Weighing the
Of Doing Business

THE ECONOMIC POWERHO
AND RESPECT IN A

By Gregor

Pros and Cons in Xi Jinping's China

USE SEEKS DOMINANCE
NEW POLITICAL ERA

McQueen

GETTY IMAGES

One of the most challenging issues for Western corporate leaders today is balancing the opportunities in the People's Republic of China (PRC) with the increased political risks under President Xi Jinping. The policy positions of Xi—who is also general secretary of the Chinese Communist Party (CCP)—have a significant impact on how companies do business in and with the PRC. There have been monumental changes in China over the past year (*see 2020 PRC Review, opposite*). So much has happened both in the United States and in China in recent months that systematic assessments are needed for corporate leaders to stay on top of the potential impact of geopolitical risks on their strategic objectives.

Can businesses expect relations between the United States and China to improve under President Joseph R. Biden Jr.? While the tone from the Biden administration is expected to be more diplomatically, scientifically, and expertise-driven, US–China relations are not expected to improve in certain areas such as national security technologies, and may indeed worsen in relation to Hong Kong, Taiwan (officially, the Republic of China), maritime freedoms in the South China Sea, the mass detention and forced labor abuse of Uighur and other Muslim minorities in the Xinjiang region, or the suppression of Tibet.

There remains hope that despite strategic competition between the two economic powerhouses, mutually important global issues such as the COVID-19 pandemic and climate change may create opportunities to collaborate.

CHINA'S VIEW OF ITS FUTURE

The PRC is a middle-income economy with a gross national income per capita of $10,410, which is roughly half that of Greece ($19,750) and about one-sixth that of the high-income United States ($65,850), according to the World Bank. Access to and the development of cutting-edge technology is critical as China seeks to move its economy away from the basic export of manufactured goods that have dominated its growth to date.

"Beijing's aim is nothing less than preeminent status within the global order," wrote Daniel Tobin, senior associate at the Center for Strategic and International Studies, in his report, *How Xi Jinping's "New Era" Should Have Ended US Debate on Beijing's Ambitions*. The CCP's commitment to this "new era" is underscored by its version of Marxist-Leninist socialism—what Xi dubbed at the party's 19th National Congress in October 2017 "socialism with Chinese characteristics." Tobin added that this aspiration toward "national rejuvenation" exists to "transform China into not only a modern, powerful country but also a country respected for its achievements across all fields of human endeavor by which great powers measure themselves, from prosperity to military power to cultural influence to scientific discovery."

In October, the CCP developed proposals for the country's 14th Five-Year Plan (2021–25) and its Vision 2035 program, which intends to propel the PRC into a "moderately developed economy" in 15 years. The final plan was presented at the National People's Congress in early March. The proposals focus on the economy, with "dual-circulation" measures to boost productivity, rebalance economic development, and reduce the economy's dependence on external markets and technology.

China is seeking to improve its innovative capabilities in order to stimulate development by upgrading and modernizing its industry value chain, as well as make its economic development more effective by focusing on leading sectors such as artificial intelligence, quantum computing, integrated circuits, health, neuroscience, genetics, cloud technologies, and deep-sea exploration.

Observers believe that Xi ultimately seeks to control the global agenda by transforming global governance and setting new international standards through entities such as the United Nations, World Bank, World Health Organization, and World Trade Organization, as well as through the use of digital currency (e-yuan) and advanced technologies such as 5G and artificial intelligence.

'CHINESE CHARACTERISTICS' FOR ENTERPRISES

China's authoritarian political party controls its economy. Its largest state-owned enterprises (SOEs) have dominant positions in many of the most critical and strategic industries, from energy production (60 percent coal) to shipping to rare earth materials. While the size and scale of these SOEs are partly a function of the large domestic market, they are also a function of the massive government subsidies given and government shields offered to SOEs in strategic sectors (e.g., banking, infrastructure, telecommunications, energy) from domestic and foreign competition.

The level of political control over SOEs is remarkable. At a 2016 work conference, Xi signaled the increased CCP role in SOEs by calling for a "modern state-owned enterprise system with Chinese characteristics." He explained that what was meant by "Chinese characteristics" was "integrating the party's leadership into all aspects of corporate governance" and "clarifying" the party's legal status within the corporate governance structure. In 2017, the CCP amended its constitution to assert that the party "plays a leadership role" in firm decision-making. Xiao Yaqing of the Ministry of Industry and Information Technology, then the head of the central SOE regulator, said, "To give full play of the party's leadership and its core political role, SOEs should stick to the political principle that all SOEs must be under the party's leadership."

Yet private enterprise has been the significant contributor to China's rapid growth, generating new jobs and tax revenues and driving innovation. The World Economic Forum estimates that

China's private sector contributes more than 60 percent of gross domestic product (GDP), is responsible for nearly 70 percent of innovation and 80 percent of urban employment, and provides almost 90 percent of new jobs.

On Sept. 15, the General Office of the Central Committee of the CCP issued *Opinion on Strengthening the United Front Work of the Private Economy in the New Era,* calling on the party's United Front Work Department (UFWD) to increase CCP ideological work and influence in the private sector. Importantly, the document calls on the UFWD to "guide" private enterprises to "improve their corporate governance structure and explore the establishment of a modern enterprise system with Chinese characteristics."

The intervention through regulation and governance measures at Alibaba Group Holding and Ant Group are recent examples of this intention to have CCP representation in private enterprises. In effect, the CCP doesn't trust the marketplace—in some instances as a result of the massive corporate debt increase over the past five to 10 years and associated financial instability. One senior CCP official put it bluntly in an interview: "Regardless of whether state-owned or private enterprises, they are all Chinese enterprises." This development is a concern because it could stifle innovation and growth, as well as lead to the deployment of private enterprises to achieve state objectives. It is also a fundamental, direct violation of the PRC's obligation to support a transparent, rules-based system per the World Trade Organization.

OPENINGS FOR FOREIGN INVESTORS

The PRC's 2020 Foreign Investment Law established a new review system for foreign investment that affects or may affect national security, somewhat similar to the Committee on Foreign Investment in the United States. The list of Chinese industries that are either restricted or prohibited for foreign investors by the National Development and Reform Commission and the Ministry of Commerce was cut to 123 sectors in 2020 (from 131 in 2019). The negative lists the Special Administrative Measures on Access to Foreign Investment and the Free Trade Zone Special Administrative Measures on Access to Foreign Investment trended in this same direction of paring the number of restrictions on foreign investment.

The new national security review system and measures that became effective on Jan. 18 involve major changes, including the following:

- expansion of the group of sectors that require a review if foreign investors take "actual control" of the target, including agricultural products, energy and natural resources, heavy equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and Internet products and services, financial services, and "key technologies"

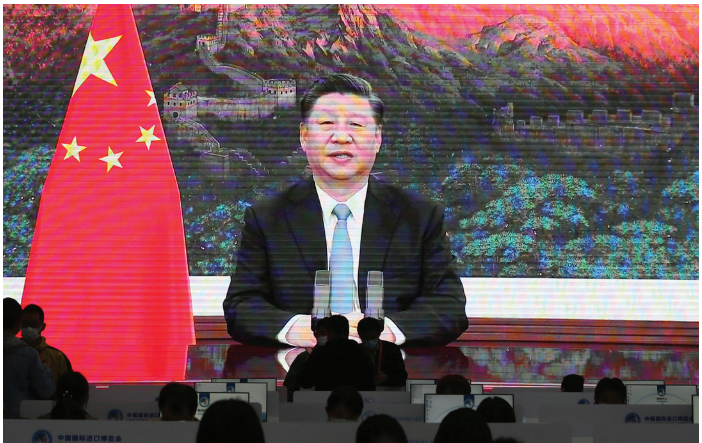
2020 PRC REVIEW

ACCOMPLISHMENTS

- The PRC and Taiwan were highly effective in controlling the spread of COVID-19 within their borders, partly thanks to past experience with emerging infectious diseases and a full focus on mask wearing, social distancing, and contact tracing (where Western countries have been much less effective).
- The economy grew despite the pandemic.
- Xi declared a "major victory" with the end of extreme poverty.
- The Tianwen-1 mission to Mars was launched via a Long March 5 rocket.
- The Chang'e 5 probe returned to Earth with lunar samples.
- The Fendouzhe manned submersible deep-sea mission that reached a national record depth of 10,909 meters in the Pacific Ocean's Mariana Trench was completed.

FAILURES

- Initial handling of the SARS-CoV-2 virus allowed millions of migrant workers to leave Wuhan and vilified whistleblower Dr. Li Wenliang before he died after being infected.
- The US–China relationship rapidly deteriorated; China failed to buy the agreed amount of goods under the Phase 1 trade deal.
- Lack of transparency continued over data related to COVID-19 and its origins.
- Violent clashes between the People's Liberation Army and Indian troops led to India banning WeChat, TikTok, and other Chinese technology services, as well as product boycotts and anti-China protests.
- The Long March 7A, Long March 3B, and Kuaizhou-11 rocket launches failed.
- Fishing practices remained aggressive.
- The Hong Kong Security Law imposed on June 30 by the Standing Committee of the National People's Congress brought widespread denunciation.
- "Reeducation" detention camps in the Xinjiang region were internationally condemned for abuse of Muslim minorities, including Uighurs, with forced labor factories inside the camps.
- Wolf warrior diplomacy strained relationships with economic coercion against the United Kingdom, Europe, Canada, and Australia. After Australia called for an independent investigation into COVID-19's origins, the PRC retaliated against Australian barley, beef, cotton, lobster, timber, wine, and coal.
- Severe flooding in central, southern, and eastern provinces displaced millions and caused billions of dollars of damage.
- Belt and Road Initiative projects were embroiled in corruption scandals or political controversies in Malaysia, Myanmar, Sri Lanka, Bangladesh, Pakistan, Kyrgyzstan, Kazakhstan, Czech Republic, Italy, Australia, and the Maldives.



President of the People's Republic of China Xi Jinping in a video speech in November at the opening ceremony of the China International Import Expo in Shanghai.

ASSOCIATED PRESS

- addition of mandatory pre-investment reviews
- expansion of regulatory scope from only direct investments to direct and indirect investments (including greenfield investments)

The new review mechanism effectively allows PRC regulators to stall virtually any deal that entails a takeover attempt of a Chinese company by a foreign firm on the grounds of national security. For investors, this increases the risks and costs of doing business in China or with Chinese companies considerably.

Is the CCP really opening up industries to foreign companies? The short answer depends on your sector, but incrementally, yes.

Companies with business in China should keep an eye on how the CCP acts and what long-term goals these actions point to. David Jacobson, a professor teaching law, global business strategy, and complex problem-solving, as well as the executive director of Cox School of Business Online Education at Southern Methodist University, believes there are ulterior motives as the CCP "invite[s] and woo[s] an increasing number of Western companies from varying industries, most of whom will not be able to resist the prospect of tapping into one of the world's largest economies."

For example, over the past year, caps on foreign ownership of securities companies, securities investment fund management companies, futures companies, and life insurance companies were lifted, leading Wall Street firms including BlackRock, Bridgewater Associates, Vanguard Group, Citigroup, and JPMorgan Chase & Co. to expand their operations. Jacobson submits that, when it matters, and to reinforce its authoritarianism and long-term strategic goals and policies, the CCP demands—and gets—companies to comply with what it wants in return for greater allowances on foreign investment. With financial companies specifically, he says the motive is to entice these companies "to favorably represent and support their nationalist narratives and policies back at home. US banks are the perfect vehicle for Beijing to achieve these aims since the financial sector has tremendous lobbying power in Washington and is by far the largest source of campaign donations to political parties and candidates."

Recent examples of China exerting such pressure specifically on the finance sector involve Standard Chartered and HSBC Holdings, both based in London. "Beijing gave the ultimatum that if they did not publicly express support for the national security law in Hong Kong, they would lose the right to continue doing business in China," said Jacobson. "Both banks complied in a move criticized by the international community. Beijing also demanded that both companies crack down on clients who had ties to the pro-democracy movement in Hong Kong, and the banks complied with this as well."

Jacobson cites another, broader example of a movie filmed in the Xinjiang region. "The controversy over Disney's live-action *Mulan* embodies some of the ethical dilemmas and pitfalls that face companies doing business in China," he said. "On one hand, to maintain their presence in China, companies must comply with the demands and expectations of the Chinese Communist Party, which are intended to garner support for the CCP's viewpoint and policies. On the other hand, their compliance comes with the cost of significant reputational risk at home." Furthermore, "if Beijing were to disapprove of something that Disney said, Disney would not only be forbidden to release any future films in China, but their highly profitable Shanghai Disneyland and other joint ventures would thereafter belong entirely to their government-owned Chinese business partners. This is likely why Disney reportedly has been slow to answer questions from US or UK lawmakers about its involvement with Xinjiang, or has only answered in the vaguest terms. Disney does not wish to provoke Beijing's ire."

Yet another example is the National Basketball Association (NBA). In today's hyperconnected world, a single social media post by a manager or executive can erupt into a political firestorm and bring CCP backlash against a corporation. The NBA fell afoul of Chinese ire when Houston Rockets general manager Daryl Morey tweeted in support of Hong Kong demonstrators, as initially reported in the *Wall Street Journal* on Oct. 11, 2019. Chinese broadcaster CCTV stopped showing games, and the resulting loss of revenue to the NBA was reported to be between $200 million and $500 million. This highlights the CCP playbook whereby it makes its own rules and uses its economic power to achieve the results it wants.

REGION-SPECIFIC CONCERNS

How companies react depends on the industry. Over the past year, localization and regionalization strategies have developed as global businesses initially examined reallocating manufacturing capacity as a result of tariffs. Post-pandemic, these strategies may continue to reduce dependence on a single supplier country and to counter the escalating technology battle between the United States and China.

The American Chamber of Commerce in Shanghai (AmCham Shanghai) has some 3,000 company members. In the report of its post–US election survey of 200 companies that operate in the PRC (50 of which have global revenues of more than $1 billion), AmCham Shanghai's president, Ker Gibbs, noted that nearly 82 percent are not planning to move production offshore in the next three years. In an interview with *Directorship*, Gibbs added that, for global boards that are rebalancing away from China, "72 percent say that uncertainty about US–China relations is the top concern." Other concerns include domestic competitors having unfair advantages, government sanctions or export controls, shifting (Chinese) consumer sentiment against American brands, and that Chinese business will negatively impact global brands.

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> CHINA'S BOLD MOVES TO TRANSFORM THE GEOSTRATEGIC LANDSCAPE ARE FURTHER REINFORCED BY A QUIETER BUT HIGHLY EFFECTIVE EFFORT TO TRANSFORM VALUES AND NORMS WITHIN INTERNATIONAL INSTITUTIONS. CHINA NOW HOLDS THE TOP POSITION IN FOUR OF THE FIFTEEN UNITED NATIONS SPECIALIZED AGENCIES… AND IT USES ITS LEADERSHIP TO ENFORCE ITS OWN NORMATIVE PREFERENCES.
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> —*ELIZABETH C. ECONOMY,* IN COVID-19 AND WORLD ORDER: THE FUTURE OF CONFLICT, COMPETITION, AND COOPERATION *(JOHNS HOPKINS UNIVERSITY PRESS, 2020)*

In AmCham Shanghai's separate annual member survey, a top concern continues to be a lack of intellectual property protection and enforcement of such protections, as over half of respondents say that this hinders their businesses. More than two-thirds of companies in the services sector believe government policy is biased toward local companies. Internet restrictions continue to hamper operations for a majority of Chamber members. Thirty-two percent of respondents say that a souring of the US-China relationship is affecting their ability to obtain and retain staff. Meanwhile, 78 percent of companies reported profits in 2019 despite the trade war. Companies in consumer retail, logistics, transportation, warehousing, and distribution were all profitable, as were those in health care and hospital services and hospitality and leisure. But nearly one-quarter of businesses in banking, finance, and insurance saw losses.

Global companies are increasingly focused on selling to the Chinese market, or being "in China, for China." But some American, Taiwanese, South Korean, and other enterprises are rebalancing production. For example, Chair Young Liu of the Taipei-based Foxconn Technology Group—a major supplier to world-leading US tech firms, as well as PRC companies Huawei Technologies Co., Lenovo Group, Xiaomi Corp., and Alibaba—confirmed that the business is splitting its production capacity between China and other countries, including Vietnam, other South East Asian countries, India, and the United States. Toymaker Hasbro, Bath & Body Works parent company L Brands, and fashion designer Steve Madden are also reportedly outlining plans to reduce their dependence on Chinese factories in the next few years.

Meanwhile, the American Chamber of Commerce in Taiwan conducted its own post–US election survey of 200 companies and reports that 85 percent of respondents express confidence in Taiwan's economic outlook for 2021, with 78 percent expressing confidence for the next three years. "The positive outlook for Taiwan's three-year economic growth is due to the decent control of COVID-19 and the healthy industrial environment," commented one business leader taking the survey. Over half of the companies view the US–China trade dispute as having a positive economic impact on Taiwan. Respondents see Taiwan's exclusion from multilateral or bilateral trade agreements as the most pressing concern for their operations and Taiwan's competitive positioning.

WEIGHING THE OPPORTUNITIES

Based on information from the National Bureau of Statistics of China, the International Monetary Fund reports China's 2020 GDP as $14.36 trillion, which is forecast to grow. It has the second-largest economy behind the United States.

Unable to travel overseas because of the pandemic, the richest Chinese went on a spending spree. Sales of luxury goods jumped 48 percent to $53.5 billion in 2020, with healthy food options in demand and leather goods and jewelry growing by more than 70 percent.

One corporate director based in Shanghai, who asked to remain anonymous, expects to see the "greatest future growth and opportunities for companies in the integrated clean-energy sector—that includes electric vehicles, 5G, and autonomous driving technologies, along with upstream generation of solar [power] and downstream industries like energy storage."

For example, he added, "When Tesla came to China, there were no electric vehicles. Tesla brought clean energy and long-range driving with high-tech battery packs, together with beautifully designed electric vehicles that are highly attractive to Chinese consumers." He continued, “Companies that don’t embrace the digital economy to improve industrial operating processes will face real difficulties in China.”

One company taking advantage of the digital economy is Pinduoduo. Founded in 2015 and headquartered in Shanghai, Pinduoduo offers low prices for household items, from groceries to fashion and beauty products to electronics. It had 731.3 million active buyers as of Sept. 30, 2020.

The anonymous director explained that “China has massive overproduction capacity, and Pinduoduo provides a virtual framework [or website] to enable people to group together to collectively bargain online to lower a product price, while remaining profitable for manufacturers.” He added that “it makes the cost of living lower” and therefore helps lift more low-income Chinese out of poverty.

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> WAGE, CONSUMPTION, SAVINGS, AND INVESTMENT LEVELS HAVE ALL ENTERED SPIRAL GROWTH… PROVIDING A GOOD ENVIRONMENT FOR CREATING A MIDDLE-CLASS CONSUMER SOCIETY.… VARIOUS FACTORS PLAY A ROLE IN THIS: CONTINUOUS HIGH INVESTMENT IN SCIENTIFIC RESEARCH; AN EDUCATED LABOR FORCE, ESPECIALLY THE RAPID EXPANSION OF ENGINEERS; AN INCREASING URBANIZATION PROCESS; HIGH SAVINGS AND INVESTMENT BY RESIDENTS; A STABLE POLITICAL ENVIRONMENT; AND A HUGE DOMESTIC MARKET.
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> *—LI LU, FOUNDER AND CHAIR OF HIMALAYA CAPITAL AND A STUDENT LEADER OF THE 1989 TIANANMEN SQUARE PROTESTS, PARAPHRASED FROM A JANUARY 2019 SPEECH*

Although the PRC’s 1.4 billion people are a huge potential market, a thorough market analysis is critical to determine actual potential customers for specific industry sectors. CCP support of specific industries and a shift in domestic consumer bias toward local companies are important factors.

Many Chinese struggle with low incomes and poor standards of living. Premier Li Keqiang confirmed that more than 600 million people—the bottom 40 percent of households ranked by income—had an annual per-capita disposable income in 2019 of only 11,485 yuan, or roughly $1,621. About 17 percent or 237.2 million people in China still live under the World Bank middle-income poverty line of $5.50 per day, but this is noticeably higher than in some other major middle-income countries.

FUTURE CHALLENGES

Companies should prepare and plan for future shocks from China. As dependence on revenue from Chinese operations increases, this perpetuates the potential impact of business interruptions. Expected “gray rhino” risks include the following:

- US-China tensions and disputes, particularly over China’s state-sponsored commercial activities and human rights and democracy issues
- more frequent emerging infectious diseases; EcoHealth Alliance, a nonprofit independent research group, published a study in 2020 of 630 novel coronavirus sequences found in China, out of a total 1,000 new diseases found in 20 countries
- a global rise in sea level due to climate change; Verisk Maplecroft’s *Environmental Risk Outlook 2020* report identified Guangzhou and Dongguan as two major metropolitan areas in China’s Pearl River Delta Economic Zone that are most vulnerable; the globally important manufacturing hub generates some 20 percent of Chinese GDP

ESG AND HUMAN RIGHTS

With the stakeholder mind-set and environmental, social, and governance (ESG) standards increasingly being adopted, there are political risks inherent in many ESG issues that boards should consider. China has consistently ignored the international community’s concerns over human rights abuses. Examples include

- the detention, arrest, and imprisonment of prominent businessmen (including 73-year-old Jimmy Lai), elected lawmakers, citizen journalists, and democracy activists in Hong Kong;
- the labor abuse of more than 500,000 people forced to pick cotton in the Xinjiang region, which produces 87 percent of China’s and 20 percent of the world’s cotton; and
- the mass detention of Muslim and other ethnic Uighurs in the Xinjiang region, exacerbated by reports of Huawei testing a facial-recognition system developed by artificial intelligence firm Megvii that could be used to identify Uighurs and trigger an alert to police.

Furthermore, product quality has improved in many sectors in China but still remains an important issue in the context of the “disposable” culture, which significantly impacts goals to reduce waste, carbon footprint, and more.

In October, the Pew Research Center published its latest findings of Western views of China, which show that a majority in each of the 14 surveyed countries had an unfavorable opinion. In Australia, the United Kingdom, Germany, the Netherlands, Sweden, the United States, South Korea, Spain, and Canada, negative views of China reached their highest points since Pew began polling on this topic more than a decade ago.

The impact of both Western and Chinese consumer beliefs and behaviors on reputation, global brand values, ESG reporting, and investor relations is likely to grow. With these risks and perceptions of China in mind, corporations may need to consider a future scenario in which either customers or governments seek a warning label for products made in countries known for environmental, human rights, or other social abuses. Companies may preempt such potential measures by instituting ESG compliance standards for their suppliers. Patagonia's Supply Chain Environmental Responsibility Program is a great example.

MINIMIZING GEOPOLITICAL RISKS

World-leading and sustainable global businesses continuously assess and improve their operations. A mind-set that is critical of both political risk drivers and buffers, as well as an awareness of potential cognitive biases, can assist government affairs and other risk mitigation programs. Operating in China means that multinational boards need to focus on the following politically driven risks:

1. US-China governmental relations that are likely to intermittently deteriorate, as well as security issues such as compliance with export and potential dual-use controls
2. revenue or supply-chain concentration
3. changing regulations and coercion
4. unfair advantages for domestic competitors
5. reputation
6. operations—rising labor costs and employee security
7. lack of transparency and judicial independence
8. restricted free speech

It is important to remember that each company has its own risk appetite. But how can corporations seek to minimize and mitigate the impact of problematic and challenging geopolitical risks? One method to use is deductive, plausible scenario planning. The Center for Strategic and International Studies' Risk and Foresight Group determined four such forward-looking scenarios to explore the changing geopolitical landscape *(see chart, below)*. The scenarios center on the relative power and influence of the United States and the PRC and the interaction between them, and also consider major US allies and adversaries.

In no scenario was the US-China relationship fully cooperative or positive, though cooperation was possible on select, shared global interests when American power and influence equaled or was greater than China's. In all scenarios, the United States and China remained intertwined, and in all scenarios other than the most severe reduction of Chinese global influence, bilateral dynamics were increasingly competitive.

Another risk to consider: In 2019, Xi said that Taiwan—which the CCP regards as a Chinese province—"must be, will be" unified with the PRC. While an outright war over Taiwan may seem unlikely, corporations should run associated scenarios for themselves and develop contingency plans.

Businesses should carefully consider their risk tolerance in China and prepare for Chinese companies to compete in their domestic markets. In essence: warning—increasingly significant political risks and strategic competition ahead. D

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SCENARIO OVERVIEWS

STRONG

Chinese Global Leadership/Influence

HAMMER & SICKLE

- China first to develop COVID-19 vaccine
- China redoubles focus on military and technology advancement
- United States retreats from international leadership
- Continued US polarization and downturn

YIN & YANG

- China and the United States both field successful vaccines
- China remains assertive, but the United States and its allies contain its revisionism and aggression
- Tech decoupling, but world trade remains largely intact
- The United States and China cooperate on select issues

SKULL & BONES

- World order fragments as COVID-19 advances unchecked
- Outbreaks ravage the world until herd immunity reached in 2024
- US alliances are strained but endure
- India and Pakistan have a nuclear exchange

STARS & STRIPES

- The United States leads development of COVID-19 vaccine
- China experiences civil unrest after botched vaccine rollout
- China's economy contracts and growth slows
- The United States renews strong leadership of international system

WEAK — US Global Leadership/Influence — STRONG

SOURCE: Center for Strategic and International Studies' Risk and Foresight Group, *Four Scenarios for Geopolitical Order in 2025–2030: What Will Great Power Competition Look Like?* by Samuel Brannan, Sept. 16, 2020