China Shuts Out GE as Homegrown Rivals Promoted Over Westerners
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By Bloomberg BusinessWeek

March 26 (Bloomberg) -- Not so long ago in China, Western business executives traveling to the provinces could expect a hearty welcome and a banquet with endless toasts of maotai liquor. In February, representatives of General Electric Co. and a dozen more U.S. companies got a taste of the way commercial relations have been changing.

They were in Wuhan, a city of 9 million on the Yangtze River, for a seminar on water-treatment technology organized by the U.S. embassy. At a dinner after the meeting they were supposed to have a chance to mingle with top local officials. At the last minute, Wuhan's mayor canceled his keynote speech and backed out of the gathering.

That same day the provincial party secretary and governor begged off a separate event for American Ambassador Jon M. Huntsman Jr., Bloomberg BusinessWeek reported in its April 5 issue. One attendee who declined to be identified speculates that the Wuhan officials were responding to direct orders from the central government in Beijing not to meet the Americans. The provincial government acknowledges that the original lineup was changed and notes other officials attended the events.

Nearly a decade after China's entry into the World Trade Organization, many foreign companies say the warm reception they once received has turned frosty. While China can still be highly profitable, some question how long that will last as Beijing changes the rules to give a lift to its domestic companies, especially state-owned enterprises.

Unlevel Playing Field

A new government procurement program known as "indigenous innovation" features rules favoring local firms: It could block sales worth billions of dollars a year, says Joerg Wuttke, director of the European Union Chamber of Commerce in China.

Beijing has written strict standards for everything from cell phones to cars, often couching them in a way that gives an advantage to domestic producers. A recently revised patent law could force foreign companies to hand over key technologies to Chinese bureaucrats. And anti-monopoly regulations have been used to limit foreign access to sectors such as construction machinery and energy.

"They have moved away from a level playing field to benefit their own companies," says Wuttke.

Trade associations can speak more openly. A Jan. 26 letter to the White House from the U.S. Chamber of Commerce, the Business Software Alliance, and more than a dozen other groups representing hundreds of multinationals such as Microsoft Corp., Boeing Co., Motorola Inc., Caterpillar Inc., and United

Technologies Corp. warned of “systematic efforts by China to develop policies that build their domestic enterprises at the expense of U.S. firms.”

‘Safer Environment’

The signatories asked the Administration for its “urgent attention to policy developments in China that pose an immediate danger to U.S. companies.”

The perception that China is tightening up is causing friction elsewhere. According to a statement released by India’s Press Information Bureau, Indian Prime Minister Manmohan Singh told a panel on March 23 that Dell Inc. wants to move procurement from China to a “safer environment” with “climate conducive to enterprise.” He cited a conversation he had had with Dell Chief Executive Officer Michael Dell.

Dell later disputed Singh’s summary of their conversation.

The release was removed from the bureau’s Web site after officials from Dell contacted the Indian press office, said Minari Shah, a Dell spokeswoman. Harish Khare, a media adviser to Singh, declined to comment.

Huawei, Geely

Why a chill now? Chinese look across the landscape of their economy today and see much that could be improved. After 30 years serving as the workshop of the world, mainly producing low-value goods for foreign brands and distant markets, they want to move up the value chain.

To date they have only been able to capture a fraction of the value of a Nike Inc. shoe or Apple Inc. iPhone. And they know they have a poor record in creating global brands.

Apart from telecom equipment maker Huawei Technologies Co., notebook giant Lenovo Group Ltd., appliance marketer Haier Group, and perhaps consumer electronics maker TCL Corp. and car companies Zhejiang Geely Holding Group Co. and Chery Automobile Co., they have few champions. Even at home, General Motors and Volkswagen AG vie for the top spot, while Nokia Oyj sells the most handsets of any company in China, with a 32.9 percent share.

Increasing Investment

“People feel that foreign brands have taken too much market share,” says Wang Yong, director of the Center for International Political Economy at Peking University.

Although China has been able to build a $227 billion trade surplus with the U.S., its manufacturing might has brought it pollution and energy waste. The Chinese want something better.

“They want sophisticated international companies and they want to give them a leg up,” says Brookings Institution senior fellow Kenneth Lieberthal.

The Chinese drive resembles Japan’s efforts in the 1960s to become a global player, though China has opened up much more.

Foreign companies have invested some $600 billion into China since 2001. Even as friction began to rise, U.S. companies increased their investment from $2.9 billion in 2008 to $3.6 billion last year.

On top of all this, China has emerged from the global financial crisis largely unscathed. As a result, political analysts say, Chinese look at the rest of the world and feel a lot less awe and admiration than they once did.

Asserting Own Interests

There is also a sense that the previous leadership of President Jiang Zemin and Premier Zhu Rongji gave away too much -- such as slashing tariffs on agricultural products and ending local-content requirements for foreign automakers -- in their desire to enter the WTO. Now, China feels it should assert its own economic interests. If that involves throwing its weight around, so be it.

Finally, China sees how other countries -- notably the U.S. -- have used standards, regulations, and buy-local policies to build their own industries. Beijing feels more than entitled to do the same. The U.S. Trade Representative's Office started 28 cases against Chinese companies last year.

And "states like California have wide latitude in their procurement policies, so they can give American companies an advantage," explains Nicholas Lardy, senior fellow at the Peterson Institute for International Economics.

Still Welcome

If foreign companies complain publicly -- which they often don't, since Beijing has shown itself capable of using inspections, delayed approvals, and courts to make life miserable for those who speak out -- China now usually says, show us where we are violating WTO rules.

China's leadership doesn't want the situation to spin out of control. The Commerce Ministry has assured foreign investors they are still welcome, and on March 2 officials met with executives from more than two dozen companies and associations to hear their concerns.

At the close of the National People's Congress on March 15, Premier Wen Jiabao told reporters the government would try "to level the playing field for foreign companies."

Wen also met with foreign delegates at the China Development Forum on March 22, saying trade and currency wars "won't help us cope with difficulties but just curb cooperation." Ambassador Huntsman declared himself "convinced that blue skies are already on the horizon" in a speech at Tsinghua University in Beijing a few days earlier.

Intellectual Property

Investment keeps rolling in. Ford Motor Co. has recently been ramping up in China. And with President Hu Jintao expected to visit the U.S. this year, both sides will no doubt extend olive branches before he arrives.

Some cool-headed analysts call the current complaints overblown. Charles Freeman, a China expert at the Center for Strategic & International Studies in Washington, argues that Beijing can't shut out foreigners because it needs their intellectual property: China's technology lags Western, Japanese, and Korean efforts in many key sectors.

Chinese wind turbines, for instance, are inferior to products made abroad, he says, but wind is key to Beijing's goal of weaning itself from coal power.

"They won't wait for Chinese innovation," says Freeman, who served as chief China trade negotiator for the U.S. Trade Representative in the George W. Bush Administration. "They will choose American, European, or Japanese products that are cheaper."

Google Glare

Those are sensible comments. Yet the frictions are mounting. The largest potential troublemaker is the fight over China's currency, the yuan. On March 16, a group of U.S. senators unveiled a bill to levy tough sanctions against China for manipulating its currency to promote exports.

Brookings's Lieberthal says the economics of that argument are weak: A 20 percent appreciation of the yuan would just cheapen China's cost of imports, like oil and iron ore, that it uses to make exports, so the final costs of U.S.-bound products would rise only slightly.

The yuan is a political issue, though, and things could get ugly whatever the economic arguments. The flap over Google Inc.'s exit from China over censorship rules adds heat to the U.S.-China debate, even though it has nothing to do with currency or trade protections.

China, meanwhile, sees a weak U.S. economy as a threat to the value of its vast holdings of Treasury bills. And Beijing is livid over the arms sales to Taiwan, President Barack Obama's February meeting with the Dalai Lama, and a March 11 State Dept. report criticizing China's human rights record.

Policies of 'Favoritism'

The efforts to develop homegrown technology are what's really worrying U.S. business.

Beijing has crafted "very direct policies of favoritism for Chinese state industry that are hitting foreign companies," says James McGregor, author of a book on investing in the mainland and former chairman of the American Chamber of Commerce in China. "We are seeing a sea change."

New rules giving preference to Chinese suppliers for government projects make it difficult for General Electric, Denmark's Vestas Wind Systems A/S, and other foreign wind turbine manufacturers to win contracts in China, a market worth some $14 billion annually.

Hewlett-Packard Co. says China's consumer protection agency has criticized its handling of warranties and repairs for certain notebook computers, the first time in memory the company has had such troubles. On March 16, officials in Zhejiang province impounded clothing made in Europe by Versace, Hugo Boss, and other luxury brands. A government agency said many garments failed quality or safety tests, a claim vigorously rejected by the companies. And last year international express mail carriers were barred from domestic deliveries of letters and documents.

Kick in 'Teeth'

The rule "is unfair and ... it's bad for China to keep the international companies out," United Parcel Service Inc.
Chairman D. Scott Davis told analysts in a conference call last fall. "It seems kicking the foreigners in the teeth is in these days," says American consultant Duncan Clark, a 15-year resident of Beijing.

China's membership in the WTO was supposed to make things easier on foreign investors, who used to be treated like honored guests and wooed with tax breaks and free land. After President Hu Jintao and Premier Wen Jiabao took over in 2002, things started to cool.

That has left multinationals far less bullish on China.
While foreigners have made substantial profits on the mainland, last year confidence about future earnings took a tumble, according to separate surveys from the U.S. and European chambers of commerce.

Tires, Steel Pipes

Both groups report a majority of members make money in China, but the ranks of the profitable are shrinking. A third of European companies now say they're optimistic about future profits, down from half the previous year. In a separate survey by the American Chamber in Shanghai, 39 percent of companies say revenue fell in 2009, the largest number since 1999.

Tit-for-tat actions against Chinese tires and steel pipes and American chicken could flare into a full-blown trade war.
Washington is mulling whether to respond to Chinese favoritism by seeking punitive measures against Beijing at the WTO and the U.S. International Trade Commission, says a senior Commerce Dept. official.

Tax Breaks, Subsidies

“What worries me is that the Chinese-American relationship is becoming more antagonistic,” says Kai-Fu Lee, a former senior executive for Microsoft and Google in China. “That is not healthy.”

Much of the angst stems from the indigenous innovation policy. First introduced as an ill-defined national goal several years ago, the initiative gathered speed last fall when Beijing began offering tax breaks and subsidies to Chinese companies and gave them preference in state contracts.

Provincial and municipal governments across China have issued lists of everything from mobile phones to traditional herbal remedies that can be purchased by their agencies.

Hardly any include goods made by foreign companies, even if they’re produced in China. Shanghai, for example, released a list of over 500 approved products -- Lenovo PCs, solar panels from Chaori Solar and more. Only two items come from enterprises with foreign ties.

Such policies aren’t in violation of WTO rules, since China hasn’t yet signed an agreement that covers government procurement. Although Beijing says it aims to sign this year, that may not have much meaning, since it has asked for a phase- in period of 15 years.

Crossing a Line

A key issue will be whether China defines government procurement to include schools, hospitals, and state-owned enterprises.

A broad definition could put billions of dollars of sales of tech goods off-limits for non-Chinese companies.

“These rules in essence will keep out not just American companies over here but also [block sales by] American companies operating in China,” says John Frisbie, president of the U.S.- China Business Council, a Washington lobbying group representing more than 200 multinationals such as International Business Machines Corp., Citigroup Inc. and Microsoft. Beijing, he says, has “crossed a line.”

A patent law that took effect in October includes a rule that would force companies to file patents or trademarks in China before doing so overseas if they want to qualify for government procurement.

Trade Secrets

Companies say that makes it impossible to sell any product developed overseas and would give Chinese bureaucrats access to trade secrets. The law could compel companies that use patents to “compete unfairly” -- as defined by a vague 2008 measure -- to release them for use by rivals.

Foreigners rarely push back publicly for fear of angering the Chinese, and often refrain from taking legal action because they feel the justice system favors domestic enterprises. “We complain but we don’t sue,” says Mark Cohen, an attorney at Jones Day in Beijing.

That attitude was reinforced when French electronics maker Schneider Electric last April settled a three-year-old patent dispute with Chint Group, a maker of products such as transformers and circuit breakers, for $23 million.

Western attorneys familiar with the case say Chint had actually lifted Schneider's technology, not the other way around. Thomas Pattloch, IP officer for the European Delegation in Beijing, says the case illustrates so-called junk patents used by the Chinese against companies whose patents they have infringed upon.

"The court did everything they could to ignore the evidence Schneider presented," says Pattloch.

A Schneider spokeswoman says the company disagreed with the court's initial decision and declined comment on the settlement.

Chint disputed the account but declined to provide details, citing a privacy agreement. The court didn't respond to requests for comment.

Buried in Regulation

Beijing's penchant for rule-making has created another big barrier. Every year, China issues more than 10,000 new standards governing industries from mobile phones to autos. That's more than the rest of the world combined, says Klaus Ziegler, the standards officer at the delegation of the European Commission to China.

The rules, ostensibly to protect the health and safety of consumers and to ensure that products will work in China, are often crafted in a way that boosts Chinese companies, foreign investors say.

Stoves, Software

Germany's Continental AG must grapple with rules mandating that all tires sold in the country be imprinted with Chinese characters and other mainland-specific information. Although there's a global standard for such specifications the Chinese insist on their own rules -- so Continental and other tire makers must make scores of special molds that cost nearly $70,000 apiece.

That's not a huge problem for mass-market tires, but it can devastate profits on specialty products such as tires for industrial vehicles.

Gas cooking stove makers faced similar problems. Buried in the 50 pages of regulations about gas-fired appliances is a clause that says burners must withstand temperatures above 700C.

That's higher than standards elsewhere, and it means burners can't be made of aluminum -- the material most commonly used by European manufacturers.

The result: Several Italian manufacturers were shut out, says EC standards officer Ziegler. "China eliminated those Italian producers," he says.

Chinese software piracy is "intractable" and "deprives U.S. software companies of literally billions of dollars each year," Robert Holleyman, president of the Business Software Alliance told the House Foreign Affairs Committee on March 10.

In another side of the software issue, an executive familiar with German software maker SAP AG says Beijing offers tax breaks and other incentives to companies that buy products from local rival Kingdee International.

Kingdee didn't respond to requests for comment, and SAP declined to address the issue.