Evaluating China's Foreign Investment Reforms

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Summary:

- The only economic reforms we can expect are those that do not threaten the Communist Party of China (CPC) or, better yet, enhance its control. Do not expect progress in areas that the Party believes it must control in order to maintain its political power.

- China's new more restrictive political environment has forced economic policymakers to think creatively about how to liberalize the economy in ways that do not jeopardize the CPC's hold on political power.

- China has been making it harder for foreign firms to operate in the mainland by disproportionally targeting them in crackdowns on corruption, food safety, etc.

- China appears to be transitioning from an FDI-focused approach to foreign investment and toward a more capital market-based approach centered on the Shanghai and eventually the Shenzhen Exchanges.

- China appears to be using the Free Trade Zone (FTZ) scheme in Shanghai (and soon Guangdong, Fujian and Tianjin) to maintain access to foreign technology transfers, marketing expertise, and intellectual property, while cloistering foreign firms into select geographic areas and sectors that it can control, benefit from, and, if necessary, easily restrict.

- The CPC appears to have successfully manipulated the negative list approach to its advantage; using it to win foreign partners and governments' acquiescence to Party control over select sectors. In this way the CPC has accepted and applied an ostensibly free trade mechanism to bolster and legitimize its political control.

- China is relaxing its capital controls by making it easier to trade the yuan and for Chinese firms operating abroad to repatriate foreign exchange. This is necessary to allow for more types of Chinese firms to expand investments abroad. The U.S. remains China's top destination for outward FDI.

Introduction:

"We shall proceed with reform and opening up without hesitation," China's President and CPC General Secretary Xi Jinping told the members of the Politburo Standing Committee at a symposium marking the 110th anniversary of the birth of Deng Xiaoping in late August 2014. These comments are not surprising. Since he assumed power in 2012, Xi has consistently advocated an agenda purported to continue the "reform and opening up" policies initiated under Deng. With an eye toward giving market forces a "decisive role" in the economy and "rectifying the relationship between markets and the state," Xi's campaign includes a call to reduce government meddling in the economy, a more level playing field for private sector firms to compete with privileged state-owned enterprises (SOEs), and promises to allow enterprises and individuals to invest more freely overseas.

Xi's reform agenda was publicly affirmed last November at the third Plenum of the 18th Congress of the CPC Central Committee; an occasion compared by many to the celebrated third plenum in December 1978 that laid the groundwork for Deng's historic reform campaign. Now, as then, the paramount leader seeks to strengthen CPC rule and marketize the economy by overcoming "vested interests" that produce inefficient outcomes. Now, as then, entrenched interests resistant to change include a web of central government ministries, provincial and local governments, powerful families, and state owned enterprises (SOEs). This time, however, the difference is that China's leaders have not encouraged more foreign competition in the domestic market; instead they are pursuing a strategy that includes the channeling of foreign investment into Free Trade Zones (FTZs), controlled expansion of select foreign investment via Chinese capital markets, the expansion of outward FDI and the establishment of ways to repatriate profits back to China.

Background: "Opening up" to Foreign Investment

It is widely acknowledged in China today that market-based competition, in principle, can help ensure more efficient outcomes. This assumption was at the heart of Deng's economic reform strategy that sought to gradually "open up" China's market to foreign firms. Throughout the 1980s, a decade-long political struggle pitted radical reformers against powerful entrenched interest groups, and was only decided after Deng's famous 1992 Southern Journey. Similarly, in the late 1990s and early 2000s, Premier Zhu Rongji used WTO membership to successfully create new pro-reform constituencies that counterbalanced reactionary conservative forces that maintained control over the means of production in several key economic sectors. The fairer treatment of foreign firms within the China market proved a powerful cudgel that Deng, Zhu and other reform-minded leaders used to realize reform over the din of powerful and deep-rooted opposition forces within the CPC.

"Opening up" to foreign investment was the key concept behind both Deng's Special Economic Zones and Zhu's drive for WTO accession. It was an essential ingredient in China's recipe for successful reform, one that both improved Chinese firms' competitiveness by forcing change upon SOE managers and attracted precious foreign technology and capital into the country. As noted above, Xi - in keeping with this tradition - has also made pronouncements suggesting that his administration will adopt an "opening up" strategy. During last month's 25th annual U.S.-

China Joint Commission on Commerce and Trade session, Vice Premier Wang Yang reassured U.S. firms that: "China has not slowed the pace of reform and opening up, and the investment environment is not tightened."[1]

The current logic for continuing a strategy of increased opening to foreign competition was set forth by Liu He, a chief economic advisor to Xi, in a 2010 interview with *Caixin* magazine: "Domestic drive often needs to be activated by external pressure. From the perspective of China's long history, a unified domestic drive and external pressure has been key to success." In an effort to harness this "external pressure" to push Xi's reform package leaders at a politburo meeting on August 27, 2013 called for a "full mobilization all positive factors inside and outside the country to form a great cohesive power for promoting reform."[2]

The Third Plenum was announced as an ambitious, longterm undertaking intended to "allow market forces to play a decisive role in the economy."[3] Nevertheless, a report from the Center for American Progress noted that: "Even if the Third Plenum and related reforms are implemented fully as announced, China's economy will still operate with broad state involvement in ownership, finance, and authority over key economic decisions and prices."[4] Thus, it is not surprising that the only economic reforms we can expect are those that do not threaten the Party or, better yet, enhance its control. Conversely, we should not expect progress in areas that the CPC believes it must keep control over in order to maintain its political power.

Recent Developments:

1. **Tightened Restrictions on Foreign Firms and Technology in China**

President Xi has not been enthusiastic about bringing foreign pressure to bear on China's SOEs. In 2009, he referred to SOEs as "an important foundation of Communist Party rule" and in March while speaking to the Shanghai delegation to the National People's Congress (NPC) he said, "deepening the reform of SOEs is a major task; not only should SOEs not be weakened, they must be strengthened." These comments were accompanied by an increasingly less friendly investment and operational climate for foreign firms operating in China. In 2006, China came to the end of a five-year schedule of market-opening measures it had pledged upon entrance to the WTO. After the WTO-mandated reforms expired, foreign firms began to complain of an increase in various discriminatory practices, including more difficulty in getting licenses and approvals, and a less friendly attitude from Chinese officials and partners. But while pressure on foreign firms began to rise under Xi's predecessor, it has reached a crescendo over the last two years with foreign firms regularly being excoriated in the Chinese official press and provincial agencies arresting and detaining executives.

In some cases, like that of meat distributor OSI International in Shanghai, entrenched domestic interest and local authorities appear to have made it far more difficult for foreigners to do business in China by clamping down on their operations and employing innovative discriminatory tactics to restrict their ability to conduct business.[5] From Microsoft in the tech industry to OSI International in the food and agriculture sectors to Chrysler in the auto space, U.S.-based companies across the board are being targeted. These come despite numerous high-level statements declaring just the opposite, most recently last month from Vice Premier Wang in

Chicago.[6] According to Deutsche Bank, more than 130 reform announcements occurred between the Third Plenum and October 2014. Despite the positive rhetoric from Beijing, the targeting of foreign interests in China continues apace. Beijing is essentially saying one thing and doing another such that one year after the Third Plenum, despite extensive government action in some areas, foreign firms are consistently saying that it has become increasingly difficult for them to do business in China. As U.S. Secretary of Commerce Penny Pritzker noted last month: "Concerns over issues like sanctity of contracts, transparency, rule of law, intellectual property protection and other issues are beginning to take their toll. Foreign companies need to know they are on equal footing with domestic companies if governments hope to attract their capital."[7] These views echo those of the European Union Chamber of Commerce in China, which has declared an end to the 'golden age' of foreign business in China, and Transparency International which bumped China 20 spots to 100 on its annual ranking of 175 countries.[8]

The uncertain business environment and a lack of transparancy have made longterm business planning difficult, thus engendering a "wait and see" approach among some foreign investors. During a visit to Hong Kong this month Nitin Nohria, dean of the Harvard Business School, explained the rational behind this approach: "For the last 10 to 15 years there was a certain vector to how China was developing, which was export-driven growth; multinationals all coming here; a government that was very encouraging of letting them get business done. There seems to be a shift, and people are trying to understand what this shift implies."[9] This sentiment is being reflected in investment flows to and from China. Earlier this month China's Ministry of Commerce said the growth of foreign direct investment into the country slowed last year, rising just 1.7 percent from 2013 to $119.6 billion.[10]

China is also in the process of purging all foreign technology from banks, the military, state-owned enterprises and key government agencies and replacing it with Chinese software and servers by 2020. The plan, which is justified by national security concerns, is an intentional move by the Xi administration away from foreign suppliers. Microsoft Windows is being replaced with a homegrown operating system called NeoKylin from China's Inspur Group Ltd and foreign servers are being swapped for those made in China. In September, the China Banking Regulatory Commission ordered banks and finance agencies to dedicate at least 5 percent of their IT budgets to ensure that at least 75 percent of their computer systems were "safe technology" by 2019. U.S. companies operating in China's IT sector are vulnerable including Cisco Systems Inc., International Business Machines Corp., Intel Corp. and Hewlett-Packard Co. Last year, regulators pursued anti-trust probes against Microsoft, raided the firm's China offices and banned Windows 8 from government computers.[11]

Increased control over foreign firms operating in China and supervision over their investment is not entirely unexpected, however. It reflects a "transformation in the country's strategic thinking," as Wang Jisi, Dean of the School of International Studies at Peking University, wrote in the March/April 2011 issue of *Foreign Affairs*. According to Wang, China appears to be focusing on sustaining "the country's high growth rate by propping up domestic consumption and reducing over the long term the country's dependence on exports and foreign investment."[12]

There are some exceptions, however. In November, the Ministry of Commerce and the Ministry of Civil Affairs of China jointly issued an announcement seeking to encourage foreign investment "to set up for-profit senior care institutions in China, in order to promote the healthy development of China's domestic senior care services industry." As China's population ages, senior care services are suffering from supply shortages that experienced foreign firms can help address: officially, the number of citizens over 60 years of age in China reached 194 million at the end of 2012, and is expected to reach 243 million in 2020 and exceed 300 million in 2025.[13]

Parcel delivery is another area where there are signs of liberalization. The State Post Bureau has recently approved Yamato (China) Transport Co Ltd, OCS Overseas Courier Service (Shanghai) Co Ltd and Kerry Logistics Co Ltd. But the impact of liberalization in this sector is likely to be minimal given the already stiff competition and low prices. There are more than 35,000 express delivery companies operating in China, including FedEx and UPS, and some can ship packages hundreds of miles in the same day for as little as two yuan.[14]

2. Channeling Foreign Investment using FTZs and the 'Negative List' Approach

After years of U.S pressure China's decision to move from a 'positive list' to a 'negative list' approach was widely haled as a diplomatic victory in Washington. With the announcement of the Shanghai FTZ (SFTZ), Beijing began the negative list approach to regulate foreign investment. Instead of classifying industrial sectors as 'encouraged,' 'permitted,' 'restricted,' or 'prohibited' this approach specifies only those areas in which foreign investment is 'restricted' or 'prohibited.' The key distinction between the negative-list approach and the restricted investment market access that China enforces outside the zones is that firms that invest in the zone are supposed to receive a more predictable and expedited document approval process. They are promised first access to investment incentives, such as expedited administrative decisions for investment and lower levels of required capital to open a business. All told, however, foreign investment in FTZs remains subject to a government approval process – albeit a less bureaucratic, expedited one.[15]

The CPC appears to have successfully manipulated the negative list approach to its advantage; using it to win foreign partners and governments' acquiescence to Party control over select sectors. In this way the CPC has accepted and applied an ostensibly free trade mechanism to bolster and legitimize its political control.

The initial "negative list," released in 2013, disappointed foreign investors. This dissatisfaction, slow progress and Li's absence from the SFTZ's opening ceremony led some American observers to note that the scheme had "failed to deliver meaningful concessions for investors."[16] According to the managing director of China Market Research Group in Shanghai: "It's great talk by [Premier Li Keqiang] and a lot of senior government officials, but there's no execution. Nobody knows what you can do."[17] Perhaps in response, in June 2014, the number of restricted industries and activities for foreign investment was reduced from 190 to 139 and in November 2014, the National Development and Reform Commission released a new draft of the Catalogue Guiding Foreign Investment. Changes in this latest draft, which was open to the public for review until December 3, include reductions in the number of restricted sectors for foreign investment, the number of industries limited to only joint ventures and partnerships, and the number of industries that required a Chinese majority stakeholder. The proposed revised Catalogue also retains the same foreign ownership caps introduced in the 2007 Catalogue.

To date investing in the SFTZ has served primarily as a hedge for foreign firms based on unclear future promises, as one strategist with Silvercrest Asset Management explained: "A foreign company might want to establish some kind of presence in the SFTZ, so that if some day actually there's a rule that allows you to do something interesting, you're there."[18] According to the American Chamber of Commerce in Shanghai, by September there were 12,226 companies registered in the SFTZ of which only 1,677 were foreign firms.[19]

To address lackluster interest among foreign investors in the SFTZ, Li, the scheme's key backer, visited the site in September and "urged government officials to push through new policies."[20] Xi himself has endorsed FTZs, first at the Third Plenum and again during a meeting with the Shanghai NPC delegation in March. More recently, on December 12, the State Council announced a "new round of high-level opening," and its intention to establish three new free-trade zones "replicating" the experience of the Shanghai Zone in Guangdong, Fujian and Tianjin. The announcement also said the SFTZ would continue to shorten its "negative list."[21] It remains to be seen, however, if FTZs, the Xi administration's flagship "opening up" policy project coming out of the Third Plenum, will produce tangible results in the reduction of tariff and non-tariff barriers. In sum, the consensus appears to be that the SFTZ is moving forward in fits and starts and that the fast-changing rules have created confusion about what is actually permitted.

3. Expanding Foreign Investment in Chinese Firms via Capital Markets

There appears to be a transition from the traditional types of foreign investment in China toward foreign investment via capital markets. In November, China launched the Shanghai-Hong Kong Stock Connect trading link, which opened up 568 Chinese companies valued at $2 trillion to foreign investors via Hong Kong. Before the link, only a select group of foreign institutional investors with special government permission were able to trade mainland-listed stocks.

The Stock Connect program, which took months to develop, was launched with fanfare with a week's notice.[22] During the first month, however, the link was underutilized. Under the scheme, the daily limit on investment bound for Shanghai is 13 billion yuan ($2.1 billion) and for Hong Kong-bound investment it is 10.5 billion yuan. But as of January 7, foreign buyers had filled only about 25 percent of the quota to buy mainland shares and 6 percent of the quota for Hong Kong stocks.[23] One reason Hong Kong has suffered is because a minimum investment amount of 500,000 yuan ($80,405) is required – far more than most non-institutional investors can invest. Furthermore, hedge funds wanting to sell holdings of Shanghai-listed shares are required to deliver the shares to banks' brokerages before 7:45 am on the day of the sale – an idiosyncrasy that exists in no other major stock market. The result has been low demand with the bulk of activity coming from short-term speculative investors, rather than from mutual funds, pension funds and private banks – as Beijing been hoped.[24] To address this problem this month the HKEx announced plans to launch a system fix in March that would allow custodians, which hold stocks on an investor's behalf, to open a separate account in the investor's name. HKEx has reassured investors they retain ownership of shares until they are sold, although legal opinion differs over whether investors could enforce their claims should the HKEx's clearing house go bankrupt.[25]

Furthermore, the HKEx is working with China's Shenzhen Exchange to develop a similar link that would allow foreign investors access to some of China's more dynamic private companies in the technology and health-care industries. The ChiNext index of small and medium size companies, listed in Shenzhen, has more than doubled over the past two years fueled by speculation about China transition to an economy driven by domestic consumption rather than investment and exports. The HKEx-Shenzhen link is set to be tested next month and launched as early as March.[26]

Last month, the China Securities Regulatory Commission (CRSC) released draft guidelines that proposed allowing foreign investors and brokerages to trade some futures contracts, granting them access to a historically volatile – although large and potentially lucrative – market. The CSRC said the initiative is "necessary" to bring in foreign institutional investors to reform its commodities futures markets and bring domestic markets in line with international practices through improved risk control and pricing.[27] Like the Shanghai-Hong Kong link, this is another effort to draw in investment from abroad to improve the liquidity and predictability of domestic capital markets.

4. Outbound FDI and Profit Repatriation

Previously restricted to sovereign entities such as China Investment Corp., Beijing now allows outbound foreign investments by private equity firms, financial conglomerates, insurance firms, and other financial players such as Fosun International. Last year, according to Rhodium Group, financial investors accounted for 22 percent of China's outbound mergers and acquisitions (M&A) value, twice as much as the average of the previous five years. Despite, this increase, however, Rhodium found that in 2014, China's foreign M&A acquisitions dropped 13 percent to $53 billion a trend it attributed to "a sharp drop in natural resource asset buying."[28]

There are large disparities in the estimates of total Chinese outward investment. According to China's Ministry of Commerce, 2014 witnessed an 14.1 percent increase to $102.9 billion.[29] The American Enterprise Institute (AEI), by contrast, reported total outbound Chinese investment had risen only 0.7 percent to $84.4 billion. AEI also reported that Chinese investment in America setting a new record in 2014 and for the third year in a row the U.S. extended its lead as China's largest recipient country. Over the past decade, the U.S. has received more Chinese investment than any other country – $78 billion.[30]

The freer repatriation of foreign capital is an essential component of the larger liberalization of outward Chinese investment that occurred in 2014. Most recently, beginning this month the State Administration of Foreign Exchange (SAFE) will no longer require Chinese firms that go public abroad to get approval to remit foreign exchange raised in their listings. This step toward relaxing inward capital flows means overseas listed firms need only register their IPOs or other fund-raising activities with the foreign exchange authorities and can then freely send funds home. The new rules also include amendments that make it much easier for overseas listed companies to send back foreign exchange surpluses. In another move to permit freer flow of foreign exchange and relaxing restrictions on yuan trading, this month SAFE published new rules giving banks leeway to short dollars by replacing daily caps on banks' foreign exchange positions with weekly limits.[31]

Conclusions:

- Beijing is restricting the presence of foreign firms in China and undermining their ability to apply real economic pressure to SOEs in ways that could reduce the Party's control over the economy. The goal is to exploit foreign firms′ capital, technical innovations and marketing techniques, while preventing the emergence of a true free market for foreign products in most of the country.

- By pushing foreign investment towards its four designated FTZs, China seeks to channel it into those geographic areas the party prefers. Similarly, the negative list approach continues China's tradition of channeling FDI away from sectors that the CPC sees as politically sensitive. Such policies are more reminiscent of the open ports established in the 19^{th} century to contain and limit foreign influence than the Special Economic Zones established by Deng Xiaoping during the 1980s that were intended to expand it.

- By granting foreign investors increased access to Chinese equities and futures via state-controlled markets and banks (rather than through FDI and joint enterprises as had been the case) Beijing both maintains control over the flow of foreign investment and can take advantage of those institutional investors that had been wary of investing directly in China due to the aforementioned risks associated with conducting business operations on the mainland.

- Reduced barriers to foreign entry into China's capital markets provide new revenue streams, increase market liquidity, and improve domestic firms balance sheets. But the door swings both ways, and the same system that allows overseas portfolio money in may later be a conduit for investors, foreign and Chinese alike, to escape during rough times. In short, contagion becomes both more likely and more serious as China expands foreign access to its capital markets. Similarly, the more foreign institutional investors become invested in Chinese firms, the more foreign markets become susceptible to contagion risk from China.

- The CPC seeks to contain and limit the domestic political externalities it associates with foreign investment, while keeping foreigners (along with their liberal ideas, religious values, and perceived security threats) limited primarily to a select number of sectors and geographic regions.

- China is working to expand the number and type of firms that can invest abroad and improve their ability to repatriate profits. Although financial firms accounted for a larger percentage of overseas Chinese M&A investment in 2014, China's total M&A fell largely due to a reduction in purchases of natural resource products. There are large disparities between the official and AEI estimates of China's total outward FDI for 2014.

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