Responding to An Empowered China

2018 Insights Guide

This 2018 Insights Guide provides: a background briefing on key trends in China and their likely effects on American businesses. This Guide includes scenarios of future events and a set of indicators that may be tracked to make sense of the future. It is the author's assessment that:

- ☐ China is growing its economy with fewer dependencies on the United States. China's central planners are fixing continued weaknesses in the State sector, using new tools of economic power. Chinese businesses and consumers will benefit from the certainty of its policymakers' direction and growth will continue in Chinese markets.

- ☐ Many American voters expressed their dissatisfaction with the *status quo* of the trade relationship in 2016. But America does not yet have a coherent policy response, and China is not waiting for America to catch up.

- ☐ The American companies that adapt to China's way of doing business will benefit the most, but there will be risks.

About I-OnAsia: I-OnAsia is a full-service business intelligence and risk management consultancy. Headquartered in Hong Kong, I-OnAsia's professionals have worked on behalf of both American and Chinese businesses since 2001. I-OnAsia has over 40 staff in Greater China. The team includes individuals with deep experience in field research, finance, accounting, and law. I-OnAsia has completed 12,500 assignments across a wide range of industry sectors; serving high net worth individuals, corporate executives, and third-party counsel.

***About the Author*:** James Tunkey is a subject matter expert on China with 25 years' experience in the region. He is I-OnAsia's group Chief Operating Officer and head of its New York office. James was a director at two other global business intelligence and risk management security companies in the 10 years prior to his joining I-OnAsia in 2004. He holds a B.A. in Chinese Studies from the University at Buffalo, and an M.B.A. jointly conferred by the London School of Economics, HEC Paris and NYU Stern School of Business. He is a member of the National Committee on U.S. China Relations and a former Term Member of the Council on Foreign Relations. James regularly helps American companies address business challenges in China. He has also managed important assignments in forty other countries and twenty American states.

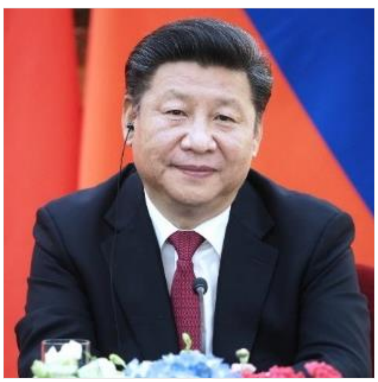
This section focuses on an assessment of China's direction and America's response.

Introducing an Empowered China

China has fully emerged as an empowered nation.

Since the December 1978 opening of China's markets by Deng Xiaopeng, China's leadership has been focused on growing China's economy to better match the scale of its population. This year will mark the fortieth anniversary of Deng's reforms. The results have been impressive. Over 500 million people have been lifted out of extreme poverty. Average annual per capita income for China's now 1.3 billion citizens has risen from a few hundred U.S. dollars to nearly ten thousand dollars. China holds $1.25 trillion in U.S. Treasuries. China's economy hit an inflection point at the start of this century, with growth taking off at an exponential rate in its cities. There are now over 300 Chinese billionaires and 200+ million middle class citizens.

At the helm, President Xi Jinping is vigorous and driven. Under his leadership, China is boldly pursuing fresh growth to deliver even better living conditions and national security. China's leadership has a clear plan for its future.



Private industry in China has been the engine of growth.

China grew at nearly ten percent each year in the thirty years beginning in 1980, by unleashing private citizens to build and operate their own businesses, and by opening up its markets to participating in the global economy. Private industry in China remains the engine for growth and innovation, attracting tremendous amounts of foreign investment.

Every week, we see Chinese enterprises tapping foreign markets for cash in great numbers. Investors are continuing to bet on size and growth potential of China's economy. Investor capital is being used to expand Chinese firms' share of domestic *and* foreign markets.

Meanwhile, China's capital markets have become very sophisticated in the past decade. Its stock markets are growing and becoming more inter-connected with other exchanges, further fueling growth.

Improving the performance of State enterprises is a priority.

A core focus for China's leaders today is the plight of employees of its generally weaker State-Owned Enterprises (SOEs).

The State still controls over 50% of all corporate assets, and SOEs employ a large and critically important workforce. But SOEs have big challenges. They often have an aging workforce, poor environmental and safety standards, are energy inefficient, or have low levels of innovation. SOEs require tremendous capital to keep afloat. Their business practices are also, on occasion, the source of global trade disputes. For example, SOEs have been accused of:

1. Theft of intellectual property and the manufacture and sale of counterfeit products. Towards the end of 2017, the U.S. was alleging that counterfeits were costing America a half a trillion dollars annually.

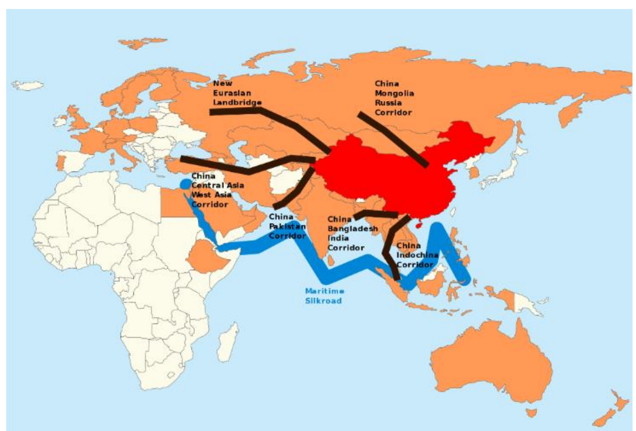
2. "Dumping" products in foreign markets, by selling goods at low prices. At the end of 2017, the U.S. alleged China was dumping scores of products in its markets, and the European Union was making similar allegations too.

3. Selling products in foreign markets while skirting foreign rules and regulations, not limited to alleged breaches of US export control rules.

The State recognizes that past policies for sustaining SOEs are not effective. State bank loans to SOEs are non-performing and extending an umbrella of sovereign immunity is unsustainable. China's President Xi Jinping announced bold new programs in 2013 to address the SOEs' problems (and to further support Chinese private industry): The One Belt One Road (OBOR) initiative; and, the Asian Infrastructure Investment Bank (AIIB).

The OBOR might be described as a supercharged Interstate Highway System. The OBOR covers both land and sea infrastructure development (see image, *right*). But its size dwarfs the US$41 billion approved to develop Eisenhower highways. The OBOR projects may cost over US$5 trillion.

The China-led AIIB is modeled much on the World Bank. It could lend up to US$20 billion per year.



Source: China Britain Business Council

Together the AIIB and OBOR initiative will give a priority to Chinese businesses while reshaping global trade. Their projects have fewer rules, reflect China's way of doing business, and give SOEs synthetic market protection that will improve their fortunes.

The United States is Less United

Without question, many American consumers and many shareholders of America's largest businesses have benefited from decades of offshoring to China. So too have American farmers and other exporters of manufactured goods. Today there is powerful political support in favor of trade with China.

But large groups of America's voters have become frustrated by the perceived failure of policies set in the year 2000 and maintained as the *status quo* by leaders of both parties despite many failures in attempts to slightly shift strategy*. Three key hopes many Americans had for China yet to reach fruition:

- Accession by China to the World Trade Organization has not fully opened Chinese markets to American companies or completely protected American intellectual property rights (IPR);
- China's need for economic development and trade with the U.S. did not minimize security threats; and,
- American internet and media companies have not opened China to democracy.

The election of President Donald Trump reflected this sense of frustration. Over the past year, American policymakers have been preparing the ground to address longstanding complaints through the imposition of new tariffs on Chinese goods and halts of Chinese acquisitions of U.S. companies.

Unfortunately these blunt tools have questionable long-term utility and do not fully address the complex challenges that have emerged out of changes in U.S. corporate structures in response to a more globalized world. Even where America's moves might appear initially successful, the results may be counter-productive. To date there is no consensus on what else to do, however.

China is in a strong negotiating position.

Whatever the fresh policy is, in order for it to be successful it will have to address the basic facts that the world looks different than it did in the year 2000. China is in a strong negotiating position. America's economy is globalist, not isolationist. American consumers are buying what China is selling, without regard to long-term consequences. U.S. companies are aggressively pursuing wider access to China's markets and even bidding on OBOR projects.

Any fresh policy will also need to accept that America's negotiating position was weakened by a global war on terror that has cost more than US$2 trillion and by the Great Recession's historic slowdown. Meanwhile, America's rivals are supporting China, helping it turn what first look like glaring Chinese weaknesses into defeats for America's interests.

* *Examples included the expansion of China's presence in the South China Sea and the restrictions on American internet and media companies in China in the interests of China's stability and security.*

This section provides a set of scenarios of future events and indicators that may be tracked.

Scenarios for American Companies

Scenario 1: American companies will continue to gravitate towards China.

60%	American companies will still gravitate to China, as: (*i.*) American investors and exporters reward China growth; (*ii.*) American manufacturers continue to make goods in China for less than in the U.S.; and, (*iii.*) American consumers demand low cost Chinese-made goods.
30%	American investment in China will stall, as a trade war increases uncertainty.
10%	America will restructure its economy to depend less on China. Persistence by America policymakers and changes in U.S. market structure will combine with continued barriers to U.S. corporations in China to create incentives to avoid China and reduce America's dependence on offshoring.

Indicators

- Moves out of China by other corporations.
- Moves in to China by other corporations.
- Moves by China to attract businesses.
- Moves by America's government that change the calculus.

Scenario 2: American companies will continue to be challenged by Chinese SOEs.

30%	Chinese SOEs will use a combination of pricing power and Chinese State support to crowd out sales by American companies in emerging markets participating in AIIB and/or OBOR projects.
30%	Chinese SOEs will use a combination of pricing power and Chinese State support to crowd out sales by American companies in other markets, including the U.S.
30%	The sale of low priced products by Chinese SOEs in foreign markets will have knock-on effects, pushing other less competitive manufacturers to engage in anti-competitive behavior.
10%	America and China will agree to policies that reduce the challenges posed by Chinese SOEs.

Indicators

- Pricing actions of Chinese SOEs, at home and abroad.
- Progress of trade negotiations between China and America.

Scenario 3: American companies will face better financed Chinese enterprises.

70%	American companies will face Chinese rivals that have greater access to financing than they once did. This will make them incredibly tough competitors.
30%	Market shocks and fresh rounds of negative sentiment about Chinese companies will limit Chinese access to capital.

Indicators

- IPOs by Chinese companies on global exchanges.
- The success of other forms of capital raises.
- Stock market prices of Chinese companies.

Scenario 4: "If you can't beat them, join them" corporate structures will emerge.

28%	In response to China's empowerment, American companies will become "more Chinese" by taking on Chinese equity investments, and giving up board seats to Chinese nationals. This will reshape corporate strategic relationships, favoring China and China engagement. A substantial shareholding in American companies will become the new bling for Chinese nationals.
2%	Those companies that have seen their dependence on Chinese markets increase the most will go further, as will those hurt most by rising trade barriers. Ripping a page from old Royal Dutch Shell and Unilever corporate structures, these businesses will set up complex dual-headed structures just as they were thought to be losing their charm. The moves will come as significant wins for China's newly sophisticated financial services sector.
10%	Some privately owned Chinese companies will be able to pass CFIUS reviews to purchase American businesses that are important sources of raw materials and expertise and market knowledge. These will be accompanied by promises to invest in America. Once bought, however, these now-Chinese companies have different economic incentives.
60%	American companies will not change their corporate structure to become more favorable to an empowered China.

Indicators

- Moves by American businesses to sell shares and grant board representation.

Scenario 5: IPR protection programs will increasingly deal with insider threats.

20%	For the American companies that adopt more pro-China corporate structures and expand their operations in China, the risks of intellectual property loss to trusted employees and partners will increase. As Chinese control and influence over American interests increases, "insider threats" will emerge with greater frequency.
78%	External threats from counterfeiters will remain a major challenge.
2%	IPR protection will be made moot for some American companies, as Chinese companies will purchase American corporate assets directly.

Indicators

- The size of reported insider threat events annually.
- The size of annual seizures of counterfeits.

Scenario 6: Corruption will be a challenge.

30%	Many of America's largest companies have already entered into settlements with the US Securities and Exchange Commission (SEC) that place strict limits on dealings with foreign government controlled enterprises. As American companies pursue new China business, or OBOR/AIIB fueled growth in countries with corruption problems, compliance challenges will flare as individual employees make unethical moves. This will result in new SEC enforcement actions against "repeat offenders".
30%	Other American companies will fall prey to corruption from trade in China.
40%	Due to a combination of Chinese leadership's anti-corruption focus, the Trump administration's unwillingness to prosecute Foreign Corrupt Practices Act cases, and stepped-up internal corporate anti-corruption efforts, American companies will avoid corruption in China. Corruption challenges elsewhere will be a larger concern.

Indicators

- Tips to reporting hotlines.
- Rewards paid to whistleblowers.
- Pace of SEC enforcement.

Scenario 7: More headline risk in trade with China.

30%	Absent effective national policies that fully address today's challenges presented by an empowered China, American companies will be forced to make their own way when trading with China. This will leave them vulnerable to headline risks typically seen elsewhere, whenever the actions these American companies take are counter-productive to America's interests overall or out of favor with portions of America's establishment or anti-establishment.
70%	Most American businesses will find a way to avoid the headlines.

Indicators

- An American policy that addresses China's AIIB and OBOR Initiative.
- Content of communications from America's policymakers.