China Is Still Risky for Foreign Businesses—but the Rewards Are Too Great to Ignore

By ChinaFile

A GlaxoSmithKline logo at a company factory at Pudong district in Shanghai (Carlos Barria/Reuters)

Arthur Kroeber:

The environment for foreign companies in China has been getting steadily tougher since 2006, when the nation came to the end of a five-year schedule of market-opening measures it pledged as the price of admission to the World Trade Organization. Soon after the WTO-mandated reforms concluded, foreign firms began to complain of an increase in discriminatory practices, more difficulty in getting licences and approvals, and a generally less friendly attitude from officialdom.

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These problems persist, and pretty much every year brings some high-profile tale of woe from an MNC in the Middle Kingdom: Coca-Cola's thwarted effort to take over local champion Huiyuan Juice in 2009; the arrest of Rio Tinto executive Stern Hu in Shanghai in 2009 in a iron-ore pricing corruption scandal; Google's acrimonious exit from the market in 2010 amid allegations of government hacking; the arrest of several Wal-mart employees over the mislabeling of pork products in 2011; Caterpillar's epic loss of $580 million in 2012 after it acquired a Chinese construction equipment company that had fraudulently inflated its revenues; and this year the burgeoning bribery case involving GlaxoSmithKline. It's easy to get the impression that China is no longer open for business.

But the headlines are deceiving. Data and company surveys both show that China continues to be a magnet for foreign firms. Greenfield foreign direct investment, according to the Ministry of Commerce, has held steady at US$105-115 billion a year since 2010, well above the pre-crisis level. Inflows in June exceeded $14 billion, the highest monthly total since 1997. Broader data from the central bank, which include reinvested earnings, show that foreign companies committed a quarter of a trillion dollars to China in 2012.

Member surveys by foreign chambers of commerce consistently reveal that despite their discontent, foreign companies in China are still quite profitable and generally want to increase their investments. A walk down any Chinese high street will quickly confirm these numbers: foreign brands occupy a far larger and more visible slice of the market in China than in most other Asian countries, including Japan, Korea and India. And big cities are filled with tens of thousands of young foreign entrepreneurs who find it easier to start a new business in China than in their home countries.

How to square the dire headlines with the cheery reality? I think several factors are at work. First, China is "normalizing." In the late 1990s and early 2000s, China was desperate for foreign cash, and rolled out the red carpet for big foreign companies. CEOs of multinationals routinely enjoyed visits with high-level government officials, right up to the Premier. Now China is a cash-rich economy and it doesn't need to flatter foreign egos to keep growing.

Second, the economy is slowing and restructuring, and yesterday's winners are having trouble adjusting. Lots of big foreign firms (such as Caterpillar) profited from China's investment boom, but as the boom fades their prospects do too. Yet Chinese companies face this problem too, and some MNCs may be better placed to weather the downturn than their local competitors, because of superior efficiency and cost control.

Third, the bigger the firm, the bigger the obstacles. Big companies often operate in capital-intensive sectors (like petrochemicals) where government licensing requirements are highest. And because they
are big, their difficulties easily capture headlines. Smaller firms operating successfully in less regulated sectors just don’t grab the media’s eye. Another problem with bigness is that when the government starts a crackdown, it often picks a foreign company as its first target. This may be why Glaxo was singled out amidst the rampant corruption of China’s prescription drugs market.

Finally, there’s no question that China is a bit of a Wild West economy, where sharp dealing and favor-buying reign, and lax regulation is the norm. When foreign firms can exploit these conditions to their benefit, they keep quiet. When they get bitten, they complain. On the whole, though, the evidence shows that foreign companies win quite a bit more than they lose.

David Schlesinger:

"Although China is politically important, it is not a remunerative field for us, and it will be some time before we reap the fruits of our enterprise."

That statement, from the annual report of my old company, Reuters, in December 1900 would not sound out of place in many a boardroom today, well over a century later. Modern day boards would have to add the words "economically important" to the first clause, both to reflect the reality of China’s being the world second largest economy and to underscore the continuing frustrations in trying to realize profit and value from their investments there.

The current onslaught of bad news about China -- much of it real, some of it the pendulum-swing of pundits piling on -- certainly makes China business seem like risky business. A slowing economy, growing social pressures, looming crackdowns or public relations campaigns against foreign companies -- none of these are good signs for companies hoping to swiftly reap the fruits of their labors.

Some executives are scurrying to look for the next best opportunity in Myanmar or the Philippines or Indonesia. But for those who stay, and for their boards, this may be a necessary reset in expectations that actually leads to healthier and more sustainable investments.

China's torrid growth rates led to huge pressures on executives to outperform the economy as a whole. Corporate one-upmanship in a media environment that seemingly celebrated golden successes up every fetid Beijing alleyway led to foolish decisions.

Board impatience for results meant business foundations weren’t laid properly.

Now that China bears are having their day, smart companies will go back and ensure the basics are right. That’s hard, slow, unglamorous work. But it sure beats having your executives jailed, your reputation sullied or your cut-corners exposed.

With growth rates slowing, social pressures rising, crackdowns on shady business practices looming and local media campaigns against targeted companies intensifying, what’s a CEO to do?

First, fix the talent agenda. Too many companies serve their star China hires badly. Training, rotations outside of China, true promotion prospects, fair pay and a shattering of any remaining glass ceilings
will build loyalty, company culture and an ethos that will ensure true successes.

Second, fix the compliance agenda. If there's one clear lesson from the Glaxo Smith Kline debacle it is that ethics and compliance have to be a fundamental part of company culture at every level and at every stage.

Third, fix the government relations agenda. It isn't enough to have the global CEO fly in once a year for a banquet with senior officials. Understanding how the company's agenda fits - or diverges - from the country's priorities is necessary on an ongoing basis. Picking up early signals of discontent or warnings about investigations can head off public relations or judicial disasters.

Fourth, fix the localization agenda. China needs Chinese products. Too many companies still try to force global solutions onto a very local market without making the necessary changes to transform themselves into local companies.

Fifth, fix the acquisition agenda. Ensure that local companies you buy truly add knowledge and understanding of the local market - and that you learn from them and not just run roughshod in an attempt to suck up sales.

Now is the time to fix the foundations before the next swing of the sentiment pendulum again creates unrealistic expectations for growth, unrealistic pressures on executives and indefensible actions by some of those entrusted with the risky business of doing business in China.

**Damien Ma:**

A few quick thoughts, jumping off of Arthur's always sharp comments:

That doing business in China can get political -- Rio Tinto, GSK, WalMart, among others -- is nothing new. It comes with the territory, since MNCs understand well that they are operating in an environment in which the government still plays an outsized role in the economy (To be fair, Chinese entities doing business in the U.S. and other countries can also can get pretty political). The bottom line is that MNCs are not fleeing the China market by any means. Simply ditching the comparative advantages that China offers for Southeast Asia may or may not make strategic sense depending on your business segment.

But the terrain for MNCs in China has surely gotten more complex -- and at times contentious -- but those are relative terms. And most of the changes in the operating environment owe to what Arthur described as China becoming a more "normal" country in which to do business. Normal, of course, being filtered through the detritus of "Chinese characteristics" -- uneven regulatory enforcement, opaque decision-making, relationships, and so on. It is worth reiterating the point that China has transformed rapidly from a capital-starved country to a capital-abundant one, and it has learned the rules of the game at the WTO and can play by them effectively. In combination, these developments make for an attitudinal shift in how China may be approaching foreign MNCs -- if they no longer really need the capital, then what do they need now?

Technology, of course. And herein lies the crux of the tensions and difficulties. No rational company,
Chinese or foreign, wants to give away technologies that will end up creating future competitors. But it appears that China is unwilling to loosen its market restrictions, in many cases, unless it is in exchange for technologies that China thinks will facilitate its own rise to the next stage of development. The desire for foreign technology also is a testament to the fact that China’s indigenous innovation drive has not generated spectacular successes. China doesn’t want to scare away MNCs, but MNCs are increasingly wary of this attitudinal shift on China's part and the actions that have followed.

Few seem to have clear ideas on how to resolve this perplex set of issues.

Steve Dickinson:

In response to the recent legal troubles of GSK, Yum Brands and others in China, the question arises: Has operating in China for foreign companies become excessively risky? Arthur says that what has actually happened is that China has become more normal. It is true that over the past 15 years, China has adopted a formal legal system that at least on its surface resembles that of a developed country and is, in that sense, "normal." The paradox is, this normality has led to greater risk for foreign companies rather than reduced risk. The environment in China in general has not become more risky. However, the risk of violating Chinese law has increased substantially.

In the old days, foreign companies just ignored Chinese law and relied on connections and the rest to operate for maximum profit. These profits were high enough that the time and effort of working in the chaos of China was justified. Over the past 10 years, the system in China has changed dramatically. This is the Wild West to Chinese law and regulation no longer works for foreigners.

This puts foreign companies operating in China in a difficult situation. The fact is that Chinese companies routinely ignore Chinese law. So, foreign companies operating in China are faced with a major decision that carries big risk. They can follow the law and struggle or fail in the Chinese market or they can act like their Chinese competitors and violate the law in order to compete on a level field.

The risk is: as China becomes increasingly stressed by the declining growth of the economy, the government has shown that it will seek foreign scapegoats. Drugs are too expensive: it is the fault of the foreign drug companies. Food is not safe: if is the fault of the foreign fast food companies. Mobile phones are defective: it is the fault of the foreign phone manufacturers. The China Dream has not been realized: the foreigners are holding us back. As a result, taking action against foreign violators of Chinese law is an obvious way for the Chinese government to deflect attention away from the deeper problems in the Chinese economy and society.

As a result, we can expect that the government will move ever more strongly in enforcing the strict requirements of Chinese law on foreign companies operating in China. They will not proceed against the foreign losers (whose numbers are legion). They will proceed against the winners. Success in China attracts attention. With attention comes scrutiny. With that scrutiny comes the risk of prosecution for failure to strictly abide by the requirements of Chinese law. If you fail in China and leave all your money in China, you are safe. But if you succeed, you become the target of attack for failing to comply with the law. But, you cannot succeed without violating the law. It is all a perfect Catch 22.
As far as I can see, this trend of focusing on the failure of the foreigners will continue for many years. It is therefore absolutely required that every company operating in China ask: Can our company operate profitably in China while complying with the strict requirements of the Chinese legal and tax system? In my own experience, very few companies ask this question. For this reason, the vast majority of foreign companies in China are operating in the face of risk that they simply do not understand. This is a mistake. No company can eliminate risk. However, every company must ask: is the reward worth the risk?

Arthur Kroeber:

All excellent points from the other contributors. They underscore that running a successful business on a large scale in China is an incredibly difficult task, and one that carries a set of large political and legal risks that are in fact unique to China. So if there's one word I would want to excise from my original post, it's "normal." China is not a "normal" market, in the sense that the challenges it poses are largely comparable to the challenges one would face in other emerging markets like India, Brazil, South Africa, Turkey, or Korea. The political and regulatory risks are unique, and these come straight from the nature of the Chinese political and governance system, which is unique -- and uniquely hard to deal with.

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