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"FOREIGN INVESTMENT CLIMATE IN CHINA: PRESENT CHALLENGES AND POTENTIAL FOR REFORM"

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Summary

Since coming to power in November 2012, the administration of Xi Jinping and Li Keqiang has embarked on an intensive effort to reform the country's economy, governance structures, and foreign policy. These initiatives do not represent a complete break from the Hu Jintao-Wen Jiabao administration -- Xi and Li have been members of China's political elite for some time -- but it is clear that they have set comprehensive new goals, many of which aim to address problems created under the previous leadership. Although the regime draws on international experiences, suggestions, and norms in developing their plans, the true initiative for these changes are internally generated. They are not being undertaken in response to treaty obligations, demands from foreign governments, or as a favor to multinational businesses. Their goal is to ensure the country's long-term sustainable economic growth, improve the machinery of governance, solidify the dominant leadership of the Chinese Communist Party (CCP), and expand China's regional and global influence. As a result, multinational businesses and foreign governments need to be clear-headed about what to expect. Foreign companies are already doing well in China, and China's wide-ranging reforms, if adopted, would improve their operating environment further and generate more business opportunities. However, even if largely implemented, foreign companies will always face substantial regulatory, political and social challenges in doing business in China. Hence, foreign governments' policy responses and multinationals' business strategies need to see the current wave of policy changes not as a final battle to turn China into a pure free-market economy, but as part of a long-term, continuous process of engagement aimed at gradually strengthening the overall economy and business environment.

The Domestic Roots of Reform

Foreign investors have done very well in China over the last few decades. Every survey taken by the chambers of commerce of the United States, the European Union, and Japan has indicated that a large majority of their members are profitable in China. At the same time, survey after survey reveals substantial challenges to doing business. And in the last few years, the proportion of companies reporting high profitability has dropped, while the sense of current unfairness and worries about the future have risen. This has been highlighted by apparent abuse of the Anti-Monopoly Law and discrimination against Western high tech firms, particularly in information and communications technologies. Many multinationals worry that the costs of doing business, in terms of demands made by the Chinese government, are rising, and that once domestic companies become technologically independent, these firms, with Chinese government support, will eventually displace them in China and in third-country markets.

Although the Xi-Li leadership is far from blameless, much of the responsibility for the current angst deserves to be placed at the foot of the previous leadership. Although the Hu-Wen administration made great strides in implementing China's commitments under the WTO and in absolute and relative terms China's private sector grew under their watch, their primary focus was on making Chinese companies competitive, particularly SOEs situated in key areas of the economy. A substantial portion of these efforts were carried out as part of China's "Indigenous Innovation" strategy, which included providing unprecedented levels of financing for firms and specific projects, ramped up attention to domestically-set technical standards and locally-owned intellectual property, and encouraging government agencies and others to buy domestic products. China's industrial policy initiatives under Hu and Wen yielded success in terms of rapid growth in GDP, greater exports, rising inward FDI, higher corporate profits, and the emergence of some well-known Chinese companies. But the costs were just as massive: highly inefficient use of capital, corruption, rising inequality, environmental degradation, and ongoing economic tensions with trading partners. Winners in industry and the bureaucracy under this system gained substantial economic and political power, becoming bulwarks against change.

The Xi-Li administration appears to be fully aware of the problems bequeathed to them by their predecessors. Even before they assumed office, they signaled that China's original economic development model had outlived its usefulness and that fundamental changes were needed to avoid China slipping into the middle-income trap and instead to move on a trajectory toward long-term sustainable growth. Among those signs was the *China 2030 Report*. Jointly written by the World Bank and State Council's Development Research Center, this document provided a blueprint for a new direction. The "Decision on Several Major Questions about Deepening Reform" issued at the 3rd Plenum of the 18th Party Congress held in November 2013 restated in definitive, politically appropriate language many of the goals and approaches found in the *China 2030 Report* and other speeches made by Xi Jinping and Li Keqiang.

In the 15 months since the Decision was released, authoritative documents and leadership statements, including Li Keqiang's speech to the World Economic Forum in Davos on January 21, 2015, have reinforced a singular message about the direction of policy. Equally important has been a long series of policy announcements and regulations, national and local, which touch upon just about every area of the economy. Among the most important are liberalization in the financial sector, streamlining business licensing and regulatory approvals, incremental liberalization of energy and water prices, reducing government intervention for major investments, expanding the revenue base for local governments while making them more responsible for debt obligations in their localities, higher penalties for pollution and greater support for green technologies, and liberalization of the residency permit system. Reforms involving SOEs have so far included permitting some non-state investment in previously banned sectors, such as rail; selling minority stakes in central SOEs to private investors; and changing the performance measurement system and salaries of SOE executives.

China has also taken initial steps to further liberalize foreign trade and investment, including creation of free trade zones in Shanghai and three other cities, the adoption of FTAs with Australia and South Korea, and the launching of negotiations for others; permitting foreign investment in domestic debt and futures markets; progress toward upgrading of the WTO's Information Technology Agreement; a new, somewhat more generous proposal to join the WTO's Government Procurement Agreement; and a willingness to carry out intensive negotiations for a bilateral investment treaty (BIT) with the United States that goes beyond protection of investor assets to provide national treatment for foreign investors except in specifically designated sectors. The latest draft of China's "Foreign Investment Law," released for comment on January 19, 2015, enunciates the basic principle of treating domestic and foreign companies on equal terms.

Reform and Foreign Business: A Political Economy Balance Sheet

Although there are certain specific elements of China's emerging regulatory system that one could take issue with, on the whole the changes represent a major positive path forward. If China were to adopt and fully implement everything already passed and on the drawing board, we would be witnesses to a watershed in China's economic governance, and foreign business, would be a huge beneficiary, as would truly competitive Chinese firms and China's consumers.

But based on past experience and certain core features of China's political economy, it would be naive to expect a rapid, straight or full adoption of these policies. Instead, as in the past, the more likely outcome is gradual, incremental and partial movement in many areas that will eventually yield an improved, though far from ideal operating environment for foreign business.

There are four factors that point toward a more incrementalist trajectory: the leadership's overall goals, the nature of China's policy process, an uneven international economic regulatory system, and the evolving place of foreign business in China's economy. Each area encompasses a mix of contradictory forces that balance against each other and make radical change unlikely.

First, the leadership hold a complex worldview. On the one hand, they have demonstrated a deep understanding of China's economic and governance challenges and in principle believe that liberalization and market forces are required to address many current deficiencies. Yet on the other hand, they also appear to believe that government intervention is necessary and that in principle there are no places where government should not be permitted to intervene. Although they have dropped the language of "indigenous innovation," they have by no means put industrial policy aside, just adjusted some of their approaches. China's leaders are nationalists who believe China was mistreated by foreign powers during the 19th and 20th centuries, and that China's rejuvenation involves a competitive element in which they should be champions of Chinese industry, particularly toward companies that are politically loyal to them.

Second, China's policy process is highly incremental. Xi Jinping has amassed substantial powers, and created new working groups within the CCP under his leadership that are making the key decisions on policy. Over the last two decades China's civil service has become more professional, particularly at the central level. Nevertheless, although policy has been centralized, the national bureaucracy is still highly influential, and most policies require their involvement. In this context, bureaucracies that are slated for losing some of their old powers are grasping for new reins of authority, and they still have the green light to pursue industrial policy with new tools. This partly explains why the Ministry of Commerce, National Development and Reform Commission, and State Administration of Industry and Commerce have so zealously implemented their respective areas of the Anti-Monopoly Law. Beyond Beijing, provinces and local governments are also central to policy implementation. Although they understand that they are supposed to be implementing reforms, they are finding it hard to prioritize amongst the many new strands of policy, and they clearly are waiting to be compensated with greater sources of income before yielding to new policies that will cut into their existing revenue streams.

Outside the state, new actors have emerged who participate at various stages of the policy process, including companies, industry associations, the media, and the courts. They are important sources of ideas and accountability. Their level of activity has risen appreciably and in some cases led to greater liberalization consistent with the interests of foreign business, but in many instances the addition of more actors has resulted in greater gridlock or the discriminatory applications of rules against foreign business. Moreover, endemic corruption that blurs the lines between officialdom and industry has made radical policy change even harder to achieve. China's anticorruption drive, clearly the leadership's number-one priority at the moment, is aimed at weakening many of these entrenched interests, but without greater reliance on other more independent accountability mechanisms, such as courts and the media, it is hard to see how the current effort is sustainable over the long-term.

Third, the international economic system has been an important source of encouraging, facilitating, and requiring China to liberalize its economy. Despite all the challenges of implementation, China's entry to the WTO was a watershed, and the WTO has been an important venue for negotiating additional liberalization measures and addressing areas of backsliding. Since it joined in late 2001, there have been 20 WTO cases launched against China, of which 15 have been completed. The complainants have won a full victory in 13 of these cases, and in most instances China has responded by modifying the relevant domestic regulations. Although in some instances, compliance has been slow and not had an immediate positive benefit on the related sectors, the overall effect has been to constrain greater

Chinese protectionism and to make Chinese more committed to the multilateral trading order.

At the same time, the comprehensive nature of the international trade order is the exception to the rule. Governance for most areas of the international economy is far from complete, with unclear norms, ambiguous rules, and insufficient mechanisms to enforce compliance. Regimes governing capital flows, prudential bank management, equity and debt markets, foreign exchange, mergers and acquisitions, cyber, climate change and the environment, and labor are all incomplete. These are precisely the areas where China's economy requires the most change. The limited nature of international norms and rules means limited external pressure or clear guideposts and models that provide a path for China to follow.

The final factor that makes an uneven trajectory for China's economic playing field likely is the evolving status of foreign businesses in China and the relevance of the global economy to the country's overall economy. Foreign industry has been critical to China's economic success since the 1980s, providing technology, products, services, capital, and management expertise. Chinese companies have become deeply embedded in global production networks and have developed strong partnerships with companies from the United States and elsewhere. Exports have been a central source of corporate revenue, consumer demand, and economic growth, particularly since the mid-2000s. Moreover, foreign-invested enterprises have been central to China's export success, accounting for over half of all exports and over 80% of high-tech exports in during the last decade. And in the last few years, Chinese companies have made overseas IPOs and debt issuance a central part of their financing strategy.

However, the status of foreign business is in some ways on the wane. China has been the top destination of foreign direct investment in the developing world for two decades, but foreign investment is a declining share of the economy. In 2003, foreign-invested firms accounted for 21.0% of all registered capital in China. By October 2014, that number had shrunk by half to 11.2%. Foreign firms' share of total fixed investment has fallen from a high of 11.8% in 1996 to 4.4% in 2003, and to only 0.9% in 2013. Similarly, although foreign trade has contributed much to economic growth, it is of declining relevance to the overall economy. At its peak, in 2006, total trade was the equivalent of 65.2% of the total economy. That figure has fallen consistently, coming in at 41.5% in 2014. China is moving from having a trade profile like Singapore to one like a mature continental-sized economy where foreign trade is a much smaller share of economic activity. Exports from foreign-invested firms are still substantial, 45.9% of total exports in 2014, but this number is also destined to continue falling. Moreover, if one takes into account that a sizeable portion of "foreign" investment and trade is with Hong Kong, and hence, to some extent masks domestic firms who simply funnel capital through the city, then the true share of foreign investment and trade is even lower.

By the simple logic of economic gravity, we can expect that foreign companies and the global economy will maintain a significant yet declining place in the country's political economy. In a country where domestic state-owned and private companies increasingly dominate and where most economic activity is internal, the concerns of foreign industry and the global community may have more difficulty finding their voice, particularly if they are not supported by international agreements to which China is a party. The primary counter-trend is growing Chinese reliance on overseas equity and debt markets, but it is unclear what kind of constraints or incentives these relationships create, particularly when majority ownership and management remain clearly in Chinese hands.

In sum, the mixed worldview of China's leaders, the complex policy process, an incomplete international economic governance system, and the growing domestic orientation of the entire economy mean that reform will likely on the whole move forward, but in a halting and incremental manner, with periods of progress interspersed with moments of backtracking.

Implications for Policy and Business Strategy

Anyone hoping for a clearer and faster trajectory to a free-market economy will likely end up feeling like the characters in Samuel Beckett's "Waiting for Godot." Given these dynamics, there are several steps foreign governments and the international business community can take to encourage a reformist trajectory.

The first is to hold China accountable to its existing bilateral and multilateral commitments, through the WTO, regional trade arrangements, and bilateral trade remedies laws. These institutions have largely been successful and need to continue to be utilized and supported.

The second is to continue and strengthen the bilateral dialogues and cooperative arrangements already in place. The Joint Commission on Commerce and Trade (JCCT) and the Strategic & Economic Dialogue (S&ED) have both been beneficial to identifying and addressing significant problems in the commercial relationship. The American business community saw particular progress emerge out of the December 2014 JCCT meeting in Chicago, and the next S&ED in Washington this spring is another opportunity for further progress.

Third, we need to develop regional, plurilateral, and multilateral governance mechanisms in those areas of activity that currently lack such institutions. The thorniest problems with China often exist where the rules are the least clear. The adoption of the Trans-Pacific Partnership (TPP), a US-China BIT, renewal of the Information Technology Agreement, and Chinese accession to the WTO's Government Procurement Agreement all need to be pursued. In addition, there are aspects of existing major multilateral institutions that need reforming of their own. The WTO's governance related to trade remedies and the distribution of voting rights within the IMF are two of the most obvious, but there are likely others deserving attention. At the same time, we need greater focus on areas of the global economy where rules are currently insufficient, including in capital flows, banking, and competition policy.

Finally, international business needs to continue to engage in its own brand of diplomacy, stepping up its engagement of the Chinese central and local governments, and have greater consultation on policy matters with its Chinese business partners. One area ripe for substantial expansion is greater consultation with Chinese chambers of commerce and industry associations. At a minimum, these organizations are sources of additional information about the policy environment, and in some cases, due to shared business interests, they could become allies with the foreign business sector, all seeking a fairer, more transparent regulatory environment.

Finally, it is important to keep in mind that regardless of whether the policy engagement occurs at the bilateral, regional, plurilateral, multilateral, or commercial level, there needs to be extensive coordination across government agencies and between government, industry, and other stakeholders. Chinese industrial and macro economic policies are complex and involve a range of measures and actors at the local, national, and international levels. An effective response does not require the US itself to adopt an industrial policy, but it does mean the US needs, to the extent possible, to coordinate information collection, analysis, and policy actions. None of these activities, no matter how well coordinated, will yield an unfettered market. Yet a clear-headed, multi-pronged strategic approach will make continued progress in the direction consistent with the interests of the foreign business community more likely in the years ahead.