Mounting Difficulties for Doing Business in Xi Jinping's China

Multinational corporations are facing increasingly difficult conditions for doing business in China. If executives can adjust their expectations and play smart, they can win in China in the long term.

By Paul Haenle

The rise of Chinese President Xi Jinping has brought to bear a foreign business environment that is at once every CEO's dream and nightmare. On the one hand, the world's second largest economy and consumer market weathered the global financial crisis with urban and rural disposable household incomes increasing faster than the nation's higher than average GDP rates and a new leader emerged with extensive authority and confidence. Officials in Beijing have demonstrated their determination to meet annual growth targets and boost consumption rates as a share of total output, while they attempt to rein in risks in the shadow-banking sector and liberalize the financial system. Leaders are looking to foreign expertise as they invest massively in urbanization, green technology, and clean energy; upgrade the manufacturing industry; and meet the healthcare needs of an aging population.

Yet, multinationals face two significant challenges in

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the current Chinese business environment. First, China is no longer the low-cost, underdeveloped market it was when many multinationals entered it. The boom years following China's opening, when foreign investment and expertise were indiscriminately welcomed, have come and gone. As China's economy slows and wages rise, multinationals are undergoing a normalization of treatment and experiencing a fall in profit margins. Chinese business partners are becoming more sophisticated and increasingly assertive in their profit sharing negotiations. Foreign businesses must adjust their expectations.

A more worrisome challenge is the increasing scrutiny and targeting of multinationals face under Chinese authorities. The broader disruptive force behind this downturn in China's foreign business environment is Xi Jinping. Since his appointment to office in November 2012, Xi has

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launched a campaign to realize the "rejuvenation of the Chinese nation" by the end of his decade-long term. Xi is attempting to push through structural reforms that will modernize China's outdated economic and governance models. The range and depth of these reforms are unlike any the country has faced since the opening of the economy three decades ago.

Xi seems to be supporting the asymmetric use of China's Anti-Monopoly Law to target foreign partners and multinationals in order to advance industrial policy objectives and support domestic companies. This appears to be the case in the uptick of accusations against prominent multinationals, most recently those in the auto industry, of price-fixing and unfair competition by the National Development and Reform Commission (NDRC), China's powerful state planning agency.

Additionally, China's State Administration for Industry and Commerce (SAIC) has gone after Western technology and consulting companies with great zeal in recent months. Chinese officials have long held suspicions about American information technology and communications products, but Edward Snowden's revelations of US government surveillance of Chinese entities and executives, and the indictment of five People's Liberation Army officers on cyber espionage charges directed against American businesses have compounded problems for Western technology companies.

In Xi's perspective, implementing a broad and complex reform agenda, though highly contentious, will be vital to the survival of the Communist Party (CCP). In preparation for the resistance to reforms expected among vested interests within the system, Xi has tightened the political and intellectual environment and unleashed the most far-reaching anti-corruption campaign in the nation's history. The anti-corruption campaign has also been used to target corporate executives of large, high profile Western companies.

In this more difficult business climate, the instinct among many executives will be to cut corners, or view China as no longer a priority market. Others will be convinced they are helpless in the face of Chinese scrutiny. Following any of these roads would be a mistake. The risks in Xi's China are significant, but not insurmountable. There are steps that every foreign executive can take to decrease the chance that their company becomes a target. Indeed, Xi's strength and determination to see through his agenda should spur optimism among foreign business leaders.

The best practices outlined below can help MNCs navigate this sensitive transition period in China and secure their stake in what China could offer if Xi's reforms succeed: a more open Chinese economic and investment environment, stronger rule of law, and access to the greatest single national contribution to growth in global consumption.

Economic Reform Progress and Upcoming Agenda

At the Third Plenum of the 18th Chinese Communist Party Congress in November 2013, Xi Jinping laid out his comprehensive reform agenda. Arguably the two most significant components were commitments to give the market a "decisive" role in the Chinese economy and to create a national economic reform decision-making small group, which Xi himself will head, to oversee reform implementation. The leadership acknowledged that too much government intervention in the past has led to low efficiency and corruption, and pledged to address these and other concerns through proposals in a number of policy announcements over the course of the year.

In the Third Plenum's policy document, known officially as "The Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms," the government

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set reform objectives to reduce the role of the state in the economy; give farmers more property rights and equal opportunities to urbanize; further open the financial sector; accelerate the implementation of market-based interest rates and the convertibility of the renminbi capital account, as well as establish a deposit insurance system; require state-owned enterprises (SOEs) to return greater dividends to the government; build more free trade areas and accelerate negotiations on mutual investment treaties with other countries; promote market prices for water, oil, natural gas, electricity, transportation and telecommunications; and reform the tax system.

The government also released an urbanization plan for 2014-2020 that commits over one trillion RMB to expanding transportation networks, urban infrastructure and residential housing. The government also announced intentions to relax some housing registration restrictions in order to urbanize 100 million additional migrant workers, further spurring domestic consumption. The success of the urbanization plan's objectives, many say, will rely greatly on the effective implementation of tax and land rights' reforms.

At the Politburo's annual mid-year review, Xi reaffirmed the leadership's commitment to maintaining growth (set to reach around 7.5% for 2014) by employing targeted stimulus measures as needed while reforms are implemented. Although some analysts have pointed to monetary stimulus measures as signs that the government is not serious about slowing growth in order to focus on quality and reform, Xi and his colleagues appear confident that sustaining growth can be consistent with reforms. The leadership also reviewed their progress on economic reform, which has seen the first concrete steps in areas such as financial market liberalization. Following a July 2013 announcement to drop restrictions on lending rates, officials announced in March 2014 plans to carry out deposit rate liberalization in the next one to two years; create a deposit insurance, and set up a trial of five private banks to provide financing for small and private businesses. The government also doubled the RMB trading band from 1% to 2% daily, and allowed its first domestic junk bond and corporate bond market defaults.

Other policy announcements of significance to foreign businesses that have emerged include a September 2013 notice by the People's Bank of China that widens the ability for approved foreign investors to use RMB for activities to expand investments in Chinese financial institutions; a February 2014 State Council notice which will reduce the requirements for registering capital and simplify those for incorporation; the 2013 legislative plan of the National People's Congress that identified the Anti-Unfair Competition Law, the Cooperative Joint Venture, the Wholly Foreign-Owned Enterprise, and the Equity Joint Venture laws as priorities for the coming five years; and a July 2014 SASAC announcement of a pilot program to introduce private ownership and address management inefficiencies at six SOEs.

In order to address resistance to more contentious reforms such as those aimed at peeling back the power of SOEs, Xi is using the central leading small group to comprehensively deepen reform and six newly-created teams under it to push economic reforms not only from the top-down, as his predecessors have tried, but also from the bottom up through mobilization of the base. At least 800 "deep reform" local reform groups have been formed across the country, motivated to compete not only to create reform and pilot programs, but also to demonstrate their commitment and successful implementation of reforms. These new incentives at the local government level, where oversight and accountability are scant, could be the difference that allows Xi's reforms to overcome the great challenges to his reform ambitions.

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Similar competitive pro-reform incentives are being used in efforts to liberalize trade and investment. The Shanghai Free Trade Zone (FTZ) was established in August 2013 as a means for the Chinese government to create a competitive reform dynamic in other areas of the country, and an opportunity to experiment with the liberalizations needed to eventually conclude a Bilateral Investment Treaty (BIT) with the US and join the Trans Pacific Partnership Agreement (TPP). The zone itself offers business leaders an idea of what Beijing hopes regulatory reform across China can eventually achieve, including its streamlined capital registration and corporate establishment, unrestricted foreign currency exchange, discretionary capital accounts settlements and advanced dispute resolution. The zone was launched with the government's first, very significant, use of a negative list system to foreign investment, allowing foreign investors equal treatment in any industry not explicitly prohibited by the list. The list was revised in July 2014 to eliminate an additional 27% of restricted industries, reducing the total from 190 items to 139. The degree to which the zone's list is shortened in the future could serve as one measure of the depth and speed of China's broader liberalization plans. Many analysts have compared the zone to how liberalizations modeled in the 1980s Special Economic Zones were eventually adopted by the entire country.

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taken. Further progress in implementing reforms in the Shanghai FTZ, liberalization of deposit interest rates, and a broader shift away from anti-corruption investigations toward the use of structural reforms, such as limiting executive pay, in order to achieve reform objectives, should be closely monitored as important indicators of prospects on achieving broader reform aims.

Backsliding on Governance, Expectations for the Fourth Plenum

Much attention has been paid to Xi's anti-corruption campaign, which last year disciplined 182,000 officials and has stepped up investigations in the first half of 2014. Xi has linked the fight against graft with structural reforms that seek to transform the relationship between the government and markets. The launch of the investigations into former Politburo Standing Committee Member Zhou Yongkang and former top PLA general Xu Caihou, demonstrated Xi Jinping's unusually broad and quick consolidation of power and authority, even among notoriously powerful factions like the military, security apparatus, and the petroleum industry. These high-level investigations changed the unwritten rule that former Politburo Standing Committee leaders are not to be investigated after their retirement.

The motivations and intentions behind the anti-corruption campaign remain uncertain. Critics are well justified in viewing this opaque crackdown as ultimately serving Party purposes, (improving the CCP's image and legitimacy and punishing political enemies) rather than a genuine attempt to improve governance. Certainly, the anti-graft campaign will remain unable to address the origin of corrupt practices in China without the establishment of credible and independent regulatory agencies and judiciary.

The Fourth Party Plenum in October 2014 offers the first opportunities for Xi to demonstrate a genuine will to address systemic corruption at its core. The introduction of processes to increase public participation in governance, create a more responsive system, improve transparency and create a more rules-based legal system would all be positive signs that the government's intentions go beyond Chinese power politics. Other reforms to the operations of the Party's Central Commission for Discipline Inspection (CDIC), such as a dual-leadership structure overseeing local inspectors, should be monitored for their effectiveness. A more established legal system could improve the treatment of foreign companies in China across the board, including those under investigation for anti-monopoly issues, which frequently face pressure and intimidation tactics from Chinese officials.

How to Navigate Risks in China

Navigating these challenges in the foreign business environment as Xi guides China through this difficult transition period will require sophisticated business leaders who are proactive, understand the domestic environment, and spend time in country to build strong relations. Above all, foreign companies must remember that they will remain easier and more effective scapegoats for political leaders looking to deter broader corruption in the industry or sector. Additional precaution will be required while reforms are underway.

- **Align yourself with the leadership's objectives:** As multinationals do in other mature and highly competitive markets, it is vital that foreign businesses in China now demonstrate their alignment with government goals and concern for the Chinese consumer. These objectives are made explicit in government documents such as the Five-Year Plan and National Party Congress and Plenum reports. Executives should develop robust outreach efforts to convey their contribution to government objectives, compliance with government policies, and support for the rise in Chinese well-being and lifestyle. Many companies have taken additional measures through corporate social responsibility efforts to give back to Chinese society, further building their support among powerful Chinese officials and agencies, as well as the Chinese public.

- **Review internal compliance procedures:** Anti-corruption investigations provide good reasons for companies to review their internal compliance procedures and risk monitoring activities, ensure that they are compliant with all relevant laws and regulations, and be cautious in areas of ambiguity. Business practices are changing and foreign companies cannot use other's non-compliance as an excuse for their own. Multinational companies should not expect international compliance policies to be adequate for their China operations—localized programs to address specific Chinese operations and environments are a must.

- **Prevent anti-trust and anti-monopoly issues:** The use of anti-monopoly legislation against foreign businesses is not explicitly prohibited under World Trade Organization (WTO) or other international trade and investment rules, and requires heightened awareness and precaution for foreign companies in politically sensitive segments, such as food safety, water, air, healthcare, and internet and information technology. Businesses can take preemptive steps to lessen their chances of targeting by assessing their pricing strategies and surveying for signs that officials or state media believe they are overcharging Chinese customers or taking advantage of the Chinese consumer. Industries with a reputation of anti-monopolistic practices or excessive leverage over consumers or the supply chain in China should take conservative measures with pricing to avoid anti-monopoly investigations.

- **Be wary of outsized reputations:** In most markets, the more visible and recognizable the brand and reputation, the better. In China, the opposite applies in the case of evading undue government scrutiny or targeting. The government can have the greatest deterrent effective by making an example of a high-profile foreign company as its first or largest target. Bragging about one's success or share in the China market in press conferences can also backfire, as Google and others have discovered. Displaying respect, a degree of humbleness for the Chinese consumer market, and a desire to align company objectives with broader Chinese objectives will do companies well. Communications can contribute to sending this message.

- **Reframe the debate:** A public relations and communications strategy is a critical component of building a robust and favorable presence in China. New businesses, services, or products should be introduced into the public debate to grow traction and institutional backing through content placement in state-backed media and supportive language in China's 13th Five-Year Plan and other strategic planning documents. These documents offer the exclusive sanction of the Chinese government for SOEs, local governments, and Chinese ministries to support, invest in, and develop certain industries and sectors.

- **Build broad strategic networks and strong access:** Strong foundations and future growth in China require the sanction and support of the Chinese government. Companies need to be proactive about identifying the key agencies, stakeholders, vertical and horizontal suppliers and consumers, with oversight and control of their business and industry, and constructing a

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strategy to gain their backing. This requires consistent engagement, meetings, and networking by a dedicated China team. Broad stakeholder analysis can help identify the influencers who impact policy and decision-making in the industry, including certain academics and think tanks, and used as the basis for the development of thoughtful engagement strategies.

- **Develop a meaningful in-country presence:** On their trips to China, a common mistake executives make is limiting itineraries to ministerial level meetings. CEOs need stronger itineraries of engagement with key influencers and should be working with advisers on the ground to find opportunities for one-on-one meetings and small, private engagements with key Chinese business leaders, media representatives, and members of the Chinese political consultative committee to inform and socialize their business ideas and vision so that they can help push the debate forward. This is a crucial, and often over-looked, element to any successful China policy as personal networks play an outsized role in business and policy. Executives should also participate in key Chinese government-sponsored conferences and dialogues including the Boao Forum for Asia, China Development Forum and World Economic Forum's Annual Meeting of the New Champions.

A Now or Never Moment

Political scientist Joseph Nye warned of the self-fulfilling prophecy, "if you treat China as an enemy, it will become one." Executives can heed this message as well. Doing business in China has become as challenging as in any other mature and competitive economy. The nature of China's political system requires sophisticated understanding of its political and cultural sensitivities, a firm grasp of China's economic reform plans and developments, and a more dedicated monitoring of domestic developments and nurturing of on-the-ground relations. But the risks are manageable and the opportunities abound.

Today's urban Chinese earn and consume more than three times than their average rural counterparts, and the nearly one billion Chinese expected to live in cities by 2025 will generate 95% of China's annual GDP. Urbanization holds enormous potential to unleash productivity and spur consumption as China transforms its current economic model. China's leaders have the correct assessment of China's economic and political structural deficits and are embarking on reforms that will allow for sustained future economic growth, greater fairness and certainty, and most importantly, a more predictable and profitable environment for foreign companies. Enormous opportunities and profit still exist in China for multinationals, if they know how to be sophisticated and play smart.

Xi is stirring the pot because he sees this as a now or never moment for China to transform from its humble beginnings as a low-income nation only three decades ago, to a mature and high-income economy and governance system in the future. If successful, Chinese citizens and multinationals will benefit, but natural risks and pitfalls are unavoidable along the way. Prudent measures can help protect multinationals against these uncertainties. If executives can adjust their expectations and play smart, they can win in China in the long term.