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Many big foreign companies in China have been under intense public and official scrutiny in recent months

This is less an anti-foreign campaign than the government's attempt to build domestic credibility

In fact, the administration is simultaneously exploring the further liberalization of foreign investment

China Policy Watch: Multinationals In China

Take The Pain, Wait For The Gain

For multinational companies operating in China, it's been a challenging few months. Mead Johnson, Danone and others were fined US$109m in August for supposedly fixing the prices of infant formula. Dairy giant Fonterra has come under the microscope due to worries about botulism. Apple has been accused of having second-class warranties for its Chinese consumers. Drugmaker GlaxoSmithKline's sales in China have plummeted following bribery revelations. And attacks against other foreign companies in official and social media have been numerous. It is not hard to draw the conclusion, as many observers have, that China's government is sponsoring a crackdown on foreign firms to fan the nationalist flames, distract public attention from more serious problems and help out domestic industry along the way.

Yet this is a distorted picture of what is actually taking place. There are certainly some parts of the bureaucracy that are taking advantage of the turn to more nationalist rhetoric to assert more power over foreign firms. And in China's system multinationals are unfortunately easy targets. But in our view the new leadership's real intention in making examples of a few foreign firms is to solidify its credentials with the public, Party conservatives and the military, so that it can gain a mandate to carry out wide-ranging economic reforms. China's new government is simultaneously trying to maintain its hold on power, reclaim its popularity among the Chinese public, and push an increasingly cumbersome system to change. These goals are sometimes in tension with each other, resulting in frequent zig-zags in policy. But we would liken this process to a sailboat tacking against the wind in order to continue on its course (see Reform Sails Against The Wind).

We suspect that the upcoming high-profile gathering of the Communist Party leadership to discuss economic reforms, known as the Third Plenum, will end up being seen as a watershed event. It would be silly to expect the bureaucracy to deliver a massive one-shot dose of radical reforms, and the Party's announcements are certain to be couched in impenetrable Communist jargon. But based on current discussions it does appear that over time there will be a substantial shift in the overall direction of policy, to eventually include tighter controls on state firms, expanded competition across a variety of sectors, liberalization of family-planning policies, decentralization of regulatory decision-making, and reform of local government finances. Foreign firms are likely to benefit from these economic changes—though they may well have to suffer unwelcome media attention and political scapegoating for a while longer.

The good old days

Many foreign executives pine for the bygone days when they were wooed by Chinese officials eager to attract foreign investment and technology. While attracting FDI was a key growth strategy for China in the 1980s and

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Foreign firms now need China's growth as much as China needs their technology

Multinationals often tend to be guinea pigs when regulatory enforcement toughens up

Yet the data show foreign firms overall are still targeted relatively infrequently

1990s, these days Chinese officials know all too well that multinationals need China's growth as much or more as China needs their technology. And China is now such a large economy that foreign firms have become relatively much less important. Over the last decade, the number of foreign-invested firms has grown by 55%, from 285,000 to 442,000 companies. But they account for just 0.8% of the total number of companies, as the number of private-sector firms has doubled over the same period.

Multinational firms do tend to punch above their weight: thanks to advantages in technology, reputation, management and human resources, they are at the cutting edge of every sector. And they are closely integrated with domestic Chinese firms: there are hundreds of thousands of close partnerships between Chinese and foreign firms as production and innovation networks have gone global. The best figure capturing this importance is that foreign-funded firms still account for around half of China's merchandise trade. China cannot attack foreign firms without hurting itself, which means that self-interest would ultimately check any all-out attack on foreign investment.

And indeed the purpose of the various high-profile investigations of multinationals does not appear to be to de-legitimize foreign business per se, but to crack down on certain types of undesirable behavior that are prevalent throughout the entire economy. For instance, while some foreign pharmaceutical manufacturers may well have used bribes to push their drugs, it is nonetheless true that they operate in an over-regulated system that invites and almost requires corruption in order for firms to operate. If the new leadership is going to try to change these practices, it makes sense that they would permit tougher enforcement first against multinationals first because of the relative ease of bringing such actions. It is harder for foreign firms to hide behind benefactors high up in the Party, so the political risk from an attack on a multinational is less than for one on a large state enterprise. Yet a look at the data in fact data shows multinationals are far from the only targets, and are still targeted relatively infrequently.

The hammer and the nail

One tool that Chinese regulators have been using more frequently is the Antimonopoly Law. But this has not been used as a blunt tool to club foreign firms into submission. The State Administration of Industry and Commerce (SAIC) has launched over a dozen investigations into anti-competitive behavior, and all but one has been directed at domestic firms, including high-profile ones such as China Mobile and Baidu. The National Development and Reform Commission (NDRC), which is responsible for regulating price fixing, has gone after some foreign firms. And its penalties against foreign companies have often been higher than for their domestic counterparts; for example, in the case where infant formula makers were accused of price fixing, the five penalized foreign companies were collectively fined over Rmb500m, while one domestic firm, Biostime, was fined Rmb160m. However, the total number of cases has still been minuscule—less than twenty in the last three years. The NDRC has said it plans to launch more investigations, but it says its new targets will likely be in sectors where state-owned firms are more prominent, such as in telecom, banking, and autos.

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Domestic firms make up 99% of all enforcement actions on pollution rules

Corruption probes into foreign drugmakers have been accompanied by actions against domestic SOEs and politicians

The situation is even clearer in another area where selective enforcement is quite easy—pollution fines. According to Ministry of Environmental Protection data from seven provinces, during the past four years 99% of pollution enforcement actions have been carried out against domestic firms, and the average fine against domestic firms has always been higher than that for foreign companies. In 2012, foreign firms on average paid a fine of Rmb83,000, while local companies paid over Rmb280,000 per case (see table for more details).

Multinationals are rarely targeted by environmental regulators

Pollution fines against foreign and domestic firms in China

Year	Foreign firms' share of cases	Foreign firms' share of fines	Foreign firms' average fine, Rmb	Domestic firms' average fine, Rmb
2010	1.66%	0.49%	161,000	542,000
2011	0.97%	0.48%	165,000	333,000
2012	1.08%	0.32%	83,000	281,000
2013	0.87%	0.55%	117,000	186,000

Note: Data is for Jan-Mar of each year and for the seven provinces of Beijing, Tianjin, Liaoning, Jilin, Shanghai, Jiangsu and Zhejiang

Ministry of Environmental Protection, GK Dragonomics research

Product recalls could be another way to restrict foreign companies' sales in China. Although a disproportionate number of recalls are issued against foreign-made products, the overall total number of recalls is still extremely low—only 67 in 2012, the highest total on record. Over 75% of recalls have been in one sector, autos, and two-thirds of those recalls have been in just the past two years. The data (see table, overleaf) show that there tend to be sudden rises and falls in the number of cases in an individual sector, which suggests a campaign-style approach of targeting problems in a particular sector rather than a broad shift in sentiment against foreign companies.

Finally, the recent prominence of corruption cases against foreign pharmaceutical firms could give the mistaken impression that multinationals are the primary targets of the current anti-corruption campaign. Although there is no comprehensive data on corporate corruption cases, the vast majority of cases reported on the web sites of the Ministry of Supervision, the Supreme People's Procuratorate, and the Party's Central Discipline and Inspection Commission involve domestic firms, particularly state-owned enterprises.

The most high-profile corruption investigation in China at the moment involves current and former officials of China National Petroleum Corp (CNPC), one of the largest and most powerful state firms in China. This probe is being interpreted in many quarters as an effort by the top leadership to rein in some powerful vested interests, and signal to others that any opposition to their new policies would be dangerous. The regime seems to be taking a highly opportunistic approach to cracking down on corporate corruption, making multinationals more vulnerable than ever, but SOEs and domestic private firms are likely even more under the microscope.

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Product recalls are mainly an issue for the auto sector, where foreign brands dominate

Recalls tend to come in campaign-style waves

China product recall cases by sector

Year	Total	Autos	Toys	Milk powder	Medical	Other
2008	19	16	3	0	0	0
2009	16	10	3	0	0	3
2010	17	10	0	0	6	1
2011	25	21	0	0	1	3
2012	67	49	18	0	0	0
2013	59	52	0	5	0	2
Total	203	158	24	5	7	9

China product recall cases by nationality of producer

	Total	China	Total foreign	USA	Europe	Japan
2008	19	6	13	3	7	3
2009	16	5	11	3	4	3
2010	17	7	10	0	6	4
2011	25	5	20	5	6	8
2012	67	30	37	2	21	12
2013	59	13	46	9	13	17
Total	203	66	137	22	57	47

AQSIQ, China Food & Drug Administration, GK Dragonomics research

The government has allowed campaigns targeting foreign firms, but it has not shifted permanently against them

So while operating in China is no picnic for foreign companies, and they do face harassment and a maze of conflicting regulations, the overall environment has not suddenly swung against them. It is fair to say the government has mounted or at least permitted a pseudo-populist campaign against the abuses of some multinationals—but also that it has stopped short of any fundamental realignment against foreign investment. In fact, the government is actively discussing changes that could lead to a renewed emphasis on attracting foreign investment and allowing more competitive space to multinationals.

A new attitude in trade talks

China's trading partners are reporting a change of tone in recent talks

Many of China's trading partners have noted a recent change of tone in foreign trade and investment policies and negotiations. At the WTO, China recently put aside its original demands and is no longer blocking a revision of the Information Technology Agreement. It has signaled it will soon make a new, bolder offer to join the Government Procurement Agreement, and it has welcome discussions over a new Trade in Services Agreement. The original hostile rhetoric against the Trans-Pacific Partnership (TPP) has been replaced by a desire to collect more information about the negotiations and consider the possibility of joining (see A Secret Plan For World Domination). China has also indicated it would like to use its hosting of the 2014 APEC leadership summit to encourage greater regional integration. Bilaterally, since the early summer

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The Shanghai FTZ is an indication that re-thinking the foreign investment regime has begun, if not gotten very far

Foreign companies will not get a return to old-style special privileges, but they may end up with a better environment

China has more enthusiastically participated in the Strategic & Economic Dialogue with the US and stepped up talks on a bilateral investment treaty. Whether these negotiations achieve major market-opening results is still in doubt, but the change in posture is undeniable.

Consistent with these signals has been the creation of the Shanghai Free Trade Zone, which promises to substantially liberalize domestic investment procedures. The details of what is on offer so far in the zone have been entirely underwhelming. As part of its industrial policy, China has long maintained a list of sectors where investment is encouraged, what is called a “positive list.” The new zone made news by only issuing a "negative list" of off-limits sectors (with the presumption that anything not on the list is allowed), but this list is so long that in effect it is not much different from the previous catalogue of encouraged and restricted sectors. And given that China still has priority and off-limits investment sectors in the rest of the country, any such regional initiative can only have a limited impact.

The real significance of the zone lies in the scope it gives to experiment with new rules that can be extended nationwide. If the zone’s innovations are not expanded beyond its borders, it will mean little. And it did take many years for the more liberal regulations trialed in Shenzhen and other special economic zones in the 1980s were expanded to the rest of the country. But at least we can say that its creation makes no sense if China is really trying to crack down on multinationals, and is consistent with a desire to rethink existing policies on foreign investment. Some optimists even see these various initiatives as a way to push forward domestic economic reforms, in the same way that entry into the World Trade Organization did in 2001.

The special privileges that foreign companies once enjoyed in China are ancient history and will not return—no longer can they count on being offered endless tax and other incentives from obsequious regional officials, or being able to call up a minister at a moment’s notice to sort out any bureaucratic problems. At the same time, multinationals are now being chosen as the first guinea pigs for enforcement. However, if the current administration is successful in pushing forward broader changes in domestic regulation and foreign economic policy against the inevitable opposition, the landscape for foreign businesses in China would become more transparent, fair and predictable than it is today.