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UNCOVERING CONTROL MECHANISMS IN CONTRACTUAL  
JOINT VENTURES IN CHINA

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**Abstract**

This paper aims to examine the control mechanisms within CJV non-equity alliances, enhancing our knowledge of one of the most important yet least understood form of foreign investment in China. The findings also help foreign investors to better understand how to use CJVs as an organizational vehicle to enter Chinese market.

**Keywords:** Control Mechanisms, Joint Ventures, China

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**1. Introduction**

The unprecedented scale of economic reform in China since 1979 has attracted a vast amount of foreign direct investment (FDI) flowing into the country. Throughout the reform era, there are three major forms of FDI prescribed by Chinese government, comprising Equity Joint Ventures (EJVs), Contractual Joint Ventures (CJVs) and Wholly Foreign Owned Enterprises (WFOEs). But EJVs and WFOEs have received far greater attention than CJVs (Pan and Chi, 1999; Wang and Nicholas, 2005; Wang, 2007). Researchers often find it difficult to study CJVs because of the ambiguity of its legal status and flexibility of

contracting form between foreign and Chinese firms (Wang, 2006). There are two key differences between EJVs and CJVs. First, an EJV in China is a limited liability company with equity capital and corporate control shared by foreign and Chinese partners (Pan and Tse, 1996; Wang, 2007). But unlike EJVs, CJVs in China often do not have independent legal status, and each party cooperates as a separate legal entity and bears its own liabilities (Luo, 1998; Wang, 2007). Second, EJVs in China conforms to the conventional type of equity alliances, in which the partners involved share profits and losses according to their respective equity contribution. The share of corporate control is often reflected in the

distribution of senior management positions, which is also determined by each partner's equity contribution to the JV alliance. But in CJVs, the terms and conditions regarding the pattern of a CJV partner's contribution, profit distribution, and management control are all negotiated between the Chinese and foreign partners rather than based on each side's equity investment (Wang, 2006). Because of these differences, Pearson (1991) points out that the CJV in China is not strictly a joint venture and Wang and Nicholas (2005) conceptualize the CJV as a non-equity inter-firm alliance rather than FDI. The lack of a clear ownership structure and the non-equity nature of CJV partnership make it difficult to uncover the mechanisms of control over the CJV by both partners, which explains significantly why the Western investors are reluctant to enter CJV arrangements with Chinese firms (Wang, 2007). This paper aims to examine the control mechanisms within CJV non-equity alliances, enhancing our knowledge of one of the most important yet least understood form of foreign investment in China. The findings also help foreign investors to better understand how to use CJVs as an organizational vehicle to enter Chinese market.

## **2. Research background**

The Contractual Joint Ventures (CJV) was among the first form of foreign capital involvement after China embarked on a market-oriented economic reform in the late 1970s and throughout the 1980s its percentage share of realized FDI in China was much higher than EJVs and WFOEs, the other two forms of FDI recognized by Chinese government (Wang, 2006). CJVs' importance at the national level declined since the 1990s, but it remained more popular in southern Chinese province of Guangdong, where the majority of CJVs were located and were founded between small-to-medium Hong Kong manufacturing firms and township and village enterprises (TVEs) in Guangdong (Wang, 2007). TVEs are collectively rural enterprises that are encouraged by township and village governments as an important channel to achieve rapid industrialization in China's rural areas (Chen, 1998). In Guangdong, the village chiefs are often concurrently the managers of local TVEs, and they often have strong kinship and family ties with Hong Kong, making them attractive business partners for Hong Kong SMEs.

Throughout China's economic reform, Hong Kong has been the number one source of FDI and the neighbouring Guangdong province the number one destination, especially for export-oriented labour-intensive industries (Pearson, 1991; Wang, 2007). Most Hong Kong firms compete continuously in the low-price segment of a wide range of consumer products manufacturing, and one

of the key success factors in these industries is the speed with which they can deliver their products to their Western customers or switch production to meet the changing demand patterns. To reduce the production costs and enhance their flexibility, by the early 1990s, four-fifths of Hong Kong manufacturing firms had relocated to Guangdong especially the Pearl River Delta area, which resulted in the manufacturing hollowing-out in Hong Kong and economic takeoff in Guangdong (Huang, 1998). Working with Chinese firms in Guangdong, Hong Kong firms concentrated increasingly on manufacturing-related services such as marketing and logistics, leaving manufacturing activities to be completed in Guangdong.

When choosing between different forms of engagement with Chinese firms, Hong Kong firms have preferred CJVs over EJVs and WFOEs for a number of reasons. First, the CJVs are easy to set up. Compared to EJVs and WFOEs, CJVs are subject to minimal bureaucratic and administrative barriers. Approval for the establishment of a CJV can be obtained at the county level, avoiding the multi-levels of provincial and state screening that is typically required for establishing an EJV. The establishment procedures for CJVs are also much less time-consuming than for EJVs (Wang, 2007). Second, the CJV non-equity partnership allows Hong Kong firms to contribute technology, equipment, managerial know-how, with no requirement on capital investment; and that is crucial for Hong Kong SMEs without substantial capital. Third, not only the entry barrier is lower but also the exit costs are far less than EJVs or WFOEs. In addition to the absence of requirement for large capital injection into the CJV, the CJV contracts allow the Hong Kong partners to terminate the partnership quickly by paying out their local partners with products, machinery and equipment for rent, utilities and labour (Wang, 2006). Finally, cultural affinity with Guangdong TVE partners also reduces the transaction costs in operating the CJVs for Hong Kong SMEs (Wang and Nicholas, 2005). In summary, the flexibility of CJVs' non-equity contracting forms provides Hong Kong firms with an ideal form of collaboration with Chinese TVEs in Guangdong to meet flexible production requirements (Wang, 2006).

Without a limited liability status, most Hong Kong-Guangdong CJVs establish a joint management committee instead of a board of directors (Wang and Nicholas, 2005). Similar to the function of a board of directors, the joint management committee is designated as the highest decision-making authority responsible for all major issues such as termination or expansion of the venture, the timing and amount of profit distribution, and wage payments (Pearson, 1991). However, differing from a board of directors in an EJV, whose main function is to monitor the

management, the joint management committee of a CJV is charged with the responsibility of both monitoring the management and overseeing the daily operation of CJVs. Therefore, the joint management committee has real control over both strategic and operational issues.

Previous research has shown that the distribution of the joint management committee members conformed to the 1995 Implementation Rules of the CJV Law and favoured Hong Kong over Chinese partners roughly 2:1 (Wang, 2006). In practice, the joint management committee rarely voted on decisions; rather, members from both sides emphasized on reaching unanimous agreement on important decisions through negotiations and conciliation (Wang, 2006). Previous research also found the chair of the joint management committee was often concurrently both the general manager of the CJV and the chair and general manager of the Hong Kong parent (Wang and Nicholas, 2005), and other Hong Kong members on the joint management committee also held senior management positions such as financial manager and sales manager at CJVs (Wang, 2006). With the unequal representation on the joint management committee and the unclear ownership structure of CJVs, how Chinese partners pursue their interests in the CJV and how Hong Kong partners maintain their dominance in control, the remaining of the paper aims to uncover the control mechanisms through which both parents used to align CJVs' interests with those of parents.

### 3. Research method

The nature of this research is exploratory, which requires first-hand data from inside CJVs. There are no published data on Sino-foreign JV's corporate control system (Huang, 1998). The standard positive theory testing approach using large sample survey data is not suitable for this research as it misses the 'test of realism', which should be the aim of international joint venture research (Parkhe, 1993).

On the other hand, although case study is appropriate for deeper understanding of the dynamics in managing inter-firm alliances, they are limited by the representativeness of the phenomenon under investigation (Wang, 2006). For this paper, I adopted a cross-case study method that allows a few research questions to be studied by analysing multiple firms, with large enough sample size for statistical testing (Berg, 1998). This research design is also consistent with previous studies on CJV operations (Wang and Nicholas, 2005; Wang, 2007)

While the geographical and industrial distributions of EJVs in China vary substantially, the overwhelming majority of CJVs have been concentrated in export-oriented consumer products

industries and formed mainly between Hong Kong SMEs and Guangdong TVEs (Wang, 2006). This paper therefore focuses on studying the control mechanisms of Hong Kong-Guangdong CJVs. To gain insights into the dynamics of change in the CJV control mechanisms, the cross-case study involves two separate rounds of structured interviews with Hong Kong-Guangdong CJVs to construct longitudinal database.

The first round of interviews was conducted in 2000 with 65 randomly selected firms. The sample firms were concentrated in consumer goods industries such as textiles, footwear, toys and household electrical appliances, reflecting the competitive strength of Hong Kong-Guangdong manufacturing firms in international market. I first identified seven most commonly used mechanisms by Hong Kong and Guangdong parents in controlling and monitoring CJV operations through 13 unstructured interviews. I then interviewed and asked managers at 65 sample firms to rank, on a 1-5 point Likert scale, the frequency of the use of those control mechanisms by both CJV Hong Kong and Chinese parents. The frequency of the use of control mechanisms is denoted by: 1 (less often than every half a year), 2 (more often than every half a year and less often than bimonthly), 3 (more often than bimonthly and less often than monthly), 4 (more often than monthly and less often than weekly) and 5 (more often than weekly).

In 2006, I tried to revisit the 65 CJVs but was unable to get access to 10 firms that I interviewed in 2000. Thus, the final sample for the research comprises 55 CJVs that I was able to interview both in 2000 and 2006. Wilcoxon test was performed as a one-sample t test for matched pairs of the two rounds of interview data with the same set of sample firms. As a non-parametric test, it takes account of the size of differences in each pair of scores by ranking and then summing those with the same sign (Bryman and Cramer, 1997; Sirkin, 1999). If there are no differences between the two sets of related scores, then the number of positive signs should be similar to that of the negative ones. This test was used to determine if the frequency of the use of various control mechanisms had changed over time. The paper reports the findings from these two rounds of interviews with 55 CJVs.

### 4. Research findings

In inter-firm alliances, control mechanisms help minimize opportunism, influence partner behaviour by rewarding long-term orientation and commitment, potentially enhancing alliance performance (Beamish and Banks, 1987). In the context of Hong Kong-Guangdong CJVs, control mechanisms ranged from direct contact between executives of the parent and the CJV, to informal control through socialization of CJV managers.

Table 1 lists CJV partners' most often used direct control mechanisms (including telephone and fax contact, regular written reports from the CJV, parent executives' visits to CJV and formal meetings with CJV personnel) and indirect

mechanisms (including arranging CJV personnel to visit parents, running management seminars and training, and organize informal meetings in social occasions) both in 2000 and 2006.

**Table 1.** The frequency of control mechanisms used by CJV partners

	Hong Kong partners		Guangdong partners	
	2000	2006	2000	2006
<b>Direct mechanisms</b>				
Telephone & fax contact with CJV personnel	4.8	4.2*	3.0	2.6*
Visits of parents' executives to CJV	4.4	3.9*	3.1	2.6*
Formal meeting with CJV managerial personnel	4.2	3.7*	2.6	2.2*
Regular written reports	3.8	4.4*	3.0	3.8*
<b>Indirect mechanisms</b>				
Run management seminars, workshops, etc.	3.0	4.1**	1.7	1.8
Organize informal meetings in social occasions	2.5	3.5**	1.8	2.0
Arrange CJV managerial personnel's visits to parent	1.4	3.3**	1.0	1.3

\* Significance levels of change between 2000 and 2006 (Wilcoxon tests,  $P < 0.1$ )

\*\*Significance levels of change between 2000 and 2006 (Wilcoxon tests,  $P < 0.05$ )

The first finding from Table 1 is that across all the seven direct and indirect mechanisms, Hong Kong partners exercised greater control both in 2000 and 2006. According to interviewees, most local partners of CJVs had the belief that Hong Kong partners possess more technological, managerial, and marketing know-how, which explains also why Chinese partners did not pursue equal representation on the CJV joint management committee. As Wang (2006) pointed out, the vast majority of CJVs' local partners are TVEs, whose main concern were their financial return and employment opportunities created by CJVs. As long as their financial return and job prospects were assured, the local TVE partners were willing to play a secondary role in managing the CJV daily operation.

Second, the direct control mechanisms are essential for JV partners to align the JV's interest with the parents' interests. But the cost of direct control mechanisms can be high because the implementation of these mechanisms may incur substantial overheads and managerial effort. For both Hong Kong and Chinese partners, telephone and fax contact was the most powerful means of aligning its interests whether in 2000 or in 2006. But Hong Kong partners used this mechanism more often than Guangdong partners, reflecting a higher degree of formal control over the CJV operation by Hong Kong partners. Sometimes telephone contacts between CJV and Hong Kong office were as intense as six times an hour and a call could be as long as half an hour. Fax was also used frequently for transmitting order-taking, order-processing, product testing, shipping, and customs documents.

Not surprisingly, the telephone expenses occupied the first place in many of the CJVs' overheads. Over time, Table 1 shows there was a significant decline in the use of telephone and fax as a direct control mechanism by both Hong Kong and Chinese parents. Given the phone call between Guangdong and Hong Kong was charged at international rates, enormous savings were made when such direct control was reduced.

Other most frequently used direct control mechanisms include visits by parent's executives to CJVs and formal meetings with CJVs personnel. The Wilcoxon tests show that there was a significant decline of the use of these direct control mechanisms over time. According to the interviews, a main reason for such changes was because over time more CJVs were managed by professional managers who were recruited from market and had no organizational loyalty towards either parent. These professional managers are often younger and better educated than older generation of CJV managers assigned by Hong Kong or Guangdong parent companies. These professional managers are more capable of managing the CJV daily operations but also demand more autonomy in their management decision-making. Consequently, the visits by parents' executives to CJVs as a means of control became not only less needed but also less welcome. The management of a CJV in 2006 resembled more closely the management of an EJV, where the organizational boundary between parents and the JV was more clearly defined. These professional managers prefer the use of business reports and resent the direct monitoring by parent firms' executives whether through the visits or via

the meetings. Consequently, as Table 1 shows, the use of written reports increased significantly between 2000 and 2006, in contrast to the significant decline of parent firm executives' visits to CJVs and meetings with the CJV managerial personnel.

Third, as a non-equity based alliance, neither side of CJVs can solely exercise its management power through direct control. Indirect mechanisms are also crucial elements for the successful control. The most frequently used indirect mechanisms conducted by the CJV parents include running management seminars and workshops, informal meetings, and inviting CJV managerial personnel to visit parent companies. These mechanisms fostered a kind of cultural control or control by socialisation (Fenwick, De Cieri and Welch, 1999). The design of informal mechanisms cannot be reduced to simple rules, since they seek to build commitment rather than establish rigid bureaucratic control. Therefore the implementation of indirect control mechanisms fosters trust between the CJV and the parents. Compared to direct control mechanisms, indirect control mechanisms based on trust between partners can be more cost-effective.

Table 1 shows the indirect control methods, such as management seminars and informal meetings, were less frequently used than direct mechanisms in 2000. However, by 2006 there was a significant increase of the use of informal control mechanisms, suggesting there was no significant increase of trust level between CJV partners. Consistent with previous research findings, the results indicate the major source of trust between CJV partners was more character-based than process-based (Wang and Nicholas, 2005). Trust between CJV partners was largely embedded in the shared social identity and cultural background of the individual managers from the two sides. Long-term association with each other seems to have little impact on the trust variable; as a result it is not surprising to see that over time many CJV partners still relied on the same level of informal control.

Finally, when taking control variables into account, the Mann-Whitney tests show that age poses a significant impact on the use of informal meetings in social occasions as a control mechanism by both sides. It was found that the older CJVs (established before 1990) used this informal mechanism significantly more often than the new CJVs (established after 1999). Many Hong Kong partners of old CJVs were small family business used to running their companies in a close family relationship. These CJVs did not establish a clear hierarchical structure for control. When moving to Guangdong, these Hong Kong family factories extended their family relationship to kinship in their hometown or home village as a control mechanism. As these old low-tech CJVs spread into the villages of the Pearl River Delta, it

was common that the Hong Kong general managers had the same family names as their local counterparts. These local managers often had some degree of ancestry connections, if not immediate blood ties, with the Hong Kong investors.

During my interviews with these CJVs, many were conducted at restaurant tables in the presence of both partners' top managerial staff. The interviews were sometimes interrupted by the conversation among managers themselves, the atmosphere of which was more like a family meeting than a business talk. In fact, for these CJVs, many important company decisions and business negotiations were completed at Cantonese style morning tea and evening tea (*Yum Cha*) rather than in the company office. In these companies, formal titles were seldom used. Familial family names were commonly heard instead, making an outsider confused about the actual family and ethnic relationship between Hong Kong and local managers. It was exactly such extended family and ethnic connections that promoted and preserved the business relationship between Hong Kong and Guangdong partners in these old and low-tech labour intensive CJVs.

Similar to the phenomenon of ethnic trading network described by Landa (1994), the CJV Hong Kong and Guangdong partners were knitted together through shared values and norms of an ethnically homogeneous group. What underpins the survival of such CJVs are the cultural affinity which fostered character-based trust relationships between the family members and their immediate relatives and kinsmen/kinwomen. The bonds between Hong Kong and Guangdong partners were based on the same native place-type networks typical of the Chinese family business, which have been widely studied (Hamilton, 1991; Kuo, 1996; Redding, 1996; Wong, 1996). These family and ethnic networks are a mechanism for reducing transaction costs in hostile or uncertain environments, such as that represented by the inadequate legal and contractual infrastructure of China. As a result, organizing informal meetings in social occasions were cost-effective and hence more heavily used by such CJVs, serving as a 'social mechanism' (Casson, 1990) for the conduct of inter-firm collaboration in the Chinese context. This informal mechanism provided an effective means for 'cultural control' (Fenwick *et al.*, 1999) especially before 2000 to reduce the risks associated with the policy uncertainty through the mediation of personal and social relationships. In other words, the existence of a strong character-based trust reduced the need for strong institutional support for CJV cooperative relationship. Boisot and Child (1996, 1999) described this kind of Chinese economic order based on clan or kinship ties as 'network capitalism', similar to the 'alliance

capitalism' as found in the social organisation of Japanese business (Gerlach 1992).

## 5. Conclusion

Among the three major forms of foreign direct investment (FDI) in China, Contractual Joint Ventures (CJVs) are understudied. Representing quasi-hierarchy alternative to conventional EJVs, CJVs are a non-equity alliance rather than FDI, employed mainly between Hong Kong small manufactures and township and village enterprises in the South China province of Guangdong. The non-equity nature of CJVs makes it difficult to understand how Hong Kong and Chinese parent companies control the CJV operation. This paper fills a gap in our knowledge about the corporate control mechanisms of one of the most important forms of foreign investment prescribed by Chinese government.

The findings have some implications both for the JV literature and the practitioners. First, the existing theories on international joint ventures (Harrigan, 1988; Hennart, 1991) are inadequate to explain the control structure of CJVs in China. Conventional wisdom is that control in JVs is the function of equity ownership (Hennart, 1988). In CJV non-equity alliances, however, parents have joint ownership of the venture and control rights are not clearly derived from the respective equity ownership of parents (Wang, 2006). Thus the real control issue in CJVs concerns mainly how partners exercise their control over the joint subsidiary by using a range of direct and indirect control mechanisms without the underpinning of equity ownership shares. In contrast to the traditional view that non-equity cooperative joint ventures do not have a separate organizational life (Contractor and Lorange, 1988; Tallman and Shenkar, 1994), this research challenges the existing JV literature to capture the underlying control mechanisms in a wider array of non-equity based alliances. Second, this paper found the use of direct control mechanisms was generally more frequent than the use of indirect mechanisms in CJV non-equity alliance. But CJV partners place significantly more emphases on indirect control mechanisms over time while the significance of direct mechanisms declined. This suggests that to effectively manage the CJV non-equity alliances, foreign partners should consider both the formal and direct control mechanism as well as informal and indirect mechanisms to foster the level of trust between CJV partners. CJVs provide a government-recognized form of foreign investment in China and possess some attractive contracting attributes such as low entry and exit barriers. But the challenge, especially for Western investors who are not familiar with this form of cooperation with Chinese firms, is to understand how the CJV operation could be better

managed and controlled. This paper represents the first step towards uncovering the control mechanisms commonly used by Hong Kong and Chinese firms in running CJV non-equity alliance, future research should examine the relationship between the use of different control mechanisms and the CJV performance.

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