European Chamber
中国欧盟商会

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OF THE EUROPEAN CHAMBER
2000–2020

European Business in China

POSITION PAPER 2020/2021

The *European Business in China Position Paper 2020/2021* represents the views of the European Union Chamber of Commerce in China. Our working groups, fora and more than 1,700 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

www.europeanchamber.com.cn

The information contained herein is based on input and analysis from January 2020 to July 2020.

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Message from the President

In late 2019, we began looking forward to what was expected to be a pivotal year for the European Chamber. In addition to celebrating the 20th anniversary of the founding of the Chamber, with festivities arranged throughout the year to commemorate how far our organisation has come, we also expected 2020 to be a golden year for European Union (EU)-China relations. On top of regular annual meetings and dialogues, hallmark events were being planned, in particular the meeting between EU heads of state and President Xi Jinping in Leipzig. The centrepiece to this highly-anticipated summit was to be the successful conclusion of the negotiations for the EU-China Comprehensive Agreement on Investment (CAI).

Instead, we have observed a year of extraordinary challenges: COVID-19 has ravaged the globe and political tensions have ratcheted up quicker than anyone could have imagined. The result is profound uncertainty about the future, with the economy now clinging to what few handholds it can find. Companies are left navigating a political minefield during a health crisis of truly overwhelming proportions, and this situation is becoming more precarious, with the previously-isolated voices that were intent on sowing political discontent slowly building into a chorus.

The China market remains one of the main rocks to which our members can cling, especially after the country managed to eventually suppress the initial COVID-19 outbreak. However, while European companies' China-based operations have largely held fast, business prospects are increasingly overshadowed by other factors. The politics of the pandemic notwithstanding, sensitive issues in Xinjiang and Hong Kong have come to a head in Europe and North America. People who two years ago could not be counted on to find either region on a map are now demanding that their democratically elected leaders take action against China to bring about a resolution to these issues.

China's small but highly conspicuous army of 'wolf warriors' in the Ministry of Foreign Affairs have done little to help this situation, instead preferring to fan the flames with decidedly undiplomatic rhetoric. Fortunately, contrasting Chinese voices are still found in some diplomatic missions, such as the one to the EU. These embassies still prove that communication can be done in a constructive manner, which has long been the hallmark of China's professional diplomacy, much to the benefit of companies in both the EU and China.

Friction over the enduring lack of reciprocity in trade and investment terms between the EU and China has been reflected in the movement of people. At the time of writing, a large proportion of foreign national residents in China that were abroad during the early days of the outbreak remain unable to return to their offices, schools, homes and communities after China's borders shut and visas were suspended in late March with barely 24-hours' notice. The few that have returned had to navigate a labyrinth of approvals and ever-shifting requirements in order to do so. This stands in stark contrast to the fact that most European nations kept the doors open to Chinese nationals possessing respective member states' residency permits. This asymmetric treatment has stirred feelings of resentment, and is doing nothing to improve EU-China relations at a time when greater alignment is required.

Nevertheless, China does have the opportunity to do its part to strengthen bonds with the EU and further solidify important economic ties with its largest trading partner. The European Chamber was founded 20 years ago to oversee China's adherence to its World Trade Organization (WTO) accession agreement. Two decades on, the Chamber is playing a critical role in advancing the CAI, by providing crucial business input to negotiators. Choosing to embrace the spirit of WTO membership in a time of potential decoupling and rising protectionism would be a very positive way for China to show that it means business. At the same time, delivering on a CAI that is sufficiently robust and produces investment reciprocity would prove to other economic partners that engagement, even after seven years and 30+ rounds of negotiations, delivers results.

Closing the gulfs between rhetoric and reality, market potential and market access, and the positive progress in China's private sector and the regression of the state-owned sector, is in China's immediate and long-term interests. Despite its undeniable economic clout, China continues to punch well below its weight, with total factor productivity—i.e. the contribution to economic growth made by managerial, technological, strategic and financial innovations—lagging well behind where it should be at this stage of the country's development. European companies and their technology and expertise are ready to act as the transition catalyst that China needs to continue down the development path to fulfil its huge potential.

It is unfortunate that, 20 years on, the European Chamber still has to pick and choose which of the challenges our members experience to include in our annual position paper, to prevent it growing much longer than its customary 400 pages. Each of the issues raised represents a roadblock, preventing European companies from bringing the full weight of their experience and expertise to bear. By positively addressing the recommendations in this paper, the Chinese authorities can release a vast reserve of untapped potential, and achieve its long-term sustainable development goals. The European Chamber will continue working with the Chinese Government and doing everything we can to ensure that this happens.

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

39
WORKING GROUPS AND FORA

MORE THAN
1,700
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 39 working groups and fora representing European business in China.

The European Chamber has more than 1,700 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 (EBOs), 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, which operate 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.

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Executive Summary

Six centuries ago, in 1420, the Yongle Emperor became the first ruler of China to occupy the newly-built Forbidden City. The third monarch of the Ming Dynasty, Yongle would prove to be an altogether different kind of emperor than both his predecessors and successors. After founding the Ming, his father, the Hongwu Emperor, began closing off the country's maritime trade routes in 1371, in part to protect his reign from outside influences. When Yongle took the throne, he brought a different viewpoint. To him, engagement with foreign nations was an opportunity to project and advance China's greatness and increase trade, as a means to enforce the Chinese tributary system, thereby legitimising his reign.

Throughout his reign, Yongle sent his close friend, Admiral Zheng He, on seven voyages with the recently-built Ming treasure fleet to establish relations with civilisations as far west as Mogadishu and as far south as Surabaya. The admiral did indeed return with foreign dignitaries, who sealed new diplomatic connections between these distant lands, and with them came agreements for tributes and trade. China had opened to the world, and both sides enjoyed the economic benefits of the ensuing exchange of goods, technology and people.

After Yongle's death, the voyages of the treasure fleet came to an end. Resuming the policy of the Ming's founder, subsequent occupants of the Forbidden City imposed the *haijin*, a prohibition on Chinese maritime ventures. This persisted well into the Qing, China's final imperial dynasty. By then, what maritime trade existed was almost exclusively conducted by foreign vessels limited to the port island of Shamian, a spit of land in Guangzhou. The reason was rather infamously expressed by the Qing Emperor Qianlong in a letter to Britain's King George III, saying, "Our Celestial Empire possesses all things in prolific abundance… [and has] no need to import the manufactures of outside barbarians."[1]

The China of 2020 has a far less restrictive economy than anything found in the imperial era. Yet, echoes of the contrasting viewpoints of Yongle and Qianlong persist. For much of the last four decades, European business has been confident that China's leaders were leaning heavily towards continued opening up after having emerged from an era of seclusion. Unfortunately, the last several years have challenged this confidence, with an increasing number of voices asking if China is leaning more towards Qianlong's belief that the Middle Kingdom has no need, or desire, for what foreigners have to offer.

The reality on the ground is not so black and white. European business sees China moving in multiple directions at the same time.

For example, as noted in the European Union Chamber of Commerce in China's *European Business in China Business Confidence Survey 2020*, a 'one economy, two systems' model has emerged. One half of China's economy continues to open, is increasingly fair and well regulated, and very much wants European investment. For instance, while late in the game, the lifting of equity caps in the automotive sector has led to meaningful opportunities for European manufacturers and their suppliers, several of which have either increased their shareholdings or are aiming to take full control of their long-held joint ventures.

However, this more market-driven half of the economy also includes saturated sectors that China seems to have finally unlocked purely to perpetuate its now familiar narrative that it will open its doors wider and

1 *Two Edicts From the Qianlong Emperor, on the Occasion of Lord Macartney's Mission to China, September 1793*, Columbia University, viewed 21st July 2020, <http://afe.easia.columbia.edu/ps/china/qianlong_edicts.pdf>

wider to foreign investors.[2,3&4] The lifting of equity caps for foreign investment in the financial services sectors serves as a key example in this respect. China's closed-off banking sector allowed domestic financiers to fully saturate the entire market without the challenge of outside competition. The eventual removal of the direct barriers to foreign banks was then hailed in Chinese state media as a monumental step towards China opening its economy. However, the fact that the reform took place so late in the game made it more akin to letting foreign investors onto a railway platform only after the train had long since departed.

In a market already dominated by state-run banks—four of which are the largest in the world—only a few remaining niches, like cross-border services, still have space for European banks.[5] After entering those niches, European banks are then confronted by secondary barriers, like restricted access to licences and complex administrative approvals, meaning that most cannot even catch the crumbs from the table. European bankers project that the already pitiful foreign share of less than two per cent of the market will shrink. Meanwhile, Chinese banks are feasting on Europe's open banking market.

The other, state-driven half of the economy sees China still nursing its national champions and state-owned enterprises (SOEs) that have largely uncontested access to a fifth of the world's consumers, producers, depositors and innovators. China's leaders reaffirmed its plan to enhance the role of its SOEs as recently as July 2020.[6] China currently has 97 behemoths run at the central level by the State-owned Assets Supervision and Administration Commission (SASAC), and another 130,000 SOEs run at the provincial and local levels.[7]

Originally, the foundational and primary sectors of the economy, as well as anything that could be deemed 'strategic' in the government's broad definition of the term, were off limits, including energy, utilities, resource extraction, refining, steel production and rail. Worryingly, there now seems to be a growing list of sectors that either restrict foreign investment, or in which support is provided to China's national champions to the extent that it squeezes out any potential European competition.

This is particularly apparent in the industries promoted in the China Manufacturing 2025 plan and similar national goals. Renewables, telecommunications, internet and high technology industries, along with other key sectors projected to drive the most growth over the coming decades, are tightening up to foreign investors. European companies have found themselves only being permitted into these areas to perform specialist roles and provide inputs where Chinese expertise is lacking.

The enduring and growing challenges facing European companies in this half of the economy are depleting business sentiment. Meanwhile, as China's indigenous companies catch up to and even surpass European firms in some areas, many European business leaders are starting to wonder if Jeffrey Immhelt, former CEO of General Electric, was right a decade ago when he said, "I am not sure that in the end [China] wants any of us to win, or any of us to be successful."[8]

2 Zhao, Yinan, *China's Door to Open Wider, Li Tells Foreign Companies, China Daily Asia*, 16th September 2014, viewed 21st July 2020, <https://www.chinadailyasia.com/nation/2014-09/16/content_15166511.html>

3 Liu, Zhen, *China's Door Will Open 'Wider and Wider' to UK, Li Keqiang tells Theresa May, South China Morning Post*, 31st January 2018, viewed 21st July 2020, <https://www.scmp.com/news/china/diplomacy-defence/article/2131456/chinas-door-will-open-wider-and-wider-uk-li-keqiang>

4 Wang, Orange, *China President Says 'Only When China is Good can the World get Better' Amid US Trade War, South China Morning Post*, 19th October 2019, viewed 21st July 2020, <https://www.scmp.com/economy/china-economy/article/3033694/chinas-door-will-only-open-wider-xi-jinping-tells-delegates>

5 Bagnall, Elinor, *Top 1000 Banks 2019*, *The Banker*, 1st July 2019, viewed 21st July 2020, <https://www.thebanker.com/Top-1000-World-Banks/Top-1000-World-Banks-2019-The-Banker-International-Press-Release-for-immediate-release>

6 Tang, Frank, *China Approves Plans to Boost Prominence of State Firms, Despite Complaints From Trade Partners, South China Morning Post*, 8th July 2020, viewed 21st July 2020, <https://www.scmp.com/economy/china-economy/article/3092339/china-approves-plan-boost-prominence-state-firms-despite>

7 Ibid.

8 Dinmore, Guy and, Dyer, Geoff, *Immelt Hits out at China and Obama, The Financial Times*, 2nd July 2010, viewed 28th July 2020, <https://www.ft.com/content/ed654fac-8518-11df-adfa-00144feabdc0>

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In the wake of the COVID-19 outbreak, new obstacles have emerged that have left Europeans feeling decreasingly welcome in China. While Chinese nationals have been able to get to Europe for essential business travel and work/residency, a large portion of China's European business community—many of them long-time, tax-paying residents—have been largely prevented from returning, even from places within China's borders like Hong Kong.[9] Furthermore, instances of discrimination directed at foreigners in China went ignored by Chinese officials at best, and were outright denied at worst.[10&11]

European Chamber members cannot help wondering if these actions and inactions are indicative of a broader mindset that while foreign capital and technology are desired in China, foreigners themselves are not.

These various directions that China is moving in indicate a huge difference in how the concept of 'openness' is understood. As an open economy, the EU has embraced the idea that market access is taken as granted through multilateral institutions like the World Trade Organization (WTO), and bilateral ones like investment agreements. Since EU-China negotiations on the Comprehensive Agreement on Investment (CAI) began in 2013, the EU has completed trade and investment agreements with several dozen other markets. But the China of 2020 seems to buy into a different way of thinking: market access is not seen as a right, but instead a privilege that is either extended to or removed from certain areas, depending on whichever part of the economy China's leaders want foreign investment to flow to at any given time.

Not only does this understanding clash with the rules-based economic order to which China voluntarily acceded, it also drags down business sentiment.

This is to China's detriment, as the potential of the market remains huge – China's development trajectory has been comparable to that of Japan and South Korea in the decades following their market reforms. As opposed to the growing narrative of foreign companies voluntarily 'decoupling' from China, European firms are actually eager to deepen their positions and compete for market share.

The European Chamber is frequently asked by the European Commission and member-state governments if Europe should seek deeper engagement with China, with the ultimate goal of China establishing a truly open and competitive market economy; or if it should accept that the state-driven half of the economy will eventually prevail. The answer is increasingly clear: build a toolkit that will work either way.

EU investment screening mechanisms directed at state-backed capital will not need to be employed if China truly liberalises its economy, but will be in place to protect against market distortions caused by SOEs if China chooses not to. Similarly, the International Procurement Instrument will have no effect on China if the country opens its procurement market, while protecting against anti-competitive bids from China's national champions if it does not. Leveraging trade and investment deals with third-market partners to counter market distortions resulting from competition from China's artificially-boosted national champions will be unnecessary if Beijing aligns with the rules-based economic system, but such steps would be needed to counter damage to European players in those markets should nothing change.

Meanwhile, both sides must commit to concluding a binding and robust CAI that brings the EU and China

9 Bradsher, Keith, *To Slow Virus, China Bars Entry by Almost All Foreigners, The New York Times*, 26th March 2020, viewed 28th July 2020, <https://www.nytimes.com/2020/03/26/world/asia/china-virus-travel-ban.html>

10 Vanderklippe, Nathan, *'Stay away from here': In China, foreigners have become a target for coronavirus discrimination, The Globe and Mail,* 9th April 2020, viewed 28th July 2020, <https://www.theglobeandmail.com/world/article-stay-away-from-here-in-china-foreigners-have-become-a-target-for/>

11 *No discrimination against foreigners: China Daily editorial, China Daily,* 8th April 2020, viewed 28th July 2020, <http://www.chinadaily.com.cn/a/202004/08/WS5e8dd64aa310e232631a4cbf.html>

as close to a reciprocal trade and investment environment as possible, and provides investor protection on both sides. This would not only bear clear tangible benefits, but also demonstrate that deeper engagement is still the best way forward, countering the growing international narrative that playing hardball in a world of zero-sum games is the only viable option.

Realising its stated reform agenda and bilateral and multilateral commitments would also resolve many of the contradictions that see China's economy perpetually pulled in different directions: the tensions of one economy, two systems; the mismatch between market potential and market access; the conflict between business and politics; and the gulf between rhetoric and reality.

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Executive Position Paper

The EU-China 'decoupling story'

International coverage of China in 2020 has been dominated by two stories: the COVID-19 outbreak and the resulting economic challenges, which have left companies navigating in the dark; and the potential for various markets to decouple from China. While the former is all too real, the latter is a far less straight-forward story.

In the areas where European Chamber members are able to participate in China's economy, they report no significant change in plans to redirect current or planned investments elsewhere. Results from the European Chamber's *Business Confidence Survey 2020* (BCS 2020) indicate that 11 per cent of member companies are considering doing so, which is towards the lower end of the norm for the last decade.[1]

It should be noted that the 2020 survey was conducted throughout February, meaning that members were responding during the rapidly-changing, early days of the COVID-19 crisis. However, subsequent surveys, as well as discussions with the European Chamber's working groups, have not revealed any reason to expect a significant change on this point.

Even taking into account the potential economic upheavals that could follow the COVID-19 crisis, European multinational companies (MNCs) in China are not making plans based on the next one or two years – they are looking to the next one or two decades. Their small and medium-sized enterprise (SME) partners remain similarly committed to serving China's market, as do the European SMEs that target Chinese customers directly.

There is certainly now the potential that the economic impact of COVID-19 will result in the diversification of certain supply chains becoming more commonplace. Many companies are naturally seeking to build resiliency after suffering supply shortages when China's was the first market to be flattened by the pandemic. However, this should not be misunderstood as 'leaving'. Instead, it is likely to mean less new investment into China as resources are spent elsewhere.

The ongoing United State (US)-China trade war has also raised questions over who will leave China, and how quickly. After what started as a trade skirmish escalated into a tit-for-tat pitched battle, the European Chamber surveyed its members in September 2019 to measure the impact. The results show that although the effects were significant, the conflict was not driving substantial numbers of European companies out of China. While eight per cent of those surveyed indicated they were moving relevant production out, six per cent said they were actually increasing their investment into the market.[2]

Discussions on this topic with China-based business leaders across a range of industries revealed some

1 The proportion of BCS respondents indicating that they planned to move current or planned investments to markets other than China has been between 10 and 22 per cent over the last 10 years; *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

2 *European Chamber Survey on the US-China Trade War Finds More Companies Making Difficult Strategic Changes to Adapt to the Indefinite Nature of the Tensions*, European Union Chamber of Commerce in China, September 2019, viewed 20th July 2020, <https://static.europeanchamber.com.cn/upload/medianews/attachments/September_Trade_War_Survey_Results_and_Findings_Final_1.1[24].pdf>

clear trends. European MNCs that are increasing investment are looking to onshore their supply chains into China and deepen their local production capacity to insulate themselves from further disruptions. Of those that are leaving, most are in China to produce for export markets rather than for local consumers.

Many companies producing in China for export have been steadily leaving for years, following market forces to set up more cost-effective production facilities to then export to China and other destinations, including the EU. Most producers for export of European origin had already been looking to leave China within a horizon of several years. The trade war has merely accelerated their decision.[3]

No economic decoupling, but a growing political story

While there are currently no economic factors strong enough in and of themselves to drive out European investors, business decisions are not made in a vacuum.

Political voices calling for a tougher stance on China are building into a chorus across the world.[4] The loudest voice is undoubtedly President Trump's, but he is hardly alone, either in Washington or globally. The only thing Americans seem to agree on these days is that the US-China relationship must enter a new era, and abandon the engagement-at-all-costs approach that defined previous administrations in favour of something considerably more hawkish.

While taking an infinitely more low-key approach, the Japanese Government has, for some time, been working in coordination with its biggest companies to decouple and diversify from China. Bilateral tensions spiked after the 2012 anti-Japanese riots in China,[5] which led to boycotts of Japanese goods and an export ban on rare earth metals.[6] Since then, Japan has seemed quietly determined to reduce its reliance on the Chinese market.[7] The Japanese Government even created a financing mechanism of more than US dollars (USD) 2 billion annually to fund Japanese companies that need support either to move production from China back to Japan or to diversify into Southeast Asia.[8]

Similar trends can be seen in Europe, though in relative infancy compared to the US or Japan. When former EU President Jean-Claude Juncker delivered his 2017 State of the European Union speech, he spoke of the need for the EU to strengthen its trade agenda. "Yes, Europe is open for business," he said, "But there must be reciprocity. We have to get what we give."[9] This signalled something of a departure from the more conciliatory approach that Europe had previously taken in its dealings with China. Since then, the tone from Brussels has continued to evolve in response to China's slow-moving economic reform agenda and what many view as an increasingly aggressive stance coming from Beijing. The EU's approach was seen to harden further in a strategic communication released in 2019, which labelled China

3 *European Chamber Survey on the US-China Trade War Finds More Companies Making Difficult Strategic Changes to Adapt to the Indefinite Nature of the Tensions*, European Union Chamber of Commerce in China, 10th October 2019, viewed 21st July 2020, <https://www.europeanchamber.com.cn/en/press-releases/3063/european_chamber_survey_on_the_us_china_trade_war_finds_more_companies_making_difficult_strategic_changes_to_adapt_to_the_indefinite_nature_of_the_tensions>

4 Wolfe, Jan, *US Senators Introduce New Bill to Punish Chinese Technology Theft, Reuters*, 21st June 2020, viewed 21st July 2020, <https://www.reuters.com/article/us-usa-china-ip/u-s-senators-introduce-new-bill-to-punish-chinese-technology-theft-idUSKBN23I34A>; *Canada Must Toughen Stance with China, Ex-diplomats Say, US News*, 23rd June 2020, viewed 21st July 2020, <https://www.usnews.com/news/best-countries/articles/2020-06-23/canadas-trudeau-must-toughen-stance-with-china-ex-diplomats-say>; Cooper, Charlie, *Britain Toughens Stance on China as it Eyes US, Politico*, 13th July 2020, viewed 21st July, <https://www.politico.com/news/2020/07/13/boris-johnson-china-huawei-359741>

5 *Anti-Japan Protests in China, The Atlantic*, 17th September 2012, viewed 20th July 2020, <https://www.theatlantic.com/photo/2012/09/anti-japan-protests-in-china/100370/>

6 Hille, Kathrin and Nakamoto, Michiyo, *Anti-Japanese Protests Sweep China, Financial Times*, 19th August 2012, viewed 21st July 2020, <https://www.ft.com/content/97805eaa-e9ee-11e1-929b-00144feab49a>

7 Shida, Tomio, *History Offers Lessons in Escaping China's Rare Earth Dominance, Nikkei Asian Review,* 25th June 2019, viewed 21st July 2020, <https://asia.nikkei.com/Economy/Trade-war/History-offers-lessons-in-escaping-China-s-rare-earth-dominance2>

8 *Abe's Right-hand Man Wants a Japan Less Reliant on China, Nikkei Asian Review*, 24th April 2020, viewed 20th July 2020, <https://asia.nikkei.com/Editor-s-Picks/Interview/Abe-s-right-hand-man-wants-a-Japan-less-reliant-on-China>

9 *President Jean-Claude Juncker's State of the Union Address 2017*, European Commission, 13th September 2017, viewed 21st July 2020, <https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_17_3165>

as an "economic competitor" and a "systemic rival".[10] A toolbox is now under development, including an investment screening mechanism, to better protect the EU Common Market from outside distortions.[11]

Importantly, the politics of the moment have brought these three economic heavyweights together to potentially take an increasingly unified approach towards China, such as through the trilateral statements issued by the trade ministers of the EU, Japan and the US in 2019 and 2020.[12&13] While this kind of alignment is useful, it would be even more effective if it was extended across more Organization for Economic Co-operation and Development (OECD) countries.

Several months of increasing tensions

While China and Europe have always encountered areas of friction outside the economic realm, the last couple of years has yielded an astonishing number of issues that have raised concerns and increased risk for businesses.

These include the political ramifications of the National Security Law aimed at Hong Kong,[14] the extensive allegations of forced labour and internment of ethnic and religious minorities in Xinjiang,[15] the insinuation of the Communist Party of China (CCP) into every aspect of civil society and even business,[16,17&18] and the politicised nature of the narrative around the early days of the COVID-19 outbreak.[19&20] One of these on their own would present a serious point of contention between the political leaders of Europe and China. Together, they risk creating a long-term, downward spiral in relations, as evidenced by the measures already applied by the US in response to Hong Kong and the Xinjiang allegations, which have the potential to seriously impact European companies.[21&22]

China's global image has been further tarnished by the rise of 'wolf warrior' diplomacy, an approach in which Chinese diplomats embrace a 'fighting spirit' in their interactions with other countries.[23] While diplomats should of course be free to advocate for everything they see fit, the tone being adopted by some Chinese diplomats to engage with the rest of the world is, by definition, undiplomatic. This relatively new phenomenon has been widely covered in foreign media, and is turning many in Western civil society

10 *EU-China – A Strategic Outlook*, European Commission, 12th March 2019, viewed 20th July 2020, <https://ec.europa.eu/commission/sites/beta-political/files/communication-eu-china-a-strategic-outlook.pdf>

11 *Screening of Foreign Direct Investment*, European Commission, 10th April 2019, viewed 20th July 2020, <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2006>

12 *Joint Statement of the Trilateral Meeting of the Trade Ministers of the European Union, Japan and the United States,* European Commission, 9th January 2019, viewed 21st July 2020, <https://trade.ec.europa.eu/doclib/docs/2019/january/tradoc_157623.pdf>

13 *Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, the United States* and *the European Union*, European Commission, 14th January 2020, viewed 21st July 2020, <https://trade.ec.europa.eu/doclib/docs/2020/january/tradoc_158567.pdf>

14 Lau, Stuart, *European Union 'Deplores' Beijing's Move to Pass National Security Law for Hong Kong, South China Morning Post*, 20th June 2020, viewed 20th July 2020, <https://www.scmp.com/news/china/diplomacy/article/3091240/european-union-deplores-beijings-move-pass-national-security>

15 Roth, Kenneth, *Europe Needs to Stop China's Assault on the Global Human Rights System*, Human Rights Watch, 11th February 2020, viewed 20th July 2020, <https://www.hrw.org/news/2020/02/11/europe-needs-stop-chinas-assault-global-rights-system#>

16 Stevenson, Alexandra, *China's Communists Rewrite the Rules for Foreign Businesses, The New York Times*, 13th April 2018, viewed 20th July 2020, <https://www.nytimes.com/2018/04/13/business/china-communist-party-foreign-businesses.html>

17 Russo, Federica, *Politics in the Boardroom: The Role of Chinese Communist Party Committees, The Diplomat*, 24th December 2019, viewed 20th July 2020, <https://thediplomat.com/2019/12/politics-in-the-boardroom-the-role-of-chinese-communist-party-committees/>

18 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

19 Wang, Vivian, *China's Coronavirus Battle Is Waning. Its Propaganda Fight Is Not, The New York Times*, 17th June 2020, viewed 20th July 2020, <https://www.nytimes.com/2020/04/08/world/asia/coronavirus-china-narrative.html>

20 Gan, Nectar, Hu, Caitlin & Watson, Ivan, *Beijing Tightens Grip Over Coronavirus Research, Amid US-China Row on Virus Origin, CNN*, 16th April 2020, viewed 20th July 2020, <https://edition.cnn.com/2020/04/12/asia/china-coronavirus-research-restrictions-intl-hnk/index.html>

21 *Issuance of Xinjiang Supply Chain Business Advisory*, US Department of State, 1st July 2020, viewed 14th July 2020, <https://www.state.gov/issuance-of-xinjiang-supply-chain-business-advisory/>

22 *The President's Executive Order on Hong Kong Normalization*, The White House, 14th July 2020, viewed 21st July 2020, <https://www.whitehouse.gov/presidential-actions/presidents-executive-order-hong-kong-normalization/>

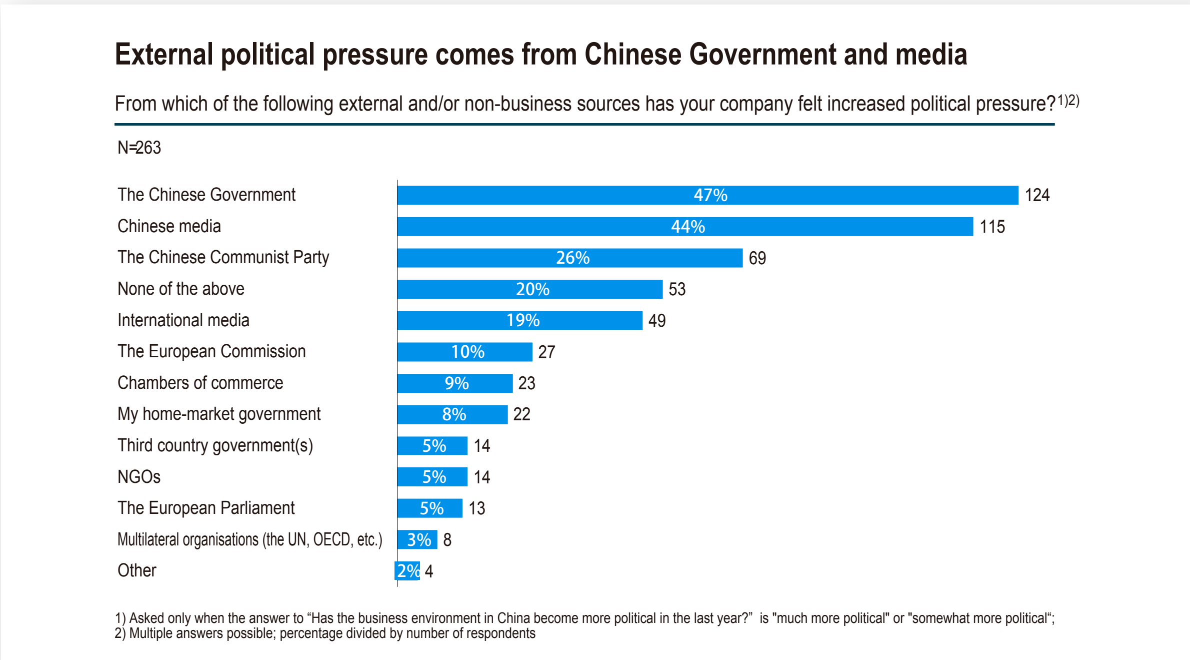
23 Shi, Jiangtao, *China Wants its Diplomats to Show More Fighting Spirit, South China Morning Post*, 12th April 2020, viewed 21st July 2020, <https://www.scmp.com/news/china/diplomacy/article/3079493/china-wants-its-diplomats-show-more-fighting-spirit-it-may-not>

against China.[24] A worst-case scenario would be a continuation of this approach, leading to increased tensions and causing politicians to disengage from China.

The politicisation of business

In the European Chamber's BCS 2020, 43 per cent of members report that the business environment became increasingly politicised compared to the previous year, with just 10 per cent saying it became less so. Members indentify the Chinese Government and Chinese media as the most likely sources to increase political pressure on businesses.[25]

Chart 1



Source: *European Business in China Business Confidence Survey 2020*

European companies in China can forecast economic trends, shifting consumer tastes, and the supply and demand of inputs, but they cannot predict ever-shifting political demands. Regardless of the areas where progress has been made in China's business environment over the past year—as outlined in the individual position papers of the European Chamber's working groups—companies now have even more reason to believe that they could become victims of arbitrary punishment being handed down to them due to the actions of their home-country governments.

For example, despite the signing of the EU-China Agreement on Geographical Indications (GIs)[26]—which in theory should help protect the quality of 200 different food and beverage products (half European, half Chinese) and increase consumer confidence—it is entirely plausible that European producers and importers of these newly protected items may face sudden disruptions should they become the focus of Chinese retaliation in response to political issues:

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24 Westcott, Ben and Jiang, Steven, *China is Embracing a New Brand of Foreign Policy. Here's What Wolf Warrior Diplomacy Means, CNN*, 29th May 2020, viewed 8th July 2020, <https://edition.cnn.com/2020/05/28/asia/china-wolf-warrior-diplomacy-intl-hnk/index.html>; Zhu, Zhiqun, *Interpreting China's Wolf Warrior Diplomacy, The Diplomat,* 15th May 2020, 8th July 2020, <https://thediplomat.com/2020/05/interpreting-chinas-wolf-warrior-diplomacy/>

25 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

26 *EU-China Agreement on Cooperation on, and Protection of, Geographical Indications*, European Commission, 4th November 2019, viewed 20th July 2020, <https://ec.europa.eu/info/sites/info/files/food-farming-fisheries/farming/documents/eu-china-gi-agreement-for-publication.pdf>

- Will Chinese state media call for boycotts of Scottish Farmed Salmon because of the United Kingdom's (UK's) stance on the National Security Law, as happened to Norwegian Salmon after the Nobel Peace Prize was awarded to Liu Xiaobo in 2010?[27]
- Will Greek Sitia Olive Oil face a ban because of a Chinese national being arrested, as happened with canola oil imports from Canada after Meng Wanzhou was detained?[28]
- Will Czech Žatecký Chmel Hop imports suddenly face a massive increase in tariffs if a city mayor meets with Taiwanese officials, as happened when Australian barley imports were hit with 80 per cent tariffs after Australian politicians suggested an independent inquiry into the origins of the novel coronavirus?[29]

Meanwhile, it is highly unlikely that European countries would respond in the same way, and that Chinese producers or exporters would suddenly find themselves in the crosshairs as a result of political spats.

- When the Chinese Embassy in France published false information about elderly French left to die en masse during the COVID-19 outbreak, French leaders did not call for public boycotts of Pu'er tea.[30]
- Sweden did not block imports on Shaoxing Yellow Wine in response to the jailing of Gui Minhai.[31]
- *CGTN*'s suggestion that COVID-19 originated in Italy did not result in the Italian Government levying 80 per cent tariffs on Shanxi Laochen vinegar.[32]

Such political interference in business is deeply disruptive, and could impact other countries' approaches towards China if not reined in.

Why do we stay?

Even as growth has slowed, both in China and globally, 39 per cent of European Chamber members reported revenue growth in 2019 of up to 20 per cent year-on-year, and 11 per cent saw even higher growth for their China operations.[33]

However, just under half of European Chamber members report missing out on business opportunities as a result of market access restrictions and regulatory barriers in China, 40 per cent of whom claim those lost opportunities amount to more than 10 per cent of their annual revenue. This is a clear indicator of just how significant China's market potential is.[34] The revenue and profitability that could be derived from the market should it become as open and fair as China's leaders frequently claim it will,[35] means that this market simply cannot be missed out on.

China's economic rise follows historical norms

China has become a pivotal market for European players over its four decades of economic opening,

27 Milne, Richard, *Norway Sees Liu Xiaobo's Nobel Prize Hurt Salmon Exports to China, Financial Times*, 15th August 2013, viewed 21st July 2020, <https://www.ft.com/content/ab456776-05b0-11e3-8ed5-00144feab7de>

28 Vieira, Paul, *Trudeao Ascribes Chinese Ban on Canadian Canola to US Trade Fight, The Wall Street Journal*, 10th May 2019, viewed 21st July 2020, <https://www.wsj.com/articles/trudeau-ascribes-chinese-ban-on-canadian-canola-to-u-s-trade-fight-11557518194>

29 *China Punishes Australia for Promoting an Inquiry into COVID-19, The Economist,* 21st May 2020, viewed 21st July 2020, <https://www.economist.com/asia/2020/05/21/china-punishes-australia-for-promoting-an-inquiry-into-covid-19>

30 Wintour, Patrick, *France Summons Chinese Envoy After Coronavirus Slur, The Guardian*, 15th April 2020, viewed 21st July 2020, <https://www.theguardian.com/world/2020/apr/15/france-summons-chinese-envoy-after-coronavirus-slur>

31 *Gui Minhai: Hong Kong Bookseller Gets 10 Years Jail, BBC*, 25th February 2020, viewed 21st July 2020, <https://www.bbc.com/news/world-asia-china-51624433>

32 Syam, Nilay, *Water Samples Suggest COVID-19 Present in Italy Before Chinese Cases, CGTN*, 20th June 2020, viewed 21st July 2020, <https://newseu.cgtn.com/news/2020-06-20/Water-samples-suggest-COVID-19-present-in-Italy-before-Chinese-cases-RtTMEUvgcg/index.html>

33 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, viewed 19th July 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

34 Ibid.

35 Tang, Frank, *Is China an Open Economy? Beijing Says it is but IMF Differs, South China Morning Post*, 24th August 2018, viewed 20th July 2020, <https://www.scmp.com/news/china/economy/article/2161265/china-open-economy-beijing-says-it-imf-differs>

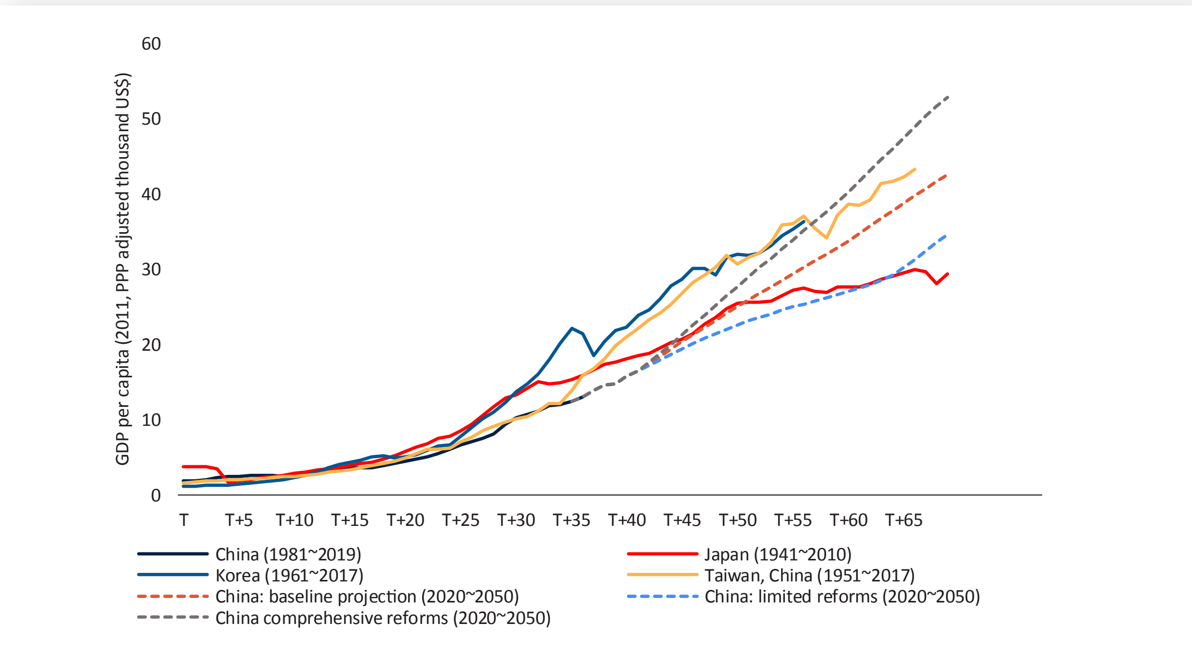
and it has the potential to follow the trends of other economic miracles predating its own. Although it is commonly stated in China that its rapid rise over the last forty years is somehow unique,[36] the European business community sees it as yet another example of how economies bloom when modernisation is prioritised and their development is predicated on market opening.

History repeating itself

Mass and rapid industrialisation and modernisation has been experienced by multiple economies throughout the last 150 years. China is following a path similar to the 'Four Asian Tigers' of South Korea, Taiwan, Hong Kong and Singapore. These markets transitioned from largely undeveloped economic systems/trading ports to highly developed, competitive centres for industry, innovation and finance, all over the course of around four decades.[37]

Larger economies have historically done the same. Like many countries during the second industrial revolution at the end of the 19th century, Germany, shortly after its unification in 1871, rapidly industrialised.[38] An even more dramatic modernisation emerged over a similar period of time when Meiji Japan went from a feudal, chiefly agrarian economy to an economic force on par with the strongest nations of the day.[39] So long-lasting were the lessons of those experiences that even after the heavy bombing sustained by both countries during the Second World War, they were able to rebuild in just a few decades to become the powerhouses they are today.

Chart 2: Output-side real gross domestic product (GDP) per capita (purchasing power parity (PPP)-based) realities and projections: distance from start of market reforms



Source: The World Bank

36 Wang, Jiamei, *China's Growth Miracle Over Past Three Decades Underlines Strategic Choice at Critical Moment, Global Times*, 3rd June 2019, viewed 20th July 2020, <http://www.globaltimes.cn/content/1152971.shtml>

37 Rabinovitch, Simon and Cox, Simon, *After Half a Century of Success, the Asian Tigers Must Reinvent Themselves, The Economist*, 5th December 2019, viewed 20th July 2020, <https://www.economist.com/special-report/2019/12/05/after-half-a-century-of-success-the-asian-tigers-must-reinvent-themselves>

38 Schirm, Stefan, A., *The Power and Norms in Shaping National Answers to Globalisation: German Economic Policy After Unification*, Taylor & Francis Online, 8th September 2010, viewed 20th July 2020, <https://www.tandfonline.com/doi/abs/10.1080/714001318?journalCode=fgrp20>

39 Atsushi, Kawai, *Japan's Industrial Revolution*, *Nippon.com*, 10th July 2019, viewed 20th July 2020, <https://www.nippon.com/en/japan-topics/b06904/japan%E2%80%99s-industrial-revolution.html>

The Chinese economy has followed similar growth trends over comparable timelines, as illustrated in the World Bank chart (Chart 2), which shows GDP per capita in PPP terms since the introduction of market reforms in respective markets. European companies are ready to play a key role in the development of yet another economic powerhouse in East Asia.

In China for China, and the world

European companies derive far more from being in other markets than just the immediate benefit of increased sales. They also benefit from the global nature of the talent they acquire, increased competition and their exposure to new forms of innovation. China is no different in this respect.[40]

European companies are here to compete

The success of many of Europe's best companies comes from decades of competing with peers at home and abroad. The formation of the European Common Market paid immediate dividends as companies previously protected by borders and tariffs were suddenly forced to cut the fat or fall behind.[41] The winners of that race then entered international markets as globalisation took off and the World Trade Organization (WTO) gave them access to other fields of competition, while also keeping them on their toes as their home markets welcomed new entrants.

With China remaining only partially open, and with a level playing field only reported by half of European companies operating in the Chinese market,[42] the resulting loss of competition for both European players and China's own champions is a grievous one.

Talent the key to competition

The foreign companies that used to have their pick of China's best and brightest now face strong competition from local companies,[43] further underlining how necessary it is to have a presence here, as well as to be able to easily assign talent from other parts of the world to China operations. European companies are keen to send their global talent into China for them to foster new skills and gain experience that can be applied elsewhere. It also helps companies unlock synergies by bringing the best local and foreign talent together.

Unfortunately, China is far more restrictive towards foreign talent than the EU's various member states. The OECD Foreign Direct Investment (FDI) Restrictiveness Index breaks down how closed off a given market is based on four main categories. One of these is how restrictive a market is to key foreign personnel, broken down over 39 specific indicators.[44] Nearly all EU Member States score a 0.000 on the calculated average of this metric. Four exceptions stand out: France at 0.002 because of restrictions in fisheries; Italy at 0.002 because of maritime, air and transport; Lithuania at 0.003 because of fisheries and maritime; and Poland at 0.006 because of restrictions in media and telecommunications. In 38 of the 39 sectors, China holds a rating of 0.05 or higher, with its sole 0.000 rating being in real estate investment.

40 *Will China Ever be on the Cutting Edge of Global Innovation?*, China Power, 27th February 2016, viewed 20th July 2020, <https://chinapower.csis.org/will-china-ever-be-on-cutting-edge-of-global-innovation/>

41 Allen, Chris, Gasiorek, Michael, Smith, Alasdair, Flam, Harry and Sorensen, Peter Birch, 1998, *The competition effects of the single market in Europe, Economic Policy*, vol 13, no. 27, pp. 439-486.

42 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

43 Morarjee, Rachel, *MNCs Need Sharper Edge in China Talent Wars, Reuters*, 17th January 2017, viewed 20th July 2020, <https://www.reuters.com/article/us-china-executives-breakingviews/mncs-need-sharper-edge-in-china-talent-wars-idUSKBN1510O3>

44 *OECD FDI Regulatory Restrictiveness Index*, OECD, viewed 20th July 2020, <https://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#>

This earns China an average of 0.048, eight times the score of the most restrictive EU Member State, Poland. By comparison, the most restricted OECD member in this metric is Canada, with an average score of 0.013. When including the non-OECD countries covered by the index, China ranks as the fourth most restrictive. Saudi Arabia holds a score of 0.077, and Indonesia and Peru are tied with a score of 0.05.

In the interests of creating a more competitive business environment, an important part of China's ongoing opening-up and development must therefore include reducing the restrictions currently placed on foreign talent, bringing it more in line with the EU.

China's market access lags its market potential

For many years, the European Chamber has advocated for more complete opening in China, and equal treatment for foreign enterprises. The current web of restrictions facing foreign companies trying to invest in China are extremely burdensome and actually hold back China's overall development. It will only be possible to unleash the full potential of its market by increasing foreign investment, which in turn will also strengthen competition.

Foreign companies that want to invest in China must first navigate the Foreign Investment Negative List (FINL), a table of different industries in which foreign investment is either forbidden or accompanied by conditions for entry. Restrictions include, for example, equity caps or requirements that the Chinese partner must have majority control in a joint venture (JV).

The list underwent a recent revision in late June 2020,[45] with seven items being removed, leaving 33 restricted/prohibited sectors. Most of the removed items are of limited significance, such as, nuclear fuel and nuclear radiation processing, oil and gas exploration, and pipe network facilities. However, the remaining items are composed of sectors across a broad spectrum of interest – traditional Chinese medicine production is not exactly a priority for European business, but legal and telecommunications services certainly are.

In addition to the FINL, foreign investors must also navigate the less frequently discussed Market Access Negative List (MANL).[46] This list affects all market players, not just foreign ones, which serves as a reminder that China's private companies are also subject to the onerous regulatory framework of the market. While the MANL has 130 broadly defined items—which translate into restrictions on the provision of hundreds of different goods and services—the vast bulk of these are not prohibited, but instead require various permissions.

European business leaders report being twice as likely to face such indirect barriers compared to direct ones.[47] Foreign banks, for example, were finally able to enter without JV requirements as of just a couple of years ago. However, once allowed in, they found a fully saturated market in which only a few niche opportunities in areas like cross-border services held meaningful potential. Furthermore, the requirements for obtaining an operating licence remain out of international norms by some considerable distance. To date, only a handful of foreign banks have been successful, though recent announcements from the

45 *Foreign Investment Negative List 2020*, Ministry of Commerce (MOFCOM), 24th June 2020, viewed 16th July 2020, <http://www.mofcom.gov.cn/article/ae/ai/202006/20200602977244.shtml>

46 *MANL (2019 Version),* MOFCOM Department of Treaty and Law, 22nd November 2019, viewed 12th August 2020, <http://tfs.mofcom.gov.cn/article/bc/201911/20191102916059.shtml>

47 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, viewed 20th July 2020, <https://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

China Securities Regulatory Commission could signal that things are moving the right direction.[48]

Insurers, which have just seen their industry removed from the most recent FINL, face different, but no less burdensome, bureaucratic barriers to full entry. To offer their services nationwide, they must apply for a separate licence in each individual province, with only one application being accepted and processed at a time. With the China Banking and Insurance Regulatory Commission issuing those licences at a pace of about one a year, this means that any foreign insurance providers wanting to offer services in even just one third of the country would need at least decade to acquire them, assuming that they were all smoothly approved.[49] Meanwhile, China's biggest insurers, which have been able to easily secure their positions across the country relatively unimpeded, are able to continue to build market share before foreign competitors can even get to them.

In information, communication and technology, there are rapidly emerging sectors with plenty of market share up for grabs. Unfortunately, most telecommunications infrastructure providers are increasingly squeezed out of public procurement as China fights to support its national champions, and licences for value-added telecommunications—including cloud and virtual private network services—remain largely out of reach to foreign companies. At the same time, digital solutions developed elsewhere by European firms have to deal with the Great Firewall and its seemingly ever-growing list of blocked sites.[50]

In addition to the removal of certain items, the revised FINL also now includes a provision that gives the State Council the power to supersede the restrictions on the list for any company that it selects.[51] It seems likely that this is meant to allow the State Council to 'pilot' opening in certain sectors after the previous piloting model, through China's free-trade zones, failed to deliver any meaningful results.

This could be good news for foreign companies that the State Council gives the green light to. However, it also raises concerns within the European business community with respect to China's increasingly politicised business environment, as described in detail in the previous section of this paper. It is not beyond the realms of possibility that a company that is in favour one year, may suddenly fall out of favour the next if its home-country government comments on an issue that is deemed to be sensitive.

Foreign investment at the gates

If greater market access were to be granted, 62 per cent of European Chamber members stated in the BCS 2020 that they are more or somewhat more likely to increase investment in China.[52] Of those, roughly half are ready to invest an additional five to 10 per cent of their annual revenue, while almost a third said they would invest even greater sums.

However, if the aforementioned direct and indirect access barriers are not dismantled to produce timely opportunities in relevant sectors, more parts of the market will become saturated by local champions rendering any subsequent market opening largely meaningless to foreign investors.

48 *Administrative Measures for Securities Investment Fund Custody Business*, China Securities Regulatory Commission, 10th July 2020, viewed 21st July 2020, <http://www.csrc.gov.cn/pub/zjhpublic/zjh/202007/t20200710_379911.htm>

49 Key Recommendation 1, Insurance Working Group Position Paper, European Business in China Position Paper 2020/2021.

50 Chan, Tara Francis, *China's Great Firewall is Taller Than Ever Under 'President-for-life' Xi Jinping, Business Insider*, 25th March 2018, viewed 21st July 2020, <https://www.businessinsider.com/china-great-firewall-censorship-under-xi-jinping-2018-3>

51 *Notice of the Two Departments on the Issuance of the Negative List of Market Access 2019*, State Council, 22nd November 2019, viewed 16th July 2020, <http://www.gov.cn/xinwen/2019-11/22/content_5454504.htm>

52 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-business-confidence-survey>

Procurement blues

For many that have successfully navigated China's entry requirements, they face further limitations in a public procurement market that remains largely closed to foreign players, with "regulations and policies favouring domestic over foreign goods and services".[53] In terms of inputs, European companies have identified some opportunities, but only to play niche roles and mostly in areas where they have a certain technology that local competition cannot replicate.

Service providers are similarly marginalised. For example, construction service providers (CSPs), long limited to only a handful of potential projects, remain tiny players within the technically open market.[54] With only four possible types of project open to foreign CSPs, it is not surprising that their market share is less than two per cent. Members of the European Chamber's Construction Working Group report that the only option they have is to play a 'consulting' role in which they do the work for a domestic CSP and receive only part of the revenue and limited recognition.

One of the main findings of the European Chamber's January 2020 report *The Road Less Travelled* is that China's procurement model is being exported via the Belt and Road Initiative (BRI).[55] BRI-related projects rarely have open procurement and tendering processes. The scant few European companies that have so far managed to become involved have almost exclusively been pulled in by an established Chinese business partner, the Chinese Government or the government of the country in which the project is being developed.[56] In the projects where this happens, European companies are, again, generally brought in to provide a certain technology, or because of their deep experience working in either the recipient countries, China or both. This sees them only playing a facilitating role.

China's splendid isolation?

Direct and indirect market access barriers aside, certain recent events have led to a growing sense that the restrictions China places on foreign companies may have a more unfavourable objective beyond just protecting its domestic companies. The European Chamber has noted a sharp increase in rhetoric and behaviour, at both government and societal levels, that has raised the question, "China seems to want our investment, our technology and our brands, but does it want us?"

Since 28th March 2020, due to the COVID-19 pandemic, China has imposed heavy travel restrictions on foreign residents stranded outside of the country.[57] These remain in place at the time of writing. This situation resulted in a huge number of European Chamber member companies being left without key personnel.

A member survey, conducted by the European Chamber's Shanghai Chapter in July 2020,[58] illustrates just how damaging this has been for business (percentages rounded up or down):

53 *Why China's Public Procurement is an EU Issue*, European Parliament, December 2016, viewed 20th July 2020, <https://www.europarl.europa.eu/RegData/etudes/ATAG/2016/593571/EPRS_ATA(2016)593571_EN.pdf>

54 *Regulations on the Administration of Foreign-Invested Construction Enterprises*, MOFCOM, 17th January 2003, viewed 18th May 2020, <http://www.mofcom.gov.cn/article/bh/200301/20030100064300.shtml>

55 *The Road Less Travelled: European Involvement in China's Belt and Road Initiative*, European Union Chamber of Commerce in China, 2020, <https://www.europeanchamber.com.cn/en/publications-belt-and-road-initiative>

56 Ibid.

57 Zhang, Zoey, *China's Travel Restrictions due to COVID-19: An Explainer, China Briefing*, 12th August 2020, viewed 12th August 2020, <https://www.china-briefing.com/news/chinas-travel-restrictions-due-to-covid-19-an-explainer/>

58 *Shanghai Business Environment Survey - Summer 2020*, European Union Chamber of Commerce in China, 6th August 2020, <https://www.europeanchamber.com.cn/en/publications-archive/823/Shanghai_Business_Environment_Survey_Summer_2020>

- 34% of companies reported that none of their foreign staff had been able to return.
- 22% of companies reported that some but not all of their foreign staff had already returned.
- 17% of companies reported that all of their foreign staff had successfully returned.
- 26% did not have staff that needed to return.

The costs of this missing talent during the intervening months have already been considerable, and continue to accumulate. According to the Shanghai Chapter survey, as of July 2020:

- 40% of companies report that sales have been negatively impacted;
- 30% of companies forecast drops in revenue;
- 29% of companies report a negative impact on research and development (R&D) and innovation;
- 18% of companies have seen staff reassigned to other markets as a result of their being unable to return; and
- 14% of companies report having to cut costs through headcount reduction to compensate for lost business.

While some companies have been able to maximise their operations through the use of digital solutions, even they have suffered from lost efficiency due to time zone differences, technological limitations and uncertainty that is becoming unbearable for some.

However, many of the foreign experts barred from re-entry have not been able to work at all, such as engineers and technicians that need to be physically present. Maintaining certain operations demands an extremely advanced skill set that would normally be provided by bringing experts into China on a rotational basis. The Shanghai Chapter survey again indicates the damage that this has already caused, with 16 per cent of companies reporting that production has been negatively affected, and another 16 per cent reporting that operational safety has been compromised due to the absence of key foreign personnel.

While the various impacts on business have been significant, they are not experienced uniformly by all companies. Large multinationals may suffer efficiency losses or a portion of their operations being down, which could mean the difference between turning a profit or bearing a loss. At the opposite end of the spectrum, SMEs tend to be more reliant on a foreign chief representative, or one or two foreign experts, that are central to their business. Their long-term absence is less a matter of profitability, and more the actual survival of the company.

The travel restrictions have had knock-on effects that threaten the long-term viability of living in China for many. At the time of writing, many international schools are missing the bulk of their teachers, and fear that these staff members will not be allowed to return in the foreseeable future. The Association of China and Mongolia International Schools surveyed international schools across China, and found that in their 10 Beijing schools alone, 769 teachers were still stuck abroad along with their dependents.[59] Online teaching, especially while teachers and students are spread across drastically different time zones, is not a sustainable option. International schools all across China are dealing with these same challenges.

As the new school year rapidly approaches, foreign residents with children are having to seriously contemplate their futures. There are also a large number of foreign nationals resident in China that sent their families out of the country during the height of the outbreak. Three months on, these divided families continue to wait for border opening that will allow their reunion.[60]

59 This data was shared by the Association of China and Mongolia International Schools, but was not made publicly available at the time of publication.

60 Roxburgh, Helen, *China's Foreigner Ban Leaves Businesses in Limbo, Asia Times*, 14th June 2020, viewed 20th July 2020, <https://asiatimes.com/2020/06/chinas-foreigner-ban-leaves-businesses-in-limbo/>

Return flights in disarray

In early June 2020, China and Germany secured an agreement to create a 'fast-track' entry channel to facilitate charter flights and tests to allow the most 'essential' foreign experts to return to China.[61] While several flights have since landed, the procedures for each flight underwent changes on a seemingly daily basis. A large number were ultimately cancelled, either due to drastic changes in procedures that could not be met within a short timeframe, or because planned flights could not be filled due to the slow processing of visas. Implementing uniform procedures for returning foreign residents and their families is urgently needed.

The lack of reciprocity in the movement of foreign legal residents between China and the EU has not gone unnoticed by the European business community. While non-essential travel was reasonably shut down on both sides of the 'border', nearly all EU Member States still allowed for essential business travel and the return of legal residents.[62]

Silence at best, denial at worst

Found in every society, xenophobia unfortunately reared its ugly head during the COVID-19 crisis, at a time when a coming together of global communities was most needed. Across Europe, despicable language was directed at Chinese nationals, ethnic Chinese and Asians more broadly.[63] Within China, foreign residents were barred entry to restaurants, cafes and bars, and even their own homes. Black foreigners in particular faced vitriol across China, but nowhere worse than in Guangzhou.[64]

While members of Europe's less palatable political persuasions instigated much of the xenophobic behaviour in the region, they were far outweighed by the voices of its political, social and economic leaders rightly condemning these actions.

This stood in stark contrast to the response from the Chinese Government to incidences within its own borders. At best, the government simply remained silent on the matter while long-time foreign residents were continuing to face mistreatment. At worst, official spokespeople outright denied that any discrimination existed, even as it was being widely covered.[65] The failure to adequately deal with this situation has added to fears that such xenophobic behaviour, which causes people to feel extremely unwelcome to the extent that they may leave, is not considered to be a problem at the highest levels.

The future of foreign nationals in China

In recent years, the number of foreign companies has surpassed the number of foreign workers in China, which still sits at under one million in total, or about 0.07 per cent of the population of the country.[66] By

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61 *China to Set up Fast Track for Foreign Business Personnel: Official, Global Times*, 14th May 2020, viewed 21st July 2020, <https://www.globaltimes.cn/content/1188417.shtml>

62 *Council Agrees to Start Lifting Travel Restrictions for Residents of Some Third Countries,* Council of the EU, 30th June 2020, viewed 21st July 2020, <https://www.consilium.europa.eu/en/press/press-releases/2020/06/30/council-agrees-to-start-lifting-travel-restrictions-for-residents-of-some-third-countries/>

63 Stolton, Samuel, COVID-19 Crisis Triggers Racism Against Asians, Rights Agency Says, Euractiv, 8th April 2020, viewed 20th July 2020, <https://www.euractiv.com/section/global-europe/news/covid-19-crisis-triggers-eu-racism-against-asians-rights-agency-says/>

64 Marsh, Jenni, Deng, Shawn & Gan Nectar, *Africans in Guangzhou are on the Edge, After Many are Left Homeless Amid Rising Xenophobia as China Fights a Second Wave Of Coronavirus, CNN,* 13th April 2020, viewed 20th July 2020, <https://edition.cnn.com/2020/04/10/china/africans-guangzhou-china-coronavirus-hnk-intl/index.html>

65 Leng, Shumei and Chen Qingqing, *'No Discrimination' Against Africans Amid Pandemic, Global Times*, 14th April 2020, viewed 20th July 2020, <https://www.globaltimes.cn/content/1185521.shtml>; *No Discrimination Against Foreigners: China Daily Editorial, China Daily*, 8th April 2020, viewed 20th July 2020, <https://www.chinadaily.com.cn/a/202004/08/WS5e8dd64aa310e232631a4cbf.html>

66 Xing, Yi, *Shanghai Home to Largest Foreign Worker Population in China, China Daily*, 16th January 2019, viewed 20th July 2020, <http://www.chinadaily.com.cn/a/201901/16/WS5c3ed0a9a3106c65c34e4d2a.html>

comparison, Japan has 1.66 million foreign workers, just over 1.3 per cent of its total population,[67] while South Korea has 884,000 foreign workers (just under the total number in China), around 1.7 per cent of its total population.[68]

Even Shanghai, Mainland China's 'international city', holds just over 200,000 foreign workers, a quarter of the country's total, which is well under one per cent of the city's 24 million residents.[69]

European Chamber member companies report that some foreign nationals stuck outside of China have simply given up and are now seeking opportunities back home, or, as mentioned, are being reassigned by their companies to other markets. Those that are currently here cannot discount the possibility that they may end up indefinitely displaced if they travel abroad in the future and the Chinese Government again implements similar restrictions with a mere 24-hours' notice. These are all considerations seriously impacting the plans of foreign nationals that may be looking to settle down in China, as well as those deciding whether or not to remain here after years of calling the country home. This is doubly true for foreign residents with spouses and children that have already faced months of separation from their families throughout the first half of 2020. More specifically, this means that senior and more experienced foreign talent will be far less likely to come and settle, leaving China with a much shallower pool from which to draw.

Is China moving in the right direction?

While the development path that China selected in the '80s, '90s and especially the early 2000s consistently drove optimism in the European business community, the direction things have gone in recent years has produced mixed feelings. Asked if China is moving in the right or wrong direction economically speaking, one panellist at a recent European Chamber event succinctly nailed overall sentiment with the answer, "Both."

Rhetorically? Things couldn't be better

On paper it appears that China is opening up its economy and moving in the right direction. In recent years, the Chinese Government has continuously reiterated this narrative. The ambitious statements in President Xi's first Davos address in 2017, offered hope for a brighter future when he said that "pursuing protectionism is like locking oneself in a dark room", and that no one would emerge as a winner from a potential trade war.[70] The plans for increased opening up of the economy to foreign investment seemed apparent.

These plans were formalised through the State Council's *Notice on Several Measures on Promoting Further Openness and Active Utilisation of Foreign Investment* (*State Council Document No. 5* or *Guofa [2017] No. 5*),[71] released in January 2017, and the *Several Measures for Promoting Foreign Investment*

67 *Record 1.6 Million Foreign Workers in Japan in 2019*, *Nippon.com,* 30th March 2020, viewed 20th <https://www.nippon.com/en/japan-data/h00676/record-1-66-million-foreign-workers-in-japan-in-2019.html>

68 *Expats Working in S. Korea Up Nearly 30% in 6 Years*, KBS World Radio, 19th January 2019, viewed 20th July 2020, <http://world.kbs.co.kr/service/news_view.htm?lang=e&Seq_Code=142394>

69 Xing, Yi, *Shanghai Home to Largest Foreign Worker Population in China*, *China Daily*, 16th January 2019, viewed 20th July 2020 <http://www.chinadaily.com.cn/a/201901/16/WS5c3ed0a9a3106c65c34e4d2a.html>

70 Full text of Xi Jinping keynote at the World Economic Forum, *CGTN*, 17th January 2017, viewed 8th July 2020, <https://america.cgtn.com/2017/01/17/full-text-of-xi-jinping-keynote-at-the-world-economic-forum>

71 *Notice on Several Measures on Promoting Further Openness and Active Utilisation of Foreign Investment*, State Council, 17th January 2017, viewed 8th July 2020, <http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm>

Growth (*State Council Document No. 39* or *Guofa [2017] No. 39*),[72] released in August 2017. An additional positive shift in China's management of foreign investment was expected with the 2019 adoption of the Foreign Investment Law (FIL),[73] which came into effect on 1st January 2020. All of these had the intention of streamlining existing regulations for foreign businesses and stimulating foreign investment.

In reality, the results have lagged far behind the promises. As recognised in the European Chamber's 2018 report *18 Months Since Davos*, which analysed China's reform progress in the 18 months that followed President Xi's 2017 Davos address, there was some indication that the pace of reform had increased. However, the actual reforms resulting from the two State Council documents were found to be "still insufficient and incomplete". Although the report identified some small market openings that had taken place, as well as improvements in the R&D environment and more stringent enforcement of environmental regulations, it also found serious issues remaining in China's economy, including state-owned enterprise (SOE) domination, unfair technology transfers and a burdensome regulatory environment, among others.[74] These conclusions are still accurate more than two years since this report was published.

A recent World Bank study pinpoints a combination of macro-economic forces and policy choices that have limited China's development and resulted in untapped potential.[75] In the late '90s and early 2000s, China's productivity in diverse sectors was a major contributor to double-digit economic growth. However, the choice not to reallocate resources from sectors with traditionally low productivity, such as agriculture, towards more productive industries and services—as well as from inefficient SOEs to private firms—has resulted in a steady drop in productivity since 2007.[76]

Even though weaker growth was undoubtedly exacerbated by the 2009 financial crisis, the World Bank study highlights the fact that SOEs still lagging far behind private enterprises in terms of efficiency has also played a role in this.[77] While China's growth potential still remains, its per capita income and productivity are far below advanced economies. In order to close this gap, China will need to allocate more resources to the private sector, invest more in human capital, and upgrade industrial processes and management practices.

One economy, two systems

China's failure to efficiently reallocate resources was highlighted by the European Chamber in its BCS 2020, which found that China is decisively moving towards a 'one economy, two systems' model.[78] On one side, certain industries are being opened up to foreign investment, albeit at a slow pace with sometimes few genuine opportunities resulting. On the other side, industries remain open only to SOEs, which are protected from any form of competition.

72 *Several Measures for Promoting Foreign Investment Growth*, State Council, 16th August 2017, viewed 8th July 2020, <http://www.gov.cn/zhengce/content/2017-08/16/content_5218057.htm>

73 *China Welcomes Foreign Investors with New Foreign Investment Law*, PwC, February 2020, viewed 20th July 2020, <https://www.pwccn.com/en/services/tax/publications/china-foreign-investment-law-feb2020.html>

74 *18 Months Since Davos: How China's Vision Became a Reform Imperative*, European Union Chamber of Commerce in China, June 2018, <https://www.europeanchamber.com.cn/cms/page/en/publications-18-months-since-davos/300#download-table-300>

75 Brandt, L. et al, *China's Productivity Slowdown and Future Growth Potential*, World Bank, Policy Research Working Paper 9298, June 2020, viewed 8th July 2020, <http://documents1.worldbank.org/curated/en/839401593007627879/pdf/Chinas-Productivity-Slowdown-and-Future-Growth-Potential.pdf>

76 Ibid.

77 Ibid.

78 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.europeanchamber.com.cn/en/publications-business-confidence-survey>

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SOE reform with Chinese characteristics

SOE reform has been on the Chinese Government's agenda for quite some time, but in recent years there appears to have been a change in the way 'reform' is now being defined. In the time of Deng Xiaoping and Jiang Zemin, reform stood for a kind of privatisation, with SOEs being broken up into smaller organisations in order to make them more efficient and responsive to market forces.[79] In the current era, the rationale for reform has undergone a complete reversal, with SOEs now being pushed to become "stronger, bigger and better" through mergers.[80] As a result, China's vibrant and productive private sector has been sidelined in many important parts of the economy, and is being starved of much needed support, with the majority of financing going to SOEs.[81]

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China's SOEs have been further empowered through industrial policy, as outlined in the European Chamber's 2017 report *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces*. SOEs have been given the role of leading the 10 industries that the Chinese Government has identified as driving China's development over the next several decades.[82]

With no serious competition allowed into certain areas of the economy, some SOEs are well on the way to monopolising their respective industries. The breadth of their presence in the economy is reinforced by data from the European Chamber's annual *Business Confidence Survey*. In 2019, 70 per cent of survey respondents stated that SOEs were present in their sectors, with financial services reporting that SOEs held over 50 per cent of the market share.

Furthermore, European companies report in the BCS 2020 that SOEs still hold the advantage in almost all areas of doing business, including access to financing, licences and public procurement, and the ability to influence policy. These issues have worsened over the last few years, with 48 per cent of European Chamber members expecting that the state-owned sector will continue to gain opportunities at the expense of the private sector, a seven percentage-point increase compared to 2019.[83]

Distortions go global

The influence of China's SOEs is not limited to the domestic market. Many have grown to become international powerhouses. The 97 SOEs under the direct control of SASAC have enjoyed largely uncontested access to China's market, allowing them to singularly benefit from growth, scale and domestic innovation in their respective sectors. They are also propped up by extensive state support through subsidies, cheap financing from state-run banks, and preferential access to factors of production like land and capital. This has resulted in massive companies at a scale that could never be reached under Europe's regulatory framework, which has weeded out such monopolistic forces and prevented their return through its competition law. Considerable friction is then created when these SOEs go out to compete with European firms in third markets around the world.

This dynamic can be seen playing out under the BRI, which is being used as a mechanism to 'export'

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79 *18 Months Since Davos: How China's Vision Became a Reform Imperative*, European Union Chamber of Commerce in China, 2018, <https://www.europeanchamber.com.cn/en/publications-18-months-since-davos>

80 *Xi Calls for Furthering SOE Reform*, *Xinhua,* 18th October 2017, viewed 8th July 2020, <http://www.xinhuanet.com//english/2017-10/18/c_136688444.htm>

81 Mitchell, Tom, Liu Xinning & Wildau, Gabriel, *China Private Sector Struggles for Funding as Growth Slows, Financial Times*, 21st January 2019, viewed 21st July 2017, <https://www.ft.com/content/56771148-1d1c-11e9-b126-46fc3ad87c65>

82 *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces*, European Union Chamber of Commerce in China, 7th March 2017, <https://www.europeanchamber.com.cn/en/china-manufacturing-2025>

83 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <ttps://www.europeanchamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

SOEs, among other things. Procurement bids for projects under Beijing's flagship programme are primarily awarded to Chinese SOEs. European companies report seeing a kind of 'vertical integration' of these SOEs, whereby bids are put together that see Chinese companies providing everything from financing, project management and post-completion services at a cost that private companies simply cannot compete with. For many countries that are recipients of BRI projects, this kind of consolidated solution, combined with comparatively very low costs, is irresistible.[84] In this way, Chinese SOEs have been able to secure a strong foothold in third markets. As a result, with China keeping many sectors of its own economy restricted to foreign investment, increasing numbers of Chinese SOEs are able to provide products and services to the entire global market, while foreign companies can service all but China.

'Competitive neutrality' must prevail

The initial stagnation of SOE reform, and the subsequent reinforcement of the state-owned sector, spells disaster for innovation and competition in the market place, and for private enterprises in general if this trend continues.

'Competitive neutrality'—the principle that the government should provide equal treatment to all enterprises, regardless of ownership structure or nationality—was the main theme of the European Chamber's *Executive Position Paper 2019/2020*.[85] The paper details how implementing competitive neutrality, and the SOE reforms that would be required to achieve it, is of paramount importance for tapping into China's entrepreneurial and innovation potential.

Some hope can be taken from the fact that former and current People's Bank of China governors Zhou Xiaochuan and Yi Gang both spoke about the need to move towards competitive neutrality.[86&87] Yi Gang even went as far as to say that China should consider applying the principle of competitive neutrality to SOEs as part of a solution to "solve the structural problems in the Chinese economy".

However, there is not a unified position within China with respect to SOE reform. For example, Peng Huagang, deputy secretary general of SASAC, has asserted that China's SOEs already "engage in fair market competition against other enterprises", and therefore should not be discriminated against "in the formation of international rules".[88] He has advanced the narrative that Chinese SOEs are being treated unfairly overseas *simply because they are state-owned* and that this goes against the spirit of competitive neutrality, which is supposed to see all companies treated equally regardless of ownership type. Mr Peng has also stated that SOEs' investments in other markets are politically neutral.[89]

The consolidation of Party and state in China, as well as calls for the CCP's influence to be further

84 *The Road Less Travelled: European Involvement in China's Belt and Road Initiative*, European Union Chamber of Commerce in China, 16th January 2020, viewed 20th July 2020, <https://www.europeanchamber.com.cn/en/publications-belt-and-road-initiative>

85 *European Business in China: Executive Position Paper 2019/2020*, European Union Chamber of Commerce in China, 24th September 2019, <https://www.europeanchamber.com.cn/en/publications-archive/757/Executive_Position_Paper_2019_2020>

86 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>

87 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/>

88 *Let China's State-owned Enterprises Become Independent Market Actors: SASAC, China Banking News*, 2018, viewed 22nd July 2020, <http://www.chinabankingnews.com/2018/10/16/let-chinas-state-owned-enterprises-become-independent-market-actors-sasac/>

89 Chu, Daye, *SOEs Face Unfair 'Bias, Roadblocks' Overseas, Global Times*, 15th November 2018, viewed 22nd July 2020, <http://www.globaltimes.cn/content/1123082.shtml>

strengthened in all areas of society and the economy, have been well documented.[90,91&92] With many SOEs having already changed their articles of association to allow the CCP a more influential role at board level, and even private enterprises being pressured to do the same,[93] the assertion that SOEs are 'politically neutral' at all, let alone in terms of just overseas investments, is highly questionable. China's national intelligence law of 2017, which states that "any organisation and citizen" must support and cooperate in "national intelligence work"[94] makes this an even more difficult premise to swallow.

Until the debate is settled, and true competitive neutrality comes into practice, China's SOE-dominated sectors will remain yet another major barrier to meaningful market opening and sustainable development.

Policy miscalculations

There are a host of other factors limiting market potential and preventing meaningful opening in China. Political and economic miscalculations—as well as the increased incidences of aggressive diplomacy and a tendency to define its own forms of multilateral engagement—has seen China's international image slowly deteriorate. At the same time, a failure to establish transparent, effective and impartial institutions and a loss of talent from within its bureaucracy raises questions over China's actual capacity to implement the changes needed to establish a fair, open and competitive business environment.

Sustainable development requires sound institutions

When businesses are looking to make long-term investments, they require the high degree of certainty that solid institutions provide. If a country fails to create a sound institutional and economic framework, it will struggle to sustain its development. The resulting lack of transparency, consistency and predictability in legal and administrative processes erodes trust and can ultimately cause long-term damage to economies.[95]

China's opening up measures have in some cases been highly promising. The removal of certain industries from the negative list has, in theory, paved the way for investments in previously off-limits sectors of the economy. However, as detailed earlier in this report, a host of indirect barriers prevent many companies from actually being able to fully contribute to China's development.

This approach to managing foreign investment provides no real transparency or legal certainty, and therefore makes China's market less attractive, particularly in the current climate in which companies are becoming more and more risk averse. Increasing predictability—by creating reliable mechanisms for granting licences and approvals based on transparent and measurable factors—would not only boost business confidence, it would also raise the credibility of China's government.

The need for institution-building is recognised by many in China. For example, it was a central

90 Mitchell, Tom, *Xi's China: The Rise of Party Politics, Financial Times*, 25th July 2016, viewed 22nd July 2020, <https://www.ft.com/content/57371736-4b69-11e6-88c5-db83e98a590a>

91 Trofimov, Yaroslav, *Has Xi Jinping Stirred a Backlash?, The Wall Street Journal*, 16th August 2019, viewed 22nd July 2020, <https://www.wsj.com/articles/has-xi-jinping-stirred-a-backlash-11565968019>

92 Tiezzi, Shannon, *Xi Jinping Continues His Quest for Absolute Party Control, The Diplomat*, 10th July 2019, viewed 22nd July 2020, <https://thediplomat.com/2019/07/xi-jinping-continues-his-quest-for-absolute-party-control/>

93 Stevenson, Alexandra, *China's Communists Rewrite the Rules for Foreign Businesses, The New York Times*, 13th April 2018, viewed 22nd July 2020, <https://www.nytimes.com/2018/04/13/business/china-communist-party-foreign-businesses.html>

94 McGregor, Richard, *How the West Got Xi Jinping Wrong on Business, Financial Review*, 11th June 2019, viewed 22nd July 2020, <https://www.afr.com/world/asia/how-the-west-got-xi-jinping-wrong-on-business-20190709-p525n0>

95 Drzeniek-Hanouz, Margareta, *Why Institutions Matter for Economic Growth*, World Economic Forum, 2nd January 2015, viewed 18th July 2020, <https://www.weforum.org/agenda/2015/01/why-institutions-matter-for-economic-growth/>

recommendation in *China 2030: Building a Modern, Harmonious, and Creative Society*, a report jointly produced by the Development Research Council and the World Bank.[96] Chinese and international experts agreed that without strong institutions, China's development will sputter just at the time it needs additional forward momentum to escape the middle-income trap.

Efficient institutions require competent officials

The European business community has noted a steady decrease of talented government officials in China in recent years, particularly in economic bodies. Tang Yalin, a professor of public administration at Fudan University describes how, "[the] current wave of [leaving] officials is unique[…]the average age of those leaving is higher, and many have specialised skills or experience in fields like technology, finance and policymaking."[97] This loss of seasoned talent is not good for continuity or policy-making/implementation, as has been seen in a number of areas over the past few years.

One stand-out example of how a lack of government capacity resulted in a sub-optimal outcome is when Beijing made reducing pollution a seemingly at-all-costs priority, by rushing out a policy to eliminate widespread industrial and domestic use of coal in order to meet 2017 air quality targets. Households and industries were forced to rapidly switch from coal to natural gas. This resulted in a natural gas shortage that left many citizens with no heat source during extremely cold weather conditions, as their coal-fired burners had already been dismantled. Local governments were then forced to divert natural gas from industrial and commercial users to those affected, which crippled many industries in early 2018.[98&99] This shows how well-intended policies can cause major upheaval due to poor choices within local bureaucracies. According to one report, an unnamed official from the National Development and Reform Commission said part of the problem is that local officials display a "sheep-flock" mentality, and tend to focus on individual targets without considering the wider implications.[100] Meanwhile, many officials still argued that there had been nothing wrong with the policy, as the objective of achieving cleaner skies and better air quality had been reached.

Another example of how poor policy implementation resulted in economic shocks is when the Chinese Government in 2019 ordered the implementation of new, tighter emission standards to reduce pollution produced by cars, through the 'China-VI' rules. This was done at such a fast pace that car dealerships were unable to clear their vast inventories of vehicles that were not compliant with the new emission rules.[101] As a result, car sales plunged 16 per cent year-on-year in May 2019, even though dealers slashed their prices by more than 30 per cent.[102]

The chemical plant explosion in Yancheng, Jiangsu Province, in March 2019, serves as further example of how a lack of capacity among local officials—in this case the inability to successfully enforce policies—can lead to devastating outcomes. In recent years, European Chamber members in the chemical industry have noted a dramatic increase in the inspection rate of their facilities, while the same has not been

96 *China 2030: Building a Modern, Harmonious, and Creative Society*, World Bank, 2013, viewed 20th July 2020, <https://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf>

97 Tang, Yalin, *Why China's Bureaucrats are Plunging into the Private Sector, Sixth Tone*, 29th December 2018, viewed 21st July, 2020, <https://www.sixthtone.com/news/1003383/why-chinas-bureaucrats-are-plunging-into-the-private-sector>

98 Ng, Eric, *China Pollution Fight Will Lead to Record Year for Natural Gas Demand, but not Terrible Shortages and Price Spikes, Experts Say, South China Morning Post*, 26th November 2018, viewed 8th July 2020, <https://www.scmp.com/business/article/2174904/china-pollution-fight-will-lead-record-year-natural-gas-demand-not-terrible>

99 Jing, Li, *What Caused China's Squeeze on Natural Gas?, The Diplomat*, 1st January 2018, viewed 18th July 2019, <https://thediplomat.com/2017/12/what-caused-chinas-squeeze-on-natural-gas/>

100 Ibid.

101 Huang, Echo, *China Paralyzed its Auto Market by Fast-tracking Stricter Car Pollution Rules, Quartz*, 4th July 2019, viewed 8th July 2020, <https://qz.com/1657862/chinas-new-emission-standard-has-paralyzed-the-auto-market/>

102 Sun, Yilei and Shirouzy, Norihiko, *Behind the plunge in China auto sales, Reuters,* 2nd July 2019, viewed 8th July 2020, <https://www.reuters.com/article/us-china-autos-insight/behind-the-plunge-in-china-auto-sales-chaotic-implementation-of-new-emission-rules-idUSKCN1TW388>

observed at Chinese chemical plants. The March 2019 explosion was a result of the plant neglecting to follow rules regarding product safety.[103] The fact that this was still possible after the government inspection campaign that started after the devastating Tianjin chemical plant explosion in 2015, when close to 40 per cent of the factories in China were forced to shut at some point and many officials were investigated, clearly demonstrates that there is much room for improvement in regulatory enforcement.[104]

Rapid shifts in priorities can also be to the detriment of good policy. Following the fall-out from the Yancheng explosion, radical initial proposals were introduced by provincial authorities to arbitrarily slash the number of chemical plants in the region, regardless of their safety records.[105] The speed and severity of the shift was such that a member of the European Chamber's Nanjing Chapter described the plans as "economic suicide". Only after intervention from Chinese and foreign business associations did the region pull back from the precipice and find a workable solution.

These examples underline the value of not only establishing sound institutions, but also working with the whole business community to form policy that is both effective and implementable.

EU must prioritise existing multilateral platforms

It is important that the EU continues to work together with China to follow through on pledges to reform the WTO. This is particularly salient given current trends: China has been increasingly engaging with the rest of the world through its own mechanisms, while the continued deterioration of US-China relations is sucking so much oxygen out of the room that there is a real danger efforts to reform the WTO may be abandoned altogether.

One example of China's homegrown form of engagement is its preference for its '17+1' initiative, instead of using the already well-established European Union and its various dialogues with neighbouring non-member states to reach the same audience.[106] With Europe having long upheld a 'One-China policy', it raises the question: why does China not reciprocate and implement a 'One-Europe policy'?

As already alluded to, the BRI provides another example of how China is forging its own ways to engage with the world outside of established global norms. While many third countries previously had to rely on existing multilateral organisations to fund major infrastructure projects, through the BRI China has created the circumstances that see it freely investing in these countries' strategic infrastructure, under conditions that, on the face of things, appear favourable. At the same time, the BRI is functioning as a platform to steadily introduce 'Chinese standards' outside of China, at the expense of globally-approved ones. According to the US-China Economic and Security Review Commission's *2018 Report to Congress,* "Chinese companies are seeking to define and export standards for a broad set of technological applications, which, taken together, could alter the global competitive landscape."[107]

103 *Cause of Deadly Chemical Plant Blast in East China Revealed, Xinhua*, 15th November 2019, viewed 8th July 2019, <http://www.xinhuanet.com/english/2019-11/15/c_138558301.htm>

104 *Navigating the Aftermath of the Jiangsu Chemical Plant Explosion, China Business Review*, 16th July 2019, viewed 8th July 2020, <https://www.chinabusinessreview.com/navigating-the-aftermath-of-the-jiangsu-chemical-plant-explosion-four-months-on/>

105 Wang, Cong, *Chinese Chemical Firms Face Regulation, Global Times*, 8th April 2019, viewed 21st July 2020, <http://www.globaltimes.cn/content/1145075.shtml>

106 The '17+1' is an initiative set up by the Chinese Ministry of Foreign Affairs to serve as a platform for diplomacy, exchange and trade and investment between China and 17 countries from Central and Eastern Europe – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, North Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia.

107 *2018 Report to Congress*, US-China Economic and Security Review Commission, November 2018, p. 269, viewed 18th July 2020, <https://www.uscc.gov/sites/default/files/2019-09/2018%20Annual%20Report%20to%20Congress.pdf>

EU poised to further protect against market distortions

The continued lack of significant and meaningful opening of China's market has increased calls within the EU for China to offer reciprocal access.[108] Europe must maintain its open market, but it can no longer afford to continue with a naïve approach in its dealings with Beijing.[109] Instead, the EU looks set to develop and deploy stronger mechanisms—including the investment screening mechanism and the International Procurement Instrument—to protect its market from non-market distortions, such as investments made with state-backed capital.[110]

The unfortunate conclusion is that former US President Bill Clinton may have been wrong when he asserted in 2000 that China would "import one of democracy's most cherished values: economic freedom."[111] Instead, it is looking more likely, at least for the time being, that Western liberal markets will need to become more like China's in order to protect themselves from the more pernicious aspects of China's economy.

European business as a transition catalyst

European companies are ready to deepen their positions in China if given the right opportunities. Ongoing investment into China from Europe's top companies means more than just numbers on a ledger. The new factories and plants currently being built by European companies are on the cutting edge, and will be among the most modern facilities in the world, integrating emerging technology, like artificial intelligence, 5G and cloud, to create operations that will set new standards. They will provide well-paid jobs that teach new skills to China's growing pool of skilled workers, laying the foundation for further industrial upgrading in China through the high-quality inputs they provide and by raising the expectations of Chinese consumers.

Complementary tech strengths

The current US administration's efforts to force decoupling from China could have a serious impact on what technology is allowed to be sold to China. Washington's push to impose export controls on American semiconductors to key Chinese companies has already revealed the potential economic damage that could be caused in areas where China is far behind, as well as the increased harm this would have on the US-China relationship.[112] Similarly, a US-China financial war could seriously impact China's best companies that are reliant on the USD, since China's tight control over its monetary system has left the *renminbi* with only a tiny share of global transactions.[113]

However, in areas where China is comparatively strong, efforts to decouple or cut-off access to American technology are likely to have a more muted impact. In some areas of technology, Chinese firms have already surpassed their American competitors. The same is true for China's internet companies, many of which are world leaders. Coupled with a robust venture capital culture, China can endure and even thrive

108 *Several Outlets – Trust and Reciprocity: The Necessary Ingredients for EU-China Cooperation*, European Union External Action Service, 15th May 2020, viewed 20th July 2020, <https://eeas.europa.eu/headquarters/headquarters-homepage/79355/trust-and-reciprocity-necessary-ingredients-eu-china-cooperation-high-representative-eu_en>

109 Blenkinsop, Philip & Emmott Robin, *EU Leaders Call for End to 'Naivety' in Relations With China, Reuters*, 22nd March 2019, viewed 18th July 2020, <https://www.reuters.com/article/us-eu-china/eu-leaders-call-for-end-to-naivety-in-relations-with-china-idUSKCN1R31H3>

110 Brattberg, Erik & Le Corre, Philippe, *The EU and China in 2020: More Competition Ahead*, Carnegie Endowment for International Peace, 19th February 2020, viewed 20th July 2020, <https://carnegieendowment.org/2020/02/19/eu-and-china-in-2020-more-competition-ahead-pub-81096>

111 Full Text of Clinton's Speech on China Trade Bill, Institute for Agriculture and Trade Policy, 9th March 2000, viewed 18th July 2020, <https://www.iatp.org/sites/default/files/Full_Text_of_Clintons_Speech_on_China_Trade_Bi.htm>

112 Whalen, Jeanne, *U.S. Tries to Narrow Loophole That Allowed China's Huawei to Skirt Export Ban, The Washington Post*, 16th May 2020, viewed 20th July 2020, <https://www.washingtonpost.com/business/2020/05/15/us-closes-huawei-loophole/>

113 *The Dangers of a US-China Financial War, Financial Times*, 14th May 2020, viewed 21st July 2020, <https://www.ft.com/content/85bca04a-9529-11ea-abcd-371e24b679ed>

if deprived of American inputs in these areas.

But Chinese companies remain overwhelmingly behind Europe, Japan and the US in industrial technology. To survive decoupling with the US in this area, China would need to bring other partners closer to compensate. This would be crucial for China to boost its productivity sufficiently to escape not only the middle-income trap, but also the demographic cataclysm that could result from its rapidly ageing population.

European and Chinese technological edges are complementary, and they could together endure in a world undergoing deglobalisation. If this is to stand a chance of happening, China must develop sound institutions to create a transparent, consistent and predictable business environment, eliminate regulatory barriers and offer the EU reciprocal access to its market in a timely manner.

Recommendations

For China:

- Complete China's opening agenda by removing direct and indirect barriers that continue to bar European investment in much of the economy.
- Develop sound institutions to provide a truly level playing field between foreign and indigenous investors, and to make administrative processes transparent, consistent and predictable.
- Reverse the current trajectory of SOE reform in China, and embrace competitive neutrality to ensure that all companies operating in China are treated equally, regardless of nationality or ownership structure.
- Create a more competitive and international business environment by reducing the restrictions currently placed on foreign talent.
- Depoliticise the business environment and de-escalate 'wolf warrior' diplomacy.
- Develop a streamlined and consistent process for foreign workers and teachers, as well as their families, to return to China, and increase the number of flights between China and the EU to meet demand.
- Deepen China's involvement with and adherence to the multilateral institutions to which it belongs.
- Engage with the European Chamber to make progress on the more than 800 recommendations found in this *Position Paper*.

For the EU:

- Continue to pursue a strong and robust CAI that puts the investment relationship as close to reciprocity as possible, and refrain from committing to 'Phase One'-style half measures.

- Engage China and other partners in reforming and upgrading the WTO, including through plurilateral agreements.
- Expand on areas of shared bilateral interest with China, especially on issues like climate change, biodiversity, energy and international development (in Africa in particular).
- Strengthen investment screening to better mitigate distortions emanating from both China's state-owned economy and state-directed capital.
- Advance the International Procurement Instrument in a timely manner to either protect European procurement markets from distortions or to leverage China to open its own procurement market to European competition.
- Leverage third-market investment agreements, especially in BRI countries, to ensure that European companies are not disadvantaged by politically-favoured Chinese competitors.
- Remain fundamentally open to private investment and ensure that Chinese private investment can continue to follow market forces into the European economy.
- Build unity within Europe so that the bloc can fully leverage its collective advantage when dealing with other economies.
- Upgrade Europe's economic foundations to maintain competitiveness, including through infrastructure upgrading and market-forces-driven industrial policy.

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