China's Challenges: Masters Versus Markets

OECD INFORMAL REFLECTION GROUP ON CHINA
June 2017 | Paris
Overview

I. Economic assessment

II. China in the Primaries

III. Legal Development

IV. China goes global

I. ICT

II. Made in China 2025

III. Conclusions and Next Steps
I. ECONOMIC ASSESSMENT
Recap: BIAC conclusions from June 2014

What to expect?
- Financial stress – possible reform?
- Regional economic slowdown, real estate bubble
- Increasing awareness of environmental damage in water, soil, air
- Stronger environmental law enforcement
- More food quality problems
- Stronger social media control
- People’s demand for better corporate governance
- Increase of disclosed corruption cases
- Increased globalization of Chinese business
- Increased involvement in international economic organizations

What not to bet on
- Political reform
- SOE reform – privatization

The main risks
- Increasing gap between middle class expectations and Party’s ability to ‘deliver’
- Too rapid economic hard landing might lead to social crisis and increasing nationalism
Masters Versus Markets

• Over time, China has exposed itself – little by little, more and more – to market forces via, for example: FDI, QFII programs, off-shore RMB programs, etc.

• For a long while, these “openings” disproportionally worked in China’s favor – bringing in ever more funding and driving ever more asset valuation.

• However, the times have changed, with market pressures now working in ways that disfavor state control of the economy, in particular slowdown dynamics.

• 2015’s financial market gyrations saw China’s resolutely gradualist approach to economic reform suddenly overwhelmed by “market forces”, and the Central Government trying to tame these forces via legacy statist economic control practices.

• The ‘Masters versus Markets’ tension will define the future business environment...
The near-term outlook

• More of the same – credit and liquidity support when things over-slow.
• Shuffling away of debt problems in any and every way possible.
• Depreciation is more and more likely – 7:1 range expected, accompanied by tightening of capital account processes to slow outflows.
• More clamps on re-leveraging.
• Stronger measures and financial innovation to mitigate, mute, obscure, and suspend defaults.
China loses its allure
Why life is getting harder for foreign companies
Key takeaways from the EU Chamber Survey 2017

1. European business reports improved financials thanks to the stimulus unleashed during the first half of 2016.

2. While the impact of the anti-corruption drive is a bright spot, in most areas the disconnect between stated reform commitments and actions taken is both pronounced and highly concerning.

3. European investment would increase substantially if market access barriers were removed and the regulatory framework improved.

4. Respondents perceive that the capacity for innovation by private Chinese companies is continuing to strengthen.

5. An EU-China Comprehensive Agreement on Investment needs to be completed soon to confirm that China is serious about opening up and offering reciprocity.
This is especially true in some sectors

How has doing business in China for your company developed in the last year? (selected industries)
Do you believe that the ‘golden age’ in China is over for the following entities?
Free Trade Zones (FTZs) continue to underwhelm

Has your company already established a presence in any of the China Pilot Free Trade Zones (CPFTZ)?

<table>
<thead>
<tr>
<th>Year</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>15%</td>
<td>85%</td>
</tr>
<tr>
<td>2017</td>
<td>17%</td>
<td>83%</td>
</tr>
</tbody>
</table>

Does your company plan to set up a presence in another CPFTZ in the next two years? 

<table>
<thead>
<tr>
<th>Year</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>13%</td>
<td>87%</td>
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<td>87%</td>
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</tbody>
</table>
European business cannot afford to be complacent about Chinese innovation

Within your industry, how innovative do you feel Chinese firms are compared to European firms?

- Significantly less innovative: 17%
- Slightly less innovative: 36%
- Slightly more innovative: 14%
- Significantly more innovative: 9%
- Equally innovative: 23%

N=562
Innovation strengthens consumer industry, especially in go-to-market and business model innovation

In which areas are Chinese firms more/less innovative than European firms? 1)

Consumer goods and services

<table>
<thead>
<tr>
<th></th>
<th>Product/service innovation</th>
<th>Process innovation (e.g. operations)</th>
<th>Go-to-market innovation</th>
<th>Business model innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>More innovative than European firms</td>
<td>18%</td>
<td>13%</td>
<td>21%</td>
<td>16%</td>
</tr>
<tr>
<td>Less innovative than European firms</td>
<td>38%</td>
<td>25%</td>
<td>15%</td>
<td>12%</td>
</tr>
</tbody>
</table>

1) Multiple answers possible. % represent the total share of sector-specific respondents who agreed with a statement.
But far less so in industrial goods

In which areas are Chinese firms more/less innovative than European firms? 1)

Industrial goods and services

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<th>Process innovation (e.g. operations)</th>
<th>Go-to-market innovation</th>
<th>Business model innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>N=81</td>
<td>16%</td>
<td>11%</td>
<td>27%</td>
<td>18%</td>
</tr>
<tr>
<td>N=111</td>
<td>43%</td>
<td>32%</td>
<td>14%</td>
<td>16%</td>
</tr>
</tbody>
</table>

1) Multiple answers possible; % represent the total share of sector-specific respondents who agreed with a statement.
II. CHINA IN THE PRIMARIES
The Business and Industry Advisory Committee to the OECD
Comité consultatif économique et industriel auprès de l’OCDE
III. LEGAL DEVELOPMENTS
Legal developments in 2016

Foreign Investment Environment

- Negative List pending / Seven Additional Free Trade Zones
- Three Laws governing foreign investment in China
- Interim Measures for the Record-filing Administration of the Incorporation and Change of Foreign-invested Enterprises
- 7th Revision to the Foreign Investment Industry Catalogue

Major Pieces of Legislation

- Foreign NGO Law
- Implementation Rules for the Consumer Protection Law
- Law on Environmental Protection Tax
- Countering Unfair Competition Law
Legal developments in 2016 (2)

Cybersecurity

- Counterterrorism Law
- Cybersecurity Law
- Insurance IT Regulations
- National Security Law
- Secure and Controllable Standard
- Cloud Computing

Window Guidance / Capital Outflow
More detail on the Foreign NGO Law

Management of Foreign Nongovernmental Organization Activities within Mainland China
• Issued by Standing Committee of National People’s Congress April 28, 2016 and effective January 1, 2017
  http://ngo.mps.gov.cn/ngo/portal/view.do?p_articleId=10894&p_topmenu=2&p_leftmenu=4

Guidance on Registration of Nongovernmental Organization Representative Organizations and Temporary Activities
• Published Nov 28, 2016
  http://ngo.mps.gov.cn/ngo/portal/view.do?p_articleId=21612&p_topmenu=2&p_leftmenu=1
• Including forms involving foreign NGO establishment application, certification concerning NGO representative record of no violations of law, foreign NGO activity table, foreign NGO application for dissolution, etc.

List of Foreign Nongovernmental Organizations Obtaining Chinese Government Approvals
• Continual updates http://ngo.mps.gov.cn/ngo/portal/toInfogs.do?p_type=1
• Currently 97 foreign NGOs, including entities from France, S. Korea, Japan, Germany, Hong Kong, USA (Global Volunteer Organization Shaanxi Rep Office, US-China Business Council (Shanghai)), etc.

Chinese Government Online Service Platform for Foreign Non-government Organizations
• http://ngo.mps.gov.cn/ngo/portal/index.do
More detail on the Cybersecurity Law

Cybersecurity Law


Provisions on Administrative Law Enforcement Procedures for Internet Information Content Management

• Issued by the Cyberspace Administration of China May 2, 2017 and effective June 1, 2017: http://www.cac.gov.cn/2017-05/02/c_1120902931.htm

Measures on Security Reviews for Internet Products and Services (Trial)

• Issued by the Cyberspace Administration of China May 2, 2017 and effective June 1, 2017 http://www.cac.gov.cn/2017-05/02/c_1120904567.htm

Interpretation on Several Issues Involving the Application of Law in Handling Criminal Cases Regarding Infringement of Citizen Personal Information

• Jointly issued by the Supreme People’s Court and Supreme People’s Procuratorate May 9, 2017 and effective June 1, 2017: http://www.spp.gov.cn/xwfbh/wsfbt/201705/t20170509_190088.shtml
IV. CHINA GOES GLOBAL
OBOR: One Belt One Road
Xi Jinping’s vision

• President Xi first announced the policy in 2013; it was later named one of China's three major national strategies, and morphed into an entire chapter in the current five-year plan.

• OBOR aims to connect Asia, Europe, the Middle East and Africa with a vast logistics and transport network, using roads, ports, railway tracks, pipelines, airports, transnational electric grids and even fiber optic lines.

• OBOR is likely to expand significantly China's political and economic leverage over its neighborhood, since most of the countries receiving Chinese funds for new infrastructure will ultimately be drawn deeper into China's trade and finance orbit
Globalization 2.0...

• China estimates that OBOR involves potentially 65 countries and 4.4 billion people. Enhancing interconnectivity in a geographical area which generates roughly 55% of global GNP, represents about 70% of global population and has an estimated 75% of known energy reserves, is likely to have a lasting and significant impact.

• OBOR Summit in May 2017: 1500 delegates from 110 countries, including 29 heads of state and dozens of ministerial-level principals

• But: China prefers to negotiate OBOR projects in bilateral arrangements, which was also confirmed in the summit. This does not favor the establishment of a multilateral dialogue.
...or an economic stimulus plan for China?
2016 Chinese take-away?

- Chinese Investment into Europe over EUR 40 billion, a 77% leap from 2015; targeting industries covered by the Made in China initiative, often by SOEs.

- EU FDI in China declined by 23% to EUR 8 billion over the same period, in part due to lack of reciprocity in market access.

- Chinese FDI in the US tripled from the previous year to $46 billion; US FDI in China, by contrast, was flat at $11 billion.
Concerns and controversial debates about Chinese M&A are growing

- Lack of reciprocity and market access.
- Targeting of strategic industries (Made in China 2025).
- Political influence.
- Sustainability concerns (financing structures, business viability, labor welfare).
V. ICT
The digital transformation challenge
Example: Industrial Automation – opportunities and risks

Source: McKinsey – Industry 4.0 How to navigate digitization of the manufacturing sector

* up to 22% (Bosch Blaichach) PWC – Industry 4.0 Building the digital enterprise
Risks through cyber-attacks

- The dark figure is big
- Many attacks are detected late or not at all
- The risk for Cyber-Attacks is growing fast, this requires effective countermeasures or higher capital surplus
Chinese regulatory approach – (new) examples

Where we’re coming from:

- MLPS, CCCi, sectoral regulation...

Plus new:

- Cyber Security Law.
- Cryptography.
- Cross-Border Data transfer.
- Access to standardization, “secure and controllable” as a persisting concept.
VI. MADE IN CHINA 2025
Climbing out of the trough

Stan Shih’s Smile Curve
The policy toolbox

- Subsidies
- Government-backed investment funds
- Market access and government procurement restrictions for foreign business
- Forced technology transfers for near-term market access
- Government-steered mergers and acquisitions
Domestic and International Market Share Targets

Made in China 2025 aims at substitution
Semi-official targets for the domestic market share of Chinese products (in per cent)

- New energy vehicles
- High-tech ship components
- New and renewable energy equipment
- Industrial robots
- High performance medical devices
- Large tractors above 200 hp and harvesters
- Mobile phone chips
- Wide-body aircrafts

Source: Expert Commission for the Construction of a Manufacturing Superpower
Under Pressure: Industrialised countries will feel the heat of Made in China 2025
Vulnerability of select industrial countries to Made in China 2025

Source: MERICS
VI. CONCLUSIONS AND NEXT STEPS
A base case perspective for now...

- China remains big, opportune and essential:
  - (Even at the lower trend growth rate of 3-4%, new nominal growth over the next 10 years will likely exceed the sum-total of growth over the last 25).

- There is huge reform potential.

- Sizeable businesses can be built and sustained, with healthy revenue growth and margins.

- China leapfrogging in business model innovation (digital transformation).

- Expectations for endless outsized business growth and profitability were never realistic.
2017 Conclusions

What to expect?
- Financial stress
- Regional economic slowdown, real estate bubble
- Increasing awareness of environmental damage in water, soil, air
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- Increasing gap between middle class expectations and Party’s ability to ‘deliver’
- Too rapid economic hard landing might lead to social crisis and increasing nationalism
- Regional tensions
- Technology grab (Made in China 2025)
OECD-China Cooperation: Where can OECD help business

Strong need for more OECD policy engagement

• Innovation “Made in China 2025”
• Big data (Social Credit System, impact on companies)
• Tax, BEPS
• Monitor OBOR impact, including procurement and new financial institutions
• Responsible Business Conduct and Anti Corruption
• Corporate Governance
• Services Trade Restrictiveness Index (market access)
Recommendations to the OECD

- **Continue the regular program for policy dialogue in China** – e.g. policy framework for investment, Services Trade Restrictiveness Index, responsible business conduct, anti-bribery, corporate governance.

- **Establish a regular program for policy dialogue in China on key policy reform issues** – e.g. policy framework for innovation; engage on big data (Social Credit System discussion).

- **Equip OECD representative in Beijing**; commit resources to scale-up OECD presence in China.

- **Engage Business at OECD (BIAC) experts in OECD events and projects** with lead notice via the Business at OECD Secretariat.
For more information please contact:

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