PacNet
Number 60

Pacific Forum CSIS
Honolulu, Hawaii

July 23, 2014

Don't kill the goose that lays the golden eggs by Ting Xu

Ting Xu (ting.xu@aetosworld.com) is a non-resident Handa Fellow at the Pacific Forum CSIS and director of advisory at Aetos Strategy & Advisory in Hong Kong.

For many foreign companies, China is an increasingly difficult assessment. The attractions of the world's largest consumer market and continued government investment in infrastructure are offset by a tougher operating environment that often makes foreign companies pay a higher price for regulatory improvements such as anti-corruption and antitrust measures. For the Chinese government, making examples of large foreign companies appears to be an easy solution for such ills, but there is a real risk that costs are becoming too large for those foreign companies to continue investing in the country. Indeed, some multinationals are so anxious about operations in China that they are leaving the country outright.

This year's investigative report of Nikon CCTV, the Chinese state broadcaster, alleging that the camera maker treated Chinese consumers unfairly and sold them defective products, is the latest in a series of foreign companies spotlighted by CCTV's annual 3.15 consumer day campaign. The 3.15 program began in 1991, but only recently began featuring popular foreign brands. Companies that have become the subject of allegations in state media (CCTV, Xinhua, and People's Daily) include: Apple, that discriminated against Chinese consumers in customer service; Carrefour, that put fake free-range labels on chicken products; Volkswagen, whose cars had safety issues; McDonald's, that sold expired food; and Starbucks, that charged higher prices to Chinese consumers. A recent scandal involving CCTV Finance Channel Director General Zhenxi Guo – alleged to have extorted money from companies to keep them off his program – has highlighted the role of media in doing business in China.

Of course companies shouldn't discriminate against Chinese customers and the changes brought about by some of these investigations are welcome. Most of the companies apologized: Apple changed its customer service policy; Volkswagen announced massive car recalls; and Carrefour and McDonalds took steps to ensure food quality. Some allegations had little factual basis, however: Starbucks charges higher prices because of higher tariffs on its input into China. Details from the Guo case suggest that the possibility of being featured in an investigation may be a way for programs such as 3.15 to increase sponsorship revenue.

The downsides to continuing to do business in China are not insignificant, however. Many big foreign companies have hired PR firms and are on alert to possible media campaigns against them. In addition, companies face the prospect of exposure by Chinese state media, rising costs that erode profit margins, and anti-trust enforcement handing out massive fines. Meanwhile, pervasive corruption makes it tough for businesses that do not pay bribes, while the government's anti-corruption campaign means that businesses that 'pay to play' run big risks. The government-backed drive to advance domestic technology raises prices for foreign companies who are requested to transfer key technologies for market entry. And the role of state-owned enterprises in key sectors of the economy is making competition more formidable for those who lack state backing. Foreign investors need to make more careful calculations before banking on profits in China and many are wondering whether they are being targeted and pushed out.

The powerful National Development and Reform Commission (NDRC) has started to beef up its antitrust enforcement. In July 2013, its senior regulator told a meeting of 30 large foreign company executives that all sectors of "strategic national interest" are being examined, and half the companies present were being investigated. Executives were advised against hiring attorneys to fight against government antitrust allegations because that could lead to triple the fines. A month later, NDRC set an unprecedented example by announcing $110 million in fines on six powdered milk producers, five of which were foreign. All companies paid the fines without challenging the regulator or seeking judicial review.

Petty corruption has been widespread in China for a long time and both Chinese and foreign businesses are well-acquainted with this problem. The Chinese jewelry industry estimates that a third of all luxury goods in China are gifts and one-tenth of them are bribes. The Chinese government has identified corruption as a key challenge and is making an effort to fight it. Many foreign companies already face higher risks than their Chinese counterparts because their business practices in China are vulnerable to prosecution under their home countries' anti-corruption laws (particularly the UK and the US). Since the US passed the Foreign Corrupt Practices Act, over 40 defendants have faced actions involving conduct in China, second only to Nigeria.

China's campaign against corruption should be welcomed by foreign companies as a means of leveling the playing field, but many foreign businesses feel they are being targeted. When British pharmaceutical company GlaxoSmithKline was fined $500 million in 2013, the government was taking in a long-standing history of illegal payments in the industry. However, many wondered whether the investigation would be even-handed or whether it marked the beginning of a campaign against foreign pharmaceutical companies. The subsequent investigations into Novartis, Sanofi, Bayer, and Eli Lily seemed to justify these fears. It has been estimated that of the 500,000 Chinese corruption investigations between 2000 and 2009, 64 percent involved foreign companies. Given foreign investment's declining share of the Chinese economy

(1.8 percent of GDP in 2009), it looks like foreign companies are being probed at a higher rate than their Chinese competitors.

It is encouraging to see China taking steps to enforce laws and regulations. However, if these important reforms are to be fair and effective, the proportion of domestic and foreign targets should reflect the marketplace. Similarly, market access should grow with foreign investment. Today, the foreign fear of becoming a scapegoat appears justified.

Foreign companies are suspicious when enforcement efforts coincide with media attention, worrying that these actions are an attempt to carve out markets for domestic companies in sectors of 'national strategic interest,' such as food, energy, pharmacy, and autos. For example, state media reported in 2010 that the Chinese government planned to increase domestic brands' share of the automobile market to over 50 percent by 2015. Subsequently, Volkswagen was featured by CCTV in a 3.15 probe and recalled 640,000 cars in China. In December 2013, carmakers Jaguar, Land Rover, Subaru, and Audi became targets in state media investigations for alleged unfair pricing.

Some long-time investors are leaving. Meiji no longer finds it profitable to sell milk powder in China, and Revlon is pulling out of China after almost two decades. Pharmaceutical company Actavis is on its way out and its CEO said that Chinese rule making and enforcement makes the business environment unfriendly and risky. Twenty-eight percent of respondents in the recent European Chamber of Commerce business confidence survey expect the Chinese regulatory environment for foreign businesses to worsen over the next two years; 25 percent expect no improvement.

Foreign companies are still crucial to China's future, even as Chinese companies grow stronger. Chinese businesses have grown much more sophisticated, but foreign investors can still contribute significantly to the Chinese economy with their capital, experience, technology, and know-how. A smooth structural transition is needed to promote more value-added industries, and facilitate service-based and consumption-based economic growth. Foreign investments have been and should continue to be an integral part of this process. The perception that the Chinese government is intentionally targeting foreign companies can damage China and foreign investors. In recent meetings with foreign business representatives, Premier Li Keqiang said that it is better for everyone to create a business environment based on fair competition. It is needed in China now.

PacNet commentaries and responses represent the views of the respective authors. Alternative viewpoints are always welcomed.