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CHINA ANALYSIS

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ABOUT

The Chinese have long been obsessed with strategic culture, power balances and geopolitical shifts. Academic institutions, think tanks, journals and web-based debate are growing in number and quality and give China's foreign policy breadth and depth.

China Analysis, which is published in both French and English, introduces European audiences to these debates inside China's expert and think-tank world and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates provide an important way of understanding emerging trends within China.

Each issue of China Analysis focuses on a specific theme and draws mainly on Chinese mainland sources. However, it also monitors content in Chinese-language publications from Hong Kong and Taiwan, which occasionally include news and analysis that is not published in the mainland and reflects the diversity of Chinese thinking.

The French version of China Analysis can be accessed online at www.centreasia.eu.

Introduction
by François Godement

This issue of *China Analysis* focuses on technical aspects of China's economic reforms: the implementation of the China (Shanghai) Free Trade Zone (FTZ) created in 2013; the enforcement of China's Anti-Monopoly Law; the future of inward FDI (foreign direct investment channelled into the Chinese economy); and the slow pace of renminbi internationalisation, which contrasts with China's huge currency reserves and mushrooming currency swap agreements.

None of the answers that the Chinese sources give on these issues line up with the debate as it is usually seen outside China. International perspectives on the Chinese economy are dominated by three questions: is Xi Jinping's tight control over China's party-state working for or against economic reforms? Is "economic nationalism", the result of Chinese pride in the country's recent economic achievements, making life more difficult for foreign firms and suggesting an even greater turn to a mercantilist economy with an uneven playing field? Finally and most importantly, could the Chinese economy collapse in a kind of scissors crisis in which rapidly growing domestic debts coincide with a sudden economic slowdown?

Our sources do not provide an answer to the third question, but they suggest a middle ground on the first two. Understanding what is happening in China's economy requires a change of perspective. For example, the Shanghai

FTZ was internationally heralded a year ago as signalling that China would soon lift capital controls. This is not happening. Apart from the regional and factional competition that often goes with new "models" in China (the first director of the FTZ is now under arrest on corruption charges), the FTZ is now functioning as a testing ground (to be replicated soon in Tianjin, Guangdong, and Fujian) for the state and Chinese firms to experiment with lighter administrative rules, with some international flexibility thrown in. In short, it is more an incubator for Chinese domestic firms to experiment with a full market economy than a paradise for foreign capital.

Similarly, the fashion today is to focus on outward investment by China, the "going out" of Chinese firms that is finally in 2014 balancing inward FDI to China. Our sources point out that inward FDI still plays an important role. This is not because foreign capital is needed – China is awash with money – but because FDI is a catalyst that helps to instil competition within the Chinese economy. Revamping FDI rules is also a tool to aid negotiations with the United States on a bilateral investment treaty (strikingly, our sources leave out Europe, in spite of three rounds of negotiation with the European Union in 2014).

At base, the strategy is neither pro- nor anti-foreign, although some of the implications are ominous: regulation and the role of foreign capital will change as dictated by the needs of the Chinese economy. Where global capitalism wants the rules of the game to be unchangeable, the Chinese Communist Party has always timed its concessions: nothing is eternal except the party itself. Thus our sources, who start by emphasising the need to continue to attract FDI, end with a suggestion to toughen post-establishment enforcement of rules for foreign firms: precisely the area where the European Chamber of Commerce is seeking clarification and liberalisation. And the sources favour ending any preferential treatment for foreign firms.

China's Anti-Monopoly Law was criticised abroad recently when it was applied to foreign auto firms (joint ventures, really, although the Chinese partners were never put in the spotlight). Our sources concede that there has been selective and political implementation. But they have a local explanation that makes the issue of economic nationalism a secondary point: the National Development and Reform Commission, frustrated by the collusion of Chinese lobbies with the Ministry of Commerce, has decided to go after high-profile foreign firms in order to increase its own legitimacy. Our sources point out that the real targets should be the "tigers" of China's domestic economy, especially the administrative monopolies (oil and gas, telecoms, and finance). Whether they will be listened to is obviously an open question.

There is a lesson here for China's partners: what happens in China should not be looked at entirely from the point of view of an ideological axis (global rules and liberalisation vs. statist rule and indigenous preference). The real debate is between those who favour adaptation to market competition and real though selective reforms and those who represent very profitable special interests, who argue that "if it ain't broke, don't fix it". For China, the consequences to foreign firms and partners are incidental to this permanent debate.

1. The Shanghai Free Trade Zone: a model for Chinese firms

Agatha Kratz

Sources:

Chen Bo, "One year on, the successes and failures of the Shanghai free trade zone", *Aisixiang*, 9 October 2014.[1]

Guo Wenjing, "Lessons and opportunities from the Shanghai free trade zone", *Aisixiang*, 30 September 2014.[2]

Wu Hongyuran, "Finding a way to supervise banking in the Shanghai free trade zone", *Xin shiji – New Century*, 19 May 2014.[3]

Pan Yingli, "Financial reform in the Shanghai free trade zone has yet to find its footing", *Aisixiang*, 16 September 2014.[4]

Fu Yugang, "What has the Shanghai free trade zone changed?", *Beijing Bao – The Beijing News*, 18 September 2014.[5]

The "Chinese (Shanghai) Free Trade Zone" (中国（上海）自由贸易试验区, *zhongguo (shanghai) ziyou maoyi shiyanqu*, FTZ) was launched on 29 September 2013.[6] Before its opening, the free trade zone was considered to be a personal project of Chinese Premier Li Keqiang. However, it has not been widely talked about during its first year of existence. In spite of the high hopes that surrounded its creation, doubts have been raised about the authorities' commitment to the project by the fact that the premier did not attend the zone's opening ceremony and by the small number of official visits made to the zone by high-ranking officials.[7] Moreover, the first head of the FTZ has been arrested for corruption. This explains some of the extensive criticism of the zone that has been made by international as well as Chinese observers since its opening.

The FTZ has not delivered on international openness

The most optimistic of the authors, Chen Bo, says that the government had several objectives in establishing the zone. The FTZ was intended to change the role of government, from being a manager of the economy to being a mediator in it. The zone was meant to liberalise the service sector. It was supposed to promote trade and exchange, especially maritime trade. It was to liberalise the financial sector and to promote financial innovation. It was intended to establish a new regulatory system in line with existing international standards. And it was supposed to create a system to manage foreign investment by means of a "negative list" (负面清单, *fumian qingdan*).

Chen believes that "definite progress" (一定进展, *yiding jinzhan*) has been made in each of these areas. Significant progress has been made in boosting government supervision, particularly in accelerating the process of business creation. Some service sectors have been opened up to competition and investment. Customs have adopted new standards that are more favourable to trade. Several financial supervision organisations have announced programmes of financial liberalisation. And some regulations on foreign investment have been reviewed.

Of the founding measures of the FTZ, the most talked about was probably the "negative list", which designates the sectors within the FTZ in which foreign investment is limited or prohibited. Any sector not mentioned in the list is open to investment. The initial negative list was published in October 2013, but was criticised as being too extensive (it included 18 industries, 190 sub-groups, and over 1,000 sectors). Chen points out that the list was shortened in July 2014.

Fu Yugang and Guo Wenjing welcome the use of the "negative list" approach and the publication of the second, shorter list, which opened several financial, property, health, and leisure sub-sectors to investment.[8] However, they say that the list is still too long. Chen Bo quotes Han Zheng, secretary of Shanghai's Municipal Committee, who expressed regret that foreign companies receive "national treatment" (国民待遇, *guomin daiyu*). This means that they operate under the same conditions as private Chinese companies, which Han believes are already "second class citizens" (二等公民, *erdeng gongmin*) within the Chinese economy.

Wu Hongyuran and Pan Yingli both talk about the creation of "free trade accounts" (FTA, 自由贸易账户, *ziyou maoyi zhanghu*).[9] These accounts would in theory allow holders

1 Chen Bo is a professor at the Shanghai University of Finance and Economics (SUFE).

2 Guo Wenjing is a lawyer at the Lingjun law firm in Wuhan.

3 Wu Hongyuran is a journalist at *Xin shiji*.

4 Pan Yingli is a professor at the School of Economics and Management of Shanghai Jiaotong University, director of its research centre for modern finance

5 Fu Yugang is the executive director of the Shanghai Institute of Economic and Legal Research

6 See Chan Yang, "La zone de libre-échange de Shanghai: un aiguillon pour toute la Chine", *China Analysis*, Asia Centre, December 2013.

7 President Xi Jinping made a short visit on 22 May 2014 and Li Keqiang visited on 18 September 2014.

8 The new list includes only 139 sub-groups, down from 190 in the original, divided between 110 "limited" (限制性, *xianzhixing*) and 29 "prohibited" (禁止性, *jinzhixing*) sub-groups. Of the 51 measures that were abandoned, the removal of 14 of them effectively opened new sectors to investments, 14 related to removed sectors where the same regulation exists throughout the rest of China, and 23 were a reclassification of sectors and categories. The 14 new sectors have, for the first time, allowed foreign investors to invest in banks and financial companies within the FTZ – albeit with significant limitations, as this type of investment remains subject to regulatory approval. Some barriers to investment in land and real estate brokerage, cyber-cafés, commercial transport by rail, distribution, and healthcare sectors have also been removed. For more information, see Wang Coaxing, "The new negative list for SHFTZ removes 51 elements", *Caixin wang*, 1 July 2014.

9 See Zhou Qun, "Free trade accounts in the Shanghai free trade zone have been officially created", *Caixin wang*, 18 June 2014. Five Chinese

to better circulate their assets abroad, between currencies as well as between business, investment, and loan accounts. However, the authors note that FTAs are still not accessible to potential clients in the zone.

The bogeyman of financial liberalisation

The authors say that the greatest disappointment about the zone has been the lack of financial liberalisation. Despite the fact that the focus of the zone was supposedly on free trade, commentators have mostly been interested in its potential for bringing about financial liberalisation. Many hoped that measures taken within the zone would contribute to accelerating the convertibility of the yuan and the liberalisation of interest rates.

However, Wu Hongyuran says that restrictions on financial services in the zone have been only partially lifted. Most controls on capital flows are still in place. Free currency conversion is still forbidden within the zone and interest rates will not be liberalised in the short term. Fu Yugang and Guo Wenjing agree: Guo even says that financial reform is "absent" (缺席, *quexi*) from the FTZ. He explains that authorities say the regulatory framework needed for financial reforms is still being developed; no date has been set for its publication.

Financial reform was just one part of the objectives of this test zone and was primarily intended as "a tool to serve the economy".

Chen Bo says that people's expectations for the zone were too high. Financial liberalisation would open up economic opportunities, but it is the most risky element of the proposed reforms, because capital is inherently difficult to control and extremely mobile. Chen believes that there are two barriers to reform: obstruction from interest groups and the "potential risk" (潜在风险, *qianzai fengxian*) of the measures. The government is afraid that liberalising the financial sector in Shanghai too quickly could destabilise the financial sector in the rest of the country. Pan Yingli adds that the conditions necessary for financial reform are not in place in Shanghai: these include respect for and protection of property rights, effective legislative and judicial systems, and the effective application of the law.

Disappointment in the zone is probably due to excessively high hopes for the scale of liberalisation that could have been achieved, as well as some misunderstanding of the FTZ's real aims. Several authors point out that financial reform was just one part of the objectives of this test zone and was primarily intended as "a tool to serve the economy" (金融改革必须为实际经济服务, *jinrong gaige bixu wei shiji jingji fuwu*). Other elements – such as the changes to the government's role, from managing the economy to only mediating – are far more important.

A model for limited state involvement in the domestic economy

The authors agree that the zone has provided tangible results in terms of administrative simplification and reducing the weight of government involvement in economic processes.

Fu Yugang says that the zone's most important achievement was the reform of company registration. Chen Bo says that business licences have been simplified and are now awarded within three to five working days, as compared to three to six months previously.

Wu Hongyuran cites other administrative procedures that have been simplified. The minimum share capital for new businesses has been lowered.[10] Administrative controls on companies have been streamlined. Some commercial procedures have been simplified, which means that goods arriving into the FTZ can be processed within two or three days.[11] Investment transactions worth less than $300 million are now validated in fewer than five working days. And financing costs for overseas transactions have significantly decreased.

Fu Yugang says that the focus of the FTZ has not been on opening up to foreign capital and companies, nor has it been on preferential policies to encourage economic activity within the zone. Instead, the main aim has been to update the administrative framework for companies within the zone so as to limit the role of the state in business operations. Chen Bo says that the "transformation of government functions" (政府职能转变, *zhengfu zhineng zhuanbian*) was the first of the five priorities listed in the "General development plan for the zone".[12] Financial liberalisation was only fourth on the list. Therefore, Wu Hongyuran says, institutional innovation is the most important initiative of the zone, far more important than financial innovation. Reforms are targeted at improving the domestic environment, especially for Chinese companies operating within the FTZ. Wu and Fu expect that the experience gained from the zone will be applied across the country so that China as a whole can benefit from the administrative progress made in Shanghai.

The reforms were not necessarily aimed at increasing openness, but even so, Pan Yingli believes they represent an opportunity for China to increase its conformity with international investment standards – even if, as Chen

banks were authorised to operate "Free Trade Accounts" (FTA): Shanghai Bank, Pufa Bank (through its Shanghai branch), ICBC, Jianshe Bank, and Bank of China. Zhou Qun says that the list of five banks could still change. Furthermore, these accounts are not always directly available to clients (either individuals or institutions) within the FTZ.

10 Due to its success, this measure has since been rolled out across China.

11 These measures should soon be rolled out to other ports in the country.

12 These include changes to government functions, improvements to the structure of foreign trade, easier international investment, wider innovation and more openness within the financial sector, and improvements to institutional guarantees for legal matters. See Chan Yang, "La zone de libre-échange de Shanghai: un aiguillon pour toute la Chine", *China Analysis*, Asia Centre, December 2013.

Bo says, the country still has a long way to go. Right now, two bilateral investment treaties are being negotiated, one between China and the United States and the other between China and the European Union. At the same time, negotiations are taking place on the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) neither of which includes China, and which Beijing views as an attempt by the US to isolate China on international trade and investment.

The authors all recognise that the progress of the FTZ has been disappointing. But they also point out that the central and regional authorities have made good faith efforts and have produced some tangible results. Financial reform has been disappointing, but mostly because hopes were too high. However, significant progress has been made in the administrative sector, which has helped to change the government's role and, as promised during the Third Plenum, to ensure the "decisive" role (决定性, *juedingxing*) of the market.

2. China's inward FDI: adapting to the times

Hongmei Ma

Sources:

Yang Yichen, Huang Mei, Xu Yue, and Wang Xinming, "'Uselessness', 'crashing the native enterprises', 'technology blockade': Confrontations between differing views about the values of FDI", *Jingji cankao bao – Economic Information Daily*, 23 October 2014.[13]

Han Bing, "PENT and the negative list approach: the impact of Sino-US BIT on China's FDI regime", *Quarterly Report of International Investment Studies*, 29 November 2013.[14]

Although inflows of foreign direct investment (FDI) have slowed in recent years, China remains the largest recipient of FDI among developing countries. A number of structural changes have taken place in China's FDI since 2000. For example, FDI in the services sector has been growing faster than FDI in manufacturing.[15] And China is now becoming an important source of outward-bound foreign direct investment.[16]

China's management of its FDI, and especially the government's recent antitrust investigations, have triggered fears among foreign investors that the world's second-largest economy is moving towards investment protectionism. China's FDI policies are being widely discussed not only abroad but also within China.

Inward FDI still has a bright future

Yang Yichen, Huang Mei, Xu Yue, and Wang Xinming say that many Chinese observers believe that FDI is "useless" (无用, *wu yong*) to China and that China no longer needs to attract foreign investment. Other observers think that, although China no longer needs to actively attract inward FDI through offering "super national treatment" (超国民待遇，*chao guomin daiyu*) to foreign-invested enterprises (FIEs), FIEs still play a significant and even crucial role in

[13] Yang Yichen, Huang Mei, Xu Yue, and Wang Xinming are journalists for *Jinji cankao bao*.

[14] Han Bing is senior research fellow at the Research Bureau of International Investment Studies in the Institute of World Economics and Politics, Chinese Academy of Social Science. This report is a product of teamwork by the Research Bureau of International Investment Studies.

[15] In 2000, services sector FDI comprised 30.5 percent of realised FDI inflow value; by 2008, the share had grown to 52.3 percent. From 2000 to 2010, in manufacturing, the share of actually utilised FDI fell from 63.5 percent to 43.2 percent. During that time, financial sector FDI rose from 0.2 percent (mainly banking and insurance) to 8.8 percent (mainly finance), while FDI in real estate increased from 11.4 percent to 20.9 percent. See Ken Davies, "China Investment Policy: An Update", *OECD Working Papers on International Investment*, January 2013, pp.13-14.

[16] According to a recent press conference by the Chinese Ministry of Commerce, Chinese outbound investment will likely surpass inbound foreign direct investment into China this year. See Lin Yuan, "Our country has entered into the net capital exporter phase", *Jingji cankao bao*, 19 November 2014.

the Chinese economy.[17] FDI is still very important in China's tax revenues, employment, foreign trade, and industrial production. Therefore, Yang, Huang, Xu, and Wang say that many people think that "continuing to make use of foreign capital [and] optimising the utilisation of foreign capital with an emphasis on introducing foreign 'talent' will still be a major task for China in the future" (继续利用外资、优化用好外资、重点引进外"智"，仍是未来我国经济领域的重要工作, *jixu liyong waizi, youhua yonghao waizi, zhongdian yinjin waizhi, rengshi weilai wo guo jingji lingyu de zhongyao gongzuo*).

Yang, Huang, Xu, and Wang say that another common objection to FDI is the notion that FIEs hold back the development of local enterprises, since multinational enterprises (MNEs) have competitive advantages over domestic firms. But for the moment, China's most important economic task is to speed up the pace of reform. Therefore, the question of whether or not foreign capital should be introduced is not relevant right now. The authors quote the president of Tianjin Finance and Economics University, Li Wei'an, who says that FIEs do take some growing space from native enterprises. However, Li believes that, as long as it is not illegal, competition with FIEs stimulates native enterprises to innovate and promotes the survival of the fittest in the market. FDI can be a "touchstone" (试金石, *shijinshi*), a "catalyst" (催化剂, *cuihuaji*), and an "ally" (同盟军, *tongmengjun*) for reform, and it has been "a driving force for reform in many economic fields" (促使国内经济领域各项改革加速推进, *cushi guonei jingji lingyu gexiang gaige jiasu tuijin*).

Another complaint about FDI, the authors say, is that FIEs will not transfer core technologies to their Chinese partners. In this view, the FIEs' technology blockade has seriously damaged the development of domestic enterprises. Therefore, rather than making efforts to attract foreign investors, China should be supporting native enterprises. However, the authors note that some people believe that the relationship between foreign investment and indigenous innovation is more complex than that. FDI has helped local enterprises to master basic technology and has prepared the ground for the development of core technologies. Moreover, labour mobility between MNEs and indigenous enterprises has contributed to technology advances in homegrown industry.

Since reform and opening up have so far yielded substantial results, the authors say that some Chinese observers believe China should continue opening up to foreign investors, while at the same time making sure it is "controlling the risks" (控制风险, *kongzhi fengxian*).

[17] National treatment means that FIEs enjoy the same advantages as local companies. "Super national treatment" suggests that FIEs have enjoyed even more preferential tax and land policies than their Chinese counterparts since the beginning of the reform and opening-up.

The current FDI regime is obsolete

Han Bing says that after several rounds of reform and "opening up", Beijing has now created a FDI regime whose main features are "management at different governmental levels" (分级管理，*fenji guanli*), "mandatory approval of each FDI project" (逐一审批, *zhuyi shenpi*), and "supervision by relevant departments" (部门监督, *bumen jiandu*). So far, China has enacted about 200 laws, regulations, and directives relating to foreign investment: the country's complex legal system on FDI is made up of three basic laws as well as the directives of the State Council and the measures and circulars of different ministries and departments.[18] In terms of industrial policies on FDI, China first issued the Foreign Investment Industrial Guidance Catalogue (known as the "Catalogue") in 1995. This directive sets out the industries in which investment is "encouraged", "restricted", and "prohibited". The Catalogue has been updated four times since 1995, allowing Chinese authorities to keep a tight control over FDI inflows. The revisions introduced simplifications and partial liberalisation, but Han says that the framework for FDI in China has remained relatively unchanged.[19]

> Given the increasing scale of FDI projects and the diversification of modes of entry, China's FDI regime has become obsolete.

Han says that China's FDI regime is a dual-track system, in that the administration regime for FDI is different from the regime that governs the investments of domestic enterprises. The FDI system is a hybrid regime that allows for preferential treatment alongside investment restriction measures. Most of the preferential policies have been gradually phased out, but preferential policies for FDI are still in place in some priority industries in western China. Restrictive measures on foreign investment access mean that each FDI project is required to obtain approval either from central or local government. Formally, the approval system has been reformed and simplified, and it is supposed to have been replaced by a verification and registration system. But Han says that no substantive changes have been achieved in practice. Given the increasing scale of FDI projects and the diversification of modes of entry, Han says that China's FDI regime has become obsolete.

The next step: Pre-Establishment National Treatment (PENT) and the "negative list" approach

[18] The three laws are the Law of the People's Republic of China on Chinese Foreign Equity Joint Ventures, the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures, and the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises.

[19] The draft of the fifth revision of Catalogue was published on 4 November 2014. See Wang Zhiling and Zhang Xu, "Substantial revision of the Catalogue of the Guidance of Foreign Investment Industries: registration will be sufficient for more than 90% projects", *21 shiji jingji daobao – 21 Century Business Insights*, 6 November 2014.

China and the United States are currently negotiating a Bilateral Investment Treaty (BIT).[20] As part of these negotiations, China is considering a Pre-Establishment National Treatment (PENT) system (准入前国民待遇，*zhuruqian guomin daiyu*) and a "negative list" (负面清单，*fumian qingdan*) approach.

PENT stands for Pre-Establishment National Treatment. National treatment is the treatment standard granted by states to ensure that foreign investors have the same competitive opportunities as national companies. To date, in most BITs, national treatment has been applied in the post-establishment phase (involving management, maintenance, use, enjoyment or disposal of their investments). But since the early 1990s, some BITs have extended national treatment coverage to the pre-establishment phase. Pre-establishment covers the entry phase, which means that host states may not apply discriminatory measures towards foreign investors on market entry conditions. Unlike in the post-establishment phase, pre-establishment commitments are normally accompanied with specific exceptions, through a "negative" or "positive" list approach. In a "negative list" approach, national treatment is afforded to all sectors and activities aside from those specifically set out in the list.

Han says that PENT and the negative list will have a far-reaching impact on China's FDI regime in both positive and negative ways. On the positive side, it could help to break through the "bottleneck" (瓶颈，*pingjing*) of FDI system reform. To achieve this goal, China's State Council set up a pilot free trade zone (FTZ) in Shanghai in September 2013, which offered more liberal rules for foreign investment based on a negative list approach.[21] The zone is to serve as a test case for applying more liberal FDI rules nationwide. And if a PENT clause is included in a BIT or multilateral investment treaty, it could have benefits for Chinese companies' "going out" strategy by removing barriers to entry in destination countries.

However, the PENT clause and the negative list approach could pose severe challenges to Chinese capacities in FDI supervision, monitoring, and risk management. To prevent China's FDI system from being "ratcheted" (锁定，*suoding*) by international investment treaties, Han says that China should reform and perfect its FDI management regime before concluding any BIT with the US.[22]

Future policy: pick and choose

Han says that to improve and perfect its FDI regime, the government should promote and broaden FTZ pilot projects, so as to build up experience that would be useful in BIT negotiations with the US. China should unify its laws on domestic investment and FDI and enact a new "Foreign Investment Law" that would cover market entry, FDI industrial policies, and FDI administration. This would help to set up a transparent, efficient, fair, and orderly investment environment.

Further, Han says, Beijing should strengthen the pre-establishment supervision system and improve its national security review system to deal with FDI entry. China expand the scope of the concept of "national security" and draw up more detailed review procedures. It should also establish an independent permanent national security review institution, like the Committee on Foreign Investment in the United States (CFIUS). This could help to improve China's risk prevention capacity and counterbalance the national security review system in Western countries. It would also help create a basis for future multilateral negotiations.

Finally, Han recommends that China strengthen its post-establishment supervision system and "standardise" (规范化, *guifanhua*) and "systematise" (制度化, *zhiduhua*) its anti-monopoly investigation system. She says that for a long time, China's FDI regime has "put too much emphasis on approval before the fact and neglected supervision after it" (重审批、轻管理，z*hongshenpi, qingguanli*). She notes that some FIEs have disobeyed Chinese laws and regulations and have operated double standards in China and abroad, which has hurt consumers' interests and damaged China's investment environment. However, she says that in the process of enforcing the law to combat these problems, several controversial issues have been triggered. But the disputes involved are hard to settle because of the lack of proof and the lack of experience of the judiciary. From now on, she says, China should work towards improving its anti-monopoly law enforcement and making its enforcement "normal" (常态化, *changtaihua*) under the principles of rigorousness, transparency, and fairness.[23]

[20] For more details, see Ma Hongmei, "Les enjeux du traité d'investissement Chine-États-Unis (BIT)", *China Analysis*, Asia Centre, October 2014.

[21] For more details, see Agatha Kratz's article in this issue, as well as Chan Yang, "La zone de libre-échange de Shanghai: un aiguillon pour toute la Chine", *China Analysis*, Asia Centre, December 2013.

[22] Ratcheting is one of the oldest concepts in the multilateral trading and investment system. It means that liberalisation must proceed forward with no ability to be wound back. This means that Chinese government will not be able to set up new regulations to restrain FDI.

[23] On China's AML, see Trey McArver's article in this issue.

3. Stepping up enforcement of China's Anti-Monopoly Law

Trey McArver

Sources:

Ren Qing, "Anti-monopoly enforcement becomes the norm", *Xin shiji – New Century*, 18 August 2014.[24]

Deng Feng, "Anti-monopoly enforcement should return to its legal essence", *Caijing*, 21 September 2014.[25]

Hu Shuli, "How to dispel suspicions of xenophobia in anti-monopoly enforcement", *Xin shiji – New Century*, 25 August 2014.[26]

Tao Jingzhou, "What anti-monopoly should not be used for", *Xin Shiji – New Century*, 1 September 2014.[27]

Yang Junfeng, "Why China's anti-monopoly storm has failed to win plaudits", *Financial Times – Chinese Version*, 26 August 2014.[28]

Wang Zhongmei, "The benefits of using anti-monopoly tool to protect the market", *Wen Wei Po*, 18 August 2014.[29]

In the past year, China has stepped up enforcement of its Anti-Monopoly Law (反垄断法, *fanlongduanfa*, AML) and initiated several high-profile investigations into foreign companies. Effective enforcement of the AML is seen in China as a key element in moving the country towards a modern market economy. Scholars and commentators have been analysing recent cases in an effort to assess China's progress (or the lack of it).

Good vs. bad monopolies

Anti-monopoly legislation is a fundamental part of a modern market economy. Hu Shuli says that the AML has been described as China's "economic constitution" (经济宪法, *jingji xianfa*) because of the role that it plays in protecting fair market competition. However, there is vigorous debate as to what exactly the AML should be used to do. Several scholars note that monopolies are not necessarily bad. Yang Junfeng argues that a monopoly won by offering superior products and services represents a just reward given by customers and so should not be punished. Punishing this kind of monopoly could have negative effects on the market by "penalising the superior and supporting the inferior" (惩优扬劣, *chengyou yanglie*). Wang Zhongmei says that the AML should not be used simply to attack the strong. The fact that a company has monopoly power does not mean that it is in violation of the law. Wang says the AML is an "unconventional measure" (非常规手段, *feichanggui shouduan*) that should be used sparingly.

Tao Jingzhou believes that the law should be used with caution because determining a monopoly is a subjective task. He quotes the Nobel Prize-winning economist, Ronald Coase, who was famously sceptical of antitrust legislation. Coase wrote: "when the prices went up the judges said it was monopoly, when the prices went down they said it was predatory pricing, and when they stayed the same they said it was tacit collusion."[30]

Enforcement postponed

The AML was passed on 30 August 2007 and came into effect on 1 August 2008. Three regulatory bodies are tasked with enforcing different aspects of the law: the Ministry of Commerce (MOFCOM) oversees issues of market dominance; the State Administration for Industry and Commerce (SAIC) oversees anti-competitive behaviour; and the National Development and Reform Commission (NDRC) oversees price-fixing. However, for the first five years of its existence, the law was rarely enforced at all. For this reason, some referred to the law as a "toothless tiger" (无牙老虎, *wuya laohu*).

Tao Jingzhou says that this changed in 2013 when high-profile cases were brought against the high-end *baijiu* (alcoholic spirit) manufacturers, Moutai and Wuliangye.[31] In the same year, another case was brought against packaging giant Tetra Pak.[32] Tao talks about the AML as a "sword" (宝剑, *baojian*) – and now that it has been unsheathed, authorities are making full use of the weapon. Within the past year, investigations have been launched into Microsoft, Qualcomm, Audi, BMW, Mercedes-Benz, and 12 Japanese auto parts companies.

Ren Qing says that the lack of enforcement in the law's first years was deliberate. Regulators needed to build up their capabilities to act and they wanted to give companies time to adjust to the new law. The spate of recent cases is simply evidence of regulators' attempts to settle "overdue bills" (历史欠帐, *lishi qianzhang*). Both Ren and Wang Zhongmei see the increase in enforcement as a sign that China is moving towards a more market-based economic system. It is part of a transition towards post-market supervision and away from pre-market approvals.

24 Ren Qing is a partner at Zhong Lun Law Firm in Beijing.
25 Deng Feng is associate professor at Peking University Law School.
26 Hu Shuli is editor-in-chief of Caixin Media.
27 Tao Jingzhou is managing partner at Dechert LLP in Beijing.
28 Yang Junfeng is a researcher for Unirule Institute of Economics (an independent, non-governmental Chinese think tank), and a frequent columnist for the Chinese edition of the *Financial Times*.
29 Wang Zhongmei is a researcher at the Shanghai Academy of Social Sciences' Institute of World Economics.

30 Quoted in William Landes, "The Fire of Truth: A Remembrance of Law and Economics at Chicago", *Journal of Law and Economics*, 1983, p.193.
31 In early 2013, the two companies were fined a total of 449 million yuan by the NDRC for violating the vertical price cartel provisions in the AML.
32 The SAIC announced an investigation into Tetra Pak in July 2013 to determine whether or not it was abusing its dominant position in the packaging market. The investigation is still ongoing.

Selective enforcement and the case for economic nationalism

Wang sees increased enforcement of the AML as a sign of progress, but he admits that recent investigations have targeted foreign companies and so have raised suspicions of bias against non-Chinese firms. But he does not believe the investigations are biased. Investigations simply reflect market structures: they have mostly focused on foreign firms because these companies form the majority of China's non-administrative monopolies.

Ren Qing believes that those who think the investigations are motivated by anti-foreign sentiment are completely missing the point. AML enforcement is evidence of increased post-establishment supervision and should be seen as part of wider efforts to overhaul China's foreign investment regime, which also involves measures such as the ongoing bilateral investment treaty negotiations with the European Union and United States.[33] As part of these negotiations, China will grant national treatment to foreign enterprises and will greatly reduce the number of sectors in which government approval is needed before foreign investment is allowed.

Others believe, however, that there is good reason to be suspicious of the motivations behind recent investigations. Hu Shuli says that the marked increase in the number of multinational companies under investigation makes it reasonable for people to be concerned. Yang Junfeng says that the investigations are evidence of increasing "economic nationalism" (经济民族主义, *jingji minzuzhuyi*). As proof, he says that foreign companies have paid three-quarters of the 2.8 billion yuan collected in fines for AML non-compliance since 2011. Tao Jingzhou asks whether the NDRC has been practicing "selective enforcement" (选择性执法, *xuanzexing zhifa*) as a "tool of industrial policy" (产业政策的工具, *chanye zhengce de gongju*) with the objective of forcing foreign firms out of the market.

Tao points out that China has a history of using the AML for apparently political motives. In 2009 MOFCOM refused to allow Coca-Cola to acquire local juice manufacturer Huiyuan. In 2011, the Ministry of Industry and Information Technology (MIIT) meddled in an anti-monopoly investigation into China Telecom and China Unicom, both of which are overseen by the ministry. And in summer 2014, MOFCOM blocked the merger of three international shipping firms (the so-called 3P network), seemingly to protect China's own shipping companies. Yang says that recent official media attacks on foreign companies such as Starbucks and McDonald's also seem like state-sanctioned nationalism.

Questions of regulatory authority

Deng Feng is concerned about what the recent cases mean for the legal system in China. He quotes Mencius's saying that "laws alone cannot carry themselves into practice" (徒法不足以自行, *tu fa bu zu yi zi xing*) to make the point that implementation is just as important as the law itself. Deng then examines the NDRC's recent investigations into foreign auto manufacturers to assess the current state of China's anti-monopoly enforcement.

In China, foreign car companies have in the past operated under the 4S (sales, service, spare parts, and surveys) model, which required all after-sales services to be handled through the car companies' own official dealers. This has the potential to drive up prices for all after-sales activities, and especially for the sale of spare parts.

Deng reviews the AML's provisions on vertical price cartels, arrangements in which manufacturers and distributors agree to sell products at or above a set minimum price. He points out that the law does not regulate "non-price cartels (非价格卡特尔, *feijiage kate'er)*:arrangements whereby manufacturers and distributors restrict competition through means other than by setting price, such as by stipulating that parts, maintenance, or other services must be conducted only by certain companies.[34]

Tao points out that China has a history of using the AML for apparently political motives.

Since the behaviour of the car companies does not contravene the letter of the AML, the NDRC does not have the authority to penalise the companies for non-price cartel behaviour. The NDRC does have the authority to regulate "in brand vertical price cartels" (品牌内价格卡特尔, *pinpainei jiage kate'er*), situations in which manufacturers require distributors to buy products at non-market prices – but it is very difficult to prove that such a cartel exists. What is more, even if such a cartel did exist, it would be legal under what is known as a "consignment exception" (代销例外, *daixiao liwai*), which allows manufacturers to set certain conditions on how a distributor sells a product. Deng believes that a consignment exception is applicable in this case because a 2004 MOFCOM order says that car manufacturers must use dedicated dealers to sell their cars.[35] Article 15 of the AML says that the law is not applicable to vertical cartels in cases where parties are undertaking agreements "as prescribed by law or the State Council". By using dedicated dealers, the car companies are following an already existing government regulation, so the AML should not apply to them.

[33] For more on in these treaties, see Ma Hongmei's article in this issue, as well as Ma Hongmei, "Les enjeux du traité d'investissement Chine-Etats-Unis (BIT)", *China Analysis*, Asia Centre, October 2014.

[34] The relevant section of the law is Article 14, which states: "Undertakings are prohibited from concluding the following monopoly agreements with their trading counterparts: 1) on fixing the prices of commodities resold to a third party; 2) on restricting the lowest prices for commodities resold to a third party; and 3) other monopoly agreements confirmed as such by the authority for enforcement of the Anti-monopoly Law under the State Council."

[35] Namely, "Implementing Measures for the Administration of Automobile Brand Sales".

Deng says that the NDRC's attempt to implement the anti-monopoly law should be seen as a political conflict in which NDRC is trying to wrest regulatory authority away from MOFCOM. The author believes the NDRC has exceeded its authority by launching investigations into the car companies. If it truly believes that the AML should supersede MOFCOM regulations, then it should have proposed an alternative model for the industry, instead of suddenly and unexpectedly going after the manufacturers in an opaque and aggressive manner. This kind of action is improper and undermines the agency's credibility.[36] Given this dangerous institutional competition, Tao thinks that enforcement could be improved by copying the EU model and establishing a single dedicated AML enforcement agency.

The real "tigers": administrative monopolies

Yang Junfeng is also not too concerned about whether or not the recent investigations are targeted at foreigners. He approaches the issue from another angle: recent investigations have failed to address China's administrative monopolies and have had little benefit for the general public. Instead of focusing on economic monopolies in luxury sectors, regulators should target administrative monopolies such as oil and gas, telecommunications, and finance. In all three industries, the monopoly positions of state-owned enterprises (SOEs) restricts customer choice. These monopoly positions have not been gained by offering superior products and services, but rather are the result of administrative rules that prevent other companies from entering the sectors.

Yang says that SOEs in these sectors offer "high prices and inferior quality" (质次价高, *zhici jiagao*) and yet reap large profits. These profits do not benefit the people; instead they are spent on high salaries, lavish banquets, and fancy corporate headquarters for SOE bosses. Regulators have failed to tackle administrative monopolies but have instead attacked economic monopolies: in a pointed reference to the ongoing anti-corruption campaign, he calls this "swatting flies while setting the tigers free" (只打了苍蝇，而放任老虎, *zhi dale cangying, er fangren laohu*)[37].

The articles show that six years after the launch of the AML, it is now being put to full use – even as the debate continues over whether all monopolies should be considered bad and harmful. In theory, the aim of the law is to introduce more competition into China's markets. Its practical implementation, however, is raising a number of issues – notably, that of institutional competition between NRDC and MOFCOM. Chinese authors are less concerned about whether investigations have targeted foreign companies and more interested in why they are not targeting domestic SOEs, which, they argue, are generating significant economic distortions in China today.

[36] Deng accuses the NDRC of being guilty of Confucius's four sins of bad governance: "不教而殺謂之虐，不戒視成謂之暴，慢令致期謂之賊。猶之與人也，出納之吝，謂之有司" (*bu jiao er sha wei zhi nüe, bu jie shi cheng wei zhi bao, man ling zhi qi wei zhi zei, you zhi yu ren ye, chu na zhi lin, wei zhi you si*), namely "To put the people to death without having instructed them; – this is called cruelty. To require from them, suddenly, the full tale of work, without having given them warning; – this is called oppression. To issue orders as if without urgency, at first, and, when the time comes, to insist on them with severity; – this is called injury. And, generally, in the giving pay or rewards to men, to do it in a stingy way; – this is called acting the part of a mere official." Confucius, *Analects*, translation by James Legge, 1893, available at http://classics.mit.edu/Confucius/analects.4.4.html.

[37] On anti-corruption efforts, Xi Jinping said that the CCDI would be "fighting tigers and flies at the same time" – a reference to both high-ranking corrupt officials and those at local and grassroots levels. See Tania Branigan, "Xi Jinping vows to fight 'tigers' and 'flies' in anti-corruption drive", *The Guardian*, 22 January 2013, available at http://www.theguardian.com/world/2013/jan/22/xi-jinping-tigers-flies-corruption.

4. Internationalising the renminbi, slowly

Jean-François Di Meglio

Sources:

Shao Yu, "Internationalising the yuan: the logic of 'reform from within'", *Caixin wang – Opinion*, 24 January 2014.[38]

Chen Delin, "Building a global centre for the offshore renminbi trade", *Xin shiji – New Century*, 21 October 2014.[39]

China's currency is on a slow track to internationalisation. These articles discuss the history, purpose, and methods of the internationalisation of the yuan.[40] They talk about the tension between the international regulatory system and China's growing influence and address the dominance of Hong Kong as an offshore market for the yuan, which now faces competition from the circulation of offshore flows to other markets.

Adapting the foreign exchange regime to the new domestic economy

Shao Yu describes the different stages of China's financial and currency reform. First of all, the authorities needed to create a stable financial environment that would support the development of the domestic economy. This was done by controlling capital flows, exchange rate fluctuations, and, in particular, the influence of external markets. These controls are now gradually being lifted. The first stages of reform led to a degree of internationalisation, with compartmentalised liberalisation of markets and capital flows, even for foreign investors. Now, China is in an intermediate stage of reform. Shao Yu accepts that reforms have been slow, but he believes that the gradual pace was necessary.

Shao says that China's entry to the World Trade Organization in 2001 was a decisive turning point for China's foreign exchange policy. It facilitated the development of China's export capacities within a period of "demographic dividend" (人口红利, *renkou hongli*) and relative economic stability, even in the aftermath of the shock of the 1997 Asian crisis. These conditions helped China to make its first reforms to the band of fluctuation of the yuan in 2005, in spite of an international exchange rate regime that was dependent on US monetary and currency policies.

Since then, China's share in global exports has hugely increased, from 4.3 percent in 2001 to 11.4 percent in 2012, in line with other growing export economies. Now it has hit a threshold between 10 and 12 percent that even developed economies such as Japan, Germany, and the US have struggled to break through. During the same period, the annualised growth rate for China's foreign trade was 18.8 percent. Given this new environment, China needed to increase its regional integration and to adapt its development to higher unit production costs. It therefore had to adjust its monetary and exchange conditions.

Shao says that the Chinese development model has serious problems in that monetary policy is constrained because of the importance of China's export industries and its dependence on external monetary policy. China has reached the end of its ability to make use of an accommodating exchange rate policy and of its need to absorb surplus cash as part of a "managed float regime" (有管理的浮动汇率制度, *you guanli de fudong huilü zhidu*). Although the policy encouraged stability and gave China the "capacity for macro-control" (宏观调控的能力, *hongguan tiaokong de nengli*), it did not transfer the benefits of China's growth to the general public. Now, China needs to avoid the "middle income trap" (中等收入陷阱, *zhongdeng shouru xianjing*) and to rebalance the economy by prioritising domestic demand. These aims make up "phase II of the reforms" (二次改革, *erci gaige*) and correspond to the arrival of a new leadership.

To achieve these objectives, Shao says, China needs to carry out pricing reforms that are impossible within the framework of the current exchange rate policy. However, moves to implement these reforms have been stymied by the international financial crisis combined with US and European monetary easing policies. Shao says that decisions taken by the State Council on 26 March and 6 May 2013 show that the instruments that China now intends to use in reform are the relaxation of the capital account and the adaptation of fiscal policy, as China adapts to international standards that it may soon be itself able to shape.

Thus, Shao says, China must review its exchange rate system, but it must be cautious about it. Quoting Sun Tzu, who said, "do not move unless you see an advantage; do not use your troops unless there is something to be gained; do not fight unless the position is critical" (非利不动， 非得不用， 非危不战, *feili budong, feide buyong, feiwei buzhan*), the author suggests that good judgement is needed in the reform process. Before it can achieve full convertibility for its currency, China must deal with the constraints of external markets and the need to ensure stable growth within its own economy. Shao also says that China can benefit from the international economic crisis by exercising influence over the rules of the international monetary system going forward. China played a huge role in boosting global trade following the crisis. And although Shao says the country must reduce its dependence on international trade, he sets

[38] Shao Yu is a professor at the School of Management of the University of Nanjing and a researcher at the Finance Research Institute of the Fudan University in Shanghai.

[39] Chen Delin is director-general of the Hong Kong Monetary Authority (HKMA).

[40] *China Analysis* first dealt with this issue in November 2010: See *China Analysis*: *Redbacks for Greenbacks : the internationalisation of the renminbi*, European Council on Foreign Relations, November 2010, available at http://www.ecfr.eu/publications/summary/china_analysis_redbacks_for_greenbacks_internationalising_the_renminbi.

out a future in which China is an integrated power within the international capital sphere and can make its opinions felt. Beijing must move away from restraint towards a more committed and clearly defined role of influence.

Hong Kong's offshore market: a one-way street to mainland China

Chen Delin talks about the role of Hong Kong's financial market in the internationalisation of China's currency. In November 2001 the Hong Kong Monetary Authority proposed opening an offshore market for yuan in Hong Kong. China's central bank approved the plan in June 2003. The official launch of the pilot project was set for 25 February 2004.

In the event, Chen says, yuan deposits were only allowed in Hong Kong in mid-2009, in parallel with the harmonisation of compensation practices and within a relatively restrictive framework (a threshold of less than 300 yuan is mentioned, although the threshold seems to have been mostly symbolic). Since then, the volume of transactions has increased by 11. Now, daily transactions total almost 700 billion yuan, making the platform the world's seventh-largest exchange.

Before it can achieve full convertibility for its currency, China must deal with the constraints of external markets and the need to ensure stable growth within its own economy.

Limits on trade in the yuan abroad still remain, including, in particular, the small number of markets that have been authorised to process offshore yuan (initially only one, Hong Kong, although now including Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan). The result has been the deregulation of part of the capital flow and the creation of special conditions for registered qualified institutional investors (or RQFII), under a system that allows non-residents to invest in China using debt or capital instruments. The multiplication of RQFII gateways and the future deregulation of stock markets, as well as the increasing number of markets authorised to deal in offshore yuan, will contribute to increasing the size and activity of the offshore yuan market and to limiting "one-way" flows (内地单, *neididan*) towards mainland China.

Chen says that four "pillars" (支柱, *zhizhu*) in Hong Kong made the development of offshore yuan trading possible: reliable IT systems, a robust institutional framework, stable market benchmarks (in the form of the Hong Kong Inter-bank Offered Rate, HIBOR), and the maintenance of sufficient liquidity through the intervention of market makers. These pillars have helped to ensure same-day clearing can be achieved, down from two days when the market launched. The offshore market is still very limited, accounting for only 1 percent of all yuan transactions, but Chen says that with such strong foundations, it is expected to grow. Chen points out the importance of the integration of Hong Kong's "special autonomous region" (SAR) – almost 60 percent of all direct investment on the mainland goes through this financial market.

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