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Role of Culture in Economic Development: China Study of China and Latin America

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Role of Culture in Economic Development:

China Study of China and Latin America

by

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A thesis submitted in partial fulfillment
of the requirements for the degree of
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Case Study of China and Latin America

Amira Fellner

ABSTRACT

The purpose of my thesis is to demonstrate the economic development of China and Latin America. My reason for choosing these two regions for my study is because they are both Third World Nations. My intention on writing this thesis is to prove that culture and the informal business networks of China are the major forces of what is driving the Chinese economy ahead of Latin America.

I will explain how the definition of culture ties in with the economic society of both regions. In writing about culture, I will attempt to explain if there really is a difference between trust in each society. To better interpret this thesis, I came up with several variables of economy that will help explain each region's development. These variables are federal direct investment (FDI), labor, and funding of businesses in each region.

In my study, I present the different approaches that are taken by each region to attract FDI. In addition, I will explain how and if informal networking is beneficial to the work force and the funding of businesses in each region.

The majority of my research for this thesis consisted on reviewing past articles of scholarly journals. From these journals I drew conclusions of my own and compared

them to other scholars' work. I also analyzed such websites like the International Monetary Fund (IMF) and the World Bank and various others to be able to come up with my own findings necessary to complete my thesis.

To anticipate the conclusion, this thesis notes how important it is for each region to find its own unique way to attract FDI and how culture can impact the development of an economy. In my thesis, I am including the importance of trust in the society and the significance of the informal business networks on the Chinese economy.

Introduction

Historical developments and a region's culture have an extreme impact on a country's economy (Greif, 1994). In addition, a region's culture strongly defines the history of economic development. Thus, culture is colossally important in demonstrating traditions of the society from past to present. Cultural perspectives provide researchers with references, which exemplify values, attitudes, and behaviors that influence economic development in China and Latin America. Culture is a combined reflection of politics and economics in any society. Culture can also be perceived as a type of productive force. As some Chinese scholars claim, politics, economics and culture are the three gears of any society and only when they move harmoniously can the whole society develop rapidly (Xuewen, 1997).

The study of the interaction between culture and economic development is not new. However, economists often overlook the role of culture in the economic development of countries. Culture generates assets such as skills, products, expression and insights that contribute to the social and economic well being of a community. Both culture and values shape economic development. According to Sen, the values held by a society will affect economic development efforts (Sen, 1997).

I chose to incorporate the importance of trust in this thesis to demonstrate how it ties in with economic development. Trust is vital to the social capital of a country. It is the mutual acceptance between two or more entities that behavior will be honest. Trust is

a symbolic credit which enhances the ability of individuals to cooperate and to forgo short run gains in transactions. Since China and Latin America are both low-trust regions, I felt that it was important to try to prove that trust is more easily placed within the Chinese informal networks than Latin America (Tsui, 1997).

Many countries in East Asia, particularly China, are resisting traditions from Western culture. It is the use of Asian values and institutions that are responsible for the Chinese economic advancement over Latin America. Despite the fact that the Chinese and Latin American culture are very similar, what I propose as well is that China has a more collective society. This is attributed by its Confucian influence. Confucianism heavily benefits China's economic development because it encourages savings and places high value on education. China has a higher level of trust than Latin America being that it has a homogenous population and a more equal distribution of wealth. According to Fan and Wang, the more China has been marketized, the higher its trust level is (Fang and Wang, 2001).

Latin America is very diverse along most human dimensions: ethnicity, language, culture, history and economic well-being. Despite the diversity, there are common threads that contribute to the lack of economic development. These include the polity-corrupt politicians, the corrupted military and business elites who protect their privileged positions (Montaner, 2000). Although, Brazil, Chile and Costa Rica have shown some progress toward human economic development, for the most part, Latin America has an unresponsive and corrupt bureaucratic structure that hinders the prospect of economic growth. This includes opportunities for small and medium sized enterprises (Warner,

2001). Since Latin America is composed of many countries, I find that overall, the society is very individualistic.

Latin America and China are among the two most active regions in the developing world for private infrastructure investment. They also receive the bulk of foreign investment directed at emerging economies. These two regions have also been evaluated in terms of their economic development progress and their ability to attract Foreign Direct Investment (FDI). By comparing and contrasting both the business and the cultural aspects of each region, I will demonstrate the advantages that China has over Latin America's economy.

I chose to compare Latin America to China because these two regions share some basic similarities in terms of economic development, colonial history, competition for FDI, and recent experiences with privatization and other market-opening initiatives. Additionally, policy makers within the Latin American region often point to the economic development paths followed by China as prescriptive models.

While explaining each region's society and economy, I also elaborate on how corruption is portrayed and how it factors out in economic development. For the purpose of my thesis, I have used the definition provided by Robert Williams to best describe corruption: abuse of public office to for private gain (Williams, 2000). According to economists, corruption increases transaction costs, reduces investment incentives, and, therefore, reduces economic growth. In countries with high levels of corruption, the public is hostile to people who have more. Taking this into account, I explained how corruption is portrayed in each of these regions, being that both China and Latin America both have corrupted political and economic systems.

Throughout this thesis, economic development will be the increase in the ability to choose and make decisions for the maximum number of people during the maximum length of time that will result in a sustainable increase in material and social welfare. This in turn will give allowances for both interpersonal and intergenerational criteria.

I will be using the cultural approach to explain why China and Latin America have had different economic performances during the past several decades. I will attempt to answer how important the cultural factors are in the economic performances of the two regions. In this thesis, I will review the notion of culture and the relationship between culture and economic development.

Chapter One

How Culture is Applied to Capital

For the purpose of my thesis, culture is defined as the socially transmitted behavior, patterns, norms, beliefs and values of a given community. Others would have that culture “is a set of shared and enduring meanings, values, and beliefs that characterize national, ethnic, and other groups and orient their behavior” (Faure and Sjostedt, 1993). According to Samuel Huntington, culture is the values, attitudes, beliefs, and underlying assumption prevalent among peoples in a society. Culture is dynamic, interactive, and synergistic, and it intermixes with all the elements of a society, especially economic development and the milieu of entrepreneurs (Huntington, 2000).

Culture is measured by indicators of individual values and beliefs, such as trust and respect for others, and confidence in individual self-determination. Culture, like institutions, is a vague concept. Culture corresponds to the social norms and individual beliefs that sustain equilibria as focal points in repeated social interactions (Greif, 1994). In this interpretation, culture is one aspect of broadly defined institutions and contributes to shape individual incentives. A more radical view is that culture directly influences individual behavior through values and preferences (Akerlof and Kranton, 2000). Others have pointed out that social norms and individual values could interact in systematic fashions (Benabou and Tirole, 2006).

Sociologists have tended to believe that cultural norms pervade economic life and that to understand economy it cannot be separated from culture. Many economists point out that the differences in economic performance from one society to another are better explained by differences in institutions and in the policies undertaken by those institutions than by cultural factors (Bell, 1994). Culture also affects the ability of societies to create and properly manage institutions. For example, in the postwar period Japan, South Korea and other East Asian countries employed industrial policies, in which the state rather than the market allocated credit to national industries to encourage economic growth.

The notion of culture has witnessed changes from time to time. More than one hundred years ago, E.B. Taylor defined culture in his book *Primitive Culture* where he defined culture as the complex whole which included knowledge, belief, art, morals, and customs acquired by man as a member of society (Greif, 1994). In the middle of this century, A.L. Kroeber described culture in his *Anthropology* as consisting of speech, knowledge, and beliefs that is learned from other man and elders (Kroeber, 1948). In *Culture: A Critical Review of Concepts and Definitions*, A.L Kroeber and Clyde Kluckhohm stated that culture consists of patterns, both explicit and implicit of behavior acquired and transmitted by symbols, consisting the distinctive achievements of human groups, including their embodiment in artifacts (Kroeber and Kluckhohm, 1952). They said that the essence of culture consists of traditional ideas. In short, culture is the total social heritage acquired by man as a member of the society.

Culture is shared and distinctive forms or patterns, that shapes human behavior, and its essence is the values embodied in the beliefs of the people. This makes value

orientation patterns the essential features of culture (Alexander and Kumaran, 1992). In discussing the relationship between culture and development, Gao Xian raises the issue of macro-culture. He points out that macro-culture includes not only culture in the narrow sense (art and literature), but also culture in the broadest sense (Xian, 1996). Therefore, the macro-culture approach to development is a holistic exploration of the development process, material and moral, current and historical, partial and total. According to Xian, the macro-culture approach primarily addresses the issue of an objective attitude towards tradition and their relationship between traditional culture and modernization development (Xian, 1996). In discussing the notion of culture, we also need to pay attention to a nation's tradition. According to Xian, tradition is what a society inherits from its history and which forms the norms of morality, concept of values, modes of behavior, methods of thinking and ideas (Xian, 1996). This serves as the foundation of the cultural identity of that particular society.

However, tradition should not be seen as good or completely bad. In other words, in dealing with tradition, people should not blindly accept everything past, nor get rid of the tradition because it is totally harmful. Traditions, which are very closely linked to culture, should be renewed and improved constantly. Mao Zedong once said "Our national history goes back several thousand years and has its own characteristics" (Zedong, 1952).

It has been acknowledged that the primary aim of the contemporary era is to seek development and peace. In pinpointing the causes of underdevelopment, some people would put more emphasis on external factors, such as a long history of colonial dominance and exploitation, unequal exchanges and the absence of a just international

economic order. However, it is also necessary to pay attention to internal factors.

Development is the result of both external and internal factors and in many cases, internal factors should always play a more important role.

In terms of internal factors determining economic development, people are increasingly emphasizing the non-economic ones like culture. As Augusto Salazar Bondy stated, underdevelopment is a state of mind, a way of expression, and a collective personality marked by chronic infirmities and forms of maladjustments (Harrison, 1985).

Similar institutions created in Latin America and other parts of the world proved much less effective than their Chinese counterparts. While effective industrial policy is partly a matter of institutional design, it is also heavily influenced by culture.

As the world has become richer and better educated, religion has not withered and nationalism and tribalism have not faded away (Hofstede and Bondy, 1988). Global economy and technological forces do not erode local cultures and values. Instead, culture and values shape economic development. For instance, when we look at China's economy, it is important to look at the fact that China has a long and complex history as well as a rich cultural tradition. China's cultural traditions still continue to exert a strong influence on almost every aspect of human interaction, including business.

Cultural differences have become more pronounced as people are empowered by greater wealth and education. Once worldviews have been absorbed, they produce different levels and types of social and cultural capital.

Culture extends across all the dimensions of the social capital of a society, underlying the basic components of social capital such as mutual confidence and responsible civic behavior. The values held by a society will affect development efforts.

The ethical codes used by businessmen and professionals form part of the productive resources of a society. According to Sen if these codes place emphasis on values in keeping with the project of development with equity, they will favor development (Sen, 1997). Values rooted deeply in the prevailing culture are essential for sustained development.

UNESCO emphasized that culture is a key element in the fight against poverty (UNESCO, 1995). The poor have their own values that are often all they have to assert. Under-privileged groups have values, which give them an identity of their own. If these values are not respected, then, even the best productive proposals can be blocked. Preserving cultural values is very important for development.

Taking culture into account requires integrating information about culture into development economic analysis in an informed way. It is evident that culture exerts real effects on development outcomes and development projects. Cultural differences might also influence governmental tendencies to structure foreign investment along certain dimensions.

China has been able to organize their economy more efficiently because of their continued reliance of *guanxi* and their informal networks in spite of their economic reform. China is a country that has distinctive political, institutional, and cultural characteristics, and it is recognized that such factors can give rise to different modes of economic organization.

Another category in which culture is said to affect economic behavior is the formation of social networks. The differing impact of cultural values on networks of social relations is the basis for the concept of social capital. Social networks affect

economic growth via enforcing informal institutions. My thesis focuses on the economic payoff of kinship networks in the context of China's industrialization to argue that kin solidarity and trust plays an important role in China's advancement in the economic world over Latin America. Reform economies, such as China, strive with informal institutions because informal norms are much more impervious to deliberate designing and take time to change.

Another factor that affects economic development is trust. Although both China and Latin America are low-trust societies, there is more trust within the Chinese informal networks than Latin America (Tzu, 1997). To define trust, I will use Francis Fukuyama's definition. Trust is the mutual acceptance among two or more entities (persons, organizations) that regular day-to-day behavior will be honest, cooperative, and predictable based on shared norms. Also, that parties to markets transaction will not exploit others vulnerabilities (Fukuyama, 1995). Trust is a measure of how people evaluate the moral fabric in their society. When dealing with specific nations, there are different levels of trust that must be taken into consideration.

The importance of trust gives a positive outlook at the societal level. Cities, regions, and countries with more trusting people are more inclined to have better working democratic institutions, to have more open economies, greater economic growth, and less crime and corruption. Countries with an initial level of high inequality and with dishonest governments are less likely to establish universal programs (Child, 2005). This is because such programs are usually based on the idea that all groups in society have a shared fate. People will place their trust only in their own groups or class.

In low-trust societies, such as those in Latin America with high degree of economic inequality, universal programs are likely to fail because of the lack of potential support. Latin America has felt the impact of low trust on economic development. For the most part, Latin America is stuck in the backwardness of social and governance dysfunction. It is imperative for entrepreneurs to create trust and social capital in order for the economy to be successful. The more trust there is the better it is for human progress and economic development. According to Evans and Flora, low-trust societies are filled with traditional values and corrupt bureaucratic structures, and the prospect of good economic development is not promising (Evans and Flora, 1996). In Latin America, since there is a lack of trust, it has been difficult to stimulate entrepreneurial activity and investment in business development leading to more jobs, innovation, and increased productivity; factors that the Chinese bode well in.

Trust is a vital part of the social capital of a country that includes institutions, networks, and attitudes. Social development in the form of higher trust is supposed to be strongly related to economic development. The higher trust encourages economic development and at the same time, economic development promotes trust especially in the long run. However, it is possible that the relationship between trust and growth will work in opposite directions. According to Fukuyama, because trust depends on expectations about future actions of others, the formation of expectations in a situation of growth should positively affect our propensity to trust others (Fukuyama, 1995). Furthermore, it is possible that in a situation of growth individuals are willing to take higher risks in trusting others because of higher potential benefits. Fukuyama's

assumption is that trust is a product of inherited and inflexible patterns of cultural inheritance.

Trust influences the decision of whether to invest or not only in low-income countries where trust between investor and recipient replaces absent, formal institutions. In high-income countries, trust affects investment choices by reallocating funds across sectors. Individuals who take higher risks might invest in future technologies where they expect high future returns on their investment. In contrast, missing trust might determine the preference for more secure investment options. It is imperative for entrepreneurs to create trust and social capital in order for the economy to be successful. The more trust there is the better it is for human progress and economic development. According to Evans and Flora, low-trust societies are filled with traditional values and corrupt bureaucratic structures, and the prospect of good economic development is not promising (Evans and Flora, 1996).

When there is economic progress, the importance of trust increases because the exchange system becomes more complex, the probability of repeated interaction falls and specialization deepens. All in all, the promotion of trust encourages domestic exchange and therefore, economic progress through size and specialization is stimulated.

Trust encourages growth and economic development by affecting the efficiency of production, exchange, formal institutions and governmental actions. Formal institutions stimulate production and exchange but also employ resources from productive and commercial activities, becoming sources of inefficiencies. Reducing transaction costs, uncertainties and information restrictions, increases the efficiency of formal institutions. Furthermore, formal institutions do not cover the entirety of

economic activities and such institutions have to be enforced by a third party (ex, courts, or the government).

Similarly, trust raises the efficiency of government performance. While some economic activities based on trust may also foster inefficiencies, in general trust increases the efficiency of an economy. This view parallels that of Edward T. Hall and Mildred Reed Hall, who say that culture can be compared with a giant, extraordinary complex, subtle computer. Its progress guides the actions and responses of human beings in every walk of life (Hall and Reed Hall, 1990).

It is imperative to point out that, although the cultural factor is important, its importance should not be exaggerated. In other words, compared with other internal factors determining economic performance, cultural factors occupy a lower position than economic policies. Culture only serves to facilitate or hinder the creation of an environment where sound economic policies can be made and implemented.

Chinese Culture

The last few decades have seen remarkable economic progress in China and their achievements are impressive. This success has been accompanied by the emergence of new theories on the role of the Chinese culture in achieving economic success (Frank, 2003). An emerging theory attributes these successes largely to the role of Confucianism. This theory has been followed more recently by the rapid transformation of the Chinese economy and society. Attention has now shifted to the special virtues of Confucianism, including the cultural tie binding China and much of East Asia.

The Confucian culture originated in China, but its influence has expanded to the whole East Asian region. Confucianism has three significant stages of development. The days of Confucius mark the beginning stage of Confucianism. The second stage is the School of Principle and the Ming Dynasty during the Song Dynasty (960-1280 A.D.). Currently, we are in the third stage of Confucianism, called the “renaissance” of Confucianism (Zhang, 2001). These proponents claim that Confucianism will continue to occupy a pivotal position in China’s cultural traditions, as well as to contribute to the modernization process in this country. Some people contend that Confucianism will continue to manifest valuable positive points and play a role in the modernization process.

Confucianism has many components. Zhang Hongyi lists the following: 1) Economic functioning should rely on comprehensive harmony, consistency with natural laws, human supremacy and avoiding extremes. 2) Economic relations should be used to curtail selfishness and reduce inequality. 3) Economic behaviors should emphasize using small ways of making fortunes, living a thrifty life and working hard. 4) Economic policies of the government should stress making people rich and reducing poverty. 5) Economic management should highlight efficient government. 6) Economic life should be integrated with economic morality (Hongyi, 1989).

Confucianist ethics is best summarized by Herman Kahn in his *World Economic Development: 1979 and Beyond* (1979). He states that Confucianism promotes a high value on education, a desire for accomplishments in various skills, and seriousness about tasks, job, family, and obligations in the individual and the family. There is very little interest in advancing individual interests (Kahn, 1979).

Westerners, such as Christopher Engholm, agree that Confucianism inculcates diligence, hard work and family devotion. For Keun Lee, Confucian values and traditions include stress on worldly achievement, discipline, and a commitment to education. These qualities are what Max Weber found in the Protestant ethic, which played a decisive role in developing Western capitalism.

While many scholars believe that Confucianism possess certain advantages over the other traditions, such as the Ibero-Catholic or Hispanic heritage in Latin America in promoting economic development, other scholars point out that simplistic cultural arguments yield several problems. According to Gary Geretti, these problems include: 1) Timing-the Confucian and Ibero-Catholic traditions have existed for centuries, but the dynamic shifts in economic performance that gave rise to the East Asia have occurred in recent decades. 2) Discussions of culture have been as inconsistent as the same Confucian beliefs that are now claimed to facilitate rapid industrialization in East Asia.

Despite the debate, there are still several codes determined to be beneficial to economic development. One of them is that Confucianist culture encourages thrift and savings, which in turn benefits the growth of investment. No economy can grow unless surpluses are created that can increase the economy's productive capacity. Economic development relies heavily on investment of physical capital in the form of roads, machine tools, and telephones. In 1965, investment rates in East Asia equaled about 20% of GDP, only a shade above the figure in Latin America. By 1990 the East Asian investment rate was 35% more than twice the Latin American investment rate (Rohwer, 1995).

Another code is that Confucian beliefs place a high value on education. This, in turn, promotes the development of human resources. Long before the European Renaissance, Confucianism heavily influenced education in China. Many other scholars emphasize the importance of investment in education. In *Economics Value of Education*, Theodore Schutts mentioned the following impacts that education had to economic development: it improves the quality of labor through the promotion of skills, efficiency and work knowledge; education increases labor mobility to promote division of labor and to strengthen labor force participation rates; scientific and technical knowledge is increased to promote invention; entrepreneurs gain more ability to improve management and the allocation of production factors, and people become more responsive to economic change (Schutts, 1967).

In spite of the impact that Confucianism has on China's education, it is erroneous to say that Latin American countries totally ignore education. Higher education in that region has advanced remarkably. However, primary education has developed at a slow rate in Latin America. China spends more on primary schooling than on secondary schooling.

The final code of Confucianism is that it stresses work ethic. According to Jack Barbash, work is an end, which is expected to bring the reward of material success. Work includes the discipline of work, punctuality, obedience, and diligence. The Confucianist teaching has it that working is a virtue, which, in turn can create high morality for anyone. Laziness generates immorality and degradation (Barbash, 1983).

In the past two decades, China's transition from a planned to a market system followed a different path from those countries in Eastern Europe. China's economic

reform and transition to a market system occurred without democratization, liberalization proceeded incrementally and privatization was delayed until recently.

Since 1949, the Chinese economy had been closed to the Western countries. When the conflict with the Soviet block broke in the early 1960's, the Chinese economy became one of the most closed economies in the world. During the "Cultural Revolution" from 1966-1975, no advertising was allowed because the Chinese economy was managed through the Soviet five-year plan (Zhang, 1996). After 1978, when the open-door policy was adopted, China evolved from an egalitarian Marxist state to a more socialist market economy, which was oriented toward economic development and modernization. In 1979, the government decided to expand foreign trade and welcome foreign investment. As a result, China is charging ahead in its efforts to become one of the key global economies.

China has had one of the highest growth rates in the world over the past quarter of a century. Enormous capital inflows and cheap migrant labor have fuelled economic growth, making China the world's factory. For the most part, China's economic success has occurred in the absence of democracy. It is true that freedom of speech is tolerated now more than at any other time since the founding of the People's Republic and there is a growing majority of social interests reflected in the emergence of village self-government. However, these changes have not been reflected in greater tolerance (Marshall, 2006).

Studies by political scientists have found that economic growth generates demands for political rights. At one level, casual practices also seem to support the view that economic growth promotes democracy in that all the developed, industrialized

nations have democratic political systems. On the contrary, most nations in the poorest segment of the world operate under various non-democratic political systems. But, with simple observation, one can see that this is not true. Casual observation also suggests that economic growth does not necessarily bring about a demand for democracy. There are examples of authoritarian regimes in South-east Asia and the Middle East where citizens are willing to forgo demand for political liberalization, provided their economic needs are being met (Smyth, 2007). It is only when the authoritarian government stop delivering on the economic front that there are calls for more political rights.

An example is the fall of the Soeharto regime in Indonesia following the Asian financial crisis, when spiraling inflation and unemployment prevented Soeharto from delivering in the economic sphere. In China, the fact is that the government is delivering on the economic front. The urban population at least has experienced a substantial improvement in living standards since the start of the late 1970's (Child, 2005).

Corruption can exist in democracies and dictatorships. China has a serious problem with corruption. Some see corruption as undermining China's growth prospects into the 21st century; but corruption does not need to be detrimental to economic growth. While some studies have found that corruption have desirable properties for growth. The latter perspective suggests corruption can act as a lubricant that makes it easier for business to get things done by cutting through bureaucratic red tape and thereby increasing the efficiency of the economy.

Hong Kong economist Steven Cheung has suggested that corruption is more likely to flourish under democracy rather than dictatorship. Cheung's rationales for his position is that in an authoritarian regime people on top want to maintain their hold on

power and corruption is one thing that will most likely destroy this. Thus, the cost of corruption is high for single-party states. But in a democracy, because power is transient, there is more incentive for elected officials to profit while they can (Smyth, 2007).

Cheung's view, however, overlooks subtleties between regime types.

There are three factors that lead to believe that corruption has different economic implications depending on the context in which it occurs. The first is comparative advantage. Economies inhabit different niches in the international division of labor, and these may require different sets of institutional capacities (Hall and Soskice, 2001). For instance, corruption may be weakening if a country is competing for trade and investment with countries where corruption is much less prevalent, but it may constitute less of a problem if it is competing mainly with countries that are equally plagued by corruption.

The second factor is political organization. It is argued that the organization of the corruption network has implications for both the level of corruption and the effect on economic activity (Shliefer and Vishny, 1993). One of the distinctions made is between a regime in which the person paying the bribe is assured that he gets the government good that he is paying for, and a regime in which numerous bureaucrats need to be bribed to get a government permit, and bribing one does not guarantee that some other bureaucrat or even the first one does not demand another bribe (Shliefer and Vishny, 1993). Kahn notes that the effects of corruption are specific to the particular distribution of power between the states and competing groups of potential clients (Kahn, 1996). This makes it possible for similar corrupt transactions to have different effects in different countries.

The third factor is rent creation. This factor explains that besides corruption being regarded as rent seeking, it is also both a response to situations where rent already exist,

and an incentive for state officials to create new rents. This latter point is one of the keys to understanding the economic impact of corruption. Many rents exist because of the opportunities for corruption they create. However, different types of rents have different implications for economic efficiency and growth. Thus, there is a distinction between growth-reducing rents, generally growth-enhancing rents, and rents that have undetermined effects on economic growth, depending on the institutional context, which include rent-like transfer and rent for monitoring (Khan and Sundaram, 2000). When China launched economic reforms, its comparative advantage lay in low-tech, labor-intensive production. In this stage, China competed for investment and export markets with other low-wage economies, many of which were also highly corrupt (Wei and Sievers, 2000).

Often, analysts make the mistake of equating formal structures with organizational capacity. It is, however, important to recognize that it is possible for states with formally centralized institutional structures to behave in a fragmented way if powerful but dispersed interest groups can prevent co-ordination by state agencies (Kahn, 2000). Conversely, states and society that are formally fragmented may nevertheless have the capacity to coordinate corrupt activities. The Chinese communist party retained its ability to control corruption, which paved the way for strong economic growth (Blanchard and Schliefer, 2000).

In China, the large variation in the patterns of corruption at provincial as well as local level suggest that the Chinese state and party agencies have in fact not been able to effectively control or coordinate corruption and other forms of rent seeking. Pei has argued that “Rampant corruption in post-Mao China arose because the decentralization of

power was accompanied by low-levels of accountability and a lack of civic participation (Pei, 2001). The continued power of the communist party suggests that China may have been in a better position to impose some semblance of order on corruption. However, the political turmoil unleashed by corruption in the form of pro-democracy demonstrations of 1989 indicates that the Chinese communist party was unable to restrain the predatory behavior of cadres. In the market reform era, organized crime has expanded on a massive scale under the political patronage of local officialdom (Chen, 2005). Corruption intensified in the sense that it increasingly involved big-stakes corruption rather than ordinary forms of official malfeasance (Wedeman, 2004).

Chinese officials have had to create rents more compatible with efficiency and long-term growth. Chinese policy makers have been more inclined to engage in rent-like transfers of a growth-enhancing nature (Pei, 2001). These transfers have encouraged new entrants to markets and intensified competition. The effect of these rent-like transfers has been to promote new entrants into high-rent markets.

In China, bureaucratic resources have increasingly been put to use to enhance rather than restrict competition. Local state governments account for a substantial portion of all the entrepreneurial activity in China. Duckett argues that these activities, which may be illegal, tend to be productive rather than profiteering, since the local entrepreneurial state is removed from the centralized administrative control of the command economy and operates in an increasingly competitive market economy (Duckett, 2001). These economic activities are not characterized by monopoly and may promote the growth of competitive markets.

Duckett also argued that corruption in reform-era China has taken two main forms. First, corruption has served as a means for non-state actors to develop alongside the planned economy, dominated by large state owned actors. Second, corruption became a means by which local governments competed for favors from the central government (Duckett, 2000). These favors took the form of both preferential financial treatment and flexibility of the kind initially accorded only to special economic zones. Thus, political zones have contributed to the establishment and spread of competitive and growth-enhancing markets and institutions (Wedeman, 2004).

Latin American Culture

The Latin American region is composed of many countries, each of which has its own cultural identity. As Frederick Turner states, whereas some social scientists view political culture as a national phenomenon encompassing the distinctive values of each national community, shaped by the community's distinctive history, others feel that there is a Latin culture that defines the region as a whole (Turner, 1995).

After separating from Spain, each nation in Latin America created their own social characteristics with local traditions and histories. Lawrence Harrison believes that values, attitudes, and culture are what differentiates ethnic groups and is responsible for Latin America's persistent instability and inequality (Harrison, 1992). Latin America still possesses a dominant Iberian Catholic political culture. Religion, culture, language, and history are all important to understanding the institutional framework through which development is filtered and the shaping of economic development. According to Wiarda, Latin America remains authoritarian, Catholic, and elitist (Wiarda, 1992).

Latin America has a long history of social activism and is the source of many studies chronicling successes and failures of culture as forces of societal well-being or backwardness. Trust, social capital and civil society are conditions that are studied and that aim to benefit people at the lower end of the socio-politico-economic scale. None of the twenty republics in Latin America can be classified as developed, and some remain poor. Pockets of wealth are found in all republics; however, these cannot conceal the deprivation and hardship suffered by the region's poorest inhabitants. Although Latin America is not among the poorest regions in the world, it has been overtaken by parts of Asia, such as China that had much lower standards of living throughout the nineteenth century.

Latin America is very diverse along the following human dimension: ethnicity, language, and history. It has been found that there are several elite groups that have contributed to the lack or backwardness of economic development in Latin America. Montaner identifies them as the polity-corrupt and wrong-headed politician; the military-sometimes imposing their own systems of occupation and social justice; the business elite-protecting their privileged positions; the clergy-using their altruistic quest, which often leads to anti-markets actions, the intellectuals-espousing views that have little credibility when laid alongside to the United State; and the left-which are the revolutionaries, who at times oppose everything (Montaner, 2000).

The Latin American culture is understood through the concepts of power, uncertainty avoidance, individualism, masculinity, context, and time orientation (Hofstede, 1980). Power orientation is the manner in which people in a culture defer to legitimate authority in societal structures. Uncertainty avoidance is the extent to which a

culture relies upon, and expects information to accomplish a task. Individualism is the degree to which a culture emphasizes the well-being of a group over the benefit of an individual; and masculinity is a culture's perspective about the roles that men and women play in society. Context is the "pattern of physical cues, environmental stimuli, and implicit understanding that convey meaning between two members of the same culture" (Thill and Bovee, 2005). Lastly, time orientation describes the culture's attitude towards time. Time is infinite in Latin American culture.

The problems that Latin America faces are many. It is a very low-trust society and the radius of trust is very narrow compared to that of China. Low trust limits opportunities for economic growth and innovation. There is a cultural heritage of not trusting others. Another problem is the persistence of the dependency theory. Harrison and Huntington both agree that in order for Latin America to grow economically, there must be a shift from the dependency theory toward a more open-market democratization process (2000). Other proponents who believe that culture does matter in economic development, and that the dependency theory should be done away with are Max Weber and Landes (Weber & Landes, 1998). As Landes puts it, "culture makes almost all the difference." Inglehart also claims that culture's trust, tolerance, and values are crucial for economic development (Inglehart, 2000). Trust is necessary and it is also a major resource for starting and sustaining new enterprises (Cohen, & Fields, 1998).

For the most part, Latin America is stuck in the backwardness of social and governance dysfunction. In Latin America, since there is a lack of trust, it has been difficult to stimulate entrepreneurial activity and investment in business development

leading to more jobs, innovation, and increased productivity; factors that the Chinese bode well in (Thomson, 2007).

Latin America has seen many decades of dysfunctional polity, which has decimated many traditional cultural and social structures. Therefore, this has left many Latin American societies bereft of trust and social capital (De Ferranti, 2004).

In a study created by M.B. Neace, with the purpose of giving understanding to the significance of trust, it was found that the entrepreneurs that he interviewed over the past decade that have succeeded have done so by developing socio-economic networks, built on trust of their own behavior. Neace concluded that trustworthy entrepreneurs have a contagion impact throughout their networks. As the enterprises gain market success, the trust component becomes more important, which serves as an inspiration to members of the networks because of the realization of both social and financial rewards (Neace, 2004). This kind of success leads to respect for diversity, necessary for innovation and increasing productivity, elevating levels of civil society in communities where these socioeconomic networks are active. As Cohen and Fields put it, trust and social capital created by entrepreneurs have benefits for the larger society far beyond their immediate organizations (Cohen & Fields, 1998).

In developing countries like Colombia, long-term economic progress depends on the growing networks of small entrepreneurial enterprises (Birch, 1979). For many of the economies in the Latin American countries, their progress requires a dynamic interaction of culture and trust among a host of actors.

Several countries, such as Argentina, Brazil, Costa Rica and Mexico have started to move toward civility but the results are mixed. Argentina currently faces some civil

unrest and economic downfalls because of poor governances regarding the economic policy (World Bank, 2006). In fact, Latin America is faced with poor governance, particularly Colombia, which is no stranger to civil unrest. Civil unrest is attributed to low levels of trust. As Fukuyama puts it, economic development parallels the movement toward democratization, the growth of civil society, and a culture that has a high amount of trust (Fukuyama, 1995).

Consideration and due appreciation of the culture of under-privileged sectors is a key point in the crucial matter of collective identity and self-esteem. Poverty is often accompanied by the depreciation of cultural values (USA Today, 2006, Nov. 28). Others look down the culture of the poor upon as being inferior and backward. Cultural patterns of the poor are sometimes blamed for being responsible for their poverty. Not appreciating their culture means weakening their identity, and that weakening can lead to feelings of low individual and collective self-esteem.

In the recent decades, Latin America has witnessed corruption in all aspects of society. This has ultimately resulted in reduced economic growth. Using data on national level of corruption from 1997 and individual opinion from 1995-1997, it was found that Latin America is aware of the seriousness of corruption in their countries (Transparency International 1997, CPI index). Pervasive misconduct may poison public sentiment toward democratic politics.

Political corruption is a significant problem in Latin America, where corruption scandals tarnished many Latin American governments in the 1990's (Gould, 2006). In Brazil, President Fernando Collor de Mello was forced to resign following a chain of scandals involving an influence-peddling ring during the electoral campaign, and reports

of a lavish private life. In Venezuela, Carlos Andres Perez was suspended from the presidency in the midst of impeachment proceedings that were initiated following news of his misappropriation of public funds. In Ecuador, the media uncovered evidence that President Bucaram stashed away for himself money that had been raised during a Christmas telethon to help the poor. This triggered a political process ending with his removal by Congress for mental incapacity (Stapenhurst, 2000). Recent history in Latin America illustrates both the extent of corruption at the national level and the difficulties of combating it. Since the early 1990's, nine Latin American presidents or former presidents have faced judicial proceedings or have been dismissed on corruption charges.

Political corruption raises several issues regarding the relationship between citizens and their governments. At one level, when the highest authorities are frequently implicated in electoral manipulation, financial scandals, or the abuse of public resources to achieve personal benefits, their bases of authority and legitimacy may be undermined. At another level, corruption constitutes a violation of the unwritten contract between citizens and public official. Political corruption distorts public demands, increases the cost, reduces quality, and delay the competition of public works. It also delays access to public administration for those people who do not pay bribes and reduces the productivity of all those involved with the state (Delia Porta, 2000).

Corruption reduces investment and slows growth for a variety of reasons. Either parties to the transaction do not report bribes. This denies the treasury needed tax revenues. Public services are focused toward assisting those who pay bribes, denying those services to those who do not. Bribes enable service providers to ignore established standards and offer substandard goods or services from which the economy suffers.

Corruption also weakens the rule of law. As a result, the transactions are made irrational from an economic point of view.

The World Bank found that among countries in which bribery was both high and unpredictable, the rate of investment was half of what it was in low-corruption companies (World Bank, 1997). High levels of corruption encourage businesses to go underground, which denies the government tax revenue and produces smaller, less effective governments. While corruption may have had its positive functions under dictatorships, it is seen as being dysfunctional under democracy. Della Porta argues that corruption is both a cause and an effect of poor government performance (Della Porta, 2000). Therefore, it reduces trust and the governments' capacity to address citizens' demands.

Two decades after Latin America began returning from authoritarian rule to democracy, public opinion in the region remains very conflicted. In most of Latin America, the majority of the public accepts democracy as the best form of government (Kauffman and Mastruzzi, 2005). But, there are many countries that have sizeable pockets of authoritarian sentiment. Most Latin Americans are skeptical about key institutions of democracy, and Latin Americans manifest some of the lowest levels of interpersonal trust observed anywhere in the world (Payne, Zovatto, Carrillo, and Zavala, 2002).

There is a relative stability of public attitudes and values in Latin America. Many countries in the region are not showing sufficient changes in their political and social culture to indicate movement toward democratic consolidation. In countries such as Colombia and Venezuela, public opinion data indicate that democracy is in serious difficulty. Democracy in these two regions has had a poor performance, which has

contributed to the decline of popular democratic commitment. Economic difficulties in these countries have also been a contributing factor.

Political institutions command a low level of trust in Latin America. Low levels of trust among people constitute a declining feature of Latin American political culture. This low level of confidence in other people derives from a common regional heritage of distrust. This includes the hierarchical structure of authority at many levels and the passivity of citizens towards the patron, the local boss, and the state. People are still accustomed to hoping that someone will solve their problems for them as opposed to solving it him or herself. Now they look to democracy to solve all of their problems. Latin Americans want democracy because they see it as a new type of patron. As Marta Lagos contends, “these people want the rights but not the obligations of citizenship” (Lagos, 2006).

Official corruption and bureaucratic inefficiency aggravate another problem in emergent economies by slowing down access to credit, thus making it difficult to create businesses and generate employment. For the poor, access to credit is almost impossible, given the difficulties they encounter in establishing legal ownership of their assets. In an interview with PBS, Peruvian economist de Soto credited the lack of property rights as the main reason why capitalism has not yielded the anticipated results in Latin American and other underdeveloped areas (de Soto, 1989). In the long run, the fact is that by denying the majority of the population full participation in the economy the system is endangering the implementation of economic reforms crucial to the prosperity of the nation.

Political clientelism has been a recurrent theme in studying the links between the poor masses and political elites in Latin America. Clientelism has been examined as one of the possible relationships between the poor masses and political elites in Latin America. At a time when public discourse is dominated by neo-liberal rhetoric that stresses the salutary retreat of the state from markets, Javier Auyero argues that politics, and personal ties are important for gaining access to resources. Clientelist networks are important because they fulfill the functions that the state is abandoning (Auyero, 2000).

In Latin America, the widespread material deprivation, persistent joblessness and misery, and unmerciful economic pressure in the working-class neighborhoods have been caused by a combination of factors: the languishing of the wage-labor economy; the casualization of blue-collar jobs, and state-neglect provoked by structural adjustment policies.

According to Ricardo Ffrench-Davis, there is a need for reforming the Latin American economy (Ffrench, Davis, 2005). Short-term macroeconomic balances affect long-term economic performance (Ffrench-Davis and Tapia, 2004). However, a policy that increases the rate of use of productive factors will contribute to long-term growth only if its positive effects are permanent.

Latin American countries (LACs) economic reforms in the 1990s (trade and financial liberalization, large privatization processes, fiscal reforms), may have contributed to a recovery in actual GDP, but it was coupled only by a temporary and slight rise in capital formation. What is argued to be needed are more structural reforms. Fostering investment must be given priority. After the implementation of liberalizing reforms in LACs, economic growth has been disappointing and investment rates have

reached historical minimum levels. Even in the three peak years of 1994, 1997 and 2004, productive investment was low compared to ratios in East Asia (MOFTEC, 2005).

Economic reforms aimed to make room for private agents in a market economy have ended up damaging the environment for investment, challenging the long-term development of the private sector.

Economically, the greatest differences between the liberalization efforts of LACs and the way in which Asian countries, such as China have opened up their economies are that most Latin American liberalization programs have been carried out rapidly and the state has played a passive role (IDB, 1998). Whereas in China, for example, the economy has been a long, state-led process, involving the construction of a production apparatus oriented towards international markets.

Most Latin American governments have only recently responded more positively to the need for modernization programs with sound macroeconomics. Among those analyzing economic reform in Latin America, there is growing recognition of the cultural or institutional factor as it operates on leaders. Countries with institutions of Spanish origin are characterized by personal relationships that often impede political stability and broadly based and shared economic growth. As Nobel Prize winner Douglas North wrote, “Informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies” (North, 1990). North traced Latin America’s limited and unequal development to the deep-seated inheritance from Spain. Mexico’s Nobel Prize author Octavio Paz pointed out the following:

Though Spanish-American civilization is to be admired on many counts, it reminds one of a structure of great solidity-at once convent, fortress, and palace built to last, not to change. In the long run, that construction became a confine, a prison (Paz, 1979).

The region constituted by Latin America as a whole has the highest level of inequality in the world, as mentioned before, and during the last three decades of the 20th century, inequality increased in most countries of the region (Morley, 2001). There is consensus that this inequality is a serious obstacle to both poverty reduction and economic growth (Economic commission on Latin America and the Caribbean [ECLAC], 2004).

Inequalities in landholding and political power originating in the colonial order are at the center of theoretical explanations for the deep roots of inequality in Latin America. After Independence, inequalities in assets and income was conditioned by reinforced inequality in political influence, and thus, in political institutions policies. This, in turn, perpetuated the vicious cycle of inequality. Latin America has a weakened record of democracy, less consolidated parties, and weaker organizations of the underprivileged, weaker labor unions and weaker parties of the left (Bradley et al. 2003).

The weakness of democracy obstructed the formation of strong political parties in general, and combined with the weakness of labor, hampered the development of parties to the left of center. This hampered forces that could build the redistributive capacity of the state and shape a model of political economy that would produce growth with equity. The small proportion of formal sector in advanced industrial countries had very different effects, covering a much smaller proportion of the population and thus being regressive instead of progressive (Lindert, Skoufias, and Shapiro, 2005). The neoliberal economic reforms of the past three decades have had a further regressive impact, due to the shrinking of the already small proportion of the formal sector employment.

Scholars also have found very significant differences among countries in Latin America, in terms of other dimensions. For instance, some countries, such as Chile, Uruguay, and Costa Rica, have long been recognized as having more effective states and social policies than other countries in Latin America. Mainwaring and Saily show important differences in the institutionalization of party systems (Mainwaring and Saily, 1995). In some countries, such as Brazil, stronger, more programmatic and disciplined parties have emerged more recently (Hagopian, 2004). It has been demonstrated on the basis of elite and mass survey evidence that the degree of programmatic orientation and coherence of political parties varies greatly between countries and between parties within the same country (Luna and Zechmeister, 2005). Moreover, Colomer and Escatel show that citizens in Latin America find the left-right dimension meaningful for the structuring of politics (Colomer and Escatel, 2004).

The prime policy instruments for shaping the distribution of income are taxes and social expenditures. In Latin America, the evidence for the distributive impact of social spending is more mixed and tends to be different for different kinds of expenditures. Social security spending is regressive (Ferranti, 2004). Social security schemes are typically tied to the formal sector and exclude the sizable informal sector. Even within the formal labor force, more highly educated force, more highly educated and more highly paid employees are the most likely to be covered by social security. Moreover, because benefits are tied to earnings, the system are highly segmented (IDB, 1998).

In an analysis done by Lee, it is shown that the impact of government spending on inequalities is dependent on regime type (Lee, 2005). In authoritarian regimes, greater government spending is associated with greater inequality. In democracies, greater

government spending is associated with less inequality. This is very plausible for social spending in Latin America, where the main alternative to democracy has been right-wing authoritarian not communism.

Chapter Two

Informal Networks in China and Latin America

It has been concurred that informal institutions, such as informal networking, matter for economic performances because they reduce uncertainty and lower the cost of transactions and productions (North, 1990). North emphasized that informal rules provide legitimacy to formal rules. A formal institution can achieve positive results if informal institutions such as customs, traditions, and codes of behavior support it. Kinship relations provide economic payoff to both Latin American and Chinese social relations. Lineage networks are a prominent feature of Chinese and Latin American life.

Informal networks exist in every society. These networks play an important role in maintaining political order and facilitating economic activities, not to mention providing social cohesion. According to Wang, there are three reasons why informal networks in Chinese society stand out more. The first is that the degree to which informal networks contradict and undermine formal institutions is high. Secondly, the influence of informal networks is unusually strong in every aspect of Chinese life. Lastly, the level of institutionalization of Chinese networks is very low (Wang, 1997).

The influence of informal networks in Chinese society is extraordinary. Historically, informal institutions, such as kinship, ancestor worship, and ritual played a central part in sustaining political order in China (Chang, 1983). While informal politics exist elsewhere, it rules Chinese politics. The Chinese informal sector has been

historically dominant, with formal politics often providing no more than a façade (Dittmer, 1995).

The role of informal networks in economic production and exchange has been salient throughout Chinese history and in Chinese communities all over the world. In traditional China, family, kinship, and clans were not only social organizations but important economic organizations as well. Augmented by the state, these informal networks formed the basis of petty capitalism, which dominated the Chinese economy for centuries (Gates, 1996). During the reform era, which is marked by the introduction and expansion of market mechanisms, informal networks continue to feature prominently in Chinese economy (Boisost and Child, 1996). Chinese informal networks are less institutionalized. In Chinese politics, the ties among member of a faction are secretive and do not have to be hierarchical (Lincoln, 1996).

Transnational relations can be defined as regular interactions across national boundaries when at least one actor is a non-state agent or does not operate on behalf of a national government or an intergovernmental organization (Rise-Kappen, 1995). A number of recent case studies of transnational relations demonstrate that domestic structures mediate, filter, and refract the efforts by transnational actors and alliances to influence policies in the various issue-areas. Specifically, they find that the more fragmented the state structure, the less capable should national governments be to prevent transnational activities (Rise-Kappen, 1995). This leads to the point that the fragmented nature of China's political and economic system has been conducive to the transnationalization of informal networks facilitating foreign investment.

In addition to the fragmented nature of China's domestic structure, which makes room for transnational relations, the tens of millions of ethnic Chinese living outside China have been active agents of the transnationalization of guanxi networks. Ethnic Chinese outside of China have a number of advantages over other foreign investors in resorting to personal networks for investment purposes. First, they have the cultural advantage, which has two aspects. One aspect of the cultural advantage is distinctively Chinese. It refers to their understanding of the Chinese language and the art of personal relationships in a culturally Chinese context. Wherever they live, whether in Hong Kong, Taiwan, and Southeast Asia, most ethnic Chinese know at least one dialect. The economic success of overseas Chinese in recent years has in large part resulted from the informal networks they have created (Hamilton, 1996). These networks based on family kinship, and other types of common bonds provide an efficient way for Chinese business people to obtain information, raise capital, reduce labor cost, and enforce contracts (Wang, 1997).

The other aspect of the cultural advantage, which is often neglected is not uniquely Chinese. It refers to the practical knowledge of operating in developing countries where the institutional environment is similar to one in China. Ethnic Chinese have concrete human connection in China. Since ethnic Chinese have ancestral homes and roots in China, they can invoke these ties as the basis of familiarity and close relationships. Moreover, many Chinese living elsewhere in the world still have relatives and friends in China, with whom they can easily reconnect and develop strong personal ties (Liu, 1998).

In China kinship networks function to protect private property rights and facilitate the growth of private entrepreneurship in China before formal property rights laws became effective. Max Weber observed that clan organization was preserved completely in China (Weber, 1951). He observed that this clan organization was the most important actor in the Chinese countryside, which ran schools, owned land and extended cheap credit to its members (Weber, 1989).

This was transformed by the Communist revolution. The Communist Party made assaults on the lineage organizations. It confiscated clan communal land and injected the ideology of class consciousness and class struggle to diffuse clan identity (Wang, 1991). The economic foundation and organizational structure of the lineage system were replaced with collective farms and grassroots administration from 1949-1979. However, the lineage culture became vibrant again during the market reform era.

Despite changes, such as the shift from the extended to the nuclear family and the phasing out of prearranged marriages, some features of Chinese familism persist (Whyte, 1995). These features include loyalty to the larger kin groups and sacrifice of personal interests for the sake of the family. The Chinese society is organized by guanxi circles, extending from the family, to relatives and friends.

Even though it is no longer considered a corporate actor, lineage remains the locus of collective action and normative control in contemporary China (Bian and Ang, 1997). Those structural features are equal to social capital benefits. Strong ties provide the bond obligations, cultural identity generalizes bilateral bonds and obligations into group loyalty, and leadership and density help to mobilize resources into collective action and normative control.

In a study done by Yusheng Peng, he concluded that kin solidarity and kin trust played an important role in protecting the property rights of private entrepreneurs and reducing transaction costs during the early stages of market reform, when formal property rights laws were ineffective and market institutions undeveloped. Data was taken from 366 villages in 1994 to determine that kinship networks in Chinese villages have large positive effects on the development of private enterprises and insignificant effects on the development of collective enterprises (Peng, 2001).

Rural industry has been the most dynamic sector in China over the past two decades and has played a crucial role in China's successful transition from a planned economy to a market economy. While China's gross domestic product (GDP) maintained an annual growth rate of 9.5% from 1978-1997, rural industry output achieved an annual rate of 27% during the same period (China State Statistical Bureau, 1998).

As China moves away from a centrally planned economy, Chinese managers are still aware that with strong lineage networks, family businesses have a better chance to prevail (Hill, 2007). In China, familism and kinship loyalty are the social roots of economic development. Kinship solidarity refers to the norm of commitment to collective interests and goals of the lineage group. Lineage remains the focus of collective action and normative control in contemporary China. Strong ties provide the bonds and obligations; cultural identity generalizes bilateral bonds and obligations into group loyalty, and density help to mobilize resources into collective action.

Informal integration is very strong in East Asia, especially in China, compared to Latin America. China's economy is characterized by the lack of coherent business laws

and strong governmental contrast over limited resources (Marshall, 2006). Developing close relationships is a necessary step to succeed in China. By developing personal relationships, firms can enhance their marketing effectiveness and efficiency. The Chinese use the guanxi networks, which are connections, accepted as a matter of course in China (Wesdenbaum & Hughes, 1996). In China, guanxi networks fulfill a significant function in a society that lacks a legitimate legal system. As Tsui & Farh explain it, a guanxi is the interpersonal relationships based on specific criteria or ties (Tsui & Farh, 1997). A guanxi is a personalized and close business relationship that is often considered a necessary condition to start a new business in China. Davies better defines guanxi as a set of personal connections that secures resources or advantages when doing business or in the course of social life (Davies, 1995). Guanxi is an enormous force supporting the way in which the Chinese conduct themselves and do business.

Guanxi makes up for the weak legal system in China. People establish and maintain guanxi through informal interactions. Consequently, people tend to engage in guanxi activities privately, outside the official domain (Redding, 1991).

Guanxi is a personal relationship and a framework in which people relate to one another as individuals rather than role occupants. It takes personal interactions and sentiment to initiate and maintain guanxi (King, 1991). In the economic realm, this means that transactions depend critically on personal rather than organization trust and relationship.

It is also a reciprocal relationship through which people exchange favors. The favors exchanged range from scarce resources necessary in daily life to professional opportunities and political support. The exchange does not have to be immediate or

direct; indeed the return of a favor is structurally uncertain (Yang, 1994). But, guanxi generally involves repayment of a favor in one way or another.

Trust is an important foundation of guanxi. Since guanxi is an informal relationship of reciprocity, it cannot rely on formal institutions guarantee of enforcement. Parties of a guanxi relationship can only rely on their confidence in each other's desire and capabilities to fulfill their respective obligations. According to Wang, Guanxi makes up for the weak legal system in China in two ways (Wang, 1997). First, it has been used to complement law, classifying legal ambiguity and providing access to legal mechanisms of contract enforcement. Secondly, it has been used to secure business opportunities with high profit potential, compensating for the high risks of investing in China.

Personal connections are impacted by the Chinese culture in a number of ways. The Confucian legacy is very central to personal connections. In Confucianism the individual is perceived as a relational being, in other words, it is the focus of how well an individual gets along with another. Relationships among strangers are also very important. It is expected that the relationship persists and that people know that other members of the network will be making judgments on their behavior. In this relationship, Confucian principles require the participants to do favors for each other, help those in need, and reciprocate favors received.

As I mentioned above, the Chinese culture is based on relationships. Although the guanxi is based on networking, it is not to be mistaken as "palanca" or connections as they call it in Latin America. It is wrong to make the assumption that guanxi is the theory who you know matters more than what you know. Bell writes that the guanxi

network has a valuation that surpasses connections. So ultimately, not everyone pertains to a network within which guanxi operates (Bell, 2000).

Because of the Open-door policy, the majority of foreign capital coming into China is provided by overseas Chinese, foreign firms and joint ventures. The ethnic Chinese business networks are beneficial because information, capital and other resources are easily transferred across national borders. Informal networks, like that of the ECBN's also makes it easier for Chinese businesses to obtain valuable information necessary for their business activities. The use of networks is very important for the future development of the economy.

The ECBN is a type of informal integration that promotes regional integration in the absence of a free trade agreement. It is very important that attention be placed on the impact of informal factors that are playing a major role in the Chinese economy.

The center of the ECBN's are concentrated along kinship and lineage. In the Chinese culture, the family is the primary basis. These EBN's have their origins in Confucianism, which places a great deal of emphasis on human relations. Trust is the major basis for ties among the ethnic Chinese. The basic conditions to build these ties are the common culture and norms. Other common bases for good ties among the Chinese include kinship coming from the same region and speaking the same language (Peng, 233). For the business networks to function there has to be mutual trust among individuals and firms and Chinese rely on these more than legal contracts. The advantage of having a strong ECBN is that all the capital made by Overseas Chinese goes straight to China to establish new production bases.

In Asia, China has the longest history and also the strongest influence on social and economic developments because a relatively high proportion of the Asian population is of Chinese ancestry. For many years, these people have been called “overseas Chinese”, reputed for their aggressive, vibrant and influential roles in Asia-Pacific profiles. Distinctive characteristics include being hard-working, pioneering, progressive and acquisitive.

The overseas Chinese as a group keep their cultural identities and they also develop their businesses along family lines. A major difference between overseas Chinese and overseas Latin Americans is that the Chinese do not have any formal organization that coordinates their activities. The overseas Chinese do not belong to any political unity, as opposed to overseas Latin Americans who strive to develop into a political community (Duckett, 2001). Latin America has always been easily influenced by Western ways. Although Latin America still has a reliance on family lineage, as the Chinese do, formal economic integration is dominating that region. Formal integration refers to economic integration through regional institutions or comprehensive free trade agreements, such as the EU and NAFTA. In contrast, informal integration refers to integration through non-institutional means based on factors such as ethnic ties and industrial linkages. It is through this informal integration the reason why the Chinese economy is more developed.

The operation of the ECBN's is informal and its commercial power is very strong. The networks make up the small scale of the overseas Chinese economy relative to the huge Western firms. The most important reason for the overseas Chinese capital to go

straight to China is to establish new production bases. They take advantage of the cheap labor for their labor-intensive manufacturing firms.

There are many advantages that come with ethnic business networks. Ethnic Chinese are skillful in dealing with the governments in various countries and Chinese businessmen are well-known for having close ties with various governments at all levels. In China's case, the ethnic Chinese have a far better understanding of the special characteristics of Chinese society that is taken into consideration when conducting business in China.

As I mentioned earlier, trust is very essential in Chinese economy. The distrust that Chinese hold towards outsiders is reflected in their preference for highly centralized control of their firms. Only people who are known very well and trusted within a Chinese-owned company are invited to be shareholders and directors in the firm. It is the informal, personal ties rather than that between incumbents of office that is more important. For the Chinese, emotional trust is more important than cognitive trust, and is based on sentiment-based ties between individuals, which may also be extended to others through the relationship network (Duckett, 2001).

Chinese businessmen believe that interpersonal trust minimizes fraud to ensure certainty and order. They maintain that by having *guanxi*, formal legal sanctions are not necessary to induce performance exchange. This can be settled informally with *guanxi*.

Xinyong is also very important in Chinese business networks. *Xinyong* refers to the integrity, credibility, trustworthiness, or the reputation and character of a person. The initial trust is more of a presumption of trust of a social category. There is a higher

presumption of trust in relatives than in non-kin. However, after several business dealings, a non-kin can acquire Xinyong through the quality of his work.

Chinese business practices emphasize personal trust. Xinyongs' underlying principals grants those who apply to it a higher sense of moral superiority because it is based upon the honesty and integrity of individuals. Since the use of verbal agreement is dependent on Xinyong, the non-use of written contracts symbolizes the extent of mutual trust between them. Sometimes this is compromised. An example of this is in dealing with a new client. For someone new, there may be written contracts involved. As time passes and the new client is known better, there are no written contracts.

A possible source of challenge to the informal business network comes from the use of the modern state. For example, stress from credentialism and the emphasis on the objectiveness of science and technology may challenge the endurance of personalism. Mandatory requirements regarding formalized transactions may be demanded by the state (Marshall, 2007). However, overtime, these demands will create new standards as to what is appropriate and necessary.

China is regarded as a country in which economic relations are strongly dependent on trust, while, at the same time, trust is difficult to build there. Chinese culture is often noted for its particularism and insistence on building up trust through cultivating personal relationships into which it is difficult for foreigners to enter (Hickson and Pugh, 2001). Some identify the root cause of the issue in China as the underdevelopment of its institutions compared to most other industrial countries, which permits corruption. This explains why the Chinese do not extend trust easily outside their

familiar social circles and why foreigners find it hard to trust the Chinese on general principals.

In China, private entrepreneurs set up and run non-farm operations such as single households or multiple households in partnerships, including both self-employed individuals and owners of private enterprises (Marshall, 2007). Because legal enforcement of private property rights has been ineffective, private entrepreneurs depend on informal norms for security. Chinese peasants do understand the difference between collective vs. private property. However, moral justice can be manipulated and is pale without the support of a social circle in solidarity.

Enforceable trust reduces costs in social exchanges such as interpersonal loans and pooling of funds. In China's reform process, private entrepreneurs have found it very hard to obtain bank loans due to political discrimination. Thus, informal financial institutions similar to rotary credit associations have been important channels for providing start-up capital or emergency cash for small-scale private businesses (Tsai, 2002).

Studies have shown that the Overseas Chinese have created informal associations to which co ethnic businesspeople from both the host countries and the mother country have access. These networks facilitate trade across polities by building trust when contract enforcement is weak to nonexistent. The work of Greif has established the idea that co-ethnic networks can promote international trade by providing community enforcement of sanctions that deter violations of contracts in a weak international legal environment (Greif, 1989; 1993).

If a business owner violates an agreement then he is blacklisted. For overseas Chinese, this is worse than being sued, because the Chinese networks will stay away from doing business with the guilty party (Weidenbaum and Hughes, 1996).

While trying to cope with local changes influenced by Western legal forms and concepts, China is enjoying rapidly increasing foreign investment. Again, I place emphasis on the *guanxi* as it provides one of the most dramatic examples of an entrenched cultural norm under pressure from international business trends.

During the past two decades, China has become a major player in world trade and has attracted substantial foreign investment (Knight and Song, 2001). With China's cautious integration into the world economy, important changes have taken place in the domestic business environment. These changes include increased privatization of business firms, a movement toward more emphasis on the rule of law, changes in forms of business operation, and increased competition (Liang, 2002).

I felt it important to demonstrate that there are some scholars who believe that China is moving away from its established traditions. The significance of this is to show how necessary a component *guanxi* is to the Chinese society. As Eakeley put it, "China is showing an interest in the rule of law" (Eakeley, 1997). Although there is a growing interest in law, there are still problems of federalism and administration and corruption plague (Nikkel, 1995). When legal remedies are not effective enough, shareholders rely on mediation or *guanxi*, which is the most common route.

There are scholars who disagree on the debate of whether China is moving toward a Westernized emphasis on the rule of law. Guthrie believes shifts in the economy have led China to redesign the legal system in a way that it would favor efficiency and produce

disincentives for guanxi-based transactions (Guthrie, 1998). He goes on to explain how increases in the monitoring of industrial organizations decrease the reliance on guanxi. Others, such as Garten, disagree arguing that the structure of China's government will not be as important to business as the officials who are in charge (Garten, 1998). Besides Garten, there are others who agree that guanxi will gain importance in international transactions because it provides a more effective means of conveying trust than formal legal contracts (Lovett, 1999).

Privately-owned firms continue to emerge, along with hybrid forms in which a governmental entity owns the majority of the shares and private investors own an interest. The Chinese government encourages privatization as a means of increasing efficient decision-making and also tapping the flexibility of global capital markets. Although privatization encountered difficulties in the late 1990s, according to Dunfee and Warren, it is expected to accelerate especially when China is finally admitted to the World Trade Organization (Dunfee and Warren, 2001).

In an attempt to sustain economic growth, China offers increasingly more attractive opportunities for foreign investment. These opportunities coincide with major changes in the legal and political environment such as the legalization of wholly foreign-owned enterprises. Such ownership opportunities continue to attract foreign investors who do not want to bother with local businesses. Tung and Worm's research on European firms conducting business in China confirm the assertion that foreign investors desire a sole ownership in their Chinese business (Tung & Worm, 1997). Their research explains how these managerial preferences stem from the fact that they want to attempt to lessen the influence of the large cultural distance between Europe and China.

The growth of wholly-owned foreign enterprises threatens to disrupt traditional Chinese practices the most, despite the fact that any type of foreign investment poses a threat to the Chinese business culture. Most importantly, these foreign-owned organizations may present competitive forces that conflict with guanxi traditions and thereby impact the effectiveness of an organization that relies heavily on guanxi.

Dunfee and Warren explain the current debate of guanxi. They address managerial perceptions of guanxi, guanxi ownership, and business uses of guanxi. They indicate that many argue that guanxi is deeply tied to the Confucian heritage of the Chinese people and entrenched in the Chinese way of life (Yeung and Tung, 1996). If guanxi is deeply rooted in traditional Chinese culture, then economic forces alone should not be sufficient to bring about major changes in the practice. If guanxi is more artificial, then it may change quickly in the face of evolving background institutions and business conditions.

To know how current Chinese view guanxi, Guthrie did a survey of Chinese managers. In that survey he found that some view guanxi as increasing in importance while others believe that it is of less importance in the emerging Chinese legal framework. Guthrie summarized the view as stating that guanxi is diminishing in importance due to both increasing competition and legalism. Those managers in higher institutions already have access to the bureaucrats who facilitate business transactions and therefore do not need to rely on guanxi as much as those managers in lower institutions (Guthrie, 1998).

Dunfee and Warren do believe that there is an impact of guanxi on economic performance. There are certain macro considerations supporting the claim that the

impact of guanxi is positive (Dunfee and Warren, 1999). Guanxi serves as a means for signaling trust and credibility in a society in which such characteristics are not supported by incentives embedded in strong background institutions (Lovett, 1999). It also constitutes an informal network allowing the bypassing of the inefficiencies inherent in a communist bureaucracy. In this sense, guanxi is seen as a substitute for the rule of law. Xin and Pearce reported that private managers were more likely to rely on guanxi as a defensive measure (Xin & Pearce, 1996). “Emphasis on personal power promotes the practice of guanxi, since an individual defines what is permissible in a given context at a particular time” (Yeung and Tung, 1996).

The Chinese businessmen who have legitimate claims over resources are governed by the moral precepts of rightfulness, fairness, and equitability. The key question is to what extent moral justice is enforceable. Without the backing of legal sanctioning, the effectiveness of informal property rights depends crucially on the sanctioning capacity of social networks. The thrust of my argument is that kin solidarity and kin trust help to enforce the informal norms of property rights. For the Chinese businessmen, kinship networks help protect them from predatory cadres, and thus reduce the uncertainty and high transaction costs associated with insecure property rights and fledging markets.

Ultimately, upon reviewing China’s continued success over Latin America, it is inevitable to attribute the overseas Chinese economic success in China to guanxi and kinship. As noted by the American Chamber of Commerce in Hong Kong, overseas Chinese receive better returns on their investments in China because they rely on family

members and friends who already possess guanxi to assist in business establishments (1997).

The importance of guanxi in business dealings is accepted as virtually a truism in certain areas of Asia. Many have argued that understanding and practicing guanxi is essential for successful market entry and sustained success in China.

As already described, guanxi is used to better facilitate efficient exchange. The ability to develop trust to create tightly linked connections between business parties is seen as a comparative advantage for firms. Gift-giving and entertainment used as a foundation for future business relationships are common in many cultures. This is very true in the United States where a large industry supports business entertaining. These practices are based on the idea that humans are social creatures and that social relationships underpin many other types of interactions. A different use of guanxi is to apply it to overriding government rules and regulations. It may be the equivalent to coarse public sector bribery where payments are made to avoid environmental or safety regulations. Another reason why guanxi is an important component to the Chinese economy is because it is used as a facilitator of business transactions in China.

The need for a networked society is rooted in the insecurity that emerged in a close-to-subsistence level society and lack of trust in the forces of modernization. Despite the fact that China's communist history of nationalist production has meant that people in China have had a different experience of business than people in the Chinese diaspora, it is regarded that the practice of networking is comparable given the shared Confucian history of ethnic Chinese throughout the world.

Luo suggests that the reason why guanxi differs from inter-firm networking in Latin America is that it is ubiquitous in playing a fundamental role in daily life (Luo, 2000). Latin American's fight for rights and the Chinese curry favor through guanxi ties. The Chinese focus on relationships created over long periods of time that are built on frequent exchanges. In China, interactions with others are viewed as part of a whole relationship, as opposed to the West, where business and social positions are separate.

Overseas Chinese

Since Chinese civilization reaches back for more than four thousand years, the Chinese had the opportunity to migrate to all areas of the world. The overseas Chinese are widely distributed around the world and live in almost every country. Finally, the overseas Chinese have had important social, economic and cultural influences in many of their host countries; moreover, they have also made important contribution to their home country of China.

When referring to overseas Chinese, I used the definition employed by others: all Chinese living abroad (outside of mainland China and Taiwan). This definition includes all persons with any Chinese ancestry.

The influence of the culture of overseas Chinese on business is very well recognized. Firms owned by Overseas Chinese often belong to loosely interconnected networks of firms that prefer to conduct business with one another. Confucian traditions, such as the primacy of relationships influence decision making in firms in ethnic Chinese communities. There is widespread acceptance that the shared culture of overseas Chinese produces some common behaviors that differ from the West.

As a group, Overseas Chinese businesses are a major economic force around East Asia. Chinese-owned businesses dominate industries anywhere from food production to property developments. In 1997, the estimated economic output by the Overseas Chinese was about U.S. \$500 billion (Zutshi, 1997).

The overseas Chinese maintain a culture that is not found in the West. Hofstede and Bond grouped these cultural characteristics under 'Confucian dynamism.' (Hofstede & Bond, 1988). Key differences include the link of the family to the business, the role of guanxi in doing business, and the financing of the firm.

In the Latin American society, the role of the family diminishes as the firms grow. As a small family-owned business grows larger, they raise money in the public equity market. Even if the family remains a principal shareholder, the financial markets require that the firm be managed in such a manner that is consistent with other public firms. The Overseas Chinese firms function as family businesses whether or not the firms are traded publicly.

Pressure from equity markets in Asia is less than that in the West. This is so because the levels of family ownership limit the degree of outside influence over poorly performing firms. This allows the top management to govern the firm with less input from the outside. The primacy of the family in Overseas Chinese firms is further insured by the strong family control over key aspects of the firm even if it is traded publicly.

There is a recognized tendency for thrift in the Chinese culture. This tendency has developed as a means to deal with the frequent political and social turmoil that has negatively impacted various Chinese communities around East Asia. One consequence

of this is that Overseas Chinese firms rely more heavily on numerous lines of credit and short-term loans than similar firms in Latin America (Liu, 1998).

Guanxi is one of the pillars that differentiate firms in ethnic Chinese communities (FECCs) from Latin American businesses. These networks initially arose in response to the absence of strong legal traditions. Without legal support, the relationships and connections provided a means to enforce, or sanction violators of contracts (Peng and Luo, 2000).

Another differentiation between FECCs and Latin America is the central role of the owner-manager. In Chinese culture, the head of the family is the father and this individual is given respect. The owner of an FECC holds the position of Board Chair and has control of the firm and its decisions. In Latin America, an owner-manager can play a similar role in closely held family-owned firms; however, in FECCs, this role is common to organizations of all sizes. Therefore, in FECCs this owner-manager would hold the title of Chairman of the Board and will make all major decisions of the firm with little supervision from the outside.

In Chinese culture, there is a tendency not to discuss negatives such as illness because it is believed to bring bad luck. This also holds true in business not only due to the potential for bad luck but also because it may cause a loss of face or respect among peers of the business person.

Chinese family businesses (CFBs) use an informal and unstructured approach to FDI. They tend to send family members overseas to be in charge of key management positions. According to Kao, many of the CFBs ownership and managerial control are concentrated within a single family (Kao, 1993). Some CFBs have become MNCs.

Competition has increasingly spread across national borders because of rapidly merging world markets.

According to a study done by E.W.K Tsang, it was found that CFBs and non-CFBs have different approaches to attracting FDI. He did this study by observing 10 Singapore companies (Tsang, 1998). At the beginning stage of evaluating an FDI project, CFBs tend to have a less formal and structured way of collecting information and conducting analysis than non-CFBs. The negotiating team of a CFB consists of the boss/head of family and his immediate family. Non-CFBs is often larger and consists of various functional managers. CFBs tend to assign family members to be in charge of key positions and they rely heavily on their boss' visits to these headquarters and overseas operations.

Strategic experience is maintained within the family of a CFB because of its highly centralized management control and strategic decision-making. Some CFBs have become sprawling MNCs. Examples include the Hutchison Whampoa of Hong Kong and the Salim Group of Indonesia. To survive competition by foreign competitors a company should leverage its strength overseas (Peng, 2000).

In a CFB, managerial ideology is shaped by Chinese cultural values such as clear hierarchy, reciprocal vertical obligation, and benevolent autocracy. The internal system of coordination and control is highly personal. Tight control is exerted on financial and production management. In dealing with the external environment, CFBs make use of extensive networking and relational contracting. These networking activities also enable a CFB to transcend its own limitation of scale through obtaining access to resources owned by other network members (Powell, 1990). There are three main features of CFBs

that distinguish them from other family firms. The first two are Chinese managerial ideology and extensive networking behavior. The third feature is the way of business succession.

Out of the 10 companies that were studied in Singapore, only three are CFBs. Singapore is a latecomer to the China investment arena. They had three main objectives to investing in China. Firstly, the huge domestic market attracted them. Secondly, they wanted to establish a business presence and gain strategic positions. The third motive was to take advantage of the lower labor cost in China.

When a foreign investor sets up an operation in China, it has to negotiate with the government bodies concerned. There are instances where Chinese negotiators may use tactics that catch their Western counterparts off guard. This is why foreign investors need to send their skillful negotiators to China in order to achieve good bargains.

Networking in Latin America

As in China, the family is of fundamental importance throughout Latin America. Family ties are the basis of identity and orientation to the greater society and political system (Vanden and Provost, 2006). However, Latin America is quickly becoming more urbanized and as urbanization takes place, financial pressures have begun to reduce family size, but not family unit. In Latin America it is the male that has a great deal of power. Effective political action is associated with the strong ruling style that most Latin American patriarchs display. It is traditionally expected that the Latin American politician exhibit characteristics identified with the strong dominant male, otherwise

known as machismo. Machismo is very much incorporated into the Latin American culture.

In Latin America, classism and elitism exists and mobility and entrance to social circles or employment opportunities are still often defined by who one is and the circle in which one's family travels than by one's accomplishments and abilities. However, as Latin America becomes more urban and educated, the Latin American society will continue to change, and many of the old barriers will be challenged.

From a historical and legal perspective, the family in Latin America is represented consistently as the fundamental unit of society, and as an institution that is essentially patriarchal, based on a system of monogamous marriage, and focused on reproduction. This vision is retained from the 16th and 20th century in spite of the remarkable diversity in family and household forms that existed in Latin America over time. The family as constructed through laws can be seen as the codification of an elite world vision, concerned with the legality of family ties, with the legal definition of marital and paternal power, the legitimacy of offspring, and the regulation of family wealth.

The family as an institution in Latin America has always been vital. Children in Latin America continue to utilize kinship and family relations in creative and adaptive ways even as they interact ever more strongly with the globalized economy. Globalization in Latin America also includes neoliberalism and free trade, which as exacerbated an already unequal distribution of income. One important characteristic of that distribution is that kinship relations have increasingly become segregated within particular socio-economic groups, as was the case historically until the 20th century (Bulmer-Thomas, 2003).

Oscar Lewis was one of the first to observe that aggregate data concealed the importance of the family as a building unit between the individual and society (Lewis, 1950). Charles Wagley similarly concluded that “there is a growing body of evidence that kinship relations and awareness of kinship need not disappear with industrialization and urbanization” (Wagley, 1964). There is every reason to believe that kinship will continue to play an important role in ordering social relations.

Antonio Gramsci’s idea of “contradictory consciousness” can be easily applied to the attitudes of working-class Mexicans to changes in gender relations and family structure in Mexico. Gramsci defines this as “those who simultaneously hold uncritically to ideas and practices inherited from the past while they also develop new ways of thinking based on the practical transformations of the real world in which they are constantly engaged” (Gramsci, 1971). This is a good description of how much most Latin America adheres to traditional ideas about the family, even as they are forced by circumstances to adapt family structure and roles to increasingly difficult economic circumstances and changing ideologies of the family. This, however, does not mean that to maintain kinship and family relations along with committing to the family has evaporated.

In Latin America, both political and economic powers reinforce each other. One has to understand the politics of the region to understand the economy in Latin America. It has been seen that the Latin American governance is breaking down, as new movements strive to challenge traditional political leadership, traditional political institutions are losing legitimacy. Recently, there has been a growing discontent with the return of democracy. Many people feel that they have been left economically

marginalized by the globalization process. It is acknowledged that the recent growth of democratic political forms and economic restructuring have done very little to remove social inequalities.

Neo-liberalism and the globalization process have had a considerable affect on the Latin American economies. There was a reduction of inflation in most of Latin America, including Brazil and Argentina. There was also economic growth in the early and mid-1990's. Some of the wealthiest people in the world are generated from Mexico. This took place in the 1980's, when the larger economic groups were temporarily weakened by the economic crisis and the 1982 bank nationalization (Vanden, Prevost, 2006). As a result, these large economic groups succeeded in reconstituting themselves with significant help from the government. New groups formed and both old and new benefited from the reprivatization of the banks.

Despite this success, there is still the inequitable distribution of wealth and income. The IMF conditionality and austerity measures that have become part of structural adjustments have crated a burden on the poor, and many in the middle class (Thomson, 2007). Inequality and continued marginality for the masses have spawned major leftist parties that have won many local and congressional elections. A growing number of workers have been forced to go into the informal sector to survive. According to the ILO, the informal sector arose as a response to the inability of the modern sector to provide sufficient jobs (Franko, 2007). Low productivity in the informal sector drags the rest of the economy down. On the other hand, productivity levels in the formal sector have been advancing. Though there is a rising trend In the informal sector, Chile is the

exception. This is due to the fact that there has been a rapid growth in the economy and other factors such as the introduction of private retirement accounts.

Mexico's performance is an example of the cost and benefits of globalization. Mexico was quick to liberalize its current and capital accounts and to integrate its economy into the North American economy. When the United States economy performed well, Mexico benefited. Growth was export-led. The economy became less dependent on oil and manufactured exports became less dependent on the assembly industry. However, Mexico went into recession as soon as the United States economy slowed down.

The large size of these family owned businesses presents a two-fold dilemma. On the one hand, their magnitude allows for economies of scale that increase their productive capacity, efficiency, and immunity to the economic hazards that characterize the Latin American environment. On the other hand, size augments their vulnerability to political controls and interventions.

The structure of second and third generation of these businesses is also affected in important ways by entrepreneurial ventures of individual family members. In economies in which there are only limited investment opportunities, individuals create ventures in order to put their money to work. While owned by a single-family member, these ventures often become dependent on the larger family business as a source of clients and customers (WEF, 2007). For example, a second-generation president of a large banking group started a private travel agency to provide travel arrangements for the executives in the family businesses. The executives felt obliged to use the agency regardless of whether or not it offered the best services in the market. When several members of a

given family replicate this kind of activity, it becomes a form of moonlighting that can create conflicts of interest and dilute the overall focus and structure of the enterprise.

As Woehrer puts it, loyalty to the family is paramount (Woehrer, 1988). There is enmeshment in these families because of the constant presence of a hostile environment in which there are vast differences between rich and poor. Wealth, high visibility, stature, and influence make these families the targets of terrorism and crime. The Chinese, on the other hand have these types of corruptions, but again, due the guanxi-based networks, the corruption is not much of a factor affecting its economy.

The impact of the Latin American environment on the inner working of the leading family enterprises can be examined by tracing the interaction between the economic, political, and sociocultural forces in the environment and the three basic domains: family, business, and ownership. These domains constitute the family business systems as identified by Davis & Tagiuri (1986).

Rapid growth also raises a number of ethical dilemmas that are unique to these societies. The Latin American economies are covered with micro enterprises providing goods and services of every variety. With the entry of a commercial giant into a given sector of the economy, the existence of small ventures is threatened. In developed economies with multiple resources and options, the high turnover of smaller businesses rarely threatens the total loss of livelihood and sustenance. In Latin America, the leading families vary significantly in their social values and political orientation. Therefore, families differ in the extent to which they are willing to handle the dilemma posed by unintended harm that may result from the growth of their business.

Family identity is powerful in Latin American societies as it is in China. In addition, family identity is inseparable from business identity for every family member (Tapia, 2004). In many families, selling a share in the company tends to augment the number of family shareholders who retain their stock ownership primarily for family rather than for economic reasons. This limits the effectiveness of attempts to consolidate the holding company stock of many family businesses (Hefferman, 2005).

However, predominantly speaking in Latin America, the *guanxi* component that the Chinese have is missing. Family businesses face the dilemma of long-term survival by not only overcoming difficulties common to all economic activities, but also conflicts specifically arising from their family-business nature (Carlock and Ward, 2001). Often, family welfare and needs take priority with no consideration for the firm's need for future growth. When the business is given priority, this usually occurs to the detriment of family communication.

Research findings by Esteban Brenes and Kryssa Madrigal suggest that survival of generational transition or the family as a whole, require defining guidelines to anticipate conflict. These research findings indicated that family structure and agreements on issues concerning succession and business control all attempt to achieve family-business balance. However, all efforts targeted family preservation. According to Brenes and Madrigal, many families in Latin America rely on external members as a way to gaining objectiveness and to avoiding conflict. Non-family members have proven important for family business development and communication.

In Latin American family businesses, family culture is strong. The role of the family in these societies is central to every facet of daily life. Family values, attitudes,

and behaviors are imported into the firm in a direct and forceful way, demanding loyalty and commitment from family and non-family members alike. Non-family employees are often treated like adopted members of the family. Security, caring, and inclusion are offered in exchange for performance and allegiance. Paternalism, which is the dominant management model, is the approach to the management of people that is protective and benevolent but also patronizing. Outsiders often misread the importance of paternalism.

There are a number of important factors that contribute to the survival and proliferation of these organizations in Latin societies, but again, the Latin American society lacks the strong hold that China has. One reason is the lack of competition in Latin economies, coupled with the fact that many commercial niches are protected from foreign companies (Brenes and Madrigal, 2003). Another reason is that the social structure of Latin societies also creates a climate in which members of the upper circles often support each other's commercial activities (Fernandez-Kelly, 2006).

In Latin America, popular capitalism exists and is created by the activities generally characterized as informal. These informal activities, illegal but not criminal, take place in the absence of legal protection and guarantees. For example, the street vendor goals in Latin America are licit but must use illicit means non-compliant with legal regulations, non-compliant with labor laws, and non-payment of taxes because there are no other alternatives. The street vendor cannot be incorporated in the formal economy because the formal economy imposes a heavy cost on Latin American societies as to make it impossible for people and entrepreneurs with minimal income to enter it. Informality is a situation whereby people want to work legally, but cannot.

In Latin America, informal commerce and public transportation services are public and visible. There are two kinds of informal industrialists in this region. One is the formal industrialist who informalizes part of the production as a result of the high cost of regulation of taxes. Even though he may conceal part of his production, he belongs to the community of established industrialists. In many cases the high cost of legality in Latin America has forced him to move part of his production to the informal sector. Therefore, he has to abandon the formal sector, or hide totally or partially in the informal sector. That occurs every time inflation rises, which in turn, raises taxes. The other kind of informal industrialists is made up of artisans and fully informal industrialists, who are employed illegally in the manufacturing sector.

The origin of informality can be found in the inefficiency of the law. Activities are informal because of the cost of legality. In Latin America, the cost of the law is very high. Latin Americans measure the cost of the law when the cost of complying with it is greater than its benefits. People comply with the law when it is convenient. When it is not, they do not comply with it.

From the law being so costly it distorts the market and excludes from it the least-favored sectors of the population. There is informality in Latin America because people cannot work otherwise, given their small incomes. They cannot comply with the law, cannot pay taxes, and cannot have access to formally built houses because they cannot afford it. In Latin America, there is a kind of capitalism where private property is not a right but a privilege and competition does not exist. The state takes it upon itself to create legal obstacles to market competition. This is where the difference between China and Latin America can also be noticed. Informal networks in China exist to motivate

economic development as a whole. In Latin America, informality is seen more as a means of survival (Thomson, 2007).

In Latin America, the 1990's were a time of significant economic and political changes that altered the social landscape of the region, and promised to reduce the poverty that still afflicts the great majority of the population. It was the beginning of the privatization of state enterprises and the opening of the economy to foreign goods and investment in countries where historically the government played a key role as promoter of development.

Today, however, the situation could not be any worse, as evidence by the economic downturn that afflicts the region. Argentina has exemplified the crisis, but it is by no means the only case: Brazil, Venezuela, Ecuador, Colombia and most nations of Central America also find themselves in a very delicate situation.

It is necessary to consider the impact of two cultural constructs on the success of any type of economic reform in Latin America: 1) corruption and the ensuing lack of trust in social institutions, and 2) highly inadequate support for the creation of small businesses. According to Thomas Friedman, the ability of an economy to withstand globalization depends on the quality of its legal system, financial system and economic management (Friedman, 2000). In Latin America, corruption has been a major problem, and in the context of a severe crisis, lack of confidence in public institutions can become a barrier to necessary reforms.

Networks of reciprocal help abound in poor neighborhoods in Latin America. Enzo Mingione coined the term *popular economy* by which he means the combination of activities undertaken for direct subsistence and for low monetary income (Mingione,

1991). In small towns throughout Latin America, these activities include raising animals, operating food stalls, undertaking self-help repairs and buildings, and industrial home-working in subcontracting chains. These activities have always been made possible by family and neighborhood networks to coagulate into a poor but socially protected way of life. Larissa Lomnitz showed in her study of a Mexican shantytown that social networks based on residence and kinship function as a surrogate system of social security for individual survival among the residents (Lomnitz, 1988). Proximate networks of reciprocity with neighbors and kins are well-studied elements in understanding how individuals confront the challenge of survival and the kinds of relations they establish in the process (Friedman, 2000). Reciprocal favors abound in the slum economies much as they do in other poor neighborhoods across the America's. But with the escalation of unemployment and underemployment and the generalized reduction of income, these networks are being progressively emptied of their resources. The avenues that formerly linked the slum economy to outside wage work are now being disrupted. When rejection from the labor market ceases to be temporary and income reduction affects every job that the unskilled residents of the poor neighborhoods can obtain, the social economy of the slum loses its traditional function as a buffer that helps cushion the impacts of economic hardship.

To fully understand the logic of clientelist interaction, one must not only focus on the objective meaning of practices but also investigate the subjective purposes of the actions of the actors involved (Colomer and Escatel, 2004). Once the empirical focus of the analysis is not only relations but also experiences, it can be seen that clientelist problem solving involves constructing personalized ties, an imagined solidaristic

community, and a protective and predictable network that buffers the harsh everyday reality of the slum.

Relations of clientelist domination exist in practice as relations that are useful from the clients perspective for solving problems, obtaining protection against the risks of everyday life, and making friends with someone who seems to really care.

While much attention is being given to Latin America's need to follow the steps of China, it is also true that a huge majority of Latin Americans are not even inserted into their own countries legal economies. More than half of Latin Americans operate within the informal economy.

While there are many Grameen-like banks now in Latin America, and growing numbers of established commercial banks are getting into the micro-lending businesses, many experts on poverty believe that the scope of these efforts are limited (Petras and Vieux, 1997). They do a great job helping the poorest of the poor, but they do not help the majority of the poor get access to larger loans that are necessary to start a small business, hire employees and become successful entrepreneurs.

De Soto has argued that the best way to win the war over poverty is to give people legal property rights and a valid commercial identity that would bring them into the formal economy. That would allow millions of Latin America to use their homes as collateral to get bank loans to start a new business, or to convince others beyond their immediate family members to lend them money for commercial projects. As it is now only the Latin American elites have access to the tools to create wealth. De Soto claims that there needs to be enabling rights in Latin America. There are many prohibitive rules,

but there are no enabling rules, that would allow most people to embark on commercial deals with strangers (De Soto, 1989).

Chapter Three

Foreign Direct Investment in China and Latin America

The purpose of attracting foreign direct investment (FDI) is beneficial to a region because it brings in capital, technology, and managerial ability. It also brings a channel to access international markets. Policymakers in less developed countries (LDCs) know that FDI is paramount in accelerating economic growth in the current global economic environment.

The behavior of economic activities cannot be explained without reference to the role of social and cultural factors (Havey, 1988). FDI is produced through a complex historical process of embedding, in which the cultural, social, political, and economic characteristics of the national home base play a dominant part (Dicken, 1992). These arguments suggest that the importance of political and cultural factors should be considered when analyzing FDI.

In the competition for limited foreign capital, states adopt strategies to maximize the favorable impact of investments. States must compete with one and other for limited investment by pursuing outward-oriented economic and trade policies to attract inward FDI, while trying to ensure that the local firms benefit from such investments (Ramamurti, 1999). According to Ramamurti, developing countries have not privatized faster because bureaucratic interests, institutional constraints, and economic rigidities have slowed the pace.

Latin America and China both have different patterns in developing FDI. China has the “dual-track approach,” which is both import-substituting industries and export-oriented industries (network-forming industries). Latin America’s incoming FDI has remained of the import-substitution-type, and the development of international production/distribution networks has yet to be seen.

According to Kimura and Ando, there are three lines of thought that must be interpreted to explain the mechanics of international production/distribution networks (Ando and Kimura, 2003). The first line of thought is fragmentation theory. In China, location patterns are determined at the production process level, and the fragmentation theory best explains the logic behind this. This thought is useful to analyze the patterns of FDI going to developing countries to formulate cross-border production sharing systems. Secondly, the agglomeration theory incorporates external economies of scale by introducing the concept of space from city planning. Finally, the third line of thought is the internalization theory of corporate firms. Firms set limits to upstream operations by purchasing raw materials from other firms and sets limits to downstream operations by selling products to other firms.

Ando and Kimura did a study on the proportion of machinery in total exports and imports of major countries in the world for the year 2000. The study demonstrated that the share of machinery in China’s total exports and imports was large. This study suggested that there is an existence of active back-and-forth transactions of intermediate goods in international production/distribution networks of machinery industries (Ando and Kimura, 2003).

It was also suggested by this study that countries in Latin America had a lower share of machinery exports than China. This is an indication that Latin America still has not yet formed networks in the machinery sector. In addition, the share of machinery imports was greater than exports; therefore, this indicates that the Latin American manufacturing production activities still have the import-substituting type.

In China, there is an abundance of human resources and stable macroeconomic fundamentals. Adding to these factors, there is the importance of development strategies applied by East Asian countries. This is called the network-forming-type FDI. This triggered the formation of international production/distribution networks by hosting FDI, extensive FDI facilitation, tariff reduction for semiconductor-related parts, and the duty drawback system.

Ando and Kimura also demonstrated in another study that the Japanese commitment to Latin America in terms of FDI has been very low when compared to Japanese commitment to China. It was found that in China, manufacturing firms own over 60 percent of the affiliates in the region (Ando and Kimura, 2004). However, in Latin America the share affiliates with manufacturing firms are only 35 percent. This indicates that manufacturing activities in Latin America by Japanese firms are much smaller than in China.

FDI in Latin America

It is evident that Latin America is one of the fastest-growing economies in the global market. The region is replete with natural resources and emerging service industries, which make it globally competitive. FDI into Latin American countries

almost doubled from 1985 to 1998 (Characteristics, 1999). More U.S. FDI flows into Latin America than to the Middle East, Asia-Pacific or Africa (U.S. Department of Commerce, 2003). FDI in Latin America reached a record \$126 Billion in 2007 according to the UN conference on trade and development (UNCTAD). The strong FDI growth was driven by new investment and expansions. The pattern was the result of strong regional economic growth and elevated corporate profits on the back of high commodity prices (Latin Business Chronicle, 2008). However, the one cultural distinction that appears to conform to expectation is the fact that greater collectivism in China attract more investment than in Latin America.

There have been success stories from Latin America that we can attribute to market, such as Brazil. The Brazilian economy is the eleventh largest in the world and the largest in Latin America. Former President Fernando Collor de Mello replaced Brazil's import-substitution strategy with an open-market economy and began a process of privatization of the state-owned industries (Vanden and Provost, 2006). The lowering of tariffs on imports reduced the barriers that protected Brazilian industry from international competition. This embarked Brazil on a new economic course, sloughing off decades of state-led growth and protectionism.

Another former president Fernando Henrique Cardoso believed that dependent economies could develop in association with the industrialized world. During his presidency, inflation was defeated in Brazil. Currently, Brazil has been able to control inflation and fiscal austerity. New programs such as Fome Zero (No Hunger), which guarantees sufficient food to Brazil's poorest regions, have proved successful (Vanden

and Provost, 2006). The constitution has been amended, bringing social security and tax reforms.

Brazil can be regarded as one of the world's great emerging markets. Transition to democratic rule was successful, role of military in domestic politics is reduced and corruption is less acceptable (Woods, 2007). Also, new social programs have been put into place for education and public health.

Despite these advances, there are still social problems that not only affect Brazil, but also the rest of Latin America. These include poverty and inequality. Unemployment still dominates and there is a high rate of infant mortality. Redistributing income and achieving government expenditures in health, education, and land reform can stretch the budget even further and trigger inflation (Payne, Zovatto, Carrillo, and Zavala, 2002).

Brazil has consistently failed to achieve its potential. Greater fiscal and monetary responsibility and low inflation have not yet enabled Brazil to shift to a higher long-run sustainable growth rate. There are numerous obstacles to faster growth in Brazil. The rate of investment is held back by low domestic savings, as in so many parts of Latin America and unlike in China. High real interest rates discourage borrowing by the private sector for productive purposes. Its income inequality is one of the worst in the world (Payne, Zovatto, Carrillo, and Zavala, 2002). Brazil does not enjoy the benefits such as high savings rates that are supposed to accompany an unequal distribution of income.

Argentina has been a case study in the dangers of inconsistent policies. In the 1990's, Argentina was the most neo-liberal economy in Latin America with widespread privatization, complete capital account liberalization, and a large measure of trade

liberalization, and a large measure of trade liberalization (Auyero, 2000). Economic growth stopped after 1998, and authorities had no instruments at their disposal with which to stimulate the economy.

The Cuban health system under the Castro regime has been lauded as one of the major achievements of the revolution. Indeed, the Cuban revolution has attracted appreciable and worldwide attention because of these purported successes in health care access, infant mortality and life expectancy. In Cuba, health care is successful because half of all the currency earned in the country goes toward the health-care system. Cutting expenditures for the health care system is not an option.

Despite the abundance of natural resources not one republic has achieved the status of a developed country. Unable to break into the circle of advanced capitalist countries, Latin America has remained a peripheral region in which external influence has been preeminent (Bulmer, Thomas, 2003).

There are several major urban areas in Latin America where laws and polity have changed to encourage foreign investments. This can be seen in Argentina and Costa Rica. Although there are changes, the benefits of economic growth are slowly coming to many rural areas including a lack of entrepreneurial development. This is due to entrenched elitists and poor governance including a lack of indigenous input.

Latin American economic development falls into three phases. The first is traditional export-led growth based on primary products. This began slow and reached its height in the first decade of the twentieth century, only to fade away in the wake of the Great Depression. The second phase is the inward-looking development. This was based on import-substitution and peaked in the quarter century after World War II. The third

phase which is globalization, became dominant after the debt crisis of the 1980s (Lindert, Skoufias, and Shapiro, 2005).

Argentina's success with exporting cattle showed that export-led growth could work well in the Latin American context. Most peripheral countries at the beginning of the twentieth century regarded Argentina as a legitimate model, envying its wealth of commodity export and diversified markets. During the inward-looking phase, the Argentine economy declined significantly (Lindert, Skoufias, and Shapiro, 2005). It was the agricultural protectionism in the developed countries and the accumulation of policy errors during the inward-looking phase that led to the decline of the economy.

The inward-looking phase was a legitimate response to the problems in international markets after 1913. The problem was that the phase began too slowly and did not become the paradigm for the region until world trade had started to expand rapidly after World War II. Eventually, the cost of the inward-looking model became too high, however at the beginning the benefits were substantial (Lindert, Skoufias, and Shapiro, 2005). For example, at the annual rate of growth increased for all republics.

Ensuring the development of the economy has always been difficult in Latin America (Morley, 2005). In the presence of barriers, such as physical, economic, and financial, the initial stimulus has often withered away before reaching low-productivity activities in distant regions. Public policy has rightly been seen as crucial in the destruction of these barriers.

Sectoral policies have a long and often successful history in Latin America. Meat in Argentina, coffee in Guatemala, and oil in Venezuela are all commodities for which the policy framework was an important ingredient in the emergence of a dynamic sector

in the first phase of post independence development. However, inadequate fiscal resources and antiquated tax structures have usually prevented Latin American governments from making the expenditures needed to increase the flexibility of the economic system (Morley, 2001). Potentially productive regions remained trapped by the lack of communications, unable to develop an agricultural surplus, and provide a market for industrial goods.

In Latin America, it is difficult to find many manufacturing affiliates in industries different from their manufacturing parent firm, as opposed to China, where it is easy (Morley, 2001). This means that switching industries within the manufacturing sector is rare in Latin America. Instead, almost all affiliates in industries different from that of their manufacturing parent firm are found in the wholesale trade sector. This point suggests that Japanese manufacturing parents establish affiliates in Latin America to sell products to local markets, sometimes with simple local processing, rather than building dense production networks.

From the study mentioned above, we see the difference in the development of international production networks between China and Latin America. The contrast is generated by economic initial conditions and policy environment for incoming FDI.

Annually, the Japan Bank for International Cooperation (JBIC) surveys the Japanese MNEs. One of the key questions asks for a list of countries that they think are potential destinations for their FDI in the short and long—run. In 2001 and 2002, China was the most important destination for forthcoming FDI. Latin America lagged way behind. Despite the size of Latin America's market, there has been a barrier preventing Japanese firms from investing in Latin America.

The conditions that were important for attracting FDI to China were market potential and inexpensive labor (Marugami, 2003). International production/distribution networks in China are being developed utilizing new economic logic such as fragmentation, agglomeration, and optimal internalization. Conversely, Latin America has yet to succeed in developing such networks. With differences in economic background, regional trade arrangements would have completely different effects.

With the formation of the FTAA, potential investors outside the region are likely to watch the formation process with optimism and concern. The concern includes that of a possibility of discriminatory treatment against non-regional investors. Most of the FDI in Latin America still have the import-substituting-type with trade protection. According to Ando and Kimura, if tariffs are removed by FTAA, incumbent investors will face more competition and be forced to reorganize their activities in frameworks beyond their national borders (Ando and Kimura, 2004). The positive side is that inefficient firms will exit the market while competitive firms will expand their operations. Ando and Kimura also state the MNEs from outside the region would face serious disadvantages in competing with intra-regional MNEs because MNEs must often import some of their key parts and components from their home country. This is due in part because local supporting industries in LDCs are typically immature (Ando and Kimura, 2004).

Secondly, Latin American countries should construct and implement policy packages to stimulate the formation of international production/distribution networks. Also essential are policy measures to reduce service link costs and to encourage the creation of a critical mass of agglomeration. With these points, Latin America can possibly learn from the Chinese experience.

Since 1995, three Spanish banks-Banco Santander, Banco Bilbao Vizcaya, and Banco Central Hispano-have become the largest foreign banks in Latin America (Maudos, 1997). These Spanish banks saw Latin America as a great region to expand internationally for many reasons: the commonality of the Spanish language has made Latin America comfortable for the Spanish and permits easy communication; also, the Spanish banks already had some familiarity with the region.

Although the timing and sequence of economic and political opening differ by country, the logical historical reference point is the Latin American debt and banking crisis of 1982. Since then, and as the Latin American lost decade lingered on, democratically elected presidents came to power across the region. These governments, with the support of broad coalitions of the middle class and business interests, managed to introduce market-oriented reforms of the financial system including liberalization of foreign entry. As Gross pointed out, from 1971-1987, the Andean pact countries barred foreign banks from owning more than 20 percent of local banks (Gross, 1997). Thus, only recently have these countries banking sectors become ripe for foreign investment.

The Spanish banks were not the only ones to respond to the developing opportunity. Following the start of the Spanish push in 1995, a number of foreign banks also started to buy banks in Latin America. The two with the widest geographic scope were Bank of Nova Scotia and Hongkong and Shanghai Banking Corporation (Wang and Hu, 1999). There are three sets of explanations for the Spanish banks' rise to Latin American investment. The first is asset seeking. The Spanish banks have been seeking to enter markets that permit them faster growth and higher margins than they are able to achieve at home. Latin America differs from the Chinese emerging market and the

advanced markets in terms of the development of the banking sector (The Gazette, 2007, March 30). The ratio of money supply GDP is lower than elsewhere. Also, expenses in Latin America and interest margins are higher than elsewhere (World Bank, World Development Indicators, 1998).

The second set is asset exploring. The Spanish banks are not just passive acquirers of assets. The Spanish banks believe that they have something to offer. That is, they believe that they can improve cash flows in their acquisitions. The Spanish Banks have transferred knowledge from Spain to Latin America. One obvious parent contribution has been the introduction of an aggressive posture built on the introduction of new products. Wherever local regulations have permitted it, the Spanish banks have introduced the lottery-linked deposit accounts they offer in Spain (Guillen and Tschoegl, 1998). The banks also have improved the issuing, pricing and term of mortgages relative to all the banks targeting the mass market of bank branches. Now that these countries are recovering from the lost-decade, the situation is one in which the opportunities for growth may not depend solely on taking market share away from others.

In addition to asset seeking and exploring, the whole expansion of the Spanish banks represent a case of oligopolistic reaction. In the “oligopolistic” reaction pattern that Flowers first identified, a firm matches the location choices of a rival in a pattern of move-countermove (Flowers, 1976). In the case of the Spanish banks, a leapfrogging of leadership occurs so that at some point one can no longer unambiguously describe one firm or the other as the overall leader.

Spanish banking FDI in Latin America requires understanding the shifting competitive environment of banking over the last decade. Financial deregulation and

privatization in Latin America have opened up new horizons, and have enhanced competition via product differentiation and effective leverage of new information and telecommunications and technologies.

FDI in China

China, up until recently, used to be a country with high barriers to foreign investment. Foreign investment is a recent phenomenon in China. China's regulatory framework for FDI has improved gradually over time since opening up to international trade. China, currently, is one the most attractive locations for FDI in the world (Benjamin and Brandt, 1997). The success of China in attracting FDI has been attributed to a variety of factors including market size, a low cost of labor, liberalized FDI policy, political stability and improved infrastructure. Much of the FDI in China can be contributed to its cultural and geographic proximity to major Asian sources, among which are Japan and the newly industrialized economies.

Most of the ethnic Chinese companies are family-owned. Although in recent years some of them have been listed as public companies, they remain under the effective control of the founding families. In addition to making investment in China themselves, ethnic Chinese outside China have also played a major role in facilitating FDI from other foreign companies. Foreign companies seeking to invest in China realize the advantages of ethnic Chinese in adapting to China's institutional environment. Many of them have used Chinese employees or middlemen to facilitate their negotiations and operations, including Chinese students both returning to China and remaining abroad (Rubin, 1995).

In China there are still many overlapping responsibilities between local government agencies and central government sectoral ministries and departments. Efficient public interest regulation is an essential part of developing and maintaining a policy environment conducive to private sector growth and investment. Unfortunately, according to Henley, Kirkpatrick, and Wilde, China has a poor reputation for transparency and bureaucracy (1999). Because China does not yet publish its rules and regulations, applicable laws are difficult to determine. Property rights and contract laws are still weak. Moreover, language and cultural barriers, corruption and legal uncertainties also present difficulties to foreign investors. The existence of internal rules and regulations, which are unavailable to foreigners, has long been a source of contention and uncertainty for investors.

However, the above-mentioned problems can give the overseas Chinese an edge. Some overseas Chinese firms have managed to turn these problems to their advantage through informal channels such as personal contact and family connections. Through these networks, trade and investment information is passed along and deals are done.

Much of China's inward FDI comes from countries or regions with a large presence of Chinese or ethnic Chinese. Other factors besides ethnicity and common language have contributed to large FDI flows from Hong Kong and Taiwan into China. These factors include geographic proximity, labor costs, and market potential. As Taiwan and Hong Kong are more technologically advanced and experience increases in labor costs, it is natural for businesses in these two regions to turn to China. China offers an unlimited supply of cheap labor and a potentially large market.

In 1995, there were about 55 million ethnic Chinese living outside mainland China (Yeung and Olds, 2000). The recent rise of East and Southeast Asia in the world economy has encouraged renewed interest in overseas Chinese networks. It is evident that ethnic Chinese networks do display flexibility and efficiency in certain settings and have been successful in Southeast Asia where market institutions are weak.

Ethnic Chinese networks have been strengthened by the formation of large-scale formal overseas Chinese associations. Examples to demonstrate is since the 1960s about one hundred world conventions of overseas Chinese associations have been held. Some associations enjoy strong financial support from ethnic Chinese business leaders and political backing from their local communities.

China experienced tremendous growth in inward FDI during the last two decades or so. Prior to 1978 when the economic reforms started, FDI was prohibited in China. Since then, FDI in China has grown to \$45.3 billion by 1997 annually and total cumulative FDI has reached \$220 billion. According to UNCTAD China is the largest FDI recipient in the developing world (UNCTAD, 1996).

In much of the 1980s, foreign invested firms were required to export a major portion of their output. Restrictions on foreign exchange also forced foreign invested companies to sell output outside China to earn hard currency in order to pay for imported inputs. Many domestic markets were closed to these firms. As a result, until 1991, almost all-industrial output by foreign invested firms was exported (Naughton, 1996). Given the limited access to China's domestic market, low labor costs should be an important factor explaining FDI in China.

By the 1990s, China became the second largest FDI recipient in the world. There is a great disparity of FDI among regions in terms of geographical distribution. The “open door policy” started with the creation of the Special Economic Zones (SEZs) in the southern zones. The opening of other SEZs in coastal cities in the 80s followed this. FDI started to spread to other provinces when the authorities adopted more economic reforms in the 90s.

The increasing openness of China to the outside world is seen in the fast growth of its foreign trade. Because China exempts many goods from import duties, actual tariff collection has been lower. The collection rate has a very low percentage rate in China.

When explaining FDI in China, two determinants are considered: domestic-market FDI is produced by size and growth of the host country (China Daily, 2003, Nov. 14). Export-oriented FDI mainly looks for cost competitiveness. To explain what impacts FDI in China, there are three factors to consider. These factors are economic structure, liberalization and preferential policies, and cultural and legal environment.

The strong market potential that China has to offer has attracted FDI. Many European and American multinationals have set up factories in China with the purpose to produce for the domestic market. Low wage costs appear to have played an important role in attracting FDI to China. It has also been proven that provinces where the infrastructure is more developed have received more FDI (China Daily, 2003, Nov. 14). Once a province has attracted a critical mass of FDI, it is easier for them to attract more FDI as foreign investors perceive the presence of other foreign investors. In addition, it is more efficient for foreign multinationals to locate in the same area. This allows them to share information and facilities. The coastal provinces of Guangdong and Fujian,

which are close to Hong Kong, have been the largest recipients of FDI and have acquired a significant advantage attracting FDI than the inland provinces (Sun, 1999).

There are many theories of FDI that demonstrate the causes of FDI in China (Zhang, 2001). The location advantage of China possesses a large pool of unskilled workers. Growing countries or regions such as Taiwan and Hong Kong invest heavily in China to take advantage of low labor costs. However, much FDI in China is still unskilled labor-intensive production aiming at the export markets in the developing world.

There were other reasons explaining why foreign firms set up production facilities in China. By 1994, foreign invested firms were able to sell half of their output in China's domestic markets. Even before China's years of reform, many companies ventured into China realizing its large market potential.

FDI tends to be more likely to promote economic growth when host countries adopt liberalized trade regime, improve education, and human capital conditions. The growing interest in China as a host to FDI is a reflection of favorable economic performance and prospects, and policy regimes that are open to both international trade and capital flows. In comparison, Latin America is lacking in both economic and policy attributes that stimulate FDI. There is an economic instability and political uncertainty dominating the region.

In another study conducted by Jonathon Doh using a database of telecommunication projects in emerging markets around the world, they investigated how differences in the economic and cultural characteristics of Latin America and China affect private infrastructure investment. He found that in general, attracting private

participation telecommunications infrastructure investment is more diverse along cultural dimensions in China than in Latin America countries (Doh, 2000). Chinese attracting investment are more individualistic, have high power distance and have less uncertainty avoidance than Latin American countries attracting private participation investors.

By studying the telecommunications infrastructure, Doh also found that Latin American countries attracting private participation investors have agreed to more telecom liberalization commitments, tend to allow more competition and, therefore, less monopoly protection, and have lower tariff levels than China (Doh, 2000). The Chinese attracting private participation investors are more diverse than Latin American countries in terms of tariffs.

In China, variations in institutional change across regions play a critical role in attracting foreign investment to a region. Given the homogeneous and stable institutions settings across regions in the West, local regions compete only through various industrial incentive systems, such as local taxes, to attract foreign investment.

China's interior region is known for its poor physical infrastructure, inadequacy of human resources, lack of business philosophy, and ailing environment (Sims, Schiff, and James, 2000). It is less attractive to foreign investors than the coastal belt, however, the interior has received a significant amount of FDI. In terms of the actual value, it was the recipient of 12% of all FDI in China between 1978-2001 (MOFTEC, 2002). This is a small proportion in relative terms, but in absolute terms, it is large. By 2001, 32,993 foreign enterprises were established in interior areas with an investment value of \$2 billion (SSB, 2002).

The relationship among FDI/foreign parent firms, personal networks, and institutional involvement have a hierarchical structure: the larger the foreign parent firms, the more institutional involvement, while the smaller the foreign parent firms, the more personal networks are involved (Qui, 2004).

It is argued that the embeddedness of FDI in personal networks and institutional involvement is perhaps best observed in peripheral regions, such as China's interior. The economic conditions and policy environment in China vary substantially among regions, and there are major structural differences between the coastal and interior provinces. In the coastal region, economic reforms and an open door policy were introduced early, and as a consequence, the economy has become highly liberalized and has shifted from the traditional centrally planned system to a market economy (Sun, 1999). Because of their proximity to foreign countries and regions, the coastal area are more commercially advanced than is the rest of the country (Tsai, 2002). For example, certain economic innovations such as the encouragement of private business and informal financing at the ground level appeared in places like Zhejiang and Fujian (two coastal provinces) well before they were officially acknowledged by the central government (Tsai, 2002). In contrast, the interior region experienced the preponderance of "socialist construction" and heavy investment in central planning during the pre-1978 period which has left it with a more conservative reputation than the coastal provinces. The interior appears to have a greater stake in preserving its old state-subsidized positions and exhibits more resistance to marketization processes. Furthermore, economic reforms and the open-door were not introduced in the region until the beginning of the 1990's, a decade later than in the coastal areas (Sun, 1999). Thus, its institutional infrastructure is problematic

and less attractive to foreign investors. As a result, business and risk are greater in the interior than on the coast and provide the breeding ground for the existence of personal networks and institutional involvement to facilitate FDI activities.

An understanding of China's processes of integration into the global economy will be enhanced if the interior is included in the analysis. The interior is important to the Chinese economy. It has always played a big role as an economic powerhouse for China's economic development and supplies China with a significant proportion of the raw materials that are required to create manufactured products. The rapid economic growth of the coastal belt over the past 20 years has depended heavily on the investor's energy and minerals supplies (Chen, 2000).

Recent Chinese regional policy has paid particular attention to the interior. Throughout the 1980's coastal-interior regional disparities accelerated; the annual growth rate of the real per-capita gross domestic product in the coastal areas was three percent faster than that in the interior (Wang and Hu, 1999). To attack these problems, since the early 1990's, the central state has proposed channeling more investment into the interior. In 1999, the Great Western Development Strategy, was launched with the aim of steering state investment, outside expertise, foreign investment, outside expertise, foreign investment, and private capital into the parts of China that are most in need of and the least likely to attract aid on their own.

FDI has been playing a more important role in the economic development of the interior and the integration of the interior into the world economy. FDI has been one of the most significant features of China's economic reform and opening up to the outside world since 1978 (UNCTAD, 2003). Throughout the 1980's because of China's

adoption of a coastal-biased regional policy, the majority of FDI went into the coastal region. FDI has contributed significantly to the opening-up and catching-up processes of some of the interior provinces.

It is predicted that the role played by FDI in the economic development of the interior will be greater (Lane, 1998). Foreign investors have become more familiar with the market and intend gradually to increase their participation in less-developed areas, where land and labor are cheaper than in the coastal areas and the market potentials have been largely unexplored.

A case study of Shaanxi province done by Ying Qui highlights the importance of personal networks and institutional involvement in determining the locational choices of FDI. Shaanxi is located in the middle of China. Political institutions have a particularly strong influence on Shaanxi's economy because the province has close linkages with the central state. In the pre-reform era, Shaanxi was described as a "transfusion" economy, since its economic growth and development relied heavily on constant transfusions of capital, subsidies, and grants from the central government (Lane, 1998). This had a great impact on its present economic structure. Today, Shaanxi is the most important location in China in terms of the total number of military enterprises and its strength and breadth in science and technology rank third nationwide (Liang, 2002). Shaanxi's close relationship with the central government offered the province new opportunities when the central government readjusted its regional policies gradually to favor the interior from the early 1990's onward.

The downside to the close relationship between the central government and Shaanxi is the political decentralization and transformation from a planned economy to a

market economy in the province has been slow compared to those in the coastal provinces. This factor increases the difficulty and uncertainty of investment and provide the breeding ground for personal networks and institution's involvement that consequently exert an important influence on FDI activities.

There is enormous heterogeneity in the interior, and Shaanxi has some features that make it unique in the region. Shaanxi was chosen as a case study because it provides insights into some of the important processes that shape FDI flows into China's interior. According to this study, economic considerations are embedded in cultural and political considerations, which include personal networks, and institutional involvement. This survey showed that the linkage between personal networks and institutional involvement is networks, which are prevalent in the everyday life of Chinese society (Xin and Pearce, 1996). This survey also showed that the use of networks is not confined to individuals; it also operates it at the institutional level. The popularity of networks at the institutional level can be regarded as the use of personal networks by groups of individuals.

Qui clearly points out that the Shaanxi survey is not representative of China's interior as a whole. This study was done to just shed light on some important features of the embeddedness of FDI, in informal and formal institutions, which contribute to an understanding of FDI flows into peripheral regions. Economic activities, such as FDI flows, are socially, politically, and culturally embedded in time-space contexts. Many unsuccessful regions do not possess the advantages enjoyed by successful regions, such as easy access to international markets. In this regard, formal and informal institutions can provide the basis for localized social and economic networks and contracts.

Chapter Four

Labor Markets in China and Latin America

The labor market is the medium through which labor moves from rural to urban areas. Scholars have not been able to come to an agreement as to how well labor markets have been functioning during the past two decades in China. Some researchers believe that significant barriers still exist in China's economy, and that the absence of well-functioning rural labor markets has delayed growth (Benjamin and Brandt, 1997). Others show that labor markets are used in assigning jobs and wages (Meng, 1995). Cook, Knight and Song all contend that healthy rural labor markets have emerged and are continuing to evolve in a positive direction in China (Cook, 1999; Knight & Song, 2001).

In analyzing the relationship between education and the labor market, I found that in rural China, students returning to school are very low. According to a study done by Mincer, China stands out as having one of the lowest rates of return in the world. This would explain why labor markets in China have not been functioning well. In other studies, it has been found that the rates of return to human capital in recent years may be higher for labor market participants that are more like those in other developing countries. This would go along with the hypothesis that better functioning labor markets in recent years are being reflected by rising returns to human capital.

By researching other studies the one explanation I found to be more consistent is that human capital has continued to be increasingly rewarded in rural China's labor

markets. As de Brauw found, this is proof that the labor market is improving (de Brauw, 2002). Increasing educational availability in rural areas would be a good policy instrument for increasing rural incomes. If rural education was made a top priority by China's government, then there would be an increase in rural incomes.

Economically speaking, foreign investments not only contribute to the overall output of China but also to the employment of a large proportion of the labor force. It is well-known that MNCs operating in less developed countries could have a positive or negative impact on the development and welfare of the host country. Critics such as De George claim that MNCs exploit the less developed countries through cheap labor, lower the cost of resources, and impoverish the less developed countries (De George, 1999). Advocates of MNCs agree that multinationals are less hostile than their local competitors to demands such as safe working environment and promotion opportunities in the interest of boosting productivity.

In China, there are four major forms of enterprise ownership: the state-owned enterprises (SOEs), the collectives, the foreign-investment enterprises, and other private enterprises. Kit-Chun Lam evaluated the ethical performance of the foreign-investment enterprises and compared them to local enterprises with different forms of ownership.

The difference between the behavior of foreign-investment enterprises and the other types of ownerships is that the foreign-investment enterprise is allowed to compete in the market and is given more flexibility in their pricing and employment decisions than the local socialistic enterprises. It also has a different business culture from that of the indigenous enterprises.

A direct contribution of foreign-investment enterprises to the welfare of the Chinese workers and the country as a whole is job and income creation. This contribution is notable in China where the economy is far from full employment and plenty of useful labor resources are available. Without the foreign-investment enterprises, employment opportunities in China would have been much less. Furthermore, the foreign-investment enterprises can also contribute to the earnings potential of the workers by increasing their labor productivity through the use of relatively more advanced technologies.

Critics of MNCs argue that MNCs are drawing skilled workers away from indigenous enterprises, causing under-development of the indigenous enterprises. Chun Lam postulates that this argument does not apply to China. The average education level of workers in foreign-investment enterprises is in fact slightly lower than that in state-owned enterprises, and is slightly higher than that in other private enterprises. The reality is that foreign-investment enterprises do provide employment to both low-skilled workers in China. Even if the foreign-investment enterprises employ more skilled workers in the future, it will only be good for the development of economy that human capital investment is stimulated by the presence of job opportunities for the high-skilled workers. Foreign-investment enterprises are ethically good for China to the extent that they bring about desirable consequences of employment and income creation as they increase the growth potential of the economy and improve the welfare of the workers.

A study done by Chun Lam resulted in explaining that higher average wage in foreign-investment enterprises is consistent with the argument that foreign-investment enterprises are more efficient in the use of resources, more productive and therefore able

to pay higher wages to their workers. Chun Lam argues that if this were the case, the diffusion of technology and management skills from the foreign-investment enterprises to the rest of the economy is expected to generate important positive external effects on the Chinese economy.

In analyzing the study provided by Chun Lam, I observed that ethical performance of foreign-investment enterprises is good compared with other local firms, and many common accusations against multinational corporations do not apply to foreign-investment enterprises in China. Foreign-investment enterprises have been morally good in creating employment and income, and offering wages higher than that in other local firms. They also promote the growth of the economy by bringing in new technologies and raise labor productivity and income. In China where there is considerable unemployment and unutilized resources, the contribution of foreign-investment enterprises in promoting welfare through employment and income creation is important.

The shift toward liberalization and economic restructuring in Latin America has provoked debate about reforming labor laws (French-Davis, 2005). The debate has raised a number of intriguing questions about current labor laws and institutions creating obstacles to structural adjustment. Another question brought to mind is if reforms are necessary, then what kinds of changes should governments adopt?

In *Reforming the Labor Market in a Liberalized Economy*, Gustavo Marques writes that many labor laws in Latin America undermine the capacity of firms to adjust to changing market conditions. While intended to provide job security and limit competition, labor regulations impose costly restrictions on hiring and firing, sanction

practices that result in low productivity, and create incentive structures that result in high job turnover. Researchers who believe this theory argue that the governments' role in bargaining should be limited to enforcing labor contracts, and labor agreements should encourage work rules that improve efficiency. At the same time, labor laws should aim to reduce strikes and conflict and establish minimum standards for remuneration and occupational safety.

Writing from a similar perspective, writers such as John Pencavel examined unions and labor movements in Latin America. He suggested that although unions can help promote democratization and raise productivity, they often increase members' wages and unemployment for unskilled workers. Gains made currently by unions may also reduce investment, which in turn, leads to less economic growth and lower employment in the future.

Carola Pessino notes that despite structural reforms adopted in Argentina, employment growth has been slow while unemployment and wage differentials have grown. A number of factors may have led to high unemployment, but she believes that labor regulations also played some role. High payroll taxes, expensive severance payments, and rigid collective bargaining agreements have reduced demand for labor and also created obstacles to labor mobility and wage flexibility in Argentina.

Since Chile's labor laws and institutions were transformed during the period of military rule, they often figure prominently in discussions about the impact of labor reform in Latin America (Lear and Collins, 1995). Since the resumption of democracy, unions have fared better, although collective bargaining remains decentralized and the rate of unionization fell between 1991 and 1996. However, the government has taken

steps to promote talks between employers and unions, and these discussions have resulted in important policy changes.

Scholars cast doubt on the claim that strong labor standards have affected employment negatively. While labor-law reforms in the early 1990s increased employer severance payments for layoffs, job creation remained strong throughout the decade. These scholars argue that macroeconomic stability has been far more important in job creation than institutional factors (Fernandez-Kelly and Shefner, 2006).

Since the early 1980s, labor-market conditions have worsened throughout most of Latin America. Some researchers, such as Petras and Vieux, have focused on the IMF and other international organizations linked to the U.S. government in explaining the spread of adjustment programs throughout Latin America. They suggest that the U.S. companies pursued structural adjustment because these policies guaranteed U.S. companies greater opportunities in Latin America, while debt-service payment helped shore up a weak U.S. economy (Petras and Vieux, 1997).

Petras and Vieux's analysis of the political responses to neoliberal reform is considered by some to be unsatisfactory on several different levels. The authors fail to note that the impact and strength of political movements against neoliberalism vary from country to country. They provide little evidence to support their assertion that widespread protest against liberalization is spreading throughout Latin America (Petras and Vieux, 1997). The authors also fail to pay attention to organized labor's activities during the last two decades. If they included more information on labor movements, they might have noted that some unions have supported reform in exchange for certain wage and employment concessions.

Although Latin American countries attracting investment are higher in terms of uncertainty avoidance than their Chinese counterparts, project sizes are larger and tend to be more diverse, and there is greater private participation. This disallows the insurance of sovereignty and security over critical infrastructure. These projects tend to have relatively smaller shares of investments by other nations' state-owned enterprises, which is pro sovereignty. This could relate to collectivism considerations. But more work would need to be done to defend that.

As Doh has suggested, there are learning effects among countries in regions so that countries may follow patterns set by others in their regions (Doh, 2000). His conclusions suggest that initial approaches and investments in a newly open infrastructure market set a pattern not just for subsequent practices in that market, but also throughout the region. An additional factor is that the same principal foreign investors tend to participate in multiple projects within a given region. For example, as Doh's study suggest, companies such as Telefonía and France Telecom have been active investors in Latin America and have participated in multiple projects in the same countries (Doh, 2000). Hence, there are various results that have derived from regional homogeneity: early investments that set a pattern followed by later project transactions within a specific country, the participation of a limited number of investors in multiple projects who adopt similar practices in the range of projects in which they participate, and cultural homogeneity in the region would tend to increase the potential relevance of learning within one market and the region for valid transference within the region, despite evidence of greater project diversity in Latin America.

Latin American labor codes favor full-time indefinite employment over part-time, fixed-term, or temporary contracts. These types of contracts differ not only in the length of the employment relationship, but also in the conditions for termination. Latin American countries severely restrict the termination of a contract. Labor codes mandate a minimum period for notifying workers prior to termination, determine which causes are considered just or unjust causes for dismissal, and establish compensation to be awarded to workers for each possible cause of termination (Marquez, 1998).

Most Latin American nations retain strict labor regulations that make it difficult to dismiss employees. Hiring has become cumbersome. As a result of this, Latin American employers find it difficult to adapt to quickly changing economies and business demands. Employers in Latin America today are hamstrung by protectionist measures. In Nicaragua, it is insufficient grounds to dismiss an employee when somebody else does his work. Even in some countries where redundancy is a justification for dismissal, employers must notify and seek the approval from third parties, such as labor unions or labor ministries, before they fire someone.

The cost of firing an employee can be prohibitive. In Brazil, the combination of advance notice requirements, severance packages and penalties is the equivalent of paying three years of the fired worker's salary.

Hiring has also become costly. As soon as someone is hired, the employer has to pay payroll taxes and make social security payments to cover everything from a retirement fund to health and unemployment insurance. This is typical, even in the developed countries but, in the Latin American economy, economic development is

highly impacted. Today, such payments are two to three times higher in Argentina, Brazil and Colombia than in the United States or Norway (OECD, 1999).

According to World Bank data, Latin America suffers from the greatest imbalance by keeping strict regulations to protect those already employed and making it more expensive for employers to hire new workers (World Bank, 2006). Therefore, piecemeal jobs are created.

Today, an estimated 23 million people in Latin America are jobless and 103 million work in an informal job sector that includes people selling goods on the street as well as day laborers. In some Latin American countries, this informal sector makes up to 60 percent of the labor force. This labor crisis explains why in opinion polls, Latin Americans want jobs over anything else, including personal safety, and would even consider a system different from democracy if it gave them jobs.

Chapter Five

Business Funding in China and Latin America

A survey of private firms conducted in 1999 by the International Finance Corporation (IFC), the private sector arm of the World Bank Group, revealed that about 80 percent of businesses in China considered their lack of access to finance to be a serious constraint. They relied heavily on self-financing for both start-up and expansion. In the case of post-start-up investments, the sample firms continued to overwhelmingly depend on internal sources (World Bank, 2002). Among external funding sources, informal channels, credit unions, and commercial banks were about equally represented. Outside equity, including public equity, and public debt markets played an insignificant role.

As it is pointed out from the survey, internal sources tend to become less important as firms grow larger. External sources for the smallest firms are mainly informal channels and Chinese firms rely more on external sources of financing.

The state owned commercial banks in China control about 70 percent of bank deposits and make about 70 percent of loans (Mellor, 2004). SOEs account for 80 percent of outstanding loans while producing just one third of output (The Economist, 2004).

There have been extensive reforms that have been instituted in recent years to address many of the problems in the financial system. An example is the new regulatory

regime for bank lending, a shift from a funds constraint to what is viewed as a capital constraint. This has encouraged the development of a large-scale deposit gathering networks.

While an earlier rise over 1994-1997 reflected FDI inflows, there was a decline in the rate of increase up to 2000 following the Asian crisis. The recent incline reflects continuing FDI flows (Ryan, 2004). While China's exports have been growing strongly, so have its imports. About half of China's imports are employed in further processing and over 40 percent of China's exports embody imports (Prasad, 2004).

Theory proposes that international financial capital flows should provide for a more efficient allocation of capital, including a greater diversification of asset holding for investors. Inflows should encourage improved economic growth performance by augmenting domestic savings, lowering the cost of capital, and facilitating the development of local institutions (Prasad and Wei, 2005). For achieving the benefits from capital liberalization, it is critical to have prudential controls and regulations, a stable macro economy and a supportive institutional environment. China's access to FDI has allowed more of the upside benefits while compensating for the poorly performing domestic finance sector and problems with SOEs (Huang, 2003).

Enforceable trust reduces costs in social exchanges such as interpersonal loans and pooling of funds. In China's reform process, private entrepreneurs have found it very hard to obtain bank loans due to political discrimination. Thus, informal financial institutions similar to rotary credit associations (such as *biaohui*) have been very important channels for providing start-up capital or emergency cash for small-scale private businesses (Tsai, 2002). The fledgling market system implies that formal and

impersonal channels of information flow are sluggish. Thus, social networks are essential in channeling market information.

In sum, kinship networks confer all three types of social capital benefits for private entrepreneurs. These three are the following: protecting private property rights, reducing uncertainty and transaction costs, and building better bridges to market information and entrepreneurial opportunity. Kinship networks lower the entry barriers and raise the survival and success rates of private entrepreneurs.

Another reason why the Latin American informal networks are not as efficient as China's is because of the absence of opportunities for large segments of the population. The exclusion of some groups on the basis of their gender, ethnic origin, or social status explains why the Latin American economy is not as organized as China's. Instead of the informal networks stimulating growth in Latin America, it increases social exclusion.

Narrow bands of trust preset small businesses with hard choices. Low-trust societies are at a disadvantage in a global market place. The reason is because foreigners cannot be trusted in those societies. Growth only occurs sometimes when extended family members could be brought into the managerial ranks of organization expansion. Low-trust economies not only have limited opportunities for growth within their own intra-organizational networks, the narrowness of relational activity negatively impacts opportunities and well being of others in those communities. Most modern liberalized democracies are not hindered by cultural, bureaucratic, elitist, religious restraints.

Latin America is a region with serious problem of poverty and lack of equity, which affect vast sectors of the population. As a result of this situation, it has been considered the continent with greatest levels of inequality. The mobilization of culture

can be a very valuable factor in the fight against poverty. The poor lack material wealth, but they do store an immense amount of culture that goes back for hundreds of years. Respect for their culture will help create favorable conditions for making use in social programs of their accumulated knowledge and traditions.

Latin America is growing at a pace above its historical average, within the context of a strong global economy. Despite this growth, there are important divergences when it comes to evaluating the economies as a whole. The high growth that has occurred in recent years is concentrated in those countries that faced a very serious crisis at the beginning of this decade, including Argentina and Uruguay, which faced serious problems from 1999-2002 (Montiel, 2003). Venezuela confronted another economic crisis of a similar character in 2002 and 2003 (Economist, 2004).

The IMF warns that in the absence of more reforms, growth will slow down in the future. The IMF warns that Latin America is falling behind other emerging regions such as those in Asia, specifically China. The great challenge facing Latin American economies is to carry out reforms that not only prolong the current buoyant conditions, but also reduce obstacles to future growth.

There are three areas where Latin American countries need to commit to making reforms. They have to modify their tax and customs policy, since tax collections are at a very low level, and that leads to low budgets, which are tied to the problem of rigidity, which does not allow them to apply appropriate spending policy. In Latin America, the allocation of revenues toward specific goals and the obligatory nature of certain expenses jointly absorb a substantial proportion of the public deficit.

In addition, some governmental reforms are necessary in order to achieve more stable and less corrupt political systems. The IMF believes that growth in many Latin American countries will continue to be limited by the weaknesses of the State. The consequences of this weakness include deficient public services; a fragile judicial system; high rates of crime and corruption; tax evasion, and a sizable informal economy.

It is necessary for Latin American economies to undertake reforms aimed at achieving financial institutions that are stable and solvent, both in the public and private sectors. The most serious problem in Latin America continues to be the poor distribution of wealth. When it comes to poverty, the situation is not positive. Poverty rates remain extremely high. The data about the region's contribution to global GDP are clear, and other emerging regions. In 2003, Latin Americans contribution to global wealth fell to 4.3%, while China's grew to 3.9% (World Bank, 2006).

Chapter Six

Latin American and Chinese Economic Situation

These last couple of years has been good for Latin America's financial markets. Currencies in Brazil, Chile and Mexico gained against the dollar on speculation that local yields will maintain their attractiveness in anticipation of the US Federal Reserves halt as interest rates increases. A diversity of deals are continuing apace, from Colombia's \$1.13 billion buyback of dollars led by Goldman Sachs and Merrill Lynch to Mexican household goods manufacturer Controladora Mabe's sale of \$200 million in privately placed notes (Economist, 2004).

Despite the deals being made, these accomplishments are products of the region's financial performance, not its competitiveness. Unless Latin America becomes more competitive, it will become irrelevant in the global economy. The region's remarkable growth trajectory is unimpressive when one considers the decline at the beginning of the decade (Montiel, 2003). Also, Latin America is growing economically almost exclusively because of external factors, especially a growing world economy and high commodity prices.

The Latin American economy has grown at a five percent rate for the past five years, but China's has been growing at a 10% rate for nearly three decades (Hill, 2007). In terms of poverty reduction, the context is even starker. China cut poverty from 50% of

its population in 1970 to 19% presently. Latin America reduced poverty only from 43% of its population to 36% over the same period (Hill, 2007).

The Chinese, along with other Asian countries are guided by pragmatism and obsessed with the future, while many Latin American countries are guided by ideology and obsessed with the past. In an article written for the Washington Post, Oppenheimer relates the times he visited China and Venezuela. Upon arriving in China, he learned that top government officials had recently welcomed the entire board of directors of McDonalds. A few weeks earlier, while traveling in South America, he learned that the Chavez government had announced a three-day suspension of all McDonalds restaurants in Venezuela to teach multinationals a lesson. Ironically, while communist-ruled China is going out of its way to attract foreign investors, several nominally capitalist Latin American countries seem to be trying to keep investors away (Oppenheimer, 2008).

Latin America's most troubling trend is its stagnation in education, science and technology. While the Chinese are creating increasingly highly skilled labor forces, most Latin American countries have barely modified their outdated educational systems (Hill, 2007). An example that Oppenheimer provides in *Cuentos Chinos* about the difference in education is that in China, children in all public schools begin English-language classes in third grade, four hours a week. In Mexico, public-school students start studying English in the seventh grade two hours a week (Oppenheimer, 2005).

Latin America's global economic competitiveness ranks low and it is clearly eroding according to the latest rankings of both the World Economic Yearbook and the World Economic Forum's Global Competitiveness Report. The highest-ranking Latin American nation, Chile, comes in at 23rd in the latter report, with the next two places

occupied by Mexico at 55th and Brazil at 65th (WEF, 2007), China ranks 11th (Marshall, 2006).

Regrettably, Latin America has not yet built a sustainable culture of competitiveness. The region's historical development, the institutions it has created and the leaders it has produced for the most part, have impeded the establishment of healthy, thriving societies where self-reliance, good governance, social justice, democratic capitalism and effective and transparent institutions prevail, and institutions matter a great deal (North, 1993).

It is recognized that Latin America has made significant progress during the last two decades in a number of areas that relate to economic competitiveness. These areas include prudent fiscal and monetary policies, privatizations, economic liberalizations and primary school enrollment. However, as Eduardo Fernandez-Arias and Peter Montiel found in their study *Reform and Growth in Latin America: All Pain, No Gain*, there has been insufficient depth and breadth of macroeconomic reform and a lack of structural and institutional second generation reforms (Fernandez-Arias & Montiel, 2001).

If Latin America is to develop and sustain a culture of competitiveness, which is a necessity not a choice, in today's global economy, it needs to undertake a number of measures. First measure would be to expedite and intensify economic liberalization. It is important to ensure continued, deeper efforts to achieve macroeconomic reforms, including in areas where there has been slippage in recent years, such as public sector financial management and energy privatization. The second measure would be to adopt and implement second generation reforms. Prudent fiscal and monetary policies are necessary, but conditions are insufficient to achieve prosperity to all. Non-economic

measures to improve education, health care, housing, social services and infrastructure are essential.

Another measure would be to institute comprehensive microeconomic reforms. Microeconomic issues are the ones that are felt most directly by business, workers and consumers (The Gazette, 2007, March 30). Foremost among the microeconomic issues in need of reform are: regulations, taxation, administration of justice, labor, research and development and financial services. In the World Bank's "Doing Business in 2006," for business regulations in 14 countries, Latin America's poor performance is nearly as miserable as that of Africa. In Brazil it takes 152 different steps and five months to start a business versus less than two nights in China (World Bank, 2006). Regulatory burdens are most harmful to small business and start-ups, the largest private employers in Latin America.

Most tax systems in the region are characterized by high rates and low collection. Also, corporate tax rates are higher than those in China. This is why tax evasion and capital flight are rampant.

Latin American labor rules raise costs, create barriers to entry and introduce rigidities in the employment structure. These include the restrictive regulation on hiring and firing practices as well as burdensome social insurance schemes. While salaries may be low by industrialized nation standards, non-salary costs such as benefits, labor production taxes and severance can double the cost of labor. Hiring a worker is easy. Firing a worker is lengthy and costly.

Despite some progress, Latin America's banking industry is inadequate, conservative, complicated and cumbersome. For the most part, bank activity is

dominated by trading government paper. The financing that is provided is often in syndicate for large preferred borrowers. If it was not for the proliferation of credit cards and retailers providing credit to customers, such as Elecrta's Banco Azteca in Mexico, the working class would have even less access to consumer goods (Thompson, 2007).

Latin America is becoming increasingly uncompetitive in a competitive world. In *Cuentos Chinos*, a book by Miami Herald columnist Andres Oppenheimer, Argentine education minister Daniel Filmus writes, "for the past 30 years, Argentina has not had a culture of excellence, nor a culture of effort, nor a culture of hard work. Our culture has rather been one of cutting corners and trying to pass the grade rather than seeking excellence through effort, hard work and research" (Oppenheimer, 2005).

In historical context, the region's descent is even more revealing. Between 1880 to 1930, Argentina was one of the world's ten wealthiest nations. Before 1959, Cuba's economic and social indicators ranked among the highest in the world. While the world spread adoption of neoliberal reforms begun in the 1980's has been laudable and highly significant, it has not been enough to create global competitiveness. Meanwhile, China has extended, deepened and quickened their economic reforms during the past decade (Tyler, 2006).

Chapter Seven

Conclusion

This thesis has suggested that culture clearly matters for economic development. Culture is a dynamic process in and through which people define who they are, what they desire, and how they seek to realize their goals. From casual experience to formal analysis, it is evident that culture exerts real and effects on development outcomes and development projects. Ignoring culture has measurable consequences. Taking culture into account requires integrating information about culture into development economic analyses in an informed way.

The values of a culture have a decisive weight in economic development. Throughout this paper, it can be seen that there has been debate on the types of values, which have helped countries to attain sustained growth and significant social achievements. If the dominant values are concentrated on individualism, indifference to the fate of others, lack of collective responsibility, lack of interest in the general good, the pursuit of personal enrichment as the central value, consumerism, and similar goals, the consequent forms of conduct may be expected to cause serious harm to the fabric of society and to lead to all kinds of regressive effects, ranging from severe economic inequity. This gives rise to serious hindrances to sustained economic development.

Research affirms the importance of cultural understanding to the development of partnership with international constituents (Baldauf, Cravens, and Wagner, 2000). I hope

to have accomplished my reasoning as to why China has passed Latin America in the economic aspect by using economic culture. China has strong cultural ties with three of the industrialized economies (Hong Kong, Taiwan, and Singapore). These ties go beyond sharing a common language, since the majority of people in these source regions are ethnic Chinese.

In review, the success of China in attracting FDI has been attributed to a variety of factors including market size, low costs of labor, liberalized FDI policy, political stability and improved infrastructure. While these factors do to some extent facilitate large inflows of FDI, less emphasized are China's natural sources. Although policy measures that improve political and macroeconomic stability as well as business environment are always at the disposal of policy makers, many natural advantages are country specific. The part of FDI in China that is due to natural advantages such as culture is not likely to be reproduced by other countries through economic policy (Marshall, 2006).

Latin America is a major player in the world economy. Although there are numerous national distinctions, the countries can be thought of as distinct region, sharing significant cultural, linguistic, political and economic characteristics. However, the region is typified as developing. The region is characterized by deep-seated difficulties in creating locally owned, innovative industries based on scientific and technological knowledge.

Enterprises in Latin America seem to have a culture that limits their ability to cooperate, especially when trying to make new innovations. Unfortunately, the state tends not to send clear long-term signals favoring the need for innovation and sponsoring

the elements that make it happen. Latin America tends to have a culture where information is hoarded, not shared. This results in a duplication of efforts, underutilization of available resources and a mismatch between supply and demand. Industrial innovation in Latin America faces significant and deep-seated difficulties.

In Latin America, the concept of the informal sector was readily adopted by the ILO's Regional Employment program, known by its Spanish acronym PREALC. The economic goal of informal enterprise is to ensure the survival of the individual and his or her immediate family in contrast to the goal of capitalist enterprise, which is to generate and accumulate profits (PREALC, 1981). This view was negatively looked on because informal enterprises were depicted as a simple survival mechanism.

An alternative theory of informality was attributed by Hernando de Soto. He attributed the origins of informality to excess regulation of the economy. According to this view, the mercantilist Latin American state survives by granting the privilege of legal participation in the economy to a narrow elite. De Soto argued that popular disregard for legal restrictions leads to de facto deregulation of the economy. More than a survival mechanism in response to insufficient job creation, informality also represents the irruption of real market forces in an economy straight jacketed by mercantilist regulation.

The role of personal networks and institutional involvement as facilitators of FDI should not be overstated. The prevalence of personal networks and institutional involvement would probably discourage foreign investors who lack the appropriate links from entering the regions, which would hamper the creation of a fair investment environment in the long term. However, my point in this thesis is that the use of personal networks and institutional involvement can provide an alternative way to solve some of

the problems that underdeveloped regions face. For a transitional economy, this could be a practical and feasible solution to current regional problems.

It is still too simplistic to attribute the different economic performance between China and Latin America solely to cultural differences. In other words, Confucianism cannot be the only answer to China's past success and for Latin America, the Ibero-Catholic culture is not the single cause of its relatively bad economic performance.

However, the cultural approach has opened a door for us to see why economic performance is different among regions and countries. As Alvin Y. So and Stephen W.K. Chiu point out, the cultural approach is not aimed at reducing economic development to a set of cultural traits (So, and Chiu, 1995). Rather, it relates development policy options and institutional choices to certain cultural antecedents that make the reason for such elections easier to be understood. In other words, cultural perspective provides researchers with a frame of reference within which they can see how values, attitudes, practices or behaviors have influenced economic development in China and Latin America. This can be seen in the differences between family businesses in China and Latin America. For example, as suggested by Brenes and Madrigal, in Latin America, if family members strengthen their focus on the business philosophical area and family integration, difficulties commonly found in family businesses would not be expected to lead to family conflict and disruption (Brenes and Madrigal, 2003).

Culture plays an important role in economic performance, as it can affect people's behaviors and attitudes towards savings, education, work ethic, and so on. Of all the factors determining economic performance, economic factors always stand on top.

Each culture has its own unique positive or negative components, but the positive ones cannot automatically create better economic performance in the absence of other necessary conditions like sound economic policies, effective institutions, favorable world economic situations, and political stability. In other words, only in a favored economic and political environment can culture trigger economic growth. This point might help explain why China made remarkable economic achievements during the past decades of economic reform.

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