies such as Starbucks have made tremendous inroads in the Chinese market, but not without a few growing pains.

More than anything else, though, China is a nation of contradictions. Although China has the world's third largest economy (behind only the U.S. and Japan), its per capita income ranks 100th in the world, making it arguably the first "poor" global superpower in history, according to *China: The Balance Sheet*. The Council on Foreign Relations notes that roughly 400 million Chinese people subsist on less than \$2 a day; China's poor are as numerous as the entire population of the U.S. and Japan combined.

The extent of China's poverty and fragile infrastructure became known to the world on May 12, 2008, when a severe earthquake wreaked havoc in Sichuan province. This incident hammered home the message of just how serious a toll a disaster can exact in a poor, densely populated country. Two weeks after the quake, 68,000 were confirmed dead, 364,000 injured and nearly 20,000 were still missing. What's more, anywhere from 4.8 million to 11 million people were left homeless. According to one commentator, there simply weren't enough tents anywhere in the world to shelter those who had lost their homes in China.



China's population of 1.3 billion makes it the largest consumer market in the world. Yet China has as many poor people as the entire population of the U.S. and Japan combined.

It will take years for this emerging nation to recover from the unfathomable tragedy. But, as we note later in this report, in the process we will learn a great deal about China's willingness to tend to the needs of its poorest citizens, accept outside assistance and become more transparent in its dealings with the media and the public.

From a business perspective, China's staggering population is both a blessing (it provides a seemingly endless labor market that is becoming highly skilled and an increasingly prosperous consumer market) and a curse. Environmental and social challenges are magnified by the fact that any reform must be coordinated across a vast land and accepted by hundreds of millions of people.

The contradictions occur at all levels. On one hand, almost every multinational that has entered China has encountered some dark days, often through roadblocks erected by unsympathetic officials. On the other hand, companies like Microsoft have made tremendous inroads with the Chinese government. In April 2006, before traveling to the White House to meet President George W. Bush, Hu Jintao stopped in Redmond, Washington, and visited the Microsoft campus before dining at the private residence of Bill and Melinda Gates.

"Because China is such a large market and dynamic economy, people get big eyes and think they can do a lot quickly," says McGregor. He advises American businesspeople to downsize their ambitions. "Get yourself settled on the ground, and then build your business," advises McGregor. "The government is involved in every aspect of what you do. You've got to go there, learn your way around, build relationships, and take it one step at a time."

For government affairs professionals, the secret seems to be getting comfortable with the idea that true success in China can only be measured in retrospect. After seven years of controversy, Starbucks finally closed its coffeehouse in the Forbidden City in July 2007, after officials announced the Seattle-based powerhouse could only operate under the Palace Museum brand.

Is Starbucks in retreat? Absolutely not. As of late 2007, Starbucks had 230 shops in 22 cities in mainland China. And in a November 2007 article in the *Columbia Law School* magazine entitled, "How Do You Sell Coffee to a Tea-Drinking Nation?" analysts predicted that Starbucks' presence in greater China could someday reach 10,000 shops. With growth potential of this magnitude, it's essential to take the long view. Closing a single controversial shop is little more than a brief detour within a much longer and more profitable journey for Starbucks or any other U.S. company truly committed to the Chinese market.

China's Recent Past

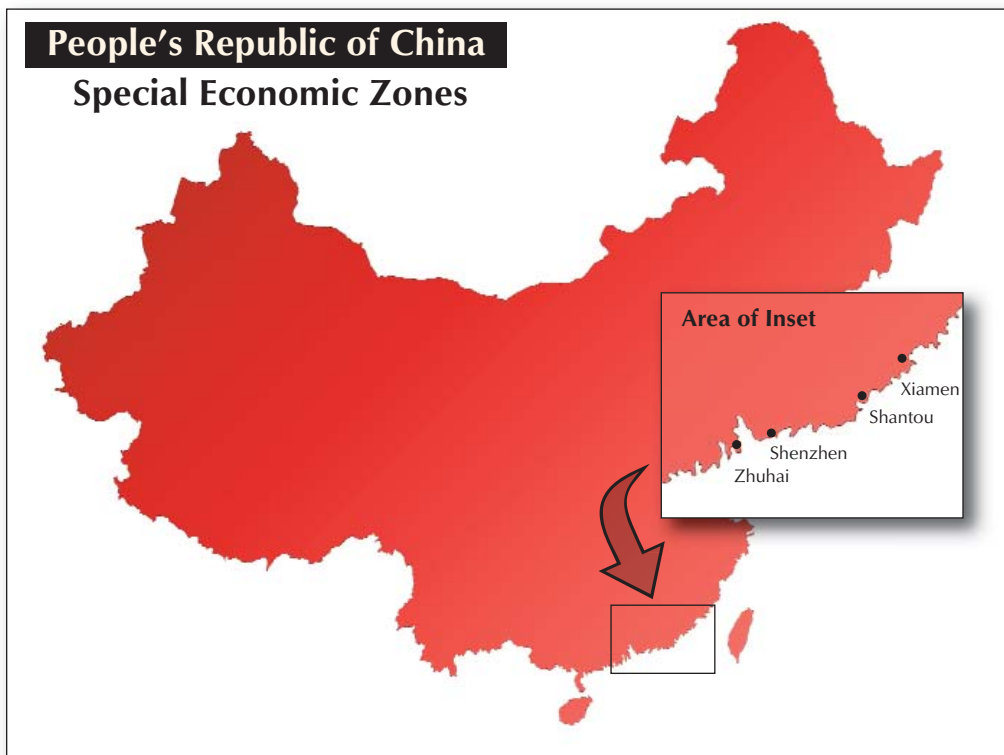
Government affairs professionals operating in China recognize the importance of familiarizing themselves with the country's history. Lessons from the recent past have shaped government officials' perspectives, and play a pivotal role in how U.S. businesspeople interact with their employees from the PRC, as well as with the regulators. What's more, Chinese thought-leaders and politicians appreciate when Americans make an effort to converse knowledgeably about China.

1972 marks the true beginning of modern U.S.-China relations. On February 21, 1972, President Richard M. Nixon and his national security adviser, Henry Kissinger, visited China together, inaugurating a period of "engagement" between the two countries.

In the late 1970s, China's leader Deng Xiaoping initiated a period of economic change known as *gaige kaifang*, or "reform and opening up." *Gaige kaifang* ushered in the beginning of direct foreign investment in China. In 1980, the Chinese Communist Party (CCP) created four special economic zones: Shenzhen, Zhuhai, and Shantou in Guangdong province and Xiamen in Fujian province. These areas — especially Shenzhen, the best known and most successful of the special economic zones — have become incubators for economic experimentation.

Although some aspects of a free-market economy have existed in China since the 1970s, it was not until the eight years between 1992 and 2000 that economic reform truly began to spread from coastal cities to the hinterland. In 2001, China began its five-year phased-in entry to the World Trade Organization (WTO), another important milestone. During this time, China made a number of concessions to Western ways of doing business, including opening up to formerly prohibited foreign industries such as banking, retail and equities.

Even today, different industries experience completely different business climates in China. For overseas companies in sectors that the government has deemed "prohibited," business is all but



[Useful Books About China]

One Billion Customers: Lessons from the Front Lines of Doing Business in China
BY JAMES MCGREGOR

China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower
BY C. FRED BERGSTEN, BATES GILL, NICHOLAS R. LARDY AND DEREK MITCHELL

China CEO: Voices of Experience from 20 International Business Leaders
BY JUAN ANTONIO FERNANDEZ AND LAURIE UNDERWOOD

Chinese Business Etiquette: A Guide to Protocol, Manners, and Culture in the People's Republic of China
BY SCOTT D. SELIGMAN

Oracle Bones: A Journey Between China's Past and Present
BY PETER HESSLER

The Business of Lobbying in China
BY SCOTT KENNEDY

Capitalism Without Democracy: The Private Sector in Contemporary China
BY KELLE S. TSAI

China: Fragile Superpower: How China's Internal Politics Could Derail Its Peaceful Rise
BY SUSAN L. SHIRK

China Shakes the World
BY JAMES KYNGE

Chinese Lessons
BY JOHN POMFRET

“In China there's an overriding preoccupation with ensuring the existence of the Communist party, and ensuring there's a certain degree of social stability in society. Everything else flows from that.”

an impossibility. On the other end of the spectrum, foreign businesses in the "encouraged" sector — most manufacturing companies find themselves in this coveted category — can do business in China without having a local joint-venture partner.

Arguably, government affairs professionals have the most interesting time in China when their industries operate in the "restricted" sector, or are open to foreign participation but only to some extent. Here, companies tend to enter into joint ventures, working with the Ministry of Commerce and other government offices to gain permission to operate more fully.

"Restricted" car manufacturers like General Motors and Ford can only assemble vehicles with local partners and can own up to — but not more than — 50 percent of the resulting venture. However, foreign companies producing components for autos operate in the "encouraged" sector and can incorporate in China, lease their own land and design their own facilities. Their products can either be sold to the joint-venture auto manufacturers or exported.

FRONT AND CENTER ON THE WORLD STAGE

In a 2007 report entitled "U.S.-China Relations: An Affirmative Agenda, A Responsible Course," the Council on Foreign Relations described the overall trajectory of engagement between the two nations as positive. And yet as China assumes the mantle of global superpower, its policies are being scrutinized more carefully. Companies doing business in China need to understand the political pressure points to negotiate successfully with officials at all levels of government — and to anticipate questions their customers might ask at home.

China's ongoing conflict with Tibet and the exile of the Dalai Lama seized headlines in the spring of 2008 as the Beijing Summer Olympics approached. French President Nicolas Sarkozy hinted that he might boycott the opening ceremony, and pro-Tibetan advocacy groups disrupted the Olympic torch's progress with riots in London, Paris and San Francisco.

In addition, a coalition of 153 pro-Tibet organizations wrote Coca-Cola CEO Neville Isdell, asking that the torch relay exclude Tibet. In a March 31, 2008, article, *Fortune's* Asia editor called the controversy a "marketing headache" for multinationals like General Electric, McDonalds, Visa, UPS, Coca-Cola, Lenovo and Samsung, all of which paid millions of dollars for the right to co-sponsor the games.

Many multinationals find themselves in a difficult spot. In an essay on *The Huffington Post*, Tom Doctoroff, Greater China CEO for JWT (J. Walter Thompson), suggested that boycotts against the Olympic games would be perceived as an insult to Brand China and the Chinese people. "A culturally tone-deaf boycott of Beijing 2008 would do more than slight the Communist party," he wrote. Doctoroff was concerned that a boycott might be perceived as an insult to the Chinese populace — with repercussions for geopolitical harmony.

Tibet is not the only China-related issue that gives American CEOs pause. Some U.S. companies eager to tap China's vast market are concerned about other social issues, including the country's treatment of political prisoners and its lack of freedom of the press.

In all fairness, China also deplores many of America's actions on the world stage. The fact that the U.S. sells arms to Taiwan is a sore point between the nations. Incidents like American warplanes' May 1999 bombing of the Chinese embassy in Belgrade, Yugoslavia, which killed three Chinese journalists during the Kosovo crisis, have created lingering hard feelings. This attack, points out Peter Hessler in *Oracle Bones*, made an indelible impression on the Chinese people even though it's all but forgotten here.

One of the best ways to take the pulse of the Chinese government is to understand the policy drivers behind its slogans. "You need to understand what government itself is being measured on," says Murray King, managing director of APCO Worldwide's Shanghai office. "In China there's an overriding preoccupation with ensuring the existence of the Communist party, and ensuring there's a certain degree of social stability in society. Everything else flows from that."

Among the most important policy initiatives are "the harmonious society," "indigenous innovation" and "scientific theory of development." These policies indicate that China is searching for answers as it strives to balance the needs of the rural and the urban, the post-1978 generation born under the "one-child policy" and the elderly, and populations from the coast, the interior, and the northern or western regions of China. They also imply that China hopes to balance its goals of economic growth against scientific solutions to its environmental woes. "You need to offer something to government as it tries to deliver on these agendas," maintains King.

Understanding Government Structure

For some companies, dealing with the Chinese government is a humbling experience. "Because you're well known in the U.S. doesn't mean you're well known in China," asserts a government affairs professional at a major American company. The converse is also true. Even the names of the highest officials in the PRC may not be familiar to businesses primarily operating in the west.

PRC President Hu Jintao and Vice President Xi Jinping preside over the Chinese government. It is, however, the State Council that administers and regulates China's day-to-day government functions. Premier Wen Jiabao heads the State Council, with support from Executive Vice Premier Li Keqiang. The most recent National People's Congress — the 11th, which was held March 5-18, 2008 — represents "the first time in recent memory that both senior economic positions have been filled by genuine reformists, committed to further reform," noted a March 21, 2008, paper by APCO Worldwide entitled "Implementing a Harmonious Society: China's 11th NPC and its Impact on Foreign Business."

The State Council consists of 28 ministries and commissions. The head of each ministry and commission carries the title of minister, a ranking equivalent to that of a provincial governor.

China's leaders are not elected and can't lay claim to a democratic mandate. Although there have been direct elections at the village level for the past 20 years, the election process has not extended to the national leaders.

The first challenge for a government affairs professional is determining which ministry governs your particular business and what regulations apply. Government decisions are not as transparent in China as they are in the United States. Newspapers don't publish the location of major government meetings and don't name the personnel involved.

In the past few years, the Chinese government has also issued a bewildering number of new regulations. All new rules and regulations are published by the Ministry of Commerce in the *MofCom Gazette*. Simply staying abreast of regulations being issued and those on the horizon is one of the most daunting challenges a government affairs professional faces, according to Julie Walton, director, business advisory services, for the U.S.-China Business Council.



Is Corruption a Problem in China?

Yes and no. Corruption is a problem but not necessarily to the extent that many American businesspeople assume. Transparency

International ranked China 70 out of 159 countries in its 2006 *Corruption Perceptions Index*. That study pointed out that privatization and other economic reforms have provided officials with opportunities for graft.

In September 2006, Shanghai Party Secretary and Politburo member Chen Liangyu was removed from office for misappropriating pension funds. Problems like this are relatively rare, though. According to the Council on Foreign Relations, he was the highest ranking member of the Chinese Communist Party (CCP) to be removed from office in more than a decade.

“If there's a gray area or new area, you may find various pieces of the government competing for domain.”

Only time will tell whether the new regulations — many of which are said to look exceedingly good on paper — prove successful. The real test is whether the rules are enforced. One thing worse than a rule that's not enforced is a rule that's enforced selectively, or only when the government wants to make an example of a certain company.

Scott Seligman, author of *Chinese Business Etiquette* and the former general manager for Burson-Marsteller in China, notes that there are many question marks in the current regulatory regime. "If there's a gray area or new area, you may find various pieces of the government competing for domain," says Seligman. In these circumstances, he advises companies to consider which area they'd prefer to be regulated by — and then strengthen their hand by sharing information with that ministry or office.

"A lot of Chinese regulations are deliberately written vaguely because the government has the upper hand if you're operating in a gray area," maintains Seligman. "Officials can choose to enforce a regulation to the letter if they want to crack down on you, or they can be benign if they don't."

U.S. companies today have a tremendous opportunity to help the government as it promulgates new regulations, especially in the product safety and environmental realms. After an idea is drafted into legislation, it enters into a consultation phase. During that phase, companies can either directly or indirectly influence the legislation before it reaches the National People's Congress. In addition, the Chinese government is proactively soliciting various business chambers for input on legislation. The local American Chambers of Commerce in China — or "AmChams," as they're affectionately known — can serve as an excellent pipeline for relaying messages to legislators.

Cultural

Dos & Don'ts

As executives regularly shuttle between Beijing and Washington, D.C., each culture is becoming more comfortable with the other, and *faux pas* are less devastating. Whenever possible, though, it's best to demonstrate your understanding and respect for Chinese culture.

- **Avoid embarrassment.** The concept of "saving face" is still alive and well in China. That's why it's best to state your position respectfully, making sure not to place the other person in a negative light. "The Chinese raise face to high art," said Seligman in a *New York Times* article. He continued: "You can contradict somebody in front of someone who is lower ranking and cause the person to lose face. Even the simple act of saying 'no' to somebody can make that person lose face."
- **Consider gifts.** The gift-giving culture of China is still prevalent, but showing up at a meeting with a gift is no longer an absolute must. The ideal gift reflects your business or geographic region but is neither very personal nor of too great monetary value.
- **Be punctual.** In China, it's considered rude to arrive late or to remain at a meeting past the designated time frame.
- **Exchange business cards with both hands.** When presenting a business card, use both hands and make sure that your name is facing the recipient. Then read the card. Simply tucking it into a pocket or wallet is considered rude.
- **Don't make comparisons to Japan.** Too often, American businesspeople generalize about Asian countries. Many Chinese still resent Japan (Shanghai was occupied by the Japanese during World War II), and any comparisons to Japan may still rankle.
- **Avoid references to age.** In the U.S., making mention of someone's youth is a compliment but it could be interpreted much differently in a Chinese business situation. Saying that someone is too young to remember a certain event would imply they're too junior to be taken seriously.
- **Remember food etiquette.** If you are the guest of honor at a business meal, the table may wait for you to start or you will be asked to start eating before others do. Alternatively, the oldest at the table may have the honor, in which case you should wait. And, whatever you do, don't stick your chopsticks into your bowl of food while you take a drink or pause from eating. Lay them flat on the table or with the tips resting in the chopstick cradle provided in restaurants.

Business Meetings and Culture

A business meeting in China has its own distinct rhythms, ones that Americans might fail to detect with potentially devastating consequences. "We're so uncomfortable with silence that we'll yammer on about anything, including giving away the store," says Scott Seligman, author of *Chinese Business Etiquette*. "Silence is a tactic the Chinese will use to let you say more than you want to say."

Even something as simple as who owns the floor during a meeting in China is rarely left to chance. Typically, the dialogue takes place between two principals, one on the Chinese side and the other on the foreign side. Any other participants remain near-silent observers.

Government affairs professionals in China emphasize that it's wise to specify an agenda well before a meeting takes place. Seligman agrees: "The Chinese don't like surprises in meetings. We somehow do. We like the idea of going in and wowing somebody with an idea they haven't thought of, but the Chinese are mortified by that," says Seligman. "They won't make a decision in the moment unless they're absolutely empowered to do so."

While American businesspeople should respect local cultural preferences whenever possible, experts find it a mistake to honor Chinese business practices if it means ceding one's own cultural strengths. This is true in both external meetings and within China operations. In *China CEO*, this is how Ekkehard Rathgeber, president of Bertelsmann Direct Group Asia, explains the fine line foreign businesspeople must walk: "If you simply adapt yourself to the local habits, then you lose a lot of advantages. You end up with something you didn't want." His advice? Pick one's battles and work patiently to instill a new business culture within Chinese operations.

Addressing the Environment

No issue poses quite the same threat to China's phenomenal economic growth as the environment. From athletes who considered boycotting the 2008 Olympics because of the poor air quality in Beijing to alarming health statistics, it's clear that China's environmental problems are seriously affecting the country's future prospects.

The World Health Organization (WHO) estimates that air pollution is responsible for 400,000 premature deaths in China each year. And a disease like SARS has the potential to wreak far more havoc in China than it would elsewhere because of the poor air quality.

Calculating the economic costs of China's environmental problems is more difficult than calculating the health implications — and yet some have tried. Pan Yue, the vice minister of China's State Environmental Protection Administration (SEPA), has said that environmental degradation costs China eight to 13 percent of its annual GDP, an estimate based on what it would cost to remedy the damage done to China's environment.

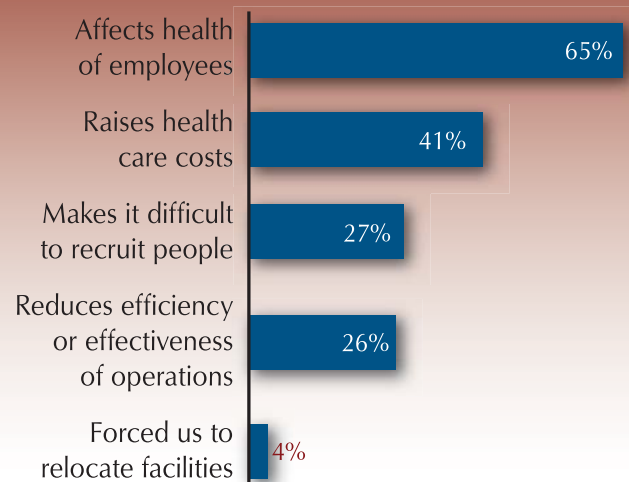
What does this problem mean for American companies doing business in China?

In a country with widespread environmental problems, it may seem virtually impossible for foreign companies to run afoul of the law. Not so. From 2003 until 2006, the Chinese government

“The Chinese don't like surprises in meetings. They won't make a decision in the moment unless they're absolutely empowered to do so.”

How Pollution Concerns Affect Business

Survey of 482 Companies



Source: 2008 AmCham-China Business Climate Survey

Otis Opens Green Elevator Factory

United Technologies' Otis Elevator Company, headquartered in Farmington, Conn., opened an environmentally-friendly elevator manufacturing facility in Tianjin in July 2007. The China Ministry of Construction dubbed Otis's 1.5 million square-foot site the first "green" manufacturing showcase center in China.

What makes this facility green? First, the buildings use 25 percent less energy than other high-performance buildings and around 40 percent less than conventional Chinese construction. Daylight sensors turn off electric lights when enough natural light is available. And rainwater is "harvested" from the roofs and combined with recycled gray water to meet all the site's irrigation and sanitary needs. In addition, the elevators that Otis produces have gearless systems that minimize energy usage.

China has shown a readiness to favor foreign companies that can help solve the monumental social and environmental problems the country faces. Although plenty of companies that use old, energy-inefficient capacity in China still exist, the government frowns upon multinationals using anything but environmentally-friendly techniques.

punished 33 multinationals for violating China's environmental laws and regulations, according to the nongovernmental Institute of Public & Environmental Affairs. The companies penalized included subsidiaries of American Standard, Panasonic, Pepsi, Nestle and 3M. Most of the citations came from the discharge of substandard waste water and for unauthorized construction activities occurring without the necessary environmental impact assessments.

In the 2008 white paper "Business Climate for American Firms in China," written by the American Chamber of Commerce in China, 65 percent of the 482 companies surveyed said the environment affects the health of employees and their families. Meanwhile, four percent of respondents said that they'd been forced to relocate facilities because of environmental problems.

For some companies, though, China's environmental woes represent a tremendous marketing opportunity. Eaton Corp., for example, is partnering with the Chinese government on ways to improve energy efficiency and is currently supplying equipment for 30 hybrid buses. "We're trying to position ourselves to be helpful in solving the environmental issues they face," explains Barry Doggett, Eaton's VP of public and community affairs.

Oliver Ye Yang, manager, corporate social responsibility and government relations for the American Chamber of Commerce in Shanghai, points out that unlike in the U.S., where investors are a company's primary stakeholders, in China the government is the main arbiter of any company's practices. Because the central government began to recognize the environment as a huge priority in 2007 and immediately took aggressive steps to find remedies, multinationals that help in this quest are viewed favorably.

Being part of the solution isn't necessarily that difficult. PMI (Pacific Market International), which is headquartered in Seattle, Wash., has several factories in China that make environmentally-friendly food and beverage containers, some of which are supplied to Starbucks through a private-label arrangement. Valerie Bone, PMI's director, quality and CSR, says that her company has recently made many environmentally-friendly changes at its factories in China, including minimizing energy usage and recycling both water and waste.



Because of its high use of coal for power generation and large number of motorized vehicles, China has 20 of the world's 30 most polluted cities, according to The World Bank.

Part II Tackling New Terrain

The Changing Face of *Guanxi*

One term bandied about by China hands and government affairs practitioners in China is *guanxi* — the social network of relationships that allow one person to prevail upon another for favors. *Guanxi* still greases the wheels in China. And yet in one of the most intriguing findings from the interviews for this report, most experts agree that the importance of personal connections has diminished recently. In other words, many believe that "whom you know" matters less in China nowadays than it did just a few years ago.

The notion of *guanxi*, as most American businesspeople understand it, is "way overblown," according to Shaun Rein, founder of the China Market Research Group, a Shanghai-based market research firm. He believes that true *guanxi* — or relationships that take decades to build and are constructed on kinship or a solid and longstanding foundation of trust — continues to be of value. However, this type of *guanxi* can't be bought. "It's important to have good *guanxi*," he says, "but you can't contrive it." In other words, a big-name representative might secure a company a meeting with a government official in China, but that government official won't feel beholden to do what the company asks.

The good news is that the ability for American companies to flourish without appealing to *guanxi* will almost certainly grow. "As China's economy continues to reform, what you know will become more important than whom you know," says Rein.

Scott Kennedy, author of *The Business of Lobbying in China*, urges American businesses that want to influence public policy in China to look beyond *guanxi*. "*Guanxi* may get you some meetings, but it rarely gets the deal done anymore," he says. Instead, Kennedy believes that it's a far better idea to draw on special business or technical expertise to influence policy.

Dr. Shan Nair, founder of U.K.-based Nair & Co., also argues that the role of *guanxi* has diminished but not altogether disappeared. He says that while it would previously have taken six months to gain the necessary permits to open a subsidiary in China, "with good *guanxi*, you could get everything done in three and a half months." At the same time, Nair notes that larger companies are now less dependent on connections. "The bigger the scale of the investment, the less you'll need *guanxi* because the more they'll want you," he says.

Finally, Murray King, managing director of APCO Worldwide's Shanghai office, believes that the notion of *guanxi* can be very dangerous because it sometimes spurs American businesspeople to get entangled with smaller companies or *guanxi* brokers who promise miracles through their personal connections. "Too many companies suspend their typical due diligence when they enter China," he says. "The key is to use the same processes that you'd use in any other market. It seems logical but you'd be surprised at how often that doesn't happen."

A Superstar Spokesperson

One of the mythic figures of the Chinese business landscape is the *guanxi* broker, or well-connected individual who can deliver introductions to important officials. The best *guanxi* brokers are so famous that Chinese officials will gladly make time to talk with them. Henry Kissinger, who played a key role in establishing diplomatic relations with the Chinese Communist Party during the Nixon administration, tops the list of American *guanxi* brokers, but Sandy Berger, Brent Scowcroft and other well-known public policy experts are on the list, too.



Chinese businesspeople still rely heavily on social networks when making business deals or addressing political issues.

“While we put a premium on breaking bad news in person, the Chinese put no premium on breaking bad news in person. In fact, it's a 'face' problem for them.”

Gary Locke, who was elected Washington state's 21st governor on Nov. 5, 1996, making him the first Chinese-American governor in U.S. history, also carries enormous clout. As a partner in the Seattle office of Davis Wright Tremaine, he's become a power broker representing clients such as Microsoft and Starbucks in China. According to a September 8, 2006, *Seattle Times* article, Locke helped arrange Chinese President Hu Jintao's April 2006 visit to the U.S., a trip that included stops at Boeing and Microsoft.

But what does hiring a *guanxi* broker get you, exactly? The answer depends on whom you ask. When Locke represented a large multinational that wanted to open a bank in China but didn't meet China's stringent conditions of having assets over \$10 billion and a two-year operating history in China, he secured a meeting with China's top banking regulator and asked for help finding creative ways to meet the company's objectives. Locke was quoted in the *Seattle Times*, saying: "If the commissioner who oversees the banking industry is receptive, then those people underneath him will be receptive. . . . If you just got to a midlevel bureaucrat, they're just going to go by the letter of the law and say no, no, no."

Beyond a doubt, certain individuals can secure meetings in China — and gain the ear of highly-placed government officials. "Third parties are useful in throwing out trial balloons, a way of testing something without owning it," says Scott Seligman, author of *Chinese Business Etiquette*. "They're also useful in breaking bad news. While we put a premium on breaking bad news in person, the Chinese put no premium on breaking bad news in person. In fact, it's a 'face' problem for them."

Making Your Own *Guanxi*

Over a decade ago, Cleveland-based Eaton Corp. built a large metal-working facility for manufacturing engine valves in what was then a suburb of Shanghai. Because of Shanghai's rapid growth, the automotive plant now finds itself in the heart of the city's booming Pudong area, bordering the airport and the river, says Barry Doggett, the company's VP of public and community affairs. Some Shanghai residents are upset about having a forge in the middle of their neighborhood, but local government officials have staunchly defended Eaton's presence.

"Because we have a good relationship with the local government, they've been very helpful to us," says Doggett. "They've told the residents, 'Eaton was here first. They're going to do everything they can to be good neighbors, but they're not going anywhere.'"

Doggett advises U.S. companies to start building relationships locally, preferably near headquarters. In a large city like Shanghai, where important political subdivisions exist, it's worth developing ties with many different authorities. "Local authorities, city government, and the provincial government each have their own set of officials that you need to build relationships with," he says.

Many companies with longstanding relationships in China — Eaton arrived in 1993 and now has 5,000 employees and over 25 manufacturing facilities there — can and do win the confidence of officials. It could be argued that these companies have made their own *guanxi*.

As a diversified industrial manufacturer, Eaton doesn't face a single monumental challenge when it comes to government relations. Instead, it is tackling a host of issues that require some level of government involvement, ranging from investment to taxation to the environment.

Eaton has a small government affairs office run by one dedicated professional in China — all other efforts are carried out by business heads and even plant managers, who are responsible for building relationships at the local and provincial levels. "Government affairs needs to be integrated with all of our activities," asserts Doggett.

Important relationship-building also takes place at home. Recently, says Doggett, Zhou Wenzhong, the Chinese ambassador to the U.S., visited Cleveland and spent a day and a half at Eaton. During that time, he met with Eaton's CEO Alexander Cutler.

Eaton, which currently derives roughly \$1 billion in annual sales from Asia, is striving to increase that number to \$2.5 billion by 2010. Such quantum growth is conceivable because the company has steadily scaled the learning curve. "The ability for western companies to build relationships in China is constantly improving," maintains Doggett. "We're understanding the differences and the structure better, and more people are getting good at it. We're learning from our experiences and from our peers who are doing a good job."

Assembling Your Government Affairs Team

"You need to have a government relations function for your China operations before you go to China," says one senior government affairs professional at a well-known American company. "You can't seriously do business without government relations. The reality is that the Chinese government extends its reach deeply into business."

Finding and retaining top talent ranked as the greatest challenge for companies operating in China, according to the U.S.-China Business Council's 2007 member priorities survey. Among the hardest jobs to fill, says the Council, are government affairs positions.

The good news is that PRC nationals covet jobs at multinationals. The pay is generally appealing and the prestige a draw. According to the U.S.-China Business Council survey, three quarters of respondents pay employees above the average wages at domestic Chinese enterprises. And 97 percent said they bring their companies' global environment, health and safety standards to their operations in China.

To Translate *or not* To Translate?

American businesspeople who speak Chinese are at a high premium. That said, even when a government official speaks impeccable English — or an American is fluent in Mandarin — most business meetings are still conducted through translators.

"It's culturally appropriate and the right thing to do to have a translator present, even when the Chinese official speaks perfect English," says Robert Holleyman, president and CEO of the Business Software Alliance. Holleyman recalls a high-level meeting with a Chinese government official in which both sides' comments were communicated via professional translators. At one point, the Chinese government official interrupted the translator, explaining that he'd said "micro-economic" rather than "macro-economic." Even though the Chinese government official's English was so sophisticated and nuanced that he could detect this small error, the translators continued to convey the messages of the individuals conversing.

The leader of a visiting delegation should also ensure that everyone in the room can understand the conversation — especially mid-level participants who must implement the decisions made at the meeting. Otherwise, misunderstandings are likely to occur.

James McGregor, author of *One Billion Customers*, emphasizes the need for professional translators because they'll translate messages accurately. "Don't expect your PRC national employee, who is an executive or manager, to be your translator because they won't translate faithfully. They have their own agendas." He continues: "I've been in many meetings where there's a foreign executive and they've got their manager from China doing the translating and the manager from China is holding a conversation. They're not really translating what's being said."

In fact, for high-level positions in China, salaries are now approaching the same level as in the U.S. "The going rate is often higher than you might expect," says Julie Walton, director, business advisory services, for the U.S.-China Business Council. "If you're looking for a very senior executive like a country manager, that pay grade is probably going to be very similar to, if not exactly what, you'd pay that person in the U.S.," she says. What's more, the rate of increase is steep. Hewitt Associates found that the average salary in first-tier cities like Beijing, Shanghai, and Guangzhou rose seven to nine percent during 2006.

When it comes to assembling a government affairs team in China, Scott Kennedy, director of the Research Center for Chinese Politics and Business at Indiana University and author of *The Business of Lobbying in China*, recommends hiring former Chinese officials for their deep knowledge of how the system works. These individuals know whom to call, how to phrase requests, how best to couch suggestions in acceptable language and how to interact with Chinese government officials. He equates hiring a former Chinese government official with hiring a former U.S. government official for his or her institutional know-how. "It's that deep knowledge and familiarity that's irreplaceable," says Kennedy.

William McCahill, Jr., a former State Department diplomat and now a partner at Beijing-based consulting firm JL McGregor & Company, argues that it pays to be choosy, even among candidates who once worked for the Chinese government. He's observed that government credentials carry less weight for individuals in their 20s and 30s than for older candidates because the best and brightest in this age bracket don't typically enter government. Ideally, he says, an American multinational would hire someone in their late 40s who's well educated and understands "the way politics and bureaucracy coincide."

McCahill also suggests that PRC nationals who've grown with the company and demonstrated loyalty can be brought along to oversee government relations.



Although almost everyone advocates a mix of PRC nationals and Americans on the government relations team, James McGregor, author of *One Billion Customers*, cautions against entrusting your entire government relations function to one or two Chinese nationals, who then possess too much power. "If they walk away from your company, they walk away with all your relationships," he warns. McGregor advises companies to work closely with hires from the PRC who can then help a range of employees develop key government relationships on their own.

Finally, McCahill cites "patience and modesty" as the key virtues for a government affairs professional working in China, given that accomplishing anything through government channels is time-consuming. "American companies that have been successful here like General Electric and General Motors understand how long everything actually takes," he says.

The search effort itself requires patience. According to the U.S.-China Business Council, government affairs positions in China can take as long as eight-to-10 months to fill. Many companies retain an outside human resource specialist for assistance. Others go the networking route. The government relations working groups at the AmChams in Beijing and Shanghai are good places to find prospects.

Even if you do manage to put your dream government affairs team in place, top executives in China and the U.S. need to stay closely involved. McCahill points out that American companies most admired for their Chinese government relations efforts tend to have CEOs or other very top officers who act as corporate ambassadors, visiting Beijing or other Chinese cities often. "Government affairs in China," he says, "is a management burden that no one faces to nearly the same extent in the U.S."

Anecdotal evidence backs this assertion. In *China CEO*, Steve Schneider, chairman and CEO of General Electric China, said that he spends 65 percent of his time working with government officials, everyone from bureaucrats to the heads of state-owned enterprises (SOEs) that are GE's clients.

Musical Chairs

Offering a very attractive pay package is no guarantee that a company will keep its new superstar hire. During the period from 2001-2005, the U.S.-China Business Council found that turnover rates rose from less than nine percent to over 14 percent — and the trend has continued.

Retaining younger employees is particularly challenging. China's so-called Generation Y is characterized by an interest in professional mobility. Chinese employees in their 20s and 30s regularly switch jobs for higher paychecks or more upside potential.

Although rotations to China have traditionally lasted three years, most government affairs experts agree that longer stints are usually better. Some major American companies report that it took five years before officials in China would talk to their government affairs staff. If U.S. employees are planning to return home just as they're becoming effective, the company faces a real problem. The advice? Whenever possible, staff for the long run.

What to Expect From a Government Meeting

When Telegent Systems wanted to make and market tuners so people can watch TV on their cell phones, the business plan revolved around selling the product in China. Along with the CEO, Reed Hundt, a Telegent board member and McKinsey consultant, began discussing Telegent's idea with everybody he could find in the Chinese government. In Chinese government circles, says Hundt, "there are a lot of different people, and at any moment you're never too sure who's the most influential. You really have to get to know all of them, and make your case with everybody. It takes a lot of time."

“In the Chinese language and in the style of communication, it’s easy and important to be very clear, very blunt, and very bottom-line oriented.”

Hundt says that the level of technical expertise in the Chinese government is very high, far superior to what he's seen within the current administration at home. "The decisions over there are taken in a collective manner, but they're usually thought through very carefully with a high degree of technical competence." He continues, "In China, you'd better be prepared. You're going to be quizzed at a very high level." Hundt also finds the communication style conducive to sophisticated exchanges: "In the Chinese language and in the style of communication, it's easy and important to be very clear, very blunt, and very bottom-line oriented."

American-style lobbying isn't known by the same name in China. In fact, in China, most policy and legislative decisions are made behind closed doors. "Lobbying exists in a gray area; because there are no laws specifically pertaining to it, it isn't even supposed to exist," according to an Oct. 1, 2007, article in the *Washington Post*.

Working With Local Government

Government affairs in Beijing looks pretty much like government affairs in Washington or Tokyo. At the local level, however, government affairs is very different, say the experts. Not only is there a gulf between Beijing and the provinces in the level of overall sophistication, but too often the central government and provincial ministers aren't even on the same page policy-wise.

Because of the sheer size of China, chances are that many multinationals will spend most of their time dealing with local officials. In fact, in China today, there are over 100 "second-tier" cities with populations exceeding the one-million mark.

In addition, so many multinationals have entered China that the central government is no longer impressed by their investment potential — and yet many second- and third-tier cities still actively encourage American business. For that reason, companies outside the *Fortune* 100 often find smaller cities far more accommodating in terms of business permits and even tax breaks.

In China CEO, Alan Brown, chairman of Unilever China, recounts how dismayed he was when a local laundry detergent manufacturer received very attractive investment terms from a local government. Unilever eventually realized that it could negotiate its own attractive investment terms in Anhui province — and ultimately moved its manufacturing facility there. "We discovered we can get the same level of support through our own relationship with a local government," Brown said.

Perhaps the biggest challenge in dealing with local government officials is corruption.

"Local officers are sometimes corrupt, and if you don't cultivate them, they can hassle you," says William McCahill, Jr., a partner at JL McGregor & Company. Hassling can take the form of charging a multinational fines — or even shutting down operations — for something as seemingly petty as failing to have the width of the front door conform to standards. McCahill's advice for dealing with government officials outside the major metropolitan areas? "Take them to lunch, give them face, and show them respect," he says. As always, though, keep in mind there are strict limits to what can and cannot be done under the Foreign Corrupt Practices Act (FCPA).

Often, multinationals prefer employees who've grown up in the system to work with the provincial, city or local governments. McCahill contends that even an accountant with good people skills could handle government relations at the local level. Here, though, a critical issue is honesty. "The guy who seems to be doing a good job may be slipping officials little red envelopes of cash," says McCahill, warning American executives to keep a close eye.

Given that lobbying in China can be a somewhat scattershot affair, with U.S. companies meeting many government officials in the hope of gaining the ear of the ultimate decision-maker, it's important to express a consistent sentiment to everyone you encounter. "You can't send mixed messages to Chinese officials," one seasoned government affairs practitioner says. "Regaining lost ground is much more difficult in China than what you'd find in the United States."

The Meeting Dance

Government relations experts can maximize their chances of scheduling meetings by observing protocol. It's deeply ingrained in Chinese culture not to take meetings with someone of a lesser title. Therefore, sending in the right spokesperson is absolutely essential, even if that means bringing in an executive from the United States. Chinese government officials are favorably impressed by American companies that go to the effort of having a high-level executive fly to China to address a particular issue.

Scott Seligman, author of *Chinese Business Etiquette*, puts it this way: "If you're only sending a director-level person into China to work on an issue, you'd be out of place asking for a meeting with a vice minister or a minister. They might meet your president or a senior vice president, but they wouldn't go much lower."

In the past few years, American companies have scaled back their expectations about whom they can reasonably meet in China. "It used to be that if you were a CEO of an American company, you could get in and see the president of China. That happened throughout the '90s, but it doesn't happen anymore," says James McGregor, author of *One Billion Customers*. He analogizes the situation to the U.S.: "If you're a CEO of a German company, can you see George Bush? No."

And — unfortunately — this is also a case where size matters. If the firm is a worldwide behemoth, the chances of getting a senior-level meeting are higher than for a smaller company.

The next challenge, then, is deciding whom to ask to meet. Most ministries are run by director generals, who set policy, and under them is the director. Often, the experts say, the directors know the industry much more intimately than their supervisors and are more readily available. What's more, directors are in an outstanding position to make recommendations to the director general.

Pinning down a meeting in China is also far more difficult than it is here. As a matter of protocol, requests for meetings with senior Chinese officials (ministers, vice ministers and above) should always be presented at least two weeks prior to the desired date. Nevertheless, confirmation of the meeting often takes place at the last minute. At the working level, officials might ask you to call them two days before the date to make an appointment.

"An oddity of China is that nothing's really scheduled very far in advance," says Hundt. "You have to go there and say, 'Can I meet with you tomorrow?' And very often the answer is 'yes.'"

Victor Zhang, director of the China office of the Business Software Alliance, notes that there are a number of reasons why officials are reluctant to schedule meetings, including that their schedules are busy, they don't "own" their time but their time belongs instead to the department they serve, and they may be on standby for assignments from their supervisors that could start with little or no notice. The best you can expect, he says, "is to be told, 'Okay, I'll probably be available.'"

Others have observed that refusing to firm up a meeting is the ultimate mind-game. If an official won't grant a meeting until the last possible moment, then the American executive is likely to be very grateful when he or she finally nails down the appointment, even if it's only hours before the conversation takes place. Instead of being confrontational, the executive may simply be so relieved to finally see the Chinese government official that the official gains a psychological advantage.



Scheduling meetings with senior Chinese government officials is no simple task. Requests should be made far in advance, but confirmation of the meeting often occurs at the last minute.

“When you come to China with the message that we want to work with you to reach your own goals of achieving balanced economic growth that benefits the Chinese people broadly, I’ve found that China’s leaders are willing to listen.”

For the government affairs professional in charge of putting together the schedule for China meetings, this process can be nerve-wracking. It’s best to inform your company’s executives early in the process that meetings will almost certainly not be nailed down until they are on the ground in China. Understanding this practice can also help ensure a smooth working relationship between a U.S.-based government affairs executive and one working for the company in China.

Finding Win-Wins

When CEOs of financial service companies are asked where they most want to invest, China ranks near the top. The bad news? The current regulations make it very difficult for large American institutions to gain a foothold. Today, a single foreign financial institution can own 20 percent of a bank in China and foreign financial institutions can collectively own 25 percent, while before China’s accession to the WTO no foreign ownership was permitted whatsoever. There are other rules, as well. If a Citibank or a Deutsche Bank has a locally incorporated subsidiary, it could open a branch in China — but only one branch a year.

"The ownership caps of 20 percent are very frustrating," notes John Dearie, senior VP for policy and research at the Financial Services Forum. What’s worse, China’s five major state-owned banks, which account for more than three-quarters of all banking in China, are accustomed to making loans at the government’s direction rather than exercising independent business judgment.

"Making the shift from state-directed lending to commercially-viable lending takes time," says Dearie. The Financial Services Forum has told Chinese government officials that it’s dangerous for the world’s third largest economy to have "one of the most primitive and underdeveloped financial systems on Earth." By allowing competition from overseas, Chinese banks would quickly gain the cutting-edge expertise to help grow the financial sector, which Dearie describes as "the cardiovascular system for any economy."

So far, Dearie emphasizes that the Financial Services Forum and its member institutions have found agreement at the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC), as well as at the Ministries of Finance and of Commerce. "They all understand and know they’ve got to move farther faster," says Dearie. "But they serve at the pleasure of their Communist Party masters."

For government affairs professionals in other industries, the real message is how best to approach government officials. "The Communist Party has set certain economic goals, articulated in their Five Year Plan, that are very ambitious and challenging. And our argument to them is that you cannot achieve those things without a world-class financial system. And the fastest way to get one is to import it. And the fastest way to import it is to open up your economy to foreign participation," says Dearie. "We try to emphasize that this is in their interests."

Don Evans, CEO of the Financial Services Forum and former U.S. Commerce secretary, says, "When you come to China with the message that we want to work with you to reach your own goals of achieving balanced economic growth that benefits the Chinese people broadly, I’ve found that China’s leaders are willing to listen." He then cites statistics that back up his world view. Research conducted by McKinsey indicates that genuine reform of China’s financial system would expand the country’s economic output by as much as 17 percent, or an additional \$320 billion a year.

Why are win-win arguments so effective with Chinese officials? The roots, says James McGregor, founder of JL McGregor & Company, lie in the psychology of China. "The whole country is involved in a national crusade to improve itself and become somebody in the world," he says. Those multinationals able to help in achieving this goal will be rewarded.

At the same time, taking an overly aggressive approach with government officials is an almost certain way to have your request denied.

Case Study: Fireworks Safety Testing

In a notable irony, Americans celebrate their national freedom each Fourth of July with a product made almost exclusively on foreign shores: fireworks. Given that 98 percent of American fireworks are hand-manufactured in China and that safety concerns are paramount, the pyrotechnics industry got serious about product testing 14 years ago, well before toy and pet food manufacturers were taken to task over Chinese-made goods that proved unsafe.

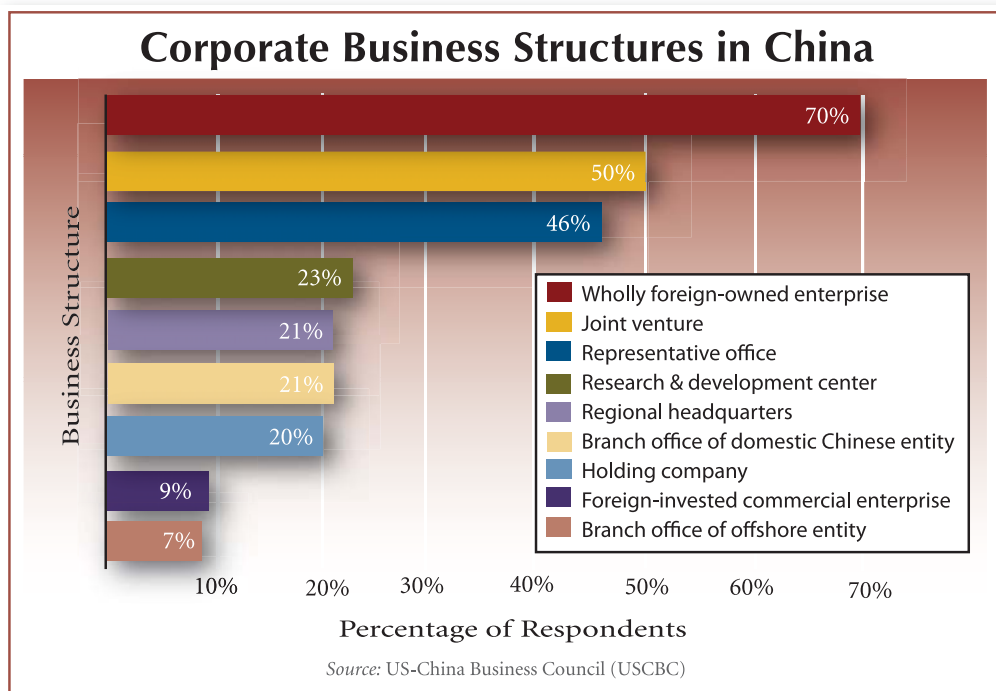
In 1989, the U.S. Consumer Product Safety Commission (CPSC) initiated a lawsuit against American fireworks companies because over 75 percent of their products didn't meet the U.S.'s safety and quality standards. Soon after, six or seven companies got together and created the American Fireworks Standards Laboratory (AFSL), recalls Executive Director John Rogers.

American fireworks merchants realized that testing in the U.S. simply wasn't feasible because of the hassle, the labor costs and other expenses of returning unsatisfactory shipments. Testing in China posed its own challenges, though. One major hurdle was a Chinese law stating that only the Chinese government could test and approve products made in China.

"In the early years, the government kept saying, 'You can't do it, you can't do it,'" recalls Rogers. AFSL repeatedly met with government officials in China to argue its case. Although the early days were tough, the bottom line, says Rogers, is that "they never threw us out."

AFSL eventually hired London-based Intertek Testing Services, Ltd., which has testing laboratories in many countries, including China, to certify fireworks. Rogers emphasizes the importance of training, noting that AFSL had to teach Intertek how to inspect fireworks to meet American safety standards. Today, Intertek has 60 people on the ground performing fireworks testing at 550 different factories in China, says Rogers. All testing is paid for by AFSL, which is supported by 145 member companies.

AFSL also translated American quality standards into Chinese and trained the factory workers to make safer products. The efforts paid off. In 2006, AFSL tested 7,113,989 cases of fireworks, 93 percent of which were compliant — up from the 64-percent compliance rate for the 902,606 cases tested in 1996.



Does China's Response to the Sichuan Earthquake Signal a New Era of Openness?

“ I think that China's government is seeing the benefits of being more open and transparent as a result of this tragedy.”

In the days following the devastating earthquake that hit Sichuan province in May 2008, Premier Wen Jiabao became an international hero, urging on rescue teams and comforting the injured. At one point, reported the *Washington Post*, he was televised telling a trapped child to "hang on because 'Grandpa Wen' was on hand."

Shaun Rein, founder of the China Market Research Group, notes that Wen has been perceived "as a leader with a human face and heart, who cares for the Chinese people." Wen's popularity has soared, earning widespread comparisons to beloved former Prime Minister Zhou Enlai, says Rein. The government also won acclaim for allowing Chinese newspapers and television stations to report on the full extent of the tragedy.

Without question, the Chinese government's response to the Sichuan earthquake marked a sharp departure from its handling of earlier catastrophes. Three decades ago, China sought to conceal the devastation from the 1976 Tangshan earthquake, which killed at least 240,000 people. In 2003 the world condemned China for trying to cover up the SARS epidemic.

Does the response in Sichuan mark a true turning point? Some say so. "I think that China's government is seeing the benefits of being more open and transparent as a result of this tragedy," says Rein.

Others remain skeptical. Roderick MacFarquhar, a professor at Harvard University who has written widely on Chinese history and political science, says that world events have given China no choice but to be forthcoming. "China realizes that if it is to be accepted as a normal member of the world community, it must take steps in the direction of transparency." He continues: "Here, China had to become transparent because it didn't want the negative press that the Burmese got [after that government's response to Cyclone Nargis.]"

MacFarquhar also points out that the Chinese government could not control how the media covered the earthquake. "The Chinese will be transparent when they have no alternative. In the case of the earthquake, it was a massive disaster. They needed help. And even the Chinese journalists who were forbidden from going to Sichuan got on the plane and went. That broke the dam."

Rein notes that the Internet guaranteed that the Sichuan earthquake story got told. "Since the scale of the tragedy was so enormous," says Rein, "many people wrote about it on blogs and Twitter or uploaded videos on online video-sharing sites within moments of when the quake struck."

Elizabeth Economy, director of Asian studies at the Council on Foreign Relations, maintains that the initial response of China's officials was encouraging. However, she says, "as time has gone on they've reverted to far more traditional means of constraining the openness of the information that's transmitted both within the country and to the rest of the world." She emphasizes that Chinese officials have attempted to halt reporting on the shoddy construction of schools because this topic could become "a trigger for a push for broader political reforms."

MacFarquhar raises a similar point, noting that transparency can lead to undesired results. "When their normal operating procedure collapsed, they had to go with transparency and make a virtue out of it," he concludes. "And yet this doesn't mean there will be transparency in all things."

Rogers attributes AFSL's success to its hands-on approach to product monitoring. He travels to China at least four times a year and has a full-time staff person who shuttles between rural Hunan and Guangxi, the provinces where the fireworks industry is concentrated. To meet CPSC standards, fuses must, for instance, burn for three to nine seconds. Rogers says that AFSL's presence helps "keep the program honest." Were AFSL not overseeing the process, it would be too tempting for factories to buy off testers willing to relax the three-to-nine-second fuse rule.

Success begets success — an important lesson when dealing with the Chinese government. "The product got better very quickly," says Rogers. "And as the product got better, sales in the U.S. grew, and the Chinese government took note." In 2007, the fireworks-related injury rate had fallen 91 percent, setting a 31-year low. At the same time, fireworks usage skyrocketed, increasing almost 960 percent from 29.0 million pounds in 1976 to more than 278 million pounds in 2006, according to the American Pyrotechnics Association.

In concluding, Rogers emphasizes that Chinese government officials are pragmatists when it comes to business. "If," concludes Rogers, "you can be persistent and demonstrate to them you're sincere about what you're doing and that what you're doing will help their market succeed, they're going to let you continue."

Resolving Conflicts

In 2007 American businesspeople and their Chinese suppliers suddenly found themselves in contentious talks concerning quality. The litany of recalls of China-made exports was lengthy, with products ranging from Barbie toys and Thomas wooden train sets to pet food contaminated with melamine and tainted toothpaste.

The fallout from this conflict was immediate and dramatic. On July 10, 2007, China executed the former head of its state food and drug administration, and on Aug. 11 the co-owner of one of the companies that supplied toys to Mattel committed suicide at one of his factories.

At the same time, the reaction of the Chinese government struck many Americans as defensive. Although some of the more well-publicized incidents have been resolved, larger questions still remain. Many U.S. businesses haven't been mollified by the official government response, which tended to minimize the situation. "Some small factories do have quality problems," acknowledged a Chinese official in a news agency article about the millions of toys recalled by Mattel and others. But the official then placed most of the blame on "improper designs" by the foreign owners of the brand, rather than taking responsibility for deficiencies. In addition, there were widespread reports that news articles about recalls of products made in China were censored or removed from newsstands.

There's a growing sense that unless products made in China are tested by a third-party laboratory, quality levels will be lower than promised. In such a large and complex manufacturing economy, this may be true. In an admittedly small but intriguing 2008 study, Williams Loft, a luxury bedding and mattress company based in Little Rock, Ark., found that Chinese price estimates climbed dramatically when testing was part of the equation.

Williams Loft asked 12 Chinese down comforter manufacturers for price estimates based on a number of specific quality requirements. Six weeks later, the company sent out the identical request to the same manufacturers with the additional requirement that product samples be independently tested before final payment would be made. When the agreement hinged on third-party testing, 10 of the 12 manufacturers raised their prices an average of 20 percent.



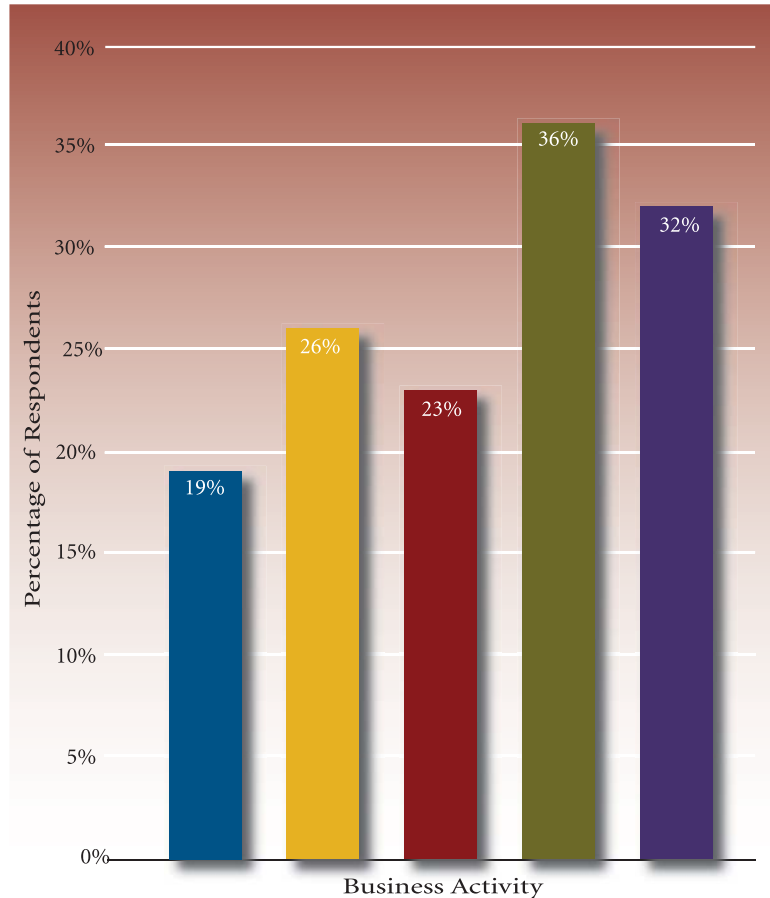
AP Photo/Eugene Hoshiko

Chinese toy manufacturers faced a major crisis in 2007 when lead paint was found on products shipped throughout the world.

Shaun Rein, founder of the China Market Research Group, points out that American consumers aren't alone in their desire for outstanding quality; Chinese consumers increasingly share their concerns and want products that they can trust. This presents an excellent opportunity for multinationals selling into China because their products are often perceived as superior.

In fact, after 1,500 in-depth interviews with Chinese consumers, the China Market Research Group found that nearly 75 percent would prefer a product made by a multinational if they could afford it and if the product directly affected their health. Rein therefore advises American consumer companies to position the products they're selling into China at the high end.

Impact of China's Intellectual Property Rights Enforcement



- Affects the type of products your company is willing to sell in China.
- Affects the type of products your company is willing to manufacture in China.
- Affects the type of products your company is willing to co-manufacture in China.
- Affects your company's interest in doing research and development in China.
- No effect.

Source: US-China Business Council (USCBC)

Because of the international embarrassment over the product recalls and the reaction of its own citizens, China seems determined to address its quality issues. But what happens when an American company must broach an unpleasant, but lower-profile problem with the Chinese government?

Tackling touchy issues requires true diplomacy. When, for instance, an American company is delivering a confrontational message, it's considered unfair to send an employee from the PRC to lead the conversation. "You can't ask a citizen of the PRC to take an adversarial position," said one senior government affairs professional from a major American company. "The official doesn't expect it."

Sometimes in China, creativity is the best approach for resolving conflicts — or avoiding them in the first place. Dr. Shan Nair, founder of Nair & Co., works with a Boston-based manufacturer of a long-life battery. Out of a fear that this unique product would be copied, the company has divided its facilities among three locations: one in northern China, one in southern China and a third in South Korea. "Even if the two Chinese management teams decided to quit and replicate the technology, they can't do it without the cooperation of the Korean team," says Nair. He acknowledges that doing business this way is more expensive, but it saves on potential headaches. "They've done a good job of protecting their intellectual property without resorting to the courts," says Nair.

As the ground shifts, with government officials working in ways more Western than not, some multinationals are finding that being forthright pays off. In *China CEO*, Steve Schneider, chairman and CEO of GE China, maintains that companies that have built good government *guanxi* can insist on their legal rights. "I have always been very direct," Schneider is quoted as saying. "If [the government] suggests things that I don't think are correct, I will let them know. I tell them what I can do and ask them to do what I think is the right thing."

Reducing IP Piracy

The pirated Louis Vuitton bags and live concert CDs that delight Chinese bargain hunters are symptomatic of a widespread problem: the Chinese have historically taken a very lax approach to intellectual property (IP) rights.

Although IP piracy is rampant, multinationals have achieved some results by making their case directly to the Chinese government. Since the Business Software Alliance (BSA) began working on this issue, software piracy in China fell from 98 percent to 82 percent as of late 2006.

International diplomacy has spurred change. Part of the price of China's entering the World Trade Organization was greater IP protection. What's more, stronger IP protection is increasingly viewed as a boon to China's growing software industry. "For the first time," says Robert Holleyman, president and CEO of BSA, "IP protection fits in with their own aspirations to have products that are desired around the world."

Now that BSA is widely known in China, it's easier to secure meetings with government officials, according to Jeff Hardee, regional director of BSA, Asia-Pacific. BSA's China operations are staffed by six full-time employees, all of whom are from the PRC. In 2006, BSA fostered additional goodwill by holding its annual meeting in Beijing.

Victor Zhang, director of BSA's China office, once worked at China's Ministry of Foreign Affairs and therefore understands many of the issues from both sides. He believes that BSA's presence in Beijing is a sign of the organization's "sincerity" and "a demonstration of the commitment of the organization to work with the government on a long-term basis."

Being a Chinese national affords Zhang an advantage. "In this job, communication is crucial. You make your arguments, you raise your issues," he says. "If you don't understand the history, the tradition and the culture of China, you'll have difficulties communicating."

BSA has worked to raise awareness of intellectual property protection through World IP Day and other media events. Holleyman points out that "if you portray a story in the right way, you can use the media." While the Chinese press don't usually report on the piracy rate per se, journalists happily covered a report sponsored by BSA and conducted by IDC, an information-technology research and analysis firm, demonstrating that information technology's contribution to China's GDP had grown almost 500 percent between 1989 and 2005. The Chinese have also embraced unique and sometimes entertaining approaches to encouraging IP protection. In Jiangsu province, for instance, BSA sponsored a copyright knowledge quiz show, notes Hardee.

A number of years ago, China embarked on a government legalization program, rolling it out initially at the national level and then applying it to state and local government offices. Two years ago, the Chinese government extended this program to businesses, including state-owned enterprises. In this process, BSA partnered with the Chinese government to introduce the benefits of "software asset management" (SAM), where government offices and enterprises perform self audits to assess what programs they already possessed, what they really need, and what needed to be purchased to ensure license compliance. BSA also helps educate government workers and enterprise managers on other benefits of SAM, emphasizing that non-pirated software is supported by the vendors and is far less vulnerable to viruses.

Zhang believes that BSA is at a critical juncture because "the government is open to listening to our suggestions for improving copyright protection in China." The challenge? Generating appealing solutions as the Chinese government struggles to purchase legal software within budget constraints. The more innovative the ideas, the more useful the organization can be to Chinese officials. "We have to work together," concludes Zhang.

“Although IP piracy is rampant, multinationals have achieved some results by making their case directly to the Chinese government.”

Reaching Out For Help

Government relations ranks high on American companies' lists of top business challenges in China. According to AmCham China's 2008 white paper surveying 324 companies on the Chinese business climate, the top four concerns — management-level human resources constraints (37 percent), inconsistent regulatory interpretation (34 percent), unclear regulations (29 percent) and lack of transparency (28 percent)— all fall squarely under the “government relations” rubric.

Given that penetrating Chinese bureaucracy can be a daunting task, many experts advise reaching out for help. Organizations such as the U.S.-China Business Council, USITO (an independent NGO focusing on the information and communications technology industries in China), and the American Chambers of Commerce in Beijing and Shanghai all represent tremendous resources. AmCham-China's membership comprises more than 2,100 individuals and 900 companies.

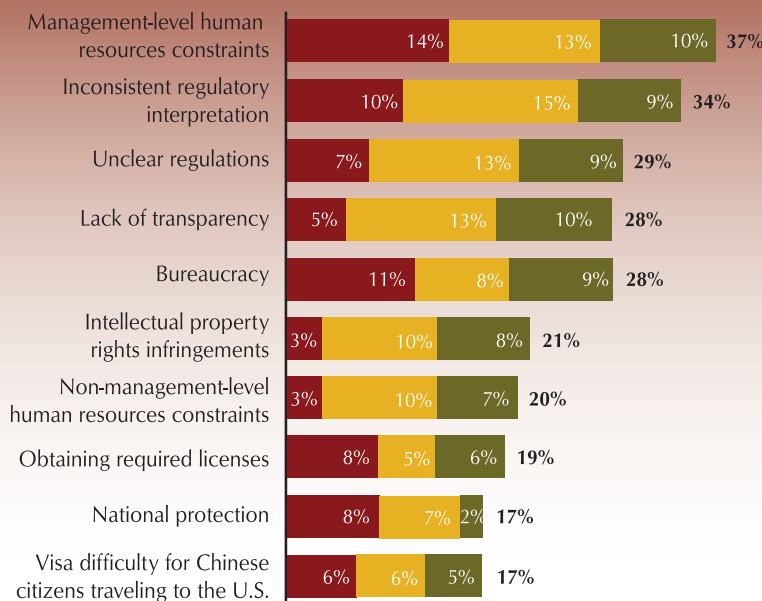
Experts also advise American government affairs professionals to become acquainted with officers at the U.S. consulate. With dismaying frequency, business travel is cancelled because of a lack of a visa or some other bureaucratic hurdle. Having friends at the consulate can help a company iron out these problems more quickly.

In addition, American companies have benefited from retaining public relations firms, market research organizations and government relations specialists. Hiring a government relations specialist or a PR firm is especially compelling for small and medium-sized companies, which almost certainly lack the staff and resources for handling complex issues in China on their own.

Top Business Challenges in China

Survey of 324 Companies

■ Challenge #1 ■ Challenge #2 - #3 ■ Challenge #4 - #5



Source: 2008 AmCham-China Business Climate Survey

Some China experts have identified the "pay-me-now-or-pay-me-later" syndrome. American companies that forego hiring expensive consultants or PR firms often find that they wind up engaging these consultants later, once a problem has arisen. The downside? Hiring consultants to manage a full-blown crisis is far more expensive than working with a consultant from the beginning. "You just can't do this on the cheap," says one senior government affairs professional from a major U.S. consumer company.

Shaun Rein, founder of the China Market Research Group, argues that hiring consultants who understand government relations makes sense because the landscape isn't static and a company's internal experts can quickly become stale — or worse.

"Political winds change very quickly, but it's the same everywhere," says Rein.

Rein recommends that a multinational's government affairs professionals run the department but not perform actual lobbying. The government affairs team should hire consultants who can then go to the government and make the company's case.

Influencing Thought-Leaders

Industry associations — an invaluable resource for government affairs professionals at home — play an important but slightly different role in China. "Most of the major Chinese industry associations can trace their origins back to the government," says Murray King, managing director of APCO Worldwide's Shanghai office. He points out that the ministries for the chemical and automotive sectors were spun off into industry associations as the Chinese government downsized from approximately 100 ministries in 1980 to about 28 ministries today.

The effectiveness of joining a Chinese association depends on your industry; some associations are transparent and fairly global, others aren't. In certain sectors, American companies have founded their own industry associations in China because the Chinese ones didn't meet their needs. USITO — a U.S. membership-based trade association for the information and communication technology industries — is an example.

Some American companies in China have attempted to influence public opinion on issues through direct involvement. Merck, for instance, is working with the Ministry of Health on HIV/AIDS awareness education in Sichuan province, committing \$30 million to the project over a five-year period. For drug companies to highlight a health issue is, of course, an excellent way for them to shape the public debate and become thought-leaders on a topic. It also gives them a hand in decision-making and paves the way for greater acceptance of their products over time.

Talking to the Media

American companies are often reluctant to approach the Chinese media with a story because they're not certain how the state-owned press will ultimately report on it. Although this is a valid concern, it's sometimes necessary to communicate with the media to avoid greater damage.



Talking about business issues with the state-owned media in China can be difficult, but it's still necessary for companies to have a media relations strategy.

Developing Ties *with* Local Firms

Not all American companies that want to change an official rule directly approach the Chinese government. Some identify local Chinese companies in much the same boat, and team up to influence public policy. These cooperative relationships — termed "transnational political alliances," or "TPAs" — are surprisingly common in China, according to Scott Kennedy.

Kennedy points out that there are many obstacles to TPAs, including the highly authoritarian political system, expectations of national loyalty, policies that benefit local industry and stark cultural differences separating Chinese and foreign business executives. And yet TPAs do exist. The longer a multinational operates within a country, the greater the likelihood it will have developed strong ties with local firms with which it can cooperate politically, says Kennedy.

McCahill outlines a similar strategy. Say the Chinese government insists that software be encrypted a certain way that departs from international standards, in effect forcing companies to add cost by running a production line for China and one for the rest of the world. Instead of approaching the government directly, a U.S. company might solicit help from Chinese businesses that share these concerns. While the American business can gather research and draft communications, the Chinese company will be better positioned to make the case for the industry before the PRC government.

"Once you've found Chinese manufacturers with the same concerns, team up and let them do the running," says McCahill.

"You may be competing against a Chinese company in your business and you don't want your competitor to tell your story because they'll tell it badly and portray you badly," says James McGregor, founder of JL McGregor & Company. "You need to tell your own story."

2007 AmCham Shanghai Corporate Social Responsibility Awards

The winning programs were selected via a rigorous review process conducted by AmCham Shanghai and the Chamber CSR Committee. By drawing attention to these organizations, the Chamber aims to acknowledge corporate CSR successes and to provide a model for other organizations looking to expand their community outreach efforts.

CSR Excellence in China, First Prize Winner:

- General Electric (China)

CSR Excellence in China, Finalists:

- Coca-Cola (China) Beverages Ltd.
- Corning China (Shanghai), Regional Headquarters
- Deloitte Touche Tohmatsu Certified Public Accountants, Ltd.
- Goodyear Tire Management Co. (Shanghai) Ltd.
- Intel China Ltd.
- Mary Kay (China) Cosmetics Co., Ltd.
- PricewaterhouseCoopers Zhong Tian CPAs Limited Company

CSR Excellence in China for a Non-Foreign Invested Business (tie):

- Guangdong Galanz Enterprise Group
- Shanghai Pudong Development Bank

CSR Excellence in China for a Small and Medium Enterprise, First Prize Winner:

- Ignition Marketing

CSR Innovation Award for Mobilizing Core Business Areas for CSR

- Nu Skin (China)

CSR Partnership Award for Collaboration Between a Company and a Non-Profit Organization:

- Cargill Investments (China)
- Students in Free Enterprise (SIFE) China

Exceptional Partner Award for Facilitating CSR Programs with Many Companies:

- Junior Achievement (China)

Environmental Collaboration Award for Facilitating Sustainable Development Initiatives with Many Companies:

- WWF-World Wide Fund for Nature, China

In an interview with the *McKinsey Quarterly*, Jorgen Clausen, CEO of Danfoss, recalled how his company used the media to publicize its hard-line stance against product counterfeiting. When his colleagues discovered a Chinese company manufacturing a product and selling it under the Danfoss label, the company documented the case and went to the authorities. The police raided the company, confiscated the goods and sent the counterfeiter to jail.

"Meanwhile," Clausen was quoted as saying, "the PR agent on our team encouraged Chinese newspapers to write articles in which we praised the police and the judge. So it became a very positive story from the Chinese authorities' point of view. They are now very happy to work with us. Our policy also acts as a deterrent. The copycats now realize that Danfoss will go after them."

Creating A Robust CSR Program

Nine days after the Sichuan earthquake hit, costing tens of thousands of lives and demolishing homes and other property, more than \$32.7 million had been pledged for China aid, according to the U.S. Chamber of Commerce Business Civic Leadership Center. Seventeen corporate donors pledged \$1 million or more in cash or a mix of cash and in-kind support. The contributors included Abbott, AIG, Anheuser Busch, Cisco, GE, HSBC, Merck and The Walt Disney Company.

Other multinationals teamed up with Chinese companies to lend a hand. Boeing not only donated cash through the American Red Cross Society, but it worked with Shenzhen Airlines to deliver supplies provided by American charities to China's hard-hit earthquake area.

These recent examples highlight the growing trend for multinationals to work on and fund social initiatives in China. In fact, corporate social responsibility (CSR) has become a very hot topic in China. The reasons, the experts agree, are rooted in societal forces. "The government itself increasingly sees that it alone can't manage all the social issues out there in the world and China. They're looking to the corporate sector to help with these societal issues," says Elizabeth Knup, co-chair for the Committee for Corporate Social Responsibility at the American Chamber of Commerce, China. "There's practically a conference every week on CSR."

Knup describes CSR as an "umbrella concept" that includes everything from corporate philanthropy and community outreach to strengthening internal policies on labor rights, maintaining an ethical supply chain, and ensuring

the health and safety of workers. The biggest trend in CSR? "Everybody does it," says Knup. "And there's a growing interest among small and medium-sized enterprises to get more engaged, even if they have limited resources."

Seattle-based PMI, which won AmCham Shanghai's 2006 CSR award for smaller companies, believes that quality and CSR go hand in hand, according to Valerie Bone, director of quality and CSR. She credits PRC native Robin Li, who oversees quality and CSR for PMI in Asia, with having spurred some minor-but-compelling changes for the company's factory workers.

Li recently told Bone that workers at one of PMI's factories in China were properly fed but complained about not liking the meals. The company made changes, and job satisfaction immediately improved. "It's not something you see in an audit report, but it's one of those things that make a nice difference," says Bone.

"When you improve a factory from a CSR point of view — you provide better work conditions and the workers aren't too tired — you have workers that are more loyal and more productive, and the quality improves," continues Bone. "It raises the whole game."

Increasingly, U.S. companies are involving themselves with local community initiatives or social causes within China. Selecting a project to support isn't necessarily easy. Most companies try to find initiatives that tie in with their businesses. Water is a key issue for many manufacturers, especially for beverage companies. In an article published on ChinaCSR.com on May 23, 2007, Dr. Eden Woon, Starbucks' vice president, Greater China, notes that Starbucks committed \$600,000 to the China Women's Federation for water education for women living in drought-stricken parts of China.

Oliver Ye Yang, manager, corporate social responsibility and government relations, at the AmCham in Shanghai, notes that environmental projects present an outstanding CSR opportunity for American companies because the Chinese government is aggressively working to confront this issue.

In addition, though, companies are inviting input from their employees about what philanthropic projects to support. Three years ago, PMI approached various international non-profits and asked for suggestions of meaningful projects that could be accomplished for a specific sum. PMI then presented three options to employees, and three-quarters voted to support the Ocean Conservancy's sea turtle conservation project. Once a year, a representative from the Ocean Conservancy visits PMI to update employees on the latest in sea turtle research.

Barry Doggett, VP of public and community affairs at Eaton Corp., maintains that the benefits of CSR for U.S. companies are manifold: "Eaton is not known like Coca-Cola or General Electric is," he says. "CSR helps us build our brand, get our employees involved, and have the government see us as a good corporate citizen."

CSR in Action

DaimlerChrysler wasn't promoting a particular product in the Chinese market when it became a sponsor of Live Earth Shanghai, one in a series of worldwide concerts held on July 7, 2007, to raise awareness of climate change. Instead, Kerry Driver, founder of Ignition Marketing, helped DaimlerChrysler introduce its "smart car" concept by importing two vehicles from Germany for this televised event, held at Shanghai's historic Pearl Tower.

Concertgoers were intrigued by the cars, and posed to have their photos taken beside the hybrid vehicles. "It created lots of word of mouth," Driver recalls. "People said, 'Hey, look at this cool hybrid car. I wish I could have one.'" The hope? That Chinese consumers will start demanding cleaner-fuel technologies from the powers that be.

Founded in 2005, Ignition Marketing, which specializes in creating direct consumer-awareness campaigns for foreign companies operating in China, counts Coca-Cola, McDonald's and Nike among its clients. Driver has made CSR a cornerstone of her mission. The company donated its services to Live Earth at cost — and, in fact, dedicates a percentage of its manpower to charitable or community projects each year. In 2007, the American Chamber of Commerce, Shanghai, awarded the 12-person firm top honors for CSR by a small company.

“ Foreign companies that give back to the local community will have a better time fighting in a more competitive market in the future.”

"We always recommend that our clients do some level of CSR," says Driver. "The market here is huge and the ability to produce high quality products at a low price is very good. And so I really feel there's a responsibility to give back to the Chinese community because we are enjoying such a great market position."

Driver's enthusiasm for CSR has its practical dimension, as well. "Foreign brands are still very attractive to Chinese consumers but there's rising loyalty to Chinese brands," she observes. "Foreign companies that give back to the local community will have a better time fighting in a more competitive market in the future."

Because of the importance that "face" plays in China, Driver advises multinationals to tread carefully, even when they're attempting to do good: "I don't recommend that foreign brands come in and say, 'We want to do this.'" Instead, she urges companies based outside China to "make sure that the local authorities are the ones that help define what the role should be for your CSR investment."



AP Photo/Craig Baker

Nike Tackles Migrant Issues

Nike's community investment in China focuses on "bringing the benefits of sports to the children of migrant workers," says Kelly Lau, corporate responsibility director for Nike in China. To this end, Nike has partnered with local schools serving the children of migrant workers in Beijing, Shanghai, Nanking and Guanzhou. "Since we began the partnership in November 2007, the program has reached 135,000 migrant youth," says Lau. This initiative bolsters the children's confidence and gives them "important social skills to adapt to their new communities."

Because caring for the children of migrant workers represents a major social issue in China, Lau says that Nike first piloted the program on a small scale, and then briefed the government in order to "gain their recommendations and support for expansion." Among the benefits reaped from this program, Nike has improved its understanding of emerging markets and boosted employee morale.

Nike has 20 employees in China dedicated to corporate responsibility, 17 of whom focus exclusively on compliance within Nike's supply chain. Nike is working to address industry concerns such as excessive overtime and to make sure that workers aren't underage.

Lau is convinced that Nike's corporate social responsibility efforts create greater trust between the company, the government and other stakeholders, and that this trust is invaluable when Nike enters into a dialogue with officials about other issues. "CSR programs facilitate relations with government leaders and community leaders in that these programs do something solid for the local people and community," Lau says. "In short, CSR reflects the heart of a company. A company with a kind heart is reliable and trustworthy."

Mao frequently quoted this slogan from the Qing Dynasty: “Gu Wei Jin Yong, Yang Wei Zhong Yong.” Translation? “Make the past serve the present, make foreign things serve China.”

As China discovers that foreign businesses can serve its interests well, the odds of negotiating favorable arrangements with government officials are increasing.

Almost everyone agrees that government relations in China is becoming less daunting as more American companies demonstrate solid success there. In the U.S.-China Business Council's October 2007 survey, 85 percent of respondents said that their China revenues had increased in 2006, up from 70 percent in the prior year's poll. Of those, 92 percent expected the increases to continue in 2007. And the overwhelming majority of respondents — 93 percent — viewed their companies' medium-term future prospects in China positively.

That said, new entrants face some serious hurdles, especially since the Chinese government is becoming far more selective in the foreign direct investment it encourages. Gone are the days when any multinational with money was welcomed, no questions asked. Today, polluting industries are viewed warily, as are those looking solely for cheap labor. The Chinese government vastly prefers "smart money," or U.S. companies in high-tech industries or firms with sophisticated management practices, so that its home-grown businesses can gain an informal education from their presence.

In addition, the Chinese government is clamping down on U.S. companies that harm the environment or run businesses that add little value to Chinese society at large. "You need to bring something that will help China and it's not just money. It's much more the intellectual technology transfer," says Shaun Rein, founder of Shanghai-based China Market Research Group.

As China steps into its new role as superpower, its policies will be more carefully scrutinized, and issues such as quality — and the tainting of Brand China — could dominate the conversation.

In the end, though, the sheer vigor of the Chinese economy may be what cements the relationship between Chinese government officials and American businesses. Overcoming differences and melding two very different political and cultural approaches are clearly perceived as "win-wins" for both nations.



The Great Wall traverses China on a journey from east to west. The world is watching to see whether China will shift its business and political environment in the same direction.

NINE CHINA WEB SITES WORTH A VISIT

www.chinability.com/China%20population%20clock.htm

For the very latest population statistics, consult China Population Clock (based on Census predictions).

www.amcham-shanghai.org/AmchamPortal

The American Chambers of Commerce in Beijing and Shanghai.

www.amcham-china.org.cn/amcham/show/content.php?Id=2361&menuid=&submid

The 2007 white paper, "American Business in China," from the American Chamber of Commerce, PRC

www.chinalyst.net

An informal community of English-language blogs on life in China (topics range from IP protection to Chinese food).

www.ChinaCSR.com

News items on corporate social responsibility in China.

www.usito.org

Site of the United States Information Technology Office in Beijing, a non-profit, membership-based trade association for the high tech sector.

www.cfr.org

Site of the Council of Foreign Relations, a nonpartisan organization dedicated to U.S. foreign policy and international affairs; many in-depth articles on China.

www.uschina.org

U.S.-China Business Council site, which has a wealth of useful information for American businesses in China.

www.china-crossroads.org

A review of corporate social responsibility issues and initiatives in China.



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