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To succeed in China, focus on interests rather than rules[*]

by
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FDI has been a major factor in China's development. Its impact and ripple effects through the economy in recent years have been estimated to reach one-third of China's GDP.[1] In 2017, China ranked third in inward FDI stock according to UNCTAD[2] and third in A.T. Kearney's FDI Confidence Index.[3] China is increasingly important to major MNEs. In some years, the China profits of companies like GM and Volkswagen have exceeded those in all other countries combined.

However, China's FDI regime remains highly restrictive. China ranked 59th of 62 economies in the 2016 OECD FDI Restrictiveness Index, having the lowest scores in transportation equipment, radio and TV broadcasting, media, telecommunications, and fisheries; and it is in the bottom 10 scores in 30 of the 42 sectors assessed.[4] Given this background, it is useful to ask how China will approach FDI, given statements by President Xi Jinping (at the recent 19th Party Congress) that China will encourage more inbound and outbound FDI.

While China's policies toward FDI have evolved substantially since the onset of the country's economic opening, the underlying approach has remained remarkably consistent. It is best described as opening to the extent necessary to promote national development, including the development of indigenous firms, while limiting the influence of foreign entities. It is a targeted, "interests" approach that focuses on China's immediate needs and concerns, sector-by-sector and region-by-region. Trying to understand China's position using a rules-based[5] approach or asking whether China is "opening" or "closing" misses the point. China can open some sectors more, while closing others, and while making life more difficult for foreign affiliates in general.

This approach could be seen during President Xi Jinping's first term. Sectors related to finance, some services, advanced machinery, and the environment were further opened. Special "Open Areas" were designated in the belief that doing so would accelerate China's development. China also showed itself willing to trade access in sectors that it considered non-strategic in order to obtain better access for its own companies in investment negotiations.

On the other hand, China has pushed back against foreign affiliates in other sectors, or when it perceived foreign influence as too strong. This was done through a selective enforcement of antitrust rules,[6] limiting license payments, increasing difficulties of repatriating earnings, and forcing technology transfer. China continues to limit foreign internet firms; has called foreign technology companies "guardian warriors infiltrating China;"[7] has tightened restrictions in the cultural, media and education sectors; has adopted cybersecurity regulations that limit the integration of China activities into global information systems; and has increased the influence of Party cells in foreign affiliates. Industrial policy initiatives, like Manufacturing 2025 and Internet Plus, include specific plans to displace foreign companies. In addition, China has increasingly sought to purchase foreign technology, expertise and brands rather than obtaining them through FDI.

The implication for many foreign affiliates in China has been greater uncertainty, an unlevel playing field as Chinese companies are favored at home and supported internationally and, for some, a rethinking of China operations.

President Xi's consolidation of power at the 19th Party Congress likely means a continuation of the trend observed during his first term. It likely means China will continue to be suspicious of foreign interests, Chinese companies will be more aggressively favored and supported in domestic and international markets, Chinese firms will become more active acquirers abroad in targeted industries, foreign affiliates will be subject to increased scrutiny, and foreign hopes that the market will be decisive when it comes to the overall direction of China's economy will not be realized.

Foreign investors will find their best opportunities in industries that China's leaders do not view as strategic (like consumer-packaged goods, personal care products, luxury goods, mid-tech manufacturing), and in those that contribute to such initiatives as One Belt-One-Road, Go Global, Manufacturing 2025, and Internet Plus. Industries with foreign affiliates with capabilities beyond Chinese firms (like environmental technologies, some service sectors, advanced machinery) will also be favored. Firms are also trading support for China's initiatives outside of China (like One Belt-One Road) for better treatment inside of China.

Crucial for how most foreign companies will be treated in China will be for them to demonstrate the clear economic value they bring to China and how specifically they will support China's major initiatives in ways domestic companies cannot—as opposed to appeals to rules or investment agreements.

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[1] Enright, op cit.

[2] http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx.

[3] https://www.atkearney.com/documents/10192/12116059/2017+FDI+Confidence+Index+-+Glass+Half+Full.pdf/5dced533-c150-4984-acc9-da561b4d96b4.

[4] http://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#. In comparison, the US ranked 38th as most open overall, and was in the bottom 10 in 5 of 42 sectors.

[5] A senior EU negotiator recently told the author: "We don't negotiate from interests, we negotiate from rules." Of course, all governments negotiate based on their interests, but the difference is still significant.

[6] Samson Yuen, "Taming the 'Foreign Tigers': China's anti-trust crusade against multinational companies, *China Perspectives*, 4/2014, pp. 53-59.

[7] "Investigation into America's eight guardian warriors infiltrating China," *China Economic Weekly,* vol. 24 (2013), http://paper.people.com.cn/zgjjzk/html/2013-06/24/content_1259857.htm.

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