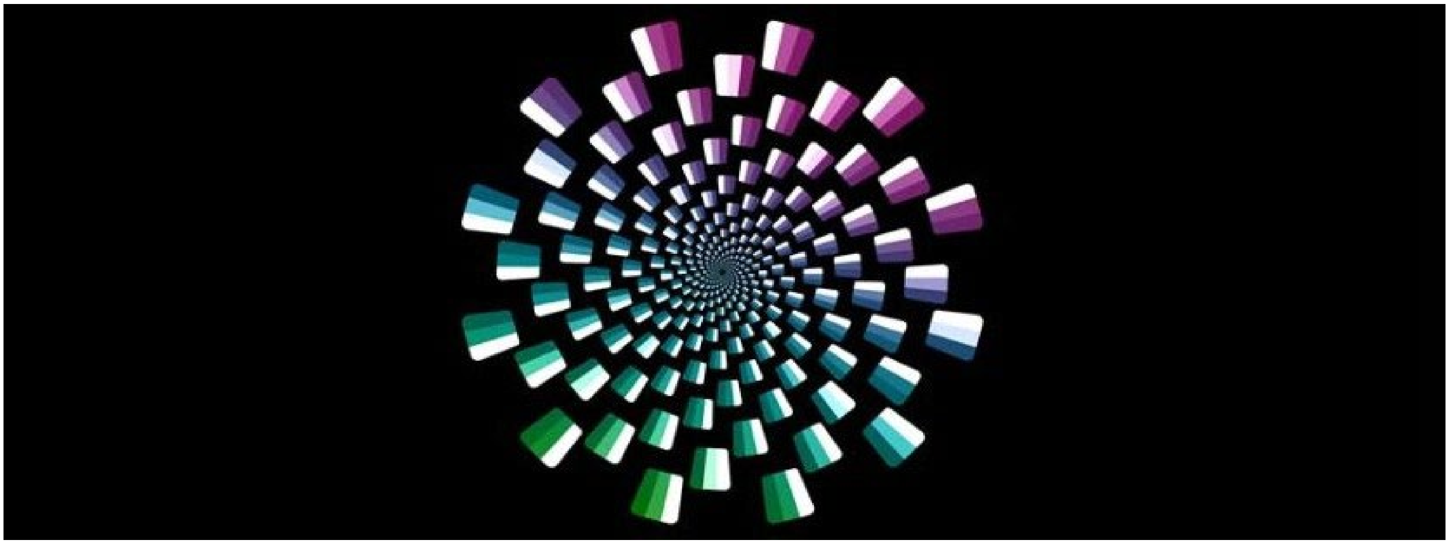

Behind the headlines: China's regulatory environment

Implications for multinational corporations in China

Ken DeWoskin, independent senior advisor to the Chinese Services Group, Deloitte Services LP, describes the changing nature of the Chinese regulatory environment and offers insights into how companies can successfully work within it.

Editor's note: For western companies planning strategic investment decisions in China, it's critical to take a long-arc perspective of five-to-10 years and beyond rather than get caught up in the latest headlines. As Ken DeWoskin, explains: "C-suite executives cannot make sound decisions based on what happened in China in 2021. In the fast-moving and uncertain reform trajectory, longer-term 'legacy norms' are critical to understanding China's direction." In the following interview, he outlines the deep-seated structural features of China's commercial environment.

Many western observers seem surprised by the headlines coming from China these days: IPOs canceled; companies forced to change from for-profit to non-profit; some of China's biggest companies on the brink of default, etc. Is it a paradigm shift? Or is something else underlying these announcements?

I would not say that we are witnessing a paradigm shift. These events, as well as regulatory and policy developments regarding the biggest players in China's property markets, internet businesses, mobility, and private education, have been in the making since the global financial crisis. And they have accelerated since 2013 when Xi Jinping took over the Party's top leadership position. What we are seeing are tactical shifts to rebalance economic power.

When interpreting recent headlines, remember two things. First, China's goal of building a socialist state remains unchanged. Second, the Chinese government has a unique approach to planning and execution. It has a distinctive practice of publishing sweeping national plans with broad ambitions. Rather than outline and follow detailed steps, China progresses incrementally and course corrects along the way to align with its grand vision. (This has been famously described as "crossing the river by feeling the stones.") What we are seeing now is a course correction toward China's long-term goals, and it comes essentially one generation after reforms were launched.

As you point out, these market reforms started back in 1979 under former Chinese president Deng Xiaoping. Can you give us an example of this course correction?

Well, after 30 years of economic reforms, we saw a return to a more command-oriented, socialist economy in 2009—a direction General Secretary Xi Jinping has been very explicit about taking China. At that time (which also coincided with Xi's rise to a new level of influence in national politics), we saw China start to limit private third-party payment providers as one example of its balancing act with capitalism. And this shift in the financial industry has taken root very gradually over time.

But again, let me emphasize that this is not a paradigm shift. There are clear continuities in general direction and big goals. The "belt and road initiative" is rooted in China's prior "going out" campaign. The "common prosperity" campaign follows from the "moderate prosperity" facet of the "China dream," articulated a decade ago. The Five-Year Plan process is in its 14th iteration. And the overall goal of a "socialist state with Chinese characteristics for the new era" was clearly envisioned in the reform launching the socialist-market economy plan.

In other words, the goals remain the same. It is just that the goalposts have moved a bit closer to a more realistic distance. For those who believe that something like World Trade Organization (WTO) membership or trade negotiations can fundamentally redirect China's economic model and the Chinese Communist Party (CCP) contract with the Chinese people, it can be useful to keep this long arc in mind.

"What we are seeing are tactical shifts to rebalance economic power…For those who believe that something like WTO membership or trade negotiations can fundamentally redirect China's economic model and the CCP contract with the Chinese people, it can be useful to keep this long arc in mind." –Ken DeWoskin, independent senior advisor to the Chinese Services Group, Deloitte Services LP

Still, it feels like the pace of change has accelerated. What's driving that?

From the perspective of Chinese leaders, there are three pragmatic issues that are driving the policy and regulatory changes:

1. **There is too great an accumulation of financial capital outside of state control.** This directly challenges the long historical tradition of the state controlling all Chinese capital resources.

2. **The private accumulation of social capital challenges China's sense of societal order.** Capitalism created wealthy and influential individuals and organizations that could shape public interest in unpredictable ways. Influencers outside of senior Party leadership are a concern. This applies to tycoons and celebrities alike.

3. **The growing wealth gap between the rich and the poor threatens social stability.** Despite an explosion of wealth at the top, the urban poor are still without housing, health care, education, etc., endangering China's vision of widespread "common prosperity." *Hukou* reform has not been a priority for years, meaning people moving from rural to urban locations cannot enjoy most urban social benefits.

These three issues are changing the way that government views the private sector. That dynamic is the key catalyst driving more intervention. Social stability is a priority for maintaining the Party's power monopoly and its ability to successfully promote its agenda and achieve its goals.

How has private property, private wealth, and social stability affected the regulatory environment?

To put this in context, it's important to acknowledge a very long tradition in China that goes back far beyond the current regime. The top leadership, whether emperors or political party leaders, owns everything, and can, at its will, assign beneficial ownership to whomever it wishes. This is very deeply ingrained and remains true today.

The economy is based on usage rights, not ownership rights, which can be extended and revoked without an institutional process. Individuals and enterprises may own buildings, but the government owns the land they stand on. This is very different from the West, where property ownership rights were articulated as early as the 4th century and are deeply embedded in our notion of the sanctity of private assets and business.

For the last 20 years, however, you have seen the growth of the private economy in China and the emergence of tycoons with fabled fortunes. People say that China mints a new billionaire every week. In fact, it is estimated that China had 1058 billionaires in 2020[1], and that probably misses some. One result of this enormous private economy: there is a huge amount of wealth and influence outside of direct Party control.

From recent reports, it appears China may be trying to constrain the wealth and influence out of the Party's direct control. Is that fair?

It may seem strange to us that China would crack down on say, celebrities and fan clubs, but it is not the first time this has happened. Decades ago, they curbed multi-level marketing firms because those firms filled stadiums with people who would cheer on the selling of brands and products, and there was no Party secretary governing that assembly. Citizens spending time on social media in an actor's fan club are not studying engineering or, more importantly, the General Secretary's thoughts. The issue is public influence and both actual and virtual assembly for activities outside the Party orbit.

As for the wealth gap, it is made increasingly visible by the juxtaposition of increasing urbanization numbers with the large population of 600 million Chinese who are not participating in economic development. If the wife of a customs official buys a $25,000 handbag, for example, it sends a very bad signal about what's going on under the Party's watch. This disparity is seen as an unavoidable pathology of using capitalist tools so long as they remain unchecked.

Deng Xiaoping introduced the private economy as a transitional accommodation for the government to jumpstart the economy, drive growth, and rapidly improve standards of living—not as a right to protect individuals' property and freedom to transact. He never abandoned the notion that China would eventually become what he called "a socialist economy with Chinese characteristics."

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What do you believe are China's economic, political, and social aspirations for the next decade?

China is already looking ahead to 2049, which is the 100th anniversary of the establishment of the People's Republic of China. By that date, China would ideally like to be the leading culture, economy, and military power in the Asia-Pacific. Over the longer-term, they have expressed confidence that they will become among the most powerful nations in the world, if not the most powerful. This has been referred to as the "100 Year Marathon."

Over the next 10 years, however, we will likely see a gradual and systematic reduction of reliance on the private sector for growth, with the goal of making this transition as non-disruptive as possible. China's regulators have been and will likely continue to get tough on their own private companies. This progressive regulatory crackdown will likely cause private companies to align more closely with state-owned enterprises and the broader Party agenda. Under the rubric of a "public-private partnership," state-owned and privileged non-state champions are gaining increased control over several sectors.

Of course, where there are some clear advantages, the private sector will likely remain visible and alive, especially in accessing global capital and technology. In technology-focused acquisitions abroad, for example, China knows that acquirers with visible connections to the government or military will likely face high regulatory hurdles.

What has been the affect so far on foreign investors?

Right now, foreign investors are not seeing major crackdowns, but some are beginning to feel the effects of how they are being regulated and treated. Reducing the power and influence of private companies will cause a meaningful shift toward state-owned enterprises to drive performance. One way this could play out is by restructuring assets from the private sector and putting them in the hands of state-controlled entities or enterprises more closely managed by Party officials.

How will this tightening regulatory environment affect MNCs doing business in China over the coming years?

We are more than 40 years into a reform process. Many lessons have been learned about China's reform trajectory and how MNCs can adjust and prosper in it.

There is consistency in the concerns that we are hearing from our biggest clients, regardless of sector. It reflects an understanding that China's distinct business environment will remain distinct and not evolve toward a fuller marketized environment, such as exists in the US. MNCs should recalibrate their perspectives and align their strategies to the ongoing Chinese reality, goals, and anticipated future trajectory. They can do so through the following actions:

1. Revisit their existing partnerships to strengthen ties with domestic enterprises that will gain privilege.
   MNCs can maximize their staying power and stability in China by focusing partnership efforts on state-owned enterprises, durable private companies, and companies with some manner of privileged support. Properly done, these partnerships can serve as anchors in the mainland marketplace, opening a channel for government incentives and favorable treatment from regulators. This could occur through supply chain realignment, joint ventures, or collaborations with domestic investors.

2. Approach China's regulatory environment with an emphasis on aligned value creation.
   MNCs should convey to Chinese regulators how their businesses will contribute to furthering the country's economic and cultural prosperity in alignment with "internal circulation" (the economic push to emphasize domestic consumption and self-reliance). Aligning corporate goals with national ones can resonate with regulators and should be communicated through well-thought-out communication strategies and the corollary support of domestic champions.

3. Localize operations and leadership while maintaining brand consistency and mitigating risks.
   There are many considerations when it comes to localization. There are pressures to increase "China for China" activity, while also protecting the MNC's brand. The pandemic has substantially amplified the risk of increased localization since HQ and local mainland organization executives are no longer traveling to and from China with the same frequency as they did previously. Consequently, there is more friction between MNC mainland organizations and headquarters and a greater potential for misalignment

4. Ensure that products and services align to national ambitions.
   MNCs should reevaluate their offerings in China to reflect national goals and societal directives. Currently, China is directing investments away from consumer goods deemed frivolous, such as luxury goods, and shifting investments to areas more foundational to basic needs and national growth, as expressed in the "common prosperity" campaign. MNCs should monitor these indicators and tailor their offerings to reflect cultural pressures. Compliance with written laws and regulations should be complemented by attention to the stated goals and programs of top leadership.

5. Shift toward Chinese capital markets.
   An important trend in the "China for China" shift is toward Chinese capital markets and the potential for IPOs. Five years ago, MNCs rarely considered availing themselves of the Chinese capital market. Now, they are beginning to explore different kinds of ventures in China that draw venture capital and private equity money and may lead to an IPO. This can enable MNCs to operate with more capital efficiency

than ever before and facilitate greater staying power in the long run. The potential for an IPO is also a strong incentive for engaging existing or prospective domestic partners.

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Finally, how can China meet its domestic goals and fulfill its larger world ambitions as it tightens reforms?

At the same time, China will likely be pragmatic insofar as its leadership realizes that it cannot detach itself from the world. China will likely insulate itself without isolating itself. This has been expressed through the principle of "dual circulation." Dual circulation can be divided into an internal focus and an external focus.

Internal circulation encompasses ideas such as self-reliance, self-sufficiency, technological advancement, and increasing global reliance on Chinese manufacturing up through the value chain. The ultimate objective is a resilient domestic economy, stronger Party controls, and a reset of the middle class, both its resources and goals. This also helps define what Xi Jinping means when he calls for "common prosperity" for all citizens—a strong nation and national pride. This nudges the goal of family wealth more toward a common goal of national strength.

External circulation reaffirms that China must remain connected to the rest of the world, especially economically through exports, critical mineral and energy imports, channels to market, and management maturity. China's top leaders have stressed a goal of preserving China as an integral player in the globe's most important goods and services value chains. The role of multinational companies (MNCs) will likely be defined in the coming years within this external realm, and it will present both new opportunities and new challenges to MNC executives.

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Endnote

[1] https://www.nbcnews.com/news/world/china-created-more-billionaires-u-s-now-it-cracking-down-n1278438

About:

About the US Chinese Services Group (CSG)

Established in 2003, CSG advises Chinese companies expanding their global presence and multinational companies (MNCs) operating or seeking to operate in China. To stay ahead of the curve in prioritizing the needs of our global clients, the CSG continues to evolve and adapt to the changing dynamics of the marketplace, providing professional advice and comprehensive solutions to address complex business challenges. We have professionals who speak Chinese and/or understand Chinese business culture in 90 countries and regions within Deloitte's member firms, with about 2,000 bilingual resources in the United States.

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