

Conducting Business in China



China in the early 21st century

China has emerged as an international economic powerhouse since joining the World Trade Organization (WTO) in late 2001. The development of the country's low-cost manufacturing sector, together with the gradual opening of the economy to international consumer goods and services, has created a variety of opportunities and threats for businesses worldwide.

As international competition intensifies, and the China price increasingly becomes the world price for a wide variety of products - from fast-moving consumer goods to heavy machinery - no company can afford to be without a China strategy. Whether establishing new distribution channels in China or diversifying their production base, a growing number of companies face make-or-break decisions about when and how to start doing business in China.

Opportunities for Foreign Companies

Everyone knows that China is open for business. Many firms saw Beijing's admission to the WTO at the end of 2001 as a sign that doing business in China had somehow become much easier. However, despite the many great opportunities available in China, opening an office there has remained a very difficult proposition for foreign companies - especially small and medium-sized enterprises.

Applications take anywhere from several weeks to several months to process, require voluminous documentation and often involve a number of government agencies. Since the authorities can ask for any additional information outside their stated requirements that they deem necessary during this process, it is impossible to be certain that any application is complete. In some instances, the officials may wish to slow down the process for internal reasons unrelated to the company's application.

The initial process involves considerable bureaucracy, and some degree of patience is required during the establishment phase.

The most important initial decision for any business looking to establish operations in China is the most basic question of what type of Chinese legal structure best suits the particular company's plans and resources. Foreign investors have many options, but often there are three basic structures used to start operations in China: a representative office, a wholly foreign-owned enterprise (WFOE) or a joint venture.

Integration into the Global Economy

China's accession to the WTO on December 11, 2001 represented a major step toward integration into the global economy. Beijing's commitments under this agreement have led to significant market opening and competition within the country. Substantial challenges remain - most notably the task of developing the country's banking sector, which despite a series of bailouts, remains saddled with high levels of non-performing loans issued to state-owned enterprises for non-commercial reasons.

Nonetheless, by signing the WTO agreement, China has tied itself into not only a rules-based system of international trade, but also an ambitious timetable for reform. Beijing's report cards have been mixed in terms of how it has lived up to the deal - some of the reforms may be slower in coming and being fully implemented than originally hoped, but there has been no reason to question China's commitment to the process.

On July 1, 2003, China also signed a Closer Economic Partnership Agreement (CEPA) with Hong Kong. This agreement removed Chinese tariffs on imports of goods produced in Hong Kong, and provided Hong Kong service companies with preferential access to the Chinese market in advance of its WTO commitments.

Although CEPA has not generated many tangible opportunities for overseas businesses, it has meant that companies operating in China have access to better quality services. The agreement has also included a variety of trade facilitation measures between Hong Kong and China, which are helpful for any company taking advantage of transportation and logistics facilities in both countries.

International Economic Pressure

With greater integration into the international community, however, has come greater scrutiny. China has faced a series of dumping allegations from the US and the EU, and Washington imposed protectionist tariffs on imports of Chinese textiles and garments just months after the end of the old international quota system, due to concerns over disruption to the domestic industry in the US.

China's currency regime had also come under considerable pressure from the US and other developed countries, which felt that the Chinese yuan's peg to the US dollar had left it severely undervalued, resulting in huge trade imbalances and distortions to the international trading system. Changes to the peg system are expected to gradually restore some degree of parity over time.

Beijing has retained currency controls on the capital account, making it difficult for Chinese and foreign companies doing business in China to take profits out of the country for investment or dividend purposes. Foreign companies generally have the right to repatriate their profits, but must go through an application process to exchange their yuan, which includes tax clearance and a number of other steps.

The Chinese government has consistently stated that its long-run policy objective is to have a freely floating yuan. However, ongoing weakness in the financial sector, together with a lack of developed derivatives markets to provide hedging alternatives, have made Beijing

approach this reform on a gradual basis. Ongoing revaluation of the yuan is highly probable, but the Chinese government will choose its own timing, and is unlikely to submit to any ultimatum from a foreign government.

Risk Factors

The potential exists for great returns on investments in China, but foreign companies also generally face higher risks than in their home countries.

China's legal system is still developing - new laws and regulations are constantly being enacted and implemented to reflect changes in the economy, and the ability to enforce these consistently and predictably generally lags far behind. The reasons for this problem range from inadequate training to local protectionism. As a result, the courts do not offer clear protection for contracts and other property rights, and judicial decisions can often seem arbitrary. Foreign companies doing business in China often need to find practical, non-judicial means to resolve disputes, rather than relying on the courts for this purpose.

The bureaucracy is similarly obscure - from the company registration process to a byzantine tax system with various rates of taxation and frequency of filings based on the tax in question, geographic region, industry or agreement with local authorities. Navigating this system requires considerable tact, expertise and patience.

And of course, the business culture is quite different in China than in most developed countries. Regardless of how much effort a company puts into choosing its China chief representative, it is very difficult to ensure that operations on the Mainland accurately reflect the parent's corporate values in terms of environmental concerns, working conditions, quality of products and services, or transparency.

Hong Kong: Still the Gateway

Although an increasing number of companies are exploring the China market directly from their home country, in many cases it makes sense to consider using Hong Kong as a gateway. Especially for mid-market companies, which tend to have more limited resources to invest in the initial stages and can less easily afford to fail, Hong Kong offers a familiar business environment and a variety of risk-mitigation options.

First, the Hong Kong legal system, guaranteed to be separate from the Chinese system until 2047, is a familiar system based on English common law. The judiciary is impartial, and the sheer volume of commercial case law makes legal outcomes more predictable. Structuring a China business with a Hong Kong parent company can allow foreign investors to enter into some contracts under Hong Kong law, and also provides a liability firewall between

operations in China and the foreign head office.

Hong Kong's tax and banking systems also allow for more efficient operations, with consistent and predictable costs. Large numbers of Chinese companies have been flocking to Hong Kong to access the international financial markets precisely because it is difficult for private companies to finance their businesses in China. Similarly, Hong Kong companies with solid commercial track records have access to a variety of equity and debt financing options.

Direct Import Programs

Because so much of China's exports are routed through Hong Kong companies, it is common for overseas trading companies to set up direct import programs out of Hong Kong to book their business. A Hong Kong company is established to book sales that likely have been generated elsewhere. The Hong Kong company then buys goods from a Chinese manufacturer, for example. The goods are shipped directly from the factory to the end user and the profits generated in Hong Kong are deemed "offshore" and hence tax-free. Accumulated profits can then be remitted out tax-free.

As the Hong Kong company's beneficial ownership does not have to be disclosed to anyone - except, in many cases, its bankers, due to increasingly stringent "know-your-client" requirements - the overseas trading company setting up this structure can enjoy some measure of anonymity if it wishes.

The China Opportunity

China offers business opportunities that are too great for most companies to let pass. In many cases, the price of missing these opportunities may be a persistent threat to the business from Chinese competitors or domestic rivals who have moved to China.

However, the cost of high rewards is often additional risk. Many overseas businesses are unfamiliar with the kinds of challenges they will face in China, and need to pay close attention to these details when they develop their China strategies. With proper planning and a solid business model, the upside can be almost unlimited.

About ICS Trust (Asia) Limited

Since 1980, ICS TRUST has been the market leader in helping entrepreneurs and successful, privately-owned businesses establish and grow their operations in Asia.

For more information about doing business in China, please contact us for a copy of the ICS TRUST "China Compass Service" brochure at: (852) 2854-4544 or ics@icstrust.com.

Elizabeth L. Thomson, President, ICS Trust (Asia) Limited