

# Reflections

Volume 4 Edition 1

## Fallout from Reform

Restructuring and Risk

### 10 Business Take-Aways

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- 1** The ambitious reform program approved by the 2014 NPC will bring opportunities to business. But challenges will arise and benefits will only be obtained if companies adapt to the changing market conditions. Agility and risk management are premium attributes for success.
- 2** Business can expect a broadening of the tax base. Strengthening of local interest groups is foreseen. Civil society will be more engaged.
- 3** The benefits of further liberalisation and market access may be tempered by some fragmentation of provincial and local markets.
- 4** There will be growing pressure for restructuring of operations and dealing with rapid reregulation, shifting patterns of risk and compliance.
- 5** Many companies are not configured to cope with the upcoming business landscape. MNCs have ponderous operating processes that impact adversely agility. Domestic companies lack sufficient processes that can travel beyond China for successful overseas investment (ODI).
- 6** Global business units are problematic if there is no countervailing coordination of strategy, compliance and liability.
- 7** Implementing effective governance and compliance systems requires focusing on the demands of Chinese authorities, rather than solely external authorities such as the EU and US.
- 8** Compared to mature markets, there is inadequate resourcing of corporate functions – legal, government relations, communications and compliance – to address adequately such challenges.
- 9** Governments at all levels will be profoundly affected by reform. The shift of roles from directing markets to overseeing market efficiency and regulator will occur over time. Performance objectives based on job creation, financial probity, and quality of life benchmarks will require a change of mind sets.
- 10** The administration's robust anti-corruption campaign is a precursor for reform. This is especially so if more administrative and regulatory authority is delegated to local governments.

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The ambitious reform package being slated for implementation is a policy mix for change management of the economy and the role of government.

A common thread of China's reforms is the increased use of market mechanisms. Ostensibly this should be welcomed by business, especially multinational companies (MNC). However, China is not on a trajectory to evolve towards European or North American-style markets. The changes will put pressure on all market operators, MNCs as well as Chinese companies.

The first section of these Reflections addresses some key features of reform that are considered particularly pertinent. We seek to preview the possible impact within both companies and governments.

Companies are presently configured to optimize their efficacy under the present economic conditions in China. With evolving market

conditions companies will be required to reassess their structures and operating processes. For many this requires changes to obtain the right organizational fit for new conditions.

Reform will also impact the roles and responsibilities of governments. It is a clarion call for attitudinal and structural changes within governments, including how central and local levels interact.



## Economic Reforms



While much has been written about China's reforms in the media, below are six themes that have been less prominent but merit consideration.

### Market Management

Market access and regulation are both increasing as the government changes its role from that of market player and manager towards that of policymaker and regulator. Investment approvals, registration procedures and administrative hurdles are being reduced and/or simplified. Concurrently, environmental regulations and those regarding food, drug and product safety are becoming increasingly stringent and burdensome, with enforcement more punitive. Notably, the Bureaus of Public Security are tasked with regulatory duties in some areas.

### New Urbanization & Consumption

Incremental changes to household registration (*hukou*) and the One Child Policy signal a direction for further easing. The New Urbanisation Plan (2014-2020) calls for clusters of smaller satellite cities to be established around large metropolises. *Hukou* restrictions will persist for very large cities, channelling urbanisation into these small- and medium-sized cities. Policies that extend social safety nets, expand credit, increase wages and collective bargaining will contribute to increased

consumer spending. These should drive growth in healthcare, FMCG, logistics and other services.

### Investment Promotion

The government has a target of US \$1 trillion for Chinese overseas direct investment (ODI) over the next six years. Presently there are bottle necks for getting sufficient companies 'export and investor ready'. The Shanghai pilot

Free Trade Zone (FTZ) and others to be replicated elsewhere across China will be instruments for promoting ODI and the emergence of Chinese MNCs. These FTZs will open up financial services so facilitating the establishment on the mainland of robust regional headquarters for international MNCs.

### Fiscal Reform and Incentives of Officials

Local governments will address revenue shortfalls by expanding the tax base with property, consumption, resources and environmental taxes. Incentives for officials are evolving from growth to job creation, environmental protection, social welfare and financial management. This changes key performance indicators (KPI) and, consequently, officials' expectations of business. Understanding incentive structures is important for anticipating policy directions and optimizing business operations.

### More Efficient Statist System

State-owned enterprises (SOE) will continue to play predominant roles in many sectors, though with emphasis on their being more efficient through market mechanisms and more accountable via increased dividend payments. Efforts to promote markets will also give more space

to private capital and increased latitude for private businesses. It is too early to ascertain whether this will open up these sectors or merely reconfigure existing interest groups. The advent of public-private partnerships is to be welcomed, though their form and substance are yet to be determined.

### Innovation and R&D

Innovation is less prominent than past years as a prime vehicle of economic transformation; previous policies of "indigenous innovation" and "strategic emerging industries" have not been highlighted as strongly. Having achieved rapid growth of R&D funding, policy emphasis has shifted to efficiency reforms, reduction of waste and increased transparency and accountability. Significantly, the establishment of IPR courts is welcome but their direction is yet to be explored.

### Politics of Reform

**Xi Jinping's Leadership.** Xi has consolidated his position among Chinese Communist Party (CCP) factions and proven himself an effective leader thus far. Establishment of the Leading Small Groups on Deepening Reform, on Cyber Security and a National Security Commission is centralizing power over domestic and foreign affairs. Moving forward Xi's political reputation now rests on implementing reform.

**Institutionalizing Change.** Leading groups are cascaded down at provincial and local levels to drive reform and transformation. These are parallel to the State Council and raise questions whether there is a permanent shift of power and influence away from established structures of government. Organisations such as the NDRC are under pressure to assume new roles.

## Restructuring



“Chinese consumers are modernising but not westernising”.  
-Head of Research Asia, P&G

For the last 30 years companies have pursued growth strategies, striving to achieve economies of scale, roll out distribution for geographic coverage and market share. Companies are now undergoing a strategic inflection point. As seen in recent surveys from both the American and European chambers, with slowing growth and profits, priorities are shifting towards better managing existing operations, improving the functionality of JVs, addressing productivity gaps and strengthening regulatory compliance.

### Chasing the Nomadic Consumer

Rapid expansion of Chinese consumers creates fast moving targets. With short product cycles and fluid consumer segmentation, there is leap-frogging of incumbent logistics and distribution models. Online shopping has burgeoned.

Many MNCs are challenged by this pace of change. Despite few restrictions on investment, international retailers, FMCG, mobile phones and electronic devices sectors are facing stiff competitive pressures. Seemingly Chinese competitors are adept at quickly

tailoring products and services with better B2C marketing.

MNCs need to respond accordingly. Estee Lauder has 60% of its sales via e-commerce in tier three and four cities and is meeting the challenge by reconfiguring its business model for China.

The Head of P&G research in Asia summed up the challenge as follows: Chinese consumers are “modernising but not westernising”.

### ...and Manufacturing Churn

Akin to Europe, China has segmented into distinct regions with wide variations of income per capita, wages and costs of doing business. For labour intensive manufacturing, competitiveness has been falling over past years, especially for the Eastern seaboard provinces. Companies dependent on cheap labour and energy can find relief by moving operations outside or to low cost locations within China.

Central, western and south western regions have lower costs and faster growth rates. Moreover, these areas are developing stronger links westward into Central Asia and onto Europe, and southward into

ASEAN.

For the eastern provinces all is not doom. Over the past decade productivity across China has grown in the order of 10 percent, faster than other BRICS. It has been a boom time for companies such as ABB, Rockwell and Honeywell in the automation and process sectors. There are still many years of potential growth ahead when China's productivity is compared to those of the U.S., Japan or even Hong Kong.

### Changing Business Paradigms

Agility, adaptation and sound risk management are premium attributes moving forward.

**Agility.** For MNCs, sticking to tried and tested corporate processes for decision-making of low growth, mature markets has become a competitive disadvantage. The lengths of decision-making, product and project implementation need to be shortened.

**Adaptation.** China cannot be treated as a single market, but as a series of distinct regions and a spectrum of consumer/customer segments. Rather than just selling foreign products, or tacit customization, product and service offerings now require true localization to the needs and expectations of various Chinese customers. This often entails going back to the start of the product or service production cycle including into the R&D phases.

Marketing, sales and distribution often operate through different channels in mature markets. Channels and geographies change over time at a rate that is often disconcerting to Europeans and Americans.



## Reforming Government



Demands for change on government sectors are more fundamental, with a paradigm shift in operating culture. If implemented, it forebodes reforms as profound as those of Premier Zhu Rongji at the turn of this century.

With job creation superseding growth as a primary objective, the Premier announced obligatory disclosure of budgets and financial accounts. Officials will be judged with their key performance indicators (KPI) to include assessments of financial probity and managerial efficiency of fiscal matters. Local governments will operate within the confines of a tighter regulatory framework enforcement of environmental and product standards, a more vibrant and engaged civil society with the need to deliver economic safety nets.

Decentralization to provincial and local governments for administrative approvals

plus fiscal reform will lead to an expansion of the responsibilities of local government and a widening of the tax base. This is introducing complexity, potential messiness and is at first sight more prone to the influence of local interest groups and corruption. For example, healthcare reform has already delegated essential drug lists and reimbursement to local authorities. This has increased the regulatory burden of companies and required personnel.

Rather than directing and managing markets, to oversee and regulate their efficiency and evolution for the social good will require different mind and skill sets.

## Risk Management

With its high growth and profitability China carries commensurate risk. It is a market of frequent corporate crises. Thirty years of lax enforcement has a legacy. Companies are exposed for structural and resource reasons. With different risk profiles, many MNCs in China experience tensions with their corporate headquarters, sitting in mature, low growth markets with risk adverse demeanours.

Hitherto, compliance within MNCs has focused on prevention of internal fraud and externally with business partners. Internal business processes have grown to be onerous and cumbersome in comparison with corporate counterparts in North America and Europe. More importantly they are ponderous compared to Chinese competitors. There is often a ready reaction towards putting companies in "lockdown" administratively. The end result is a stifling of innovation, agility and flexibility in the market.

### Global Business Units

The standard practice for international

companies has been to operate through global business units (BU). Most have been configured for compliance to the Foreign Corrupt Practices Act, UK Bribery Act or EU regulations, but not to Chinese laws.

The limitations of BU are exposed in China, especially without strong operational coordination. One lesson from the 2013 healthcare scandals was the vulnerability of BU. Operational authority and profits ("full line") were separated from China management ("dotted line"). The risk profile was heightened by separation of operations and profit from liability, which rested with the local management as far as the Chinese authorities are concerned.

### Regulatory Risk

Overall, the reforms will exacerbate regulatory risk for which many are ill equipped. Manufacturers tacitly ignored caps and limitations within production licenses, often with the complicity of local governments. Attitudes were also flexible towards environmental compliance and

consumer protection. Marketing and sales practices were at times questionable and now face more rigorous enforcement.

### Resourcing for Reform and Risk

Both MNCs and Chinese companies lack adequate resourcing and compliance processes to address adequately the challenges of rigorous enforcement. In comparison to developed markets, corporate functions are much leaner, having fewer personnel. This includes government relations and regulatory affairs, public affairs, corporate communications, legal, HR and compliance itself.

*"Be careful what you ask of government, that it may be given to you."*  
– old GR proverb

## About Us

North Head is a strategic communications and public affairs consultancy with a clear China focus. It specializes in partnering with multinational companies operating in this dynamic but challenging market, and supporting Chinese companies extending their reach globally. To receive future issues of China Reflections, please send an email to [info@northheadcomms.com](mailto:info@northheadcomms.com)

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The Business Integrity Handbook II can be downloaded [here](#)

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