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European Business in China

POSITION PAPER 2019/2020

The *European Business in China Position Paper 2019/2020* represents the views of the European Union Chamber of Commerce in China. Our working groups, fora and more than 1,600 member companies have together compiled the latest assessments, concerns and recommendations of European businesses operating in China.

We hope that this position paper will promote constructive dialogue between Europe and China, at both the political and business levels. We look forward to continued improvement in business cooperation, to the benefit of both Europe and China.

European Union Chamber of Commerce in China

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The information contained herein is based on input and analysis from January 2019 to July 2019.

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Message from the President

In October 2019, China will mark the 70th anniversary of the founding of the People's Republic of China. Undoubtedly, the scale of the celebrations will be commensurate with the country's impressive development over the last seven decades, and the accomplishments of the last four in particular.

Meanwhile, another significant anniversary from much further back in China's history is likely to slip by mostly unobserved: 2,100 years ago, the course of the Western Han Dynasty was set when China's brightest minds were called upon to debate key aspects of the economic system of the time. The ensuing 'Discourses on Salt and Iron' boiled down to two different factions arguing over the state's involvement in the economy.[1] One side demanded the state remove itself from the market and end its monopolies on salt and iron production and distribution, while the other defended the importance of holding on to these industrial commanding heights.

Little has changed in the intervening twenty-one centuries.

China's salt monopoly, which once employed a 25,000-strong salt police force to enforce its dominance, only saw the initial stages of liberalisation just two years ago.[2] The steel industry, with a slow influx of private players taking up market share, is perhaps more advanced, but while China has six of the world's ten largest steel producers by volume, only two are privately owned, and they only occupy the sixth and ninth rankings.[3]

The contemporary discourse also encompasses a wide variety of sectors in addition to iron and salt, but the core characteristic remains unchanged, which is, as one debater put it in 81 BC, "the state competes with the people".[4] Indeed, in the European Chamber's *Business Confidence Survey 2019*, 70 per cent of members reported that SOEs are present in their sector. In addition, there are many industries where SOEs enjoy exclusive access or their market domination effectively blocks international companies from competing.

This situation has been exacerbated by the profound changes that have taken place in recent years, with the government pursuing SOE reform with Chinese characteristics. Rather than cutting SOEs down to a manageable size, determining the industries that would be most appropriate for them to operate in and privatising the rest, the goal has been to make them "stronger, better and bigger".[5]

This has resulted in a truly resurgent state-owned economy, with SOEs impacting sectors way beyond those in which they have major presence. Financing flows to private firms have dried up, from 57 per cent of all non-financial corporate loans in 2013, to a measly 11 per cent in 2016, at the same time that Chinese SOEs have seized a much greater share of funding,[6] jumping from 35 per cent to 80 per cent in the same timeframe. The screws have also been tightened on the private sector with SOEs imposing abnormally long payment periods in their agreements, which act as *de facto* loans from suppliers. This has unfairly impacted a great many European firms directly, but far more have suffered indirect effects, such as when their local partners have struggled to make ends meet as a result, leading to disruptions to both upstream supplies and downstream demand.

The benefits that many SOEs currently enjoy from their vertical monopoly position comes at the expense of sound market competition. This happens for example in the energy sector, where some of the same firms that produce

1 A full text of *The Discourses on Salt and Iron* can be found at the following link: <http://www.8bei8.com/book/yantielun.htmll>

2 Viard, Brian, *China's Salt Monopoly: Cracking Down on Illegal Contraband, Forbes*, 4th August 2014, viewed 29th August 2019, <https://www.forbes.com/sites/ckgsb/2014/08/04/chinas-salt-monopoly-cracking-down-on-illegal-contraband-2/#213bab563d75>

3 *Top Steelmakers in 2018: List of Companies with Tonnage of More Than 3 Million in 2018*, World Steel Association, 2018, viewed 29th August 2019, <https://www.worldsteel.org/en/dam/jcr:80ce948e-6a12-47d0-baf1-26799888db67/2018%2520Top%2520Steel%2520Producers_Extended%2520List.pdf>

4 *Chapter One: The Basic Arguments, The Discourses on Salt and Iron*, <http://www.8bei8.com/book/yantielun_2.html>

5 *Xi Calls for Further SOE Reform, Xinhua*, 18th October 2017, viewed 29th August 2019, <HYPERLINK "http://www.xinhuanet.com/english/2017-10/18/c_136688444.htm" http://www.xinhuanet.com//english/2017-10/18/c_136688444.htm>

6 Lardy, Nicholas, *The State Strikes Back*, Peterson Institute for International Economics, January 2019, Washington D.C., Figure 4.1

energy also own the grid – a huge, unfair advantage over private energy companies that must pay their competitors to deliver their product to customers.

Conflicts of interest also occur, with SOE executives and regulators frequently switching hats over time, which adds another layer of unfairness for private companies to overcome. For example, the high thresholds that have been set for obtaining various operating licences in the financial services sector has seriously restricted meaningful participation of international finance companies in the markets they have only recently been allowed to enter.

From all this, it could be assumed that China's current leadership has simply arrived at the same conclusions that the Western Han Dynasty came to 21 centuries ago. Fortunately, this is not the case: a robust debate is underway in Beijing, with different voices throughout the government periodically spilling out into the public forum.

'Competitive neutrality', the principle that the government should provide equal treatment to all enterprises, regardless of ownership, has been on the lips of some of China's most important economic policymakers in recent months. Former and current People's Bank of China governors Zhou Xiaochuan and Yi Gang both spoke on the concept in late 2018, followed by the new and powerful State Administration for Market Regulation, the State Council and even Premier Li Keqiang in his *2019 Work Report*.

Competitive neutrality would put an end to China's 'economic caste system', whereby it differentiates and favours state-owned over private first and foremost, and then local over foreign. The greatest benefit of abandoning such a system, and developing strong institutions to provide recourse when enterprises encounter unequal treatment, would be the resulting surge of confidence in China's market and the accompanying boost in investment.

Those calling for these reforms recognise the need for greater efficiency in the economy that a strong private sector provides. The European Chamber has long added its voice to this chorus, having advocated relentlessly for a level playing field between all company types, regardless of ownership, and recognising that competitive neutrality and SOE reform are central to achieving this.

Having been in China since the earliest days of the reform and opening up period, European companies have witnessed how previous Chinese leaders have applied bold reforms aimed at economic liberalisation. There is now an increasing expectation that this can, and must, happen again, not just because of past accomplishments, but also because China has accumulated a wealth of experience, is much stronger than ever before and now possesses a far more sophisticated regulatory system.

Realising competitive neutrality and embarking on true SOE reform is key to achieving a variety of goals: ushering in a true market economy, making the most of China's entrepreneurial potential and accelerating development. This would be an enormously positive next step for China's reform agenda, while bringing a decisive end to a debate that has been rumbling on for 2,100 years.

Jörg Wuttke
President
European Union Chamber of Commerce in China

ABOUT THE EUROPEAN UNION CHAMBER OF COMMERCE IN CHINA

FOUNDED IN
2000
BY 51 MEMBER COMPANIES

33
WORKING GROUPS AND FORA

MORE THAN
1,600
MEMBER COMPANIES

OPERATING IN
9
CITIES

The European Union Chamber of Commerce in China (European Chamber) was founded in 2000 by 51 member companies that shared a goal of establishing a common voice for the various business sectors of the EU and European businesses operating in China. It is a member-driven, non-profit, fee-based organisation with a core structure of 33 working groups and fora representing European business in China.

The European Chamber has more than 1,600 member companies in seven chapters operating in nine cities: Beijing, Nanjing, Shanghai, Shenyang, South China (Guangzhou and Shenzhen), Southwest China (Chengdu and Chongqing) and Tianjin. Each chapter is managed at the local level by local boards reporting directly to the Executive Committee.

The European Chamber is recognised by the European Commission and the Chinese authorities as the official voice of European business in China. It is also recognised as a foreign chamber of commerce by the Ministry of Civil Affairs. The European Chamber is part of the growing network of European Business Organisations (EBO), which connects European business associations and chambers of commerce from 37 non-EU countries around the world.

Mission statement

As a member-based organisation, the European Chamber seeks several things:

1. To ensure greater market access and a level playing field for European companies operating in China.
2. To improve market conditions for all businesses in China.
3. To facilitate networking among members and stakeholders.
4. To provide specific, relevant information to its members on how to do business in China.
5. To update its members on economic trends and legislation in China.

Principles

1. We are an independent, non-profit organisation governed by our members.
2. We work for the benefit of European business as a whole.
3. We operate as a single, networked organisation across Mainland China.
4. We maintain close, constructive relations with the Chinese and European authorities, while retaining our independence.
5. We seek the broadest possible representation of European business in China within our membership: small, medium and large enterprises from all business sectors and European Member States throughout China.
6. We operate in accordance with Chinese laws and regulations.
7. We treat all of our members, business partners and employees with fairness and integrity.

Competitive Neutrality: Reining in China's Industrial Hegemons

Introduction

Coming out of the failure of the centrally-planned economic model used in the first three decades of the People's Republic of China, Deng Xiaoping seized the opportunity presented by uncertainty to blaze a trail, undertaking bold and daring reform and opening-up measures, beginning in 1978.

When some in China began to question the merits of opening up, Deng further pushed China's economic liberalisation with his Southern Tour in 1992, laying the foundation for a major wave of foreign investment into the market. Although Deng's passing brought another moment of anxiety for the Chinese economy, Jiang Zemin and Zhu Rongji picked up the torch, launching extensive liberalisation and state-owned enterprise (SOE) reform in 1998, and setting up China's accession to the World Trade Organization (WTO) in 2001.

This sent a clear signal to the international business community: China's leaders are adept at handling moments of economic crisis and uncertainty, and using them to quickly advance economic liberalisation.

China now stands on the cusp of a new and different type of economic crisis, as growth slows while regulators attempt to rein in debt and policymakers seek to pull the appropriate levers to further boost productivity and innovation.[1] This could be the moment for China's leaders to emulate their predecessors, and again seize the opportunity presented by this crisis to take several large steps forward.

China's internal debate

An internal debate has been going on for some time about how to best shore up China's economic system as it heads into difficult waters. In 2012, now-Vice Premier Liu He led the drafting of the report *China 2030: Building a Modern, Harmonious, and Creative Society* with the World Bank,[2] which lays out many of China's underlying structural issues that need to be addressed. This was closely followed by the *Decision* document that resulted from the Third Plenum of the 18th Central Committee of the CCP in 2013, which seemed to signal to the rest of the world that China was ready to again advance along the road towards opening up.[3] Unfortunately, the most critical structural reforms needed to rein in SOEs and advance market forces failed to materialise. Some hope was briefly restored following President Xi's speech at Davos in 2017, but this too led to only limited results.[4]

1 Harada, Issaku, *China's Debt Mountain Scales New Heights on Trade War Stimulus, Nikkei Asian Review*, 19th June 2019, viewed 6th August 2019, <https://asia.nikkei.com/Economy/China-s-debt-mountain-scales-new-heights-on-trade-war-stimulus>

2 *China 2030: Building a Modern, Harmonious, and Creative Society*, World Bank and the Development Research Council of the People's Republic of China, 23rd March 2013, viewed 6th August 2019, <documents.worldbank.org/curated/en/781101468239669951/China-2030-building-a-modern-harmonious-and-creative-society>

3 *Decision of the Central Committee of the CCP on Some Major Issues Concerning Comprehensively Deepening Reform*, China.org, 16th January 2014, viewed 2nd August 2018, <http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm>

4 *President Xi's Speech to Davos in Full*, World Economic Forum, 17th January 2017, viewed 6th August 2019, <https://www.weforum.org/agenda/2017/01/full-text-of-xi-jinping-keynote-at-the-world-economic-forum/>

After the Jiang Zemin administration handed off power to the next generation, SOEs retrenched themselves.[5] Now, they have resurfaced to play a more decisive role in China's economy: they are at the centre of many national strategies while President Xi exhorts them to become "stronger, better, bigger".[6] This has coincided with private firms, including foreign ones, coming under increasing pressure to formalise a role for the Communist Party of China (CCP) in their governance structures, casting serious concerns over how the party-state apparatus may distort the decisions of otherwise free agents in a market economy.[7&8]

However, there is still a push for greater economic liberalisation coming from some in China, which is clearly having an impact on the business environment. This was recognised by the International Monetary Fund (IMF) in their 2019 Article IV Consultation with China, which noted, among other improvements, the release of a clearer *Market Access Negative List* that applies to both foreign and domestic enterprises; the strengthening of IP protection through the establishment of the IP tribunal in China's Supreme Court and the revisions to the Patent Law; small reforms to the household residency registration system (*hukou*); and China's rise up the rankings (up 32 places to 46th) in the World Bank's *Doing Business 2019* report.[9&10]

A new focus for another surge in reforms?

The voice for reform has been heard clearest in the recent calls from Chinese leaders for 'competitive neutrality' to guide the relationship between the government and business. Meant to indicate that government provides no differentiated treatment between private and state-owned enterprises, the term was used by former People's Bank of China (PBOC) Governor Zhou Xiaochuan in mid-September 2018. As *Reuters* reported:

"'We should change the mentality. We should learn more about WTO rules. There could have been some inappropriate behaviour sometimes, but we are improving,' Zhou told a seminar at Geneva's Centre for Trade and Economic Integration. To deal with US accusations about China not being a market economy, he said Beijing aimed for OECD-style 'competitive neutrality' – a level playing field for state-owned and private enterprises. 'We haven't done enough, but we are moving in that direction.'"[11]

On 14th October 2018, Zhou Xiaochuan's successor and current PBOC Governor Yi Gang breathed life into the idea on the sidelines of the G20 meeting in Buenos Aires when he said:

"To solve the structural problems in the Chinese economy, we will accelerate domestic reform and opening up, strengthen intellectual property protection, and consider treating state-owned enterprises with the principle of 'competitive neutrality'."[12]

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5 Scissors, Derek, *Deng Undone, Foreign Affairs*, May/June 2009, viewed 6th August 2019, <https://www.foreignaffairs.com/articles/china/2009-05-01/deng-undone-0>

6 *Xi Calls for Furthering SOE Reform, Xinhua*, 18th October 2018, viewed 6th August 2019, <http://www.xinhuanet.com//english/2017-10/18/c_136688444.htm>

7 Yu, Nakamura, *More Companies are Writing China's Communist Party into their Charters, Nikkei Asian Review*, 24th August 2017, viewed 6th August 2019, <https://asia.nikkei.com/Politics/More-companies-are-writing-China-s-Communist-Party-into-their-charters>

8 Martina, Michael, *Exclusive: In China, the Party's Push for Influence Inside Foreign Firms Stirs Fears, Reuters*, 24th August 2017, viewed 6th August 2019, <https://www.reuters.com/article/us-china-congress-companies/exclusive-in-china-the-partys-push-for-influence-inside-foreign-firms-stirs-fears-idUSKCN1B40JU>

9 *Doing Business 2019*, The World Bank, 31st October 2018, viewed 6th August 2019, p. 163, <https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2019-report_web-version.pdf>

10 *People's Republic of China: 2019 Article IV Consultation – Press Release; Staff Report; Staff Statement and Statement by the Executive Director for China*, International Monetary Fund, 9th August 2019, viewed 12th August 2019, p. 33, <https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Peoples-Republic-of-China-2019-Article-IV-Consultation-Press-Release-Staff-Report-Staff-48576>

11 Miles, Tom, *Ex-PBOC Chief says China Must Address "Loopholes" as Part of WTO Reform, Reuters*, 19th September 2018, viewed 6th August 2019, <https://www.reuters.com/article/us-china-economy-zhou/ex-pboc-chief-says-china-must-address-loopholes-as-part-of-wto-reform-idUSKCN1LZ0XU>

12 Antonini, Renato, *Comment: Expect More on 'Competitive Neutrality' in WTO Reform Talks, Borderlex*, 12th December 2018, viewed 6th August 2019, <https://borderlex.eu/2018/12/12/comment-expect-more-on-competitive-neutrality-in-wto-reform-talks/>

This led to a surprisingly public airing of the internal debate, with a response from Peng Huagang, then deputy secretary general of the State-owned Assets Supervision and Administration Commission (SASAC), being reported in the media:

"However, Peng Huagang […] said at a press conference in Beijing on Monday that Chinese SOEs shouldn't be discriminated against. He stressed that SOEs have already been integrated into China's 'market economy' and that they are already competing on an equal footing with privately owned firms in the market. His words are quite ironic as Chinese SOEs have always enjoyed an advantage in terms of government support."[13]

Not long after, the term was given play by the State Administration for Market Regulation (SAMR) in November 2018, the State Council in December 2018, and then during Premier Li Keqiang's annual work report during the 2019 'Two Sessions'.[14,15&16]

Where does European business stand?

While European companies in China face problems unique to foreign companies, they also have a great deal in common with local private firms: European companies in China are Chinese companies – they pay taxes in China, hire Chinese staff and executives, and contribute to the country's innovation and development. European businesspeople live and have families in China, serve in industry associations and non-profits and have communities throughout the country. The future of China is therefore integral to the future of European business, and the best way to secure its long-term success is by completing the process of economic liberalisation. Realising competitive neutrality is an important step in this process, and is essential for future development in this critical market.

With economic challenges arising from China's structural problems and the global tensions ensuing from the government's inadequate response continuing to grow,[17] the need for reform is amplified. These conditions echo the circumstances under which Deng and Zhu pursued opening up, and provide a perfect context for completing the SOE reform that began two decades ago, realising competitive neutrality across the country.[18]

Why is China having this discussion?

A defining moment

Old habits are the hardest to break, and the predominance of China's SOEs in the mixed economy runs deep and lies at the intersection of the country's economics and politics.[19] Strong vested interests have

13 Gao, Tianyou, *[Competitive Neutrality] Rashomon (a reference to an acclaimed Japanese film about the differing accounts of an event by various actors), Hong Kong Economic Journal*, 18th October 2018, viewed 6th August 2019, <https://www1.hkej.com//dailynews/article/id/1968806/%E3%80%8C%E7%AB%B6%E7%88%AD%E4%B8%AD%E6%80%A7%E3%80%8D%E7%BE%85%E7%94%9F%E9%96%80>

14 *China's Market Regulator to Secure Fair Competition Between Public and Private Firms, Xinhua*, 6th November 2018, viewed 6th August 2019, <http://www.xinhuanet.com/english/2018-11/06/c_137584360.htm>

15 Yue, Zhang, *Support for SMEs Intensified, China Daily*, 25th December 2018, viewed 6th August 2019, <http://global.chinadaily.com.cn/a/201812/25/WS5c216be0a3107d4c3a00298c.html>

16 *China will Issue More Actions Based on Foreign Investment Law, Premier Says*, State Council, 26th March 2019, viewed 6th August 2019, <http://english.gov.cn/premier/news/2019/03/26/content_281476580744466.htm>

17 Hornby, Lucy, and Liu, Xinning, *China's Economy Grows at Slowest Rate in Nearly 30 Years, Financial Times*, 15th July 2019, viewed 6th August 2019, <https://www.ft.com/content/73f06b8a-a696-11e9-984c-fac8325aaa04>

18 Zhang, Chunlin, *'Competitive Neutrality' for SOEs Can Help China At Home and Abroad, Caixin*, 16th October 2018, viewed 6th August 2019, <https://www.caixinglobal.com/2018-10-16/competitive-neutrality-for-state-firms-can-help-china-at-home-and-abroad-101335637.html>

19 Jin, Keyu, *Reforms will Stall Unless Beijing Tackles Vested Interests, South China Morning Post*, 27th January 2015, viewed 6th August 2019, <https://www.scmp.com/comment/insight-opinion/article/1693301/reforms-will-stall-unless-beijing-tackles-vested-interests>

stood against meaningful SOE reform in the past and they will certainly continue to have an influence in this respect. However, failure to address SOE reform and advance economic liberalisation will leave the market burdened by a bloated and inefficient state-owned sector that weighs the country down as it attempts to climb out of the middle-income trap.[20] This is a defining moment for China.

Do you want a stone and mortar castle, or a steel and glass skyscraper?

SOEs were once the bedrock on which China's economic order was built. But just as you can only build a tower so high on traditional stone pilings before it starts to wobble, the Chinese economy can only develop so far without stronger foundations.

A gross misallocation of resources towards the state-owned sector, which also enjoys privileged access to the factors of production, has historically deprived the more vibrant and efficient private sector. It was only during the Third Plenum of the 18th Central Committee of the CCP in 2013 that the CCP determined that the market should play the "decisive" role in resource allocation. Yet, contrary to that commitment, China has since gone back on the decision to reduce the footprint of the state-owned sector by directing ever larger quantities of resources to SOEs, which subsequently expanded both in terms of assets and debt. Many are now categorised as 'too big to fail', meaning that, under the current model, SOEs will continue to soak up resources and deprive the private sector of the fuel it needs to propel China's economy onwards and upwards.[21]

Growth of debt outpaces that of assets, revenues and profits

"…as of end 2017, nonfinancial SOE debt reached CNY 118.5 trillion, for the first time exceeding 100 trillion in November of the same year. This is an increase of nearly fourfold compared to end-2007. During the same time, SOE assets grew 337 per cent, revenues 159 per cent and profits 60 per cent."[22]

The rudimentary foundations for further economic development are modern institutions and good governance, with the role of the state confined to that of regulator. The increased talk about competitive neutrality in the midst of the debate over China's economic model is a hopeful signal that there is at least an understanding of the need for such foundations.

A tale of two 'Shens'

The effectiveness of the two respective economic models China could pursue can be most clearly demonstrated in the stark contrast between the North, represented by Shenyang, and the South, represented by Shenzhen. The two regions follow significantly different approaches to economic governance, with the North being more heavily reliant on SOEs and a state-led approach, and the South leaning towards private enterprises and market forces.

The results of these models? A struggling northern rustbelt and a thriving southern city on a hill.

Shenyang and the surrounding region were long referred to as the 'eldest son' of the Chinese economy, as state-led investment poured into the local heavy industry from the earliest days of the People's Republic of China. As a result, a staggering share of China's industrial output came from the area via the

20 Fickling, David, *Xi's Leading China Toward Stagnation, Bloomberg*, 13th January 2019, viewed 6th August 2019, <https://www.bloomberg.com/opinion/articles/2019-01-13/xi-s-leading-china-s-economy-into-the-middle-income-trap>

21 Lee, Amanda, *China's State-owned Companies Enjoy Record Profits, Even as Private Sector Flounders, South China Morning Post*, 18th January 2019, viewed 6th August 2019, <https://www.scmp.com/economy/china-economy/article/2182552/chinas-state-owned-companies-enjoy-record-profits-even-private>

22 Molnar, Margit, and Lu, Jiangyuan, *State-owned Firms in China's Corporate* Debt, Organisation for Economic Co-operation and Development (OECD), 7th February 2019, viewed 8th August 2019, p. 16, <http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2019)5&docLanguage=En>

large SOEs that controlled the economy.[23] When China's national economic model adopted more market-based approaches after Deng Xiaoping began the reform and opening up period, the North struggled to adjust, preferring to stick to the old way of driving development instead.[24]

Shenzhen's story could not differ more. China's first special economic zone (SEZ) was developed in Guangdong, the province that Shenzhen occupies, giving breathing space to an historically entrepreneurial region to do what it does best. The subsequent 'economic miracle' saw Guangdong outpace growth in the North within a decade, with businesses given the room to pursue their own ambitions and more foreign investors drawn in. Even after the province began to enter economic maturity, and expectations of a cooldown grew, it continued to see skyrocketing growth.

Since then, the South has advanced its market economy as far as the central government will permit it to, while the North's inertia has led the government to dedicate extensive resources to the region just to prop it up. The Revitalise the Old Northeast Industrial Bases plan stands alongside the Rise of Central China and Great West Development plans in an attempt to push development beyond China's more prosperous coastal regions.[25,26&27] However, only in the SOE-dominated Northeast is the plan about bringing the economy back rather than pushing an initial phase of development forward.

The European Chamber has seven chapters spread across the country, and the concerns they put forward in their respective local position papers reflect the divide between the different regions. The differences between the most recent editions of the *Shenyang Position Paper* and the *South China Position Paper* could not be more evident.[28&29]

For example, the biggest human resource concern raised in the *Shenyang Position Paper* is about the migration of talent from the region. Meanwhile, the *South China Position Paper* focuses on the insufficient number of skilled migrants to keep up with the region's booming economy. Even the overall tone of the two papers demonstrates the contrast between the two regions. The *Shenyang Position Paper* focuses on consolidating and improving the economic situation to get things moving in the right direction. The *South China Position Paper* argues that Guangdong needs to stop measuring itself against the rest of China and start aiming to become the best place to do business globally.

Growth woes: North versus South

Aside from the 2008 financial crisis, China has little experience in mitigating a major downturn, and the response that it employed back then cannot be repeated: debt levels are already far too high and an aggressive monetary policy would bring on a whole slew of other problems. Fortunately, the government clearly understands this and has repeatedly clarified that massive stimulus should not be expected and will not be pursued.[30]

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23 Batson, Andrew, *My Guide to the Debate Raging over China's Northeast Rust Belt,* Andrew Batson's Blog, 1st September 2017, viewed 6th August 2019, <https://andrewbatson.com/2017/09/01/my-guide-to-the-debate-raging-over-chinas-northeast-rust-belt/>

24 *Liaoning Worst Performer as China's Northeast Lags Behind Country's Economic Growth, South China Morning Post*, 31st July 2017, viewed 6th August 2019, <https://www.scmp.com/news/china/economy/article/2104789/liaoning-worst-performer-chinas-northeast-lags-behind-countrys>

25 *Northeast Revitilisation Plan*, State Council, 20th August 2007, viewed 6th August 2019, <http://www.gov.cn/gzdt/2007-08/20/content_721632.htm>

26 *The Rise of Central China Strategy*, China Xiguan – Guoqing, 20th November 2018, viewed 6th August 2019, <http://guoqing.china.com.cn/xijinping/2018-11/20/content_74314707.htm>

27 *The Great Development of Western China*, The History of the People's Republic of China, 20th August 2009, viewed 6th August 2019, <http://www.hprc.org.cn/gsgl/dsnb/zdsj/200908/t20090820_28292_1.html>

28 *Shenyang Position Paper 2017/2018*, European Union Chamber of Commerce in China, 5th December 2017, <https://www.europeanchamber.com.cn/en/publications-archive/563/Shenyang_Position_Paper_2017_2018>

29 *South China Position Paper 2019/2020*, European Union Chamber of Commerce in China. 10th April 2019, <https://www.europeanchamber.com.cn/en/publications-archive/661/South_China_Position_Paper_2019_2020>

30 *China Vows to Stick to Targeted Stimulus Amid Jobless Pressure, Bloomberg*, 15th March 2019, viewed 8th August 2019, <https://www.bloomberg.com/news/articles/2019-03-15/china-won-t-use-qe-or-indiscriminate-easing-for-economy-li-says>

With the 2019 Q2 growth rate slowing to 6.2 per cent, one would expect China's most developed regions to see even lower growth as they grow from larger bases. However, for the people who call the coastal South home, this is not the case. In 2018, Guangdong enjoyed a strong growth rate of 6.8 per cent while Liaoning—home to Shenyang—saw modest growth at 5.7 per cent.[31] However, Liaoning's growth rate is best interpreted as a recovery after it became the first province in years to report negative growth in 2015, with a 2.5 per cent dive from the previous year. Additionally, the province was found to be misrepresenting its economic data from 2011 to 2014, meaning that the downturn could have been going on longer than reported.[32]

Other metrics of growth

To get a nuanced view of the situation, it is not sufficient to look at GDP rates alone. Such figures can be inaccurate—an historical problem in China's northeast[33]—misrepresent actual value-creation (for example, if the government pays someone Chinese yuan (CNY) 100 to dig a hole and then fill it back up, it technically counts as GDP growth, but produces no value) and fail to take into account important indicators like consumer confidence.

Applying a similar approach to the one that Premier Li Keqiang took when serving as party secretary in Liaoning Province from 2004 to 2007 can provide a better understanding of the economic situation. The 'Li Keqiang Index' ignored official growth numbers and instead looked at railway cargo volume, electricity consumption rates and bank loans.[34] Using such different factors can help provide a more accurate comparison of different provinces' economic outlook, as inputs and outputs are much harder to falsify than numbers in a report.

Automotive sales are one major indicator of consumer confidence, and reveal a pronounced discrepancy between the two Shens. In the first four months of 2019, car sales have generally slipped year-on-year across the country. However, while Liaoning Province saw an average decrease of 12.6 per cent, Guangdong only saw a 2.5 per cent drop, at least some of which likely came from ever-tightening restrictions on automobile ownership in the highly congested metropolises of the Pearl River Delta.

Migration patterns are also useful for determining which regions inspire the most confidence. People vote with their feet, and the number leaving the SOE-dominated North compared to those moving to the South demonstrates a notable vote of confidence in the latter.[35] The migration patterns of young people reflects this particularly well, as many have yet to lay down roots that might otherwise keep them in a less promising location. Working-age people have moved en masse to places like Guangdong, which now has 9.7 workers per senior citizen; Liaoning, on the other hand, has a mere 1.8 workers per senior citizen.[36]

In conclusion

The trends are quite clear, and the increasing gulf that is developing between North and South China is informing the debate on the country's economic future. The numbers are clearly in favour of those arguing

31 *GDP Growth by Year by Province*, National Bureau of Statistics of China, viewed 8th August 2019, <http://data.stats.gov.cn/easyquery.htm?cn=E0103>

32 Tang, Frank, *Chinese Province Admits to Cooking its Books, South China Morning Post*, 18th January 2017, viewed 8th August 2019, <https://www.scmp.com/news/china/economy/article/2063125/liaoning-governor-confirms-economic-data-faked-2011-2014>

33 Hornby, Lucy, *China Accuses 2 More Provinces of Faking Data, Financial Times*, 12th June 2017, viewed 6th August 2019, <https://www.ft.com/content/fcf7e3a4-4f40-11e7-bfb8-997009366969>

34 *What is China's 'Li Keqiang Index'?, BBC*, 17th October 2013, viewed 6th August 2019, <https://www.bbc.com/news/av/business-24573373/what-is-china-s-li-keqiang-index>

35 Lu, Ming, and Xia, Yiran, *Migration in the People's Republic of China*, The Asian Development Bank Institute, September 2016, viewed 6th August 2019, <https://www.adb.org/sites/default/files/publication/191876/adbi-wp593.pdf>

36 *China's Demographic Divisions are Getting Deeper, The Economist*, 21st September 2017, viewed 6th August 2019, <https://www.economist.com/china/2017/09/21/chinas-demographic-divisions-are-getting-deeper>

for the state to reconsider its role, and for SOE reform and adherence to market forces to be pursued.

Reinvigorating SOE Reform

'SOE reform' in contemporary China

During his tenure as premier, Zhu Rongji tackled the state-owned sector and pushed through privatisation as the government divested itself of much of the economy. Doing so freed up resources to flow to the country's private sector. It did, however, lead to a difficult transition for many workers who found themselves without work, as firms that had been privatised suddenly had to answer to market forces, and trimmed down their operations.[37] The process was undoubtedly disruptive to the lives of many, but it was a necessary step to lay the foundations for the explosive growth that China was soon to experience.

Unfortunately, concerns about stability led to complacency regarding SOE reform, which still exists today.[38] The reform process first slowed to a standstill, until the idea of 'SOE reform' somehow mutated into the concept of reinforcing the state-owned sector at the expense of private enterprises.[39]

In recent years, SOE reform has focused on 'mixed-ownership reform' – the idea being that private investors will take on shares in SOEs to help boost efficiency. Unfortunately, this has not worked out as well as had been hoped. One state-private fund that was intended to facilitate this process, Siyuanhe Equity Investment Management Co Ltd, was established in early 2017, with between CNY 40 and 80 billion to invest. Zhou Zhuping, the CEO of Siyuanhe, said in January 2019 that attempts to combine SOEs and private sector management have only resulted in "a mix at the capital level". He further explained that: "They have not carried out mixed reforms regarding the governance structure of companies and their internal operations, and still follow the old form of an SOE."[40]

This shift, coupled with a worrying amount of talk from leaders about China's need for self-sufficiency, raised understandable concerns from the private sector. These concerns were compounded when, in early 2018, Zhou Xincheng, a professor of Marxism at Renmin University, argued in the *Qizhi* column of the CCP Theory Journal *Qiushi* that private ownership should be abolished. This was followed in September 2018 by an alarming blog post penned by a former financier—which rapidly went viral—declaring that the private sector had accomplished its historic mission to provide growth, and that it should now be wound down.[41,42&43]

SOEs are everywhere and universally privileged

That President Xi has designated the goal of SOE reform in China is for them to become "stronger, better, bigger" has done little to inspire confidence among European companies.

37 Cho, Yusho, and Kawase, Kenji, *How China's State-backed Companies Fell Behind, Nikkei Asian Review*, 23rd May 2018, viewed 6th August 2019, <https://asia.nikkei.com/Spotlight/Cover-Story/How-China-s-state-backed-companies-fell-behind>

38 Scissors, Derek, *Deng Undone, Foreign Affairs*, May/June 2009, viewed 6th August 2019, <https://www.foreignaffairs.com/articles/china/2009-05-01/deng-undone-0>

39 *China's Private Sector Faces an Advance by the State, The Economist*, 8th December 2018, viewed 6th June 2019, <https://www.economist.com/business/2018/12/08/chinas-private-sector-faces-an-advance-by-the-state>

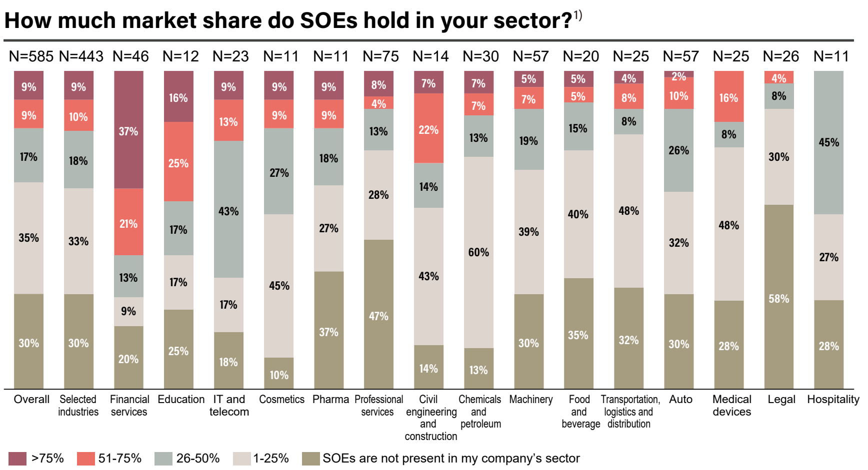
40 Luo, Guoping, and Kirton, David, *Most Mixed-Ownership Reform Fails to Bring Meaningful Change, Expert Says, Caixin*, 11th January 2019, viewed 8th August 2019, <https://www.caixinglobal.com/2019-01-11/most-mixed-ownership-reform-fails-to-bring-meaningful-change-expert-says-101369194.html>

41 Wang, Orange, *Beijing's Tilt Towards State-owned Enterprises Raises Doubts About Future of Private Sector in Chinese Economy, South China Morning Post*, 21st September 2018, viewed 6th August 2019, <https://www.scmp.com/news/article/2165254/beijings-tilt-towards-state-owned-enterprises-raises-doubts-about-future>

42 Tang, Frank, and Wong, Alan, *Is the Cat Black or White? China's Trillion-dollar Question, Inkstone News*, 15th November 2018, viewed 6th August 2019, <https://www.inkstonenews.com/business/marxism-or-market-chinas-trillion-dollar-question/article/2173417>

43 *A Chinese Writer Calls for Private Companies to Fade Away, The Economist*, 6th October 2018, viewed 6th August 2019, <https://www.economist.com/china/2018/10/06/a-chinese-writer-calls-for-private-companies-to-fade-away>

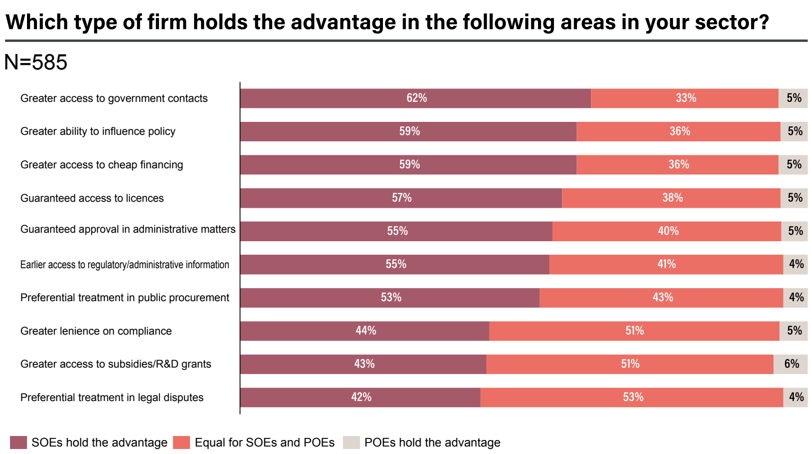
In the European Chamber's *European Business in China Business Confidence Survey 2019* (*BCS*), 70 per cent of respondents reported that SOEs were present in their industry, with 18 per cent saying that SOEs controlled at least half of the Chinese market share.[44]



1) Selected industries are those with at least 11 responses

When asked to describe their outlook on the relationship between private business and the state-owned sector in China over the next two years, only 20 per cent of *BCS* respondents said that the private sector would gain opportunities at the expense of the state-owned sector, compared with 40 per cent who said the opposite.

European companies are by no means alone in their struggle against the surging tide of SOE ascendency. Chinese private companies in a wide range of sectors are similarly impacted by SOEs, which enjoy more beneficial treatment. When surveyed on whether SOEs or privately owned enterprises (POEs) hold the advantage in government interactions, *BCS* respondents found overwhelmingly in favour of SOEs.[45]



44 *European Business in China Business Confidence Survey 2019*, European Union Chamber of Commerce in China, 20th May 2019, p. 42, <https://www.europeanchamber.com.cn/en/publications-business-confidence-survey>

45 Ibid, p. 44.

Water flows to the least productive fields

Even in areas without an SOE presence, the private sector feels the tremors of the sector's resurgence. Access to financing is by far the clearest example. State-owned banks have always preferred SOEs due to their implicit guarantee from the government: who wouldn't bet on that level of certainty? This has led state-owned banks to become complacent, preferring to do business only with SOEs and large private firms.[46]

Although always an issue, this became particularly pronounced in recent years due to the combination of the crackdown on shadow banking and the deleveraging campaign, both of which were necessary. However, the state-dominated banking sector has failed to fill the financing gap left by the shadow-banking system, leaving many companies in significant trouble and without a line of credit to manage daily operations.[47] Based on reporting by the *Financial Times*, the financing drought became so problematic that "[t]wenty-one privately owned groups have sold large stakes to SOEs since the start of 2018, according to stock exchange filings. Of these, 10 are *de facto* nationalisations because the SOE will become the formerly private company's largest shareholder."[48]

A simple look at bank loan data makes the situation abundantly clear. As pointed out by Nicholas Lardy in the July 2018 Australian National University *China Update*, "the share of bank loans to nonfinancial corporations that went to private firms fell from 57 per cent in 2013 to only 19 per cent by 2015, while the share that went to SOEs almost doubled over the same period—from 35 per cent to 69 per cent."[49] Lardy followed up with updated numbers in his recent book, *The State Strikes Back*, which indicate that this trend continued in 2016, with the share of bank loans to SOEs jumping to 80 per cent and the share going to POEs down to just 11 per cent that year.[50]

While some positive change has been seen in recent months regarding financing the private sector—banks have been urged to increase loans to private borrowers by 30 per cent—the applied methods have been of limited effect and are, as the Asia Society/Rhodium Group China Dashboard put it, "a state-directed solution in lieu of a functional financial system."[51]

On top of China's heavy reliance on subsidies to direct the economy in general, the dependence on subsidies that SOEs have developed in order to turn red balance statements black is particularly concerning. A reasonable chunk of total direct subsidies from the government go to private companies, but the bulk over the last several years has gone to SOEs. This in itself is an issue, but when coupled with the subsidy-like effect of cheap loans from state-owned banks, along with the *de facto* loans that SOEs generate by employing excessively long payment periods to suppliers, SOEs end up with heavily inflated bottom lines. A recent Gavekal Dragonomics report projected that without these three sources, SOEs would see a decrease in return on assets of 35 to 40 per cent on average.[52]

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46 Wildau, Gabriel, and Jia, Yizhen, *Why Banks are Wary of Beijing Plea to Back Private Companies, Financial Times*, 20th February 2019, viewed 6th August 2019, <https://www.ft.com/content/aedef990-335b-11e9-bd3a-8b2a211d90d5>

47 *The World Will Suffer if China's Nonstate Economy Runs Dry, Bloomberg*, 15th November 2018, viewed 6th August 2019, <https://www.bloomberg.com/news/articles/2018-11-14/the-world-will-suffer-if-china-s-nonstate-economy-runs-dry>

48 Wildau, Gabriel, and Jia, Yizhen, *China State Groups Gobble up Struggling Private Companies, Financial Times*, 26th September 2018, viewed 6th August 2019, <https://www.ft.com/content/c3eab59a-c09c-11e8-95b1-d36dfef1b89a>

49 Lardy, Nicholas, *Private sector development*, in Garnaut, R., Song, L.., and Cai, F. (editors), *China's 40 Years of Reform and Development: 1978–2018*, Australian National University Press, Acton, July 2018, p. 339, viewed 27th July 2018, <https://press.anu.edu.au/node/4267/download>

50 Lardy, Nicholas, *The State Strikes Back*, Peterson Institute for International Economics, January 2019, Washington D.C., Figure 4.1.

51 Brattberg, Erik, and Soula, Etienne, *Is Europe Finally Pushing Back on Chinese Investments*? Carnegie Endowment for International Peace, 14th September 2018, viewed 6th August, <https://carnegieendowment.org/2018/09/14/is-europe-finally-pushing-back-on-chinese-investments-pub-77259>

52 Gatley, Thomas, *The Size of State Subsidies*, Gavekal Dragonomics, 25th July 2019, viewed 13th August 2019.

This is all happening at the same time that both the assets and debt of China's industrial SOEs are exploding: from 2014 to 2018, SOEs' assets went from United States dollars (USD) 15.3 trillion to USD 26.8 trillion; meanwhile, industrial SOEs' debt rose from USD 10 trillion to USD 17.3 trillion over the same period. Return on assets dropped from six per cent to three per cent for SOEs, compared to a drop from 14 per cent to 10.5 per cent for private firms.[53] This does not bode well for China's efforts to escape the middle-income trap, which requires profitability and productivity, neither of which SOEs are displaying, even as they fatten up at the cost of private sector expansion.

The knock-on effect goes beyond the impact on growth. European companies that have systems for financing their operations may seem as capable of dealing with this challenge as well-funded SOEs. However, supply chain disruption is impacting European firms as their upstream suppliers and downstream purchasers struggle to find sufficient operational funding. At best, this requires European business leaders to adopt a more flexible approach to payment timelines, at worst it demands the reconfiguring of supply chains.

Would you like to know more?

For more information on how European banks could help improve China's financial system, read the *Banking and Securities Working Group Position Paper*.

State capital's ascendency raises barriers abroad

When Chinese state money went abroad in earnest, first eyebrows were raised, then barriers were: the purchase of the crown jewels of European technology with state-/party-backed capital drove the development of the European Union's (EU's) investment screening mechanism.[54] Fortunately, the transparent due process of the screening mechanism allows for private Chinese companies that make market-based decisions when conducting mergers and acquisitions.[55]

The negative impact of state-backed capital going abroad should not be underestimated, and nowhere is this clearer than with the ongoing US-China situation. The role of SOEs has been at the core of the arguments made in the US' 301 investigation (the March 2018 report mentions SOEs 124 times), and scrutiny over state-backed funds have been central to the Trump administration's application of the Committee on Foreign Investment in the United States (CFIUS).[56] Alongside these factors is the continued mixing of politics and business, with the CCP insinuating itself into the governance structures of private companies. This blurring of the lines between business and the state means that even Chinese POEs that may have legitimate motivation for investing abroad are being placed under enhanced scrutiny by foreign governments.[57]

Actual SOE reform is called for

A comprehensive examination of the role of SOEs in China's economy is required, with a measured and steady approach that strips them of both their privileges and their excessive responsibilities. The aim should not be for complete privatisation of the economy within an unrealistically short timeframe: nobody wants China's economy to look like Russia's in the 1990s.

53 Lardy, Nicholas, *The State Strikes Back*, Peterson Institute for International Economics, January 2019, Washington D.C., Table 3.3.

54 Hanemann, Thilo, Huotari, Mikko, and Kratz, Agatha, *Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies*, MERICS, 6th March 2019, viewed 7th August 2019, <https://www.merics.org/en/papers-on-china/chinese-fdi-in-europe-2018>

55 *Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Under Section 301 of the Trade Act of 1974*, Office of the United States Trade Representative, 22nd March 2018, viewed 7th August 2019, <https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF>

56 Tai, Catherine, *China's Private Sector is Under Siege*, *The Diplomat*, 22nd December 2018, viewed 7th August 2019, <https://thediplomat.com/2018/12/chinas-private-sector-is-under-siege/>

57 Feng, Ashley, *We Can't Tell if Chinese Firms Work for the Party*, *Foreign Policy*, 7th February 2019, viewed 7th August 2019, <https://foreignpolicy.com/2019/02/07/we-cant-tell-if-chinese-firms-work-for-the-party/>

Doesn't the EU have SOEs?

SOEs play important roles in many EU Member States. Between the common rules across the entire union and varying practices from member state to member state, there are valuable lessons for China to learn from, both positives and negatives. At the centre of SOE governance in the EU is competition law, which applies to both private and state-owned firms.[58] By providing clear definitions of the legitimate role and purpose of SOEs, establishing supportive regulatory frameworks to ensure that they operate appropriately, and ensuring sound corporate governance, the EU has helped facilitate a more balanced approach to development.

The legitimate role of SOEs

However, unlike in the EU, massive SOEs dominate in many Chinese sectors, with European companies in China in the agriculture, aviation, banking, chemicals, construction, energy, environment, insurance, shipbuilding, shipping, and quality and safety services (QSS) industries particularly impacted.

There are certainly sectors in which either an SOE or a heavily-regulated monopoly makes sense, such as the management of the energy grid, railways and roads. These resource-intensive sectors call for natural monopolies, as having multiple grids, railway tracks and roads alongside one another would be exorbitantly wasteful.[59]

On the other side of the coin are the companies that produce energy, trains and automobiles. Far from natural monopolies, these sectors benefit from extensive private competition to develop new technology at cost-efficient prices. Yet still, energy production and train-making in China are both completely dominated by SOEs, and the automotive sector sees a high proportion of producers that are either SOEs themselves, hold major quantities of state capital or are engaged in a joint venture (JV) with an SOE.

Would you like to know more?

To learn more about the energy and automotive sectors in China, and the concerns and recommendations of the respective European Chamber working groups, read the *Energy Working Group Position Paper* and the *Automotive Working Group Position Paper*.

In these areas, SOEs have disappointed: Chinese energy production is notoriously inefficient and dirty;[60] high-speed train producers first copied foreign technology then grew in a protected market with a fifth of the world's population, absorbing state support when going abroad;[61] and Chinese SOE automotive manufacturers have yet to make models that meaningfully compete abroad, let alone against the consistently better vehicles produced by Chinese private-sector automotive manufacturers, even after the government forced foreign companies to partner with them.[62]

Serious consideration therefore needs to be given to which sectors warrant the presence of SOEs, before China develops a steady and moderate path to privatisation in all other areas.

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58 *State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context*, European Commission, July 2016, viewed 8th August 2019, <https://ec.europa.eu/info/sites/info/files/file_import/ip031_en_2.pdf>

59 *Glossary of Statistical Terms: Natural Monopoly*, OECD, 10th March 2003, viewed 7th August 2019, <https://stats.oecd.org/glossary/detail.asp?ID=3267>

60 Eaton, Sarah, and Kostka, Genia, *Central protectionism in China*: *The central SOE problem in environmental governance, The China Quarterly,* SOAS University of London, September 2017, viewed 20th August 2019, <https://www.cambridge.org/core/journals/china-quarterly/article/central-protectionism-in-china-the-central-soe-problem-in-environmental-governance/42D6B6E158861C4FC2B7B76C878AFCC1/core-reader>

61 Shirouzu, Norihiko, *Train Makers Rail Against China's High-Speed Designs, Wall Street Journal*, 17th November 2010, viewed 7th August 2019, <https://www.wsj.com/articles/SB10001424052748704814204575507353221141616>

62 *China's Car Revolution is Going Global, Bloomberg Businessweek*, 24th April 2018, viewed 7th August 2019, <https://www.bloomberg.com/news/features/2018-04-23/china-s-carmakers-want-to-dominate-world-s-next-era-of-driving>

Tight regulation for remaining SOEs

The SOEs that remain would need to be more thoroughly regulated by new rules and the robust implementation of competition policy, as they would inherently enjoy a certain degree of privilege, especially those in a sanctioned monopolistic position.

One simple, yet damaging, example of SOEs taking advantage of their position is their practice of drawing out payment periods for suppliers. A long payment period means that private firms must retain large sums of cash to cover their accounts receivable while they wait for payment for goods or services already supplied to an SOE customer. This allows SOEs to float their payments while utilising what they are yet to pay for, freeing up capital for them to use elsewhere – a *de facto* loan from private suppliers.[63]

This, coupled with the draining away of financing from POEs more generally, could significantly impact the future of the Chinese economy. As one China analyst put it, "If left uncorrected, this forced transfer of capital from the productive private sector to a relatively unproductive state sector bodes ill for the long-term trajectory of investment and economic growth in China."[64] Clear regulations are needed to rein in such behaviour and prevent SOEs from abusing their market position. Premier Li Keqiang followed up on this issue in late 2018, but the impact of the subsequent provisions remains uncertain.[65]

Would you like to know more?

For more information on how these payment periods affect European small and medium-sized enterprises (SMEs), read Key Recommendation 3 in the *Inter-Chamber Small and Medium-sized Enterprise Working Group Position Paper*.

Both SOE privileges and responsibilities belong to history

Chinese SOEs enjoy tremendous privileges, from monopoly statuses, implicit guarantees and cheap capital, to accelerated administrative approvals, favoured procurement bids and a seat at the policy-making table. These all need to go.

But SOEs also shoulder a great burden. While far from the old 'iron rice-bowl' model, they still provide extensive employment, insurance and benefits that generally go beyond those expected of a private company. In fact, it was not until the end of 2018 that SOEs were ordered to handover schools and hospitals to the local government for management,[66] prior to which many had run their own for workers and their families. China should now look to other areas where SOEs bear similar responsibilities and follow suit.

The state also uses SOEs as a source of additional funds when necessary. For example, the government is gradually cutting back on certain taxes to try and support growth and consumption. To compensate for budget shortfalls, they have increased the amount of money that SOEs need to contribute back to the state.[67] This, too, is an unfair burden on the state-owned sector.

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63 Gatley, Thomas, *The Working Capital Heist*, Gavekal Dragonomics, 18th January 2018.

64 Ibid.

65 *Li Keqiang: Focus on Solving the Problem of Government Departments and State-owned Enterprises Defaulting on Private Enterprise Accounts*, State Council, 10th November 2018, viewed 7th August 2019, <http://www.gov.cn/premier/2018-11/10/content_5339135.htm>

66 *China's SOEs to Shed Hospitals and Schools in Bid to Streamline, Business Times*, 26th August 2017, viewed 7th August 2019, <https://www.businesstimes.com.sg/government-economy/chinas-soes-to-shed-hospitals-and-schools-in-bid-to-streamline>

67 *State-Owned Enterprise: State-Owned Enterprise Policy Reform*, Asia Society's China Dashboard, Spring 2019, viewed 7th August 2019, <https://chinadashboard.asiasociety.org/spring-2019/page/state-owned-enterprise>

Corporate governance

At the centre of good corporate governance lies the need for clear separation of authority and responsibility between different bodies. Most commonly, there must be a divide between shareholders, the board and management, each of which have distinct roles to play and a clear relationship to one another. A similar division theoretically exists in China with the SASAC (and the state more generally) serving as shareholders, while the board and management fulfil similar roles to what is common internationally.

However, this structure is where the similarities end. The relationship between these three bodies is complicated by the connections between the personnel in each role: it is far from uncommon to see SASAC officials end up on the board of SEOs or in management roles, muddying the divisions between the tiers.[68] As a March 2019 *Caixin* editorial rightly observed, "the relationship between the funders, the board of directors, and the management to the rights and responsibilities is still not clear enough."[69] This relationship cross-over is further complicated by, yet again, the role of the CCP. The presence of the Party within the decision-making process in SOEs often results in a bizarre situation in which Party roles conflict with state roles which conflict with corporate roles which conflict with board roles.

The division of responsibilities within the corporate governance of SOEs therefore needs to be clearer, with the scope of the role that the SASAC plays in need of serious reconsideration. A conversation on this topic has already begun in China, with a different *Caixin* editorial noting that "the supervision of state-owned assets should shift from 'managing people, affairs and assets' toward simply 'managing capital'."[70] In lieu of a precise solution, the fact that issues of corporate governance in China's SOEs are being publicly discussed raises confidence that positive changes may be on the horizon.

No need to reinvent the wheel

As stated by the IMF in its 2019 Article IV Consultation with China, the Chinese Government's SOE reform needs to be reinvigorated in the following areas:[71]

- "*Limit SOE use of credit advantages*. The flow of SOE borrowing should be constrained by hardening budget constraints. Dividend payments to the budget should be increased, while completing the transfer of social responsibilities to the government. Deleveraging goals should be set in terms of SOE debt/GDP ratio.

- Support the *removal of implicit guarantees* to SOEs by allowing SOE and Local Government Financing Vehicle (LGFV) bonds to default.

- *Complete classification/identification/zombie exit*. Classification of SOEs into categories (competitive, social, strategic) should be published, along with a timetable for moving SOEs out of competitive sectors. Progress on 'zombie' local SOEs should move forward with the publication and exit of local zombies, facilitated by a comprehensive amendment of the Enterprise Bankruptcy Law. Exits should not reduce competition through top-down mergers with other SOEs, but rather release resources to the

68 Song, Houze, *State-Owned Enterprise Reforms: Untangling Ownership, Control, and Corporate Governance*, Macro Polo, 4th December 2017, viewed 7th August 2019, <https://macropolo.org/analysis/state-owned-enterprise-reforms-untangling-ownership-control-corporate-governance/>

69 *Editorial: Governance of SOEs Must Adapt to the New International Situation, Caixin Global*, 26th March 2019, viewed 7th August 2019, <https://www.caixinglobal.com/2019-03-26/editorial-governance-of-soes-must-adapt-to-the-new-international-situation-101397203.html>

70 *Editorial: How China Can Achieve 'Competitive Neutrality', Caixin Global*, 23rd October 2018, viewed 7th August 2019, <https://www.caixinglobal.com/2018-10-23/editorial-how-china-can-achieve-competitive-neutrality-101338043.html>

71 *People's Republic of China: 2019 Article IV Consultation – Press Release; Staff Report; Staff Statement and Statement by the Executive Director for China*, IMF, 9th August 2019, viewed 12th August 2019, p. 33, <https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Peoples-Republic-of-China-2019-Article-IV-Consultation-Press-Release-Staff-Report-Staff-48576>

private sector. Zombie exits should be facilitated by strengthening the social safety net.

- *Increase competition* by opening up non-strategic sectors to private and foreign enterprises, strengthening the role of the State Administration for Market Regulation and independent arbitration in dealing with SOE monopolies, and submitting a high-quality revised offer to join the WTO Agreement on Government Procurement.

- *Improve SOE governance*. The authorities should increase transparency of governance at the group level, by increasing information disclosure on group level board meetings, and promote the appointment of managers with international and private sector experience (e.g. by following the 2015 OECD guidelines on corporate governance of SOEs)."

Competitive neutrality

While SOE reform will help trim the fat from bloated firms, strong institutions are needed to ensure that SOEs are not only pared down to an appropriate role, but that they also exist and compete with the private sector on a level playing field. To achieve this, competitive neutrality must be embraced.

What is competitive neutrality?

Australia, birthplace of competitive neutrality

Throughout the 1990s, Australia underwent a series of microeconomic reforms to boost the efficiency and competitiveness of Australian companies. One of the most critical reforms was to create a level playing field between private and state-owned firms and rein in market distortions. As the Australian Treasury explained:

"Competitive neutrality policy […] should be understood in the context of the economic reforms which have been implemented progressively in Australia and elsewhere over the past decade or so. A consistent theme in those reforms, whether in international trade, domestic regulation or public sector management, has been an increased reliance on market-based mechanisms and competition to promote efficiency and competitiveness."[72]

A definition

The Organization for Economic Co-operation and Development (OECD) Competition Committee introduces 'competitive neutrality' in competition policy as "a fundamental principle of competition law and policy that firms should compete on the merits and should not benefit from undue advantages due to their ownership or nationality […] Governments can affect the way markets function sometimes to the detriment of free competition. They can set procurement/tax rules or regulatory regimes putting private companies at a disadvantage compared to state-controlled or supported firms, or yet, they can participate in a market by providing services directly or through state-owned/controlled firms. Ensuring a level playing field is therefore key to enable competition to work properly."[73]

In other words, SOEs and POEs should be treated equally.

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72 *Commonwealth Competitive Neutrality Policy Statement*, Australian Treasury, June 1996, viewed 26th July 2019, <http://archive.treasury.gov.au/documents/275/PDF/cnps.pdf>

73 *Competitive Neutrality in Competition Policy*, OECD, viewed 13th August 2019, <http://www.oecd.org/competition/competitive-neutrality.htm>

What does competitive neutrality mean for foreign companies?

The concept of 'competitive neutrality' is most often referenced in relation to SOEs versus POEs, but the core concept is that ownership status should not impact how the government treats *any* company. In most mature economies, there is no legal distinction between 'foreign' and 'local' companies, beyond the limited purposes for national security and taxation. A Chinese private company that invests in the EU is legally treated as a private company alongside its local counterparts. It has therefore not been necessary to expand the definition of 'competitive neutrality' to incorporate the concept of a foreign/local divide.

However, China does maintain a different legal status for foreign companies invested in its market. This legal distinction will soon be simplified when the Foreign Investment Law comes into force in January 2020, but will remain nonetheless.[74] As such, if China is to fully embrace competitive neutrality, the definition of differentiated legal ownership will need to be expanded to include both private versus state-owned companies and foreign versus local.

…But one cynical thought...

The timing of the discussions on competitive neutrality could point towards market reformers among China's leadership seizing the opportunity to advance economic liberalisation. However, they could equally be the result of China's profligate national champions being reined in abroad. If the concept of 'competitive neutrality' indeed becomes little more than empty rhetoric, used only to advance the interests of China's SOEs in other markets, it may result in the EU developing ever stronger defences to protect against their distortive effects.

European businesses are not alone in these concerns

"It is worth noting that, as soon as the Chinese government began expressing firm acceptance of competitive neutrality, some officials and scholars began warning of so-called 'reverse discrimination' against SOEs. Their arguments are worrying and inconsistent with reality, reflecting stubborn prejudices. Private enterprises still don't have access to fair competition – how would they even dare to engage in 'reverse discrimination'? How can comparative neutrality be implemented if people sensationalise the risk of 'reverse discrimination'?"[75]

Why does China need competitive neutrality?

A vibrant private sector under siege

China's private sector is its real engine of growth, yet it is struggling as the economy tightens, in no small part because resources continue to flow to SOEs.[76]

Unfortunately, measures undertaken to support the private sector in the past few years have largely been incremental and piecemeal. As welcome as it is to see administrative procedures shortened by a few days, social security contributions lowered ever so slightly and marginal tax cuts, more is expected. Such steps are akin to a doctor providing medication to lessen the symptoms of an illness. While they provide some temporary relief, the illness will remain until the underlying causes are treated.

74 *Foreign Investment Law of China*, State Council, 15th March 2019, viewed 6th August 2019, <http://www.gov.cn/xinwen/2019-03/20/content_5375360.htm>

75 *Editorial: How China Can Achieve 'Competitive Neutrality', Caixin*, 23rd October 2018, viewed 13th August 2019, <https://www.caixinglobal.com/2018-10-23/editorial-how-china-can-achieve-competitive-neutrality-101338043.html>

76 Wildau, Gabriel, and Jia, Yizhen, *Why Banks Are Wary of Beijing Plea to Back Private Companies, Financial Times*, 20th February 2019, viewed 7th August 2019, <https://www.ft.com/content/aedef990-335b-11e9-bd3a-8b2a211d90d5>; *Financial System: Financial System Policy Reform*, Asia Society's China Dashboard, Spring 2019, viewed 7th August 2019, <https://chinadashboard.asiasociety.org/spring-2019/page/financial-system>

This is critical both for China's future growth, employment and innovation, and for attracting further foreign investment. European businesses are tired of competing on an uneven playing field in general, but especially against SOEs. This is *the* structural issue at the core of China's economic woes, and failure to deal with it will continue to dampen long-term confidence in the Chinese market.

Don't forget global tensions

By making meaningful progress in creating a level playing field and realising competitive neutrality, China could significantly ease some of the tensions caused by the distortions emanating from its market.[77] While the immediate justification for the US-China trade war may change from tweet to tweet, the core of the US' complaints against China has long focussed on the Chinese state-planned economy with SOEs at its centre.[78]

While widely recognised as an issue among many other countries, the EU in particular has begun to critically review China's heavyweight SOEs and state-backed activity in the EU. More importantly, it has gone a step further and taken action. Tighter investment screening and potential tools to push back against subsidised Chinese national champions performing a variation on dumping in Europe's public procurement markets are among the first tools the EU is sharpening to address this issue.[79]

If competitive neutrality is realised, China can negate the justification for such protective measures and ensure that all of its entities have a place in the EU market. Without doing so, the chances of China encountering tighter scrutiny abroad will only increase.

At least zombie SOEs are on the chopping block

There are some indicators, at least at the central level, that there is a desire to see the most egregious examples of state-support-gone-wrong disappear.[80] In July 2019, 13 ministries jointly released the *Plans for Accelerating Improvements of the Market Entity Exit System*, which include a critical section on cutting support for 'zombie companies' that already meet the conditions for bankruptcy.[81&82] This plan explicitly forbids any level of government from providing support that perpetuates the existence of SOEs that meet these conditions.

This positive step is welcomed by the European business community, and shows that the government is at least ready to deal with SOEs that do nothing but drain from the system.

How to implement competitive neutrality in China?

While suggested models for effective overall implementation of competitive neutrality can be found with the likes of the OECD and the World Bank, the European Chamber has several specific examples to contribute to the conversation in China. These individual cases, raised by specific sectors, represent the

77 Heilmann, Sebastian, *Europe Needs Tougher Response to China's State-led Investments*, MERICS, 10th June 2016, viewed 7th August 2019, <https://www.merics.org/en/blog/europe-needs-tougher-response-chinas-state-led-investments>

78 *Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Under Section 301 of the Trade Act of 1974*, Office of the United States Trade Representative, 22nd March 2018, viewed 7th August 2019, <https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF>

79 Moon, Louise, *Chinese Overseas Deals Fall Amid Heightened Scrutiny in US, South China Morning Post*, 21st August 2018, viewed 7th August 2019, <https://www.scmp.com/business/global-economy/article/2160734/chinese-overseas-deals-plunge-amid-heightened-scrutiny-us>

80 Tang, Frank, *China Cracks Down on Subsidies to Zombie Companies as US Trade War Hits Economy, South China Morning Post*, 16th July 2019, viewed 7th August 2019, <https://www.scmp.com/economy/china-economy/article/3018778/china-cracks-down-subsidies-zombie-companies-us-trade-war>

81 SCMP Editorial, *Sooner China Can Kill Off Zombie Firms the Better for Economy, South China Morning Post*, 23rd July 2019, 7th August 2019, <https://www.scmp.com/comment/opinion/article/3019817/sooner-china-can-kill-zombie-firms-better-economy>

82 *Plans for Accelerating Improvements of the Market Entity Exit System*, State Council, 16th July 2019, viewed 24th July 2019, <http://www.gov.cn/xinwen/2019-07/16/5410058/files/bbaef6612fed4832b70a122b39f1d5bd.pdf>

kinds of issues faced by the European business community in China related to unequal treatment and the need for competitive neutrality.

Market access – beyond the negative list

Competitive neutrality is especially important in China's energy sector. Foreign energy companies have long faced a variety of barriers that inhibit them from meaningfully participating in the industry, which is saturated by SOEs. The 2019 revision to the *Foreign Investment Negative List* removed direct barriers to entry for natural gas exploration and exploitation; a move in the right direction.[83] However, a wide range of other *de facto* barriers to entering the market also exist.

In order to have full access to the natural gas sector in China, foreign companies need to be free to operate in the upstream (exploration and extraction), midstream (transportation and storage) and downstream (processing) aspects of the industry. Currently, a wide variety of approvals must be obtained for those areas that are already 'open' thanks to revisions of the *Foreign Investment Negative List* and further restrictions are then found on China's *Negative List for Market Access*.[84] These result in foreign energy companies being left out of critical parts of the natural gas sector like natural gas liquefaction, transportation and storage management.

Would you like to know more?

To learn more about the natural gas sector in China and the concerns and recommendations of European energy companies, read Key Recommendation 1 in the *Energy Working Group Position Paper*.

Furthermore, the domination of the natural gas industry by SOEs drives concerns that administrative approvals required for gas exploration and exploitation will favour state-owned companies. Embracing competitive neutrality would necessitate that a fair and transparent system for determining which companies are given access to gas fields is created to ensure equal opportunities for all firms, regardless of their ownership. This is also a critical step for China to show that national treatment, as legally guaranteed in the Foreign Investment Law, can be expected by foreign investors.[85] As the government prepares for the implementation of the Foreign Investment Law at the start of 2020, ensuring that the regulatory groundwork exists to provide equal treatment for foreign energy companies and local SOEs, to ensure that they have fair access to natural gas deposits and the entire production, transportation and processing stream, is becoming more of a priority.

Monopolies – Zhu Rongji undone

During the late 1990s reforms of Zhu Rongji, China's shipbuilding monopoly was split between the China Shipbuilding Industry Company (CSIC) and the China State Shipbuilding Company (CSSC), with the CSIC gaining control over shipbuilding assets north of the Yangtze River and the CSSC taking those to the south. Unfortunately, this reform appears to be coming undone, with the two having recently announced their intention to merge.[86] Given the excitement about this prospect in state media, and the alignment of the planned merger with President Xi's "better, stronger, bigger" approach to SOE reform, the European shipbuilding community anticipates that the merger will go through.[87]

83 *Comparison of Changes to Special Administrative Measures on Access to Foreign Investment (Negative List)*, European Union Chamber of Commerce in China, 1st July 2019, viewed 8th August 2019, <https://static.europeanchamber.com.cn/upload/medianews/attachments/European_Chamber_Comparison_of_Free_Trade_Zones_and_National_Negative_List_for_Foreign_Investment_1.0[15].pdf>

84 *Market Access Negative List*, National Development and Reform Commission, 21st December 2018, viewed 8th August 2019, <http://www.ndrc.gov.cn/zcfb/zcfbtz/201812/W020181228564278445267.pdf>

85 *Foreign Investment Law of China*, State Council, 15th March 2019, viewed 6th August 2019, <http://www.gov.cn/xinwen/2019-03/20/content_5375360.htm>

86 *CSSC-CSIC Megamerger Confirmed at Last, Maritime Executive*, 1st July 2019, viewed 13th August 2019, <https://www.maritime-executive.com/article/cssc-csic-shipbuilding-megamerger-confirmed-at-last>

87 *China Plans to Merge Two Large Ship-building Corporations, Global Times*, 2nd July 2019, viewed 7th August 2019, <http://www.globaltimes.cn/content/1156452.shtml>

If so, it will create an industrial hegemon that controls 20 per cent of global market share. This behemoth will certainly be the beneficiary of extensive support from the state as policymakers have clearly designated the shipbuilding sector as a key industry under the China Manufacturing 2025 (CM2025) initiative. In December 2018, action plans were announced to advance development in the liquified natural gas carriers, luxury cruise liners, icebreakers and offshore engineering equipment sectors.[88] European shipbuilders expect these areas to receive extensive state support, further distorting markets both in China and overseas.

Such monopolistic power within the market is bad enough, but the knock-on effect is likely to be similar to that experienced in the steel and solar panels industries, which saw overcapacity and dumping in global markets. Regulators urgently need to rein in such mergers and ensure that competition law is rigid.

Would you like to know more?
To learn more about the shipbuilding industry in China and its European participants, read the *Shipbuilding Working Group Position Paper*.

Public procurement – 'Buy China'

While winning a public procurement bid in China when competing against an SOE can be an incredibly difficult proposition for any company, the legal distinction drawn between foreign and domestic companies puts foreign enterprises at a further disadvantage. One of the clearest cases of legal discrimination experienced by European businesses in China is in the procurement of medical devices.

In recent years, the Chinese Government has promulgated several high-level policies in the name of creating a fair procurement market in China. *State Council Document No. 5 (2017)* clearly stated that products manufactured by foreign enterprises in China will be treated equally in public procurement bids.[89] In December 2017, the National Development and Reform Commission (NDRC) led two other ministries in publishing the *Notice on the Working Plan 2017/2018 to Abolish Anti-competition Policies*, another document that touches on this issue very explicitly.[90]

However, many local procurement policies include a provision that hospitals are encouraged to buy domestically-made medical devices as long as they meet quality requirements, and even explicitly stipulate the purchase of "domestic brands".[91]

This violates the principle of fair competition and equal treatment of registered companies in China, and is furthermore an insurmountable trade barrier for foreign-invested enterprises (FIEs). It also affects the fairness of procurement and greatly reduces the attractiveness of China as a destination for foreign investment in medical equipment manufacturing. Of no less concern is that it puts hospitals in a position where they have to consider something as arbitrary as the origin of a brand.

The allocation and use of medical equipment and instruments in public hospitals should be based on open

88 *Action Plan for Promoting Transformation to Intelligent Berth-assembling and Shipbuilding (2019–2021)*, MIIT, 30th December 2018, viewed 22nd May 2019, <http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057585/n3057594/c6566590/content.html>; *Intelligent Shipbuilding Promotion Action Plan for 2019–2021*, State Council, 30th December 2018, viewed 22nd May 2019, <http://www.gov.cn/xinwen/2018-12/30/content_5353550.htm>

89 *Notice of the State Council on Several Measures on Promoting Further Openness and Active Utilisation of Foreign Investment (State Council Document, Guofa [2017] No. 5)*, 17th January 2017, viewed 13th August 2019, <http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm>

90 *Notice on Working Plan 2017/2018 to Abolish Anti-competition Policies*, State Council, 12th December 2017, viewed 5th May 2018, <http://www.gov.cn/xinwen/2017-12/12/content_5246226.htm>

91 *Approval on Allocation of Type B Large Medical Device Equipment to Medical Institutions (Shen Wei Ji Fa [2018] No.39)*, Health Commission of Shenzhen, 14th August 2018, viewed 4th May 2019.

market competition, the needs of medical service providers and selecting the best clinical outcomes for patients. During the procurement process, the government should give priority to patients' clinical needs, and conduct evidence and value-based procurement.

On 14th August 2018, the Shenzhen Health Commission released an approval list to local hospitals, on the allocation of Type-B large medical equipment (see Table 1).

<table>
<tr><th colspan="5">Table 1: Approval List</th></tr>
<tr><td>Total</td><td colspan="4">46 Hospitals</td></tr>
<tr><td rowspan="2">Approved type-B large medical equipment</td><td colspan="2">CT</td><td colspan="2">MRI</td></tr>
<tr><td colspan="2">23 units</td><td colspan="2">24 units</td></tr>
<tr><td rowspan="2">Must be domestic indigenous brands</td><td>Units</td><td>Percentage</td><td>Units</td><td>Percentage</td></tr>
<tr><td>7</td><td>30.4%</td><td>10</td><td>41.7%</td></tr>
</table>

Ending such blatant discrimination against foreign companies and their JVs with local companies is critical to maintaining the efficiency of China's procurement system. It is also an important step towards realising the full meaning of 'competitive neutrality' by ending the distinction between foreign and local ownership, and affording all companies in China a level playing field.

Would you like to know more?
To learn more about the concerns and recommendations of the medical devices industry, read the *Healthcare Equipment Working Group Position Paper*.

SOEs suck up all the oxygen, leaving little for SMEs

As discussed previously, China's state-owned financial system has always provided extensive funding for other SOEs, with much less going to the private sector, and only a small portion of that going to SMEs. Historically, alternative sources of financing, like shadow-banking, grew to fill this need. The ensuing crackdown on the legally grey sources of financing in China has meant that many Chinese SMEs have recently had to go without. European SMEs, on the other hand, have *always* struggled to access financing in China, often having to rely on credit from original equipment manufacturers (OEMs), financing from European banks, or just operating on a shoestring budget to make ends meet.

The government has pushed banks to drastically increase the number of loans going to private firms, but this is merely addressing a symptom of the problem rather than its causes. In the long-run, the implicit guarantee of SOEs must be addressed, as well as the shortcomings of the country's ratings and bankruptcy systems.

This imbalance is mainly driven by the fact that centrally-owned SOEs will be bailed out by the government if needed, and locally-owned ones often have the same relationship with their regional officials. Ending these implicit guarantees of SOEs is not just a critical part of realising competitive neutrality, it is also central to financial system reform. There must also be a demonstrable pattern of both local and central SOEs being held to the same fiscal discipline as the private sector, and that may mean forcing some SOEs to restructure, or even dissolve.

The second major cause of the shortage of financing for SMEs comes from China's limited capacity for ensuring accurate risk assessment for firms, as well as the toothless and seldom used bankruptcy system. Fortunately, these are areas where reforms are either happening or are inbound. The ratings agency market was opened up to foreign investment in January 2019, which should help boost capacity for accurate ratings through competition,[92] and an overhaul of the Bankruptcy Law was announced in March 2019.[93] These are good starting points, but it will take time for their effects to be realised so that well-run SMEs are rated appropriately and given the financing they deserve, while also ensuring that failing companies are able to go through the bankruptcy process smoothly and free up capital for healthy investment.

Would you like to know more?
To learn more about the Bankruptcy Law and the situation for ratings agencies, read Key Recommendation 6 in the *Banking and Securities Working Group Position Paper*.

The urgency of addressing these core issues has been increased by the emergence of a new trend. In recent months, companies have begun relying on 'commercial acceptance bills'—an official form of an IOU, of which over USD 200 billion are in circulation in China—to make up for the shortfall in funding.[94]

China has launched several measures to address this, but the effects have so far been less than what the situation demands. Measures such as the Law of the People's Republic of China on the Promotion of Small and Medium-sized Enterprises, and the *Guiding Opinions on Promoting the Healthy Development of Small and Medium-sized Enterprises*,[95] are welcome steps in the right direction, but the financing tools that were established subsequently are insufficient due to both limited scope and problems with execution. The NPC sent inspection teams to assess the implementation of the SME Promotion Law—including financing-related measures—earlier this year. The European Chamber hopes that their findings lead to more effective implementation that produces meaningful results for SMEs, foreign and local alike, thus moving the market further towards competitive neutrality.

Would you like to know more?
To learn more about the financing concerns and recommendations of European SMEs in China, read Key Recommendation 1 in the *Inter-Chamber Small and Medium-sized Enterprise Working Group Position Paper*.

Administrative support as protectionism

The CCP and the Chinese Government are currently undergoing a process to define SOEs as either 'commercial' or 'public welfare enterprises'. The idea is actually a good starting point for determining the legitimate roles of SOEs, as those that serve commercial roles beyond areas such as natural monopolies ought to be considered for privatisation. However, concerns arise over the potential misuse of this classification system, and the need for objective decisions to be made in the categorisation process.

The Testing, Inspections and Certification (TIC) industry is already heavily dominated by the nearly 11,000 SOEs that operate in the sector.[96] There is considerable fear among European TIC providers that the administrative categorisation of many of these SOEs as 'public welfare enterprises' will result in them

92 Sun, Nikki, *China Picks S&P Global as First Foreign Bond Rating Agency, Nikkei Asian Review*, 28th January 2019, viewed 15th April 2019, <https://asia.nikkei.com/Business/Markets/China-picks-S-P-Global-as-first-foreign-bond-rating-agency>

93 Shan, Yuxiao, and Teng, Jing Xuan, *China Moves Closer to Overhaul of Bankruptcy Law, Caixin Global*, 29th March 2019, viewed 15th April 2019, <https://www.caixinglobal.com/2019-03-29/china-moves-closer-to-overhaul-of-bankruptcy-law-101398784.html>

94 Stevenson, Alexandra, and Li, Cao, *Short on Cash, Businesses in China Rely on I.O.Us to Keep the Lights On, The New York Times*, 6th August 2019, viewed 7th August 2019, <https://www.nytimes.com/2019/08/06/business/china-cash-commercial-acceptances.html>

95 *Guiding Opinions on Promoting the Healthy Development of Small and Medium-sized Enterprises*, State Council, 7th April 2019, viewed 17th May 2019, <http://www.gov.cn/zhengce/2019-04/07/content_5380299.htm?mc_cid=9c9e233ad4&mc_eid=51671cb827>

96 *SAMR Releases Data on TIC Industry of China in 2018*, Certification and Accreditation Administration, 8th June 2019, viewed 12th June 2019, <http://www.cnca.gov.cn/xxgk/hydt/201906/t20190606_57262.shtml>

being given considerable advantages. This would significantly worsen the already limited amount of competition that this sector experiences in China and potentially result in an administratively supported monopoly driven by TIC service companies that are almost exclusively state-owned. At a time when Chinese companies are expected to produce higher-quality goods and services, the value of proper TIC services will only increase, making the monopolistic power of an industry dominated by SOEs particularly concerning.

Would you like to know more?

To learn more about the administrative concerns and recommendations of European TIC providers in China, read Key Recommendation 2.1 in the *Quality and Safety Services Working Group Position Paper*.

No 'competitive neutrality with Chinese characteristics'

Applying competitive neutrality in all cases except when it is not convenient to do so would result in the death of the principle. Like all sound institutions, it should be implemented in absolute terms, not only when it suits 'special conditions'. A core part of the *Decision* passed on the Third Plenum of the 18th Central Committee of the CCP, to let market forces play the "decisive" role in resource allocation, fell victim to such an approach, and the Chinese economy remains one where market forces continue to clash with the state-led model as a result.

Adopting an absolute approach is challenging. It will require government to remove its grip from critical parts of the economy and make room for the invisible hand of the market to fill the void. Although this will entail accepting new risks, China has been at this point before under Deng Xiaoping, and later Jiang Zemin and Zhu Rongji, with the risks subsequently proven to be worth taking. The difference now is that China has that much more experience, strength and confidence.

What can the EU do to advance Chinese SOE reform and competitive neutrality?

If China intends to pursue SOE reform and competitive neutrality, it will find a productive partner in Europe. Between upholding the multilateral rules-based order and completing an impressive number of comprehensive free-trade agreements (FTAs) in recent years, the EU has shown pragmatism when dealing with like-minded governments.

It is in the interests of European business to cooperate with China in its efforts to bring about competitive neutrality and complete SOE reform, by providing expertise and consultation. Meanwhile, the EU and member-state governments can help to prepare the foundations for more robust and productive engagement with China.

Results-based cooperation must be the aim

Any cooperation must be pursued on a conditional basis, to provide a framework and clear goals for any dialogues that take place. Wherever engagement bears fruit, it should be pursued decisively. Capacity-building will be a critical area where the EU can make a difference, as most EU Member States have their own experiences with SOE reform and realising competitive neutrality. Sharing what worked well and what did not can help facilitate China's own plans.

The EU-China Comprehensive Agreement on Investment (CAI) is a golden opportunity for engagement that can produce results.[97] A sufficiently ambitious CAI will act as a major source of confidence-building between the EU and China. Once brought into force, other avenues of cooperation will naturally present themselves. The agreement could even pave the way for discussions on an EU-China FTA.

Bolstering the EU's position

Meanwhile, the EU can further strengthen its own tools to guard against potential market distortions caused by China's SOEs, while also methodically setting the conditions for them to access the world's largest common market. This would apply affirmative pressure, and could provide the additional incentive required for China to follow through with meaningful SOE reform.

The EU's new investment screening mechanism is a good starting point.[98] It is important to keep the system up to date, and to refine and improve it to deal with any future challenges. It is also important to coordinate better between member states, to ensure that a common approach is taken and that each has the capacity to investigate suspect investments.

The International Procurement Instrument (IPI)

The IPI is another tool the European Commission has at its disposal.[99] The IPI allows the Commission to launch an investigation into the government procurement practices of other markets. If significant barriers exist that affect companies from the EU that want to bid on government procurement projects in that country, the EU will enter into consultations with that country to attempt to resolve the issue. If changes are not made, the IPI would then allow the Commission to restrict the access of companies, goods and services from the relevant country.

China is by no means the only country that protects its public procurement market while enjoying wide access to the EU's. However, it does so with national champions that are beefed up with cheap loans and subsidies, while enjoying an economy of scale from their vast and heavily-protected home market. Meanwhile, many European companies have all but given up on China's government procurement market due to the unfair treatment they face under bidding and tendering processes. The IPI would put pressure on China to reform its SOEs and public procurement system by potentially impacting the bids of the country's national champions in EU public procurement tendering for as long as China delays its own reforms.

A stronger common market

The EU should also further strengthen the common market to prevent exploitation of individual member-states or their segmented nature. One key example comes from the International Liner Shipping Sub-working Group.

A number of coastal countries, including some EU member-states, have cabotage laws that restrict or forbid foreign-flagged vessels from participating in domestic shipping.[100] In China, this means that one foreign-flagged vessel shipping goods out of Tianjin and another shipping goods out of Shanghai cannot then consolidate and reorganise their cargo between the two ships in a Chinese port to more efficiently

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97 *EU-China Comprehensive Agreement on Investment*, European Parliament, viewed 8th August 2019, <http://www.europarl.europa.eu/legislative-train/theme-a-balanced-and-progressive-trade-policy-to-harness-globalisation/file-eu-china-investment-agreement>

98 *EU Foreign Investment Screening Regulation Enters into Force*, European Commission, 10th April 2019, viewed 8th August 2019, <https://europa.eu/rapid/press-release_IP-19-2088_en.htm>

99 *International Procurement Instrument*, European Commission, viewed 8th August 2019, <http://trade.ec.europa.eu/doclib/docs/2019/march/tradoc_157728.pdf>

100 *Cabotage Laws of the World*, Seafarers Rights International, 2018, viewed 8th August 2019, <http://ftp.elabor8.co.uk/sri/cabotage/flipbook/mobile/index.html>

move goods to their respective final destinations. However, Chinese-flagged vessels operated by a wholly Chinese-owned company can.

On the face of it, this may look like reciprocal treatment, as a few member states have similar restrictions. The issue is that China has a massive coastline (the world's 11th longest[101]) with many busy ports (nine of the world's top twenty busiest ports by container throughput).[102] The EU only holds three of the world's busiest ports in Rotterdam, Antwerp and Hamburg, all of which are in different member states, none of which have a long coastline. This means that a Chinese flagged vessel can load up in Hamburg, consolidate with another Chinese-flagged ship in Rotterdam, then do it yet again in Antwerp so that goods from these three markets can then be shipped more efficiently to other markets, all within less distance than it takes to sail from Tianjin to Qingdao.

This puts European shipping companies at a disadvantage when competing against the Chinese shipping industry. One possible remedy is through an EU-China agreement that allows EU-flagged vessels to engage in international relay in Chinese ports to rearrange containers (not to be confused with domestic shipping). If such an agreement cannot be reached, a layer of common cabotage laws could then be introduced in the EU, preventing non-EU-flagged vessels from performing international relay. Such a common EU approach could help to leverage a resolution to this situation.

These are shields, not swords

These proposed measures are not offensive tools to be used against Chinese companies, or as methods to boost protectionism in the EU market. They are instead fail-safes. In the event that China does not follow through with SOE reform and competitive neutrality in the coming years, such measures will be necessary to protect the EU market; not from competition but from distortions caused by entities that do not conform to the multilateral trade and investment system. If China's reforms are forthcoming, then these mechanisms become all but irrelevant to Chinese businesses looking to invest in the EU.

Europe's Sputnik moment: the need to boost internal competitiveness

Between persistent market access barriers, perpetual unequal treatment, extensive support for SOEs and the state-directed nature of its top-down industrial policies, China has fallen short of many of its WTO commitments. It has also repeatedly resisted the spirit of WTO membership, which is to continue to push beyond initial accession agreements and join other members as a fully open and fair market. China's national champions now exert an economy of scale based on their uncontested dominance of their home-market of a fifth of the world's consumers. This, coupled with state support, allows them to go abroad and undercut market prices, dominate public procurement bids and push out competition.

As such, the EU must explore innovative ways to counter the imbalance in the global system caused by the distortions emanating from the Chinese market.

Europe's own debate

Just as there is a debate underway in China to re-examine the role of the state-owned economy, a discussion is also taking place within the EU about potential changes to the Common Market. Industry associations like the Federation of German Industries (BDI) and the General Confederation of Italian

101 *Countries with the Longest Coastline*, World Atlas, viewed 20th August 2019, <https://www.worldatlas.com/articles/countries-with-the-most-coastline.html>
102 *One Hundred Ports 2018, Lloyds List Maritime Intelligence*, 2018, subscription service.

Industry (Confindustria) have been joined by political leaders like German Federal Minister for Economic Affairs and Energy Peter Altmaier in calls for reforms in the EU.[103,104&105]

One such reform being called for is the creation of an EU industrial policy suited to its market economy. While China's industrial policy often focuses on state-directed innovation and providing undue support to hand-picked national champions, the EU approach should follow market principles and empower SMEs as major drivers of innovation and growth. Tax incentives for research and development (R&D) can help encourage innovation in the private sector, but stronger support for basic research in non-profit and educational institutions can ensure advances in new areas.

EU competition law would also benefit from some re-evaluation. Within the European Common Market, tight controls to limit the power and market share of individual companies has helped drive competition. However, as other major economies have either laid aside anti-trust rules (as in the USA) or have shaped national champions through market intervention and protection (as in China), the EU may have little choice but to examine how to allow the market to create its own European champions so that external markets become fields of competition rather than places that have already been claimed by industrial giants from other economies.

Finally, boosting the amount of resources at the disposal of the EU for building modern infrastructure in rural areas and in less wealthy member states could help drive fresh growth, while also ensuring that the talent in those places have the foundation they need to build world-class companies and contribute even more to European innovation. Doing so can also help to build greater unity across member states, which will further strengthen the Common Market.

Connectivity is another key

It is also advisable for the EU to continue to look beyond its own borders to mitigate the distortions emanating from China. While much of the hype surrounding China's Belt and Road Initiative (BRI)—its signature foreign policy for the last six years—is overblown, the impact on global competition is considerable.[106] The BRI follows its own approach to things like procurement for its projects, resulting in a system where Chinese firms win the lion's share of bids and keep out foreign competition.[107]

Further consolidation and promotion of the EU Connectivity Strategy can help in this respect, by boosting cooperation with trade and investment partners while also building their capacity for following fair and rules-based systems.[108]

The earlier the EU can start down this road, the better.

103 *China – Partner and Systemic Competitor: How Do We Deal with China's State-Controlled Economy*, BDI, January 2019, viewed 7th August 2019, <https://english.bdi.eu/media/publications/#/publication/news/china-partner-and-systemic-competitor>

104 *Italy, Europe and China: Recommendations for a New Cooperation Strategy*, Confindustria, 2019, viewed 7th August, <http://www.confindustria.eu/documentDownload?id=9966&ext=pdf&name=Position+Paper+China+2019_Eng>

105 *National Industry Strategy 2030*, German Ministry for Economic Affairs and Energy, 2019, viewed 7th August 2019, <https://www.bmwi.de/Redaktion/EN/Artikel/Industry/nationale-industriestrategie-2030.html>

106 Ghossein, Tania, Hoekman, Bernard, and Shingal, Anirudh, *Public Procurement in the Belt and Road Initiative*, World Bank, December 2018, viewed 9th August 2019, pp. 31–32, <http://documents.worldbank.org/curated/en/143241544213097139/pdf/132786-MTI-Discussion-Paper-10-Final.pdf>

107 Devonshire-Ellis, Chris, and Zhou, Qian, *China's New Foreign Investment Law and the Impact on the Belt and Road Initiative*, Silk Road Briefing, 25th June 2019, viewed 9th August 2019, <https://www.silkroadbriefing.com/news/2019/06/25/chinas-new-foreign-investment-law-impact-belt-road-initiative/>

108 *EU Steps up its Strategy for Connecting Europe and Asia*, European Commission, 19th September 2018, viewed 8th August 2019, <https://europa.eu/rapid/press-release_IP-18-5803_en.htm>

The campaign to uphold multilateralism and a rules-based order

Since the global multilateral and rules-based economic order came under threat from the recent surge in nationalism and protectionism—including from countries that historically championed institutions like the WTO—the EU has stepped up its fight to maintain the system. It has also made clear its intention to cooperate with like-minded nations to reform the WTO, for example, by forming a working group with China to explore what needs to be done.

It is important for WTO reforms to be holistic in nature. Rather than using reforms to tweak a few areas of concern, they should be viewed as an opportunity to advance the cause of economic liberalisation. This will entail addressing new developments like the rise of e-commerce and digital goods, but it also means that the WTO should broaden its scope to more thoroughly cover investment between members.

Agreements abound

Since the EU and China began negotiations on the CAI in 2013, the EU has successfully concluded a wide range of agreements with other major economies. For example, the EU-Japan Economic Partnership Agreement—the talks for which began around the same time as those for the CAI—was brought into force in February 2019. Similar agreements, along with FTAs and bilateral investment treaties (BITs), have been implemented in South Korea (2016), the South African Development Community (Botswana, Lesotho, Mozambique, Namibia, South Africa and Eswatini (formerly Swaziland)) (2016), Canada (2017), Singapore (2018) and Vietnam (2019).[109]

Other negotiations have also seen the EU reach agreements in principle, with just the details in need of ironing out, such as those with Mexico (2018) and Mercosur (Argentina, Brazil, Paraguay and Uruguay) (2019). Looking forward, the EU has already begun negotiations with the Philippines (2015), Myanmar (2015), Indonesia (2016), New Zealand (2019) and Australia (2019).[110]

It is very encouraging that the EU and China signed a *Joint Statement* during the 21st EU-China Summit on 9th April 2019, which included a commitment to complete negotiations on the CAI by 2020. After more than seven years of negotiation, the concluded agreement will act as a clear indicator as to the strength and future direction of the EU-China relationship, and the sincerity of China's reform and opening agenda. It should be bold and result in meaningful improvements in market access and operating conditions for European firms in China.

Recommendations

Recommendations for the Chinese Government

- Align China's reform agenda with the OECD's, the World Bank's and the IMF's SOE reform and competitive neutrality recommendations, establish a timeframe and a roadmap to pursue these in a

109 Note: readers can find more information about each individual agreement in the following links: Japan <http://ec.europa.eu/trade/policy/in-focus/eu-japan-economic-partnership-agreement/>; South Korea <https://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2010036>; the South African Development Community <http://ec.europa.eu/trade/policy/countries-and-regions/regions/sadc/>; Canada <http://ec.europa.eu/trade/policy/countries-and-regions/regions/sadc/>; Singapore <http://ec.europa.eu/trade/policy/in-focus/eu-singapore-agreement/>; Vietnam <http://ec.europa.eu/trade/policy/in-focus/eu-vietnam-agreement/>

110 Note: readers can find more information about each individual agreement or negotiation process in the following links: Mexico <http://ec.europa.eu/trade/policy/in-focus/eu-mexico-trade-agreement/>; Mercosur <http://trade.ec.europa.eu/doclib/press/index.cfm?id=2048>; The Philippines <http://ec.europa.eu/trade/policy/countries-and-regions/countries/philippines/>; Myanmar <http://ec.europa.eu/trade/policy/countries-and-regions/countries/myanmar/>; Indonesia <http://ec.europa.eu/trade/policy/countries-and-regions/countries/indonesia/>; New Zealand <http://ec.europa.eu/trade/policy/in-focus/eu-new-zealand-trade-agreement/>; Australia <http://ec.europa.eu/trade/policy/in-focus/eu-australia-trade-agreement/>

realistic and steady manner, and share it publicly so that progress can be clearly measured.

- Follow up on the China 2030 report and the *Decision* passed on the Third Plenum of the 18th Central Committee of the CCP to unleash market forces in the economy and ensure that China can escape the middle-income trap.
- Reinvigorate China's opening up process to embrace a holistic understanding of market access that goes beyond direct barriers like the negative lists and also considers secondary barriers like licensing.
- Increase engagement with the European business community in China to pursue reforms in the 800-plus recommendations found in the European Chamber's *European Business in China Position Paper 2019/2020*.

Recommendations for the EU and Member States

- Continue to advance cooperation with China, emphasising areas where advances are most feasible, and pursue a results-orientated approach.
- Strengthen protective mechanisms like investment screening and the IPI to mitigate distortions caused by China's protected SOEs and national champions.
- Further strengthen the European Common Market, identifying areas that are prone to abuse by external actors, such as international shipping.
- Craft a market-based EU industrial policy that encourages innovation and development while supporting SMEs, and take greater efforts to modernise infrastructure for countries within the Common Market where required.

Recommendations for the EU and China

- Meet the 2020 deadline for a meaningful CAI that contains bold and reciprocal commitments for market access and fair operating conditions.
- Pursue additional bilateral and multilateral cooperation on issues such as WTO reform and for addressing problems like steel overcapacity.
- Approach WTO reforms in a holistic way that advances the cause of economic liberalisation.

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